AN OVERVIEW OF BALANCE OF PAYMENTS POLICY[1]

In twenty-one of the past twenty-eight years New Zealand has experienced current account deficits in the balance of payments.[2] In other words, in these years, more was spent on imports and overseas services than was earned in receipts for exported goods and services. When New Zealand's major economic objectives are discussed, the need for a manageable balance of payments position and an acceptable level of overseas reserves are invariably high on the list of desirable aims. In analysing the country's economic problems, and possible solutions to them, the external position is usually seen as one of the major constraints on the ability to manoeuvre the economy towards a higher rate of economic growth. Nevertheless, despite the emphasis given to the balance of payments in much of the policy debate, New Zealand's external difficulties have not only persisted over a lengthy period but on average worsened substantially during the 1970's

In part, the persistence of the overseas deficit can be explained by the fact that Government is anxious to pursue a number of other competing economic objectives, including the desire to achieve a reasonable rate of growth, to reduce the rate of inflation and desirably to achieve price stability, and to promote an efficient and full utilisation of resources which implies also a wish to avoid unemployment. By way of providing some historical perspective, table 1 sets out various measures of these major economic objectives. The dilemma which faces Government can be readily seen by noting the very sharp increase in the balance of payments deficit which occurred in 1974/75, a deficit which has been reduced in more recent periods but is still running at around 5 percent of GNP. The table also shows the acceleration in the rate of inflation during the 1970's; the emergence of unemployment as a major problem in the last few years; and the more erratic rates of economic growth which have been recorded in the second half of the 1970's.

THE ORIGINS OF THE PROBLEM

The present balance of payments current account deficit, although significantly reduced on the figures of several years ago, remains both substantial and worrisome. Estimates for the 1979/80 March year suggest a figure in the region of $1,000 million or about 5 percent of GNP. On an overseas exchange transactions basis, the latest comparable current account deficit was close to $532 million, for the year ended June, 1980.

1 This paper is a modified and updated version of addresses given to the Cost and Management Accounting Division of the New Zealand Society of Accountants at Massey University, Palmerston North, May 1978, and to a series of seminars run by the New Zealand Society of Accountants as part of their continuing education programme in Auckland, Wellington, Christchurch, and Dunedin in October 1979. These addresses were given by Dr R.S. Deane, Chief Economist of the Reserve Bank of New Zealand.

2 The Government Statistician's balance of payments figures should be distinguished from the 'cash flow' overseas exchange transactions data prepared by the Reserve Bank. The coverage of the former is more complete, incorporating both cash and non-cash (accrual type) transactions. On the basis of March year balance of payments statistics, current account surpluses were achieved in 1953/54, 59/60, 68/69, 69/70, 72/73; in all other years between 1952/53 and 1979/80 inclusive, deficits were recorded.

It is rarely possible to attribute a balance of payments current account deficit to any one single cause. In the simplest sense such a deficit reflects a situation where aggregate demand exceeds aggregate supply for the domestic economy as a whole. One of the consequences of this is likely to be that import payments will exceed export receipts (the other major consequence is, of course, that higher domestic inflation will result). While this truism hints at possible ways in which a deficit problem may be resolved — by reducing the demand for imports or increasing the supply of exports — it really masks what may be a rather complex interaction of several factors in contributing to a country's external difficulties during any particular period.

For example, two rather fundamental difficulties have been with New Zealand for some time: until recently, a lengthy period of relatively stagnant farm production; and widespread problems of access to export markets. In fact, during most of the 1970's the volume of traditional agricultural exports (which still comprise about 70 percent of total exports) remained almost static on average, despite some year to year fluctuations. This compares with an average of about 3 percent annual growth achieved in the 1960's. The market access problems are well known. They were highlighted by the United Kingdom's entry into the E.E.C. but restrictions are prevalent also in other major markets such as the United States and Japan. In the last few years, E.E.C. restrictions have particularly affected the export of butter and cheese to the United Kingdom with lamb currently under threat.

