Economic Management

THE TREASURY

14 JULY 1984

Economic Management

PART ONE

Economic Situation and Outlook

PART TWO

Policy and Organisational Issues

THE TREASURY

14 JULY 1984

27 August 1984

OFFICE OF MINISTER OF FINANCE
WELLINGTON, N.Z.

ECONOMIC MANAGEMENT

This document contains Treasury's analysis and comments on the management of the economy. As is customary, this briefing material was completed prior to the General Election for submission to the incoming Minister of Finance whoever he or she might be. As such, this piece of work is a comprehensive, independent and professional assessment of the state of New Zealand's economy and of the many difficult policy issues which confront us all.

It is as part of the Government's pledge to 'open the books' that this document is being published. While reports on the state of the economy have previously been published in similar circumstances, this is the first occasion on which Treasury's discussion of a wide range of policy issues has been released. In authorising this publication, however, I want to make it clear that the Government does not necessarily agree with the views contained herein.

The material is being published as it was submitted to me apart from a small number of changes that are of little substance. In addition to correcting minor and printing errors, amendments have been made in eight places where it would be improper to publish the full text because, for example, specific advice was proffered which if publicly known could confer commercial advantages, or comment was made about the policies of other countries.

The forecasts in the brief assumed the continuation of the policies of the previous administration as these were then in force. Some care in interpreting elements of the economic outlook presented is therefore required as it does not incorporate the effects of more recent policy changes, notably the devaluation, changes in monetary policy and export subsidy schemes, and the Government's firm commitment to contain inflationary pressures.

In releasing this Treasury document, and in the interests of informed public debate, I commend a close study of it to all those interested in understanding the major economic issues facing the nation.

Roger Douglas

INTRODUCTION

This *Economic Management* briefing is divided into two parts. The first part deals with the domestic and international economic situation and outlook through to 1986. The second part introduces the major economic management issues that face the incoming Government.

Part One is divided into six chapters. The first assesses the current international economic situation and outlook. Individual assessments of the major OECD economies as well as consideration of the non-OECD economies, the debt situation, and the oil market are included. The second chapter provides an analysis of the domestic economic situation and a discussion of likely economic developments in 1984/85 and 1985/86. A detailed discussion of recent developments in New Zealand's external sector and the prospects for the overseas exchange transactions through to June 1986 are provided in the third chapter. The fourth chapter sets out forecasts of government expenditure and revenue for 1984/85 and compares these forecasts, and the resulting fiscal deficit, with the 1983/84 outturn. This is followed by a description of the current status of the public debt and official reserves, and the borrowing programme to June 1985 implied by the economic forecasts presented in previous chapters. The final chapter reviews developments in the distribution of income in New Zealand in recent years. In particular, it discusses changes in households' share of total income and changes in income distribution within the household sector.

The forecasts contained in this part were prepared on the basis of a continuation of existing government policy assuming no policy change and were finalised in early July before the change in administration. In particular it should be noted that these forecasts do not incorporate the effects of more recent policy changes, notably the July devaluation, the changes in monetary policy, and announcements on the future of export incentives.

Part **TWO** has fifteen chapters and addresses important areas of economic policy. Included in the first chapter, which provides an overview of economic management, is a section setting out the key points contained in the chapters which follow. As a short guide to the second part of the brief, this section is a useful reference both as a descriptive outline of the chapters and as a summary of some of the more general observations made.

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PART ONE

Economic Situation and Outlook

Chapter One

Current International Situation and Outlook

This paper assesses the current international economic situation, and the outlook through to 1986. It is based on the latest available set of international economic projections, namely the *OECD Economic Outlook* published earlier this month. A summary of those projections is contained in Appendix A. We have also drawn on commentary from a number of other sources, plus data that have only recently become available.

Overview

Both output and demand in the OECD area recovered strongly in 1983 and early 1984. Real GNP is now rising at an annual rate of nearly 5 percent. The recovery was led by the United States but by the end of 1983 was also established in Japan, Germany and the United Kingdom. The rate of consumer price inflation slowed to nearly 5 percent in 1983-half the 1981 rate-while the average unemployment rate levelled off at around 8.5 percent. The volume of world trade is estimated to have recovered by 2 percent in 1983, largely as a result of strong growth in United States imports.

The outlook for the next eighteen months is for the rate of economic growth in the OECD area to moderate somewhat. Real GNP is projected by the OECD to grow by 4.5 percent in 1984, slowing to 2.5 to 3 percent in 1985. The magnitude of this slowdown reflects the OECD's forecast of a significant deceleration in the United States economy from the second half of 1984 onwards. We doubt if the deceleration will be that sharp. Inflation is expected to remain around its current rate of 5 percent, as further improvements in Europe are offset by a slight acceleration of inflation in the United States and Japan. The outlook for unemployment is poor . While employment should continue to grow, rising labour force participation is expected to push the unemployment rate up further in Europe. Overall, the driving force behind growth in the OECD area appears to be moving from consumption to investment . Buoyant export markets are underpinning production growth in many countries; this stimulus should moderate somewhat after 1984, although remaining well above the level of recent years. World trade volumes are expected to grow by 7 percent in 1984 and 5.5 percent in 1985.

Looking ahead to the end of 1985 and into 1986, it is likely that the broad trends that are now being established will continue. At some point the United States economy will move through the deceleration phase of its business cycle. Given a reasonable degree of success in implementing the current mix of policies, it is however plausible to expect modest but sustainable rates of growth in the OECD group, economic recovery in many (though not all) debtor developing countries, and rising levels of world trade.

An uncertainty in the outlook is the future course of monetary and fiscal policy in the United States. A conservative monetary stance is necessary to prevent a resurgence of inflation. Interest rates will therefore remain high and adversely affect business investment, exchange rates and the financial position of major LDC debtors unless the United States authorities are successful in unwinding their expansionary fiscal position. As the strong dollar continues to widen the United States current account deficit, pressure is growing for a shift downwards in its exchange rate. A sudden fall could have adverse consequences.

Prospects for the Major OECD Economies

The *United* States economy has been experiencing strong economic growth for the past eighteen months, fuelled by rapid growth in consumption, residential construction and stocks. Real GNP surged in the first quarter of 1984 to an annualised growth rate of 9.7 percent, largely as a result of unusually large stock build-ups. Unemployment has fallen sharply from 10.4 percent of the labour force in January 1983 to 7.5 percent in May 1984. In response to both the rapid growth in domestic demand and a strong dollar, the trade deficit increased sharply from $43 billion in 1982 to almost $70 billion in 1983.

Recent data indicate that the economy is still expanding at a rapid rate, with real GNP growing at an annualised rate of 5.7 percent in the second quarter. The driving force behind this growth is the strength of business investment, responding to high levels of profit and of domestic demand, which have more than offset the effects of high interest rates. The combination of a loose fiscal policy and a carefully balanced monetary policy has thus far successfully accommodated a major expansion in economic activity while avoiding a resurgence of inflation. The OECD envisages the pace of United States recovery slowing significantly over the next eighteen months as continuing high interest rates act to moderate the sharp rise in business investment, and a slight increase in inflation slows consumer demand. Growth in real GNP of 6.0 percent is forecast for 1984, dropping to 2.5 percent for 1985. We consider that their concern for the impact of high interest rates may be overstated and that rates of growth may be higher, in the second half of 1984 and in 1985, than the

OECD forecast. At some point in 1985 or 1986, however, the maturing of the American business cycle will act as a temporary brake on the rate of growth.

Consistent with brisker than expected economic growth, the unemployment rate dropped in June to 7.1 percent, the lowest level in more than four years. This decline does not appear to be strengthening inflationary pressures; it is worth noting that the GNP deflator rose in the second quarter at an annual rate of only 2.8 percent. The budget deficit is expected to be reduced slightly, from the present 5.3 percent of GNP to around 5 percent, although it remains very large for the upswing of a business cycle. Growth in 1985 and beyond will be influenced to a considerable extent by progress in further reducing the deficit. The United States administration, assuming a successful winding down of the fiscal deficit and conservative monetary policy, predicts real growth of ,4 percent from 1985 to 1989. Without a significant reduction in the deficit, however, the attendant financial pressures could have adverse consequences for investment and growth.

]apan's economic prospects are satisfactory. Real GNP accelerated to a 7.4 percent annualised growth rate in the first quarter of 1984 after growth of 3 percent in 1983. While export growth provided most of the initial stimulus to recovery, with exports increasing by 14.5 percent in volume terms from 1982, growth in domestic demand has strengthened substantially and is expected to contribute to sustained growth in 1984 and 1985, despite a restrictive fiscal stance.

Private fixed investment has begun to pick up in face of much improved corporate profits and declining interest rates, and is expected to increase strongly. Personal consumption, on the other hand, has been restrained by low wage increases, but some strengthening is expected, as recent income tax cuts and expected wage growth feed through into disposable incomes. Unemployment is expected to reduce slightly from the 2.7 percent rate of March 1984. While imports should pick up sharply as domestic demand accelerates, exports too are expected to continue increasing, although at a slower rate than in the past as the United States recovery moderates.

Recovery in the *European* economies began slowly, and has generally proceeded at a much weaker pace than in the United States. This comparative!y poor performance has been attributed to the relative inflexibility of these economies, with inflation and real wages slower to respond to counter-inflationary policies. In addition, many European governments are continuing to apply tight fiscal policies, which is contributing to fairly slow consumption growth. The outlook for business investment, however, is improving. Strong export growth is also acting as a stimulus to most European economies. In most of Europe, unemployment remains an intractable problem, with employment gains likely to be insufficient to offset labour force growth.

The *German* recovery in output began in early 1983, with modest growth of 1.3 percent achieved in that year, and gained momentum in early 1984. Initially driven by domestic factors, notably a large drop in the household savings ratio and a build-up of stocks, the recovery was then supported by a strong growth in exports. The rate of inflation has fallen sharply, to 3 percent in 1983 compared to its average of about 5.5 percent over the previous three years. Unemployment has declined from its mid-1982 peak of 9.5 percent to below 8.5 percent.

While the German economy seems well placed, following settlement of the metal workers' strike, for continued economic growth, the overall outlook is for only modest expansion, with new investment likely to be sluggish. The Government is committed to limiting public expenditure growth and further reducing the fiscal deficit (which stood at 2 percent of GDP in 1983). German estimates of the 1984 growth rate (both official and unofficial), have recently been revised downwards from 3-3.5 percent to around 2.5 percent.

In France, the recovery has been slow in emerging, with initial gains coming largely from the pick-up in foreign demand. The Government's austerity programme (introduced in 1982 after the balance of payments deficit had deteriorated sharply) is intended to restore external balance by restraining domestic demand and improving external competitiveness. While it has achieved a certain success with inflation (which fell to 9.6 percent in 1983 from 13.4 percent in 1981), unemployment has risen sharply, to around 8.5 percent. These trends are expected to continue over the next eighteen months. With falling real wages and rising profit margins providing some stimulus to investment, and continued growth in exports, GNP is projected to increase 1.25 percent in 1984, rising to 1.75 percent in 1985.

The recovery in the *United Kingdom* strengthened considerably during 1983, with real GDP growing by just under 3 percent. In 1984, a slowdown in consumption spending is being offset by a rapid increase in business investment. Despite a recovery in employment since early 1983, unemployment has recently been edging upward to over 12.5 percent. The OECD projections are for the rate of inflation to stabilise at around 5 percent. Nevertheless, inflationary pressures remain which could act to moderate growth below the 2.5 percent projected for 1984 and 1985.

Australia

The pick-up in the Australian economy began in mid-1983 when the rural sector recovered from the severe drought in 1982/83. This agriculture-led growth moderated towards the end of the year, and broadened out as improvement in the housing sector and in non-farm exports contributed to the recovery. Overall, real GDP grew by 7.9 percent over the year to March 1984, comprising 40.1 percent growth in farm product and 6.3 percent growth in non-farm output. On the other hand, economic growth remains unevenly spread. Private dwelling investment increased in real terms by 32.7 percent over the year to March, but investment in other areas is still well below its level of a year ago. Private consumption has shown only modest growth over the past year, with much greater stimulus to growth coming from government consumption expenditure.

The outlook for the next eighteen months is for overall output growth to slow, but to be more broadly based. The OECD projects real GDP to grow by 6 percent in 1984, slowing to 4.5 percent in 1985. Official forecasts are more optimistic: around 7.5 percent in the year to June 1985. Private consumption growth is expected to accelerate, while there is recent evidence of a pick up in business investment, reflecting improved profitability and a favourable outlook for wage costs. Unemployment has so far continued to fall, to 8.9 percent in May compared with the peak of 10.4 percent in September 1983. However, further improvements may come only slowly in future. The assessment of price developments has been complicated by the transfer of much medical insurance expenditure from the private to public sector under the new Medicare scheme. Neverthless, it is clear that substantial gains against inflation have been made, although it still remains undesirably high (the GDP deflator rose by around 7.8 percent for the year to March 1984, compared with over 13 percent in the year to December 1982).

The Australian economy is in a strong though patchy growth phase which is likely to continue into 1985. This relatively favourable outlook for the short term is however subject to a number of uncertainties for 1985 and beyond. The Public Sector Borrowing Requirement (PSBR) is currently around 9 percent of GDP and is unlikely to be reduced by more than 1 to 1.5 percent over the next year. These are high levels for an economy in which private business investment is showing signs of a recovery. This conflict between the private and public sectors' borrowing requirements is being eased by foreign capital inflows, but this will place upward pressure on the Australian dollar. It is also likely that any attempt to avoid the problem by relaxing monetary policy would result in an increase in the inflation rate. An increase in inflation could put pressure on the wage/price accord which has been successful thus far.

Non-OECD Countries

The sharp reduction in OPEC imports continued in 1983 (when import volumes fell by nearly 10 percent) as oil revenues continued to fall and governments adopted more restrictive fiscal policies in an attempt to control current account deficits. From the second half of 1983, however, demand for OPEC oil began a gradual recovery after four years of decline. This improvement in export receipts is expected to continue over the next eighteen months, allowing a modest increase in import volumes from the second half of 1984. The OECD projects a growth in import volumes of 5 percent in 1985.

