REVIEW OF DOMESTIC AND EXTERNAL ECONOMY

The pattern of economic activity over recent months has been heavily affected by GST. This article examines the effects of GST and provides an outlook for economic activity following the initial post-GST downturn.

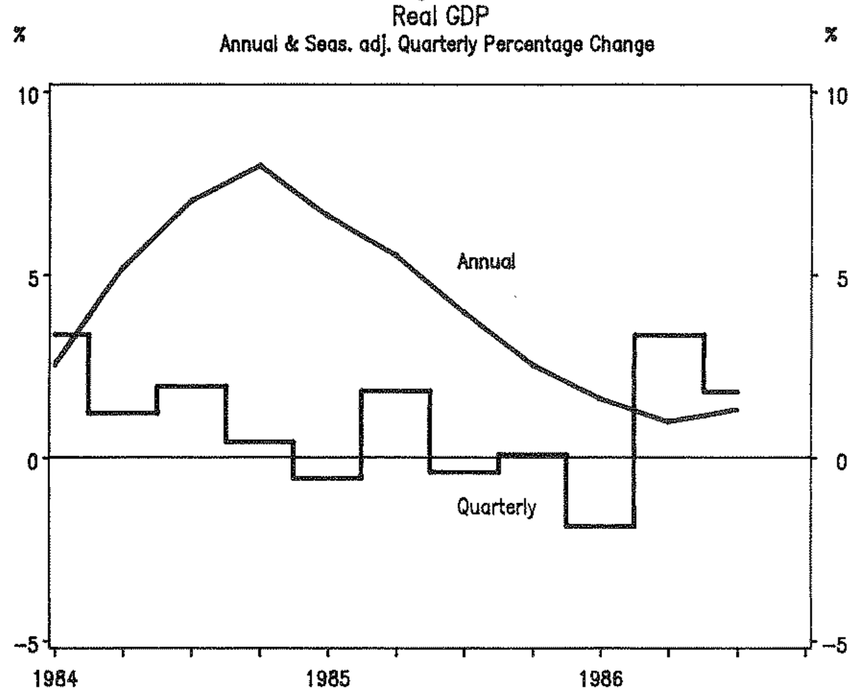
The introduction of the Goods and Services Tax (GST) on 1 October 1986 has had a significant one-off impact on the economy and has clouded the true underlying economic trends. Prior to the introduction of GST, in the September 1986 quarter, output and demand indicators recorded significant increases. As expected, after 1 October, demand fell dramatically and consumer prices, including a 6-7 per cent GST effect, increased by close to 9 per cent over the December quarter. Underlying the boom-bust GST shocks, economic growth appears to be relatively flat with no indication of a major upturn or a major downturn in the near future.

GST and Activity

GST appears to have influenced economic activity as early as the June quarter when consumers began to bring forward their expenditures, particularly with respect to consumer durables, in anticipation of price increases after 1 October. Retail trade (excluding the automotive sector) in the three months to June increased 2.6 per cent with furniture sales rising 11.4 per cent, both in real seasonally adjusted terms. While this GST-inspired surge in consumption helped boost economic activity in the June quarter, the strong 3.4 per cent increase in real GDP was largely a statistical aberration (see December quarter *Bulletin*) and activity was not expected to continue at that rate into the September quarter. However, the pre-GST surge in consumption gathered momentum as the introduction of GST drew nearer (figure 2). In the three months to September the real value of retail trade had increased 7.4 per cent with furniture, hardware, and household appliances increasing by 30.9, 23.9 and 22.7 per cent respectively.

Increases in consumption of the sort seen in the June and September quarters do not lead to an increase in output and employment if firms, in responding to the increase in demand, choose to run down inventories and/or increase imports of finished goods. Firms appeared unwilling to increase employment and expand existing capacity in response to the pre-GST surge in consumption because, by its very nature, the boom in demand was expected to be temporary. Thus, firms tended to run down inventories (the ratio of retail stocks to sales fell 12.8 per cent in the September quarter), increase utilisation of existing capacity and, to some extent, push up prices.

