Reserve Bank Bulletin

QUARTERLY REVIEW OF THE EXTERNAL ECONOMY

Although slowing significantly in the first half of 1985, the overall rate of economic growth in OECD countries has picked up once more. Recent forecasts suggest that the upturn in OECD countries will continue for at least another year and a half. OECD real GDP rose 2.7 per cent in the 1985 calendar year and is forecast to rise by 3 per cent and 2.5 per cent in 1986 and 1987 respectively.

Introduction

This review of the external economy outlines recent economic developments in the OECD group of industrial countries. Particular emphasis has been given to those countries of most significance in terms of New Zealand's external trading relationships.

In mid-1985, after more than two years of uninterrupted world economic growth, signs appeared suggesting that the upturn had lost some impetus. Growth in the first half of the calendar year slowed substantially as the main force in the upturn, the strong recovery in the United States, appeared to pause.

The United States economy has been the main driving force behind the world upturn which began in early 1983, generating growth in other economies through a strong expansion in the demand for their exports. There were two distinct factors contributing to this — a domestic demand effect and a competitiveness effect. Buoyant domestic demand conditions provided a considerable stimulus to imports into the United States. Superimposed on this the large fiscal deficit added to domestic interest rate pressures, and the capital inflow associated with the relatively high returns available in the United States domestic capital markets pushed up the value of the dollar, giving other industrial countries and developing economies a competitive advantage in the United States market.

But as growth in the United States slowed through the first half of 1985, underlying economic conditions in most other industrialised countries did not improve to the extent necessary to replace the United States as a source of stimulus for growth. Many of these countries considered that they had only limited scope to implement expansionary financial policies, since they were concerned about the potential inflationary consequences on their currencies, which tended to be weak as a reflection of the strength of the United States dollar. They were reluctant to exacerbate this situation. When the slowdown in the United States was confirmed, concern developed that other industrial countries would not be able to provide the necessary impetus to keep the world economic expansion going.

In the event an early end to the recovery did not occur. Although overall growth in the industrial countries is now more moderate, it is also better balanced, and therefore more sustainable. Rates of growth in domestic demand are converging, inflationary pressures remain low and interest rates have fallen. Even before the recent decline in oil prices inflation appeared likely to subside over the short-term, and now that oil prices are expected to add substantially to the disinflationary process, there are improved prospects for non-inflationary growth in industrial and non-oil developing countries alike. This convergence in economic performances should contribute further in alleviating current international economic imbalances; specifically, external trade imbalances.

The encouraging convergence in economic conditions has been matched by greater agreement on economic policies. A number of developments suggest improved prospects for relieving those strains in the international economy which have put the upturn increasingly at risk. In the first instance, the focus for policy has been to sustain the expansionary forces still at work — by consolidating the progress already made in resolving obstacles to more sustained, widely distributed economic growth. The larger industrial countries have reached agreement that greater attention needs to be paid to the interaction between their domestic policies and the ultimate impact of these policies on international trade and finance, on interest rates and exchange rates. They have taken the additional step of reopening discussions on other more longstanding international financial issues — in particular the continued difficulties faced by the most heavily indebted developing countries, and by the very low income countries in the developing world.

In the most important single development, the United States has taken steps to reduce the relative size of its fiscal deficit. Capital inflows to finance this deficit have underpinned high international interest rates and, by contributing to a deteriorating level of international competitiveness for the United States, have generated rising protectionist pressures within their Congress.

In addition, the large industrial countries have now committed themselves to work towards complementary policies, which should bring about a greater convergence in economic performance and hence reduce exchange rate misalignment and associated protectionist sentiments. In September 1985, the group of large industrial countries, known as the Group of Five (G5), met and resolved to work towards these goals. As a first step, priority was given to bringing about an orderly decline in the United States dollar exchange rate.

Finally, an important initiative has been launched to assist the heavily indebted countries to maintain economic growth while continuing with essential economic adjustment policies. The 'Baker Plan' put forward by the United States has the objective of assisting developing countries with large overseas debts to continue to meet their debt servicing commitments, while also strengthening the adjustment process and sustaining growth in these countries. It also sets out a framework for the transfer of more resources to the very low income developing countries which have faced particularly difficult economic problems in recent years.