The volume of imports of the *non-oil developing countries* was static in 1983 following a 5 percent reduction in 1982, which came in response to a sharp cut-back in available financing. The combined current account deficit of these countries has been virtually cut in half between 1981 and 1983 solely as a result of this large scale compression of imports. Given somewhat improved recent and prospective financial flows to these countries (described below), and the prospect of reasonably strong export growth and improving terms of trade, the OECD forecasts that these countries should be able to combine an increase in imports with a further reduction in the current account deficit, at least through 1984. Import volumes are forecast to increase by 5.5 to 6 percent in both years, with export volume growth of around 7 percent in 1984 and 5 percent in 1985. This relatively optimistic assessment for the group as a whole does not exclude continued serious difficulties for many countries, major debtors in particular.

International Banking Flows and Debt Developments

Lending to developing countries (in the form of medium and long term bank loans and bond issues) picked up in the first five months of 1984 from the very low levels of the second half of 1983. The greater part of this lending was accounted for by Brazil (US$6.5 billion) and Mexico (US$3.8 billion). Almost all lending to Latin America now takes place under arrangements involving the restructuring of maturing debt and the coordinated provision of “new money”. These arrangements aside, “spontaneous” lending to developing countries continued to decline. Overall the attitude of banks towards lending to developing countries remains cautious. There is however an increasing differentiation in the treatment of major debtors. Those such as Mexico who are implementing succesful adjustment programmes have been able to obtain (with the support of the IMF and the major economies) longer term and more finely priced debt rescheduling. At the other extreme the prospects for resolving Argentina’s financial difficulties, and avoiding the realisation of large losses by the banks involved, remain bleak.

Looking ahead to 1984 as a whole, the IMF expect it will be possible for the non-oil developing countries to maintain the precarious financial balance achieved in 1983. The continuation of new bank lending at its 1983 rate of around US$20 billion (as compared to US$71 billion in 1981) would in combination with 1983 levels of net foreign investment, aid, and official lending be sufficient to finance a projected current account deficit of US$SO billion, and even permit a rebuilding of reserves. One area of uncertainty concerns the consequences of recent rises in interest rates, which have had a direct effect on debt servicing costs. Against this needs to be set gains in export earnings that are proving to be stronger than expected earlier this year. Another area of uncertainty concerns the very large "errors and omissions" component of the capital account of this group of countries. Believed to represent mostly illegal capital flight, this amounted to an outflow of US$45 billion over 1981-83. Improved prospects here, as for bank lending, are closely tied to the restoration of confidence in economic prospects and management.

The Oil Market

Towards the end of 1983 oil consumption in the world's major markets increased for the first time in four years. The seasonal decline in demand since then has not been matched by a corresponding reduction in OPEC output, which stands at around 18.2 million barrels per day (Mbd). Most OPEC countries are exceeding their production quotas. This OPEC overproduction has caused spot prices to fall below official prices despite the recent tensions in the Persian Gulf. In the second quarter of 1984 Western oil stocks rose by around 1.8 Mbd as a result of this oversupply.

The low level of demand, adequate stocks, high levels of unused production capacity and negative refinery margins all suggest a fundamentally weak market. While disturbances in the Persian Gulf may cause short-term increases in spot prices, the overall outlook is for continued downward pressure on real oil prices.

Uncertainties in the Outlook

The major risks underlying the projections of a moderating but sustained recovery in the OECD area arise from uncertainty surrounding monetary and fiscal policy and the future level of interest rates in the United States, and also the future track of the United States dollar. Although the possibility of a resurgence in inflation remains, this appears less likely given continuing moderation in wage negotiations and monetary restraint in most countries. Most economies in the OECD area have moved from the initial phase of economic recovery, characterised by a drop in the savings ratio and stock re-building, to the point where future growth is dependent on the growth of investment. High levels of profitability and a reduction in the level of real interest rates will be key factors for sustained, non-inflationary growth. The role of United States interest rates is particularly important, because of their interaction with the value of the United States dollar and their impact on the debt servicing of many countries.

The charts in Appendix B illustrate recent developments in United States interest and exchange rates, and show the upward trend over recent months as rising interest rates (responding to rapid activity and competition for funds between public and private sectors) have boosted the dollar's value. With a further rise in the dollar over recent weeks to record levels against European currencies, it is increasingly uncertain how long its strength can be sustained. Despite high interest rates, the United States economy may begin to lose some of its attractiveness for foreign investors. Moreover, the widening trade deficit is also putting increasing downward pressure on the dollar.

What is not clear is whether a decline in the value of the dollar will be gradual, or abrupt, and whether it will be associated with falling or rising interest rates. Various scenarios are possible, with either favourable or unfavourable consequences. At one extreme a gradual decline in the value of the dollar, in response to lower interest rates that in turn reflected reductions in the Federal deficit, could benefit growth in the United States by encouraging investment. Other countries would benefit from a combination of lower costs of imports, and of debt servicing, and increased freedom of manoeuvre to relax domestic monetary policies and reduce interest rates. At the other extreme, a sharp fall in the dollar could provoke a significant tightening of United States monetary policy leading to a rise in real interest rates in the United States and elsewhere, with adverse repercussions for investment and sustained economic growth.

Another area of uncertainty concerns the financial difficulties of major debtors in Latin America and of their United States bank creditors. While these difficulties are likely to continue, and in individual cases could well intensify, the global impact is likely to be limited. The contribution of these countries to world trade is not large, while any bank problems should be able to be handled by the same "lender of last resort" techniques used in the Contintental Illinois case.

Implications for New Zealand

The outlook implies continuing strong growth in OECD import volumes in 1984 and 1985 (albeit at a reduced rate as growth in these economies slows) and a resumption of growth in non-OECD import demand. Combined with improved prospects for Australia, this represents strong growth in the import demands of New Zealand's major trading partners and represents, by recent standards, a comparatively favourable international economic environment.

Although the general prospects for world trade are promising, some major markets and commodities of particular interest to New Zealand are suffering oversupply and access problems, which will mean that our export growth is likely to be uneven. In addition the expectation that real interest rates will remain high implies that New Zealand cannot expect a significant reduction in the real cost of foreign borrowing.

APPENDIX A

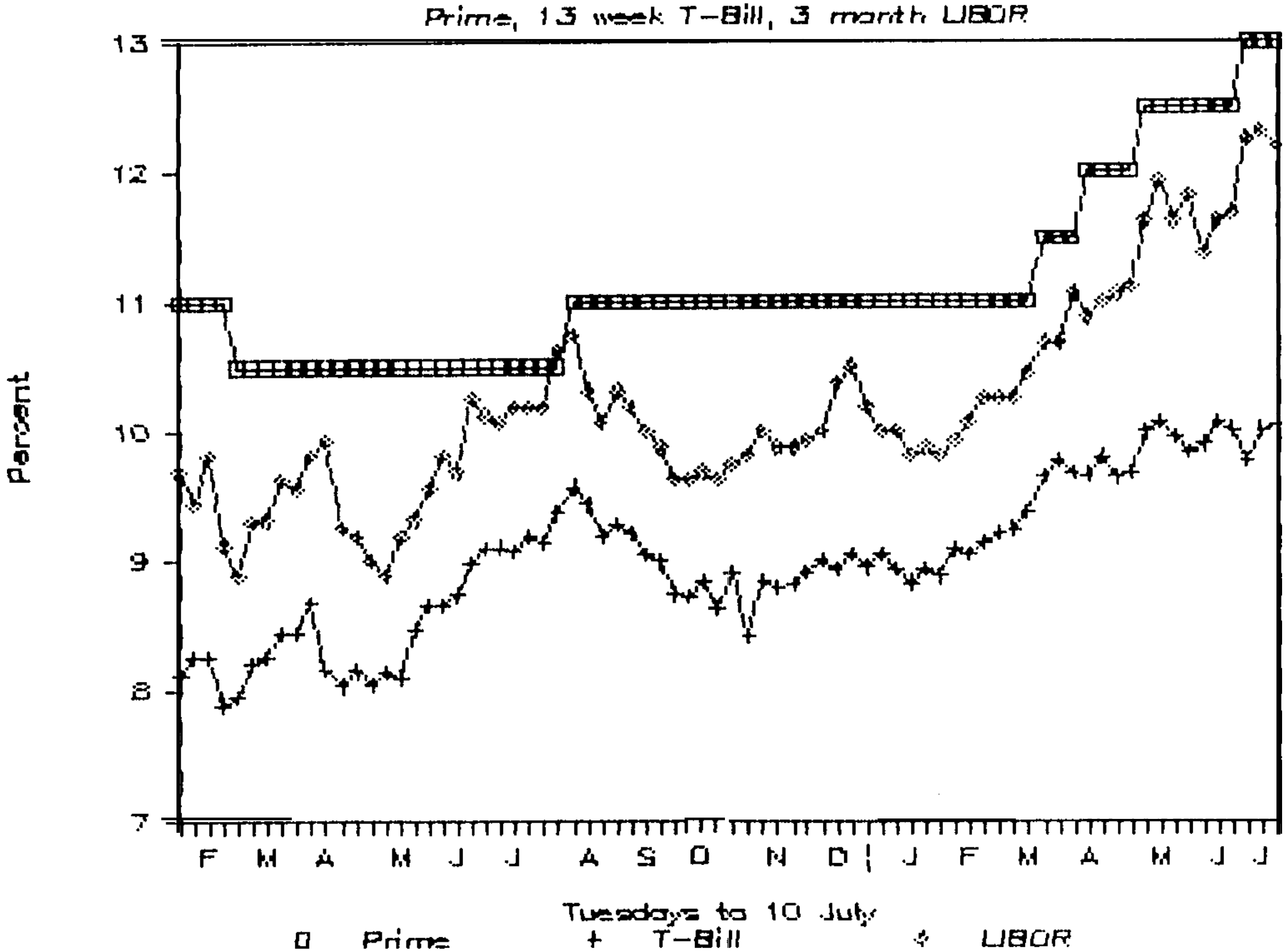
SUMMARY OF LATEST OECD PROJECTIONS

	1983	1984	1985	1984		1985	
				(Seasonally!' Adjusted al Annual Rates)			
Real GNP	Percentage Changes from Previous Period						
United States	3.4	6.0	2.5	6.5	3.3	2.5	2.5
Japan	3.0	4.8	3.8	5.0	4.0	3.8	4.0
OECD Europe'	1.3	2.3	2.3	2.3	2.5	2.3	2.5
Australia	1.2	6.0	3.5				
Total OECD	2.4	4.3	2.8	4.5	3.0	2.5	2.5
Real Total Domestic Demand							
United States	4.6	7.3	3.0	8.3	3.5	2.8	2.5
Japan	1.5	3.8	3.3	4.0	3.8	3.0	3.3
OECD Europe'	1.0	1.8	2.0	2.0	2.0	1.8	2.0
Australia	-1.7	5.8	3.5				
Total OECD	2.6	4.5	2.5	5.0	3.0	2.5	2.5
Inflation (Private Consumption Deflator)							
United States	3.9	4.0	5.3	3.5	5.3	5.0	5.3
Japan	1.5	2.3	3.0	2.5	2.3	2.8	3.5
OECD Europe'	7.5	6.0	5.3	6.0	5.5	5.5	5.0
Australia	9.4	6.0	6.8				
Total OECD	5.5	5.3	5.3	5.0	5.5	5.3	5.3
Unemployment				% of Labour Force			
United States	9.6	7.5	7.3	7.0	7.5	7.5	7.3
Japan	2.6	2.5	2.5	2.8	2.5	2.5	2.5
Europe	10.5	11.0	11.3	11.0	11.0	11.3	11.5
Australia	9.9	9.3	8.8				
Total OECD	8.9	8.5	8.5	8.5	8.5	8.5	8.5
Current Account Balances				US$ Billion			
United States	-41	-86	-105	-80	-92	-105	-105
Japan	21	30	36	30	31	34	38
OECD	-25	-52	-52	-50	-53	-56	-49
OPEC	-19	-8	-12	-7	-9	-11	-12
Non-Oil Developing Countries	-43	-40	-46	-39	-42	-45	-48

Assumes no change in ‘actual and announced policies, current exchange rates, or nominal dollar oil prices

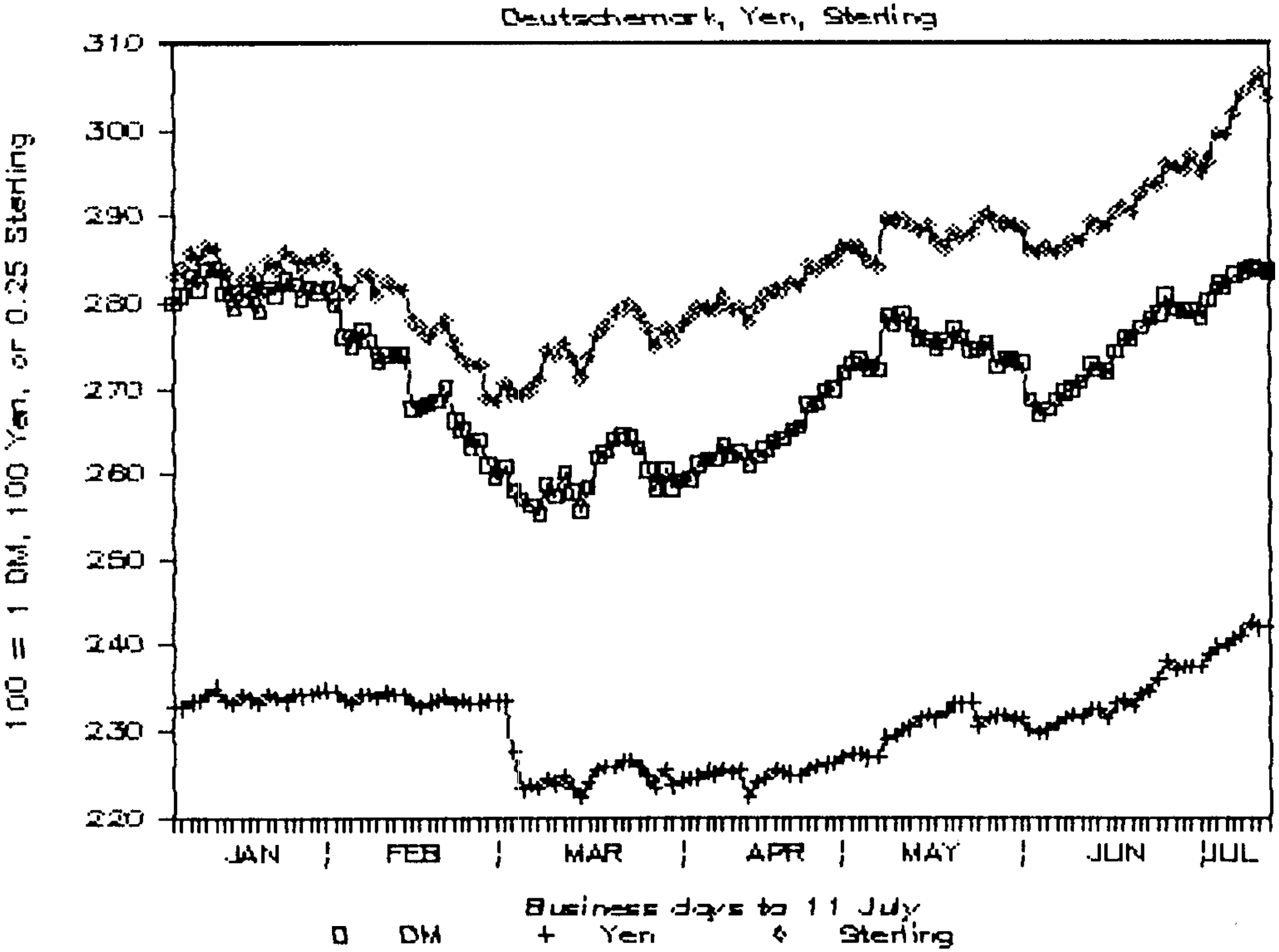
Source: OECD *Economic Outlook*, July 1984

