Reserve Bank Bulletin

QUARTERLY REVIEW OF THE NEW ZEALAND ECONOMY

The Government's firm monetary and fiscal policies are clearly having an impact of the New Zealand economy. Real Gross Domestic Product fell for the third successive quarter in March while the Consumers Price Index has continued to decline sharply. There is a general expectation that economic activity will reach a trough towards the end of 1986-early 1987 and thereafter recover throughout 1987.

Overview

With real Gross Domestic Product (GDP) falling for the third successive quarter in March and the annual rate of increase in the Consumers Price Index (CPI) continuing to decline, it is clear that the Government's firm monetary and fiscal policies are having an impact on the New Zealand economy. The firm monetary policy has been associated with sustained high interest rates which have affected some but not all areas of investment and interest-sensitive consumption expenditures; and a strong New Zealand dollar which has impacted on the exporting sector. The 1985/86 fiscal deficit was reduced to under \$1.9 billion through expenditure cuts and increased effective average tax rates which cut disposable incomes and further weakened demand. Also contributing to the downturn was a cyclical slowdown of the economy following two years of strong economic growth and the lagged effects of weak international commodity prices on the rural sector. The downturn in output has been quickly reflected in the labour market and unemployment has grown by 17 per cent in the four months since February.

On the positive side the strong Kiwi dollar and weaker domestic activity have had a significant effect on inflation. The CPI has fallen from a peak of 16.6 per cent over the year to June 1985 to 10.4 per cent over the year to June 1986.

Investment indicators remain mixed. The sharp falloff in dwelling permits issued in late 1985 and early 1986 points towards a fall in real dwelling investment over the first half of 1986. While significant falls are expected in investment in plant and machinery, leading indicators suggest that investment in buildings will be strong through 1986 and, if recent announcements of major property projects in the main centres are a guide, possibly for considerably longer. Recently, consumer spending appears to have been providing some strength to the economy. Retail trade appeared to have increased over April and May as the first signs of pre-GST spending started to emerge. Higher wages and salaries following the wage round and some sales tax cuts would also have stimulated spending.

While these positive factors imply some short-term buoyancy, a number of other variables will influence the future track of the economy. There may be a dip in consumption and housing construction after the introduction of GST, while its impact on inflationary expectations and hence the level of settlements in the forthcoming wage round is still unclear. A moderate level of settlements in this wage round is critical to further success in reducing inflation and vital to the health of the 'exposed' sectors of the economy which are already under considerable pressure. Excessive settlements in these areas will result in the laying-off of staff and, in the worst cases, the closure of businesses. The strength of the New Zealand dollar over the medium-term and the level of domestic cost increases will have a direct bearing on output in exporting industries. Evidence is emerging that some exporters are pulling out of markets and are no longer holding market share at the expense of profitability. A high wage round will accelerate that process. Due to the seasonal and biological lags in farming, the rural recession is not expected to decrease output for at least one or two years, but the current reduction in farm expenditure is already having a direct impact on the level of activity in rural towns and provincial cities throughout New Zealand and is being reflected in employment and rural investment statistics.

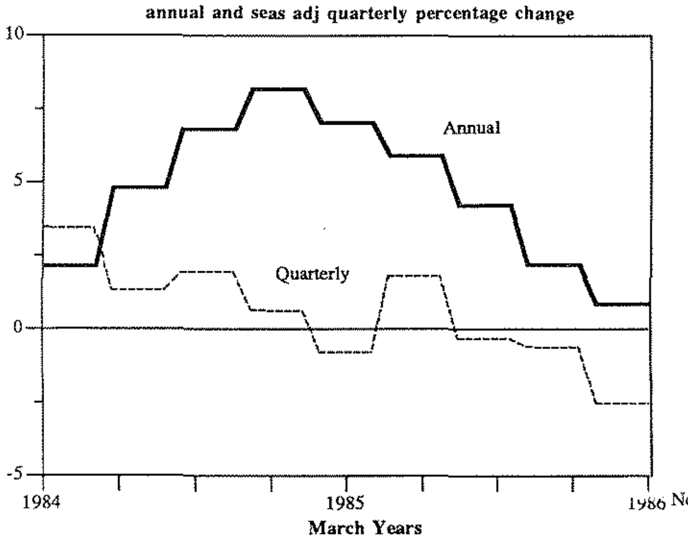
The short-term outlook is a mixed one and the future path of the economy will depend upon the relative influences of the variables discussed above. However, there seems to be a general expectation that, providing the wage round is moderate, the downturn in economic activity will reach a trough towards the end of 1986-early 1987 and that there will be gradual recovery during 1987.

