2. CURRENT ECONOMIC SITUATION AND PROSPECTS

Despite higher productivity and reduced inflation, the New Zealand economy is fragile. Growth of 0.8% is forecast for the year to March 1991, down from 2.4% forecast in the July Budget. Unemployment is projected to rise to 7.9% of the labour force, and the current-account deficit to 6.6% of GDP, by March 1991.

A scenario for 1991/92 and 1992/93 is based on projections of financial deficits of $3.7 billion and $4.5 billion respectively.

This shows growth increasing to 2.6% in 1991/92, before slowing to 1.6% as higher interest rates depress private consumption and investment. Unemployment rises slightly over the period. The current-account deficit remains over 5.5% of GDP. There is also an ever-increasing risk of a major loss of international confidence in New Zealand.

The impact of a lower financial deficit on the economy depends on how the reduction is achieved. A lower deficit would initially slow growth and raise unemployment, but interest rates would be lower than otherwise, and our current-account deficit would be improved. This position would be more sustainable.

Apart from the fiscal position, there are other risks and uncertainties. For example, the projections assume continued wage restraint, world oil prices dropping back to about US$25 per barrel this year, and continued (but slower) world growth. If any of these assumptions do not come to pass, the outlook would change.

INTRODUCTION

In recent years the economy has experienced weak growth, with unemployment rising to high levels. The balance of payments deteriorated substantially during 1989 while inflation (adjusted for GST) has stabilised at around 5% since June 1989.

The relatively gradual recovery, however, masks some positive changes in the way businesses operate and in the nature and quality of goods and services they produce.

This chapter discusses the changes taking place in the economy and presents our outlook for the economy for 1990/91. Economic scenarios for 1991/92 and 1992/93 have been prepared on the basis of large financial deficits of $3.7 billion and $4.5 billion respectively, with monetary policy directed at achieving and maintaining price stability.

RECENT ECONOMIC EXPERIENCE

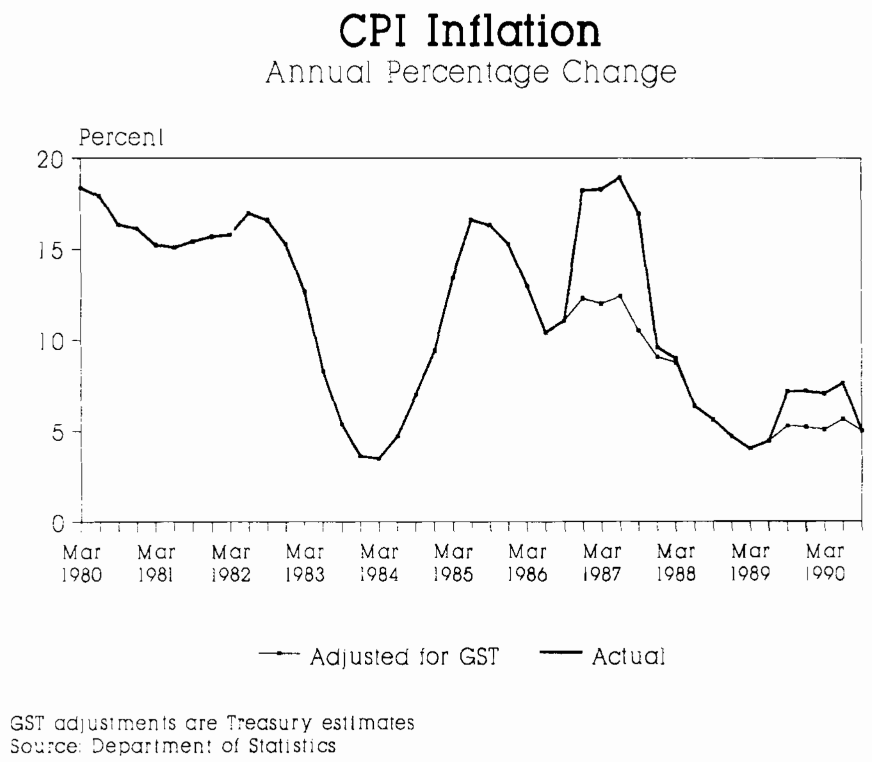
During the second half of 1987 the economy moved into recession. A number of factors were responsible, foremost among them the tightening in monetary policy and reduction in the fiscal deficit. The competitiveness gains from the 20% devaluation in July 1984 had largely been eroded by the combined effects of the 18% wage round in 1985/86 and increases in the nominal exchange rate. At the same time, structural reforms were reducing the demand for labour, particularly in the public sector. The recession coincided with the fall in share prices world-wide in October 1987. The drop in the market value of corporate equity since then has been greater in New Zealand than in any other OECD economy.

