Briefing to the Incoming Government

1993

NOTE

Unless otherwise stated, all years refer to years ending ~~31 March~~.

Data on a fiscal year basis refer to years ended 31 March to 1988/89 and years ended 30 June thereafter.

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An Overview of Issues

INTRODUCTION

The incoming Government has the opportunity to bring a long-term focus to the major issues of raising the standard of living of New Zealanders and reducing unemployment.

The Government does not face an immediate fiscal or policy crisis.

The New Zealand economy is growing and, while moderate, this growth looks sustainable.

Fiscal performance is improving and is forecast to move close to balance in 1995/96.

The major issues facing the Government - raising economic performance, incomes and employment - are not simple. Dealing with these issues will require well formed, coordinated policy that is also well executed.

WHERE THE ECONOMY IS HEADING

The economy is growing solidly by recent New Zealand and international standards and is starting to generate higher employment growth.

The economy has been growing since mid-1991 and grew by nearly 3% in the year to June 1993.

Employment has been growing since December 1991. In the year to June 1993 total employment rose by 17,100.

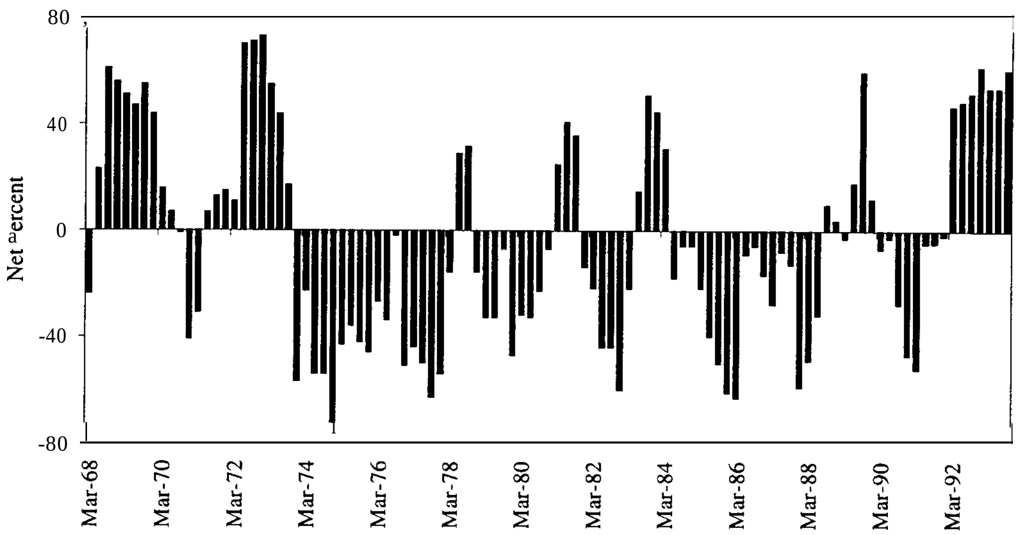
Many of the characteristics of a successful economy are now emerging.

Increased international competitiveness is resulting in strong investment growth, supported by research and development, quality and training programmes, market development and strategic planning.

Skills are increasingly being rewarded with higher relative wages. The benefits that accrue from higher skills are being reflected in increasing education participation and investment in staff training by businesses.

Confidence in the future of the economy is now strong. For example, the NZIER Quarterly Survey of Business Opinion has recently recorded the most extended period of optimism in the survey's 25-year history.

Figure 1.1
Business confidence sustained at high levels



Source: *NZIER Quarterly Survey of Business Opinion*, September 1993

The outlook is for continued growth at around OECD averages or better.

Consensus forecasts[1] project growth at around 3% per annum, employment growth at about 20,000 to 30,000 jobs per year, inflation at 0% to 2%, a sustainable current-account position, and continued fiscal consolidation.

This is occurring despite slow growth in the rest of the world, and without monetary and fiscal stimulus. There is also strong business confidence and high investment growth. These all suggest the current recovery will prove sustainable.

Periods of strong growth have been accompanied in the past by a build-up in inflationary pressures, with growing current-account deficits and wages blow-outs. This is now less likely to occur as reforms have reduced uncertainty over the focus of macroeconomic policy and resulted in a more flexible labour market.

1 *NZIER/New Zealand Consensus* Forecasts, September 1993.

Recent information suggests growth in 1993/94 will be stronger than earlier projected.