There are also difficulties which arise from sharp, and often sudden, fluctuations in New Zealand's terms of trade, or the ratio of export prices to import prices. Prior to the 1970's, the terms of trade tended to move in sympathy with fluctuations in export prices for primary products since up to that time import prices exhibited relative stability. In more recent times, however, import prices have shown much higher rates of increase, reflecting both the emergence of higher inflation rates abroad and special factors such as the large oil price changes. The scope for potential movements in the terms of trade was well illustrated in the 1974/75 period when they fell by about one third within the space of a year or so.

Superimposed on this problem are pressures arising from changes in New Zealand's domestic policies and especially those related to demand management. For instance in late 1977 through to mid-1978, despite a large external current account deficit, monetary and fiscal policies tended to be expansionary in order to lift the economy out of a recession and to ease the problem of rapidly rising unemployment. Not surprisingly, the demand for imports was greatly stimulated and these rose substantially in 1979/80, a year in which import prices are also increased sharply reflecting higher rates of inflation abroad and the effects of devaluation by New Zealand. Accordingly, despite much improved export prices and reasonable increases in export volumes, the balance of payments current account deteriorated significantly in 1979/80 as compared with the previous year. On the import side, the increased cost of oil imports, while an important consideration, was by no means the only factor underlying this situation. The

TABLE 1
Measures of Economic Policy Objectives

Year ended March	*Real GNP $m. (1965/66 prices)*	*Unemployment**	*Consumer Price Index Base: 1965 = 1.000*	*B.O.P. Current Account Surplus (+)/ Deficit $m.*	*Real GNP Annual % Change*	*Unemployment % of Total Labour Force*	*Consumers' Price Index Annual % Change*	*B.O.P. Account Surplus (+)/ Deficit as % of GNP (Current Prices)*
1960	2,851	1,122	0.872	80.6	4.2	0.13	2.13	3.27
1961	3,005	513	0.880	- 109.1	5.4	0.06	0.92	- 4.12
1962	3,113	498	0.899	- 112.5	3.6	0.06	2.16	- 4.09
1963	3,195	1,146	0.921	- 46.1	2.6	0.12	2.45	- 1.56
1964	3,399	769	0.940	- 30.4	6.4	0.08	2.06	- 0.94
1965	3,596	659	0.978	- 37.0	5.8	0.07	4.04	- 1.05
1966	3,823	593	1.007	- 179.2	6.3	0.06	2.97	- 4.69
1967	3,958	608	1.039	- 160.2	3.5	0.06	3.18	- 4.03
1968	3,936	7,315	1.104	- 83.4	-0.6	0.70	6.26	- 2.02
1969	4,000	7,118	1.152	48.6	1.6	0.68	4.35	1.12
1970	4,194	2,648	1.207	29.6	4.9	0.25	4.77	0.62
1971	4,380	1,666	1.303	- 198.2	4.4	0.15	7.95	- 3.58
1972	4,500	4,885	1.432	- 15.6	2.7	0.44	9.90	- 0.24
1973	4,679	7,073	1.522	138.8	4.0	0.63	6.28	1.85
1974	5,018	2,277	1.663	- 91.5	7.2	0.20	9.26	- 1.05
1975	5,230	2,103	1.860	-1,364.4	4.2	0.18	11.85	-14.44
1976	5,274	9,632	2.151	-1,015.6	0.8	0.80	15.65	- 9.31
1977	5,228	11,887	2.495	- 831.5	-0.9	0.98	15.99	- 6.50
1978	5,076+	21,230	2.860	- 715.8	-2.9+	1.73+	14.43	- 5.11+
1979	5,203+	47,810	3.172	- 483.0	2.5+	3.87+	10.91	- 3.03+
1980	5,359+	50,627	3.671	- 987.0	3.0+		15.73	- 5.25+

* Includes workers employed on Special Government Employment Programmes (from 1966)
\+ Estimate.

