ECONOMIC REVIEW

In this quarter's Economic Review, Robin Clements offers a preliminary assessment by sector of the economic effects of the Government's anti-inflation strategy.[1]

Introduction

Since 1984 the Government has put in place a wide-ranging set of economic reforms aimed at improving New Zealand's economic performance. The two main streams of these reforms have been in the areas of stabilisation and liberalisation policies. Stabilisation policies are those directed at reducing inflation to rates at least comparable with those of our major trading partners. Monetary policy is the policy instrument assigned principally towards reducing inflation, supported by exchange rate policy and overall fiscal policy. Monetary policy works by influencing interest rates, the exchange rate, the availability of credit and, directly or indirectly, people's expectations regarding future inflation rates.[2] Liberalisation policies are, in general terms, those reforms or deregulatory moves which have been taken to promote efficiency of resource use through a greater degree of competition in markets. While the goals of liberalisation policies are desirable in their own right, these policies can also be seen as an important component of the anti-inflation strategy from a broader perspective.

These and other policy reforms, along with external economic developments, have combined to produce the economic outcomes of the last few years. The net effect of these factors on the economy as a whole seems to have been somewhat less than might have been expected, in purely economic terms at least. For example, real GDP grew at (revised) rates of 2.1 per cent and 1.9 per cent in the years to March 1986 and 1987, before apparently starting to flatten out in the June quarter of 1987, when a 0.1 per cent seasonally adjusted quarterly increase was recorded. Similarly, real consumption grew by 0.1 and 2.4 per cent in those years, and seems to have held up reasonably well at least until the middle of 1987: real retail sales grew at a seasonally adjusted quarterly rate of 0.9 per cent in the three months to June, before declining by 1.6 per cent over the September quarter. (But even in this quarter, when the automotive sector is excluded real retail sales still grew by 0.4 per cent). Also, the strength of the commercial building sector has been well known — the value of non-residential building permits in the September quarter of 1987 was still 42.5 per cent higher than year earlier levels — and this has acted to offset some of the weakness in other categories of private investment. A further point is that although registered unemployment has risen sharply over the first three quarters of 1987, various measures of unemployment based on the conceptually superior Household Labour Force Survey have shown a much flatter trend. (See the article in this issue on unemployment measures.)

In order to gauge the ongoing impact of the current policy framework, it is important to also look behind the broadest aggregates and try to assess the real economic effects of stabilisation and liberalisation policies, and their relative impact, across the various sectors of the economy. Such an assessment will help to identify where and in what form the pressure is applying, and hence give indications as to the appropriateness of the current stance of financial policies and the pace of market liberalisation. An analysis of this sort might also point to areas where liberalisation moves might be altered to more evenly spread the impact of tight financial policies.

This article reviews the experience of the main productive sectors of the New Zealand economy over the last three years and discusses significant developments in the context of the overall disinflationary pressures coming through interest rates and the exchange rate. A broad assessment is then made of these pressures and the associated output and employment losses. Finally some concluding remarks are made with respect to possible implications for further policy action.

Definitions

The definitions of the sectors referred to in the rest of the article are based on the System of National Accounts production groups. The groups have been split so as to form five main sectors of interest. The descriptions of the sectors, with each sector's share of total GDP in June 1987, appear in table 1.

Table 1

Sector Definitions

Sector	Share of GDP Year To June 1987 %	Description
Agriculture	7.3	Raising of livestock, growing of crops and agricultural services.
Manufacturing	22.0	Manufacture of: food, beverages and tobacco; textiles and apparel; wood products; paper products; chemical products; metal products.
Distribution	17.8	The wholesale and retail distribution of goods; operation of restaurants and provision of accommodation.
Services	29.2	Electricity, gas and water; communication; financial and insurance services; community, social and personal services.
Other	23.7	Fishing, hunting, forestry and mining; construction; transport; general government services.

[1] John Huddleston assisted in the preparation of this article.

[2] See 'A Layman's Guide to Monetary Policy', *RBNZ Bulletin*, June 1987, for a full discussion of how monetary policy operates.

For each of these sectors a graph has been provided showing trends in real Gross Domestic Product (GDP), employment, Producers Price Index (PPI) (outputs) and PPI (inputs) trends. More specific definitions for these data are given in table 2.

price index does not cover wage or interest costs, so that it will not necessarily be an accurate reflection of trends in total costs of production. For example, if output price growth exceeds input price inflation this will imply increasing margins only insofar as wage and/or interest rates have not been rising more quickly than intermediate input prices. If they have been rising more quickly, then any wedge which appears between input and output prices will at least in part be because the input price series does not cover all costs of production.

Table 2

Data Definitions

Key	Definition
Employment	Annual percentage (point-to-point) changes in full-time employment from the Labour Department's Quarterly Employment Survey, except for employment in agriculture, which comes from the Statistics Department's agricultural full-time employment data.
Real GDP	Annual changes in the Statistics Department's quarterly index of gross domestic product at constant prices for the year ending in a given quarter.
PPI (Outputs)	Annual percentage (point-to-point) changes in the Statistics Department's producer price index for outputs.
PPI (Inputs)	Same as above but for the inputs index (which excludes labour and interest costs.)

