REAL ECONOMIC DEVELOPMENTS AND THE BALANCE OF PAYMENTS

Over recent years the balance of payments current account position has deteriorated, with a marked improvement being recorded in the most recent figures. This article links balance of payments developments to trends in the domestic economy.

Recent balance of payments statistics have shown a marked improvement in New Zealand's external deficit performance. The current account deficit for the year to April 1987 fell by more than $1,500 million from the level of the previous year, and as a proportion of GDP declined to its lowest level since 1981.

That there has been a decline in the current account deficit from the unsustainable levels of the previous two years was to be anticipated given the policy changes that have been made over the past two years. Put simply, a current account deficit is the aggregate of the financial surpluses and deficits of the Government, business and personal sectors. The Government has taken significant steps to reduce its fiscal deficit and has put in place a range of reforms intended to improve the price signals that private sector operators face when structuring their own balance sheets. If these sorts of policies are continued it is to be expected that New Zealand will eventually emerge with a sustainable external balance which is compatible with the long run growth potential of the economy.

It was recognised, however, that a lasting improvement in the current account deficit would require significant adjustments in the domestic economy and that these take time to accomplish. In the interim, therefore, it is possible that short run movements in the current account might temporarily reflect an adverse adjustment path, and at times could be dominated by transitory factors such as cyclical variations and shocks to domestic consumption and investment, fluctuations in international commodity prices, and the effect of domestic monetary policies.

This article outlines recent developments in the balance of payments and addresses the question of the extent to which the recent improvement represents a fundamental improvement or is simply due to the coincidence of a number of favourable short-term factors. It concludes that both sets of factors played a part, but that the prospects for an immediate and significant further decline in the current account are not strong. It then goes on to examine the domestic imbalances which are the source of any sustained external imbalance; and looks at the issue of how anti-inflation policy may be assisting or hindering a rapid correction of the external deficit.

Recent Developments

The balance of payments current account deficit for the year to April 1987 was $1,874 million (or about 4 per cent of GDP) and represented a substantial improvement on the deficits recorded in 1984/85 and 1985/86 March years of $3,200 million and $3,300 million respectively (8.3 per cent and 7.5 per cent of GDP respectively).

This current account improvement consists largely of movements in the merchandise trade balance which moved from a deficit in 1985/86 to a surplus of just over $1,200 million — an improvement of $1,670 million for the year. The overall invisibles deficit offset the merchandise trade improvement in a minor way, rising by $104 million to $3,074 million. The historical track of all three balances are shown in Figure 1.

While official price and volume data for the full 1986/87 March year were not available at the time of writing, the data available for the first three quarters as well as Reserve Bank estimates for the final quarter provide a preliminary picture of developments during the year. The most striking fact that emerges is that a significant rise (in the order of 6 per cent) in export volumes was recorded over the March year — an outcome which, at first sight, seems to be at variance with the expected picture of an export sector under pressure from a strong New Zealand dollar. A closer examination of the sectoral breakdown however indicates that the growth did not reflect a stronger sustainable upward trend (refer table 1). While meat exports rose sharply, this was primarily due to the freezing works strike at the beginning of 1986 which resulted in a sharp fall in meat exports in the March 1986 quarter and a carry over of about $200 million in meat and animal product exports into the 1986/87 year. Wool and dairy produce exports were also temporarily boosted during the year by a rundown of stocks. These short-term factors thus masked an unfavourable competitive situation for New