New information available since the Pre-election Economic and Fiscal Update suggests growth in 1993/94 is likely to be in the range of 3.5% to 4.5%.

The current strong domestic demand may be signalling a stronger economic cycle than projected. This would carry some risks of inflation pressures and a weaker current account.

However, the prospect of higher trend growth averaging more than 3% cannot be discounted.

Growth will fluctuate.

A number of risks normally associated with an economy like New Zealand's will move the actual path of the economy away from its average growth rate from time to time:

- ❑ A weaker-than-expected international economy would tend to slow overall growth.

- ❑ New Zealand's high debt leaves it exposed to adverse movements in interest and exchange rates.

- ❑ New Zealand is still vulnerable to fluctuations in commodity prices, despite increasing diversification in products and markets.

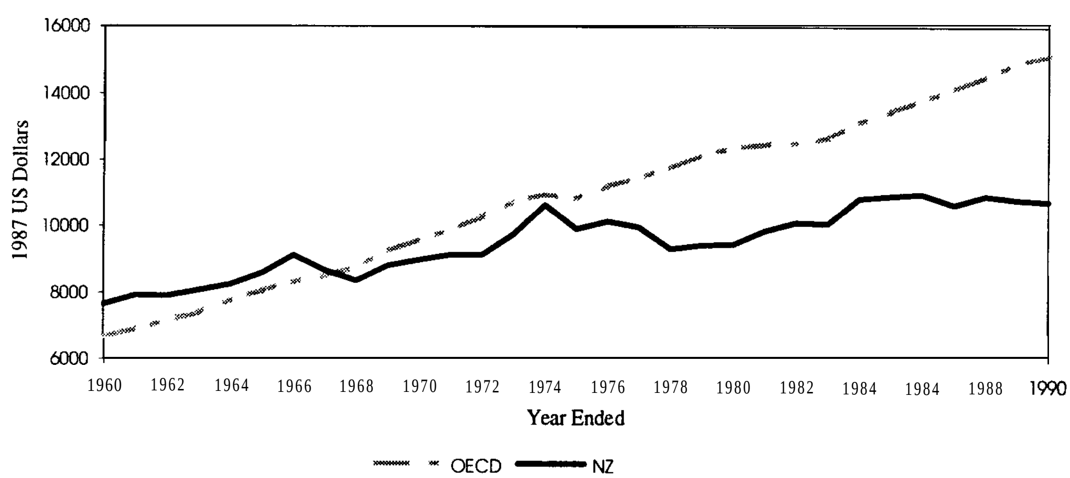
It will be important to monitor inflation and balance-of-payments indicators closely over the next few quarters.

While the current approach to monetary policy has not been tested over periods of strong growth, it is expected to make inflation pressures much easier to cope with than in the past.

New Zealand has the potential to achieve higher growth rates.

New Zealand's current average per capita income stands at 54% of the United States level and 73% of that of Australia.

Figure 1.2
New Zealand incomes have fallen behind on per capita GDP, leaving a sizeable gap



Source: *The OECD Economic Outlook*

The potential to close this gap was recently demonstrated by Tradenz. It worked with different sectors to identify a number of ways for businesses to "stretch" substantially their export growth potential.

To fulfil this potential requires investment in skill, market and product development, and a continued drive for innovation and quality.

New Zealand's location is becoming less of a constraint than it used to be:

- The world economy is becoming increasingly integrated. Transport and communications have become easier, opening up new possibilities for trade and improving access to international capital markets.

- New Zealand is relatively close to the new centres of rapid growth in Asia and Latin America.

Fulfilling this potential will involve working off the legacies of past behaviours and history.

New Zealand's historical policy environment did not encourage adaptation, innovation or skill development.

Producers were generally not subjected to strong competitive pressures. Investment was typically not supported by expenditure on research and development, market development, training or quality sys terns.

High tax rates and large tax shelters diverted management effort towards strategies to minimise tax, rather than adding most value.

The industrial relations system led to little difference in wages between high- and low-skilled individuals. It encouraged many young New Zealanders to leave school at an early age.

Overcoming this legacy will need innovation and specialisation to become much more deep-seated and widespread in the economy.

The dynamic and innovative pockets of the economy, while growing, are still relatively small. Export growth in the non-traditional manufacturing sector, which accounts for only 15% of total exports, is projected to be around 13% per annum.