Although the outlook is now much more positive, the conditions for sustained medium-term growth have still not been definitely established. Potential economic problems do still exist. Probably the most important point is that despite the advent of 'balanced budget' legislation in the United States, there remains some doubt concerning its effectiveness and interest rates remain unusually high. The OECD notes that although international interest rates have fallen in nominal terms (and in real terms to a lesser extent) they remain well above the rate of economic growth in most economies.

A similar degree of uncertainty surrounds the timing involved in a reduction in the external current account imbalances in the OECD area. Despite the convergence in economic growth rates and a weakening in the United States dollar, the large current account imbalances of the United States and Japan seem likely to persist in 1986. Most recent information suggests that only a levelling off in these imbalances is likely in the following year, and therefore the threat to continued world growth posed by protectionist measures remains real.

Finally, it appears that the pace of structural reforms in many OECD economies, in Europe in particular, has been relatively slow, and there have been limited successes in resolving market imbalances and rigidities. Since it is these factors which pose the main barrier to stronger economic growth and higher employment, the strength of the upturn in these economies will be reduced.

The outlook for the developing countries also remains mixed. Some have been successful in implementing policies designed to ease balance of payments and other structural adjustment difficulties, and in reducing inflation. Others have not been as successful, and could experience difficulties in coping with continued depressed commodity prices and a projected slowdown in their export growth to the United States. For the developing countries as a group the recent oil price decline should signify improved growth prospects, but this is likely to be partly counterbalanced by the outlook for commodity prices. The position of the oil exporting countries — in particular, Mexico, Nigeria and Venezuela — could deteriorate substantially. These countries may be forced to cut back imports sharply and to reduce their rate of domestic growth; or alternatively, they may choose to suspend or delay repayment of a proportion of their overseas debt. The former outcome could lead to political difficulties which would make it difficult to sustain the adjustment process. The latter option could pose difficulties for the stability of international financial institutions with large loan commitments to these countries.

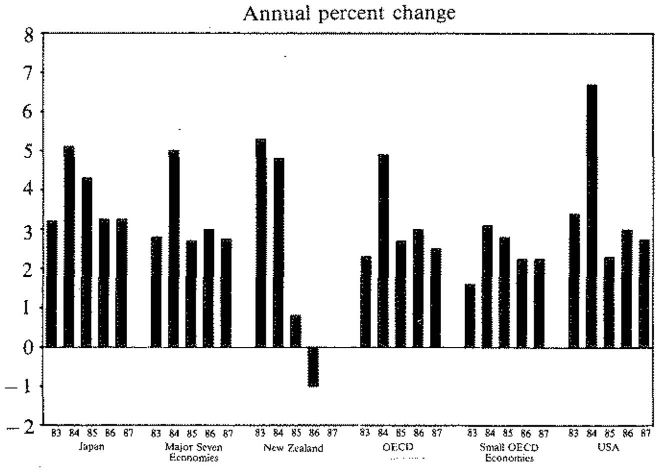
Recent Developments

Growth, Employment and Inflation

Real output in the major industrial countries grew by 2.7 per cent in the year ended December 1985, less than had been anticipated and well below the 4.9 per cent experienced in 1984. The fall in overall economic growth was largely due to a slowdown in the United States economy and to a similar weakening in Japanese growth. In 1984, the United States economy grew 6.7 per cent, reflecting the expansionary fiscal policy stance, strong investment expenditure, and rising consumer confidence. But in 1985, these influences began to taper off, a reversal in stockbuilding occurred, and a much greater proportion of the strong increase in domestic expenditure was accounted for by imports. As a result, output in the United States grew only 2.3 per cent in 1985. A general slowdown in world trade was reflected in slower Japanese growth, which declined from 5.1 per cent in 1984 to 4.3 per cent in 1985. In Europe, in the absence of any significant change in economic fundamentals, real growth of 2.3 per cent continued at the same relatively moderate pace as in 1984.