TABLE 2
Movements in Exports and Imports

Year Ended March	*Export Volume*	*Annual Percentage Changes* *Export Prices*	*Import Volume*	*Import Prices*	*B.O.P. Current Account Balance $m.*	*Annual Percentage Change in Real GNP**
1960	+ 9.7	+ 15.3	- 5.8	- 1.8	80.6	
1961	- 7.4	- 7.1	+ 21.7	+ 1.2	- 109.1	+ 5.4
1962	+ 10.0	- 4.1	+ 0.1	- 0.1	- 112.5	+ 3.6
1963	- 1.3	+ 4.4	- 2.9	- 2.3	- 46.1	+ 2.6
1964	+ 11.8	+ 12.3	+ 18.4	+ 1.1	- 30.4	+ 6.4
1965	- 1.7	+ 3.8	+ 3.1	+ 1.4	- 37.0	+ 5.8
1966	+ 1.8	- 3.1	+ 10.7	- 0.3	- 161.5	+ 6.3
1967	+ 2.7	- 2.4	+ 2.4	+ 0.3	- 144.9	+ 3.5
1968	+ 5.3	- 7.5	- 18.1	+ 6.0	- 91.4	- 0.6
1969	+ 16.6	+ 10.3	+ 2.8	+ 13.9	- 12.8	+ 1.6
1970	+ 5.9	+ 4.4	+ 7.6	+ 3.7	3.2	+ 4.9
1971	- 2.8	+ 0.9	+ 18.0	+ 7.6	- 198.2	+ 4.4
1972	+ 6.4	+ 12.9	- 0.4	+ 4.2	- 15.6	+ 2.7
1973	+ 4.1	+ 23.0	+ 4.1	+ 5.0	138.8	+ 4.0
1974	- 8.3	+ 22.0	+ 23.9	+ 6.2	- 91.5	+ 7.2
1975	- 8.3	- 6.8	+ 19.1	+ 35.0	- 1,364.4	+ 4.2
1976	+ 13.8	+ 9.6	- 22.6	+ 28.4	- 1,015.6	+ 0.8
1977	+ 16.6	+ 30.3	+ 1.4	+ 20.1	- 831.5	- 0.9
1978	- 0.1	+ 8.1	- 7.0	+ 6.7	- 715.8	- 2.0+
1979	+ 4.2p	+ 10.4p	- 0.5p	+ 5.5p	- 482.5p	+ 2.5+
1980		+ 23.9p		+ 17.8p	- 987.0p	

* Real GNP $m (1965/66 prices)
\+ Estimates.
p Provisional.

general expansion of economic activity from the second half of 1978 through 1979 was associated with a strong rise in non-oil imports which did not show signs of easing until well into 1980.

Table 2 further illustrates the importance of fluctuations in export and import volumes and prices, by setting out the percentage changes in these variables over the past two decades. It can be seen that export volume growth has been erratic, but not nearly as much so as the fluctuations in export prices which have moved both up and down by significant percentages. On the import side, the table shows the relative stability of import prices for a long period during the 1960's, and the acceleration in the rate of increase of import prices which occurred during the 1970's particularly in the middle of that decade. Import volumes have also moved rather erratically although in this case the rises tend to be associated with period of relatively strong domestic economic growth, as illustrated by a comparison of movements in import volumes with the annual percentage changes in real gross national product (shown in the final column of table 2). It should be noted that there can be significant lags in this process.

As far as the other items in table 2 are concerned, export volumes tend to depend on a number of factors including the level of overseas prices and demand generally in New Zealand's trading partners, and on domestic weather and other supply conditions such as livestock numbers, stocks of primary commodities held in store, etc. For most New Zealand exporters, their overseas prices depend on demand and supply conditions in foreign markets, a situation over which New Zealand has little influence in most cases. Similarly, import prices tend to depend on rates of inflation in overseas countries. Another factor which will affect export and import prices in domestic currency terms is the exchange rate.

In summary, a current account deficit reflects an excess of aggregate domestic demand over aggregate domestic supply. Such an excess may arise from inflationary pressures generally within the economy (and in this respect monetary and fiscal policies may play either a contractionary or an expansionary role), or may be associated with, say, a sharp deterioration in the terms of trade (falling export prices, rising import prices), problems of access to markets abroad, and difficulties in obtaining increases in export production. Obviously, these factors may be closely correlated.