On the other hand, livestock-based agricultural exports, which account for 30% of total exports, are forecast to grow at only around 1% per annum for the next three years.

As a result, overall growth is likely to accelerate only gradually.

World markets provide virtually unlimited opportunities for New Zealand. However, the international trading environment will keep changing. Success will require effective, focussed and adaptable business strategies.

Australia, where much of New Zealand's manufacturing export success is based, is reducing its tariffs, making other countries' products more competitive with ours.

New Zealand's primary products will face increasing competition from Latin America, Southern Africa and Eastern Europe.

The strongest growing parts of the international economy at present are in Asia and Latin America, where New Zealand does not have strongly developed market networks.

World trading rules are uncertain. Possibilities range from global liberalisation to the world splitting into several trade blocs.

While employment growth will be stronger than in the past, unemployment is expected to decline only gradually.

Newly created jobs - around 20,000 to 25,000 per year - may only be sufficient to cover growth in the workforce.

However, employment could grow faster than projected.

Businesses and workers are now operating under a more flexible industrial relations regime. The economy is in a new, untested environment of strong growth. Domestic demand is now growing strongly. Business confidence is high. Stronger growth in the service sector - where most people are employed - is becoming more evident. As a result, stronger employment growth than expected could still occur.

Lower-skilled people will be slower to benefit from stronger economic growth.

Many of the long-term unemployed have low or inappropriate skills. They currently account for half the unemployed. Economic growth will reduce the size of, but not eliminate, this group.

A group of people experiencing multiple disadvantages - including poor health, poor housing, low income, and low skills and education - will, without some assistance, be less likely to benefit from growth.

Children in situations of disadvantage will have particular difficulties.

Growing up in such conditions tends to constrain the choices and opportunities available to children. In particular, there appears to be a link between disadvantage in childhood and subsequent unemployment.

RAISING ECONOMIC PERFORMANCE

To raise the performance of the economy and improve the quality of life of New Zealanders will involve meeting a number of challenges.

Government policy should aim to consistently encourage behaviours that lead to better incomes and employment prospects. This will involve:

- reinforcing and broadening innovative, internationally oriented business behaviour
- enhancing the prospects of higher standards of living through employment and raising the skills of the population
- managing the risks to the gains already made through consistent Government policies.

Reinforcing entrepreneurial behaviour

Improved performance by the business sector will depend on its ability to adopt the best practices of the leading firms worldwide.

These practices involve more than just keeping costs down and investing in new plant. They also involve investment in training staff, developing relationships with customers and suppliers, and continuous search for opportunities to improve performance.

Government policy can have a substantial influence on the quality of business practice.

When policy exposes business decision-makers to competition and avoids discrimination between -different types of investment, better quality investment will result.

International experience illustrates that competition provides a strong spur to innovation and better performance.

Consistent and credible policy plays an important part in reducing the risk premium built into the cost of capital in New Zealand.

It is important that policies are designed in a way that leads to the most positive outcomes from business performance.

The recent World Bank study of East Asia[2] illustrated that this will primarily involve getting the economic fundamentals right - stable macroeconomic management, encouraging quality skill development, and developing open and competitive markets.

A number of policies will have a strong influence on business sector performance.

Overall policy stability and consistency, good tax and regulatory design, and the maintenance of sustainable low inflation will make investment in New Zealand more attractive. Moving into fiscal surplus will raise overall savings and help reduce the cost of capital.

Applying low tax rates across the full range of income will have a positive effect on the quality of investment, as well as lowering compliance and administration costs. The new Government will need to address issues of international taxation. Decisions here should contribute to lowering the costs of capital facing New Zealanders and to strengthening international linkages.

A review of post-1996 tariff policy is scheduled for 1994. It should be a high priority for the new Government to ensure

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2 *The East Asian Miracle: Economic Growth and Public Policy*, World Bank, August 1993.

that the outcome of this review is consistent with the need to achieve high rates of productivity and innovation.

Each year a Government makes or amends hundreds of regulations. It is important that these regulations are designed to recognise the wider effects that they might have on overall economic performance.

A particular focus should be on the legal framework for business activity. This is important in shaping management attitudes, and business formation and evolution. Company law, for example, affects whether a business, with its shareholders, can organise itself to best reduce its risks and maximise its opportunities.

The performance of the agricultural sector is extremely important, because of its size in proportion to total exports. Small increases in the sector's growth would give a significant boost to overall growth rates.

