REVIEW OF DOMESTIC AND EXTERNAL ECONOMIC DEVELOPMENTS

This article examines the meaning and implications of the most recent economic indicators.

Introduction

Forecasters have been expecting a slowdown in economic growth to be happening over 1986, along with a marked improvement in the Balance of Payments position. Some of the economic data released recently throws some doubt on the accuracy of such forecasts. This article suggests both reasons why the data may be to some extent misleading, and reasons why the economy's short-term path might differ from that previously expected.

Background

The likely short-term path of the real economy following the Labour government's policy innovations has been a matter of some conjecture.

Two crucial factors will heavily influence the growth performance: the willingness of customers worldwide to buy New Zealand products and services (including entrepreneurial skills) at profitable prices, and the ability of the economy consistently to put resources into areas where the demand is greatest and where the use of those resources is most efficient. The latter factor includes the 'supply side' considerations which, rather than determining the growth path itself, will determine how close the economy may perform to its potential.

The conjecture about the short-term path of the economy relates to both factors noted above. But it is the impact of the latter which generates the most uncertainty. The economic policy moves of late have been designed to improve resource allocation by allowing the market to more accurately signal the actual willingness of customers worldwide to buy New Zealand output. [The issues underlying the design of this policy approach are discussed in more detail in an accompanying article in this *Bulletin*, entitled 'Liberalisation, Structural Change, and Employment'.] Because resources have been misallocated, the policy moves involve a disinvestment in some areas and new investment in others. How the short-term path of the economy turns out depends importantly on the timing of the new investment phase relative to the disinvestment. Most commentators expect disinvestment to show up more rapidly; but there are wide differences of view on when and how strongly the subsequent investment will occur.

Recent developments on the domestic and external fronts will eventually form part of an overall picture which will enable full answers to these questions. This article forms part of a developing process of interpretation of events which seeks clues as to how the adjustment path will fully evolve.

Table 1
Real GDP by Industry
4qrt Annual Percentage Change

Industry	% to June 1986
Agriculture	8.5
Fishing/Hunting/ Forestry	16.7
Manufacturing	- 5.1
Electricity/Gas	2.6
Construction	5.4
Trade/Services	−1.6
Dwelling	1.8
Transport	4.8
Government	- 0.9
All Industries	0.9

Domestic Developments

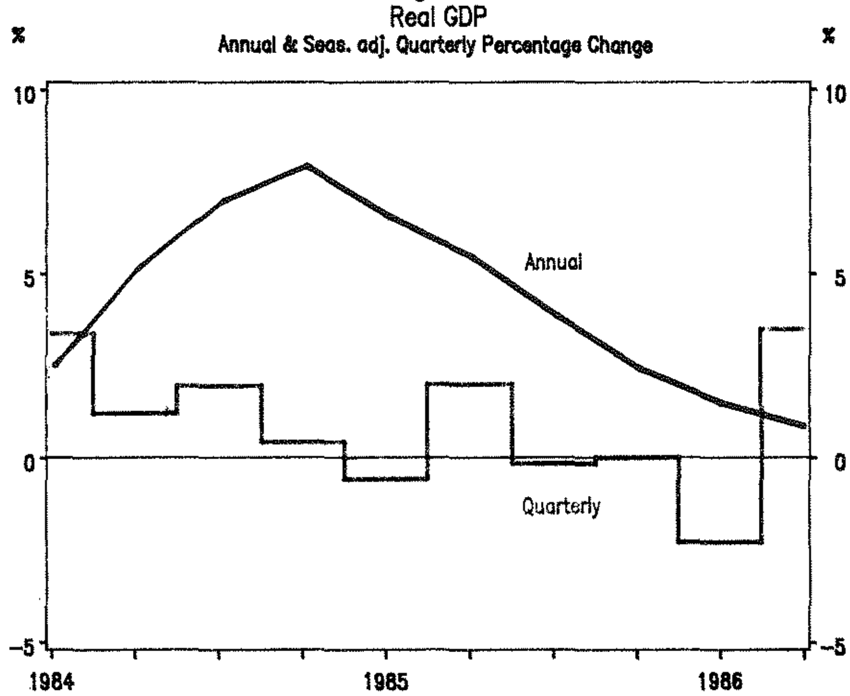
At first sight,recent labour market and output indicators seem to be presenting almost diametrically opposite pictures of recent developments in the economy. On the one hand the total level of employment has started to fall and registered unemployment has risen by more than 20,000 in a little over six months, with a prospect of further increases to come. On the other hand, the Statistics Department's measure of the economy's real activity, quarterly Real Gross Domestic Product, (GDP) increased by a boom-like 3.5 per cent over the June quarter (seasonally adjusted).