Output

Real GDP (seasonally adjusted) fell 2.5 per cent in the March quarter following falls of 0.3 and 0.6 per cent in the September and December quarters of 1985. The decline in March reduced the annual increase to 0.9 per cent after strong growth of 7 per cent was recorded in the year to March 1985. Industrial action in the meat processing industry during March was largely responsible for the 7.3 per cent decline in the manufacturing group and is estimated to have contributed between 0.75 and 1 percentage points to the decline in the March quarter GDP.

The other major fall occurred in the construction industry where output fell 11.4 per cent over the quarter, with residential building activity in particular showing a large decrease. The only significant rise was recorded in the electricity, gas and water group while the other groups remained constant or declined.

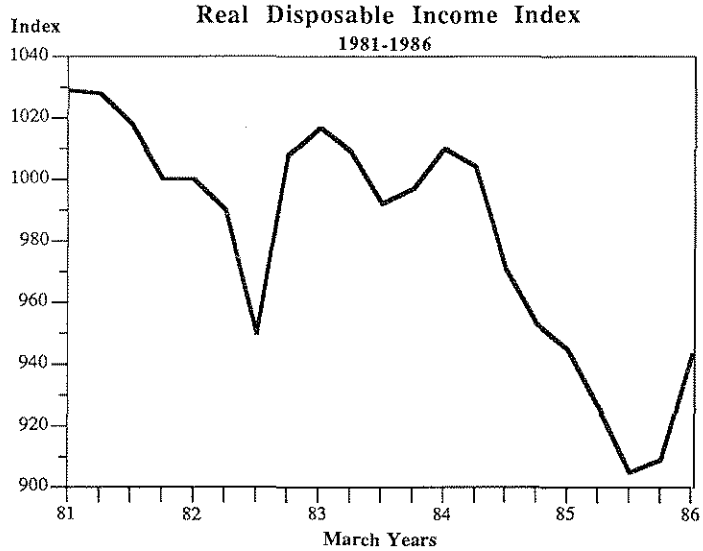
Real GDP
annual and seas adj quarterly percentage change



Incomes

As expected the impact of the December wage round fed strongly through into wage and salary earners' take home pay packets in the March quarter of 1986. Real average after-tax wage and salary incomes increased by 3.7 per cent after a 0.4 per cent increase in the December quarter of 1985. The rise resulted from a 7.6 per cent increase in average gross incomes which was partially offset by a 2.3 per cent increase in the CPI and a 3.9 per cent increase in average tax rates over the quarter. The consecutive increases in December and March did not offset falls of 2.3 and 2 per cent in the September and June 1985 quarters respectively, however, and resulted in a 0.2 per cent decline in real incomes over the year to March. The slight fall over the 1985/86 fiscal year is largely explained by an increase in the average tax rate from 27.4 per cent in March 1985 to 29.3 per cent in March 1986. Although actual tax rates were not increased, the sharp increase in wage and salary levels meant that there was a large fiscal drag effect. Although real after-tax salaries and wages were up 4.2 per cent from the low of September 1985, they were still 6.6 per cent below the level of March 1984.