Despite being an area of strong potential competitive advantage for New Zealand, agricultural production is forecast to fall as a percentage of GDP.

This raises questions as to why independent forecasters do not expect this sector to be one of the dynamic ones.

The sector has benefited from substantial reforms over the last decade in areas like ports, tariffs, transport and the labour market.

In the future New Zealand agriculture will face new opportunities in the fast-growing markets of Asia and Latin America. It will also face increased competition from producers in the Americas and Eastern Europe. To successfully respond to these challenges the organisations that control processing and marketing will need to become more innovative and adaptive.

Agricultural processing and marketing is characterised by statutory boards and, to a lesser extent, co-operatives. This is in contrast to forestry, fishing and some parts of food processing. While strong support for these arrangements continues in many quarters, they are being increasingly questioned within and outside the industries.

While current structures may limit the sector's development, there is little information available to assess the performance of the processing and marketing operations.

A number of important issues affecting these agricultural industries will arise over the next three years. Because the boards are creatures of statute, the Government will need to be closely involved in many of these issues. The issues are complex and are likely to require industry-by-industry approaches. The Government should work with each industry to ensure the solutions to their problems enable agriculture to achieve its full potential.

Stronger trade performance and reduced vulnerability to international forces will be assisted by stronger international linkages.

New Zealand has a very strong interest in the outcome of the GATT. But irrespective of GATT, New Zealand should develop strong relationships with important, outward-looking regional groupings such as APEC.

Asia and Latin America will be the fastest-growing markets over the next decade. New Zealand's international focus, though, is still strongly orientated to the more established OECD economies. New Zealanders will need to develop their knowledge and understanding of those new, growing economies to take advantage of the opportunities they offer.

Government policy can shape the ways these linkages form and the depth of the relationships that develop by:

- maintaining a strong international orientation to policy, which signals to firms the need to invest in lasting commercial relationships with overseas customers and suppliers

- adopting a liberal approach to foreign investment, air access and international telecommunications

- developing more formal relationships such as technology agreements, bilateral tax agreements, investment agreements and formal economic relations (such as CER).

The Government also has a significant impact on the cost and quality of many goods and services through regulation, provision by a Government entity, or a combination of both.

The focus of policy should be on achieving better quality service and cost-effectiveness in the provision of these goods and services.

The Crown's commercial operations also represent a substantial element of the Crown's balance sheet. Risks associated with these operations need to be managed carefully.

Experience with Government entities shows the importance of having management systems that provide clear objectives and effective accountability.

Skills to improve employment and incomes

Improving skills is the best long-run solution to reducing unemployment and raising incomes for the low-skilled.

Productivity growth is necessary for higher incomes and economic growth. People's skills, abilities, and education all contribute to their productivity, as does the quality of their management, and the plant and equipment they work with.

International success increasingly depends on the ability of people to generate and implement ideas, and less on natural resources or other special advantages.

While higher economic growth will create more job opportunities, the abilities and education of individuals and the willingness of managers to invest in training will be a major determinant of longer-term income prospects.

For many, employment provides the necessary opportunities to improve skills and increase real income.

Many New Zealanders are not yet well-equipped with the skills likely to be in demand in the economy in the future.

A high proportion of the current workforce has few qualifications. Over time the workforce will become more skilled as businesses improve their ability to operate in a more competitive labour market and invest more strategically in training their employees.

Improving skill levels will be a gradual process.

Just as it has taken time for the labour market to work more effectively, there will also be a lengthy process of skill improvement. This is not simply a matter of the time involved in learning. It also relates to the decisions people make whether to take up, pay for, or offer learning opportunities.

The decision to undertake additional training is influenced by the life and income opportunities that training can create. This means that a widening of pay differentials is likely to be helpful in encouraging people to acquire skills. It also means the Government should be hesitant about adopting tax or assistance policies that reduce the attractiveness of learning new skills by compressing these differentials. Improving opportunities to work and improve skills will better spread the gains of economic recovery in a pro-growth way.

Employers face decisions whether to offer training opportunities. Their decisions will be strongly linked to competitive pressures that push them to improve productivity and quality. The firms that succeed are more likely to be those who make a balanced investment in staff skills, capital and marketing.

The responsiveness of schools and other educators to the needs of a dynamic economy will be essential.