POLICY ALTERNATIVES

Given this brief and simplified sketch of the considerations which may underlie an external current account deficit, the broad policy alternatives which are open to a country to cope with the problem are as follows:

(1) Reserves Management

In many countries the usual response to a short run balance of payments problem, and especially one which may initially seem to be of simply a cyclical or even a seasonal nature, is to utilise existing overseas reserves and then borrow abroad. But there are obviously limits to these courses of action. On the one hand, reserves run out, and on the other hand, borrowing is a palliative but not a cure if it subsequently turns out that the external deficit is more persistent than was at first thought likely.

Indeed, if the problem emerges as one of a fundamental nature, as New Zealand's seems to be, borrowing may do little to achieve a re-structuring of the economy and an associated adjustment of the overseas deficit. It merely provides the time, and increasingly expensive time at that, in which to re-shape policies and achieve the necessary changes to cope with the situation.

Although New Zealand's credit rating still remains very favourable, it is a fact that the official overseas debt now exceeds $4,000 million and the country's debt service ratio is running at about 6 percent (i.e. the ratio of interest on official debt to total export receipts). The higher these figures become, the more difficult it is likely to be to continue to borrow on favourable terms in overseas capital markets. It is important for overseas lenders to be convinced that New Zealand is pursuing economic policies which will genuinely resolve the balance of payments problem in time.

(2)Direct Controls

An approach New Zealand has often turned to in the past, but one not favoured as much in more recent years, is resort to direct controls. These can take various forms: import licensing, exchange controls, quotas, and so on.

The real problem with controls of this sort is that they may do little or nothing to ease the underlying cause of the problem, which is essentially a desire to spend more abroad than is earned in overseas exchange. Neither does New Zealand's long history of a combination of import restrictions and overseas deficits do much to provide empirical support for the notion that controls actually solve the problem. Too often, they simply promote the illusion of a need for yet further controls. Beyond this, controls frequently protect inefficiency and promote misallocation of resources, to say nothing of the problems of a large bureaucracy administering them in an equitable manner not simply based on historical precedents.

As far as the protective affects of these measures are concerned, they have undoubtedly helped to promote additional domestic manufacturing activity. But this has involved the rest of the community affectively subsidising the protected industries (by, for example, paying a higher price for local as compared with imported goods, or suffering a reduced range of available goods). If this subsidy is eventually to yield a return to the community, the degree of protection should gradually be reduced as far as possible. This can be done much more readily by tariffs than import licensing, and such a policy would in time yield a more efficient, and hence internationally more competitive, industrial structure.

On direct controls then the lesson is twofold. First they do not solve balance of payments problems and through their misallocative effects they may actually aggravate such problems, especially in the longer run. Secondly, if these controls are to be used to protect and promote local industry, they should be used in such a way as to permit a gradual easing of the degree of protection over time. In a policy sense, this implies that New Zealand should be moving from a system of licensing to tariff protection more quickly than currently seems to be the case. About 25 percent of total imports are still subject to licensing[3], and there are some commodities which are completely barred from entry.

3 Or some other form of Government regulation, such as Government departments' imports.

(3) Foreign Investment

Private capital inflows assist the financing of an external deficit. If they take the form of direct foreign investment they may be of a relatively permanent nature, adding to the country's capital stock and future income flows. The host country's share in these income flows accrues mainly from the additional taxation receipts of Government and indirectly from what economists term the 'external economies', which is simply the gain in new skills and enhanced know-how.

Although New Zealand has a reasonably liberal attitude towards overseas investment, and does not in fact limit either profit remittance or capital repatriation, it is not clear that this generally accommodating attitude is as well known as it should be. This may be partly because New Zealanders are somewhat schizophrenic in their attitudes towards foreign capital; they wish to participate in the benefits of the capital inflow but are dubious about the implications for national sovereignty of too heavy reliance on overseas investment.