Figure 1
Balance of Payments
Twelve Month Running Totals, $m

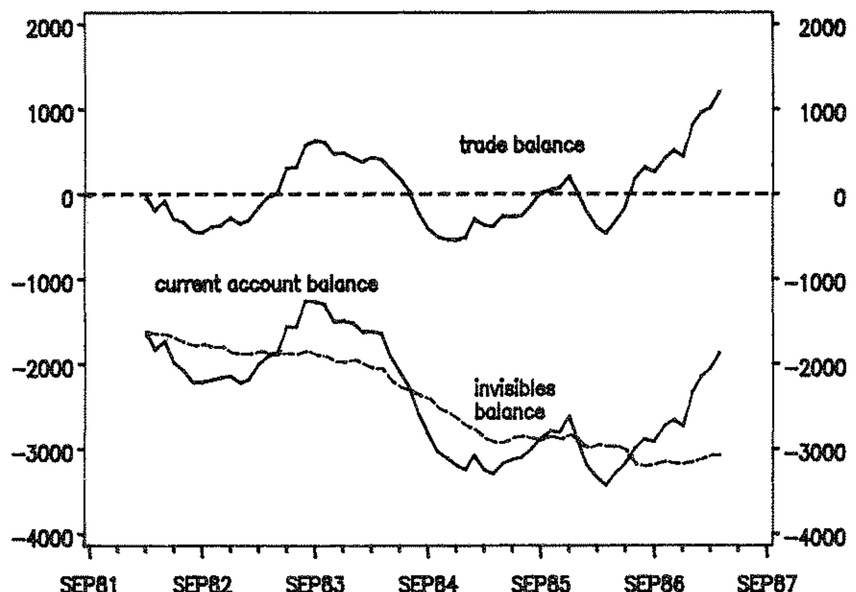


Table 1
Annual Percentage Changes in Export Volumes and Prices

Exports	Annual Percentage Change to March 1987	
	Price	Volume
Meat	-7.1	19.6
Wool	6.2	9.5
Dairy Products	-2.7	-0.7
Other Animal Products	5.4	9.1
Forestry Products	5.6	-2.3
Other Primary Products	6.8	17.0
Manufactured Goods	2.0	-4.1
Other	10.5	-29.1
Total Exports	1.4	5.9

Zealand's traditional pastoral exporting sector. Overall the prices which are currently being received have not been sufficient to hold current farm expenditures at a level which will maintain productive capacity in the sector, and new investment has been sharply cut. The prospect in the immediate future must therefore be for stagnant or declining pastoral exports, although it may be some time before this is fully apparent in the export volume figures.

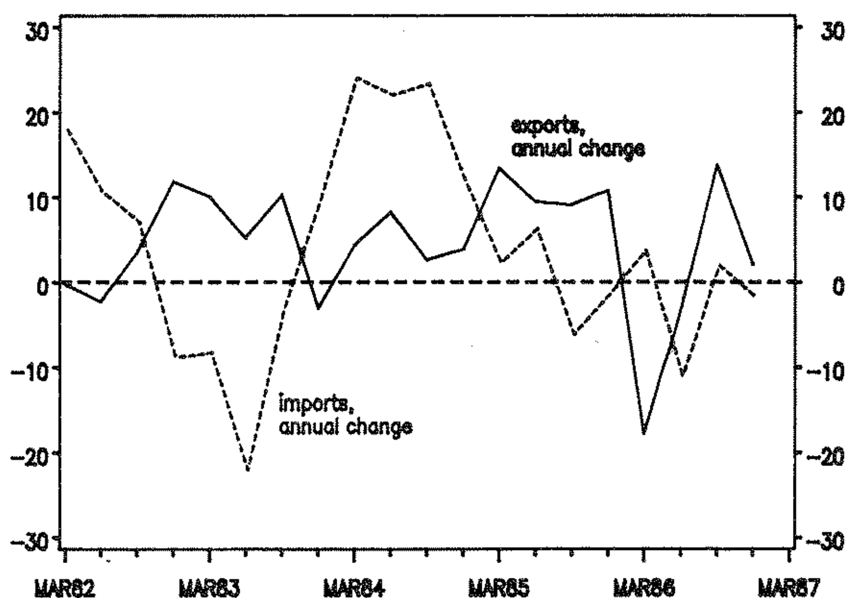
Lags in the response to lower profitability in the manufacturing sector are typically much shorter. While there were earlier indications that manufacturers were prepared to maintain trade with established markets despite less favourable prices, a lengthy period of strength for the New Zealand dollar against the Australian dollar, the phasing out of export incentives and lower demand in the key Australian market resulted in a significant decline in manufactured exports. Manufacturing export volumes fell by 8 per cent in the first three quarters of 1986/87 and while the full year outcome is not expected to show as steep a decline it will clearly remain negative. On the positive side very strong volume growth, perhaps as high as 17 per cent, was recorded by the 'other primary' sector reflecting the movement of more kiwifruit and apple orchards into a mature production phase, and an increase in offshore fish quotas together with favourable export prices for the export fish catch.