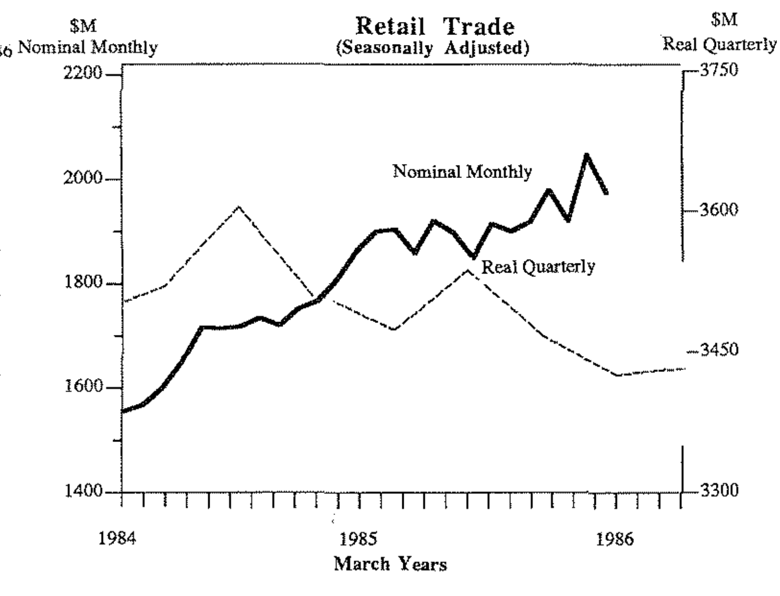
Real Disposable Income Index
1981-1986



Consumption

After declining over the second half of 1985, consumption expenditure flattened out in the March quarter of 1986 and appears to have picked up slightly during the June quarter. Real seasonally adjusted retail turnover in the March quarter increased by 0.2 per cent after declines of 1.3 and 2 per cent in the December and September 1985 quarters respectively. Seasonally adjusted nominal retail sales increased strongly by 6.6 per cent in April, but there was a 3.5 per cent decline in May. While the month-to-month volatility in the series suggests the data should be interpreted carefully there appeared to be some underlying strength in consumption expenditure during the June quarter.

Retail Trade
(Seasonally Adjusted)



This strength is probably explained by a combination of increased nominal incomes, the payment of sizeable backpays, the imminence of GST and significant sales tax cuts. More of the wage round appears to have fed through into consumption than was originally anticipated and the household savings ratio does not yet appear to be returning to its normal historical level after a fall in 1985. Demand for those goods and services which are most likely to be affected by GST was strong in both April and May. In particular, the furniture store group increased by 23.2 in April and 2.8 per cent in May, while the department and general store group increased by 12.3 per cent in April and the household appliances group by 4.6 per cent in May.

Stocks

A cautious attitude towards stock management over the last six months resulted in a further decline in the nominal value of retail stock levels during the March quarter. The 1.5 per cent drop during the quarter follows a fall of 0.3 per cent in the December quarter, and has reversed a steady increase in the stocks to sales ratio which had occurred throughout most of 1985.

The level of manufacturers' stocks of materials remained constant over the quarter after declines in both the September and December quarters of 1985. However, it appears that this cutback in inputs failed to arrest the build up of finished goods stocks as a percentage of sales. The latter increased by 3.5 per cent over the March quarter, continuing the steadily rising trend in the ratio of finished goods stocks to sales recorded over the latter half of 1985.

Investment

While most other indicators pointed to an easing in economic activity, the investment indicators provided mixed signals. Business investment in non-residential buildings remained strong during the first quarter of 1986 and investment intentions, as measured by the value of permits issued, also remained steady during the quarter. Dwelling investment and intentions on the other hand continued to soften during the first two quarters of 1986, although the imminence of GST underpinned the additions and alterations section of the market which remained particularly strong. The decline in dwelling investment was primarily responsible for the 11 per cent fall in activity in the construction industry over the March quarter. Surveyed import orders for plant, machinery and transport equipment were still weak, although there appeared to have been a reversal of the previous downward trend during the March quarter.

The real value of other building permits issued fluctuated widely over late 1985 and early 1986, but the average for the three quarters ending March 1986 was around 20 per cent ahead of the same period a year earlier. Actual investment in other buildings was strong throughout the March and June quarters of 1986, with real investment for the six months ending June 1986 around 25 per cent ahead of the same period a year earlier. As there is a long lag between the issue of permits and actual investment, the sustained strength of investment intentions in early 1986 suggests that actual investment will continue at a high level into late 1986.

While aggregate investment in other buildings has been strong, a breakdown into components indicates that the growth has not been even across all building types. Increases in permits issued for offices in particular and also for hotels, and shops and restaurants were the main contributors to the rise, while significant falls were recorded in the value of permits issued for farm buildings and factories (refer table 1).