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



There was, nevertheless, a 1.8 per cent increase in real GDP over the September quarter (figure 1) with the most significant increase in activity (7.5 per cent) recorded in the Trade/Restaurants/Hotels industry. Activity in the manufacturing industry was maintained at high levels — falling only 0.8 per cent after a 10.5 per cent increase in the June quarter. Manufacturing activity was expected to decrease significantly in the September quarter because activity in the previous quarter was unusually high due to earlier industrial action in the meat processing industry. The sustained level of manufacturing activity in September was partly a result of the increase in utilisation of existing capacity in response to pre-GST buying (although the utilisation of existing capacity was still below levels recorded in the 1984/85 period of sustained economic growth).

As anticipated, demand fell away sharply in the December quarter. Following the 20.5 per cent increase in the nominal level of retail sales in September, sales fell 29.3 per cent in October, and in November remained 2–3 per cent down on levels of the previous year.

Employment

However, as already noted, while real activity over the middle of the year appeared healthy, employment trends were not. The impermanence of the pre-GST surge in consumption, underlying pessimism of employers about economic activity in the immediate future and the drive to increase labour productivity arising from the combination of anti-inflationary and market liberalisation policies helps explain the opposite movements in output and full-time employment. Output through the year to September rose 3.1 per cent but private sector full-time employment through the year to August fell 3 per cent. Also, the broad measure of unemployment (registered unemployment plus people employed on subsidised work schemes), rose by 34.4 per cent or to approximately 6 per cent of the labour force between the low point in September 1985 and December 1986.

However, in contrast to the noted 3 per cent fall in private full-time employment, private part-time employment rose 4 per cent over the same period. If firms were reluctant to increase permanent numbers employed in the face of the pre-GST surge in consumption they were willing to increase the number of part-time employees. The increase in part-time employment also reflects a longer-term trend in employment patterns, i.e. greater female participation in the work force and/or more flexible working hours in the retail trade sector.

In general, the (un)employment figures reflect the timing differences between the benefits and costs of the government's liberalisation policy. In the long term the reduction in government-imposed distortions to the operation of the price mechanism will mean a more efficient allocation of resources, more internationally competitive industries, and higher sustained economic growth, employment and income. In the short run, however, the moves to reduce the fiscal deficit, expose industries to market forces, limit import protection and maintain tight monetary conditions have resulted in lower incomes in those previously protected sectors now open to international competition, high interest rates and a strong New Zealand dollar. This has contributed to recessionary effects in agriculture and manufacturing. The meat industry, for example, in addressing the problems of excess capacity, inefficient killing processes, and high cost structures has closed the Shortland plant and the Whakatu plant resulting in the loss of 900 and 1,600 jobs respectively.

Other sectors of the economy have, of course, benefited from the policy mix. Respondents from the business services sector to the NZIER's Business Opinion Survey report an increase in profitability and employment over the September and December quarters. The tourism and construction sectors are also experiencing growth. Nevertheless, the persistence of high interest rates and a high exchange rate, the short-term immobility of the labour force, the shortage of skilled labour, and the multiplier effects of the downturn in agriculture and manufacturing are all factors which have in general dominated and been more pervasive. Table 1 shows that private sector full-time employment was lower in August 1986 than in August 1985 in all sectors of the economy, but one.

Table 1
Private Sector Employment Levels Percentage Change from August 1985 to August 1986

Industry	Per Cent
Forestry/Mining	-10.9
Manufacturing	-4.6
Construction	-7.0
Trade/Communications	-3.6
Finance/Business	9.9

Investment

The introduction of GST has also affected, to a lesser extent, investment. The imminence of GST helped boost residential construction over the September quarter. The value of residential building work put in place in the three months to September increased 24.9 per cent, following a 3.4 per cent decline in the June quarter. Builders probably brought forward their construction activity, as best they could, in an attempt to avoid paying GST on materials, labour and building permits. However, the dominant effect on residential construction may have come from the financial side with a higher take-up of mortgages in response to lower interest rates and an increased willingness by banks to lend. Commercial building activity was also significant in the September quarter, largely reflecting a commercial property boom in Auckland and Wellington. The sources of this commercial property boom are not entirely clear. There has been a reported increase in the demand for office space from the rapidly expanding services (financial and other) sectors. Commercial property also has added advantages under the New Zealand tax system in that the wealth gains from property revaluations are free of tax while the debt service costs involved in acquiring property are, in most cases, tax deductible. The net result of the increase in both residential and commercial building activity was a 6.8 per cent increase in real value added in the construction industry over the September quarter.