On the other side of the ledger, import volumes appear to have declined by about 4 per cent over the year. It should be noted, however, that the total figures tend to overstate the rate at which falling import demand has contributed to a sustainable improvement in the underlying current account balance. Imports associated with the major projects and other large 'one-off' items fell sharply from the previous year's levels but the 'base load' import volume, which more closely reflects underlying demand conditions, appears to have remained relatively flat.

Meanwhile the influence of movements in prices on the external balance was generally favourable. Export prices for meat and dairy producers generally remained depressed but wool prices increased significantly and prices for fish, horticultural and forest products were reasonably strong. The low rate of inflation in the international economy also meant that prices for many import items have been essentially stable. With the cost of oil imports falling by half, import prices fell overall and contributed to a steady improvement in the terms of trade from a low index level of 71 at the beginning of the year to 74 in the December 1986 quarter.

As noted, partially offsetting the improving trade deficit has been a further moderate deterioration of the invisibles deficit. Although receipts for exports of services rose strongly (mainly reflecting the growth of the New Zealand tourist industry) they were more than offset by the increase

Figure 2
Export and Import Volumes
Annual Averages



in service payments. Discount airfares and a strong New Zealand dollar produced a countervailing outward tourist flow of New Zealanders.

In marked contrast to most earlier years the deficit on investment income recorded only a moderate rise despite the further deterioration in New Zealand's net external wealth position implied by the current account deficit. Three factors appear to be responsible for this outcome. First there has been a major realignment of exchange rates on international markets with a substantial fall in the US dollar. Since about half of New Zealand's external debt is denominated in US dollars, the result has been a reduction in the New Zealand dollar cost of servicing that debt.

Secondly, there has been, until very recently, a downward trend in international interest rates. Although details are not available it is believed that a large proportion of private sector overseas debt carries a floating rate; thus existing as well as new borrowers have benefited from the interest rate decline. In addition a significant amount of official debt with fixed interest rates has been refinanced to take advantage of the lower rates.

Thirdly, there is the possibility of some understatement of total interest payments because of under-reporting. The same problem arises with interest receipts on New Zealanders' overseas assets, but it is likely that the absolute level of any under-reporting is greater on the payments side.

Summary of Developments, and Short Term Outlook

To summarise developments in the external accounts over the last year, there has been a substantial fall (equivalent to three per cent of GDP) in the current account deficit but it would appear that much of the improvement, perhaps as much as half, was due to 'one-off' factors which will not continue to contribute to a trend reduction in the deficit. In the immediate future prospects for further significant improvement are therefore limited. With the productive capacity of the traditional pastoral sector stationary or declining, and with the pressure placed on manufacturing exports by the strong New Zealand dollar, vis-a-vis the currencies of their main markets, little or no growth is expected in export volumes this year, reflecting the artificially high 1986/87 base. While forestry and horticulture should make significant contributions in 1988/89, the overall increase is expected to be moderate, say about 3 per cent.

The prospect of any marked improvement in the terms of trade appears remote, though a slight improvement is expected for 1987/88 and 1988/89. The world economy is now in a mature phase of its growth cycle and there is unlikely to be a general demand-driven increase in the relative prices of primary products. Although some welcome moves have been made in the EEC and US to reduce agricultural stockpiles and resolve the problem of excess production which has depressed prices on the international market, this process of reform is likely to be a slow one and there appears little prospect of a substantial improvement in returns in the short term. A positive effect of reduced New Zealand agricultural production will, however, mean less reliance on 'disposal' markets, and in some cases, upward pressure on market-wide prices. The impact on the terms of trade will, however, be largely offset by increasing oil prices (relative to last year's average levels).