In 1979 the Government announced some liberalisation of policy with respect to overseas investment and this has been given appropriate publicity abroad. Given the major industrial projects which are scheduled to come on stream during the 1980's in such fields as energy, aluminium, forestry, steel and so on, it will clearly be necessary for overseas capital to participate in these projects. New Zealand will need both the additional capital which foreigners can provide and the technical assistance which is likely to accompany it (if the investment is of a direct type involving significant overseas shareholdings in the various enterprises).

If an acceptance of the economic gains of direct investment can be developed and policies adopted which minimise its costs, then there can be little doubt that this is one way in which the balance of payments can be assisted, not only in the sense of helping to finance the current account deficit, but also in the sense of facilitating the development of a more internationally competitive industrial structure. To do this, policies need to be pursued towards foreign investment which are not dissimilar to those which should be adopted with respect to local industry, including the avoidance of over-generous protection, the discouragement of monopolistic or collusive domestic marketing practices, and the encouragement of exporting by making this generally the most profitable activity available to the community.

(4) Domestic Demand Restraint

Domestic demand restraint by broad macro-economic policies in both the fiscal and monetary areas is probably generally regarded as the most fundamental way in which to tackle a balance of payments problem.

Essentially, as mentioned earlier, an external deficit represents an excess of total demand for goods and services over the available domestic supply. Such an excess in monetary demand may be reflected in two ways; the price of goods may increase to help equate supply with demand, and price inflation results; or the excess demand may spill over into the balance of payments, where payments for imports would exceed receipts from exports. This situation may arise either because domestic expenditures increase too rapidly relative to output capacity or it may emerge as a consequence partly of events beyond one's immediate control, such as a sharp fall in export prices and a decline in the terms of trade.

In either case, this analysis suggests that the remedy is twofold. On the one hand, domestic output and productivity should be increased, but in such a way as to promote exports and discourage imports. This is really a longer term structural response to the problem. If this is not done, the only alternative is to take the shorter term but less satisfactory route of reducing domestic expenditures. This latter course of action can be pursued by means of tight monetary, fiscal and incomes policies, and should help in three ways. It should reduce the demand for imports, release domestic production for exports, and ease domestic cost pressures (thereby protecting the competitiveness of export industries).

Appropriate macroeconomic policies designed to help reduce an overseas current account deficit can take various forms. For example, the demand for imports can be reduced by such fiscal measures as reduced government spending and higher taxes, which lower the community's disposable income. These moves would tend to reduce the government's budget deficit before borrowing which in turn would tend to dampen the growth of money and credit. Alternatively (or in addition to moves of this sort) monetary policy could be tightened by increased borrowing by government from the non-bank private sector which would also tend to reduce the money supply and hence dampen the community's ability to spend on imports (and, of course, also on domestic production). Increased borrowing by government can be achieved by higher interest rates on government securities or increased reserve ration requirements on the financial institutions. Incomes policies, which take a wide variety of forms but which are all essentially designed to moderate rises in incomes (and prices), can also be used to dampen domestic demand. There is much disagreement however about how effective income policies can really be, especially in the longer run, in over-riding the normal demand and supply pressures in labour markets.

But there are some major complications. Domestic demand restraint carries with it the implications of higher unemployment and reduced plant capacity utilisation. These problems are accentuated in a situation such as New Zealand's where the terms of trade decline in the mid-1970's was dramatic. They may be judged to be intolerable in the face of the size of the adjustment process required if the economy were to adapt rapidly to the external deficit.

Another difficulty with expenditure dampening moves is that although theoretically reduced demand for domestic output releases resources for export activities, higher export volumes will only result if overseas demand is sufficiently strong and if New Zealand's exchange rate is appropriate to encourage local producers to pursue exporting despite the slowdown in the domestic economy. Some exporters, especially in the manufacturing sector, argue that a firm and reliable domestic market base is really required to underpin the relatively more risky export trade. This argument may apply particularly in the early stages of developing an export market. Thus much may hinge on the adoption of an appropriate exchange rate, since this helps to determine just how profitable exporting is vis-a-vis other activities.

