Reserve Bank Bulletin

QUARTERLY REVIEW OF THE EXTERNAL ECONOMY

This article summarises recent trends in New Zealand's balance of payments, in the context of developments in both the international and domestic economies.

Introduction

With a continued convergence in inflation rates and in economic growth, a trend towards lower international interest rates and a recent substantial realignment of exchange rates, the economic outlook for industrial and developing countries over the next year and a half is positive. Nevertheless, there remain a number of structural imbalances which raise uncertainties as to the longer-term prospects for the international upturn. One of the most visible and important of these is the United States balance of payments current account deficit, for which both the IMF and the OECD foresee little reduction in prospect over the period to 1987. This is despite anticipated slower United States economic growth relative to its trading partners and despite the realignment of the US dollar. The forecasts have therefore served to focus attention on the policies required of the United States and its trading partners for an orderly resolution, consistent with continued international growth, of their current account imbalances.

This review of the external economy begins with a brief outline of recent developments in overseas industrial economies, then summarises the issues relating to balance of payments imbalances in the major industrial countries. With this background, the review goes on to outline recent trends in New Zealand's balance of payments, commencing with a broad overview of the current and capital accounts, and then an analysis in greater detail of the major developments within each of the main components of the balance of payments.

As in previous articles, analysis of the current account uses the Balance of Payments (BOP) statistics produced by the Department of Statistics. These are based on transactions between New Zealand residents and non-residents, and are measured at the point of a change in ownership rather than on a cash transactions basis. Owing to the unavailability of quarterly BOP capital account statistics, it has been necessary to use Overseas Exchange Transactions (OET) statistics produced by the Reserve Bank for analysis of the capital account. These statistics are derived from cash transactions effected through authorised foreign exchange dealers and so they are not comprehensive. Nevertheless, they do provide a broad and timely indication of developments in the capital account.

International Economic Developments and Prospects

Recent Developments

The rate of economic growth in OECD economies slowed substantially in the first half of 1985 but then recovered, reflecting a strengthening in the United States economy and more particularly a recovery in the rate of European economic growth. The overall economic expansion in 1985 was therefore well below that recorded in 1984, but still represented significant growth by the standards of earlier years. The United States economy grew 6.6 per cent in 1984 and 2.2 per cent in 1985, the Japanese economy (largely due to the importance of its export links to the United States) also experienced a slower rate of growth in 1985; 4.6 per cent compared to 5.1 per cent in 1984. The European economies as a group continued growing at a relatively moderate rate.

One important and encouraging development has been the continued downward trend in inflation throughout the current growth cycle. This outcome has been a primary factor in ensuring the continuation of the economic upturn. After moderating to 4.3 per cent in 1984, the rate of inflation in industrial countries fell further in 1985, to 3.9 per cent. Although the continued pursuit of anti-inflationary monetary and fiscal policies on the part of the authorities in the major industrial countries has been a principal factor in this outcome, depressed world commodity prices and (more recently) a fall in oil prices, have greatly assisted the deflationary process. The OECD estimates that between late 1985 and early 1986, the average price of oil imports for the region fell about 40 per cent (to US$15 a barrel). Some measure of the impact of this can be seen in the fact that consumer prices in the OECD region (largely reflecting developments in the three largest economies — the United States, Japan and West Germany) fell 0.1 per cent in February and March 1986. The rate of inflation in the United States for the year to March 1986 was 2.3 per cent, that for Japan 1.1 per cent and for West Germany only 0.1 per cent. However, the outcome for the largest industrial economies continues to contrast with that for some of the smaller industrial economies, such as Australia and New Zealand which recorded comparable rates of 8.3 per cent and 13 per cent respectively.

Prospects

The fall in oil prices, lower international interest rates and the realignment of exchange rates have significantly improved the general outlook for both inflation and economic growth in the industrial economies. The OECD region has gained considerably from the decline in oil prices, through a marked improvement in the region's terms of trade with other countries, and for many OECD countries these gains have been extended in the short-term by the recent appreciation of their currencies against the US dollar. The OECD suggests that, in the absence of the oil price fall, there may have been a marked slowdown in economic growth in the region (and therefore internationally) since underlying economic conditions indicated that the European economies would not have grown at a rate sufficient to offset the expected United States slowdown in 1986 and 1987. Economic growth is now expected to stabilize at approximately 1985 levels. For the region as a whole, the OECD suggests that economic growth in 1986 will be 3 per cent, with most of the larger economies growing at similar rates but some diversity in the predicted outcomes for the smaller economies. For New Zealand's main export destination, Australia, the OECD predicts economic growth in 1986 of 3.5 per cent, with about the same expansion in 1987.

A substantial reduction is predicted in the rate of inflation in 1986, and a further fall is expected for the following year. For the major seven economies, the OECD suggests the rate of inflation will fall to 2.5 per cent in 1986 (from 5.2 per cent in 1985) and 2 per cent the following year. Two of these countries, Japan and West Germany, are expected to record near-zero rates of inflation over this period.