US Interest Rates, 1983 & 1984



APPENDIX B

US $ Exchange Rates, 1984



Chapter Two

Economic Situation and Outlook to 1985/86

CAUTION: ALL FORECASTS IN THIS CHAPTER ARE CONDITIONAL ON POLICIES IN PLACE PRIOR TO 14 JULY 1984

Overview

The following table summarises the forecasts:

	Actual or Estimate	Forecast	
	1983/84	*1984/85*	*1985/86*
Change in Real GDP (%)	+2	+3	−1
Change in Employment (%)	-0.6	1.8	−0.5
Inflation Rate (CPI-%) ..	5.1	6.0	7.5
Current Account Deficit (% of GDP)	-4.6	-7.2	-6.4

(All figures show change in annual average level over previous year)

The domestic economic expansion, which began early in 1983, is now easing. It has been driven in part by strong growth in overseas markets for manufactures and forestry products, the response to which has been reinforced by the gains in manufacturing competitiveness achieved during the freeze. A substantial part of the stimulus, however, has stemmed from more transient factors such as the expansion in domestic spending associated with very high rates of money and credit growth, and purchases of durables in anticipation of price increases. Because of the nature of international recovery and serious imbalances in some international commodity markets, the domestic economy has not benefitted from the normal cyclical strengthening in pastoral export prices and farm incomes.

Assuming that the international economy remains strong through 1985, as appears likely, the ability of New Zealand to sustain a high level of activity will depend critically on at least maintaining the gains in competitiveness that have been made and preventing a resurgence of inflation. That, in turn, will require positive action to deal with the present serious macroeconomic policy imbalances. Some easing back in activity is inevitable, as real private consumption slows and the deteriorating external situation dampens the rate of money and credit expansion.

The Graph 1 below provides an indicative profile of the movements in quarterly real GDP that lie behind the annual movements in real GDP contained in these forecasts.

Graph 1: Quarterly Real GDP (1977/78 Prices)

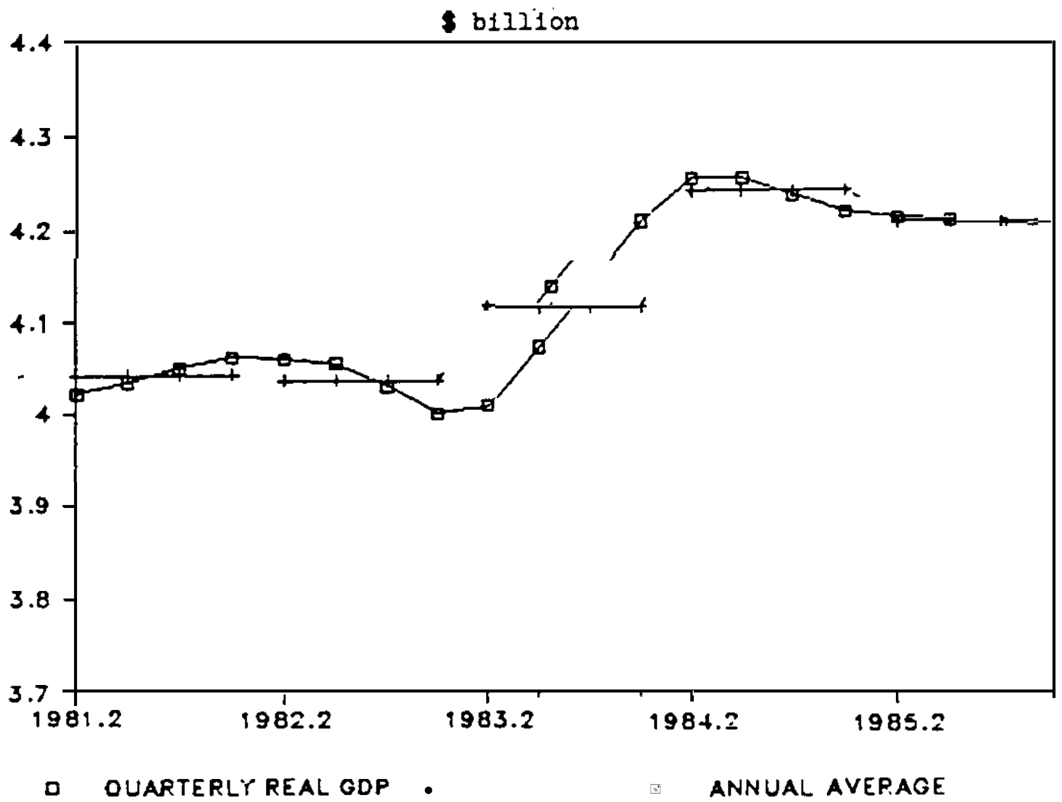


TABLE 1

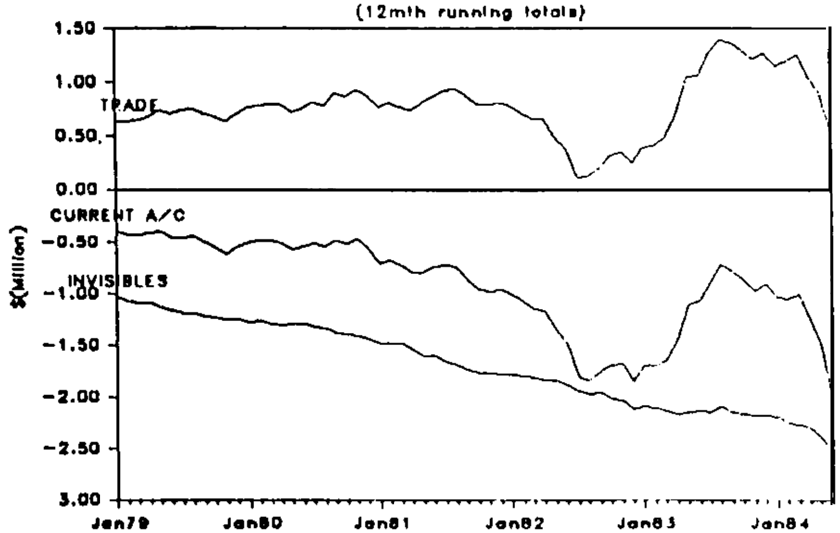
SHORT TERM PROSPECTS
(Annual Percentage Volume Changes)

	Actual *1982/83*	*Estimate* *1983/84*	*Forecast* *1984/85*	*1985/86*
	Years Ended March			
Total Consumption	-1.4	1.2	0.9	–0.5
Private ..	-1.7	1.5	1.0	-0.7
Central Government ..	0.1	0.1	0.3	0.2
Local Government	-0.4	0.1	0.4	0.1
Total Investment	6.2	1.4	6.5	-3.5
Private ..	-0.1	1.0	10.5	-4.5
Central Government ..	26.1	2.4	-1.0	-2.0
Local Government	0	0.8	1.1	0.4
FINAL DOMESTIC DEMAND	0.3	1.3	2.2	-1.3
Stockbuilding[1]	-0.9	-0.8	1.6	-0.9
TOTAL DOMESTIC DEMAND	-0.5	-0.4	3.7	-2.1
Exports	1.5	6.4	5.8	0.3
Imports	1.7	1.4	7.6	-3.5
FOREIGN BALANCE' ::	-0.1	1.5	-0.8	1.4
GDP (EXPENDITURE)	-0.7	2.0	3.0	-0.8
Memorandum Items				
Consumer Prices[2]	12.6	3.5	7.5	9.0
Unemployment Rate[3]	5.4	5.0	5.2	6.1
Current Account Balance[4]	-6.4	-4.6	-7.2	-6.4
Terms of Trade (1957=100)[5]	74	74	74	74

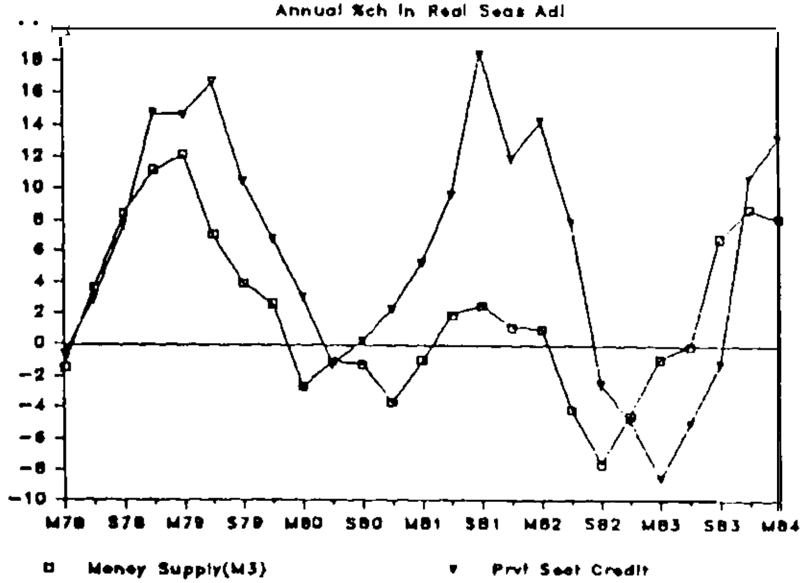
[1] Contribution to change in real GDP
[2] March quarter on March quarter preceding year
[3] Registered unemployed as at 31 March as a percent of employment plus registered unemployed
[4] As a percent of GDP (balance of payments basis)
[5] Average level year ended March

