Reserve Bank Bulletin

QUARTERLY REVIEW OF THE NEW ZEALAND ECONOMY

After an extended period of exceptionally strong growth, the rate of expansion in the New Zealand economy slowed in late 1984. Activity during the first half of 1985 has been essentially flat with a decline in seasonally adjusted output of 0.8 per cent in the March quarter being followed by a 1.3 per cent increase in June.

As earlier reviews have noted, a peak in the level of activity was inevitable although it occurred somewhat later than initially expected, with a number of indicators continuing to show signs of buoyancy well into 1985.

Several factors have combined to account for the peaking of economic activity. First, the very rapidity of the expansion was pushing the economy against capacity constraints and the additional demand pressures were overflowing into price increases and imports rather than increased output.

Secondly, real household disposable incomes appear to have been declining for several quarters. Household consumption expenditures have been maintained by a decline in savings but are now being progressively restrained by rising nominal interest rates. Finally, the fiscal deficit has been declining at a relatively rapid rate over the past year, placing downward pressure on economic activity.

The signs of a faster downturn are now becoming more prevalent although some demand indicators are still at relatively high levels, making the strength of the downturn difficult to assess. A relatively high wage round could help to buoy consumption expenditure in the short-term. Over a slightly longer perspective however, a large across the board wage increse, in an environment characterised by a tight monetary policy and a strong New Zealand dollar, is likely to result in lower exports and a downturn in investment. This in turn may lead to an erosion of recent employment gains. Initially part-time workers would bear much of the burden of a slowdown in the demand for labour, together with those with relatively few skills and little work experience. In some service industries, where the poor prospects for the agricultural sector will impact significantly, the contraction in activity could be felt quite quickly across a range of occupations.

To the extent that greater insecurity as to future earning prospects leads salary and wage earners to adopt a more conservative approach to current expenditure decisions, then the boost to consumption from the wage round will be muted. Manufacturers are also likely to adopt a conservative approach to what would be only a temporary boost to demand and would be more disposed to draw down stocks rather than increase production.

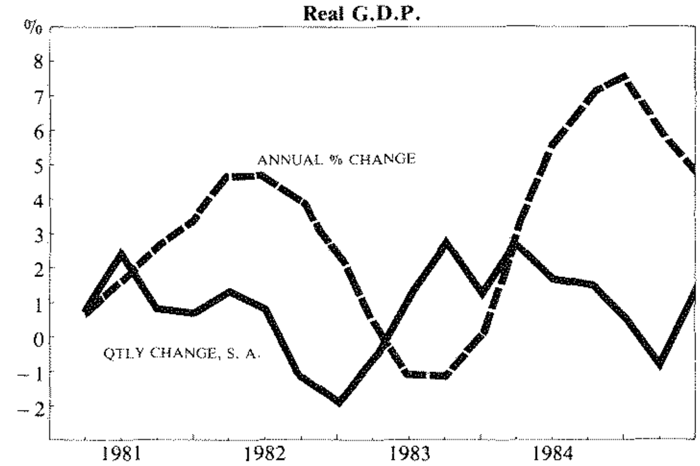
While the wage round will have some impact on inflation in the short run, this effect is likely to be moderated by the easing of demand pressures and by the falling price of imports. Some further moderation of the rate of inflation from the 2.8 per cent increase recorded in the September quarter is likely and the annual rate of increase in the Consumer Price Index could be close to single figures by the June-September quarters of 1986.

The current account deficit for the year to June 1985 reached $2,662 million, or approximately 6.4 per cent of GDP, compared to $2,016 million for the previous year. This expansion in the deficit resulted from the higher level of expenditure (including investment expenditure) which has been observed over the past year. However, an improvement in the balance of payments is likely as the economy slows and a number of investment projects reach completion.

Output

The level of activity, as measured by the Department of Statistics' quarterly index of real GDP, rose 1.3 per cent (seasonally adjusted) over the June quarter, after falling 0.8 per cent in the March quarter, and rose 4.7 per cent over the year to June, after rising 6 per cent over the year to March 1985.

Real G.D.P.