The GDP figures do not, however, point to a dramatic turnabout in economic activity. The June quarter expansion looks less extreme against the background of the 2.3 per cent fall in the 3 months to March. The strike in the freezing works during January and February meant that much of the production that would normally have occurred in the first quarter of 1986 was shifted to the June quarter. It is not possible to be exact about the size of this shift as we do not know precisely how the meat killing season would have gone in the absence of the strike. However, a rough estimate of the effect would be about 1.5 per cent of GDP.

Adjusting for the freezing works strike effect gives an increase of about 2 per cent over the June quarter - still a reasonably strong increase. A closer examination of the figures shows that roughly a third of this increase was accounted for by a very sharp increase (of 12 per cent) in the Fabricated Metal Products, Machinery and Equipment group of the manufacturing sector. There is no ready explanation for the magnitude of this increase and it may in part reflect measurement aberrations or the lumpiness of deliveries to large projects. In addition the contribution of the farming sector to GDP is reported as increasing by 5.5 per cent over the June quarter, accounting for about 0.4 percentage points of the overall increase. This outcome is a function of the particular methodology used to calculate real farm GDP rather than a reflection of the 'health' of the sector; the farm sector is probably best excluded when analysing movements in aggregate output measures.

After adjustments for these factors the statistical record of the economy's recent development becomes more explicable. After peaking in the middle of 1985 non-agricultural output appears to have remained relatively constant during the rest of the year before dipping in the March quarter and recovering by perhaps 1.5 per cent in June with the start of the pre-Goods and Services Tax (GST) spending boom. Broadly speaking, the picture of a static underlying level of real activity is compatible with developments in the labour market. The decline in private full-time employment of nearly 2 per cent in the year to May probably reflects a normal ongoing improvement in labour

Figure 1
Real GDP
Annual & Seas. adj. Quarterly Percentage Change



force productivity, as well as some additional labour shedding resulting from the structural change which is underway in the economy.

Not unexpectedly, GST is thought to be an important factor in the short-term path of the economy described above. The pattern of trade data tends to confirm this view. Excluding the automotive sector, real seasonally adjusted retail trade increased by 2.6 per cent in the June quarter, with the most 'GST sensitive' category, furniture sales, increasing by 11.4 per cent. The subsequent monthly data indicates that the consumption surge continued into the September quarter, with the July and August nominal turnover figures being up by 2.2 and 3.1 per cent respectively.

The consumption recovery may not have been solely GST driven though. Last year's wage round (which averaged about 18 per cent) left real average wage and salary levels more than 6 per cent higher in the June quarter than a year previously. This movement was more than sufficient to offset the negative effects on real disposable incomes from higher taxation 'fiscal drag', slightly lower overall employment levels and the decline in farm incomes.

The slowdown in economic activity from last year's growth rate of 5.5 per cent (June 1985 year) has clearly not impacted evenly across the economy. The withdrawal or reduction of government subsidies combined with low international commodity prices and the relatively strong New Zealand dollar has combined to sharply reduce farm incomes. Both current and capital farm expenditures have been cut and this has had a flow-on effect into the farm servicing sector. As a consequence, unemployment has risen more sharply in rural and provincial areas, and by September 1986 three regions - Whangarei, Gisborne and Hastings, had registered unemployment rates of over 10 per cent compared to a nation-wide average of 5.5 per cent. Some further deterioration in unemployment in the provincial areas is likely as the restructuring of the meat processing industry proceeds, although the impact on particular regions will depend on which processing plants close.