Sectoral Review

Put simply, the framework of analysis for each sector centres on those factors that have the greatest bearing on profits in that sector. Using a simple accounting identity we might define profits as consisting of:

Pre-tax Profits
= Output volumes x output prices
- Intermediate input volumes x input prices
- Employment x wage rates
- Interest costs

The real GDP measure in table 2 captures movements in the real contribution to GDP by the sector involved or, in terms of the items above, the difference between output and intermediate input volumes. Output and input prices are measured by the respective producers price indices while employment measures the total numbers of persons engaged full-time in the sectors.

The difference between the growth rates of the two producer price indices can be used to some extent as a proxy for changes in margins or mark-ups being applied by the sectors. However, it is important to note that the input

Agriculture

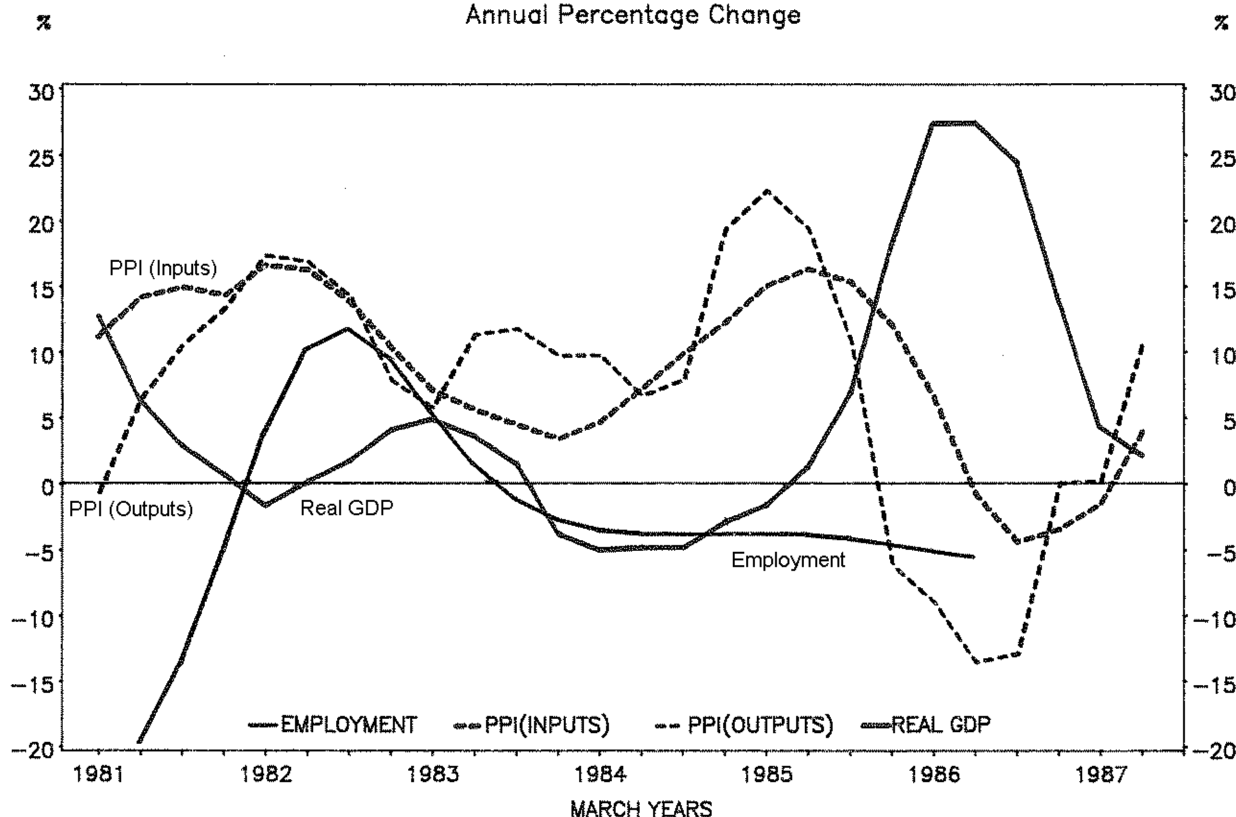
Agriculture is the sector which appears most likely to illustrate the impact of high interest and exchange rates. However, because the effects of a firm monetary policy have come on top of a rapid elimination of many agricultural support measures, such as supplementary minimum prices, together with a major decline in international commodity prices between 1984 and 1986, it will be difficult to examine the effects of interest and exchange rates in isolation.

Considering Figure 1, we can see that input price inflation had fallen to below 5 per cent by the end of 1983 as a result of the wage and price freeze. Over the 1983/84 period output price growth remained closer to 10 per cent so that, with interest rates at controlled levels and wage inflation running below other input price inflation, this suggests that for this year at least the agricultural sector enjoyed increasing margins. The devaluation of the New Zealand dollar in the third quarter of 1984 increased the returns to the agricultural activities sharply while also contributing to an increasing rate of input price inflation following the lifting of the wage and price freeze.

The gap between input and output prices over late 1984 would, however, tend to overstate the degree of any increase in margins for this period because the lifting of interest rate controls, at the same time as the devaluation, saw the beginning of a general rise in farmers' interest costs.

The floating of the New Zealand dollar in March 1985 and the dollar's ensuing appreciation, coupled with the deterioration in world commodity prices, resulted in a rapid decline in output price inflation but a rather slower reaction by input prices. Combined with further increases in interest costs and the earlier removal of government subsidies, this produced a dramatic fall in farm incomes which has only recently been partially reversed as world commodity prices recovered over the June-September quarters of 1987.