TABLE 1
OECD Main Economic indicators

	1984	*1985*	*1986* (f)	*1987* (f)
Real GNP[1]				
United States	6.6	2.2	3.0	3.8
Japan	5.1	4.6	3.3	3.0
West Germany	3.0	2.4	3.5	3.0
Major Seven OECD Economies	5.1	2.7	3.0	3.3
Other OECD Economies	3.3	2.9	2.5	2.3
Total OECD	4.8	2.8	3.0	3.3
Inflation[1,2]				
United States	4.1	3.2	2.8	2.5
Japan	2.1	2.2	0.5	0.0
West Germany	2.5	2.0	0.0	0.3
Major Seven OECD Economies	4.3	3.7	2.5	2.0
Other OECD Economies	11.1	10.9	9.3	8.8
Average OECD	5.3	4.8	3.5	3.0
Unemployment[1,3]				
United States	7.5	7.2	7.0	6.8
Japan	2.7	2.6	2.8	3.0
West Germany	8.2	8.3	8.0	7.3
Major Seven OECD Economies	7.6	7.5	7.5	7.3
Other OECD Economies	11.5	11.6	11.5	11.8
Total OECD	8.4	8.3	8.3	8.3

Source: OECD
[1] Annual changes, per cent.
[2] Private consumption deflator.
[3] Per cent of labour force.
f OECD forecasts.

A similarly positive outcome does not appear likely for unemployment. The rate of unemployment in the industrial countries decreased only slightly in 1985, and is not expected to show any major improvement in the current year or in 1987. The current national differences in labour market trends also seem likely to persist, despite converging rates of economic growth. The OECD suggests that the United States unemployment rate is likely to continue to moderate, but small increases in unemployment may be recorded in Japan, and the relatively high rates experienced in Europe and in some of the smaller OECD economies are expected to remain.

Also of concern, the OECD notes, is that the favourable trends predicted for economic growth and inflation do not appear likely to be matched in the outlook for the current account imbalances of the major OECD economies. Despite the downturn in the US dollar 'effective' or trade-weighted exchange rate (which peaked in March 1985), the United States current account deficit continued to widen over the year, reaching US$117.7 billion (or 3 per cent of GNP), largely due to a steady deterioration in the merchandise trade deficit. This was reflected in a further improvement in the current account balances recorded by many of the United States' trading partners. In particular, the Japanese and West German surpluses widened significantly in 1985 to US$49.3 billion and $13.1 billion respectively. (See table 2)

TABLE 2
Balance of Payments Current Account Balances[1]

	1984	*1985*	*1986* (f)	*1987* (f)
United States	−107.4	−117.7	−132	−125
Japan	35.0	49.3	77	71
West Germany	6.3	13.1	29	22
Total OECD	− 69.0	− 59.2	− 16	− 30
OPEC	− 9.6	− 12.7	− 49	− 34
Non-oil developing countries	− 22.1	− 28.2	− 25	− 28

Source: OECD
[1] US$ billions.
f OECD forecasts.

The large external imbalances now evident in the United States, Japan and West Germany seem likely to persist well into 1987, despite substantial exchange rate changes recorded in recent months. Between September 1985 and late April 1986, the Yen appreciated over 40 per cent against the US dollar, reversing in a short space of time most of its cumulative depreciation against the dollar over the previous five years. Over the same late 1985 — early 1986 period, the Deutschmark appreciated over 30 per cent against the US dollar, again countering a large proportion of its earlier cumulative depreciation. Nevertheless, OECD forecasts suggest that the United States current account deficit may rise sharply in 1986, to US$132 billion (or 3.1 per cent of Gross National Product (GNP)), and decline only slightly the following year, to US$125 billion. Correspondingly large increases appear in prospect for the Japanese and West German surpluses in 1986 — to US$77 billion and US$29 billion respectively.

There are a number of factors underpinning the persistence of these imbalances in the face of very substantial exchange rate adjustments. First, a substantial proportion of the recent and projected improvement in the current account positions of industrial countries other than the United States reflects their relatively large terms of trade gains from the decline in oil prices and from the decline in the US dollar (as it affects the world price of their imports for instance). This is particularly the case for Japan. The slow response in the US trade balance may also be partly due to a pattern of relatively slow adjustment in the domestic price of United States imports, relative to domestically produced goods. Essentially, a volume increase in United States imports may continue despite a fall in the exchange rate because exporters to that country have chosen to largely absorb the exchange rate changes, rather than pass them on in increased prices. This pattern may persist well into 1986. Another factor identified by the OECD is that although the United States' international competitiveness has improved in some areas as a result of recent exchange rate changes, measures of cost-competitiveness provide only a partial measure of 'true' international competitiveness in other areas, such as high technology and manufactured products. Import volume growth in these products could therefore continue at close to recent levels.

Finally, a more long-term, but less tractable, factor in the United States' balance of payments position has emerged in the invisibles balance since the early 1980s. Cumulative United States current account deficits since 1982 have significantly worsened the net foreign assets position of the United States implying a substantial deterioration in net investment income (or more particularly, a rise in net interest payments to foreigners), and therefore the invisibles balance. A reversal of this trend can only be achieved over the medium-term. In the short-term, policy measures consistent with lower international interest rates (for instance through moves to reduce the relative size of the United States fiscal deficit) may be of more immediate significance in this area than any further exchange rate initiatives.

One policy option which was raised in the United States during 1985 in response to their growing current account deficit was a move towards greater protectionism. However, it was recognised that this would have adverse implications for the continuation of the current recovery, would increase the debt servicing difficulties of the heavily-indebted developing countries, and would adversely affect the medium-term outlook for inflation and economic growth in the United States itself. An alternative response to the deficit which was also considered was to sharply reduce the demand for imports through contractionary economic policies. However, this was largely ruled out on the basis of domestic United States economic considerations and in the context of the international recovery, so that neither of these options has been taken further (although protectionist sentiment in the United States persists).