Economic Indicators

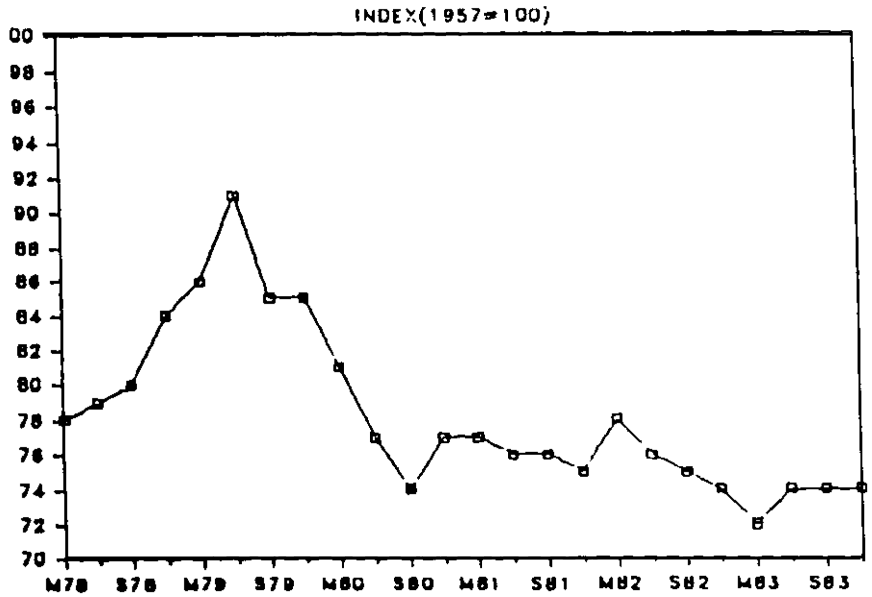
Money & Credit



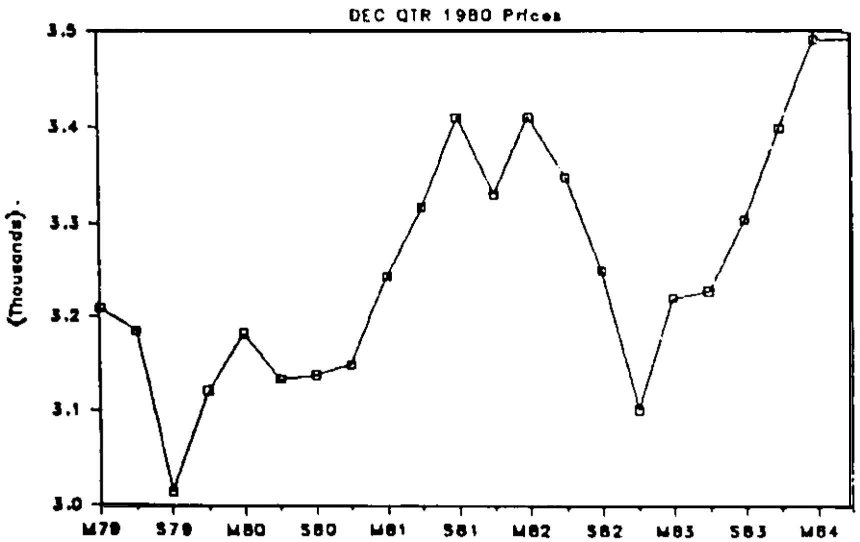
O.E.T. Balances



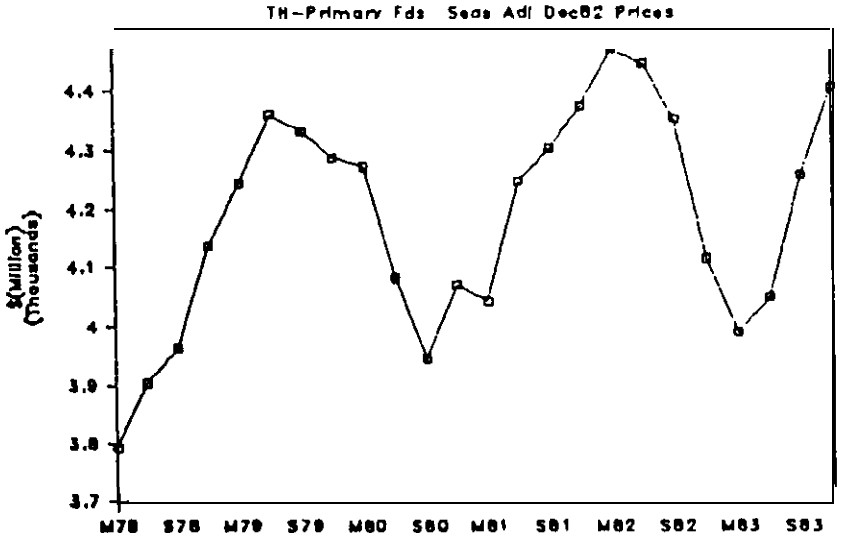
Terms of Trade



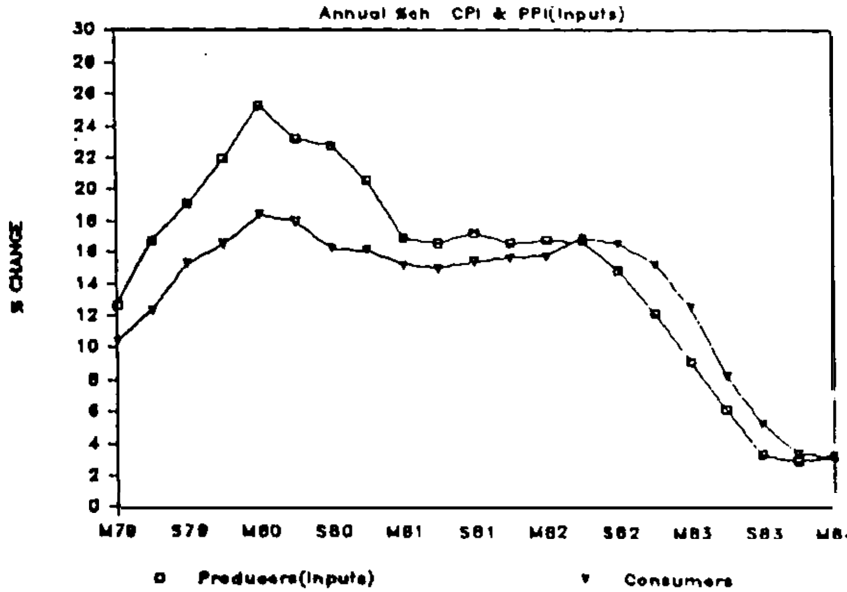
Retail Trade (Real Seas Adj)



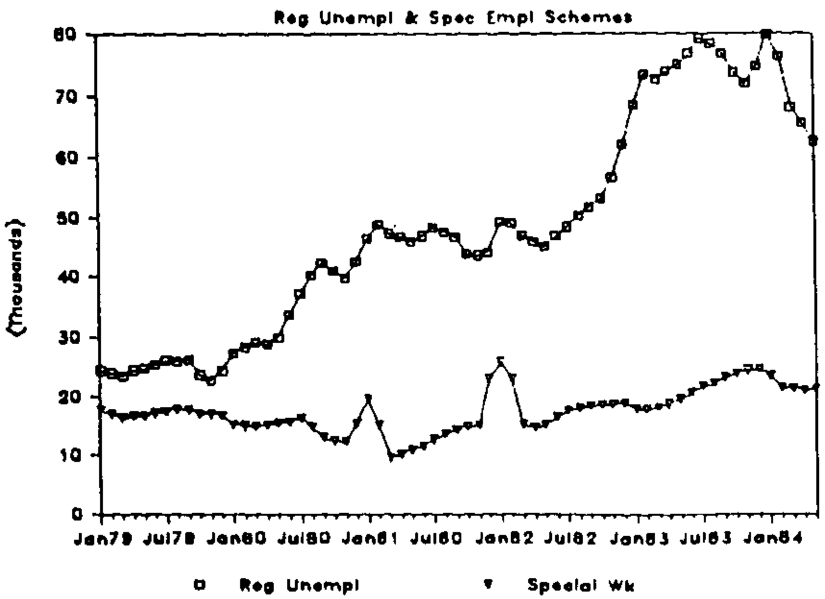
Manufacturing Output



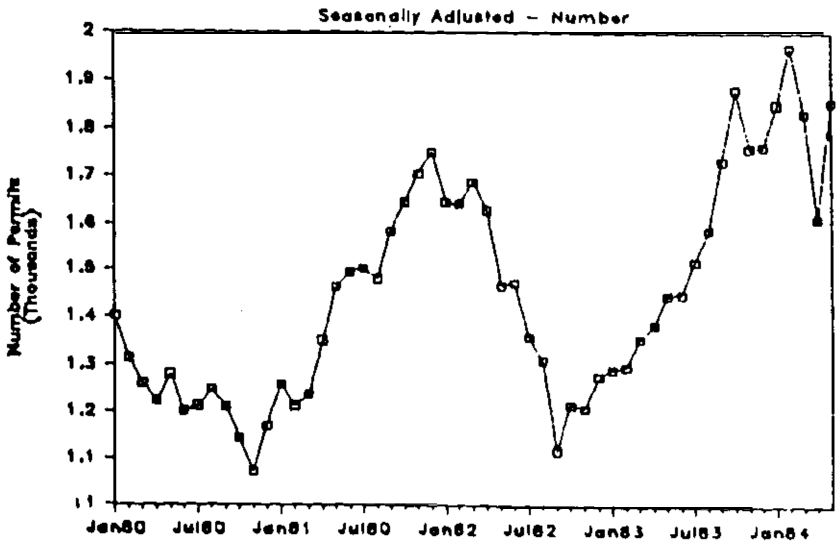
Prices



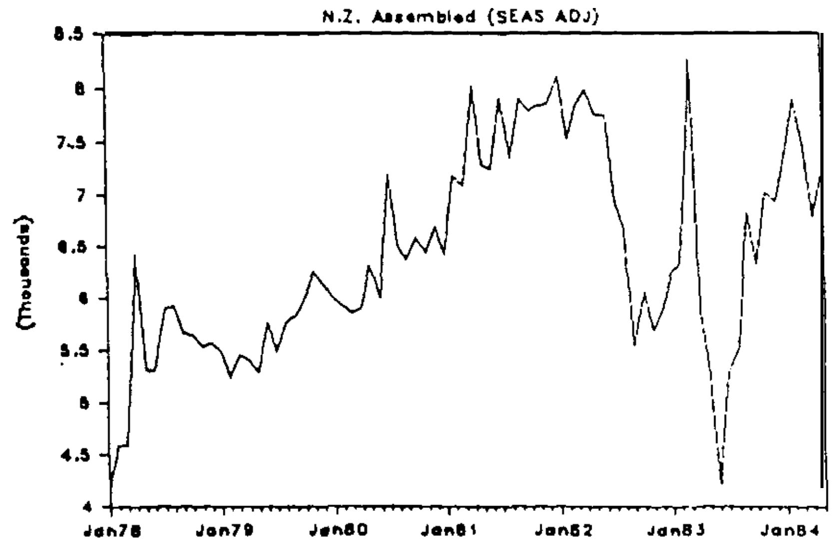
Unemployment



Dwelling Permits



New Car Registrations



Introduction

This paper is presented in four sections:

A a background section which discusses factors underpinning developments in the economy over 1983/84;

B a summary of the forecasts for 1984/85 and 1985/86, the forecasting assumptions employed, and an analysis of how the recovery is likely to unwind;

C the risks and uncertainties underlying the forecasts and the sensitivity of the forecasts to the policy stance assumed;

D a more detailed discussion of the major components of the forecasts,

SECTION A

1983/84 Background

The contraction in output, which commenced early in 1982, bottomed out early in 1983. Since then output in the manufacturing, building and service sectors has increased quite strongly and real GDP for 1983/84 as a whole is estimated to have increased by 2 percent on 1982/93. Seasonally adjusted real manufacturing output was 8 percent higher in the second half of the 1983 calendar year than in the first half. In the building and manufacturing sectors, surplus capacity is now at the lowest level since 1974.

There were main four factors contributing to the recovery in domestic activity:

— manufactured exports
— private consumption
— monetary and credit conditions
— increases in farm production due to favourable weather conditions

a *Manufactured Exports*

The international economic recovery and resulting change in overseas demand coincided with improved export competitiveness in the New Zealand manufacturing sector, reflecting the March 1983 devaluation, productivity growth and the rapid decline in the domestic inflation rate. The volume of manufactured exports in the year to March 1984 grew by 17.6 percent over the level in the previous year, although part of this growth reflects an increase in major project exports.

b *Consumption*

Real consumer spending picked up sharply in the second half of 1983 despite a fall in real personal disposable incomes. Consumption appears to have been driven by a combination of the following factors: the reduction in nominal interest rates (which has increased the ability to borrow); speculative spending on durables prior to the lifting of the price freeze; wealth effects associated with real increases in the prices of shares and property, and with holdings of fixed interest bearing financial securities during a period of falling nominal interest rates; growing real money balances; and the growth in population.

c Monetary Conditions

Liquidity grew rapidly from mid 1983 as a result of the large fiscal deficit and the relaxation of the Government's debt sales programme following the removal of Kiwi Stock I in June 1983. Trading bank reserve assets increased from $1.5 billion in June 1983 to around $2.5 billion in March 1984. Over the nine months to March 1984, the money supply (M3) increased at an annual rate of 17 percent.

The upturn in domestic demand and output was accompanied by a resurgence in the private sector's demand for money and credit. The rapid growth in reserves enabled the financial institutions to accommodate the increase in demand for funds, and private sector credit grew at an annual rate of over 20 percent in the nine months to March 1984.

d *Farm Production*

Favourable weather conditions resulted in a record level of milkfat production (up 11 percent over 1983/84) and this would also be expected to result in higher pastoral production in 1984/85. As this increase in dairy production coincided with a downturn in international markets, **an** increase in dairy product stocks has resulted.

Two unusual features of the current upturn are the lack of stimuli from stock building and the terms of trade.

Stock Cycle

In contrast with previous recoveries, comparatively little of the strength in the present recovery in activity has so far been due to stock building. Producers generally experienced considerable unplanned stock-building in late 1982/83 because of the unexpected severity of the simultaneous downturn of both the domestic and Australian markets. Stock levels were rapidly reduced so that, once the domestic and export markets commenced growing again in 1983, the increase in sales was matched reasonably quickly by increased output. In contrast to previous recoveries, producers do not generally seem to have increased output by more than the growth in current demand in order to build up stocks to more normal levels in relation to sales. Instead, producers have been content to supply increased sales from current production and maintain a stable low level of stocks. As a result, finished oods and raw materials stocks to sales ratios at the March quarter 1984 (the latest quarter for which data are available) are the lowest recorded level in data going back to 1977.

Terms of Trade

Previous international recoveries have boosted the domestic economy as the improved tern-s of trade increased farm incomes, which then flowed through to the rest of the economy. In contrast, the current international upturn has been reflected in rapid increases in the volume of manufactured exports rather than any marked upturn in the terms of trade. This is because of market problems for the pastoral products which New Zealand exports (discussed in a separate paper **on-the** OET position).

SECTION B

Forecast Assumptions

The forecasts have been prepared on the usual assumptions of no change in economic policies. In particular it is assumed that:

a following the $8 per week cost of living allowance from 1 April 1984, there is no further wage adjustment until a return is made to wage bargaining under a reformed system in 1985/86. Wage settlements in 1985/86 are assumed to average around 8 percent, i.e. around the expected inflation rate at that time;

b the fiscal deficit is around 7 percent of GDP in both 1984/85 and 1985/86. This in turn assumes that there is no change to the personal income tax scale and existing schemes which are due to terminate are not replaced;

c Government charges increase by an average of 5 percent during 1984/85. In 1985/86 Government charges are assumed to be indexed to the annual rate of inflation;

d primacy in monetary policy will be given to maintaining a lower structure of nominal interest rates. The 1 percent private sector credit guideline will remain for some time but deviations from the guideline will persist;

e the nominal exchange rate remains fixed against the basket throughout the forecast period;

f the terms of trade average 74 in both 1984/85 and 1985/86.

The importance of these assumptions to the forecast cannot be emphasised too strongly. Implications of varying assumptions are discussed later.

Short Term Outlook

Detailed forecasts of GDP in current prices and in constant 1977/78 prices are shown in Annex I. Table 2 below shows the relative contributions of the components of GDP to the forecast growth in GDP.

The forecasts suggest that real GDP will grow by a further 3 percent in 1984/85 and decline by around 1 percent in 1985/86. Real output is forecast to level out over the next few months and begin to fall around the end of 1984.

The forecast fall in aggregate output next year is largely in response to a forecast fall in domestic consumption. Export performance for non-agricultural products is likely to remain strong throughout 1984 and 1985, particularly given the forecast movements in unit labour costs. The growth in export demand is to a large extent a result of the buoyant demand, particularly in Australia, and the improvement in New Zealand manufacturers' competitiveness.