Looking at trends in the agricultural sector's contribution to real GDP, the most obvious feature is what appears to have been a period of surprisingly strong measured growth following the downturn from mid-1983 to mid-1985. Two main factors are likely to be largely responsible for this outcome. First, and probably most significantly, because the sector's contribution to GDP measures output volumes less intermediate input volumes, a reduction in input volumes with no change in output produces an increase in the sector's measured contribution to GDP. Therefore as farmers significantly cut back on maintenance expenditures and fertiliser applications etc., this tends to show up as a boost to real GDP. The second factor has been that, with falling returns to farmers from the high exchange rate and declining world prices, herd sizes have



been reduced on the expectation that returns will remain depressed. This has served to sustain measured output volumes in the short term.[3]

Following very large declines in the early 1980s, employment levels in the agricultural sector recovered during 1982/83 before declining again from mid-1983 onwards. In general these earlier employment trends correspond reasonably well with patterns in real agricultural GDP. From early 1985 on, however, employment has not risen in line with measured output, and indeed the previous downward trend seems to have accelerated somewhat. This result is consistent with the observation that measured output growth in recent periods has been largely caused by falling input volumes, leading to reductions in employment in agricultural supply and servicing activities.

[3] Part of the explanation of the high growth in real output by the agricultural sector since 1984 must also lie in the spectacular growth experienced by some of the non-traditional primary products such as kiwifruit and other horticultural activities.

In summary, the agricultural sector has undoubtedly sustained a marked deterioration in margins and profits since 1984 due to external market conditions, together with deregulatory (i.e. the removal of subsidies) and disinflationary policies. However, measured output has grown strongly, albeit on a probably less-than-sustainable basis. Employment has contracted further, although at least up to mid-1986 the losses have been slower than in the early 1980s. More recent trends in input and output prices suggest some improvement in margins but it is likely that the earlier outlook for a continuing improvement of world commodity prices may now be weakened by any drop in world demand which results from the sharemarket collapse. The prospect of a lower domestic rate of inflation would nevertheless still suggest that cost pressures could subside substantially.

The outlook for measured net output is less positive because if maintenance and fertiliser expenditures recover to more normal levels, this will show up as an increase in input volumes and therefore a decrease in the contribution to real GDP. Similarly, as the rundown in herd sizes comes to a halt, output volumes will eventually decline. Also, the past reductions in fertiliser application and some maintenance activities may impact detrimentally on the productive capacity of some farm land thus decreasing overall yields. Employment prospects in agriculture are not entirely clear, although an improvement in input volumes and the associated expenditures should reverse or at least limit further losses in associated service industries.

Manufacturing

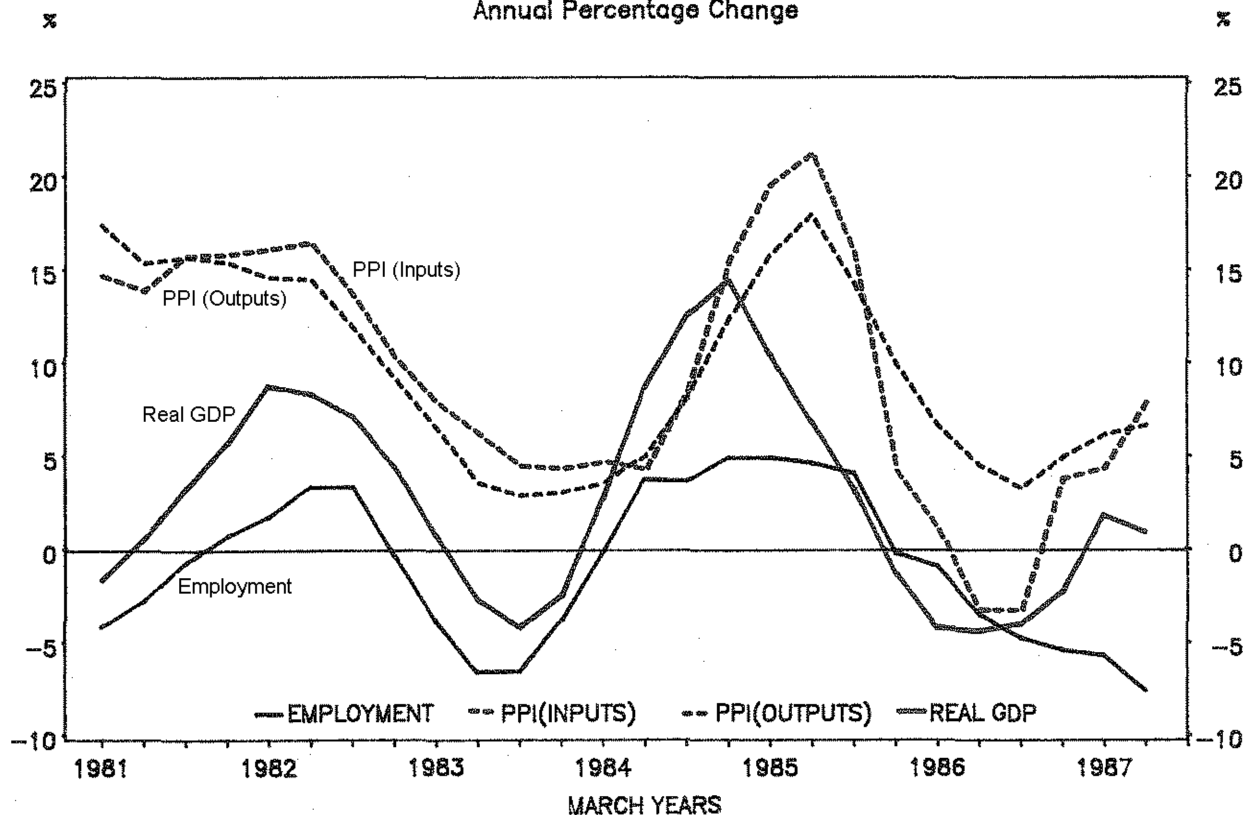
Within the manufacturing sector, there is considerable variation between domestic/export market orientations, product-mix, protection or assistance