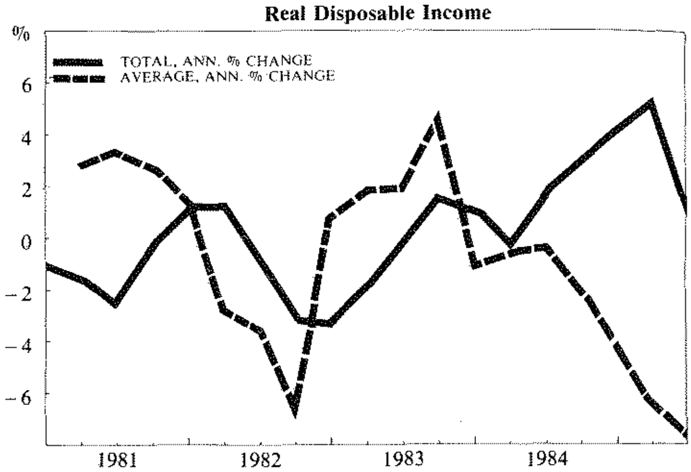
The quarterly series measures 'net output' in nine separate sectors. One sector recorded a sharp contraction over the June quarter — the Electricity, Gas and Water group fell 4.5 per cent — and net output in the Agricultural Sector fell 1.5 per cent (for the second successive quarter). However, Manufacturing Sector net output levelled off, after declining 2.4 per cent in the March quarter, and there was also no change in the level of General Government Services. Moderate increases were recorded in the Trade, Restaurants and Hotels Group (reflecting in particular the upturn in retail trade over the period) and in the Transportation, Communication and Services Group.

The overall upturn in the June quarter was largely underpinned by strong rises in two groups. The level of activity in the Construction Sector rose 6.2 per cent, after falling 4 per cent the previous quarter, and the (small) Fishing, Hunting, Forestry and Mining Group rose 23.9 per cent after falling by 11.4 per cent in the March quarter. The upturn in construction activity reflected equally strong expenditure on dwellings and on other buildings over the June quarter, but the change in the second group is largely explained by changes in the level of oil exploration activity. As such activity involves 'expenditure' without any (current) 'output', a fall in exploration activity causes (other things being equal) an increase in net output. Although the group is relatively small (it accounts for about 2 per cent of total real GDP) the scale of the fluctuations suggest that the March quarter decline somewhat overstated the true reduction in real GDP while, conversely, activity over the June quarter was probably weaker than the 1.3 per cent rise recorded.

Incomes

The Department of Statistics' Real Disposable Income Index indicates that average real disposable wage and salary income fell 2 per cent over the June quarter, after a 0.8 per cent fall over the three months to March. The index declined 7.8 per cent over the year to June. Gross nominal incomes rose relatively strongly by 4.4 per cent over the June quarter after a 4.9 per cent rise in March, reflecting settlements in the December wage round and some wage drift. However, the June increase was more than offset by the strong per cent rise in the June quarter Consumers Price Index and by a 3.4 per cent increase in the average tax rate faced by wage and salary earners.

Real Disposable Income



In order to provide more detailed indications of the changes in purchasing power, the gross nominal income index is subdivided in terms of five income groups — the highest 20 per cent or quintile representing those persons earning $24,800 and over, and the lowest requesting those earning under $12,100. The scale between these two quintiles is graduated at $12,100 to $15,400; $15,400 to $19,100; and $19,100 to $24,800.

The series suggest that gross nominal incomes for these different groups have been growing at roughly comparable rates over recent quarters — between 10.3 (for the top 20 per cent) and 11.3 per cent (for the bottom 20 per cent) over the year to June. Countering this however has been the fact that the average tax rate faced by those on high incomes has risen relatively strongly. As a result, although the real after tax income of those in the lowest income group fell 1.7 per cent over the June quarter and 4.4 per cent over the year to June, average real disposable income for those in the highest income group fell 2.3 per cent over the June quarter and 8.7 per cent over the year to June. Results for those in the middle income groups vary, but in general over recent quarters, they appear to have fared better than the highest income group but less well than those in the lowest quintile.

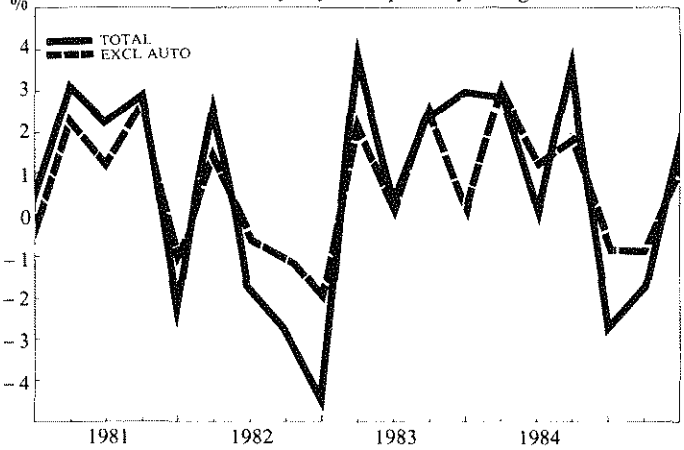
The decline in total household real disposable incomes has been less pronounced than the fall in average wage and salary incomes. Employment has continued to grow although the rate of increase has slowed over the June quarter, and income growth from sources other than salary and wages has generally been buoyant through to the middle of the year.