Further depreciation of the US dollar effective exchange rate (either through a less restrained monetary policy or in the context of co-ordinated policy measures such as those exercised by the major economies in late 1985) — does not appear to be under current consideration. The US dollar effective exchange rate is presently at about the same level as in late 1980, just prior to the sustained appreciation over the early-mid 1980s, and on trade grounds alone it is not clear that any further substantial deterioration is warranted. The upturn in inflation which could result would force a tightening in macroeconomic policies and would put both the United States and the international upturn at risk. However, a complicating factor stems from the fact that although the dollar's effective exchange rate has fallen considerably, it remains relatively strong against the currencies of several of the United States' smaller trading partners. Well over a third of the United States' imports are from countries which have either experienced a larger exchange rate depreciation than the US dollar in 1985, or which peg their currencies against the US dollar. An improvement in United States competitiveness relative to these countries may therefore hinge principally upon the policy stances adopted by their respective authorities.

The apparently slow response of the United State's trade and current account deficits to the recent substantial shifts in exchange rates poses risks for a continuation of the current international growth cycle because it could spark unilateral policy moves (such as protectionist measures) which could have damaging international repercussions. However, there is now a consensus that consistent co-ordinated policies on the part of the major industrial economies are essential for an effective resolution of these current account imbalances. Furthermore, although additional exchange rate adjustments will be necessary in line with inflation differentials and productivity trends, it is clear that exchange rates and exchange rate policy are only two of the elements in the economic policy mix required for a return to more sustainable balance of payments positions.

The key requirement over the next two years appears to be stronger growth in the industrial countries other than the United States, to underpin a rise in their demand for imports and thus an improvement in the United States trade deficit. The exchange rate adjustments outlined above and the moves to reduce the relative size of the United States fiscal deficit are also consistent with a reduction in the United States current account deficit. However, recent OECD projections, suggest that the lag between these exchange rate adjustments and their full effect on trade volumes could be between two and three years. This serves to highlight the complexity and breadth of the adjustments needed for an effective resolution of what is now a large and long-established balance of payments problem.

New Zealand's Balance of Payments: Overview and Summary

Over much of the 1985 calendar year, New Zealand's balance of payments current account displayed steady improvement, principally reflecting a turnaround in the balance on merchandise trade from deficit to surplus. This turnaround reflected a significant divergence in the rates of export and import volume growth. Whereas moderately strong export volume growth continued over 1985, the rate of import volume growth fell away sharply compared with the high rates evident over 1984 and early 1985. To a large extent, the decline in import volume growth reflected an emerging weakness in domestic demand as the economy slowly entered a cyclical downturn. Reinforcing this influence was a fall-off in oil imports associated with the coming on-stream of the synthetic oil plant and refinery project. Offsetting these influences, however, was an increase in major project-related imports, mainly associated with construction of the last stages of the major energy and steel projects.

The balance on invisibles also contributed to the overall improvement in the current account over 1985. In contrast to the pattern of a sharply increasing invisibles deficit evident over most of the last decade (and particularly over 1984 and early 1985) the invisibles deficit fell slightly over the latter half of 1985. As in the trade balance, the improvement in the invisibles balance was to a large extent attributable to a weakening in domestic demand. This resulted in a relatively sharp contraction in the imports of services and a consequence improvement in the services balance. A further factor contributing to the easing in the invisibles deficit was the appreciation in the exchange rate that occurred over the latter half of 1985. This had the effect of scaling down the invisibles deficit by reducing the New Zealand dollar value of both credits and debits — in contrast to the scaling-up effect associated with the devaluation in July 1984.

The steady improvement in the current account balance that occurred over 1985 was abruptly interrupted in the March 1986 quarter. In that quarter, the current account deficit increased sharply on the level of one year earlier, with the result that most of the gains made over 1985 were reversed. Just as the bulk of the improvement over 1985 occurred in the trade balance, so too did the deterioration in the March 1986 quarter. A substantial fall in export volumes, largely due to the effect of industrial action in the freezing works and a deferral of meat and wool production due to favourable climatic conditions, resulted in a sharp decline in export volumes over the March quarter. Conversely, import volumes were boosted as a result of purchases of 'bulky' capital equipment items (particularly Air New Zealand aircraft). Reflecting both developments, the trade balance recorded a substantial deficit in the March quarter. A decline in the terms of trade, principally due to weaker pastoral export prices (particularly for butter and beef) also contributed to the deterioration. Aside from the terms of trade influence, however, the deterioration in the trade balance in the March quarter was principally due to timing factors, and therefore does not signal the emergence of a protracted deterioration, at least in the short-term.

Despite the difficulties being faced by the exporting sector, particularly pastoral farming, the current account is expected to resume its pattern of improvement over the remainder of 1986. First, the industrial action that held back some pastoral exports in March will result in a correspondingly boost to export shipments over the rest of 1986 by shifting those shipments to later quarters in the year. Secondly, any reductions in livestock numbers associated with the rural economic downturn are likely to have a positive impact on meat export volumes in the short-term by increasing the slaughter rate, although this will adversely affect wool production. A further impetus to pastoral exports should result from the favourable growing conditions experienced over recent months. Whereas these resulted in a lower kill and shear in the 1985/86 year as farmers held back stock, they should boost export volumes of meat and wool in the 1986/87 year.

On the import side, volumes are likely to resume their contractionary phase over 1986 in line with the expected weakening in domestic demand associated with the cyclical downturn. Reinforcing this influence is the expected decline in major project-related imports and oil imports. The former should decline as the construction phase of the major projects draws to a close, while the latter will fall following the coming on-stream of the synthetic oil and refinery projects. Lower import prices following the sharp drop in oil prices should also exert a favourable influence on the current account, although this is likely to be offset by an underlying weakness in pastoral export prices.