levels and so on. There has therefore also been considerable differences in recent experience, as between different manufacturers. The focus here, however, is restricted to looking at the sector as a whole.

From Figure 2 it can be seen that up until 1984 input and output prices tracked each other fairly closely. The mid-1984 devaluation of the exchange rate had a greater impact on input prices than it did on output prices so that there was some loss of margins experienced by the manufacturing sector over 1984/85, partly offset by more slowly rising wage costs in this period. The appreciation of the exchange rate in 1985 similarly had a greater impact on input prices than it did on output prices. Input prices reflect a large degree of imported inputs, so that the strong exchange rate, tariff reductions, the fall in the price of oil, and the liberalisation of import quotas have brought down imported input price inflation rapidly. Offsetting these reduced cost pressures, was the particularly high 1985/86 wage round which saw wage costs climbing by around 15 per cent in the following year as well as higher interest costs. However, even taking these factors into account it appears (from data in the Quarterly Manufacturing Survey, for example) that output price increases have remained at least comparable with overall cost inflation. Thus, it would appear that increased competition from imports has not significantly diminished the ability of the manufacturing sector as a whole to apply cost-plus pricing and perhaps even to increase margins.

One possible explanation for this feature is that, compared to the declining volume of sales in export markets, the largely protected domestic markets have been relatively buoyant and this has enabled manufacturers (on average) to effectively subsidise the less profitable exporting activities. The strong exchange rate has forced a compression of margins on manufactured exports but buoyant demand and high remaining levels of protection for some industries has generated higher relative margins on domestic sales. This has tended to dampen the effect of the firm financial policies on pricing behaviour in the manufacturing sector as a whole.

Output trends for the manufacturing sector follow general trends in domestic economic activity. The major growth peak of mid-1984, for example, followed earlier expansionary monetary and fiscal policies which impacted on domestic consumption patterns. As such, this period represents a continuation of the cycles in economic policies and activity which characterised the previous decade or more of New Zealand's economic history. Assessed in this light, the downturn in real output growth by the manufacturing sector over 1985/86 can be seen to have been, at least in part, an inevitable reversal. In particular, this downturn appears broadly similar to that experienced



during 1983, albeit slightly deeper and of longer duration.

Employment growth trends have followed the pattern of output closely over the review period with a sustained period of employment growth associated with the output growth of 1984/85. It appears that this relationship may have broken down to some degree since mid-1986. Employment levels have continued to fall despite a reversal in the trend of output. In the past this upturn could have been expected to be matched by a similar movement in employment trends. However, rationalisation and restructuring within the manufacturing sector may be delaying this process as firms seek to identify ways in which to improve efficiency and productivity.

Summarising for the manufacturing sector, the aggregate statistics do not appear to offer much evidence of major adjustment costs (in terms of output, employment and profits), additional to those which probably would have occurred anyway. What is likely in the recent downturn, however, is that particular groups within the total sector have had markedly different performances. The aggregate manufacturing figure combines two very different types of activities. First, there are those firms which incur a high degree of domestic costs but export to international markets — these are the exposed exporters who have experienced pressure from the exchange rate and interest rates from fairly early on. The second group consists of those activities which source inputs from abroad but trade predominantly in protected domestic markets. This latter group tends to closely follow domestic economic activity cycles and so has experienced both buoyant sales levels and low input costs resulting from the level of the exchange rate.