Surveyed import orders have also been growing rapidly. Orders for transport and machinery/electrical equipment in the three months to November 1986 were 96 and 19 per cent higher, respectively, than in the three months to November 1985. While orders for transport equipment are clearly up in real terms on the previous year, this partly reflects a low base and lumpy purchases by major users of transport equipment. Also, a large component of auto imports represent consumption rather than business investment expenditures. It is more difficult to make an assessment of the implied volume change in machinery/electrical equipment imports because of the lack of a suitable deflator. The significant appreciation of the currencies (against the New Zealand dollar) of many of the principal source countries for machinery would suggest that price increases could be reasonably high, although overall price increases would be unlikely to offset the full nominal increase in import orders. The lower real increases in machinery/electrical equipment probably reflect the disinvestment in the rural sector and the utilisation of existing capacity below peak levels in manufacturing.

Prices

The most significant distortion resulting from the introduction of GST has been in the measured inflation rate. Prices rose 8.9 per cent in the three months to December, the largest quarterly increase since the consumer price index (CPI) was first prepared in 1926. Although it is impossible to calculate precisely, GST has probably boosted the CPI by around 6–7 per cent over the long term. This means that the GST–adjusted annual rate of inflation has increased from 10.4 per cent in June to 11 per cent in September to 11–12 per cent in December 1986. The Budget night decision to increase the price of tobacco had an important one-off price effect on the CPI in the September and December quarters. In addition, it appears that retailers have boosted their profit margins, first in the September quarter in response to the pre-GST surge in demand and then in the December quarter by pushing up prices by more than was warranted by GST. However, retailers may have brought forward regular price increases to coincide with GST in order to keep administration costs involved with repricing stock to a minimum. A further easing in pressure on profit margins should occur as retailers face the post-GST slump in consumption expenditure.

The response of unions to GST will have significant implications for the future track of the inflation rate. The 1986/87 wage round has produced an average level of settlements of between 6 and 7.5 per cent. Although these levels of settlements appear low given inflation levels over the last year they are probably sufficient to maintain living standards. The NZIER predicts that the income tax cuts associated with GST will increase paypackets by 7 per cent. Thus, with-