The upswing, which began in early 1983, is forecast to last about 18 months, longer than the twelve month upturn in the 1981/82 cycle. There is, however, considerable uncertainty about the timing and strength of the downturn; this is discussed more fully later in this paper. The duration and strength of the present upturn is in part due to a number of supply side factors whose origins lie in the effects of the 1982/83 contraction, the October 1982 tax cuts, and the wage-price freeze. The upturn has also been driven by the easing in monetary conditions and the growth in the international economy.

The 1982/83 economic contraction resulted in severe destocking and labour shedding. Many businessmen have commented that the contraction and the price freeze forced them to examine ways of improving their efficiency and competitiveness. By mid 1983, when domestic and export demand began to grow, the business sector was in a position to expand production rapidly. The associated improvements in labour productivity and competitiveness meant that corporate profits began to grow quickly along with the increase in output.

Employment is forecast to increase by around 17,000 (1.3 percent) over the year to March 1985. Much of this increase is forecast to occur during the first six months of 1984/85. Many businessmen have indicated to us that they are very uncertain as to the path of domestic demand and are reluctant to increase full-time employment in response to what may be a short-lived increase in domestic orders.

Output growth during 1984 is likely to be strongest in the manufacturing, building and services sectors. Agricultural production is expected to increase in 1984/85, reflecting favourable weather conditions. The underlying trend is for unchanged output, reflecting in part the low levels of farm investment during the previous four years and in part the pessimistic outlook for farm product prices.

The growth in real profits, coupled with the presence of capacity constraints in the building and manufacturing areas, has resulted in business investment picking up markedly in recent months. The NZIER Survey of Business Opinion suggests that capacity utilisation in the manufacturing and building sectors was at its highest level since December 1974.

The level of aggregate demand, and the likelihood that capacity constraints for some sectors are becoming serious, will place upward pressure on prices. The consumers price index is forecast to increase by around 7.5 percent in the year ended March 1985 and 9 percent in the year to March 1986.

The high domestic demand and limited corporate restocking will mean that import demand continues to strengthen for some months and that the annual OET current account balance will progressively deteriorate until late in 1984. The deterioration in the OET balance will contribute to a tightening in monetary conditions in late 1984 and into 1985, but the slowing in the rate of growth of the money supply is not expected to be sufficient by itself to depress spending, as happened in 1982.

The main dampening effect on domestic demand and output in 1985 is likely to be the weakness in household disposable incomes. Real household disposable incomes are forecast to rise by 1 percent in 1984/85 and to fall by around 3 percent in 1985/86. The evidence available suggests that expansion in domestic demand continued into the June quarter, but at a lower rate. There are some tentative signs that, in some product lines, domestic demand was starting to fall away at the end of this quarter. It is too early to say whether this represents a general trend, or simply reflects factors specific to these particular markets. In general, however, businessmen are not confident that the current level of domestic demand would be sustained during the next six months.

In 1985/86, the forecast decline in real domestic demand will be reinforced by a fall in major project expenditure. Major project investment is forecast to fall from around $1.5 billion in 1984/85 to $1 billion in 1985/86.

Producers are expected to respond to a fall in domestic spending in 1985 by cutting production and employment. In the year to March 1986 a fall in employment of around 10,000 (0.7 percent) is forecast, and numbers of registered unemployed are forecast to rise by 12,000 and total around 82,000 by 31 March 1986.

TABLE 2

CONTRIBUTION TO THE RATE OF GROWTH IN REAL GDP

	Estimate (%)		Forecast (%)	
	1982/83	*1983/84*	*1984/85*	*1985/86*
Final Consumption	-1.1	1.0	0.7	-0.4
Gross Fixed Capital Formation	1.4	0.3	1.6	-0.9
Change in Stocks	-0.9	-0.8	1.6	-0.9
GROSS NATIONAL EXPENDITURE	-0.6	0.4	3.8	-2.2
Exports of Goods and Services	0.4	2.0	1.9	0.1
imports of Goods and Services'	-0.6	-0.5	-2.7	1.3
External Balance	-0.1	1.5	-0.8	1.4
EXPENDITURE ON GDP	-0.7	2.0.	3.0	-0.8
Residual Discrepancy	0.5			
Department of Statistics GDP	-0.2			

• Rising import volumes imply relatively less expenditure on domestic production and therefore they make a negative contribution to real GDP growth.

SECTION C

Risks and Uncertainties

The most critical factors which will shape the path of the economy over the next two years are:

a the Government's fiscal and monetary policy stance;

b the strength of the movements in the terms of trade and the growth in export volumes;

c business and consumer confidence.

The major driving influences behind the lift in output currently under way are the expansionary fiscal and monetary policies and the growth in export demand. The main uncertainties centre on the timing of the subsequent downturn rather than its likelihood.

If monetary conditions were to be appreciably tighter than forecast as is possible given the tightening of liquidity which is occuring with the recent foreign exchange outflows, then inflationary pressures and the rate of deterioration in the external balance would be reduced, leading to a more sustainable level of domestic activity. By contrast, easier monetary conditions might temporarily sustain domestic demand and output through 1984/85. They would, however, undoubtedly lead to a more rapid acceleration in the rate of inflation and a sharper deterioration in the balance of payments. The effect would be to aggravate the scale of the subsequent downturn.

A greater than forecast improvement in the terms of trade would imply a stronger external position and higher real incomes. It would, however, impose a greater burden on monetary and debt management policy if a more rapid acceleration in the rate of inflation was to be avoided.

The assumptions and forecasts in this paper imply that substantial real profit growth will occur over 1983/84 and 1984/85. In a medium term framework this is essential to the achievement of higher economic growth. Nevertheless, in the short term the effect is likely to be increasing pressure, both overt and covert, on the wage freeze. Should real wage rate growth exceed that forecast, which does include an allowance for higher drift, then private consumption may hold up longer. At the same time, inflationary pressures would be aggravated, as would the deterioration in the balance of payments.

Producers in the non agricultural sector appear doubtful consumer demand will remain buoyant to the end of 1984. They are even less confident of the economic outlook in 1985 because of the uncertainties surrounding export incentives, domestic monetary and fiscal policies, and the continued strength of the international economy in 1985/86.

SECTION D

Detailed Forecasts

Monetary Conditions

Growth rates in the main monetary aggregates since the September quarter 1982, and forecasts for the June and September quarters of 1984, are summarised in Table 3. All the money and credit aggregates have recorded strong growth since the second half of 1983. This primarily reflects the large ongoing injections of funds into the financial system from the fiscal deficit, the passive role of public debt policy in offsetting this, and a pick-up in demand for credit which was translated into rapid lending growth during the December 1983 quarter in particular.

TABLE 3

Percentage Changes in Ml, M3, and Private Sector Credit

		MI		M3		Private Sector Credit	
		Quarterly* Increase	Annual Increase	Quarterly* Increase	Annual Increase	Quarterly' Increase	Annual Increase
		%	%	%	%	%	%
1982	3	−2.4	3.0	1.1	9.0	1.8	17.3
	4	2.6	5.9	3.9	10.8	-1.3	14.1
1983	1	3.6	4.3	4.5	11.8	1.5	4.1
	2	-2.5	1.2	-1.5	a.2	1.3	3.3
	3	8.0	11.8	5.1	12.3	2.6	4.2
	4	5.4	14.8	3.9	12.4	8.1	14.0
1984	1	-2.6	8.3	3.1	11.7	2.8	15.5
	2F			3.5	17.0	3.6	18.3
	3F			4.2	16.5	2.1	18.0

'Seasonally adjusted
FForecasts

Debt policy has not been sufficiently aggressive since the withdrawal of Kiwi Stock I in June 1983 to contain real money and credit growth to sustainable rates. The subsequent rapid build up in reserves left financial institutions well placed to accommodate the rising demand for credit. The fall in reserve levels and severe tightening of liquidity experienced over the past few weeks are primarily a result of the speculation against the exchange rate. This situation is expected to ease once the speculative flows are reversed.

The most recent annual rates of growth in M3 and private sector credit are well in excess of the rate of increase in consumer prices. Private sector credit and M3 are envisaged to have grown by 18.3 percent and 17 percent respectively in the year to June 1984, when consumers prices increased by only 4.7 percent.

More up-to-date data are available on Trading Bank lending. These data, given in Table 4, show Trading Bank lending increased dramatically during the months of May and June. Some of the increase in June may be associated with the recent foreign exchange outflows.

TABLE 4

Trading Bank lending-Monthly % Change (Seasonally Adjusted)

1984	January	-0.4
	February	+3.0
	March	+1.3
	April	+0.4
	May	+2.6
	June	+3.8

Tables 5 and 6 summarise the estimated and prospective major influences on primary liquidity and the money supply over 1983/84, 1984/85, and 1985/86.

TABLE 5

influences on Primary Liquidity

	1983/84	1984/85 ($ million)	1985/86
Fiscal Deficit ..	2,984	2,520	2,800
OET Transactions ..	-560	-1,800	-1,800
Reserve Bank Influences..	-268	+140	
Total Primary Influences	2,156	860	1,000

TABLE 6

Forecast M3 Growth(l)

	1983/84	1984/85 ($ million)	1985/86
Base: M3 at beginning of the fiscal year.	16,107	17,996	19,956
Total Primary Influences (from Table 5)	2,156	860	1,000
Private Sector Credit Growth[2] ..	1,670	1,800	1,800
Less Non M3 Debt Sales	-1,949	-1,000	-1,000
Residual	-12		
M3 at the end of the fiscal year	17,996	19,656	21,456
Annual percentage growth in M3	11.7	9.2	9.2

1 The table ignores some of the minor influences on M3 growth. It indicates the relative significances of the main influences and their likely net impact.

2 Annual Percentage Growth in Private Sector Credit	15.5%	14.5%	12.6%

3 The non-M3 debt sales projections have been made on the assumption that over the forecast period no highly competitive retail debt debt instrument will be available and the Government’s interest rate objectives will continue to restrain sales of Government stock under the tendering programme.

The following graph of real M3 growth (the rate of growth of M3 after allowing for the rate of increase in the consumers price index) illustrates the extent of the monetary stimulus to the economy that the current and prospective growth rates of M3 represent.

Graph 2: **Real M3 Growth; Annual Percent Change**

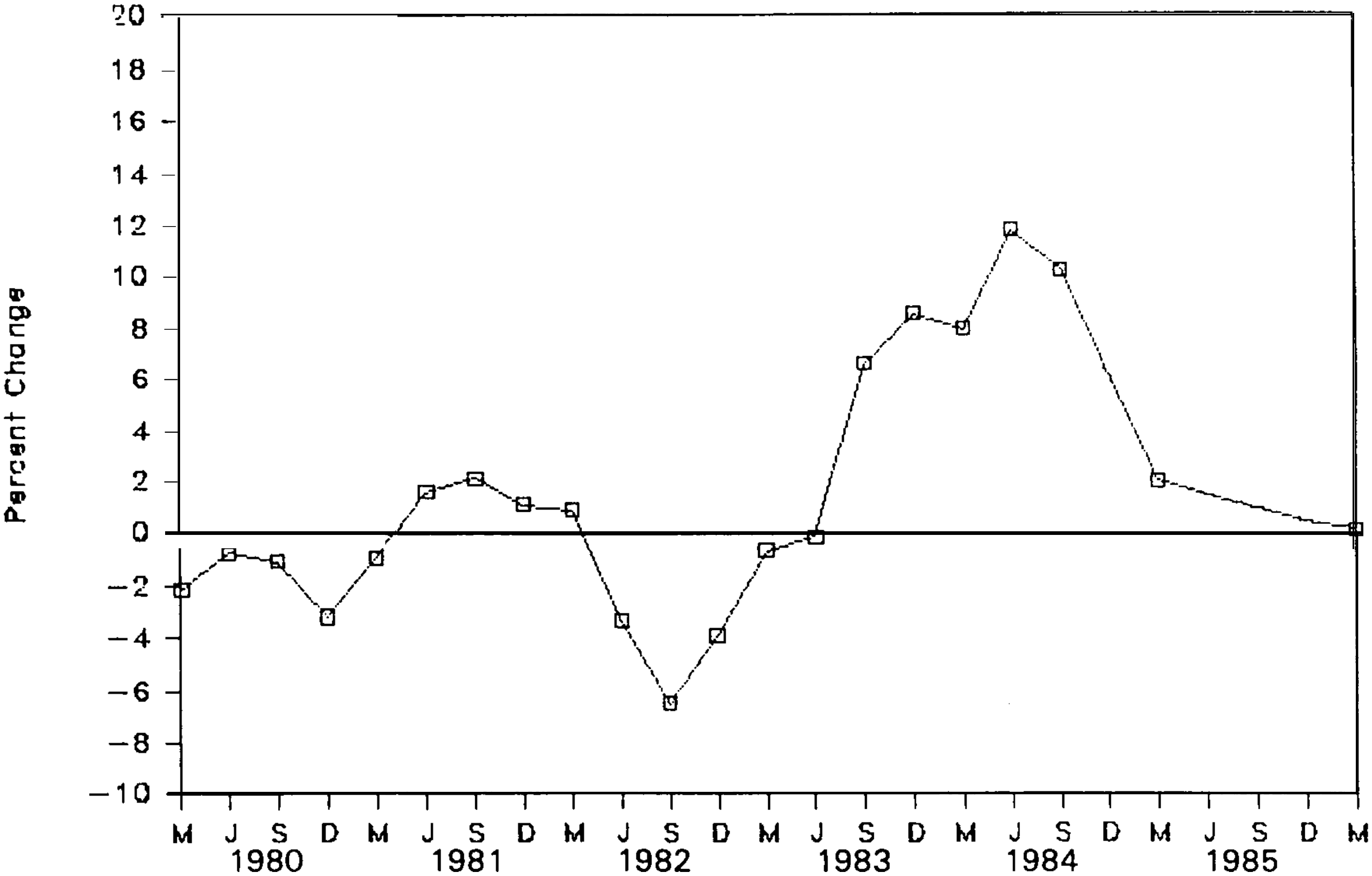


TABLE 7

Balance of Payments Current Account Balances

	Estimate 1982/83	Estimate 1983/84	forecast 1984/85	Forecast 1985/86
	Years Ended March ($ million)			
Export of Goods	+7,207	+8,384	+9,093	+9,590
Imports of Goods	+7,315	+8,108	-9,590	-9,380
Balance on Merchandise Trade	-108	+276	-497	+210
Balance on Invisibles and Transfers	-1,932	-1,860	-2,198	-2,740
Balance on Current Account	-2,040	-1,584	-2,695	-2,530
% GDP	-6.4	-4.6	-7.2	-6.4

The balance of payments forecasts indicate that sizeable current account deficits can be expected during the next two years despite the growth in the economies of many of our trading partners. This is due to two factors. Firstly, the difficulties being experienced in some major primary commodity markets are limiting any improvement in the terms of trade. Secondly, the end of the rundown of primary commodity stocks and the beginning of the phase-out of export incentives is forecast to result in a slow down in the rate of growth in export volumes in 1985/86.