Over the coming year these influences are likely to be reversed. The growth in other incomes has levelled off and a sharp decline is in prospect for farm incomes. Employment growth is likely to slow considerably but average real wage and salary levels are likely to increase after the wage round as the rate of inflation falls.

Consumption

In real terms (and adjusted for seasonal variation) retail turnover fell in both the December 1984 and March 1985 quarters. Many of the major store groups (in particular, supermarkets and grocers, furniture stores, department and general stores and liquor and licensed accommodation) experienced a downturn or only sluggish sales over the two quarters, but the main contribution to the overall contraction came from sharp declines in the automotive stores group, the result of an adjustment in the level of demand for vehicles in the wake of the boom following the July 1984 devaluation.

Retail Turnover
(in real terms)
seasonally adjusted quarterly change



This trend in retail turnover was apparently reversed when retail trade (in real terms, seasonally adjusted) rose 1.6 per cent over the June quarter. Again, the automotive stores group (which accounts for about 40 per cent of total retail turnover) was the main factor in the overall change. Turnover excluding this group expanded 1.1 per cent. Sales in the other main store groups therefore remained generally sluggish over the June quarter, and an analysis of monthly data indicates that much of the real increase probably occurred over the earlier part of the quarter. Turnover excluding automotive stores (seasonally adjusted) rose only 0.1 per cent in May, 0.5 per cent in June and then fell 0.2 per cent in July. August sales however were unexpectedly high. Total turnover was up 3.4 per cent and sales excluding the automotive sector increased by 2.4 per cent.

Stocks

There have been indications of some stock build-ups in the motor vehicle industry, and there have been parallel indications of similar developments in other areas of retail trade. However, business opinion surveys have shown that manufacturers and retailers have maintained a cautious attitude with regard to their stock levels and have not been taken unawares by the downturn in demand. Improved stock management techniques were developed partly as a result of experience gained over the downward phase of the previous cycle and these have been sharpened further by the impact of higher nominal interest rates on the costs of maintaining stock levels. The most recent business opinion surveys do not suggest that there has yet been a significant or widespread degree of involuntary stockbuilding in the retail sector. Stock-trade ratios are still low by historical standards and this, together with the imminent Christmas sales season, should help to ensure that stock levels do not move significantly away from the levels desired. In turn, this suggests that the gradual downturn in domestic expenditure may not be translated into a sharp fall in the demand for manufacturing sector output and therefore in employment.

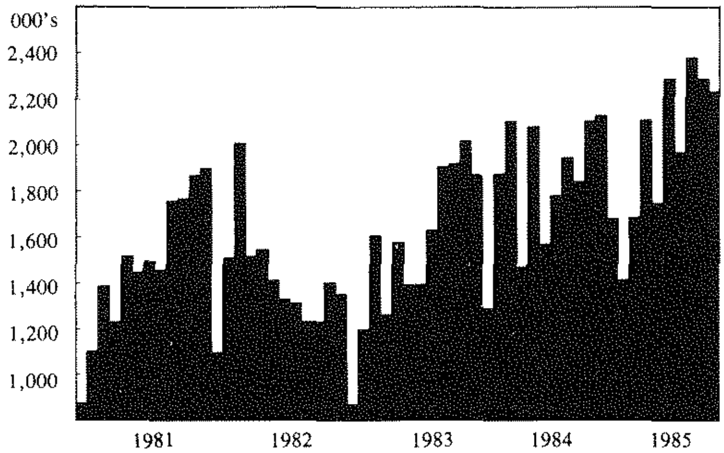
Investment

Leading indicators suggest that residential dwelling investment slowed down in late 1984 before picking up again over the first half of 1985. This occurred despite further increases in nominal interest rates and in building costs, and despite the absence of any growth in real incomes. Factors which help to explain this include the number of recent economic policy measures that have increased the actual and potential supply of finance for the housing market. First, the removal of interest rate controls has generally allowed the return on mortgage instruments to move to more competitive levels.

Secondly, there has been a substantial rise in the supply of housing finance through two government agencies — the Housing Corporation and the POSB. In particular, a very substantial increase in POSB lending commitments over the June quarter possibly explains the sharp rise in building permits for dwellings recorded over this period.