Figure 2
Retail Trade
Seasonally Adjusted

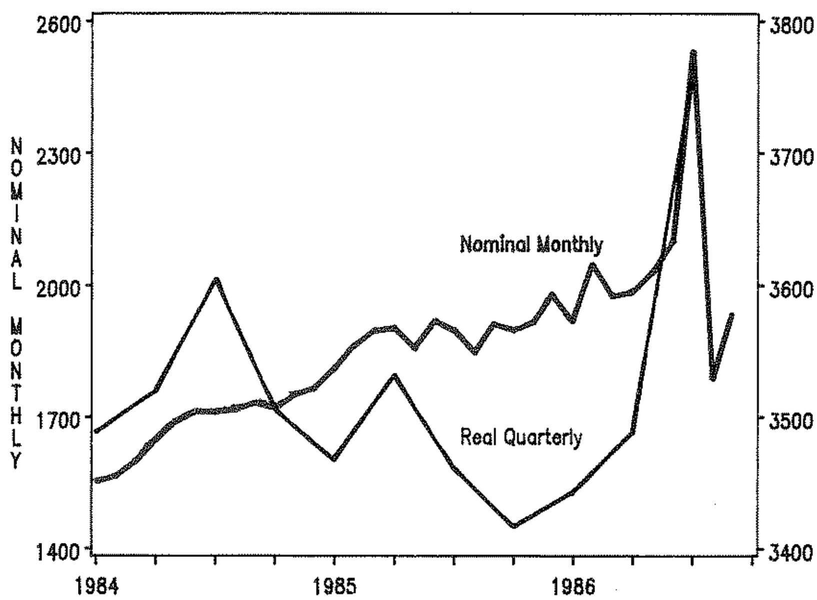
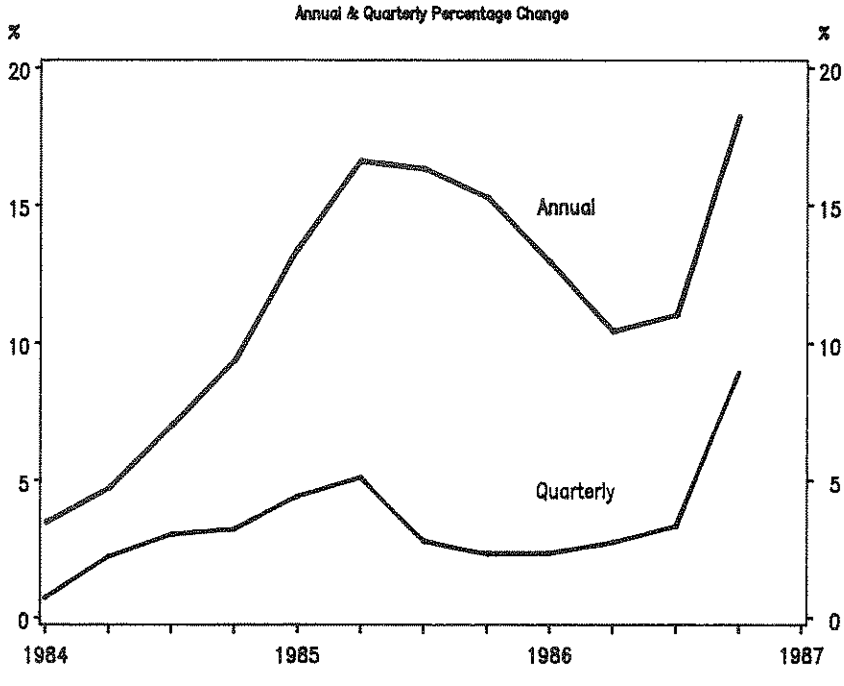


Figure 3
Consumer Price Index
Annual & Quarterly Percentage Change



out a further increase in wage settlements, wage and salary earners would be marginally better off by September 1987. Moreover, wage settlements at the 6 to 7.5 per cent level will contribute to a decline in the underlying inflation rate and assist New Zealand firms to compete with the non-inflationary cost structures of our trading partners. If future wage settlements, at the end of the 1986/87 round, or more importantly in the 1987/88 round, involve a delayed extra compensation for workers for the direct price effects of GST, the deflationary forces affecting retailers' margins (mentioned above) would temporarily be mitigated and would ultimately result in a slower decline in the underlying inflation rate.

External Developments

Balance of payments developments in the June and September quarters of 1986 provide encouraging signs that the downward trend in the current account deficit that was interrupted earlier in the year has resumed. Earlier sharp fluctuations in merchandise exports and imports (reflecting timing problems and other temporary disruptions to normal trading and production patterns) have now resolved themselves, leaving clearer indications of an underlying move towards a lower and more sustainable current account deficit.

This adjustment does appear to be taking place at a relatively slow pace. With little improvement in overseas market conditions, the possibility of a further weakening in the terms of trade and the prospect of continued growth in the invisibles deficit, this is not altogether unexpected. Although prospects for any significant immediate reductions in the current account are limited, the process of balance of payments adjustment requires a complex set of price adjustments, and changes in consumption, production and investment behaviour which do not occur rapidly.

Such a process of adjustment is a medium term one. Within a shorter time frame, it is to be expected that the balance of payments will be dominated by the influences of cyclical patterns in production and consumption, by other fluctuations or temporary disruptions to the domestic economy or international environment and by the impact of structural changes on current production and investment. As a result, it may be difficult to draw firm conclusions on the progress of the adjustment process from the data released to date. This is highlighted in the recent pattern of developments in New Zealand's balance of payments.