Import volumes increased by 15.2 percent in the September quarter 1983, but fell slightly in the December quarter and increased by 10.9 percent in the March quarter 1984. The overall growth in imports since the June quarter 1983 has been spread across most subgroups. As indicated by Graph 3, which presents changes in the volume of forward orders, the growth in imports looks likely to continue over the rest of this year. (More detail on the external sector forecasts are contained in the accompanying OET paper.)

The official overseas borrowing requirement is forecast to be around $3,395 million in 1984/85 and $2,895 million in 1985/86 (June years) in order to maintain reserves at around $1 billion during the forecast period. New Zealand's official external debt:GDP ratio on a June year basis is forecast to increase steadily from around 30 percent in 1983/84 to 31 percent in 1984/85 and 33 percent in 1985/86.

As a result of the sharp increase in imports coinciding with difficulties in some major primary commodity markets, the OET current account deficit has deteriorated since August 1983, to reach $1,457 million for the year ended May 1984. The OET current account deficit for the year ended June 1984 is estimated to have widened to $1,995 million. This reflects increased OET payments and reduced OET receipts as a consequence of speculation against the exchange rate in June. Assuming normal payment patterns are restored, a corresponding reduction would be expected to occur in the forecast current balance for the year ending June 1985. However, it is possible that not all the flows will in fact be reversed.

Graph 3: Imports Orders

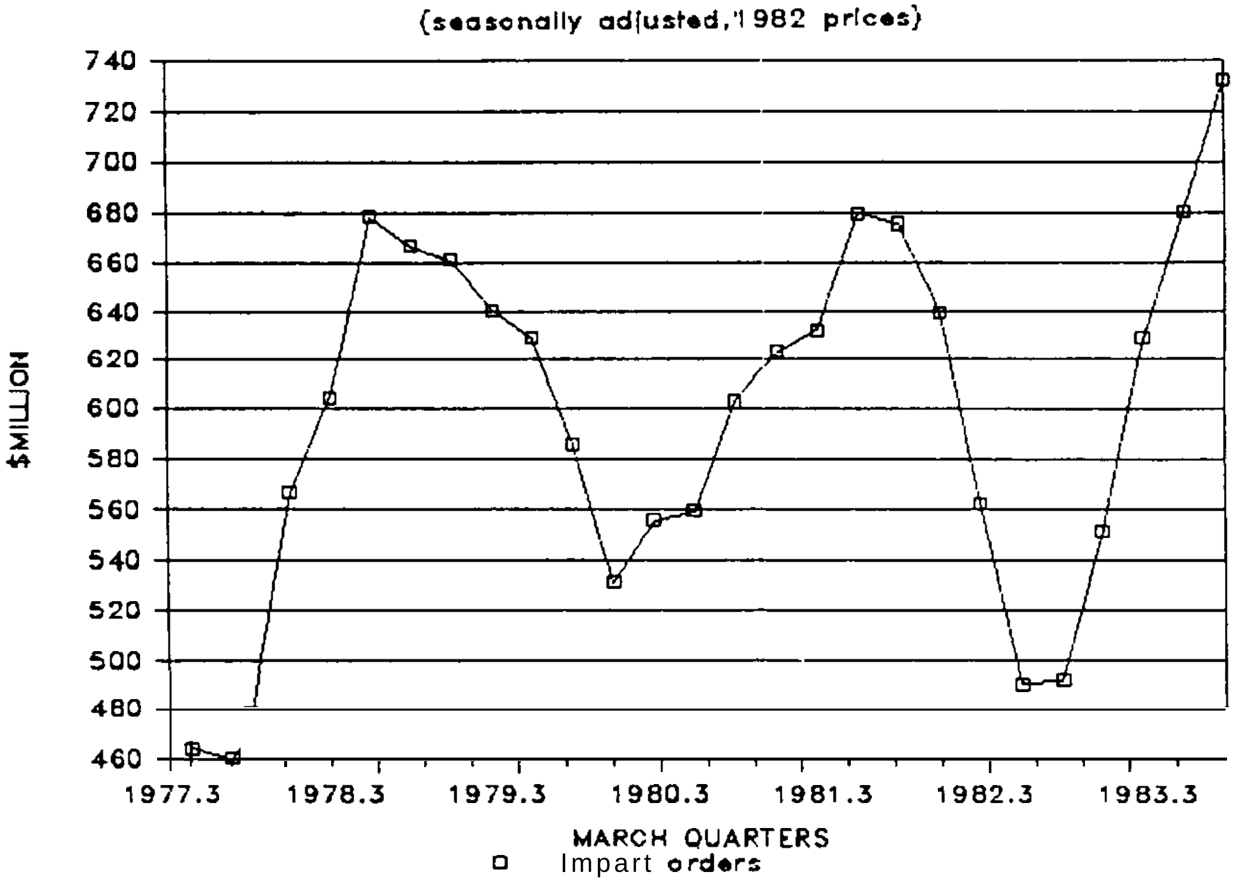


TABLE 8

Percentage Growth in Household Incomes

	1983/84	*1984/85*	*1985/86*
Pre-tax Incomes			
Farm Income	2.7	-6.4	−1.0
Non-Farm Income			
Wages and Salaries	1.9	7.5	3.8
Other Income	8.5	8.8	9.1
Total Factor Incomes	3.1	6.8	4.6
Benefits	8.5	9.6	11.3
TOTAL PERSONAL INCOME ::	4.0	7.3	5.7
Less Taxes	1.4	8.5	10.3
Nominal Disposable Income	4.8	7.0	4.2
of which: Farm Income	-5.4	-6.0	3.0
Non-farm income	5.4	7.7	4.2
Consumers Price Index (Annual Average)	5.1	6.0	7.5
Real Disposable Income	-0.3	1.0	-3.1
of which: Farm	-10.0	-11.4	-4.2
Non-farm	0.3	1.8	-3.0

The forecast growth in GDP is likely to result in only modest growth in national disposable income. This is because two of the components of GDP not included in national disposable income, net overseas remittances and depreciation, are forecast to grow quite rapidly over the period from 1983 to 1986.

The share of national disposable income going to households is not expected to change significantly over 1983/84 and 1984/85. In 1983/84, for example, although factor incomes accruing to the household sector are estimated to have grown by only 3 percent, because of the growth in transfers and the full year effect of the 1982 tax cuts, household disposable income grew by almost 5 percent. National disposable income is estimated to have grown by 5.7 percent over the same period.

In 1984/85 household factor incomes are forecast to grow more strongly, and the net effect of taxes and transfers is still positive. In 1985/86 however, the effect of fiscal drag is more marked on the assumptions adopted.

While the share of national income going to the household sector is not forecast to alter significantly, marked changes in the distribution of income within the household sector are occurring. For example, real disposable farm incomes are forecast to decline over the period while real disposable income from benefits are increasing. Real disposable wage and salary incomes fell in 1983/84 from the level reached in the previous year. This reflects the decline which took place prior to the wage freeze. The October 1982 and 1983 personal income tax cuts maintained average real disposable full-time wage and salary incomes during the period of the wage freeze at above the level reached at September 1982.

Real corporate profits are forecast to increase in both 1983/84 and 1984/85, and to fall slightly in 1985/86. Some of the increase in real corporate profits may be reflected in household net worth, as a result of increased dividends to individual shareholders or rising share prices, and hence in private consumption. However, some of the increases in corporate profits will be remitted offshore, invested in capital goods or returned to financial institutions. The last three possibilities will not directly affect household consumption behaviour.

The 3.1 percent decline in real household disposable incomes forecast for 1985/86 reflects the fall in employment and the impact of fiscal drag. On the assumption that the tax scale is not indexed to the inflation rate, average tax rates (collections basis) are forecast to increase from 23.7 percent in 1984/85 to 24.7 percent in 1985/86.

Private Consumption

In 1983/84 real private consumption is estimated to have increased by around 1.5 percent. The recovery in real retail and wholesale turnover commenced early in 1983 but appears to have peaked in the March quarter.

TABLE 9

Quarterly Percentage Increase in Real Seasonally Adjusted Retail Turnover

	Quarter	*Durables*	*Semi Durables*[1]	*Durables*[2]	*Total Retail Turnover*
1982	March	4.2	3.3	0.6	2.4
	June	-3.2	-0.9	-0.6	-1.8
	Sept	-5.8	-5.1	0.2	-2.9
	Dec	-7.8	-4.6	-1.5	-4.5
1983	March	5.9	6.4	1.7	3.8
	June	0.0	-3.9	1.0	0.2
	Sept	2.3	0.5	2.7	2.3
	Dec	7.5	-0.5	-0.7	2.9
1984	March	3.5	3.7	1.9	2.8

[1] e.g., footwear. clothing. hardware.
[2] e.g., food. department and general, restaurants and takeaways. liquor, accommodation

Real wholesale turnover in the March quarter 1983 was 7 percent higher than a year before.

The recovery in retail and wholesale turnover has not been of equal strength across all categories. Growth has been strongest in durable goods, e.g., cars, whiteware and electrical goods.

Outside the durable goods sector, the the cumulative rates of growth have been weaker. The growth in real private consumption has occurred despite a fall in real personal disposable incomes. In 1983/84 the personal savings ratio appears to have fallen to its lowest level since 1977/78. Possible causes include: the fall in interest rates increasing the capacity to borrow, price discounting during the period of rapid destocking in the first half of 1983, some end-of-freeze speculative expenditures, and gains in personal wealth which are not reflected in measured real household disposable incomes. Other factors which may have contributed include increased tourist spending, the removal of the hire purchase regulations on cars, and population growth of 1.2 percent.

In 1984/85 real private consumption is forecast to increase by 1.0 percent with the growth being concentrated in the first half of the year. The household savings ratio is forecast to remain flat for the year as a whole.

Investment

Real fixed investment outside the major projects is estimated to have fallen by around 1 percent in 1983/84, with a rise in other construction expenditure being more than offset by falls in farm investment and investment in plant and machinery and transport equipment. Major project construction peaked in 1983/84, with associated capital expenditures increasing from around $1,100 million in 1982/83 (15 percent of total fixed capital formation) to around $1,600 million in 1983/84 (20.3 percent) of estimated total capital formation).

TABLE 10

The Contribution of Major Project Investment in Total Gross Fixed Capital Formation

	Estimate 1983/84	Forecast 1984/85	Forecast 1985/86
Major Project Investment ($M)	1,600	1,500	1,000
Other Investment ($M)	6,266	7,285	8,149
Total Investment ($M)	7.866	8.785	9.149
Major Project Investment as a proportion of total investment (%)	20.3	17.1	10.9
Real Growth in Capital Formation (%)	1.4	6.3	-3.5
Real Growth in 'total Private and Central Government Capital Formation excluding the Major Projects (%)	-0.8	8.5	2.6
Split into:			
Private	-0.4[1]	9.6	-1.5
Central Government	-3.4	4.6	16.7[2]

[1] The estimated 0.4 percent fall in real private sector investment, excluding major project expenditures, follows a fall estimated at 2.5 percent in 1982/83.
[2] Largely results from replacement aircraft for Air New Zealand.

Investment appears to have responded to the upturn in output and capacity utilisation. Forward orders, imports and the wholesale trade in investment goods such as plant and machinery and transport equipment appear to have picked up markedly from the levels in early 1983.

Real private sector investment, excluding the major projects is forecast to grow by around 10 percent in 1984/85, largely as a result of continued strong residential and commercial building and some corporate investment in plant and machinery. Housing completions are forecast at around 17,000-18,000 in 1984/85, up from an estimated 14,000 in 1983/84 and 14,800 in 1982/83. While new building permits (seasonally adjusted) appear to have peaked in March 1984, the lags between permits being issued and housing starts and completions suggest that the level of activity in the building sector should hold up over 1984/85.

Private sector investment outside the major projects is forecast to fall in 1985/86 as a result of the forecast decline in real corporate profits and the fall in capacity utilisation.