The year to March 1986 represents the first full year since the floating of the New Zealand dollar in March 1985. One of the consequences of adopting a freely floating exchange rate (with no official intervention to influence the rate) is that net official overseas borrowing is no longer required to fund any shortfall in the current account; private capital inflows now serve this function. Consequently, net official overseas borrowing fell sharply over 1985/86, being undertaken solely for the purpose of building up the level of official foreign currency reserves. In contrast, net private capital inflows continued strongly over the year. As a consequence of these developments, New Zealand's overseas debt is now changing in composition and profile, with private debt growing more rapidly than official debt — in sharp contrast to the pattern characteristic of the 1970s and early 1980s.

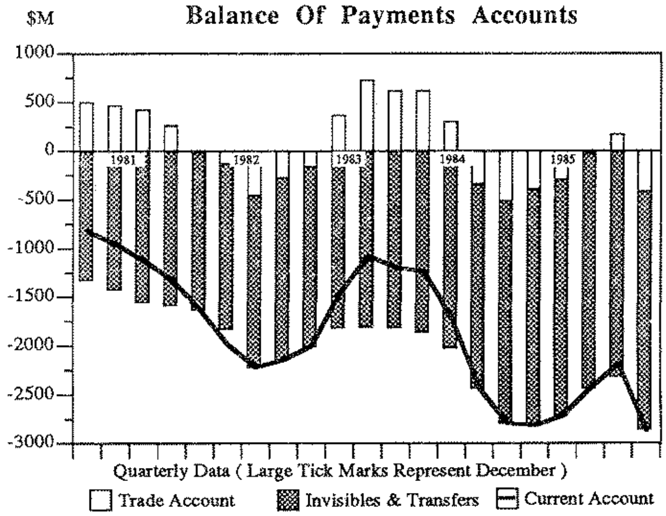
The Current Account

As can be seen from table 3 and Figure 1, the current account deficit improved steadily over 1985, declining from a peak of $2,818 million in the year to March

TABLE 3
Balance of Payments Current Account
Four Quarter Running Totals
(NZ$ millions)

Four Quarters Ended	*Balance on Merchandise Trade*	*Balance on Services*	*Balance on Investment Income*	*Balance on Invisibles*	*Balance on Current Account*
1984 Mar (P)	+622	− 710	−1,277	−1,853	−1,235
June (P)	+304	− 866	−1,269	−2,019	−1,714
Sept (P)	−337	− 931	−1,345	−2,097	−2,434
Dec (P)	−516	− 970	−1,551	−2,282	−2,796
1985 Mar (P)	−395	−1,033	−1,627	−2,424	−2,818
June (P)	−294	− 924	−1,779	−2,417	−2,712
Sept (P)	− 21	− 863	−1,804	−2,415	−2,434
Dec (P)	+178	− 821	−1,704	−2,337	−2,158
1986 Mar (P)	−422	− 937	−1,726	−2,449	−2,870

P Provisional



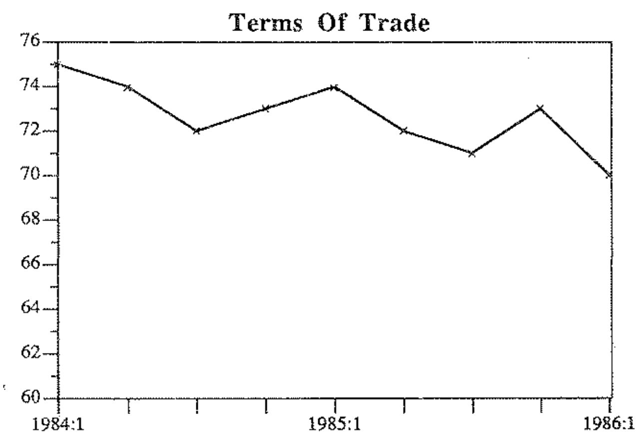
1985, to $2,158 million in the year to December 1985. Most of the improvement occurred in the trade balance, which turned around from a deficit of $394 million in the March 1985 year, to a surplus of $178 million in the December 1985 year. Over the same period, the invisibles balance also improved, with the deficit declining from $2,424 million to $2,337 million respectively. In the March 1986 quarter, however, a sharp deterioration in the trade balance reversed most of the improvement in the current account, resulting in a current account deficit of $2,870 million for the year ended March 1986. The salient factors underlying the developments in the current account include:

— a continuation of moderately strong export volume growth over 1985, tapering away in the year to March 1986 to an annual rate of 1.9 per cent (compared with 7.3 per cent in the year to March 1985);

— a sharp decline in import volume growth over the latter half of 1985 to an annual rate of just −0.3 per cent in the year to March 1986 (compared with 14.2 per cent over the preceding March year);

— a 2.6 per cent decline in the terms of trade over the year to March 1986 from an average of 73.4 in 1984/85 to 71.5 in 1985/86;

— an improvement in the services deficit to $937 million (from $1,034 million in 1984/85). In contrast, the investment income deficit continued to deteriorate to $1,726 million in 1985/86 (from $1,625 million in 1984/85).



The following sub-sections cover in greater detail the main components of the current account.

Exports

Over the year to March 1986, the value of total merchandise exports grew by around 3.6 per cent on the level of the previous March year. This was well down on the annual value growth displayed over most of 1985, and reflected a particularly sharp 19.2 per cent export value decline in the March 1986 quarter (on the same quarter one year earlier). The slowdown over the year to March 1986 can be attributed to a decline in both export volumes and export prices in the March 1986 quarter (relative to the same quarter one year earlier). Reflecting this, export volumes for the year ended March 1986 were only 1.9 per cent above those of a year earlier. This compares with the consistently strong volume growth recorded over most of 1985 when, for example, annual growth was 9.2 and 10.5 per cent in the years to September and December 1985 respectively.