The deficit for the year to December was (provisionally) $2,726 million, 4 per cent lower than the deficit for the previous year, and significantly smaller than those recorded in 1984/85 and 1985/86. The overall improvement was largely driven by the improvement in the trade balance since the March quarter 1986, and would have been more substantial but for the unexpected strength of domestic activity.

Trade Balance

The prolonged upward phase in the domestic economic cycle delayed the predicted turnaround in the trade balance, with the strength of domestic consumption preventing a more prompt easing in import expenditures. The effects of this underlying demand strength were greatly magnified in mid 1986 by the impact of GST on the timing of consumer expenditure (in particular on durable goods). Import volumes have nevertheless now begun to subside and the 1.3 per cent fall in import volumes in the September year, combined with the growing positive trade balance over mid-late 1986, reflects the passing of this consumption surge.

Economic indicators for some major trading partners in the past year have also been more difficult to read. The international economy has remained balanced between a slow, uneven, recovery and a return to zero or negative growth, while international financial conditions have been extremely volatile. With only sluggish increases in overseas demand, the terms of trade have remained low. The relative strength of the dollar over the earlier part of the year had the effect of scaling down both import and export prices in New Zealand dollar terms. Despite a very large fall in the price of oil over the year, export prices declined more sharply than import prices, with the result that the terms of trade for the year to September fell 0.7 per cent below those for the September 1985 year, offsetting some of the favourable impact on the trade balance of the fall in import volumes. Very low rates of inflation in most of New Zealand's major trading partners' economies helped reduce import costs also, but this was accompanied by consistently low prices for major traditional exports, with sharp falls in meat and dairy export prices. Furthermore, little improvement in export prices seems likely in 1987, although the planned disposal of some European Community agricultural product stockpiles (particularly butter) should ultimately strengthen prices.

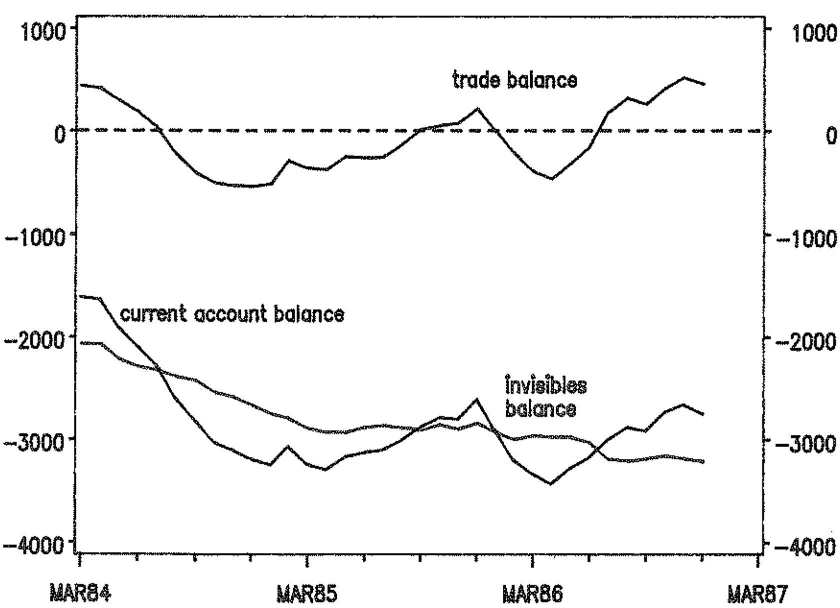
Finally, fundamental changes in domestic economic policies have resulted in large shifts in resources and changes in relative prices. One effect has been to temporarily boost consumption (reflecting a rescheduling of purchases), while other measures (in particular those with the objective of encouraging structural change) have had a temporary impact on production levels, particularly in those sectors now exposed more directly to changes in world market conditions. Structural adjustment in the traditional agricultural sector and in manufacturing seem likely to place short term constraints on the rate of growth in export volumes, and some of the interim consequences of these structural shifts can be seen in the path of the current account deficit over 1986. These effects are likely to be exacerbated by the impact of the drought in the current season. The drought is likely to be reflected in substantially