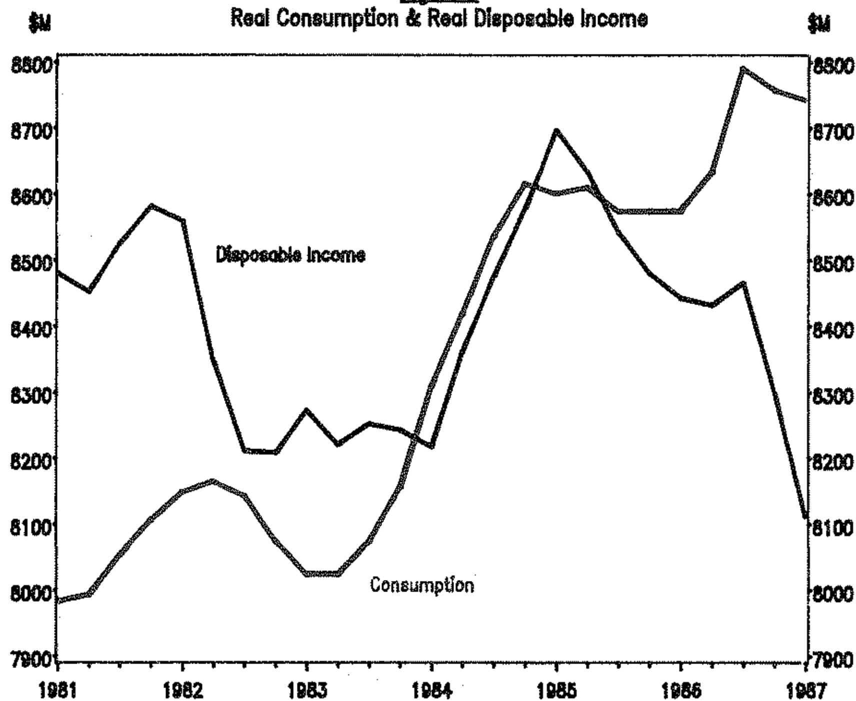
On the debt servicing side, the slide in international interest rates appears to have been halted, and indeed partially reversed. Further, another fall in the US dollar on the scale of recent experience is unlikely. Debt servicing costs are therefore likely to rise in line with New Zealand's accumulating stock of debt.

Commentary and Analysis

On the basis of the factors discussed in previous sections, the May 1987 Reserve Bank econometric forecast is predicting current account deficits of $1.9 billion and $1.5 billion for the March 1988 and 1989 years respectively. These outcomes are, however, predicated on a flat real domestic economy. While output is expected to pick up gradually from a trough around the middle of this year, a further decline in investment is expected following last year's fall, while consumption is also expected to decline compared to the previous year's average. Import volumes are consequently expected to remain unchanged over the next two years.

If domestic expenditures prove to be stronger than forecast, imports would also be stronger and the expected decline in the current account deficit would be less likely. Consumption expenditures in particular have proved to be unexpectedly resilient in the face of high interest rates and declining real disposable household incomes over the last year (refer Figure 3). At the time of writing there appeared to be surprisingly little evidence of the anticipated downturn in consumer spending. A fall from exceptionally high spending levels in the immediate pre-GST period was to be expected and did occur in the December quarter, but consumption now appears to be running at least as high as year earlier levels. Real retail trade (excluding the automotive sector) for the March quarter increased by 2 per cent over the corresponding quarter last year and new car registrations have also risen although off a low base. Perhaps reflecting this demand, forward import orders have also picked up: in the three months to January 1987 forward import orders were 20 per cent above last year's level.

Nevertheless, while the fall in real consumption expenditures has yet to materialise, on the basis of no significant further dissaving (i.e. borrowing in order to consume now rather than later) by the household sector in New Zealand, the Bank expects real consumption levels to fall. Thus, while it is too early to conjecture about the longer term path of the current account, the expected on-



going nature of the external deficit in the face of two years of weak domestic demand raises the question of how long it will take the current mix of policies to produce sustainable current account outcomes which are consistent with reasonably strong economic growth.

In order to address this question it is useful to review the main elements of the policy framework which is being applied to external balance issues.

New Zealand has experienced persistent and often large current account deficits since the mid-1970s, and a range of policies have been directed to overcoming this problem. For example, restrictive demand policies were applied from time to time to reduce imports; a range of export incentives have been provided to encourage export growth; and import substitution schemes — the energy related think big projects in particular —were introduced, directed at reducing specific categories of imports.