The short-term outlook for the industrial countries has however improved considerably over the past six months (see Figure 1). A projected sharp improvement

OECD GDP Growth
Annual percent change



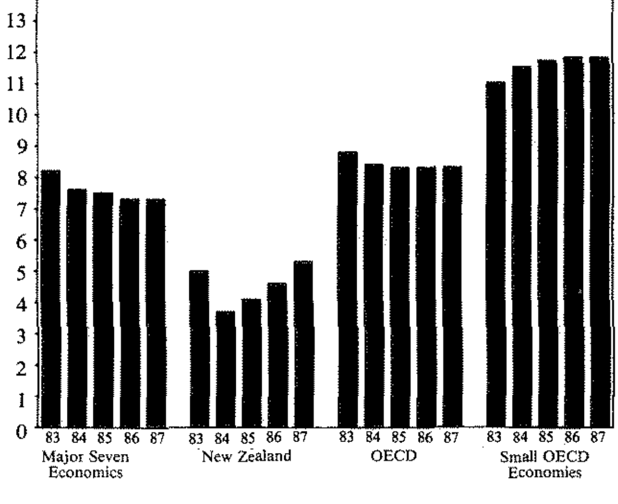
in the terms of trade for the OECD region as a whole is the principal reason for this. The effect of this improvement (which reflects the oil price decline and the probability that commodity prices will remain relatively low) is to raise both consumption and investment expenditure and to lower inflation. The most recent short-term outlook for economic growth is for an overall expansion in the OECD area of 3 per cent in 1986 and 2.5 per cent in 1987. These rates are relatively modest by the standards of previous decades, but are nonetheless encouraging. They represent the fourth and fifth years of a recovery from probably the severest international recession for forty years. Previous upturns have generally been more pronounced, but have generally also been shorter lived. In more recent years they have ended in a resurgence in inflation and in other economic imbalances, signifying substantive unresolved obstacles to sustained economic growth. In the current context inflationary pressures remain manageable; and although large current account imbalances persist, in general these are not expected to widen over the next year or so.

The average rate of growth predicted for the OECD region as a whole masks some differences in the outcomes for different country groupings. In particular, for the major seven economies, the slowdown from a 5 per cent overall rate of growth in 1984 to 2.7 per cent in 1985 is predicted to be only partially reversed, with a 3 per cent expansion predicted in 1986 and a 2.7 per cent rise the following year. For the smaller OECD economies, the 2.8 per cent expansion in 1985 appears likely to slow further in 1986 and 1987, to 2.3 per cent in each year.

Increases in overall employment have been and appear likely to remain moderate. The unemployment rate for the OECD area in 1985 was about 8 per cent — only 0.5 of a percentage point below its peak in early 1983. This overall outcome again masks widely differing labour market developments in particular countries. A continued downturn in the unemployment rate in the United States was partly offset by a small upturn in the Japanese rate and contrasts with stable but high rates in Europe generally (although the rate did fall in Germany and some of the smaller OECD economies). The OECD suggests that only a marginal improvement in unemployment seems feasible in the industrial countries in 1986 and 1987, with the different pattern of experience outlined above being maintained (see Figure 2).

OECD Unemployment Rates

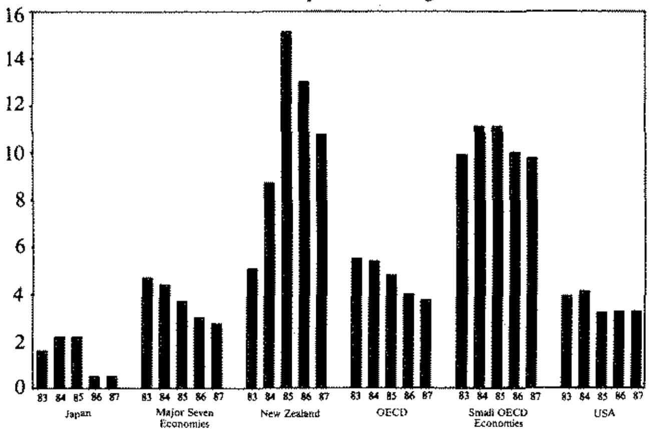
Percent of labour force



One of the most distinctive features of this upturn is the absence of any resurgence in inflation and inflationary expectations. The base for this was set by consistent, restrained economic policies over a number of years, although more recently, depressed commodity prices and the fall in oil prices have also assisted. Consumer prices in the OECD area rose by 4.8 per cent in 1985. On the assumption of unchanged policies and oil prices at US$22/barrel, the OECD suggests that this overall rate of inflation will moderate to 4 per cent in 1986 and 3.8 per cent in 1987, but recent economic developments suggest that a significantly lower average could be achieved, particularly if oil prices remain below the level assumed in compiling these forecasts (see Figure 3).