The major urban areas have not entirely escaped the downturn. The manufacturing sector has also been affected by the strong New Zealand dollar (*vis-a-vis* Australia in particular) and there is evidence that export volumes started to fall during the year. A shrinking provincial market would also have affected some producers. In Auckland and Wellington, however, these influences appear to have been overshadowed by strong growth in the business services sector and the possibly related commercial property boom. Although unemployment in these cities has increased (by 23 and 13 per cent respectively over the September year) the proportionate change has been much less than that for the rest of New Zealand (up 60 per cent over the same period). The current experience contrasts quite sharply with the previous downturn in the economy which was predominantly urban led. In the year to July 1983 unemployment in Auckland and Wellington rose by 107 and 82 per cent respectively compared to a rise of 47 per cent for the rest of New Zealand.

Inflation Outcomes and Prospects

While the introduction of GST helped to boost real activity its short-term effect on inflation has not been favourable. The Consumers Price Index (CPI) rose by 3.3 per cent during the September quarter bringing the annual rate of increase to 11 per cent, up from 10.4 per cent in the year to June. Increases in the taxes on tobacco announced in the July Budget accounted for around 1 percentage point of the rise but general demand pressures arising from pre-GST spending probably induced some retailers to increase their margins. The first measure of the actual impact of GST was the 10 per cent rise in the Food Price Index in October which brought the annual rate of increase to 18.9 per cent. GST would have accounted for 8 to 8.5 per cent of the rise. This implies that the underlying increase was at least 1.5 per cent, an unexpectedly high result given the increases of 1.7 per cent which had already occurred in August and September. Factors which might

Figure 2
Unemloyment & Assisted Employment
monthly, seas. adjusted, thousands

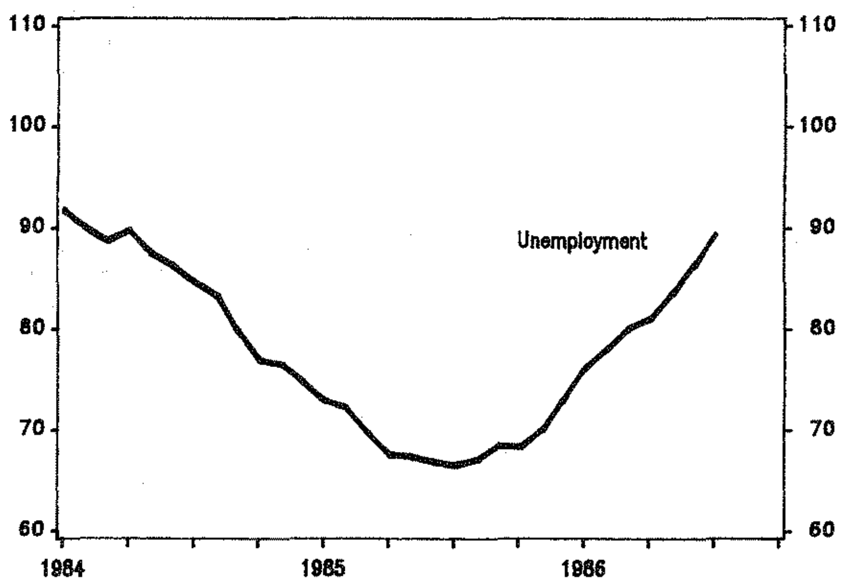
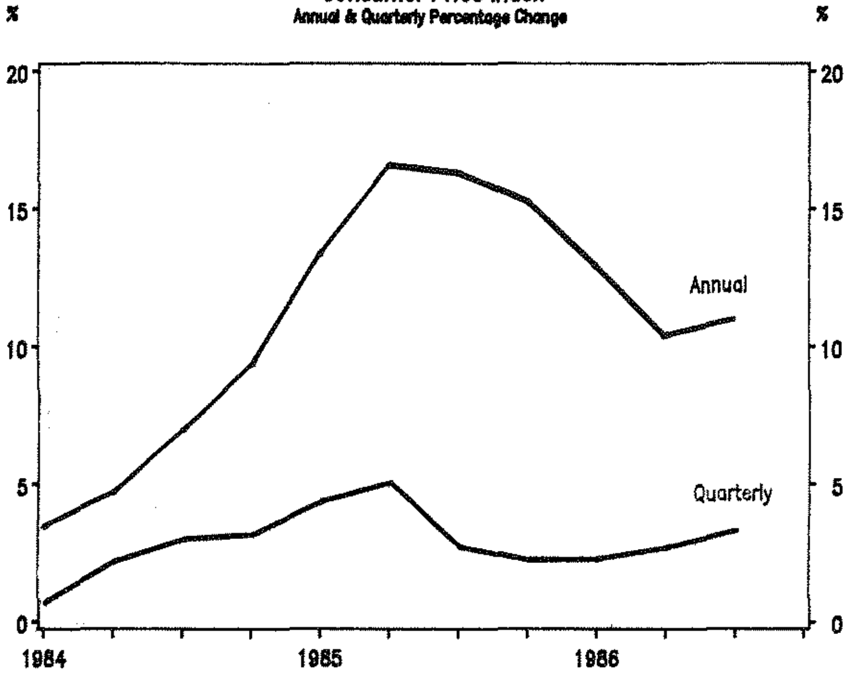