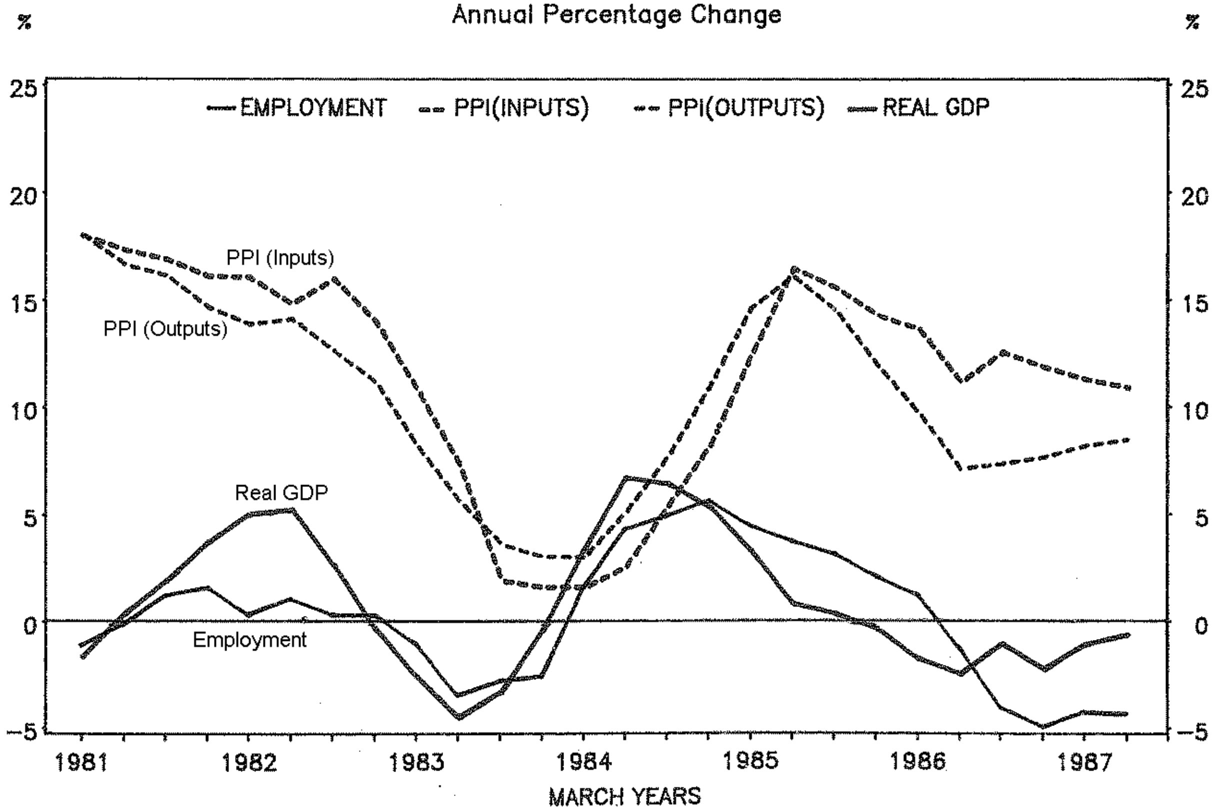
Thus, even though there may be relatively few actual businesses that fit neatly into these classifications, it is likely that much of the observed downturn in output and employment recently has occurred in those areas that engage in exporting activities rather than those domestically oriented. In addition, it is also probable that while exporting has involved declining margins, a continued application of cost-plus pricing has occurred in those protected activities which have enjoyed both growing demand and falling input costs.

Distribution

The distribution sector, which consists of both wholesale and retail trading, together with the operation of restaurants and hotels, shares a similar history to that of the manufacturing sector, at least until early 1985. Although real output after this point continued to move in a manner broadly similar to the manufacturing sector, other indicators moved in different directions.

In particular, Figure 3 shows that from the second quarter of 1985 a widening gap of input over output price inflation has developed which, when taken in conjunction with the size of the 1985/86 wage round and the high level of wage costs as a

Figure 3
Distribution
Annual Percentage Change



proportion of total production costs for this sector, points to falling margins over this time. Given the constantly increasing cost of meals away from home as measured by the Consumers Price Index regimen and more anecdotal evidence about the level of accommodation tariffs, it may be that the deterioration in margins was felt most by retail and wholesale traders rather than by restaurants and hotels. Greater import penetration into the New Zealand market as import quotas have been liberalised, and the relative price attractiveness of imports brought about by tariff reductions and the level of the exchange rate, has increased the degree of competition within the industry. This competition has come not so much from existing importers but from the tendency for retailers to develop their own channels for importing directly and pricing competitively in order to secure a share of the market.

Net output for the distribution sector has been declining since late 1985, although starting to stabilise gradually through the first half of 1987 (ignoring the GST effect). Despite apparently lower profit levels, the downturn has been shallow in comparison with the previous decline in 1982/83, although it has been more extended. Relatively strong domestic demand for both New Zealand and imported products has underpinned activity in this sector to some extent.

Growth in employment levels continued beyond the start of the dip in real output but has declined more sharply than output since mid-1986. Part of the explanation for this could be that the increased competition brought about through importing items directly for distribution through retail outlets has also produced a tendency to bypass wholesalers. Thus while some expansion may even have occurred in the retailing side of the distribution sector, increased attention to the costs of sourcing products has led to some rationalisation of wholesaling. More recently, with real activity apparently bottoming out, the rate of employment losses also seems to be abating.