In the event these policies did not prevent a persistent accumulation of debt, in part because the restrictive demand policies were not applied consistently but primarily because policies were directed at improving one part of the external balance (such as exports) without being accompanied by the appropriate domestic policies which were required if persistent external imbalances were to be corrected. Such imbalances reflect the net financial deficits of the business, government, and household sectors: unless those are addressed, the current account deficit will persist. Indeed, rather than improving the current account situation, it is probable that some of the past strategies may have worsened it. The various incentives for land development and SMP's which were both intended to increase or maintain pastoral exports are a relevant example. The aim of raising the volume of exports was achieved (although much of the marginal production was sold at disposal prices) but at a heavy fiscal cost which ultimately contributed to pressures for the current account to worsen. As the Government was previously the residual financer of balance of payments deficits under the fixed exchange rate regime, such incentives eventually led to a sharp rise in the Government's external debt servicing load.

The current policy involves the government moving to correct its own imbalance, by reducing the fiscal deficit, and relying on the market mechanism to motivate balance in the private sector. Market prices are intended to determine the mix of investment, production and consumption; the real exchange rate to determine the mix between the production of tradeables and non-tradeables; and the interest rate to regulate the extent to which the private sector will fund its investment and consumption from borrowing. With flexible interest rates it is intended that businesses and households will bear the full cost of that borrowing and have an incentive to ensure that any debt servicing load is consistent with their expected future incomes. Allowing market prices to reflect underlying resource costs therefore should produce a natural balance sheet constraint against the accumulation of 'excessive' debt.

At the same time a tight monetary policy is employed against the economy's other major macroeconomic imbalance — inflation — by increasing real interest rates and reducing domestic demand. To the extent that higher interest rates increase national savings the natural tendency for the current account to improve is accelerated.

While we do not have the full income and expenditure data which give a precise and comprehensive accounting of how each sector has contributed to recent changes in the current account balance, and therefore is 'responsible' for the ongoing external deficit, there is sufficient evidence to give a general picture of the more significant developments.

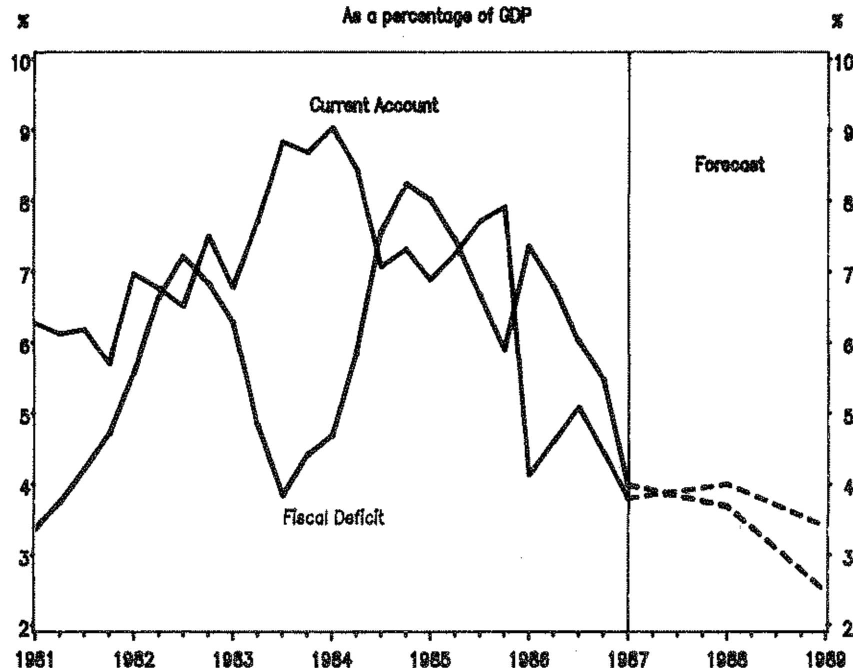
Superficially it could appear that the government's fiscal deficit almost totally explains the level of and movements in the current account deficit. The size of the current account and fiscal deficits (at $2.1 and $1.9 billion respectively) and the extent of the improvement since 1984-85 (both down from over $3 billion) make the

link appear fairly strong, but it would be a mistake to assume that there is a one-to-one link between the two. First, a fiscal deficit has to be funded, and to the extent that a rise in the deficit increases interest rates and reduces private expenditures there will not be a commensurate rise in the external deficit. Second, and most importantly, the conventional measures of the fiscal and external deficits do not portray appropriate and comparable pictures of the government's internal and the country's external deficits. What is important in an analysis of expenditure and income imbalances (and of debt accumulation) is real, not nominal, deficits. However, both the fiscal and current account measures include the inflation premium component of interest as an expenditure item when in economic terms this should be placed 'below the line' as a capital repayment.