Price growth also fell away sharply in the year to March 1986, with average export prices being just 0.8 per cent above those of a year earlier. This marks a sharp decline from the 18.3 and 8.7 per cent annual price growth recorded in the years to September and December 1985 respectively. After adjusting for increases in the cost of foreign exchange (mainly associated with the devaluation in July 1984), the foreign currency price of exports increased by around 2.2 per cent over both the September and December 1985 years (compared with the same periods one year earlier). In the year to March 1986, however, the foreign currency price of exports remained largely unchanged.

A closer examination of exports by sector (see tables 4 and 5) reveals that most of the slowdown in total export volume growth occurred in the largest exporting sectors: pastoral, forestry and manufactured exports. In value terms, these sectors recorded annual growth of −1.2 per cent, −8.4 per cent and 2.5 per cent respectively over the year to March 1986. In contrast, the non-traditional sectors, such as horticulture and fishing, have continued the high growth trend apparent over recent years, increasing in value terms by around 16.5 per cent over the year to March 1986. Similarly, other animal products (mainly hides and skins) also continued to record strong growth, expanding some 23.8 per cent over 1985/86.

As can be seen from table 5, the pronounced deceleration in export volume growth over the March 1986 year compared with earlier periods is explained primarily by strong contractions in the forestry, wool and meat sectors. These declines arise mainly from timing factors rather than any substantial change in the underlying growth trend. In the case of wool, net purchases by the Wool Board in response to expectations of an exchange rate depreciation were a significant reason for the shortfall in export volumes relative to the estimated production levels over the year to March 1986 (although a decline in production did occur, primarily as a result of reduced livestock numbers). In the meat sector, the meat works strike was partly responsible for the approximate 35 per cent reduction in the March 1986 quarter volumes relative to the same quarter a year earlier. Further reinforcing these influences on meat and wool exports has been the climatic influence of particularly favourable growing conditions, resulting in a deferral of the lamb kill and wool shearing in the March quarter. The fall in forestry

TABLE 4
Balance of Payments Current Account
(NZ$ million)

Years Ended March	*1985(P)*	*1986(P)*
Exports		
Meat	1,991.6	1,992
Wool	1,406.4	1,297
Dairy	1,687.0	1,737
Other Animal Products	582.5	721
Forestry	724.6	664
Other Primary Products	1,067.1	1,243
Manufactured Goods	2,502.6	2,565
Base Minerals, Other	276.8	452
Adjustment to BOP Basis	127.9	197
Total Exports	10,367	10,745
Imports	10,763	11,165
Merchandise Trade Balance	− 395	− 422
Exports of Services	2,725	2,836
Imports of Services	3,755	3,776
Balance on Services	−1,031	− 937
Investment Income Receipts	399	463
Investment Income Payments	2,027	2,189
Balance of Investment Income	−1,628	−1,726
Transfers Credits	653	710
Transfers Debits	417	494
Balance on Transfers	+ 236	+ 216
Balance on Invisibles	−2,424	−2,449
Current Account Balance	−2,818	−2,870

(P) Provisional

TABLE 5
Export and Import Volume and Price Movements
Annual % Change

Years Ended March	*1985*		*1986*	
Exports	*Price*	*Volume*	*Price*	*Volume*
Meat	18.7	−10.4	− 4.6	− 0.5
Wool	24.9	1.2	+ 5.7	−11.0
Dairy	4.7	12.6	− 4.8	+ 8.5
Other Animal Products	26.0	6.0	+10.0	+12.5
Forestry	26.8	2.0	+ 7.9	−15.1
Other Primary Products	15.7	31.6	+ 7.1	+ 8.7
Manufactured Goods	14.6	19.8	+ 1.1	+1.6
Base Minerals, Other	28.0	17.5	+ 5.0	+55.5
Total (BOP Basis)	17.1	7.3	+ 0.8	+ 1.9
Imports (CIF)	19.0	14.2	+ 3.6	− 0.3

export volumes is largely explained by strike action in newsprint and pulp production, which reduced export volumes by 20 and 11 per cent respectively in the year to March 1986. Further contributing to these declines were the effects of a sustained domestic demand for building supplies and the persistence of a natural supply constraint.

Given that the decline in export volume growth over 1985/86 can be largely attributed to timing factors, it can be expected that export volumes will accordingly be boosted over 1986/87. Moreover, a further boost to meat exports could be expected from the likely reduction in livestock numbers (increasing the slaughter rate) as farmers adjust to less favourable price signals. Wool exports are not likely to experience significant overall growth over the coming year, however, as any growth due to timing factors (such as Wool Board stock sales or the lagged effect of favourable growing conditions) is likely to be offset by a fall in production due to reduced livestock numbers and the lagged effect of lower fertiliser input.