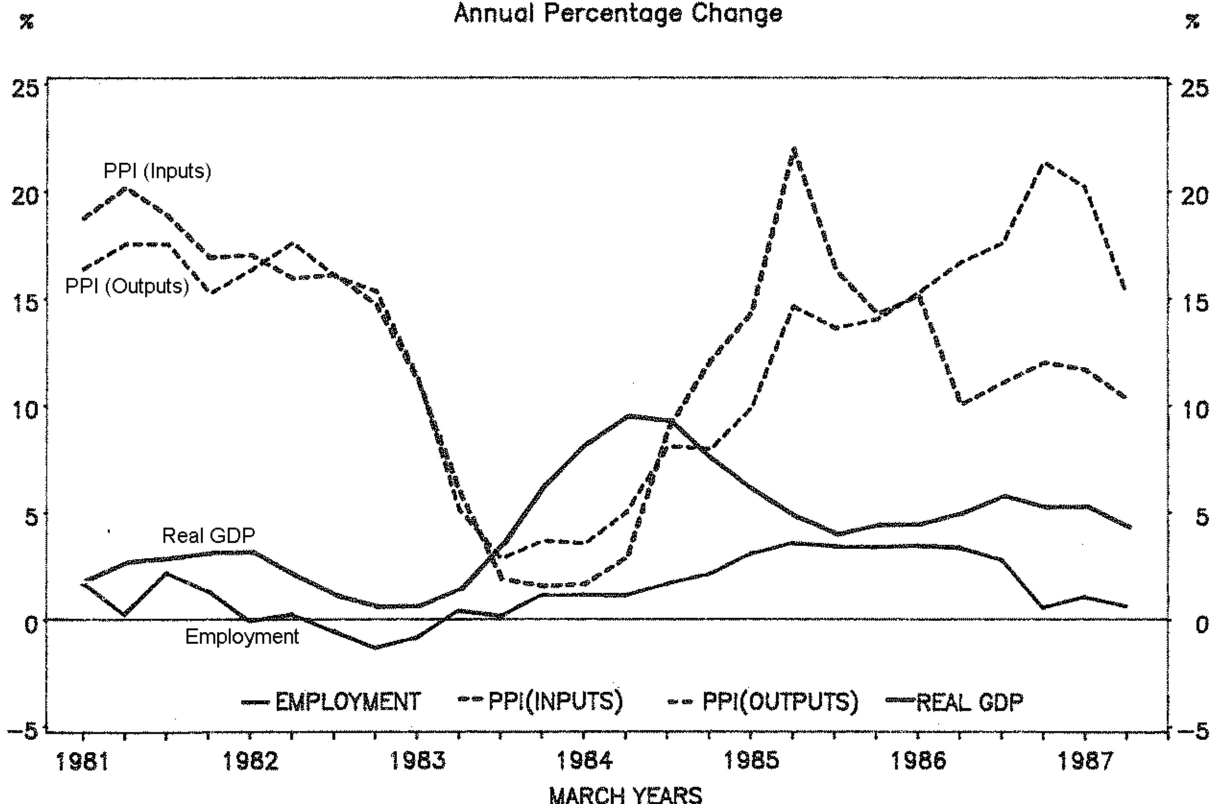
Services

The service sector represents those industries involved in the provision of electricity, gas and water, communications, financing, insurance and business services along with private and non-profit health and recreational services. One distinguishing feature of the services sector in the last three years or so has been the impact of deregulation on the financial sector. This has helped produce price, output and employment trends markedly different to those experienced by the other main sectors of the economy, as shown in Figure 4.

Both output and employment growth rates have been positive since 1983. This record stands in marked contrast to the other sectors which have sustained both output and employment losses at some time or another since 1984.

As with each of the previous sectors examined, input and output price inflation movements were very similar up to around 1984. The devaluation of the exchange rate in 1984 contributed to a sharp escalation of input costs for

Figure 4
Services
Annual Percentage Change



the services sector. This outcome results from the high level of imported inputs used by the services sector. For example, the communications industry relies heavily on imported electrical componentry, finance and business services require a high level of imported computing technology and much of the equipment used in the provision of health services is also imported. Input price inflation remained above the rate of output price increases until late 1985 as the appreciating exchange rate reduced the cost of imports.

Up until late 1986 output price inflation for the services sector was on an upward trend. Nevertheless, from mid-1984 to the end of 1985, greater input price inflation meant that the services sector probably experienced reduced margins. From 1985 to late 1986, however, a widening gap appeared, with output price inflation significantly above input cost rises.

One of the main factors contributing to this outcome has been the strength of demand for financial services. The financial services area has been growing more strongly than the rest of the economy for many years, but in the review period this trend has been made even more marked because of the accelerated pace of financial innovation, together with financial deregulation. For financial consumers, a much increased range of financial techniques, instruments and institutions has become available. The strength in demand appears to have allowed an increase in margins despite increased and more equitable, competition between institutions as a result of deregulation.

In addition, recent output price movements for this sector have also reflected relative price increases in areas such as electricity and communications. These have resulted from reductions in the implicit subsidies to users which previous public sector pricing policies involved.