Indicator analysis of dwelling investment on the other hand suggests that the sharp fall-off in the number of permits issued towards the end of 1985 and into early 1986 points towards a continued fall in dwelling investment over the first half of 1986. The number of new dwelling starts declined by 9.6 per cent in the March quarter compared with the December quarter. Empirical analysis of the relationship between the leading indicator and actual investment suggests that dwelling investment in the current quarter is closely related to the value of permits issued in the previous two quarters. On this basis, a decline in real dwelling investment of around 8 per cent can be expected over the year to June. While the number of seasonally adjusted dwelling permits increased by 0.7 per cent in March and 4.7 per cent in April, there was a further 5.9 per cent decline in May which suggests that the outlook for dwelling investment is for a continued weakening.

Surveyed import orders of transport and machinery and electrical goods are both running below the levels of a year earlier. While the nominal value of orders for transport goods over the three months to April was 18.5 per cent lower than for the same period in 1985, there appears to have been some upturn from the low point reached in the December 1985 quarter. Machinery and electrical orders, on the other hand, remained weak in the three months to April, and were 19.9 per cent down on the previous year.

Table 1
Non-Residental Building Permits Issued by Type — Quarterly

	September 1985		*December 1985*		*March 1986*	
(Quarters)	*$m.*	*Annual % Change*	*$m.*	*Annual % Change*	*$m.*	*Annual % Change*
Hotels and Motels	22.7	(169.1)	21.6	(39.5)	39.4	(126.9)
Shops and Restaurants	37.6	(39.2	23.5	(-30.0)	48.0	(94.7)
Office and Administration	160.2	(117.8)	108.7	(- 1.4)	150.1	(166.3)
Factories	107.9	(59.5)	87.1	(6.4)	75.0	(-23.1)
Farm Buildings	19.4	(-8.0)	15.2	(-18.2)	12.5	(-30.2)
Total All other Buildings[1]	447.2	(37.4)	396.2	(12.1)	415.0	(38.8)

1 Includes other types not listed in the table.

Employment

The Labour Department's quarterly survey of employment showed that seasonally adjusted employment increased by 0.4 per cent during the February quarter. However, the late start to the freezing works killing season has distorted this series and the underlying trend over the quarter was probably moderately downwards. Surveyed employment increased by 1.4 per cent in the year to February, with the major contributors to the rise being a 6.5 per cent rise in part-time private surveyed employment and a 0.8 per cent rise in private full-time surveyed employment.

A regional breakdown of annual employment trends highlights the uneven impact of the economic slowdown. Major urban areas experienced strong employment growth over the year to February, reflecting the strength in the urban economies, while employment in the remainder of the country either remained static or declined (table 2).

Table 2
Employment Trends

	Annual % Change to Feb. 1986	*Percentage of Total Employment Feb. 1986*
Auckland-Wellington-Lower Hutt Urban Area	2.9	43.75
North Is. (remainder)	0.6	31.04
Christchurch	2.8	12.08
South Is. (remainder)	−2.8	13.13
New Zealand Total:	1.4	100.0

These divergent trends are likely to be understated by the employment statistics as the Quarterly Employment Survey does not cover employment in agriculture and farm-related services which represent approximately 10 per cent of the total labour force.

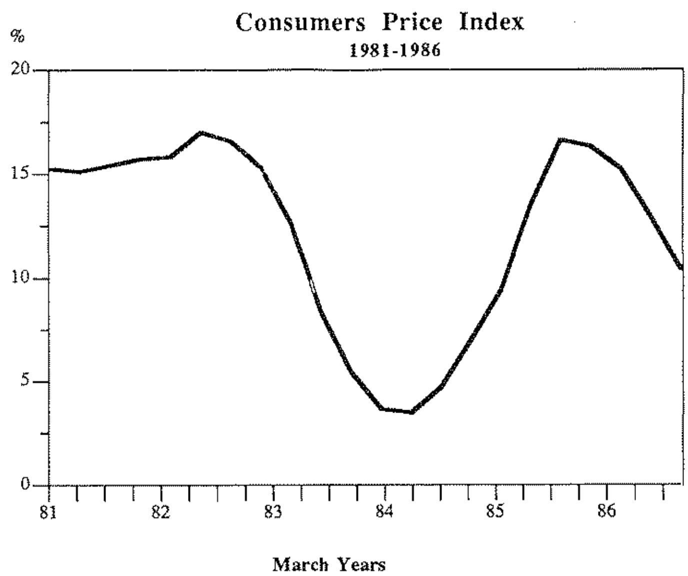
The second set of quarterly data from the new Household Labour Force survey showed an increase in unemployment over the March quarter (from 3.8 to 4.3 per cent). This upward trend in unemployment has accelerated since February, with registered unemployment rising by 17.8 per cent in the four months to June. The 2.4 per cent rise in the month of June was preceded by a 5.6 per cent increase in May which was the highest monthly (seasonally adjusted) increase since February 1983. There had previously been increases of 3.6 per cent and 5.4 per cent in the months of April and March respectively. This sharp jump has resulted in the level of unemployment being 25.3 per cent above the low of mid-1985. A regional breakdown of the growth in unemployment since February shows unemployment unchanged in Wellington but increasing by 11.7 per cent in Auckland and by 18.6 per cent in the rest of the country. These statistics suggest the uneven regional trends highlighted in table 2 may have been accentuated over the June quarter.