Figure 3
Consumer Price Index
Annual & Quarterly Percentage Change



be important in explaining the underlying October figure are higher meat prices due to the better returns on overseas markets, the lagged effects of the depreciation of the New Zealand dollar in August and possibly some concentration of price increases that may normally have occurred later in the quarter.

Although the short-term news has not been good the medium-term prospects for inflation are favourable. While much of the decline in the annual rate of increase in the CPI which has occurred over the last year has been due to low international inflation, and the strong New Zealand dollar, there are now clear signs that pressure is being brought to bear on domestic sources of inflation. Certainly the wage round is likely to produce an outcome much lower than most observers would have predicted a few months ago.

Providing there is no significant decline in the New Zealand exchange rate then there remain good prospects that the GST-adjusted inflation rate will ease down into the single figure range over the coming year.

The Short-term Outlook

For the period immediately ahead the short-term indicators do not seem to point to any pronounced movement in the economy either up or down. The rural sector is unlikely to provide a significant impetus to economic growth. Although prices for pastoral agricultural products have risen from their low points and returns in the horticultural sector are particularly good, the full season effects of the downturn in the dairy milkfat payout has yet to be felt and restructuring in the farm servicing and processing areas still has some way to go.

Most of the indicators are pointing to a slowdown in investment. The value of non-residential building permits has been falling since the June quarter, suggesting a decline in actual building activity in late 86, early 87. The outlook for the residential building sector is a little more uncertain. Following a decline in activity over the first half of the year, there was a sharp rise (totalling 28 per cent over the three months to August) in the number of permits issued after the trading banks lowered their mortgage interest rates and competed more actively for mortgage business. Permit approvals fell moderately in September so it is not clear whether the earlier rises represent a sustainable shift in the effective demand for new housing to a higher level, or simply a temporary surge occasioned by the banks' desire to rapidly increase their home mortgage portfolios. In any event, it would appear that the post-GST decline in home building will be much less pronounced than was earlier predicted, if it happens at all.

A number of factors will bear on consumption levels in the near term. To the extent that expenditure was shifted to take advantage of pre-GST prices then there may be an offsetting decrease in the quarter or two beyond its introduction. The outcome of the wage round is uncertain at the time of writing but it appears likely that the average level of settlement will not maintain real after-tax wages over the next year. On the other hand, giving a more immediate positive boost to consumption will be the very large income tax cuts associated with the introduction of GST.

Taking all of these influences in the economy together there may be some slight downside for economic activity over the near term and it may be a few quarters yet before a significant resumption in growth is seen. This view tends to be confirmed by the September quarter NZIER Business Opinion Survey which reported that sentiment for the general business outlook over the next six months was still slightly pessimistic.