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)	+437	– 711	–1446	+106	–2051	–1615
June (P)	+185	– 865	–1503	+ 88	–2276	–2094
Sept (P)	–408	– 930	–1637	+152	–2412	–2881
Dec. (P)	–542	– 968	–1899	+212	–2653	–3197
1985						
Mar. (P)	–365	–1031	–2060	+209	–2880	–3245
June (P)	–263	– 923	–2201	+251	–2865	–3127
Sept (P)	+ 13	– 861	–2257	+224	–2894	–2879
Dec. (P)	+213	– 819	–2169	+161	–2828	–2611
1986						
Mar. (P)	–391	– 932	–2198	+186	–2949	–3338
June (P)	–160	–1018	–2170	+175	–3019	–3178
Sept. (P)	+270	–1115	–2264	+191	–3191	–2921
Dec. (P)	+512	–1050	–2276	+ 91	–3235	–2726

(P) Provisional

Figure 4
Balance of Payments
twelve month running totals, $m



lower agricultural production, in particular in the dairy industry. In contrast, the prospects for non-traditional agricultural exports — for instance horticultural products and fish — remain positive.

Invisibles Balance

The main and most immediate focus for concern is the invisibles balance. In the past decade, a sustained increase in the invisibles deficit has more than offset improvements in the trade balance, with the result that the current account deficit has seldom fallen below 3 per cent of GDP.

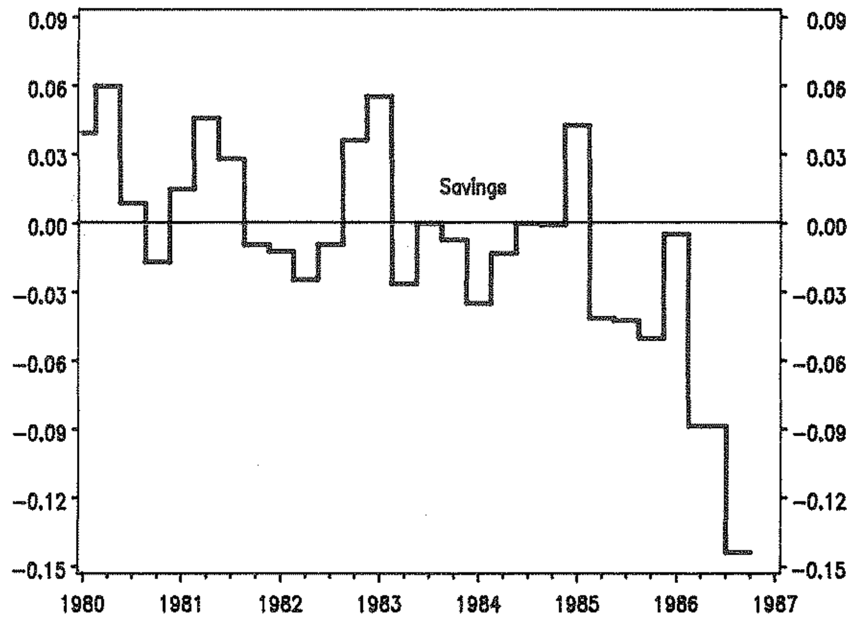
The primary factor in the widening invisibles deficit is the deteriorating balance on investment income, reflecting a growing divergence between earnings on overseas investment and interest payments on overseas debt. Private sector portfolio diversification since the removal of exchange controls in 1984 has resulted in a strong increase in overseas assets (although comprehensive data is not yet available) and this in turn has underpinned a steady increase in investment income (investment credits). However, in terms of absolute magnitude and rate of growth, investment credits remain overshadowed by the interest payments on overseas debt.

A new quarterly survey on overseas debt found that total overseas debt (official, government corporation and private) at the end of the September quarter 1986 was $33,124 million, or about 60 per cent of GDP. In the June and September 1986 quarters, valuation changes and a temporary build up in overseas reserves have been the predominant factors in changes in the level of debt. However, more generally, current account deficits necessarily involve offsetting capital account surpluses, and therefore increases in net overseas debt (or a rise in direct investment inflows). The current account deficit of just over $2,700 million for the year to December 1986 therefore provides an indication of the increase in net overseas indebtedness over the past year.