Net outward migration continued at relatively high levels over the first six months of the year and probably moderated the rise in the level of unemployment. The net outflow of permanent and long-term migrants increased from 13,264 in the year to June 1985, to 21,804 in the year to June 1986 and has averaged about 1,750 per month over the last six months.

Prices

The decline of the annual inflation rate from its recent peak of 16.6 per cent in the June quarter of 1985 to 10.4 per cent in the June quarter of 1986 provides a measure of the success of the current policy stance. The CPI increase of 2.7 per cent over the June quarter meant that there had been four successive quarterly increases below 3 per cent. Excluding the wage and price freeze period of the early 1980s, this was last achieved in the year to March 1979. A quarterly increase below 2.3 in the forthcoming September quarter would result in single figure inflation for the first time since September 1973 (again excluding the freeze).

It is now apparent that businesses have absorbed a proportion of the increased wage costs associated with



the 1985 wage round, and have not passed these on into prices in the traditional manner. The breaking down of the traditional cost-plus or mark-up pricing attitude is a significant step towards increasing flexibility in the economy. Falling world crude oil prices were also passed on into domestic petrol prices during the quarter and this had a significant downward impact on the index.

The prospects for single figure inflation (excluding the effects of GST) look particularly encouraging. Rising interest rates over the last twelve months had been contributing to the rise in the CPI through the housing component of the index. Recent falls in interest rates should therefore ease this pressure and, depending upon movements in house prices, may exert a downward influence on the CPI in the near future. In addition, most increases in Government User charges were passed on during the June quarter.

The Food Price Index has recorded annual growth of below 10 per cent since March and increased by 7.4 per cent in the year to June. The index rose by 0.3 per cent in the month of June after a decline of 0.2 per cent in May and an increase of 0.9 per cent in April. The Producers Price Index rose 2.1 per cent over the March quarter for both inputs and outputs, giving annual increases of 7.9 and 9.2 per cent respectively. Given the lower average exchange rate for this quarter, and the potential flow-on effects from the wage round, this was a relatively moderate increase.

Government Sector

The maintenance of a firm fiscal policy stance by the Government contributed to the lowest deficit out-turn as a percentage of GDP since 1976/77. The 1985/86 deficit was $1,871 million, or 4.1 per cent of GDP, down by $900 million on the previous year's deficit of $2,784 million. The 1986/87 Budget was announced on 31 July and, while forecasting an increased fiscal deficit over 1986/87, maintained a consistent approach towards economic management. Significant measures in the budget included the taking-over of $7.2 billion of debt incurred through major project investment and support of producer boards; the tightening up of tax laws and the provision of a new housing assistance package. The deficit before borrowing is forecast to be $2,452 million or around 5 per cent of forecast GDP. A cash loss of about $460 million on the synfuels plant, provided for in the main estimates, is one factor behind the increase in the deficit. Net expenditure is forecast at $19,583 million for 1986/87, up 10.8 per cent on last year's outturn, while total receipts are forecast to be $18,027 million or 14.1 above 1985/86 receipts.

The $7.2 billion provided in the supplementary estimates for taking-over the debts of the Think Big projects and the producer boards, merely changes the form of the liabilities faced by the government sector and is not expected to involve any significant change in net liquidity injections into the financial system or in the Government's domestic borrowing programme.