Figure 2.1

The economy has experienced a relatively modest and uneven recovery since the latter half of 1988. The recovery was driven initially by terms-of-trade increases, improvements in competitiveness, and the completion of a period of destocking when producers and retailers attempted to bring stock levels in line with overall demand.

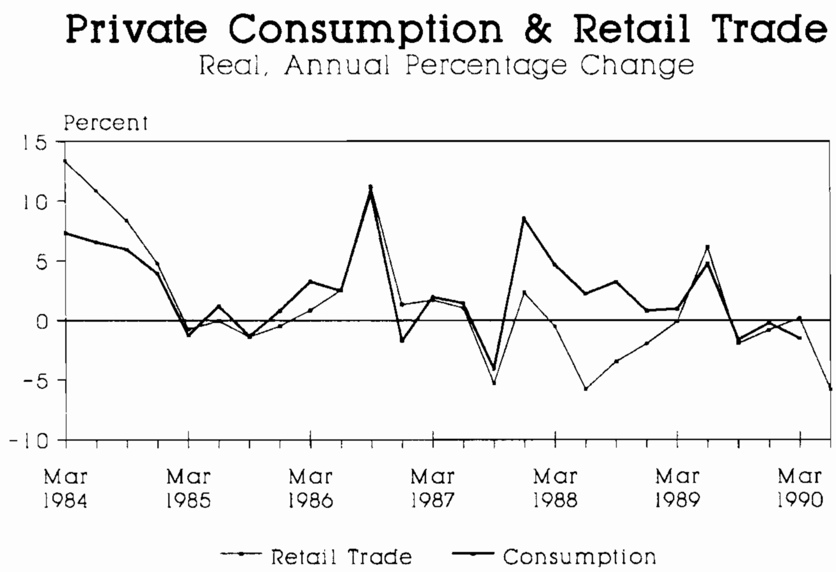
However, the recovery has been weak and tentative, despite a favourable international trading environment. Output in the economy as a whole grew slowly in the last two years. Within this modest growth, output has been growing somewhat unevenly across industries and regions.

Figure 2.2



Furthermore, progress in reducing inflation has been halted recently, while the economy appears to have slowed markedly. Output declined in real terms in the first half of 1990. Private consumption slowed and retail sales have remained very weak throughout the last year. The fall-off in consumption was reflected in the rapid build-up in stocks during the year, much of it sourced from imports.

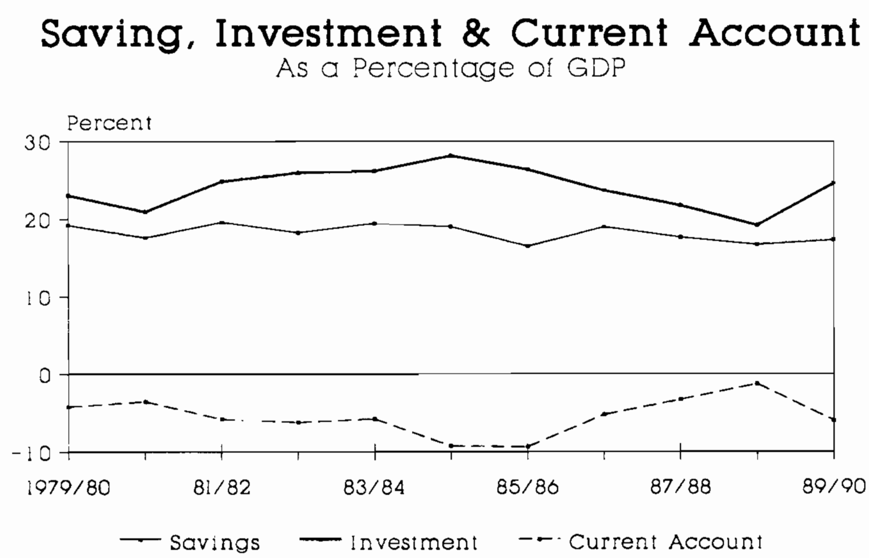
Figure 2.3



Consumption at 1982/83 prices
Retail Trade at March 1990 prices
Source: Department of Statistics