Dwelling permits (seasonally adjusted) rose 9.3 per cent in June and then 4.4 per cent in July. An estimate for August suggests a reversal of this strong surge, with the number of permits falling by 5.5 per cent. The total number of permits issued in the year to August was 23,415 which represented the highest annual total since 1977.

Building Permits



The lack of comprehensive current data makes it more difficult to assess trends in business investment but a range of indicators suggest that it has remained relatively strong up until mid-1985. The New Zealand Institute of Economic Research in its June Quarterly Survey of Business Opinion found that although intentions with regard to fixed investment had weakened, the overall response still suggested a relatively strong level of investment expenditure. The value of import orders for machinery and electrical equipment has shown consistently strong growth over recent months. An approximate allowance for increases in capital equipment prices indicates that there has been growth in real (volume) terms as well.

The value of building permits issued over recent months for buildings other than dwellings has continued its moderate upward trend and investment expenditure in this area appears to remain reasonably firm. The growth in the value of permits over the first half of 1984 was reflected in a strong increase in the value of building work put in place over the September and December quarters 1984. After a relatively quiet period over the first three months of 1985 the level of building activity appears to have picked up again over the June quarter, with the value of work put in place (seasonally adjusted) increasing 15.2 per cent over the quarter. However, the value of permits issued over the June quarter provides an indication that the level of investment may not continue to grow strongly over the rest of 1985 and in real terms may record a decline.

Although much of the overall growth in (non-dwelling) investment over the year to mid-1985 appears to have occurred in the tradeable goods sector and despite the possibility that the profitability downturn resulting from the recent appreciation of the New Zealand dollar (if maintained) may lead to a downturn in private fixed (non-residential) investment, the overall level of investment still appears to have remained relatively strong. This is particularly true by comparison with the pattern of developments over the contractionary phase of previous cycles. This difference may represent an underlying degree of confidence by a number of sectors in medium-term prospects for the economy — expectations which have not been heavily influenced by short-term or transient changes in economic indicators.

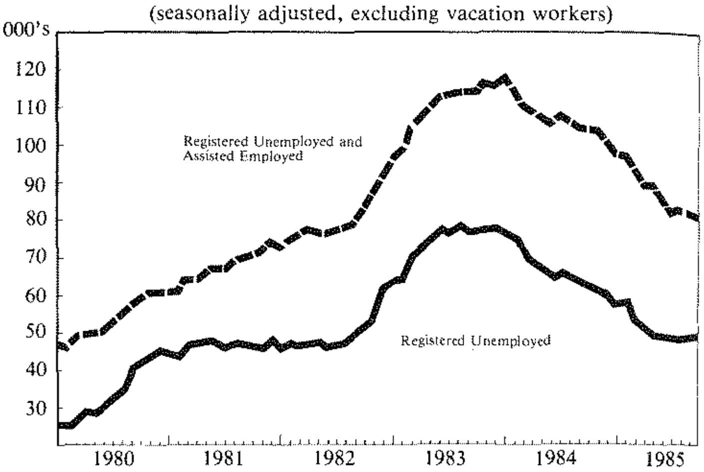
Employment

Although unemployment figures in mid-1985 rose very slightly, the overall level of employment remains high. The May quarterly survey of employment conducted by the Department of Labour found that total employment had risen to 1,182,908, 3.4 per cent above the level a year earlier and 1.6 per cent above the level in February 1985. Most of this additional employment occurred in the private sector and reflected the strength of the economy and also the moderate change in unit labour costs over the past year and a half. The unemployment rate (expressed as the ratio of registered unemployed to the total labour force) fell to a new low of 3.3 per cent in May 1985, compared with 4.5 per cent for May 1984.

The number of registered unemployed (after adjustment for seasonal factors) has however moved upward over more recent months, and this may provide the first indication of a weakening in labour market conditions. The number of registered unemployed (seasonally adjusted) rose by 1.5 per cent and 0.2 per cent in July and August, respectively. Notwithstanding these increases, the numbers on assisted employment schemes have fallen consistently throughout the year and as a result, the combined total of those unemployed or on assisted employment schemes continued to decrease. This total, at 81,602 at the end of August was 22.6 per cent below the level in August 1984.