If both deficits were inflation adjusted[1] then the 1986/87 fiscal deficit would fall quite sharply to perhaps 1 per cent of GDP, while the adjustment to the current deficit would be much smaller, in real terms probably remaining around 3 per cent of GDP. The reason for the difference in the size of the respective inflation adjustments is that a large part of the government's net debt is in New Zealand dollars. Because of New Zealand's relatively high inflation rate the inflation adjustments to the government's interest flows are also correspondingly high. On the other hand the officially recorded external debt of the private and public sectors is nearly all denominated in low inflation currencies and the inflation premium component of the interest payments in the current account are correspondingly small.

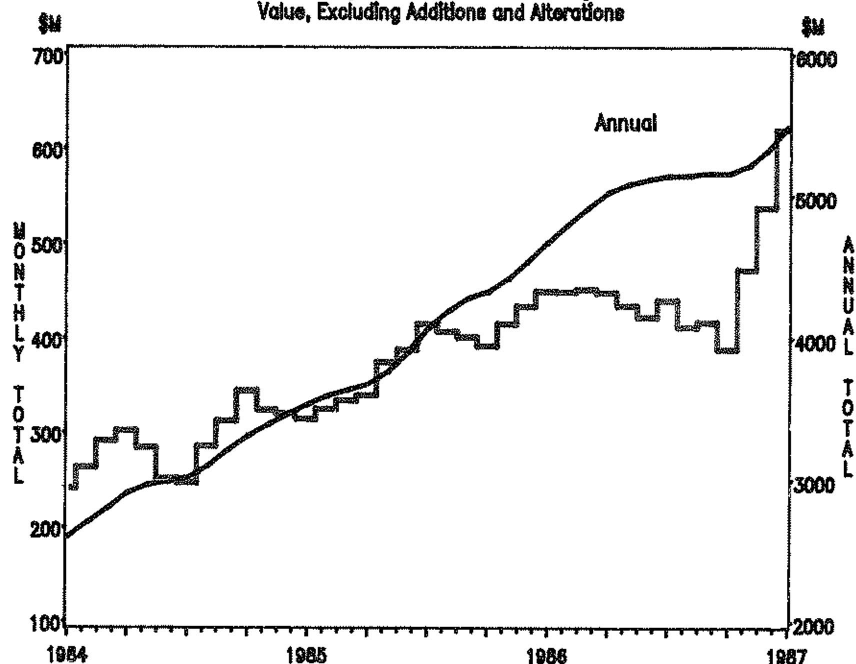
1 For a discussion of inflation adjusted fiscal deficit refer to the December 1986 *Bulletin* article 'Interpreting the Fiscal Deficit'.

While the real fiscal deficit is relatively low, this does not imply that the deficit is an unimportant factor in the analysis of the causes of current account imbalances. Historically the fiscal deficit has been the major reason for sustained current account imbalances, and the fall in the real fiscal deficit over the last two years almost certainly has been a factor in the reduction in the current account deficit which has become more obvious over the last year. What an analysis of the respective real deficits does point to is the possibility that part of the explanation for the ongoing current account deficit lies with developments in the business and household sectors.