These considerations point to the importance of achieving the right mix of economic policies. Given that there is a range of economic objectives, of which a reasonable balance of payments position is only one, then there is a need to use a range of economic policy instruments.

In New Zealand the Government has basically chosen to endeavour to maintain a moderate level of domestic activity, which has nevertheless involved periods of significant fiscal and monetary restraint; to support the balance of payments by substantial continued overseas borrowing, mainly by Government; and to achieve a gradual adjustment to the external imbalance by use of the exchange rate and export incentives to encourage the growth of exports. More recently, attention has also turned to the important issue of easing the extent of protection in New Zealand in order to encourage the development of a more internationally competitive economic structure. The industry studies programme is an illustration of the moves in this direction.

(5) Resource Switching Policies

New Zealand has made considerable use of export incentives in the form of taxation concessions. A major rationalisation of the incentives system, involving a range of improvements, was announced in the 1979 Budget.

There can be no doubt that these incentives have encouraged both the growth and the diversification of the export base, especially in the manufacturing sector where an annual average rate of expansion of about 30 per cent in nominal terms was achieved during the decade of the 1970's. Nevertheless, there must be some doubts about just how much further taxation concessions could be pursued in this area, given the high implicit subsidy levels which already exist and bearing in mind the need for fiscal restraint. The budgetary cost of these incentives is very large in terms of taxation revenue foregone.

On the agricultural side, export incentives have also been used actively, such as in the form of free Government provided technical services, input subsidies (such as on fertiliser), the livestock incentive scheme, priority access to low cost Rural Bank and Reserve Bank finance, and farm income stabiliation schemes. These have taken various forms over the years, with a major contribution to farm confidence coming from the supplementary minimum price scheme introduced in 1978. This scheme runs alongside price smoothing arrangements operated by individual producer boards.[4]

However, over the medium to longer run the most powerful resource switching device is the exchange rate. An appropriate exchange rate, accompanied by firm fiscal and monetary policies to combat domestic inflation, ensures that the export sector remains profitable and confident of its ability to undertake expansion (indeed, it should be *the* most profitable and expansionist-minded sector); encourages new and alternative export activities that may not benefit as much from existing selective incentives, such as aspects of tourism and horticulture; and discourages spending on imports and overseas services such as travel abroad.

It has to be recognised that exchange rate changes may only effect export and import volumes over a considerable time period. The lags in the process can be lengthy, as a consideration of the livestock development cycle illustrates clearly. In the meantime, since exchange rate changes have an important influence on income distribution, those sectors which may feel that their relative positions have been eroded by a change will pursue claims to restore their previous positions. If they are successful, the benefits of any devaluation may be diminished, and the main outcome may be a higher rate of inflation. This is why exchange rate changes must be accompanied by appropriate settings of all the other macro-economic policy instruments.

The need for this sort of co-ordinated approach to a resource switching policy, involving use of the exchange rate, fiscal and monetary policy, protection policy, and incomes policy, cannot be too strongly emphasised. It is only by doing this that sufficient time can be gained for exchange rate changes to produce their benefits in the structural sense of promoting exports and discouraging imports.

In order to assure exporters that their profitability would not be eroded by differing rates of cost increases in New Zealand and abroad, a new flexible exchange rate system was introduced in the 1979 Budget. Under this arrangement the value of the New Zealand dollar in terms of the basket of currencies against which it is determined is adjusted by small amounts (each of less than half of one percent) at more frequent intervals than in the past. The adjustments are based primarily on a regular quarterly assessment of future changes in exporters' production costs within New Zealand relative to the rates of inflation likely to be recorded by the country's trading partners over each coming twelve month period. The difference between these relative rates of cost increases is then used to indicate the extent of any progressive adjustments needed to New Zealand's exchange rate.

Beyond this, if the terms of trade alter in such a way as to warrant a greater or lesser change in the exchange rate than that indicated by movements in relative prices, supplementary adjustments to the rate may be necessary to cope with these structural factors. Any such additional adjustments would also be incorporated into the 'small step' process, spread over time. In any event, changes warranted by structural alterations in the terms of trade are likely to be less than under the previous pegged rate system, given that the regular 'relative price' adjustments should do much to maintain the profitability of exporting.