With little prospect of an upturn in output in the short-term, any substantial increases in relative labour costs could see unemployment climb further over the

Labour Market
(seasonally adjusted, excluding vacation workers)



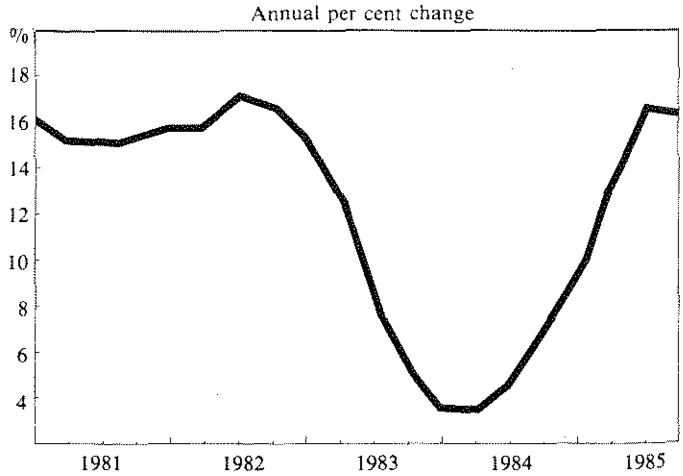
short-term. Initially, the main impact is likely to be reflected in a decline in overtime hours worked and in a reduced demand for part-time workers as employers attempt to economise on labour inputs. Particular categories of skilled labour, by contrast, may remain in relatively short supply over the immediate future, but this may be counterbalanced by a slowdown in the level of net outward migration. There was a net outflow of permanent and long-term migrants of 15,327 over the year to August 1985, compared to an inflow of 1,210 over the comparable period last year.

Prices

The Consumer Price Index (CPI) increased by 2.8 per cent in the September quarter bringing the annual rate down marginally, from its June peak of 16.6 per cent, to 16.3 per cent. Of the component increases in the CPI the housing group contributed most as higher mortgage interest rates and building costs boosted home ownership costs.

The September increase was well below the 5.1 per cent increase recorded in the June quarter which had been inflated by an 18.2 per cent increase in dwelling rentals following the lifting of rent controls in March.

Consumer Price Index
Annual per cent change



The levelling off of the economy and the reduction in petrol prices resulting from the appreciation of the New Zealand dollar also contributed to the slower increase in the September quarter CPI. These factors could be expected to exert further downward pressure on the rate of increase in prices over the next year.

The Government Sector

The fiscal deficit (Budget Table 2 deficit) for the six months to September 1985 was $2,075.5 million. This was higher than had been projected for the period. Net expenditure was $8,484.7 million (22 per cent above that over the same interval in 1984/85) and receipts were $6,409.2 million (18.4 per cent up). Net borrowing in New Zealand, at $2,410 million, combined with net borrowing overseas, at $822.5 million, generated an overall cash surplus in the Public Account of $1,157 million.

Conclusion

After a period of economic growth which proved both stronger and more protracted than most forecasts had initially suggested, the level of activity appears now to have peaked. The economy, over the first half of the year, has been in a transition phase with several important indicators showing no clear pattern of growth or decline. The latest indicators however suggest that economic activity is now on a clear downward trend. A continued downturn in the year ahead would seem inevitable.

Although the relatively high level of settlements in the present wage round (together with the prospects for a continued downward trend in prices) could sustain consumption in the short-term, underlying economic conditions do not suggest that this support can be maintained. There is now little room for any further decline in the aggregate level of household savings, and to the extent that wage increases are directed to stabilising or raising the level of savings, some of the impact of the wage round on consumption expenditure will be neutralised. When the effects of the rise in wage and salary incomes have dissipated, the slower growth foreseen for other incomes and for total employment is likely to lead to a marked downturn in real consumption expenditure over the coming year.

The recent slowdown in the economy has coincided with the completion or near completion of a number of major public sector investment projects, and with a narrowing of exporters' margins due in part to the strengthening of the New Zealand dollar. These factors must dampen the medium-term outlook for investment which, in a number of respects, is more favourable than it has been for a number of years. Additional uncertainty over the short-term prospects for the domestic economy and for exporting may also act to counterbalance the relative strength of earlier investment intentions.

The recent strength of the New Zealand dollar has been an important factor in the levelling off in the domestic price level. The effects of many of the policy measures introduced over the past year have now been largely absorbed. Indeed, many of the measures aimed at freeing up the economy along with the slowdown in the domestic economy should now start to provide a constraining influence on the rate of increase in prices.

A more rapid reduction in domestic demand and activity will place additional strains on a number of sectors already facing a marked need for structural adjustment. The degree of responsiveness in these sectors could be a principal factor in determining the path taken by the economy, and hence the outcome for employment and real incomes, over the coming year. The downturn will assist in achieving a greater degree of price stability, a reduction in interest rate pressures, and further reductions in the balance of payments deficit. The size of these gains in relation to the costs of lost output and employment opportunities over the period ahead will depend crucially on the speed with which individual price setters in the economy adapt in line with the Government's anti-inflation policies.