OECD Inflation Rates

Annual percent change



The average rate of inflation for the major seven economies is expected to fall to around 3 per cent in 1986 and to continue at a similar level through the first half of 1987, but a much less positive outcome seems in prospect for the smaller industrial economies. Their average rate of inflation, 11.1 per cent in 1985, appears likely to remain relatively high at about 10 per cent in 1986 and 1987.

Fiscal and Monetary Policy

The main source of uncertainty in the outlook for fiscal policy in the OECD area relates to the United States. If the Federal deficit were reduced in line with official projections, and if the other major industrial economies maintained their current fiscal policy stance, this would be reflected in a shift in the overall OECD fiscal policy stance from mildly expansionary in 1986 to restrictive in 1987. Despite recent moves to support domestic demand, Japan's fiscal policy stance appears likely to remain tight, although German policy has shifted from a restrained to a somewhat more accommodating setting. In the United Kingdom, continued problems in restraining the growth in public expenditure and depressed earnings from North Sea oil are likely to be reflected in a continued expansionary fiscal policy stance.

The outcome for the smaller countries also varies widely, with a clear need for consolidation evident in these countries with relatively large fiscal deficits. The OECD suggests that this is likely to be reflected in a similar switch to a slightly less expansionary overall fiscal policy stance for these countries as well. As a result, the fiscal deficit for the OECD area as a whole, which stabilised at about 3.6 per cent of GNP in 1985, could decline to around 3 per cent by 1987.

Monetary policy in the major industrial countries for the past five years has remained firm in its intent to reduce both inflation and inflationary expectations. Increased flexibility has been possible more recently in some countries as these objectives have been achieved, but for many other countries monetary policy remains primarily influenced by the need to contain inflation and stabilise the exchange rate.

Nevertheless, the continued decline in inflation rates in the major industrial countries has made possible a decline in international nominal and (to a lesser extent) real interest rates in 1985. In the United States, despite the recent change in the direction of fiscal policy, the Federal Reserve has maintained a cautious monetary policy stance. Short-term United States interest rates have remained generally stable over the late stages of 1985 and early 1986 period, but longer term rates fell by up to 4 percentage points between August 1984 and October 1985. In part, this policy stance reflects a concern that inflationary pressures be contained in the wake of the 'G5' initiative on exchange rates and the readjustment of the dollar.

The resolve of the G5 countries to bring about an adjustment in the United States dollar exchange rate has also been a primary consideration in the stance for monetary policy in the other major industrial countries. In Japan, policy was tightened to bring about a strengthening in the Yen, although the OECD believes that if the Yen does remain strong, the overall policy stance in Japan is likely to become more accommodating in support of domestic activity. The German monetary policy stance has been more flexible in accommodating real activity, reflecting that country's considerable success in containing inflationary pressures, but in the United Kingdom, France and other large industrial economies, exchange rate pressures have continued to exert a constraining influence on policy.