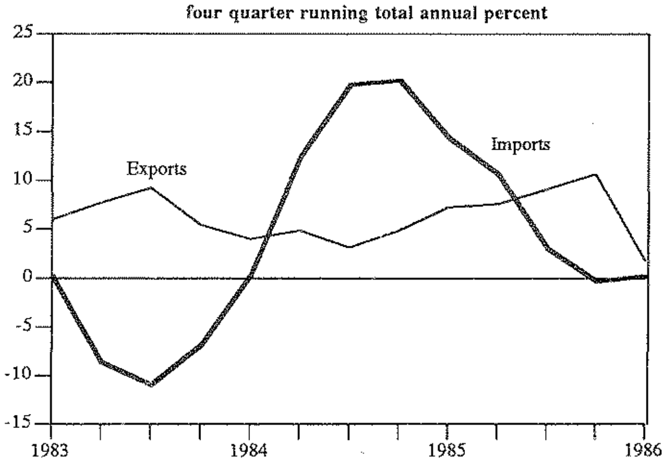
In contrast to the sluggish volume growth in meat and wool exports over 1985/86, the third main component of the pastoral sector — dairy exports — displayed relatively strong 8.5 per cent volume growth over the year, continuing the momentum of the previous March year. The main reason for the continued growth in dairy export volumes was again the favourable climatic conditions that have prevailed in the last two years. Production is likely to decline over 1986/87, however, given the likely sharp reduction of the schedule price payable to dairy farmers in the coming year (in line with falling returns in overseas markets and the appreciation of the NZ dollar vis-a-vis the US dollar). Export volumes could be expected to fall less sharply due to the run-down of Dairy Board stocks, although the price at which these stocks can be sold is likely to be less favourable.

Manufactured exports displayed moderate volume growth over 1985/86, although the rate of growth was well below that of earlier periods, continuing the trend of deceleration evident over 1985. Over the year to March 1986, manufactured exports recorded annual volume growth of 1.6 per cent, compared with 19.8 per cent in the previous March year. While the slowdown reflects growth coming off a higher base, to some extent, it is also indicative of the deteriorating export competitiveness experienced by the manufacturing sector over the latter half of 1985/86. The main factors contributing to the fall in competitiveness were the appreciation of the New Zealand dollar relative to the United States and particularly the Australian currencies, the increase in domestic costs relative to overseas costs, and the removal of a number of export incentives. Although these factors may induce further weakening in manufactured export volume growth over 1986, a number of other factors may offset these effects. In particular, the recent fall in the price of oil and the likely boost this represents for the growth in overseas economies (such as Japan and the United States) should provide some impetus to overseas demand for manufactured exports (although signs of a deceleration in growth in the Australian economy may offset these effects). Some further impetus could be expected from the probable decline in domestic economic activity over 1986/87 and the resultant reduction in domestic off-take from manufactured output.

Although there was, on average, only slow growth in export prices over the year to March 1986, price performance differed markedly between the export sectors. Pastoral export prices were held back by the appreciation of the New Zealand dollar relative to the United States dollar (the main currency in which pastoral exports are priced), but were also adversely affected by depressed foreign currency prices. In particular, beef and butter prices fell sharply (in foreign currency terms) in the latter half of 1985/86, mainly reflecting large surpluses of red meats and butter in world markets, and continued marketing difficulties. Manufactured exports were even more adversely affected by exchange rate movements, with a large proportion of exports being priced in Australian dollars. Unlike pastoral exports, however, manufactured export prices displayed moderately positive growth in foreign currency terms, moving broadly in line with world inflation. In contrast to the relatively poor overall price performance of the traditional export sectors, other primary products (comprising mainly horticulture and fish), forestry, and other animal products (mainly hides and skins) performed considerably better, with price growth (in New Zealand dollar terms) of 7.1 per cent, 7.9 per cent and 10 per cent respectively.

Export And Import Volume Trends

four quarter running total annual percent



Imports

One of the main factors exerting a positive influence on the current account over 1985/86 has been the rapid deceleration in import volume growth. From a peak of 19.2 per cent in the year to September 1984, the annual rate of import volume growth fell rapidly to −0.5 per cent in the year to December 1985, and then to −0.3 per cent over the March 1986 year. Just as the surge in import volumes over 1984/85 had been primarily due to the strong upturn in economic activity over that period, the rapid deceleration in import volume growth over 1985/86 largely reflects the emergent downturn in domestic demand. The Reserve Bank estimates, for example, that whereas real domestic expenditure grew by 6 per cent over 1984/85, it fell marginally in the year to March 1986. This decline may not have been as large as previously expected, due to economic activity holding up until the latter half of 1985/86. This, combined with the appreciation of the exchange rate which reduced the New Zealand dollar cost of imports, resulted in the demand for imports falling away less rapidly than would otherwise have been the case. Also buoying up imports over 1985/86 were an increase in major project-related imports and (in the March 1986 quarter) imports of aircraft by Air New Zealand. It was primarily for the latter reason that the downward trend in import volumes was interrupted in the March quarter.

Over the remainder of 1986, however, the growth in imports should resume its downward trend, exerting a positive influence on the trade balance. The main factors contributing to this are the likely continuation of a decline in real domestic demand as the recession gathers pace (at least over the first half of 1986/87), a sharp decline in major project-related imports as the construction phase of the major projects draws to a close, and a decline in oil imports as the synthetic oil and refinery projects become fully operative. A further impetus to a decline in imports should come from reduced import price inflation (in foreign currency terms) following the recent fall in oil prices and the consequent reduction in world inflation.

Invisibles

In sharp contrast to the protracted deterioration in the invisibles deficit that has characterised much of the last decade, the invisibles deficit remained largely stable over the year to March 1986. In that year, the invisibles balance recorded a deficit of some $2,449 million, compared with $2,423 million in the year to March 1985. As can be noted from tables 3 and 6, the improvement was solely due to a steady decline since March 1985 in the services deficit. In the year to March 1985 for example, the services deficit amounted to $1,032 million, whereas one year later it had declined to $937 million. Over the same period, the balance on interest and investment income continued to deteriorate, although at a considerably slower pace than had been the case over 1984. In the year to March 1986, the deficit on interest and investment income stood at $1,726 million, compared with a deficit of $1,625 million one year earlier.