External Developments

In contrast with the improvement registered through 1985, balance of payments figures for 1986 have recorded a persistent current account deficit in the order of $2,900 million. This outcome has been taken by some commentators to foreshadow a less positive outlook for the balance of payments over 1987. Previous forecasts in early to mid-1986 had placed the current account deficit for the year to March 1987 at about $1,500 million, but this is now seen as overly optimistic.

Some caution is however warranted when attempting to interpret recent data. While a close look at the detail of the external accounts, together with the forecasts for domestic and international growth in 1987, does suggest that the current account deficit will remain larger than earlier anticipated and that the adjustment process may be more protracted, it is not clear that recent current account developments are indicative of an emerging underlying trend.

A number of factors are likely to be involved:

— One of the major influences expected to lead to an improvement in the external balance was a significantly weaker domestic economy. As discussed earlier, there are some doubts as to whether the growth pause will be as significant as earlier believed. Pre-GST buying surges in particular will have had some impact on the external position.

— The international economy has not provided a particularly advantageous trading environment, with the terms of trade falling to low levels by historical standards, and real economic growth positive but less so than previously. Moreover, there has been a significant slowdown in the Australian economy.

— The trade liberalisation moves, including both quantitative and tariff barrier reductions, are likely to produce adverse import effects ahead of the associated export benefits.

— And macroeconomic policy tensions generated by an anti-inflation monetary stance in combination with a continuing significant fiscal imbalance undoubtedly induced real exchange rate pressures throughout most of 1985, with the lagged effects now being felt.

In addition to these economic 'fundamentals', there are a number of special circumstances which have also been important, including timing problems produced by large lumpy items and industrial action, valuation effects from fluctuating exchange rates, and statistical difficulties arising from changes in data sources.

Of course from a policy perspective the main issue of interest is the impact of the economic policy moves on the Balance of Payments path. Both the liberalisation and macroeconomic policy aspects are relevant here—both have implications for the real competitiveness of New Zealand exporters and import competing producers, as well as demand patterns here and abroad. Liberalisation moves directly change the relevant prices faced by those in the sector concerned, while the non-accommodating monetary policy in conjunction with the continuing fiscal deficit places upward pressure on the exchange rate, typically via interest rate pressures.

How much of recent developments can be attributed to such factors? Broadly speaking, other things being equal, the most immediate impacts of the domestic policy moves would be expected to be rising imports and falling exports. The invisibles balance would also tend to deteriorate as the capital inflows (responding to interest rate pressures) raised debt servicing expenses. The main immediate factor in the persistence of the deficit at its current level has in fact been the steady deterioration in the invisibles balance.

For the year ended June 1986 the deficit on invisibles stood at $2,726 million (compared with $2,441 million to June 1985) and early estimates for the September year indicate the deficit could be as large as $3,000 million. A deteriorating trend in the invisibles balance has been evident for many years and is mainly a reflection of the growing gap between international investment income and payments. Although at a slower pace than in 1984, the balance on international investment income continued to worsen. For the June 1986 year the deficit was $1,878 million in comparison to the previous year's deficit of

$1,777 million, and largely reflects the continued growth in interest payments on net overseas borrowing. The invisibles deficit has also been adversely affected by a weaker services balance, with lower tourism receipts, particularly from Australia, a significant factor.

The trade balance however, has exhibited a different pattern. Although fluctuating from quarter to quarter, the trade balance has improved slowly from March 1985. This pattern was temporarily reversed in March 1986 but the underlying trend has continued . The trade deficit of $154 million for the year to June 1986 was about half the deficit for the previous June year. Preliminary data for the September quarter indicates that the balance has moved back into surplus, with net exports over the year to September of $249 million.

While there is therefore no clear indication of an emerging trade imbalance, the improvement has been less rapid than anticipated. But at the same time the international economy has grown less strongly than seemed likely at the start of 1986. Export forecasts earlier in the year were underpinned principally by the prospect of stronger international economic growth which appeared to be held out by the sharp fall in oil prices early in 1986 and by the reductions in international interest rates. This upturn however, has not yet materialised, and the relatively slow rate of growth in the industrial economies in 1985 has persisted well into 1986.