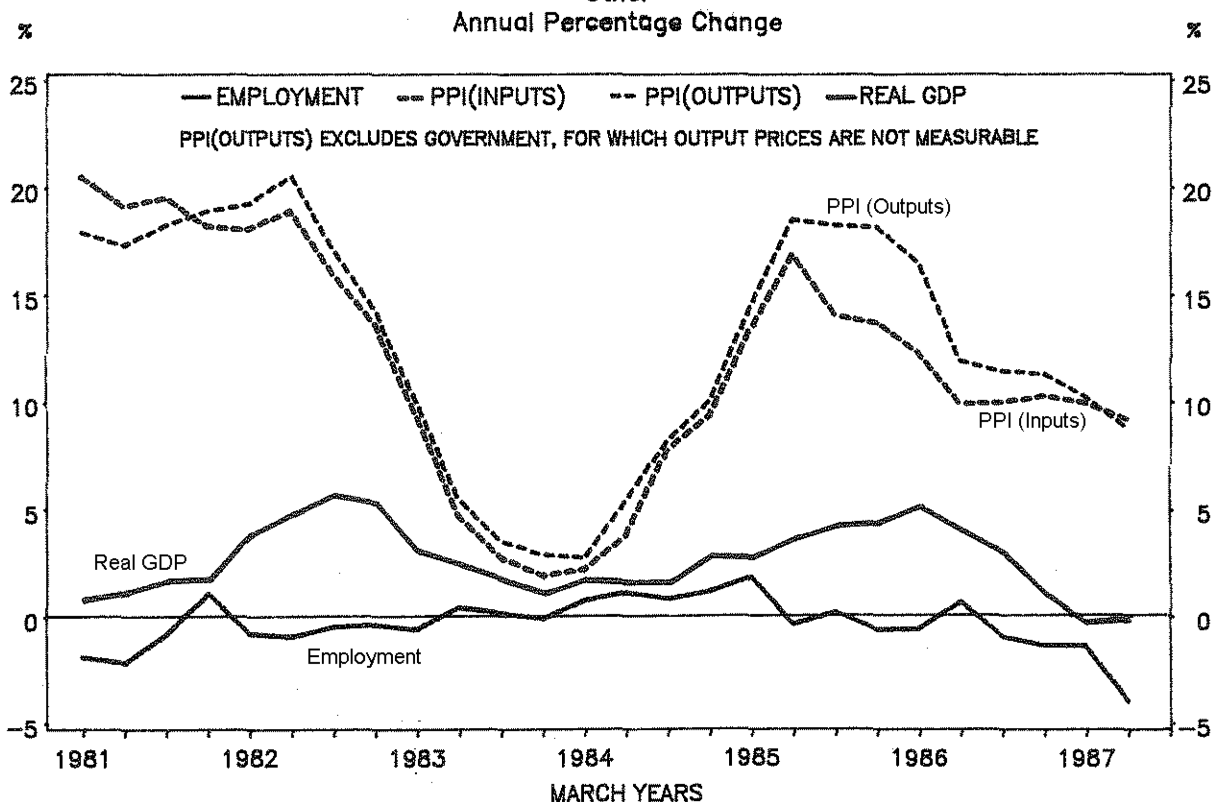
A partly offsetting factor is that the sector has been able to pass on relatively larger rewards to those within the industry. Thus the difference between measured output prices and input prices tends to overstate any increase in profit margins.

Other

The fifth and final sector is made up of a number of different production groups including fishing and hunting, forestry, mining, construction, transport and storage and services provided by central and local government. Taken together these production groups represent a sizeable proportion of output and employment in New Zealand but involve very diverse types of activities and historical experiences.

In overall terms, as Figure 5 shows, input and output price inflation for the sector tracked closely together up to early 1985. Some divergence between the rates then appeared over 1985/86 with output prices increasing faster than input prices. However, it seems likely that little or no increase in margins occurred during this period as wage inflation also peaked at this time at an average rate higher than input

Figure 5
"Other"
Annual Percentage Change



price inflation. In addition, the 'other' sector is dominated by government services, which do not have measured output prices and for which output is defined in terms of wage costs. Taking this into account makes it even more likely that the sector as a whole has not enjoyed higher margins, although some of the smaller groups within the sector have. In particular, fishing has undergone a dramatic increase in margins as the world price of several species of fish has driven up both export and domestic prices. Also construction, which has been in a boom period over the last two-three years in the area of commercial buildings, has been able to widen margins.

Activity for the sector as a whole has grown consistently over the entire period and has only recently levelled off. The main sources of this growth have been the construction and fishing, hunting, forestry and mining groups. The latter is notable for the influence of the petroleum extraction and petroleum exploration activities. Because exploration activity consists of current expenditure without a matching gross output, the contribution to gross domestic product is negative. Therefore, the strong measured growth for this group in 1985/86 actually reflected a wind-down in exploration activities, while a more recent drop in output growth is indicative of a larger amount of exploration activity being carried out. Construction, on the other hand, has been expanding its net output by an average of over 5 per cent in each of the last four years.

The total number of persons employed by the 'other' sector has been relatively steady over the bulk of the period of interest, but with a decline noticeable since the beginning of 1986. Employment has fallen across most of the categories in this sector, with a significant decline in the numbers recorded as employed in forestry. A large proportion of these however, are a result of the creation of the Forestry Corporation with the subsequent transfer of some staff from a directly employed basis to a contracted basis. The construction industry has provided less employment in the last year overall, as growth in those employed in the construction of commercial buildings has been more than offset by losses in the construction of housing. Government moves to improve the efficiency with which its services are delivered has also contributed to the fall in the sector's employment levels. Finally, deregulation in the transport sector over recent years has had a marked impact on the Railways Corporation which, in adjusting to the more competitive environment, has considerably reduced staff numbers.

Assessment

Having reviewed the main factors that have influenced the five broad sectors in the economy, one way of making a preliminary assessment of the output and employment costs of the current economic strategy is to compare current levels with those in an appropriate earlier base period. Ideally we would like to make a comparison with levels that prevailed prior to the introduction of concerted disinflationary policies. However, it is impossible to isolate the effects of one set of policies from those of another set, or from the effects of external developments. Nor is to easy to identify when the impact of new policies began.

Table 3 presents data by sector on shares of total GDP and employment, and percentage changes from two alternative base periods for both GDP and employment. As can be seen, agriculture and services have increased their shares of GDP somewhat in the three years to June 1987, at the expense of the remaining sectors. As a proportion of total full-time employment, the services sector has been the only sector to expand its share while the distribution sector has retained a virtually constant share of employment.