Apart from net investment income, the other major component of the invisibles balance is the balance on services (mainly transportation and fares). This has grown steadily in recent years, but has remained in a relatively stable negative balance.

Some questions can be raised regarding the completeness and reliability of the data from which balance of payments statistics on invisibles transactions are compiled; in particular there are indications that some of the recent increase in private overseas debt has been matched by an increase in overseas assets (and in associated investment income) which is not being picked up in the balance of payments statistics. It nevertheless is likely that a rising level of interest payments on overseas debt and a widening trend in the invisibles deficit will remain a prominent feature of the balance of payments until the necessary structural adjustments in the domestic economy are completed.

Figure 5
Household Savings Ratio
Seasonally Adjusted



Economic Prospects for 1987

Looking ahead into 1987, following the December quarter post-GST slump, the outlook is for two or three quarters of little or no real economic growth.

The prospects for an improvement in consumption beyond the initial post-GST slump will depend on developments in real disposable income and the future path of the savings ratio. The 1986/87 wage round, combined with the reductions in income tax and increases in welfare payments, will offset the price affects of GST on real disposable income, but only marginally. Moreover, 1986 has left many households with an historically low savings to income ratio so it is possible that any improvement in disposable incomes over 1987 will lead to a restoration of savings to more normal levels rather than an increase in spending. Predictions about household savings patterns are, however, difficult to make at the moment as the savings ratio seems to have undergone a trend change following the removal of interest rate controls in mid-1984 and the subsequent upward shift in household debt levels (figure 4). A further negative influence on savings in 1985 and 1986 arose from the increasing value of equity holdings.

To the extent that structural shifts in debt ratios have now been complete and if declining share prices generate continuing negative wealth effects through 1987, then any stimulus to consumption arising from an increase in real disposable income will be mitigated by a recovery in the savings ratio.

Lower levels of consumption expenditure will tend to delay the recovery in business investment. Moreover, high interest rates and a firm exchange rate will continue to discourage new investment including new housing which displayed remarkable interest rate sensitivity in 1986. However, holders of real assets have an advantage over holders of financial assets under the tax system and this could sustain the demand for housing in spite of the additional housing costs arising from GST.

The high real exchange rate, persistently low terms of trade and high interest rates will continue to adversely affect economic growth in the traded goods sector over the short-term. Consequently, over the first half of 1987, there is likely to be more disinvestment in the traditional farming sectors and further rationalisation beyond the farm gate. Manufactured exports are expected to undergo a moderate recovery but this is unlikely to stimulate much new investment given the present levels of spare capacity.

Therefore, in the wake of the pre-GST boom, the stimulus to domestic demand in the immediate future will tend to come from investment in the newer primary industries such as horticulture and fishing, and in sectors benefiting the most from the restructuring process - the business services and tourism sectors. Continuing growth in these sectors should also add impetus to the construction industry. Permits for Office and Administration building remain at historically high levels despite the general decline in the value of non-residential building permits since the peak in March 1986. With the 2 to 3 quarter lag between building intentions and building activity, commercial construction should continue to provide impetus to economic activity into the first half of 1987.

With only modest growth prospects for manufacturing and anticipated further disinvestment in the traditional farming sectors only being partially ameliorated by growth in horticulture, fishing and tourism, the improvement in the trade balance is expected to be a gradual one. Adding in a rising level of interest payments on overseas debt, then the scope for significant reductions in the current account deficit is clearly limited. On the other hand, lower levels of consumption should help to reduce imports and an increase in tourist revenue is expected to contain the invisibles deficit, thus giving the prospect of a definite improvement in the current account over the short term. Looking further ahead, a much stronger growth in net export receipts and a medium term reduction in the relative size of the fiscal deficit will be required to restore the current account to a more sustainable position and to stabilise (in relative terms) the level of overseas debt.

With only modest growth prospects for domestic demand and net exports, economic activity is likely to be flat over the first half of 1987. In the longer term, however, both domestic demand and net exports are expected to strengthen economic activity as the liberalisation and disinflation policies produce a more efficient allocation of resources and more internationally competitive industries.