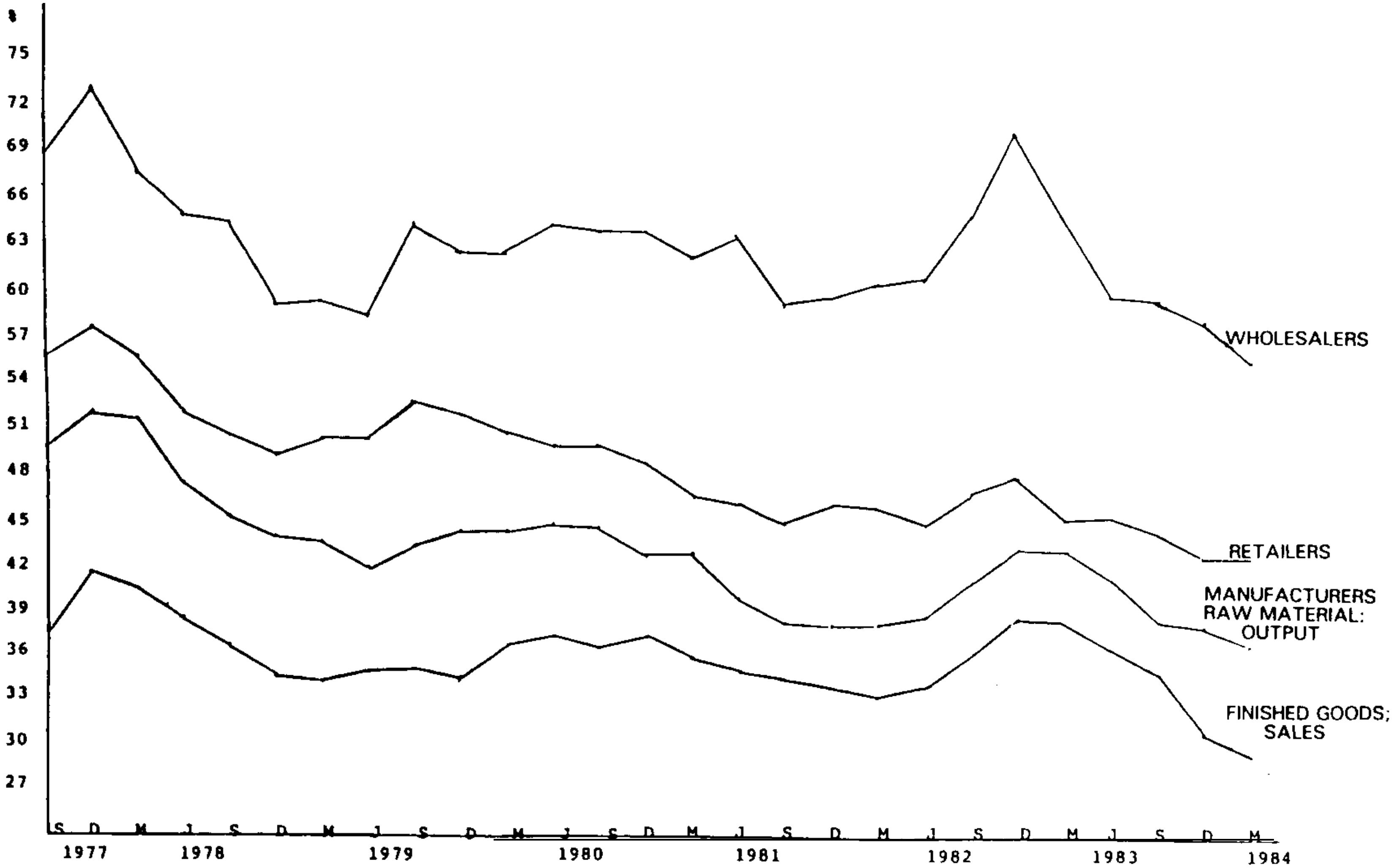
Stockbuilding

Following the unintended build up in stocks during the second half of 1982, stocks to sales ratios fell dramatically throughout 1983. By the end of the March quarter 1984, stocks to sales ratios for wholesalers, retailers and manufacturers were at hisorically low levels. The effect of the stock rundown during 1983/84 by the Meat and Wool boards was largely offsett by the build-up in Dairy Board stocks. Graph 4 shows recent movements in stocks to sales ratios for manufacturers and merchants.

Producer Boards are generally expected to continue to run down their stocks during 1984/85. Manufacturers and merchants are not expected to undertake significant restocking during 1984/85, as low stock to sales ratios are expected to be maintained until some limited involuntary stockbuilding occur as demand slows towards the end of the period 1984/85.

By 1985/86, the economy is expected to have entered the next downturn and destocking will commence following the 1984/85 stock build up.

Graph 4: Stocks: Sales Ratios (Seasonally Adjusted)



Labour Market

The growth in output has resulted in only a modest increase in the demand for labour. Employment growth over the year to March 1984 was around 1.1 percent or around 13,000 jobs (full-time equivalent). Hours worked increased more rapidly over 1983/84, suggesting that employers have been reluctant to take on additional labour and have instead resorted where possible to increased overtime. The annual growth in employment from March 1983 to March 1984 was strongest in the private sector service industries such as finance on real estate and in construction, while employment in manufacturing was unchanged for the year.

While there was limited employment growth over the twelve months to March 1984, annual average employment in 1983/84 was 0.5 percent below the level in 1982/83. As a result productivity per employee appears to have grown strongly over the whole economy during 1983/84.

Employment is forecast to grow by a further 17,000 (1.3 percent) over the year to March 1985. Table 11 contains forecasts of the components making up the supply of and demand for labour. The forecasts of registered and census level unemployment need to be treated with considerable caution. One of the somewhat puzzling features of the year to March 1984 was the fall in registered unemployment. In a year when the contribution to the labour force due to natural increase and a small net imigration inflow was around 27,000, and employment as recorded by the Labour Department survey has grown by around 13,000, registered unemployment has fallen by 4000.

In the absence of any direct measures of unregistered unemployment and changes in participation rates, it is difficult to provide any precise explanation of fluctuations in labour market statistics. Table 11 is drawn up on the assumption that unregistered unemployment bears a constant relationship to registered unemployment, and participation change is the residual to balance the table. The table implies that a sharp fall in the residual participation change occured over 1983/84.

Such a fall in participation rates is difficult to explain. Historically, participation has followed a possible trend associated with married women joining the workforce and the growth in part time employment. Participation has only been negative when total employment fell. Since 1976 (the period for which data are available) there has never been an annual fall in participation in a year of employment growth and, even in years when employment has fallen, no decline in participation of the magnitude implied by Table 11 has been recorded.

Without more detailed data it is only possible to speculate about the source of this difference. It may be, for example, that the “discouraged worker effect” became established during the 1982/83 recession and that any change in participation will now significantly lag employment growth. The main conclusion that can be drawn from current data is that the volatility of the components of labour supply make it difficult to be confident about accurately forecasting relatively small changes in the number of registered unemployed.

TABLE 11

Supply and Demand for Labour

	Annual Change Year Ended March 1983	1984	1985	1986	Levels al 31 March 1986
		(000)			
Natural Increase	21	22	21	20	
Net Migration of Actively '&gaged'	11	5	-5	-15	
Participation Change	−10	−19	3	−3	
Total Change in Supply	22	8	19	2	
Employment					
Total:	-10	13	17	-12	1,315
Private	-9	14	17	-11	989
Public	-1	-1	0	-1	326
Unemployment					
Total: (Census Level)	32	-5	2	14	102
Registered	26	-4	2	12	82
Unregistered	6	-1	0	2	20
Memorandum Items					
Total Unemployment Rate (%)	6.6	6.2	6.3	7.3	
Registered Unemployment Rate (%)	5.4	5.0	5.1	5.9	
Number on Subsidised Employment (000)	33	39	43	41	

Inflation

The sharp deceleration in the measured rate of inflation from June 1982 to the end of the price freeze in the March quarter 1984 reflects a number of influences. Amongst these are the wage-price freeze itself and the low rate of escalation in import price. The economic recession and firm monetary conditions were major factors over the first twelve months of the freeze.

Table 12 presents the quarterly movements in the prices of "controlled" and "uncontrolled" food and non food groups from early 1981 to the end of the freeze. It indicates that, even without the wage-price freeze, a reduction in the rate of increase in consumer prices could have been expected as a result of the factors referred to above.

TABLE 12

Quarterly Movements in the Price of Controlled and Uncontrolled Subgroups of the Consumers Price index

INDEX

	Food Group		*All Groups*	
Ouarter	*Uncontrolled*	*Controlled*	*Uncontrolled*	*Controlled*
1981				
(1) . .	0.6	4.6	3.1	3.1
(2)	1.7	4.0	3.0	4.3
(3)	5.6	3.8	5.6	3.5
(4) . .	6.6	3.5	6.2	3.1
1982				
(1)	-0.4	3.1	4.6	2.9
(2)	2.6	3.7	5.0	5.0
Freeze-				
(3)	0.7	2.1	5.0	3.2
(4)	0.1	0.2	6.0	1.7
1983				
(1)	2.9	0.1	2.1	0.5
(2)	1.5	0.2	2.3	0.6
(3) . .	6.1	0.2	2.3	0.4
(4) :: ::	3.3	0.6	2.1	0.6
1984				
(1)	-1.5	0.7	1.1	0.6
Cumulative increase from 1982(2)	13.7	4.2	22.8	7.8

Recent quarterly movements in some major price indices are set out below:

	Percentage Change									
	1982				*1983*				*1984*	
	(1)	*(2)*	*(3)*	*(4)*	*(1)*	*(2)*	*(3)*	*(4)*	*(1)*	*(2)*
Consumer Price Index										
Food Group	2.2	3.5	1.7	0.2	0.7	0.4	1.7	1.2	0.1	2.3
All Groups	3.2	5.0	3.6	2.7	0.8	1.0	0.8	0.9	0.7	2.2
Producer Price Index										
Inputs-All Market Groups	3.1	4.1	3.4	0.9	0.3	1.4	0.8	0.6	0.7	
Outputs-All Market Groups	3.6	3.9	2.6	0.9	0.7	1.0	1.3	0.8	0.8	
Capital Expenditure Price Index										
Houses, Flats, Garages	6.1	3.4	3.6	0.8	-0.1	0.7	0.3	0.7	0.3	
Commercial Buildings ..	5.9	2.5	2.3	0.4	1.0	1.1	0.1	0.3	0.6	
Cars less than 1600 cc ..	1.9	3.9	1.7	0.7	0.7	4.9	2.3	0.5	3.2	
Farming Inputs Price Index										
All groups including livestock					0.2	1.0	1.6	0.5	1.5	
Export Price Index	1.5	1.4	1.2	0.6	-1.4	6.8	0.8	0.7	1.2	
Import Price Index	0.6	4.1	2.8	1.2	1.3	4.1	0.5P	0.6P	-0.3P	
Urban House Property Price Index (six monthly)		17.5		4.6		2.7		5.9		

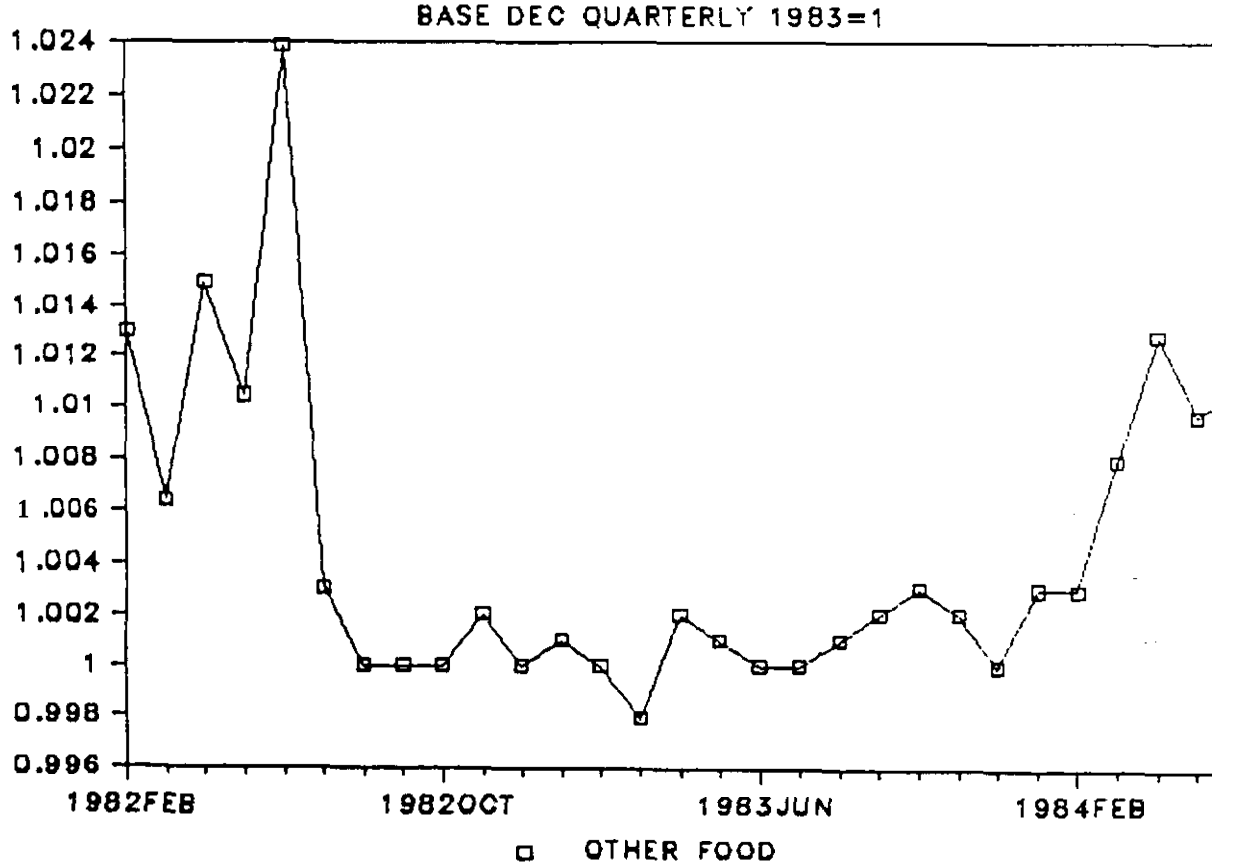
P=Provisional

It is too early to draw any firm conclusions about the extent to which the June quarter CPI result reflects once-off price increases after the lifting of the freeze rather than a sustained acceleration in the rate of increase in consumer prices.