Import volumes grew significantly last year, with the main contribution coming from imports of intermediate goods. Another major source of import growth was the strong increase in investment, much of it due to re-equipment of commercial vehicle and aircraft fleets, and strong investment by state-owned enterprises (SOEs). Together with a fall in agricultural export volumes, this led to a large increase in the balance of payments current account deficit.

Figure 2.4



Investment comprises gross fixed capital formation plus stockbuilding
Current prices, year to 31 March
Source: Department of Statistics, except
for 1989/90 which are Treasury estimates

The weak state of domestic activity is being reflected in the labour market. In recent months employment has fallen, reversing the increases recorded at the end of 1989. The unemployment rate has also started to rise again, reaching nearly 8% in August.

Over recent years a number of factors have been influencing the development of the economy. These include:

- The agricultural sector has been adjusting to the reductions in assistance and the 20% fall in land prices that occurred between 1983 and 1988. This fall forced many farmers to concentrate upon debt repayment and debt restructuring. Much of the income gained from the improvement in the terms of trade since 1986 is likely to have been directed towards debt repayment. Significant reductions in stock numbers took place, while farm investment and spending on other inputs was cut back.

- The 1987 sharemarket fall seriously weakened a number of corporate balance sheets, forcing businesses to concentrate on strengthening their cash flow in order to reduce debt levels.

- Commercial construction remained very buoyant until the end of 1987. Real private investment in this sector more than doubled in the four years to 1987/88. Over the past two years overcapacity has led to drops in property and rental values in many urban centres and a marked fall in construction activity.

- The Development Finance Corporation and Bank of New Zealand difficulties, together with the continued pessimism of the sharemarket, have made overseas investors much more cautious about New Zealand. At the same time domestic banks have placed much greater weight on credit risk, and have tightened their lending criteria.

- The external competitiveness of the economy declined up until early 1988. This reflected the effects of high domestic cost increases compared to our main competitors and the effects of tight monetary policy on the exchange rate. Competitiveness began to improve during 1988 following a significant decline in the nominal exchange rate and strong productivity growth.

- The removal of import licensing and reduction in tariffs have increased consumer choice and generally forced New Zealand companies to become more discerning about the range and quality of the goods and services they produce. Imports of commercial vehicles, cars and a range of other consumer goods have grown strongly.

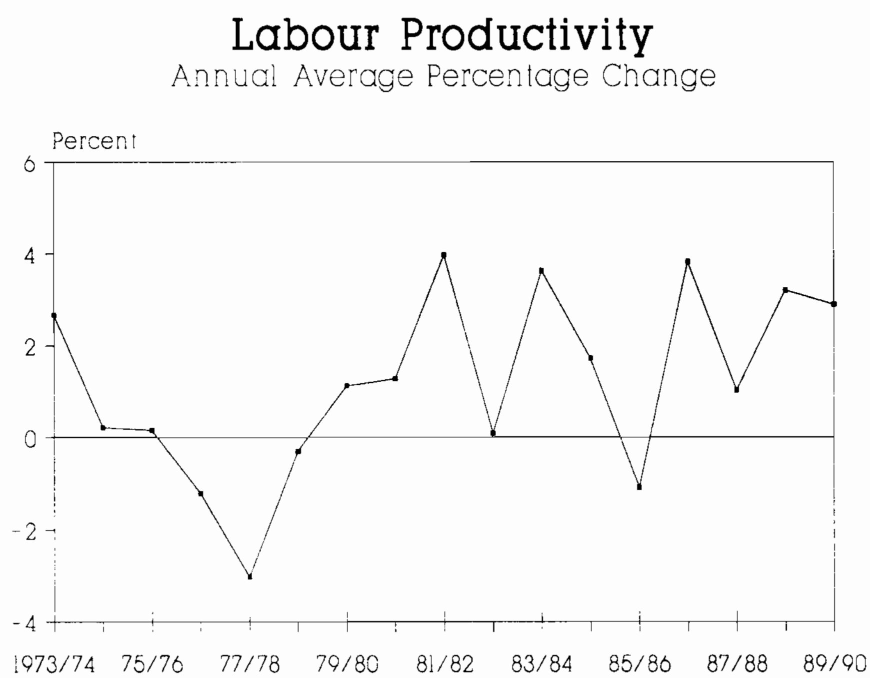
- Consumer spending following the GST increase in July 1989 was much weaker than most businesses had anticipated. Consequently a substantial build-up of inventories occurred. These inventories are still being run down, with production lower in the meantime.