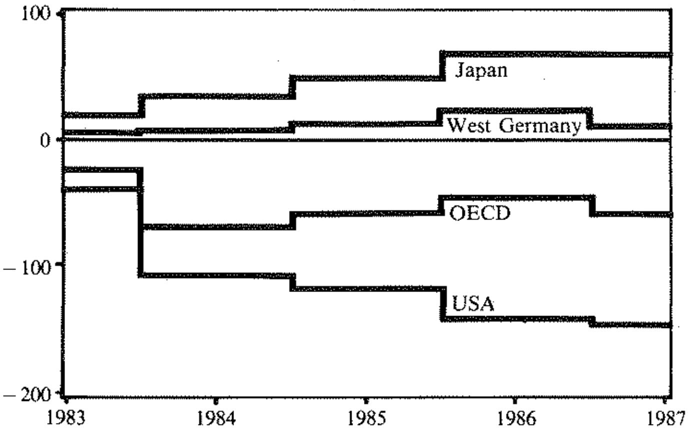
The OECD suggests that although prospects appear reasonable for further reductions in interest rates, the outcome will remain substantially dependent on developments in the foreign exchange markets. The current monetary policy stance appears consistent with further reductions in interest rates in the United States, Japan and Germany, provided that foreign exchange markets remain stable and do not provoke any sharp tightening in monetary policies. Greater co-ordination of economic policies could play a pivotal role in ensuring this outcome, by reducing the possibility of exchange rate overshooting.

External Current Account Balances

One measure of the slowdown in economic growth in 1985 can be seen in the sharp reduction in the growth of world trade. The volume of world trade rose by almost 9 per cent in 1984, but then slowed sharply, expanding by only 3 per cent in 1985. The downturn in trade growth within the OECD area was most pronounced between Japan and the United States. Outside the OECD area, there was a general slowdown in the growth of import volumes, reflecting balance of payments adjustment programmes being pursued by many developing countries and, in particular, by some oil exporting economies. There was also a fall in export volumes, largely attributable to a decline in OPEC exports.

The OECD does not expect current account imbalances within the area to diminish in 1986 (see Figure 4). For the OECD region as a whole, the terms of trade improvement stemming from the oil price decrease is likely to underpin a small reduction in the current account deficit (relative to GDP) in 1986, although this appears likely to be reversed in 1987. The OECD assessment of the United States current account deficit and the Japanese surplus indicates that neither are likely to fall, widening in 1986 and then only stabilising the following year, but a more prompt adjustment in the German current account surplus appears likely.

OECD Current Account Balances
US $ Billion



The United States

Although the rate of economic growth in the United States slowed in 1985, activity has since picked up again, helped in part by a decline in United States interest rates and in the dollar. As the OECD notes, there are now improved prospects for stronger growth in United States domestic production and investment as the year progresses, although it is not clear if this will be sufficient to defuse some of the protectionist sentiment generated by that country's widening external trade deficit. Conversely, these developments leave less room for manoeuvre for monetary policy in the short-term (and therefore less potential for further interest rate declines), and thus they give emphasis to the importance of reducing the relative size of the United States fiscal deficit.

The downturn in activity in the United States in early-to-mid 1985 primarily reflected developments in two areas. First, domestic demand continued to increase strongly, but an increasing proportion of this expenditure absorbed imports, rather than domestic production. Secondly, there was a sharp slowdown in stockbuilding, which in the first year and a half of the upturn had provided a strong expansionary impetus. The OECD estimates that together, these two factors may have reduced real economic growth in the United States by as much as 3 percentage points in 1985.

In the second half of the year, a decline in interest rates and in the effective exchange rate of the dollar provided some additional expansionary stimulus. Residential investment (and to an extent stockbuilding) recovered in response to the decline in interest rates. Export and import competing industries have benefited from the decline in the dollar and domestic industry in general has gained from lower interest rates. Business fixed investment continued to expand, although less rapidly than in the previous year. Employment growth remained relatively strong over the year, contributing to the continued strength in consumer expenditure.

The outlook for inflation is a critical factor in assessing the short-term prospects for the United States. A wide range of evidence suggests that the pace of structural change in the United States has been relatively high, and gains in productivity and moderate wage settlements have played key roles in holding down United States inflationary pressures.

The increase in the consumer price index for the year to December 1985 was 3.8 per cent — only marginally different from the increase in 1984. Before the fall in oil prices, the short-term outlook was for a gradual increase in inflation in response to the weaker dollar. Import prices now appear likely to rise at a more moderate rate than earlier expected, reflecting the decline in oil prices. Taking this into account, the OECD suggests that a rate of inflation of 3.6 per cent in 1986 is now possible, with the rate falling back to about 2.9 per cent in the following year.