The growth in the volume of overall world trade has also slowed and commodity prices have remained weak. New Zealand's terms of trade have remained depressed falling to their lowest level in over a decade in the March 1986 quarter, despite the contribution from significantly lower oil prices. Import prices for the latest June year fell 4.1 per cent, but export prices decreased 6.8 per cent. Part of the reason for the decline in both sets of prices can be found in the 'scaling' effect of the relatively strong New Zealand dollar in late 1985 early 1986. Underlying this though is a continued deterioration in the relative

Table 2
Balance of Payments Current Account
Four Quarter Running Totals
(NZ$ millions)

Four Quarters Ended	Trade Balance	Services Balance	Investment Income Balance	Transfers Balance	Invisibles Balance	Current Account Balance
1984						
Mar (P)	+655	– 711	–1277	+106	–1883	–1228
June (P)	+333	– 865	–1269	+ 89	–2046	–1713
Sept (P)	–308	– 930	–1343	+153	–2122	–2430
Dec. (P)	–486	– 968	–1540	+213	–2305	–2791
1985						
Mar. (P)	–364	–1031	–1625	+211	–2447	–2811
June (P)	–263	– 992	–1777	+260	–2441	–2704
Sept (P)	+ 13	– 861	–1803	+225	–2440	–2427
Dec. (P)	+214	– 820	–1704	+163	–2364	–2151
1986						
Mar. (P)	–391	– 934	–1807	+186	–2557	–2948
June (P)	–154	–1020	–1878	+173	–2726	–2880
Sept. (P)	+249	..	..	..	–3166	–2917

(P) Provisional

Figure 4
Balance of Payments
four quarter running totals, $m

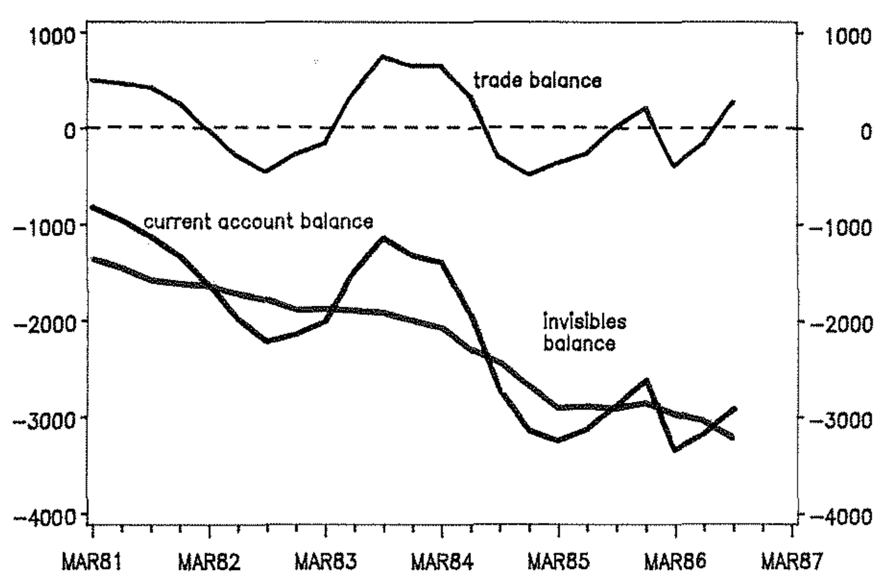


Table 3
Balance of Payments Current Account
(NZ$ million)

Years Ended June	1985 (P)	1986(P)
Exports		
Meat	2228	1732
Wool	1479	1292
Dairy	1773	1646
Other Animal Products	706	633
Forestry	772	697
Other Primary Products	1103	1222
Manufactured Goods	2702	2535
Base Minerals, Other	552	814
Adjustment to BOP Basis	– 95	– 144
Total Exports	11220	10427
Imports	11483	10582
Merchandise Trade Account	– 263	– 154
Exports of Services	2909	2771
Imports of Services	3831	3791
Balance on Services	– 922	– 1020
Investment Income Receipts	417	464
Investment Income Payments	2194	2342
Balance on Investment Income	– 1777	– 1878
Transfers Credits	718	734
Transfers Debits	460	562
Balance on Transfers	258	172
Balance on Invisibles	– 2441	– 2726
Current Account Balance	– 2704	– 2880

(P) Provisional

prices on international markets of some key exports. Dairy product prices, which have been under pressure as a result of subsidised overproduction overseas, were on average 10.4 per cent below the previous year's levels. Other pastoral products and manufactured exports prices also recorded declines, with the former reflecting depressed international prices for a broad spectrum of primary products.