TABLE 6
BOP Invisibles Transactions

(NZ$ million)

Year Ended March	*1985 (P)*	*1986 (P)*
Exports of Services		
Transporation	1,533	1,661
Travel	597	548
Other Misc. (incl. insurance)	502	554
Government	93	73
Total	2,725	2,836
Imports of Services		
Transportation	1,601	1,682
Travel	893	817
Other Misc. (incl. Insurance)	1,124	1,077
Government	191	200
Total	3,755	3,776
Balance on Services	−1,032	− 937
International Investment Income — Credits	399	463
International Investment	2,027	2,189
Balance on International Investment Income	−1,628	−1,726
Transfers — Credits	653	710
Transfers — Debits	417	494
Balance on Transfers	+ 236	+ 216
Balance on Total Invisibles	−2,423	−2,449

(P) Provisional

To some extent, the improvement in the services balance over 1985/86 can be attributed to exchange rate movements over the latter half of the year. The appreciation in the exchange rate over the September and December 1985 quarters would have scaled down the deficit by reducing the New Zealand dollar value of both exports and imports of services. In addition, the appreciation in the exchange rate would probably have reduced the value of imports more than exports given the likelihood that a higher proportion of services imports would be priced in foreign currency terms than would exports of services. Reinforcing the exchange rate effects has been an underlying weakening in the volume growth of services imports relative to exports of services over 1985/86. In particular, travel payments declined sharply over 1985/86, probably reflecting a lagged adjustment to the devaluation (and the associated increase in the cost of foreign travel) and declining real personal disposable incomes. Slow growth in the volume of transportation payments also contributed to the improvement in the services balance.

Although the deficit on interest and investment income increased over 1985/86, the rate of deterioration slowed considerably compared with earlier periods. One of the reasons for this, as in the case of services, was the scaling-down effect of the appreciation in the exchange rate that occurred over the latter half of 1985/86. A further reason was the faster rate of growth in income receipts than in payments, with respective increases of 15.8 per cent and 8.1 per cent over the year to March 1986. It appears that a major factor underpinning the increase in income receipts has been the growth in overseas assets held by residents as a result of portfolio diversification following the removal of exchange control. Corporate investment overseas has also probably been a contributing factor. The slower growth in income payments primarily reflects a marked slowdown in net official overseas borrowing. Given the higher level of borrowing now being undertaken by the private sector, however, income payments from this source should display stronger growth over 1986/87, although this may be tempered by the recent substantial decline in world interest rates.

Capital Account

The year to March 1986 represents the first full year since the floating of the New Zealand dollar. The Government has permitted the dollar to be determined freely by the market forces of demand and supply, with no official intervention being undertaken to influence the level or direction of the exchange rate. As such, there has been no need for net official overseas borrowing for balance of payments purposes. This contrasts with the situation under the former fixed exchange rate system, whereby any shortfall in the current account (measured on an OET basis) not offset by net private capital inflows was funded by net official overseas borrowing. Since the float, net official overseas borrowing has only been undertaken in order to build up the level of official foreign currency reserves (although substantial gross borrowing was used to refinance maturing debt and to restructure existing debt). Reflecting this, net official overseas borrowing amounted to $466.5 million over the year to March 1986 — well down on the $1,231.6 million for the preceding March year. As a result of this borrowing, and valuation changes due to exchange rate movements, the level of reserves increased from $1,940 million as at March 1985, to $2,667 million as at March 1986.

In contrast, net private capital inflows continued at a high level, amounting to $1,715.6 million over 1985/86 — down only slightly on the $1,899.0 million recorded in 1984/85. Most of the large net inflows occurred in the first half of 1985/86 when, between April and August 1985, net private capital inflows amounted to $1,175.0 million. These large inflows reflected both increased overseas borrowing by the New Zealand private sector and greater interest shown by non-residents in investing in New Zealand. Among the main factors which encouraged these developments were a rise in domestic interest rates relative to declining rates overseas, increased confidence in the New Zealand economy and in the policy approach being adopted, a weak US dollar and expectations of a moderately firm New Zealand dollar. The relaxation of overseas borrowing controls, and a relatively small and heavily tapped domestic capital market, were further contributing factors over that period.

Over the remainder of 1985/86, however, an easing in domestic interest rates, a degree of market saturation for certain forms of borrowing (e.g. Eurokiwis), and possibly an expectation of greater downside risk in the exchange rate reduced the magnitude of capital inflows. Conversely, private capital outflows increased over the latter half of 1985/86, partly reflecting an increase in resident holdings of foreign assets in response to portfolio diversification. As a consequence of both these developments, net private capital inflows declined over much of the latter half of the year. The details of OET capital flows by composition, are presented in table 7.

TABLE 7
OET Capital Account Transactions
Net Capital Flows

	Year to March 1985 *NZ$ million*	*% Total*	*Year to March 1986* *NZ$ million*	*% Total*
Official	1,231.6	39.3	466.5	21.4
Private	1,665.5	53.2	1,456.6	66.7
Government Corporation	233.5	7.5	259.1	11.9
Total	3,130.6	100.0	2,182.2	100.0
Of Private:				
Borrowing	527.4	31.7	757.0	52.0
Investment	940.3	56.5	787.2	54.0
Assets[1]	197.8	11.9	– 87.6	–6.0
Total	1,665.5	100.0	1,456.6	100.0
Long-term	662.5	39.8	856.4	58.8
Short-term	1,003.0	60.2	600.2	41.2
Total	1,665.5	100.0	1,456.6	100.0

[1] A net inflow (positive) represents a net reduction in resident holdings of foreign assets. Conversely, a net outflow (negative) represents a net increase in resident holdings of foreign assets.