The outlook for the overall economy is for continued growth. Real GNP appears likely to expand at a faster rate in 1986 and 1987, with a better balance in the various components of national income. The oil price decline and the decline in interest rates should provide support for investment and consumer spending, counteracting the move to a less expansionary fiscal policy stance. The gap between domestic demand and production is likely to narrow as the trade balance (slowly) improves. The OECD expects that the recent rapid growth in imports will moderate in 1986, and exports should recover. The negative contribution to economic growth from the difference between import and export volumes is expected to diminish in 1986 and to reverse in 1987, but no immediate improvement in the external current account deficit (US$119 billion in the 1985 calendar year) appears likely. In the opinion of the OECD, an improved export performance will be an important element in ensuring a continuation of the United States recovery, but it is difficult to assess the speed with which the external current account deficit is likely to adjust.

Japan

Japan's economic prospects are still substantially dependent on the export sector, although more recently, policy measures have been taken to stimulate domestic demand and expenditure in response to the slowdown in the rate of growth in Japanese exports.

The OECD estimates that real GNP in Japan grew about 4 per cent in 1985, after a 5.1 per cent increase the previous year. Export growth was weaker, but this was more than offset by a downturn in import volumes. Hence, the external trade balance continued to exert a positive influence on real GNP. Private consumption weakened as the growth in incomes slowed, but this was partly matched by an upturn in housing investment. Industrial production and investment growth have both slowed along with exports, although investment expenditure is expected to remain relatively strong overall.

The OECD expects real economic growth to remain modest — about 3.3 per cent in 1986 and 1987. Private consumption is expected to strengthen further, in response to economic policy measures introduced in late 1985 and also to the recent substantial improvement in the Japanese terms of trade. Although domestic consumption has been taking an increasingly central role in sustaining domestic activity, it is not yet clear whether this will be sufficient to fully offset the probable levelling off in export growth. Export volumes are forecast to rise by only 1 per cent in 1986 and then by 5 per cent in 1987. Together with the projected growth in import volumes, this implies a small negative impact from the real trade balance on the growth in real GNP in 1986. One positive aspect is that lower import prices are expected to assist in a further fall in inflation. Consumer prices in Japan rose by 2.2 per cent in 1985, but on the basis of the changes in oil prices assumed in the OECD forecasts (US$22/barrel) and unchanged economic policies, the rate of inflation is expected to moderate significantly — to only 0.5 per cent in both 1986 and 1987.

Major European Economies

The West German economy experienced a 'technical' rebound over the second half of 1985 following adverse weather conditions and a disrupted car sales market relating to uncertainties associated with possible car exhaust emission regulations. The United Kingdom economy also entered a relatively buoyant phase in mid-to-late 1985 representing a similar adjustment (in this case in response to the ending of the coal miners' strike in March 1985). Despite these adjustments, underlying economic conditions in the major European countries, in general, did not change substantially in 1985, and continued to improve only slowly.

Real GNP in the Federal Republic of Germany recovered strongly in late 1985. The construction sector was initially depressed by adverse weather conditions, and consumer expenditure was also initially subdued (although it has since strengthened steadily). The real foreign trade balance remained broadly unchanged and the main single element in the relatively moderate 2.3 per cent rate of economic growth was a strong increase in investment in machinery and equipment. German exports have levelled off in volume terms since mid-1985 and import growth has expanded — but this has been more than compensated for by a large improvement in the terms of trade. As a result, the German current account surplus more than doubled in 1985 to DM38.6 billion (US$13 billion) or about 2 per cent of GNP.

The OECD believes that the overall prospects for the German economy have improved in the past six months. Although the outlook for exports is less favourable, a further rise in the external current account surplus is likely in the first half of 1986 (due to a further improvement in the terms of trade), before falling significantly later in the year and again in 1987. Domestic demand has assumed an increasingly important role in sustaining economic growth. Consumption expenditure should continue to strengthen and, in the assessment of the OECD, the fall in oil prices should bring inflation to a virtual halt, boosting domestic incomes and expenditure and adding to projected continued strong business fixed investment expenditure. Inflation is expected to come down to about 0.5 per cent in 1986 and 1987 — the lowest rate since the 1950s, and the rate of growth in GNP in 1986 could reach about 3.5 per cent.