These influences have tended to restrain growth. They have forced the private sector to concentrate upon reducing cost structures, improving cash flow and restructuring in order to remain competitive. They also contributed towards higher productivity and investment growth, despite weak economic growth overall.

Productivity

Economy-wide labour productivity has grown by an average of 2.7% over the last four years. Labour productivity in manufacturing has increased by an average of around 5% a year over the same period. However, because the economy was only growing slowly, the counterpart to this productivity gain was a large number of job losses as firms rationalised their operations. Although investment has grown rapidly, it is likely that average capital productivity has also increased, as firms closed down and less efficient plant and equipment was scrapped.

Figure 2.5

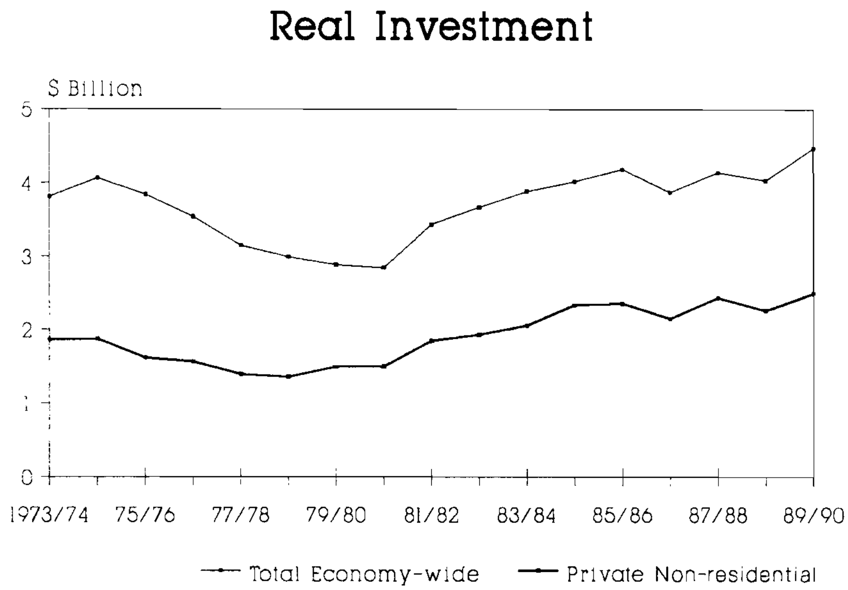


Real GDP per full-time equivalent person employed, year to 31 March
Source: Department of Statistics and Department of Labour

Investment

Commercial investment grew strongly last year. This growth was driven by several influences. Domestic deregulation created new investment opportunities. For example, the introduction of competition to the domestic aviation market led to the upgrading of aircraft fleets and terminal facilities.

Figure 2.6



1976/77 prices, year to 31 March
Source: Reserve Bank

Favourable international prices encouraged investment in the forestry, dairy and mining sectors. Investment in manufacturing has been very weak overall, although there has been considerable investment in parts of the manufacturing and service sectors in new technology and improved management aids (for example, computerisation and inventory control techniques). Business profitability grew strongly during 1988 and 1989 as a result of the increase in export prices, the growth in productivity, and cost containment. Over the last two years profits (before tax and interest payments) rose by around 35%, albeit from a low base. This growth was offset in part by higher corporate tax receipts in 1989/90.

The price of investment goods on average has fallen by about 20% relative to all goods and services since 1985/86. This decline has helped offset the effects of higher interest rates.