Overall, it is likely that business investment fell last year although there was a diversity of experience in the different sectors. Farm investment fell sharply and the Statistics Department's survey of fixed capital investment in manufacturing and distribution recorded nominal falls of 10 and 25 per cent respectively (implying considerably larger real falls). The major exception has been investment in commercial office buildings in the main centres, and to a lesser extent tourist accommodation, which was strong throughout 1986/87. Based on building permit figures issued in the three months to March (which were 55 per cent above the previous year's figures) the boom has continued (refer Figure 5). Both demand and supply factors have played a role. Deregulation of the financial sector has increased the uptake of space from new and expanding clients while there has probably also been a tendency for existing tenants to update accommodation. On the supply side, full deductibility of interest payments on the relevant borrowings has meant that the effective real cost of borrowing has been low. To what degree the implicit tax subsidy on interest has encouraged excessive investment in the commercial office sector is, however, difficult to establish. Although probably significant, it was not likely to have been the major factor in maintaining activity.

Turning to the household sector, interest rates do appear to have had an effect in dampening the demand for residential dwellings although pre-GST spending provided a temporary boost in mid-1986. However, as noted, consumption expenditures have been unexpectedly strong. While it appears that the Reserve Bank's measure of real household disposable incomes fell by at least 3 per cent in 1986/87, consumption is estimated to have risen by about 2 per cent.



Rather than rising in response to high real interest rates, household savings actually fell.

A number of factors help explain this development. First, the introduction of GST provided very strong incentives for households to bring forward purchases of previously non-taxed items. Secondly, financial deregulation has given households greater access to borrowed funds (both onshore and offshore), allowing more rapid accumulation of consumer durables than previously. This is a temporary stock adjustment process which, while underway, will reduce the current level of savings. Thirdly, the sharp rise of the sharemarket last year increased the wealth of households which own shares. Such wealth increases can motivate spending. Finally, the counterpart to the favourable tax treatment of corporate borrowers is that lenders are over-taxed when there is inflation. Even with interest rates of 20 per cent, the real after tax rate of return to savers facing the top margin tax rate is close to zero. The incentive for households to increase their savings is therefore much lower than that implied by nominal interest rates alone.

Although monetary policy has not yet reduced real consumer demand (although it would have helped restrain the rate of increase) it has nevertheless had a significant influence on domestic activity through its effects on the exchange rate. In common with several other countries which have gone through the disinflationary process, tight monetary conditions in New Zealand have been associated with an appreciation of the real exchange rate, which, while not of the magnitude of the appreciations experienced by the United Kingdom and the United States, has nevertheless been significant. When calculated using movements in the relative GDP deflators it appears that the real exchange rate has moved up by around 10–15 per cent since immediately after the July 1984 devaluation. Further, if allowance were made for the faster rate at which the various subsidies and incentives which previously compensated for an overvalued exchange rate have been abolished compared with the rate of removal of import protection, the adverse effect on the relative profitability of exporting is even more pronounced.

It should be noted that the average exchange rate movement obscures rather diverse experiences with respect to different currencies. There have been quite large real depreciations against the yen and the Deutschmark, aiding exporters selling products whose prices are set in those markets. On the other hand manufacturers, a large proportion of whose exports go to the United States and Australia, have experienced a much larger real appreciation than the average.

Overall, though, it is clear that exporters' profitability has fallen, and with it investment and employment growth. Much of this was inevitable as producers diversified away from sectors and products which were previously made profitable only by subsidies. Nevertheless, an appreciation in the real exchange rate over its likely medium-term trend level will adversely impact on the incentives for resources to be attracted into alternative international trading activities. The strength of the New Zealand dollar has, however, placed a considerable degree of pressure on inflation both directly, because it has held down the prices of the importables and exportables which enter into domestic price indices, and indirectly because reduced profitability in the export sector was a significant factor in the sharp reduction in the average level of settlements in the last wage round.

It is by no means certain that the pressure on the domestic rate of inflation and on the profitability of the internationally traded goods sector arising out of the strong exchange rate can be maintained. Other things being equal, a high real exchange rate is likely to depress real incomes which in turn is likely to discourage saving as people try to maintain at least for a time their earlier consumption levels. As a result the current account deficit is more likely to hold up, potentially generating concerns about the viability of a further expansion in New Zealand's external debt which could eventually result in a slackening of the inward flow of capital and a fall in the exchange rate. Because of the

way expectations work in financial markets, this adjustment is likely to occur well before the debt servicing becomes unsustainable. With a floating exchange rate there is in a sense therefore a mechanism that will act to correct a persistently overvalued exchange rate. Whether, when, and to what extent, concerns about balance of payments deficits might outweigh the counter attraction of high New Zealand dollar interest rates is impossible to predict, as it will depend in large part on the international capital market's perception of the quality of economic management as much as objective measures of indebtedness.