A further positive underlying trend has been the continued reduction in the German fiscal deficit. As a proportion of GDP the German fiscal deficit fell from 1.9 per cent in 1984 to 1.1 per cent in 1985. After four years of budgetary consolidation, fiscal policy is expected to be slightly expansionary in 1986 and monetary policy has also eased, underpinning a lower level of interest rates.

The outlook for the United Kingdom is less positive. The rate of economic growth in the UK slowed markedly in late 1985 but although the economy appears to be weakening, the authorities' room for manoeuvre remains limited. Strong growth in investment and a positive contribution from the trade balance were the two main factors sustaining growth over most of 1985. Both appear to have weakened late in the year but consumption expenditure has strengthened, and should strengthen further given projected strong growth in household incomes. An assessment of short-term prospects is complicated by the implications of the oil price decline for the level of domestic expenditure and for the direction fiscal and monetary policy can take. On balance though, the indications are that the rate of growth will fall from 3 per cent in 1985 to about 2.5 per cent in 1986 and then to 2 per cent in 1987.

Australia

The Australian economy grew by about 5 per cent in 1985, but the rate of growth slowed somewhat in the second half of the year. Most components of domestic demand contributed towards the overall upturn — private and government consumption, non-farm stockbuilding and non-residential investment. However, monetary and fiscal policies were tightened over the year, in response to a significant weakening in the effective exchange rate of the Australian dollar and concern at a widening external current account deficit. Accordingly, domestic demand is expected to slow in 1986, since tight monetary policy is likely to constrain investment growth and export growth is also expected to slacken — although this latter factor could be offset by an improvement in the terms of trade. The OECD expect the Australian economy to expand by about 3.8 per cent in 1986 and by 3.3 per cent the following year.

Conclusion

Although there are important differences between countries, the short-term outlook for the industrial countries as a group and for the non-oil exporting developing economies is now markedly more positive than appeared likely even six months ago. The current world economic upturn has been the second most prolonged since the early 1960s, and underlying economic conditions in the major industrial countries remain generally consistent with those required for continued non-inflationary growth. Growth rates, recorded in 1984. This will occur despite the expansionary impact of recent oil price falls.

In its most recent assessment of short-term prospects, the OECD emphasises that although there has recently been a convergence in member countries' economic growth rates, the main determinants of growth in the region have not basically changed. The principal factor which underpins a continued recovery is the success with which inflationary pressures have been contained over the past two years. Despite the sometimes severe domestic economic stresses generated, economic policy in the major economies has remained committed to achieving and maintaining the stable environment essential for sustained growth in investment, output and employment.

Balancing this outlook though, the OECD points to a number of other issues that still need to be resolved if the prospects for economic growth beyond the next year and a half are to remain relatively favourable. The pace of structural adjustment in some OECD countries still appears to be relatively slow, with measures to promote efficiency and productivity growth, to reduce underlying inflationary pressures and to reorganise public finances not being pursued uniformly throughout the OECD area. The re-emergence of protectionist measures could pose an additional threat to the viability of the upturn. Regarding international financial issues, the ongoing debt problem and volatility in exchange rates are still of major concern, and although international real interest rates have moderated, they remain relatively high. The course of the current upturn is extremely sensitive to the outcome in each of these areas.

Continued growth in New Zealand's export markets should imply improved short-term prospects for the level of activity in this country. The terms of trade, though, have remained depressed and the outlook for commodity prices holds out little prospect of any significant improvement over the short-term. New Zealand has not benefited from the international upturn to the extent that many other small industrial countries have. Although a further deterioration in this country's economic prospects as a result of the levelling off in international growth earlier expected now appear less likely, there are no indications that the international environment will become any easier for New Zealand. Although considerable moves have recently been made to achieve an economic environment that will allow New Zealand to achieve a higher growth path over the medium-term, the need for further structural changes, particularly in the labour market, remains strong and these changes require the ongoing support of consistent fiscal and monetary policies. As other small countries have discovered, economic problems which are not resolved while conditions remain relatively favourable can sometimes appear almost intractable in a harsher economic environment.