In total, commercial investment grew by 17% in real terms last year, with SOEs accounting for most of the growth. While gross investment has been strong, the scrapping of existing capital stock following the restructuring over the last few years means that the overall capacity of the economy will not have increased to the same extent.

Changes Within Firms

There have been significant changes in the way firms manage and operate their businesses. Some evidence on the scale of change is provided by a survey of 116 firms[1], conducted in April 1990. Although there was a wide divergence of experiences over the last five years, a number of trends emerged:

- Firms have improved product quality and reduced costs in response to increased competition.

- There has been little change overall in the share of output that is exported. However, firms in textiles, clothing and leather goods have increased their export share.

- The main objective of investment has been to improve technology and reduce costs.

- More than one-half of the firms have experienced changes in ownership over the past five years. There has also been a sharp rise in foreign ownership of equity, and in overseas investment by New Zealand companies.

- Most firms have made significant organisational changes, mainly in marketing and consumer services, computerisation, management structure, quality control, work methods and flow, and management information systems. More than half the firms had diversified and/or consolidated their lines of business.

ECONOMIC PROSPECTS

The economic projections presented here are conditional on the following assumptions:

- The latest fiscal projections show that on the basis of unchanged policies the financial deficit is expected to reach $3.7 billion in 1991/92 and $4.5 billion in 1992/93.

- Monetary policy is assumed to be directed at achieving price stability, defined as 0%-2% inflation by December 1992.

- Other government policies are assumed to continue operating on their current basis.

Based on these technical assumptions, the projections (summarised in Tables 2A and 2B) represent in our view the most likely path for the economy. However, it is important to bear in mind that there is a wide margin of error surrounding both the official estimates of the recent state of the economy and the projections presented here. The main risks and uncertainties are summarised later in this chapter.

[1] Baird M and J Savage with A Petherick (1990), "Responding to Change: What Firms Say About Adjustment" (NZIER Research Monograph 54).

TABLE 2A - SHORT-TERM MACROECONOMIC PROSPECTS

Annual average percentage changes (March years)

Real components of GDP	**1988/89**	**1989/90** (Estimate)	**1990/91**
Private consumption	+1.9	+0.3	0.0
Public consumption	+1.6	-1.7	+2.2
Private investment	-5.0	+6.1	+4.2
Public investment	+3.1	+28.4	-1.8
Domestic Demand	**+0.8**	**+2.9**	**+0.9**
Stockbuilding[1]	-0.5	+4.1	-2.0
Gross National Expenditure	**+0.3**	**+6.9**	**-0.9**
Exports	+1.3	-3.5	+7.8
Imports	-0.7	+15.4	+1.7
Gross Domestic Product[2]	**+1.0**	**0.0**	**+0.8**
Current account deficit (% of GDP)	1.3	6.0	6.6
Consumer price inflation (%) (March quarters)	4.0	7.0	5.5
Employment[3] (% change)	-4.5	-1.7	+0.1
Unemployment[4](% of labour force)	7.4	7.3	7.9

Forecasts finalised 25 October 1990

1 Percentage contribution to GDP growth
2 Expenditure based
3 Full-time equivalents, annual average
4 March quarters, HLFS basis

Note:

Estimates of expenditure on GDP published by Department of Statistics are based on the structure of the economy in 1982/83. Large changes to the structure since then mean that growth in 1989/90 is almost certainly understated by the current official estimates.

The Outlook for 1990/91

Real GDP is projected to grow by just under 1% in 1990/91.

Several factors have led us to revise downwards our expectations for growth since the 1990 Budget:

- The international outlook has deteriorated over the past four months. Oil prices are currently around US$30 per barrel[1] - up substantially from US$19 just before Iraq invaded Kuwait. Oil prices are assumed to fall back again to average US$25 per barrel this year, and to ease slightly next year.

- Partly as a result of higher oil prices, world growth is likely to be lower than in recent years. We expect growth in the whole OECD area of 2%-2½% next year. However, North America, the United Kingdom and Australia are likely to fare somewhat worse, with recent indicators suggesting that these economies have slowed considerably. The risk of a world recession has increased.

- Dairy and wool prices have weakened significantly, due in part to increased export subsidies paid by the European Community.