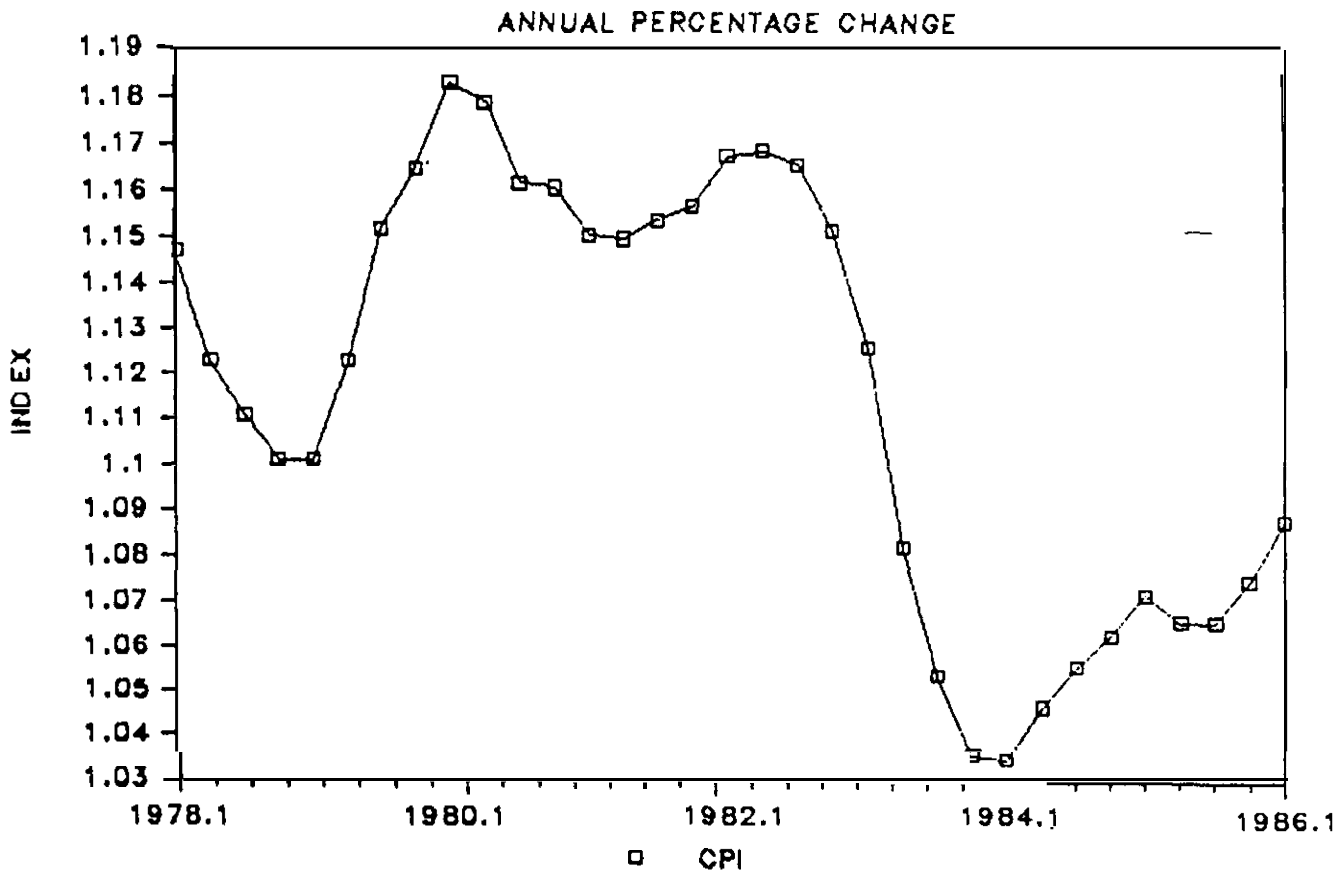
The food price index, the only group of the CPI which is surveyed monthly, does however provide some evidence of an apparent increase in the rate of price increase since the lifting of the freeze. Graph 5, which shows the monthly percentage change in the “all other foods” sub-group since early 1982, illustrates the reduction in the rate of increase in prices during the period of the freeze and the subsequent “bounceback”. Since February 1984, the “other food” sub-group has risen at the following monthly rates : 0.8 percent, 1.3 percent, 1.0 percent, 1.1 percent. If the rate of increase for the last few months were to be continued for a full year, it would result in an annual rate of increase of 13.4 percent.

Graph 6 shows annual increases in the consumers price index since the March quarter 1980 and forecast movements until March 1986.

Graph **5: CPI Other Food**



Graph **6: Consumer Price Index**



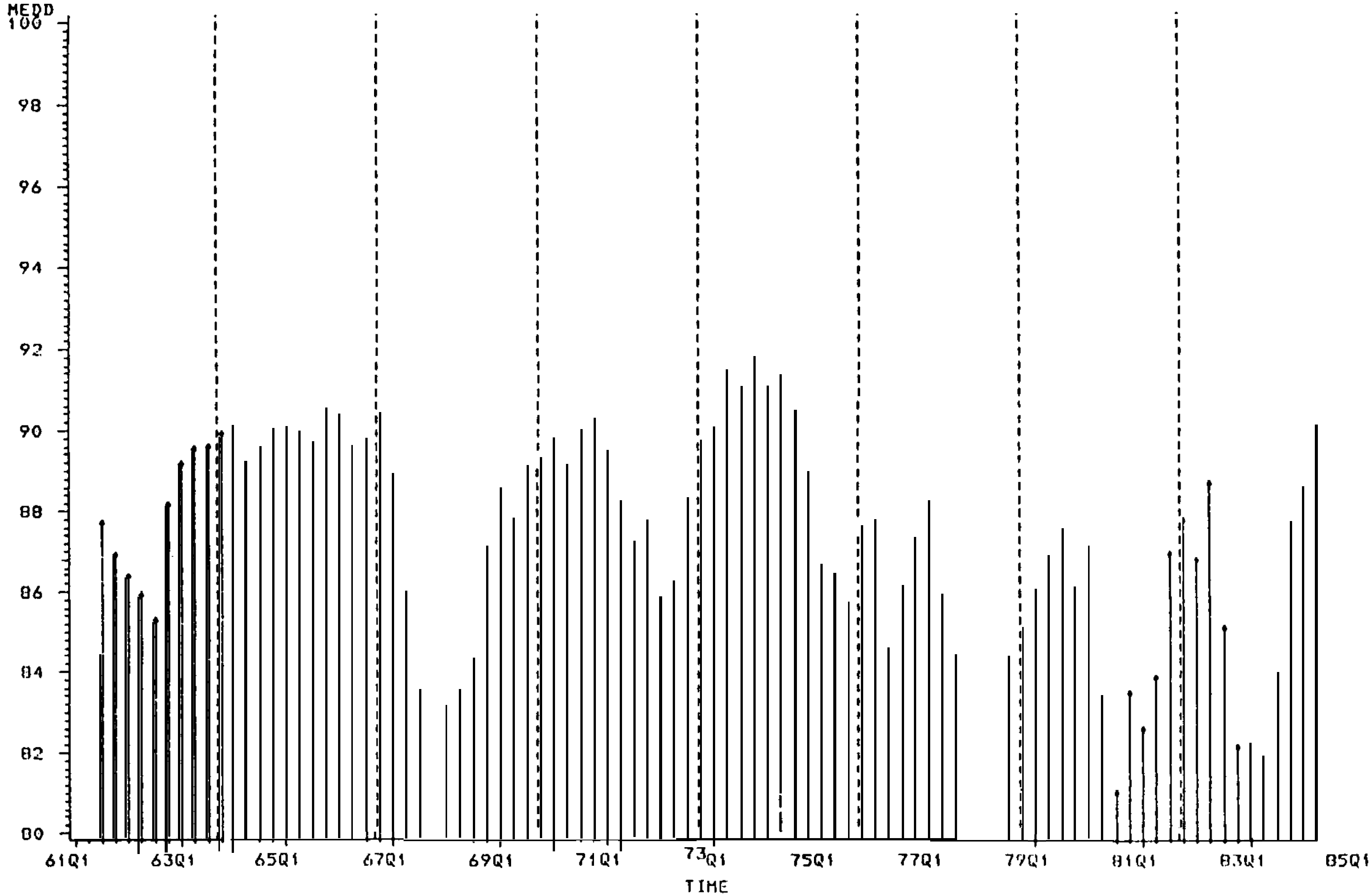
Forecast Movements in the Consumer Price Index are:

Year Ended March	*Annual Percent Change*	*Annual Average Change*
1984 . .	3.5	5.1
1985	7.5	6.0
1986	9.0	7.5

The rate of inflation is forecast to rise over the forecast period and reach an annual rate of around 9 percent by March 1986. The increase in the rate of inflation is expected to result from both cost and demand pressures. With the monetary conditions and the level of consumer demand prevailing at present, most businessmen should have little difficulty passing on the $8 a week cost of living allowance, and in many cases increasing unit profit margins.

As liquidity continues to increase and demand remains relatively buoyant, prices will increase faster in product, factor, and asset (e.g., property) markets. Wage drift can be expected to increase. Pressures will become more pronounced in product markets as production bottlenecks develop. Graph 7 indicates capacity utilisation in the manufacturing and building sectors. It shows that capacity utilisation in these sectors has increased quite strongly since the June quarter 1983.

Graph 7: **Median Capacity Utilisation**



LONG TERM MEAN=87.20

NZIER BUSINESS OPINION SURVEY

ESTIMATED GROSS DOMESTIC PRODUCT AND EXPENDITURE ON GDP
(Current Prices - $ million)

	1981/82		%	1982/83		%	1983/84		%	1984/85		%	1985/86	
Compensation of Employees	15778		9.5	17276		1.9	17604		7.5	18925		3.8	19644	
Operating Surplus	9332		8.7	10146		10.5	11215		6.3	11925		8.2	12904	
Other Private		4785	15.5		5527	8.6		6003	8.4		6507	8.0		7028
Agriculture		1640	-7.3		1521	23.5		1878	-0.5		1868	0.4		1876
Manufacturing		1933	-0.8		1918	12.0		2148	10.7		2377	12.9		2684
Central Government		856	22.7		1050	9.0		1144	2.7		1175	15.8		1361
Local Government		186	24.7		232	-3.9		223	7.6		240	7.5		258
Owner/Occupied Housing		619	16.5		721	3.3		745	7.5		801	8.2		867
Bank Service Charge		-687	19.8		-823	12.5		-926	12.6		-1043	12.2		-1170
Consumption of Capital	1872		15.0	2152		13.6	2445		13.4	2772		13.2	3138	
Indirect Taxes	2914		17.9	3435		9.7	3769		6.5	4014		3.2	4141	
Less Subsidies	-600		28.2	-769		-6.4	-720		13.9	-620		-38.7	-380	
GROSS DOMESTIC PRODUCT	29296		10.0	32240		6.4	34313		7.9	37016		6.6	39447	
Final Consumption Expenditure	22033		12.1	24690		5.6	26080		6.4	27757		6.9	29663	
Private		17011	12.0		19058	6.7		20330	6.9		21735	7.5		23365
Central Government		4430	7.9		4959	1.9		5053	4.7		5291	4.4		5526
Local Government		592	13.7		673	3.6		697	4.9		731	5.6		772
GROSS FIXED CAPITAL FORMATION	6216		19.4	7425		5.9	7866		11.7	8785		4.1	9149	
Private		4262	12.9		4813	5.2		5063	16.0		5873	3.1		6055
Central Government		1461	40.9		2058	8.0		2223	3.4		2298	5.8		2431
Local Government		493	12.4		554	4.7		580	5.9		614	8.0		663
FINAL DOMESTIC DEMAND	28249		13.7	32115		5.7	33946		7.6	36542		6.2	38812	
Change in Stocks	528		-38.1	327		-80.1	65		843.1	613		-48.9	313	
GROSS NATIONAL EXPENDITURE	28777		12.7	32442		4.8	34011		9.2	37155		5.3	39125	
Exports of Goods & Services	8292		8.9	9028		14.5	10341		10.0	11375		5.1	11960	
Goods		6654	9.0		7255	13.0		8197	9.1		8941	4.5		9340
Services		1638	8.2		1773	20.9		2144	13.5		2434	7.6		2620
Imports of Goods & Services	-9194		12.5	-10342		8.4	-11210		11.8	-12536		1.3	-12702	
Goods		-7129	10.9		-7912	8.7		-8600	14.7		-9862	-0.3		-9833
Services		-2065	17.7		-2430	7.4		-2610	2.5		-2674	7.3		-2689
EXPENDITURE ON GDP	27875		11.7	31128		6.5	33142		8.6	35994		6.6	38383	
Stock valuation adjustment	1033			691			275			383			489	
Statistical Discrepancy	388			421			896			639			575	
GROSS DOMESTIC PRODUCT	29296			32240			34313			37016			39447	

ESTIMATED GROSS DOMESTIC PRODUCT AND EXPENDITURE ON GDP
(Real 1977/78 Prices - $ million)

	1981/82		%	1982/83		%	1983/84		%	1984/85		%	1985/86	
Final Consumption Expenditure	12357		-1.4	12189		1.2	12338		0.9	12445		-0.5	12378	
Private		9939	-1.7		9770	1.5		9917	1.0		10016	-0.7		9945
Central Government		2133	0.1		2135	0.1		2137	0.3		2144	0.2		2148
Local Government		285	-0.4		284	0.0		284	0.4		285	0.0		285
Gross Fixed Capital Formation	3471		6.2	3686		1.4	3736		6.5	3980		-3.5	3841	
Private		2377	-0.1		2375	1.0		2398	10.5		2650	-4.5		2531
Central Government		832	26.1		1049	2.4		1074	-1.0		1063	-2.0		1042
Local Government		262	0.0		262	0.8		264	1.1		267	0.4		268
FINAL DOMESTIC DEMAND	1528		0.3	15875		1.3	16074		2.2	16425		-1.3	16219	
Change in Stocks	296		-45.27	162		-80.9	31		790.3	276		-52.5	131	
GROSS NATIONAL EXPENDITURE	16124		-0.5	16037		0.4	16105		3.7	16701		-2.1	16350	
Exports of Goods & Services	4757		1.5	4826		6.4	5135		5.8	5435		0.3	5449	
Goods		3817	1.6		3878	5.0		4072	4.9		4272	-0.4		4255
Services		940	0.9		948	12.1		1063	9.4		1163	2.7		1194
Imports of Goods & Services	-5360		1.7	-5451		1.4	-5525		7.6	-5946		-3.5	-5740	
Goods		-4040	0.2		-4049	1.7		-4117	10.6		-4555	-5.2		-4317
Services		-1320	6.2		-1402	0.4		-1408	-1.2		-1391	2.3		-1423
GDP EXPENDITURE PROXY	15521		-0.7	15412		2.0	15715		3.0	16190		-0.8	16059	
residual discrepancy	649		12.8	732										
DEPARTMENT OF STATISTICS GDP (Adjusted for SVA)	16170		-0.2	16144										