Compared with the year to June 1984, all sectors except distribution have shown moderate to strong real GDP growth over the three year

Table 3

Comparison of Output and Employment Levels

	Real GDP				Employment[1]			
	Percent Share of Total June Years		Percent Change To June 1987 June Years		Percent Share of Total June Years		Percent Change To June 1987 June Years	
	1984	1987	1984	1985	1984	1987	1984	1985
Agriculture	6.0	7.3	31.7	30.0	2.5	2.3	-9.4	-5.6
Manufacturing	23.1	22.0	3.1	-3.5	29.6	28.2	-6.4	-10.6
Distribution	19.5	17.8	-1.9	-2.8	15.3	15.2	-2.1	-5.6
Services	27.6	29.2	14.3	9.2	25.3	27.6	7.7	4.0
Others	23.8	23.7	7.6	3.8	27.3	26.7	-3.9	-3.5
TOTAL	100.0	100.0	8.0	3.8	100.0	100.0	-1.4	-4.1

[1] Full-time employment data from the Labour Deprtment's Quarterly Employment Survey, except agriculture which is from the Statistics Department and only available up to June 1986.

period to June 1987. The agricultural sector has shown very high measured real growth over the period, (but recall the qualifications noted earlier about the nature of that measured growth). The services sector has grown at an average real rate of close to 5 per cent per year, 'other' by around 2.5 per cent per year, and manufacturing by around 1 per cent. Distribution has shown an average decline of a little more than 0.5 per cent per year. Total real GDP expanded by over 2.5 per cent, per year, on average. With respect to employment, the comparison over the same period indicates that agriculture and manufacturing have been the areas where employment losses have been greatest, and only the services sector has expanded employment. This has helped to keep employment losses for the three years as a whole down to 1.4 per cent.

The choice of any particular base period is always a matter of debate, and here the choice of the year to June 1984 might be criticised on the basis that it was prior to a substantial period of growth in output and employment by several sectors. Thus, it could be claimed that the choice would tend to bias the comparison towards finding that output and employment levels are not substantially worse than they were in 1984. The choice of a later period such as the year to June 1985 could be more appropriate as this would more likely reflect a point just prior to when policies began to impact, especially with the floating of the dollar in March 1985. However, it can be argued in response that the choice of the later base year is also biased, but on the side of finding a more unfavourable comparison. In particular, much of the growth in output and employment in the manufacturing and distribution sectors over 1984/85 can be attributed to expansionary economic policies in the preceding period. Therefore, to choose the base period at the peak of the policy-generated growth cycle would make no allowance for the fact that more austere policies have traditionally followed such upswings, so that there would have been a downturn in economic activity quite apart from the effects of the new strategy implemented by the current Government.

Nevertheless, a comparison based on the year to June 1985 does show somewhat lower average growth rates in most sectors, with the most significant difference in manufacturing, where growth is now negative. Partly offsetting this is even stronger measured growth, on average, for the two year period in agriculture. The employment comparison has changed in a broadly similar way, with the services sector showing lower average employment growth over the two years, the losses in manufacturing, distribution and 'other' being at a higher average rate, but with average losses in agriculture being slower.

Conclusions

To sum up, a preliminary assessment would tend to favour the view that real economic activity has been stronger than was previously expected for the 1984-87 period. All sectors except distribution appear to have increased their net output over the three years, although in the case of manufacturing, this was only in the first year of the three. Strong growth is evident from the agricultural and services sectors, although the agricultural sector growth is likely to be reversed to some degree in the short term. Whilst the conclusion for output would appear to be relatively positive, the conclusion for employment is less so in that employment levels have been falling in all but the services sector.

Financial sector deregulation, which enabled consumers to gain increased access to credit, together with an earlier strong sharemarket and the stimulus provided from previously loose monetary and fiscal policies, resulted in rapid spending growth over the last three years. The resilience of domestic demand has served to moderate the adjustment costs in non-traded and still protected areas, particularly in comparison to the agriculture sector where a combination of factors has meant that the impact on profits has been greater than for other sectors of the economy.

In addition, the relatively buoyant domestic economy has meant that inflation and perceptions of future rates of inflation have not been reduced as fast as would have been desirable. Some domestic suppliers have not been sufficiently constrained in their pricing decisions by competition or a lack of domestic demand. This has affected the cost structure faced by other domestic producers, as well as prices and wages in general.

The conclusion for policy is that, notwithstanding the stock market decline, it is most important to credibly sustain firm monetary conditions in order to ensure a downward revision of inflationary expectations held by producers, households and wage setters. (The factors mentioned above have served to slow progress to date on reducing inflation but the indications are that single digit inflation will be achieved at least by March 1988.) At the same time actions to induce greater competition, such as accelerating the reduction of protection levels and removing the restrictions on competing with some state owned enterprises, will limit the possibility of further increases in margins. Similarly, greater flexibility in labour markets should lead to agreements which more closely reflect labour market conditions and changes in productivity.

The available evidence shows that the pressure from disinflationary policies and deregulation have fallen predominantly on exporting activities. Clearly there is scope for broadening the pressure of policy to reduce the emphasis on the presently exposed sectors and to bring competitive forces to bear on the pricing/output decisions of the largely non-traded and protected sectors. Moves in these areas should enhance the prospects of reducing inflation while at the same time minimising the incidence of adjustment costs.