- Macroeconomic statistics released over recent months have pointed to slower-than-expected growth in New Zealand, with business confidence and labour market conditions particularly weak. Interest rates have risen since the beginning of August.

Adverse terms of trade movements are likely to lead to weaker income growth. Farm incomes in particular are expected to fall. As a result, private consumption is not projected to grow at all in real terms this year. Investment growth is also expected to slow down as the recent upgrading of transport fleets reaches completion and some large investment projects by SOEs wind down.

Higher oil prices will add to inflation and increase the cost of imports. Export earnings will be reduced by the fall in agricultural prices. However, export volumes are expected to pick up. Dairy and meat exports are likely to grow strongly, as temporary factors which depressed exports in 1989/90 (including delays in dairy shipments) unwind. Manufactured exports are also expected to continue growing strongly as a result of ongoing improvements in competitiveness. Although import growth is projected to slow in 1990/91 as domestic demand slows, the current account deficit is still expected to increase to around 6.6% of GDP.

Employment is not likely to grow this year. Increases in labour supply resulting from a marked reduction in net outward migration and other demographic trends are expected to result in unemployment remaining high in 1990/91.

Important factors driving these projections are:

- **Weaker terms of trade.** The terms of trade are projected to fall by some 8% in 1990/91, reflecting the world economic situation, higher oil prices,

[1] North Sea Brent blend on 25 October.

recent European Community moves on dairy prices and the continued weakness in wool markets. This fall in the terms of trade will markedly reduce the growth in domestic real income.

- **Stronger export growth.** Part of the expected export growth involves selling down some agricultural stocks built up in 1989/90. Exports are also expected to be boosted by increased timber production. Growth in manufactured exports is projected to continue. Over the past two years non-food manufactured exports have grown by 12% in real terms. Although Australian import growth is weakening, New Zealand manufacturers have gained market share in recent years and this is expected to continue, helped by the implementation of CER.

- **Weak agricultural sector.** Reflecting the effects of the weaker terms of trade, farm disposable incomes are projected to fall substantially this year. This will tend to discourage the tentative pick-up in farm investment and fertiliser application that started to take place last year. In some instances, it may lead to the re-emergence of debt problems.

- **Reduced commercial property investment.** Investment in urban centres has declined sharply and asset values have fallen. Debt ratios deteriorated as a result. While significant excess capacity remains, a number of investors will hold poor performing and illiquid assets. This will restrict the ability of such investors to redirect resources to alternative uses.

- **High real interest rates.** Real interest rates are expected to remain high as a result of both international and domestic factors. Strong demand for finance in Eastern Europe will provide one source of pressure. Inflationary pressures in some other economies and the continued large US external deficit will be another. In New Zealand uncertainties about domestic policies and the projected large fiscal and external deficits suggest that investors will continue to seek significant risk premiums for New Zealand investments. These influences will constrain the speed with which balance sheets within the economy can be improved and hence limit to some extent the ability of domestic firms to undertake new investment.

- **Inflation.** Inflationary pressures should ease once the oil price effects work through. Behind these projections is an assumption that labour cost increases will be kept low as a result of wage restraint and continued productivity growth. One factor which may moderate wage settlements is the recent growth initiative involving the Government, the CTU and the Reserve Bank. Weak domestic demand, increased competitive pressures and ongoing benefits from tariff reform are also seen as acting to slow inflation.

The Outlook for 1991/92 and 1992/93

The prospects for the economy in these years depends on the effects of two major influences.

- **The effects on the trend rate of growth of the economy as a result of structural reforms.** More than any other factor, New Zealand's medium-term growth rate will depend on the productivity of our resources. Economic reforms over the last decade have contributed to labour productivity growing in the last five years by as much as it had in the previous 20 years. Over the next two years labour productivity is projected to increase on average around 2% per annum.

- **The prospects of large fiscal deficits**. The size of the projected deficits, the range of policy responses available to the Government, and the possible reactions of markets all create a very large degree of uncertainty about the pattern of activity. Fiscal deficits of the size projected will increase the prospects of adverse reactions in financial markets. Given these uncertainties we discuss the outlook for 1991/92 and 1992/93 in terms of different assumptions about fiscal policy.