The international environment has therefore proved less positive than anticipated, but the problems posed for exporters by such relatively slow growth in many of New Zealand's overseas markets (and in particular, the sluggish performance of the Australian market) have been compounded by fluctuations in New Zealand's international competitiveness *vis-a-vis* specific countries over the past year. There have been some significant realignments in exchange rates overseas, and these have been important factors in altering bilateral exchange rates between New Zealand and its trading partners. In addition, while the relative strength of the New Zealand dollar through 1985 has since eased to bring overall competitiveness back closer to predevaluation levels, marked differences in bilateral competitive positions remain. Significant competitive gains have been recorded for New Zealand exporters to Japan and West Germany, while against Australia and the US and to a lesser extent, UK, the position is weaker.

Given these influences, export receipts for the year to June 1986 were $10,427 million, about 7 per cent below the level a year earlier. Most of this decline was the result of the fall in export prices, but there was also a fall in volumes of 1.4 per cent. Manufactured export volumes contracted over the year, but the principal factor in the overall decline was a sharp reduction in the value of pastoral product exports. This latter outcome, however, is largely accounted for by the abnormal factors which disrupted export shipments in the March quarter, the effects of which are still seen in data for subsequent quarters. In contrast to the contraction in New Zealand's traditional pastoral products, exports of other primary products (notably fish, horticultural products and hides and skins) have continued to grow strongly. Horticultural exports for instance, boosted by high kiwifruit shipments increased almost 30 per cent in volume in the recent June year. More recent figures indicate some recovery in export receipts. There have recently been signs of a recovery in wool prices, and the outlook for forestry products and other resourcebased products is also encouraging, particularly for those commodities exported to Japan and Europe.

The outlook for imports is less clear. Import forecasts were partly based upon an expected downturn in the domestic economy over mid-late 1986, a downturn which now appears to have been much less marked than early figures suggested. Import flows have nevertheless eased relative to levels a year earlier, with import receipts for the year to June 1986 falling about 8 per cent, and import volumes falling about 4 per cent. Oil imports have fallen as the synthetic oil and refinery projects have come onstream.

However, private import orders (excluding mineral fuels) placed overseas, which give some indication of imminent import volumes recorded small increases in July and August, (relative to the same months a year earlier). This was the first growth in the indicator since May 1985, possibly reflecting some restocking following the strength in domestic consumption expenditure over the middle of the year.

In summary, although the promise of a definite turnaround in the deficit was evident at the end of 1985, it now appears that the adjustment process for the balance of payments may be more protracted than previously envisaged. As noted, in part the persistence of the current account deficit at about $2,900 million reflects the 'scaling' effect of the exchange rate (which at the end of September was 12 per cent below the level a year earlier), while depressed overseas growth and commodity prices, the downturn in activity, and the restructuring of the New Zealand economy have also contributed. In addition, the abnormally low March 1986 quarter trade result is acting to distort the annual trends, while the nature of the main factors in the deficit particularly the trend in the invisibles balance provides grounds for a cautious interpretation of short-term fluctuations (with comprehensive overseas exchange transactions data no longer available as an indicative balance of payments measure, many invisibles items have had to be estimated, with a consequent loss in reliability).

Despite these reservations, the current account deficit for March 1987 is projected to be below that for March 1986, both in absolute terms and relative to GDP. The reversal of the March 1986 quarter timing factors, coupled with divergent growth in export and import volumes, is projected to have a favourable impact on the trade balance for the March 1987 year as a whole.