On the other hand, primary product exporters will continue to suffer fluctuations in their incomes in local currency terms since prices for their exports may well change at rates different from the general rate of inflation. Thus there will continue to exist a need for effective farm income stabilisation schemes, to say nothing of the even more obvious need for an effective overall monetary policy.

It is also hoped that both exporters and importers, as well as companies borrowing abroad, will benefit from the now greatly extended forward exchange system which was announced at the time of the 1979 Budget.

In an effort to assist with the re-structuring of the economy, the Government has been giving increased attention to the encouragement and development of some major new industrial projects which it is hoped will be of an export generating or import substituting type. These include the range of projects in such areas as energy (especially gas), forestry, aluminium and steel. In the short run, during the early 1980's these projects are likely to add substantially to the demand for imports, since much of the capital equipment will come from overseas, and to the need for overseas borrowing.

4 A full description of the various types of farm income stabilisation schemes is contained in chapter 22 of *Monetary Policy and the New Zealand Financial System*, edited by R.S. Deane and P.W.E. Nicholl, Reserve Bank of New Zealand, Wellington, 1979.

Some of the projects will be financed partly by direct foreign investment in New Zealand. Over the longer haul, the projects should result in some savings on the import side (because, for example, a higher proportion of our energy requirements will be met from local resources) and an expansion of exports.

While such developments hold the promise of assisting the balance of payments position in the longer term it must be remembered that an external current account deficit basically reflects an excess of domestic expenditures over physical production. Accordingly, if New Zealand prices continue to rise faster than prices in overseas markets and incomes and spending continue to outstrip the country's productive capacity, the country will still be faced with balance of payments problems despite these large scale industrial projects. In other words, it would be naive to think that these developments will by themselves resolve New Zealand's external difficulties. It will still be necessary to pursue an appropriate mix of monetary, fiscal, incomes and exchange rate policies; and if this is not done the overseas deficits will persist in much the same way as they have over the past two decades.

The other important factor in determining New Zealand's longer run balance of payments situation will be the trend in the country's terms of trade. In this area, New Zealand is largely dependent on trends and policies in overseas markets. This sort of dependence, and the fact that the terms of trade can fluctuate sharply in relatively short periods of time, emphasises the need to turn attention more closely to the most fundamental way in which an overseas deficit problem can be resolved. That is by adopting attitudes and pursuing policies which will ensure that New Zealand's rate of inflation is lower than that prevailing in the countries with which we trade. Unless this is done, overseas deficits will continue and there will be a continuing need to devalue. If New Zealand's rate of inflation could be reduced below that of the rest of the world, then under the present exchange rate system revaluations would take place thus assisting further in a lowering of the rate of inflation.

CONCLUSION

In practice, in coping with an external deficit, a combination of policies will be pursued. This is as it should be. Government is faced with a range of economic objectives, of which the balance of payments is only one. Some trade-off between the various objectives is thus inevitable.

Nevertheless, the size and persistence of the balance of payments problem in recent years have resulted in considerable changes in policy. A comprehensive system of export incentives and farm income stabilisation arrangements have been developed. There has been a move to a flexible exchange rate system and a much improved forward exchange cover package. Foreign investment policy has been liberalised and some rationalisation of import licensing is taking place.

Taken together, these moves amount to a package of measures of considerable potential substance. They clearly need to be supplemented by stable fiscal and monetary policies, aimed particularly at reducing New Zealand's high inflation rate. Moreover, some of the policy moves are quite recent and will take time to become effective.

Despite the possible persistence of overseas deficits for some years to come, the policy instruments available to help cope with the balance of payments problems are now in better shape than has been the case in some past periods. This is not to say that the external constraint will in time disappear. But it does mean that New Zealand should be better placed to deal with it, providing there is a willingness to make appropriate use of the available range of instruments.