Unchanged Fiscal Policy

The forecasts presented in Table 2B represent a realistic path for the economy, if the fiscal deficit is allowed to increase over the next two years in line with the fiscal projections. Increased public spending would result in strong growth in private disposable incomes. Some of this income would probably be spent, rather than saved, and the additional demand would probably result initially in some increase in domestic production and higher import volumes. We would not expect the increase in domestic production to lead to substantial increases in employment. Employers would be unlikely to expect the boost in demand to be sustained. Thus, they would be more likely to increase production by increasing overtime rather than by increasing employment.

The tensions between monetary policy and fiscal policy would be considerable. The increase in nominal demand resulting from the expansionary fiscal position would add to inflationary pressures. Furthermore, an adverse reaction can be expected in the form of downward pressures on the exchange rate. Monetary policy actions are assumed to be directed towards offsetting the inflationary pressures of both higher demand and the downward pressures on the exchange rate. As a result, short-term interest rates would almost certainly rise. Long-term interest rates would also be likely to rise, reflecting the increased risk of investing in New Zealand.

Higher interest rates would tend to lower the growth of spending by consumers on interest-sensitive items (mainly durables) and lower investment. Investor confidence, which is already at a very low level, would be further damaged by a rise in interest rates.

TABLE 2B - MACROECONOMIC PROJECTIONS ASSUMING UNCHANGED FISCAL POLICY

Annual average percentage changes (March years)

Real components of GDP	**1991/92**	**1992/93**
Private consumption	+1.9	+1.1
Public consumption	+1.8	+1.3
Private investment	-4.6	+0.2
Public investment	-5.8	+3.5
Domestic Demand	**+0.1**	**+1.2**
Stockbuilding[1]	+0.8	+0.2
Gross National Expenditure	**+0.8**	**+1.4**
Exports	+5.3	+3.7
Imports	+0.4	+2.7
Gross Domestic Product[2]	**+2.6**	**+1.6**
Current account deficit (% of GDP)	5.7	5.6
Consumer price inflation (%) (March quarters)	3.1	2.0
Employment[3] (% change)	+0.3	+0.2
Unemployment[4] (% of labour force)	8.0	8.2

Projections finalised 25 October 1990

1 Percentage contribution to GDP growth
2 Expenditure based
3 Full-time equivalents, annual average
4 March quarters, HLFS basis

The outlook contained in the projections set out in Table 2B shows economic growth accelerating in 1991/92 to around 2.6%, but with little rise in employment. Growth in real GDP is led by public and private sector consumption. Despite continuing strong growth expected in export volumes, the current account deficit is still projected at nearly 6% of GDP in 1991/92. The fiscal expansion is expected to raise import growth in total, with higher imports of consumer goods only partly offset by lower capital goods imports.

In 1992/93 economic growth is expected to begin to slow as a result of the continuing high interest rates depressing private sector consumption and investment. The current account deficit remains over 5.5% of GDP. Unemployment is projected to increase.

Throughout this period and beyond there would be an ever-increasing risk of a major break in financial market confidence. This could see a very sharp depreciation in the exchange rate take place, further upward pressures on interest rates and the need for urgent corrective action.

Fiscal Consolidation

The economy would develop differently if the fiscal deficit is progressively reduced. It is not possible to be precise about the response, as much would depend on how the fiscal consolidation was achieved. The likely path of investment, employment and output growth would be considerably different if the deficit was closed more by raising taxes than by reducing expenditure.

Regardless of how the deficit was reduced, it is likely that a sizeable reduction would constrain private sector disposable income, consumer spending and import demand in the short term.

Deficit reduction would reduce the risk of higher interest rates. It would not avoid the initial adverse effects of a fiscal outlook that is worse than most commentators are expecting. It would inevitably take time for markets to be reassured that policies were being put in place to achieve sustainable reductions in the deficit.

As fiscal consolidation was secured, financial markets would be likely to react more favourably. As a result, risk premia built into interest and exchange rates should decline.

Part of the initial fiscal adjustment could involve increasing the prices of some government services. This would raise measured inflation and exert some pressures on monetary policy.