Overseas Debt

As a consequence of the reduced level of net official overseas borrowing and an increasing amount of private borrowing over 1985/86, New Zealand's overseas debt has been changing in composition. Table 8 provides data on New Zealand's overseas debt disaggregated into its main components: official (Government and Reserve Bank); government corporation; and private. Although adequate data are available for overseas debt incurred by the official sector and government corporations, there is a lack of timely information on private sector overseas debt, with the latest available being as at March 1985. It has therefore been necessary to estimate the level of private overseas debt as at March 1986 using private borrowing statistics from the OETs. (As the OETs record only cash transactions through New Zealand foreign exchange dealers, they do not capture borrowings or repayments made outside the New Zealand foreign exchange market/banking system. Accordingly, the estimate of private overseas debt is likely to underestimate the true level.) A lack of adequate data also precludes analysis of New Zealand holdings of overseas assets. As a result, the debt figures are presented in gross terms. Given that a proportion of private borrowing has probably been for the purpose of increasing foreign assets, the net private debt position would have increased less rapidly than the gross debt position.

As can be seen from table 8, official overseas debt stood at $15,630.2 million as at March 1986 — up 12 per cent on the level of one year earlier, but largely stable relative to Gross Domestic Product (GDP). As noted above, this increase solely reflects borrowing undertaken to build up the level of reserves together with valuation changes due to exchange rates movements. In net terms, therefore (excluding valuation

TABLE 8
New Zealand's Gross Overseas Debt
(NZ$ Millions)

As at 31 March	*Official*[1]	*% GDP*	*Government Corporation*[2]	*% GDP*	*Private*[3]	*% GDP*	*Total*	*% GDP*
1980	4,296.8	20.4	. .	—	. .	—	—	—
1981	4,809.0	19.7	. .	—	. .	—	—	—
1982	6,776.5	23.1	1,114.1	3.8	. .	—	—	—
1983	9,251.6	28.6	2,218.0	6.9	3,078.8	9.5	14,548.4	45.0
1984	9,387.9	26.9	2,804.8	8.0	3,885.3	11.1	16,078.0	46.1
1985	13,959.6	34.1	4,617.8	11.3	5,448.9	13.3	24,026.3	58.6
1986	15,630.2	33.8	5,486.3	11.9	5,800.0 (E)	12.6 (E)	26,916.5 (E)	58.3 (E)

[1] Comprises overseas debt incurred by the Treasury and Reserve Bank. From March 1982 the audited Treasury debt figures have been adjusted to exclude Railways loans that were outstanding to the Crown when the Railways Department became a corporation. The above figures include this component (which in March 1985, for example, represented $43.3 million).
[2] Obtained from regular Reserve Bank surveys. (The survey was extended slightly in coverage in March 1986).
[3] Figures for 1983, 1984 and 1985 are from a Department of Statistics survey, while that for March 1986 is an estimate based on OET private capital flow data (attributable to borrowing), adjusted for exchange rate movements.

changes), official debt was unchanged over the year. With reserves now at a more satisfactory level, the main source of growth in official overseas debt over 1986/87 is likely to come from valuation changes due to exchange rate movements rather than substantial net borrowing.

Reflecting continued net overseas borrowing and exchange rate movements, overseas debt incurred by government corporations increased quite rapidly over 1985/86, although not as much as in earlier years. As at March 1986, government corporation overseas debt stood at $5,486.3 million (or $5,350.5 million using the same corporations surveyed in earlier years) — up 18.8 per cent on the $4,617.8 million recorded in March 1985. As in previous years, some of the borrowing was for major project-related purposes. Now that the construction phase of the major projects has largely drawn to a close, this reason for borrowing has diminished, and in the future, net overseas borrowing by government corporations should increasingly reflect broader commercial and economic developments in both the domestic and international economies.

Despite the relatively high level of net overseas borrowing by the private sector over 1985/86 (amounting to $757.1 million compared with $527.3 million in 1984/85 as measured on an OET basis), private overseas debt is estimated to have increased only slowly over the year. As at March 1986, private offshore debt is estimated at around $5,800 million — just 6.4 per cent higher than the $5,448.9 million recorded one year earlier. Expressed as a proportion of GDP, this represented a decline from 13.3 per cent in 1985 to an estimated 12.6 per cent in 1986. The main reason for the slow growth in private debt, given the extent of new borrowing undertaken, is the large proportion (around 70 per cent) of debt denominated in US dollars — a currency against which the New Zealand dollar appreciated by 15.5 per cent over the period March 1985 to March 1986. As a consequence, the New Zealand dollar value of this debt fell sharply over the year. This was in contrast to the overall valuation increase applicable to official overseas debt, most of which is denominated in currencies against which the New Zealand dollar depreciated over 1985/86. Valuation changes aside, however, it could be expected that private and government corporation overseas debt will increase relative to official overseas debt over the year ahead.

Conclusion

Over much of 1985, New Zealand's balance of payments current account displayed steady improvement, mainly due to the divergence between export and import volume growth. Although a sharp deterioration occurred in the March 1986 quarter, this was largely due to timing factors rather than a change in underlying trends. For this reason, it could be expected that the current account balance will resume its pattern of improvement over the remainder of 1986 as exports benefit from the influence of timing factors and as imports contract, principally in line with the economy moving further into a downturn. The extent to which the current account improves beyond the end of the year, however, is largely dependent upon whether the traditional exporting sectors can maintain their momentum beyond the one-off boost due to timing factors that should occur over the middle of 1986.