While a possibility, the risk of a significant fall in the exchange rate should not be overstated. While New Zealand's large outstanding stock of external debt makes further progress in reducing and indeed reversing the current account deficit desirable, the fact remains that there has been a large improvement in the deficit and the forecast deficit for 1988/89 is only 2.5 per cent of GDP. Moreover, as noted, the extent of appreciation of the real exchange rate seen in New Zealand is less than that experienced elsewhere during similar disinflation phases. In this light, deficits of the magnitude of the present New Zealand current account deficit, while not necessarily desirable, are probably not unsustainable.

Summary and Conclusion

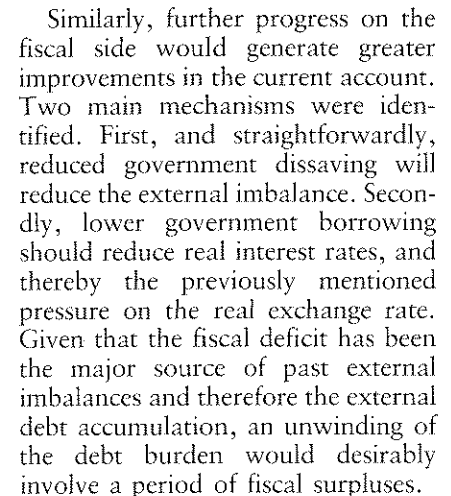
This article has reviewed recent trends in New Zealand's balance of payments, in particular from the perspective of distinguishing fundamental from short-term explanations of the marked improvement in the current account balance. The economic analysis of events has included both an examination of specific factors likely to be important in determining the near-term path of major import and export categories, and an evaluation of developments in terms of the savings, investment and consumption interaction of all sectors of the economy.

The broad picture painted is consistent with an ongoing balance of payments deficit produced by a reduction in the fiscal deficit (especially if appropriately measured) largely offset by a marked increase in household consumption. The recent decline in the current account deficit can be thought of in part as the product of specific reductions in the government's use of other people's (including foreigners') savings to finance major project investments and other activity, and in part as the result of a less than complete increase in the private sector's use of other people's savings to maintain consumption. The private sector has simultaneously decreased its call on others' savings to finance investment, except notably in relation to commercial buildings.

Prices are the mechanism by which consumption, savings and investment developments are integrated across the various sectors of the economy. Two of the more pervasive and important prices were discussed. Real interest rates at first sight have increased to provide motivation for all sectors of the economy to switch from expenditure to savings, thereby decreasing their call on foreigners' savings, i.e. thereby reducing the current account deficit. The developments described in relation to consumption do not yet fit with this characterisation, a feature of recent economic developments which is probably attributable to the impact of the tax system and regulatory reforms which have increased households' access to credit markets.

Secondly, the real exchange rate, in a pattern similar to that seen with previous international examples of disinflationary policies, has been strong. The consequences of this include more rapid progress on the inflation front than otherwise, but at the expense of making more difficult the competitive situation of New Zealand producers of internationally tradeable goods and services.

The outlook for the next few years largely depends on progress on these fronts. The strength of household consumption may be part of a stock adjustment process, which will reach a natural end. Reinforcing this, continued progress in reducing inflation may, due to the workings of the tax system, increase the real incentives for households to forgo consumption and increase savings. This combination of influences would act to further reduce the current account deficit, and this is substantially the basis for the Reserve Bank's prediction of a fall in the deficit to 2.5 per cent of GDP by March 1989.



Similarly, further progress on the fiscal side would generate greater improvements in the current account. Two main mechanisms were identified. First, and straightforwardly, reduced government dissaving will reduce the external imbalance. Secondly, lower government borrowing should reduce real interest rates, and thereby the previously mentioned pressure on the real exchange rate. Given that the fiscal deficit has been the major source of past external imbalances and therefore the external debt accumulation, an unwinding of the debt burden would desirably involve a period of fiscal surpluses.