Our judgement is that reducing the deficit would initially lead to lower economic growth and higher unemployment compared to the projections presented in Table 2B. However, it would also result in relatively lower interest rates, a smaller current account deficit and lower public debt. The overall effect though would be a more sustainable mix of policies.

Early action to reduce the fiscal deficit and achieve a more sustainable policy mix would be expected to result beyond the forecast period in stronger economic growth and lower unemployment than otherwise. It would also assist investment growth, which would strengthen longer term growth prospects.

Other Risks and Uncertainties

Any forecast inevitably involves degrees of risk and uncertainty. In addition to the substantial uncertainty relating to the fiscal position, several other factors are important:

- The economic relationships inherent in any forecast are not known with precision. For example, fiscal consolidation could have a range of short-term impacts on the economy depending upon how well the policies have been anticipated and how they influence business confidence and financial markets.

- We are dependent on what happens in the rest of the world. At present many countries and regions are confronting difficult economic problems. The way these are handled could influence our export growth and terms of trade.

- There are uncertainties about the recent state of the economy. In times of rapid structural change, economic statistics can become less reliable.

Specific downside risks and uncertainties include:

- Considerable uncertainty remains as to how the Middle East situation will develop, and hence the outlook for oil prices. We are assuming a relatively modest slowdown in world growth with the OECD countries still growing by about 2.5%, but the actual outcome could be worse. Slower world growth would lead to a further weakening in New Zealand's terms of trade, which would cause lower domestic incomes and weaker demand. Of particular concern to New Zealand businesses, especially in some sectors of manufacturing, is the current weakness of the Australian economy. It appears possible that the 'soft-landing' hoped for in Australia - slowing growth, declining inflation, and an improving current account position - could tip over into recession.

- New Zealand's current account deficit, which is estimated to be 6% of GDP in 1989/90, is expected to remain high if the projected increase in the financial deficit occurs. As other countries have shown, it is possible to finance large current account deficits for several years, provided overseas investors' confidence remains strong. But the increasing level of public sector and international debt implied by our projections carries a substantial risk that overseas investors would at some stage re-evaluate their exposure to New Zealand, resulting in downward pressure on the exchange rate. The impact on the economy of any fall in the exchange rate would depend upon the extent to which higher import and export prices fed through into cost and price increases elsewhere in the economy. It would also depend on the extent to which interest rates rose in response.

- Continued moderation in wage settlements is assumed, compared to measured inflation and productivity growth. However, if wage settlements turned out higher than assumed this would pose risks for the attainment of the Government's inflation target and for improvements in competitiveness. Unemployment would be likely to increase more rapidly than we are currently projecting.

Factors that could increase growth include:

- the possibility of more rapid improvement in labour and capital productivity leading to increased competitiveness and domestic output
- the potential for current levels of profitability to support stronger investment if businesses, including farmers, feel that their debt is manageable
- the possibility that New Zealand exporters may gain improved market access, for example through the successful completion of the current GATT round.

CONCLUSIONS

The current economic situation is fragile. A number of adjustments are working through the economy. Some of these adjustments reflect policy changes of recent years. Others reflect changes in the rest of the world. The weaker international situation and higher oil prices will contribute towards a significant fall in our terms of trade which will have a depressing effect on economic activity in the coming year. Over a longer timescale, the recent increases in productivity, investment and export volumes should contribute to stronger economic growth.

There are considerable uncertainties surrounding these forecasts. The external situation is at present very volatile. Events in the Middle East, the GATT decisions, the problems facing Eastern Europe together with weaknesses in the United Kingdom, United States and Australian economies all pose potential short-term uncertainties.

The major uncertainty centres on the fiscal outlook. Fiscal deficits of the order currently projected are not sustainable. In the short run they could result in stronger GDP growth, but would lead to higher interest rates, a worse current account position, and increased debt levels. Failure to reverse these projections would see a serious weakening in business confidence and investment. In the short run, fiscal consolidation would result in weaker domestic demand but a slowly improving current account. In the medium term, it would result in more rapid economic growth.

Many firms and sectors are still adjusting to policy changes and external events of recent years. Looking ahead, there is a need to improve the overall balance of policies. The way the economy responds will depend, to a large extent, on how confident investors and producers are about the sustainability of the policy changes.