While advances have been made in this area, securing the maximum value from the investment being made in education will require attention to:

- reviewing funding and charging practices
- establishing better information for parents, students and employers about performance
- relaxing constraints on managers of education institutions
- improving areas of low performance, such as where students are leaving school directly into unemployment.

Though improving skills is the best long-run solution, there are no easy answers to unemployment in the short term. However, attention to specific Government policies will help.

The decision to offer or accept employment is always a significant step which people do not take lightly. This means that policy changes cannot be expected to offer a quick fix to unemployment. However, there are moves which would help more people to participate in the economic recovery.

- ❑ Rules on benefit eligibility and the duration of assistance can encourage people to seek out work opportunities.

  Important trade-offs, though, are involved in the design of the welfare system, including the risk of imposing unnecessary hardship.

- ❑ Some of the most consistently effective policies overseas have included intensified placement and counselling services.

- ❑ Employment schemes and benefit administration, can assist the least-skilled to gain work experience and to improve their skills.

Long-term unemployment and disadvantage are likely to require a variety of specific interventions.

People in these situations often face a number of problems, including limited work abilities, poor social skills and poor health.

The complex nature of these problems and their interrelationship may demand that a case-by-case approach is taken. Effective intervention may require a more substantial role for community groups or others close to the problems. A certain amount of piloting of programmes may be warranted.

The longer-term focus on these problems is likely to require a greater emphasis on “preventive” policies - as is happening in health, education and policing.

MANAGING THE GOVERNMENT'S CONTRIBUTION

Raising the performance of the economy will require the same high standards of management in government that are being demanded of the private sector.

Quality management will be required in all aspects of the government's activities, from the design and implementation of specific policies through to the management of the government's overall financial position.

Macroeconomic management

It is essential that the Government maintains stable macroeconomic policies.

Irrespective of how well individual policies or agencies are managed, the experience of many countries around the world shows how poor macroeconomic policy poses large long-term risks to incomes and employment.

Low inflation has been achieved. The challenge now lies in continuing to maintain price stability. The Reserve Bank Act, with its long-term focus, should provide confidence that future inflation pressures can be contained.

Despite substantial effort over a number of years, fiscal balance has proved elusive. It is now clearly within reach.

Current interest rates reflect the expectation of continued progress toward fiscal balance. This favourable situation has been hard to win and could be easily lost.

A number of fiscal risks will need to be managed.

The rise in New Zealand's public debt over the past two decades has increased New Zealand's exposure to variations in interest rates. The Crown has accumulated liabilities that exceed its assets by a significant margin.

There are a variety of specific fiscal risks to be managed. On balance these risks are more likely to worsen the fiscal position.

The fiscal trend is improving and surpluses are now a real prospect.

Current forecasts project fiscal balance in 1995/96.

Net debt as a percentage of GDP is projected to fall from 47.9% in 1992/93 to 44.6% in 1995/96.

Achieving fiscal surpluses in the second half of this decade would support long-term growth prospects.

The practical cost of high indebtedness is shown in New Zealand's poor credit rating, which leads to interest rates being higher than they would otherwise be.

Fiscal surpluses allow debt to be reduced and national savings to increase. By making the economy more resilient, lower debt would encourage stronger investment and growth.

Lower debt would also reduce the vulnerability of the economy to interest-rate variations. It would help exporters by reducing the burden on monetary policy to constrain inflationary pressures during periods of strong growth.

However, achieving these fiscal surpluses will not be easy.

Reaching and maintaining fiscal surplus would require:

- ❑ continued firm control over aggregate expenditure, with new policies needing to be funded from savings elsewhere

- continued protection of the tax base, which would require constant policing of the tax system to prevent major tax-avoidance opportunities re-emerging

- careful management of the fiscal risks in the current outlook.

Past experience shows that control over expenditure gets more difficult as the fiscal position gets close to balance. Both Britain and Australia, which ran surpluses in the 1980s, are once again grappling with sizeable deficits.

The next 10 years provide a window of opportunity to secure a significant reduction in debt.

The fiscal outlook is trending in a favourable direction.

The economy is projected to grow steadily, with the international economy becoming more supportive. Growing tax revenues and declining unemployment will help close. the deficit and offer a more resilient economy in which rapid fiscal progress can be made.

The demographic impact of the post-war "baby boom" generation on Government spending and revenue is still favourable.

The ageing population represents one of the biggest challenges for fiscal policy as New Zealand moves into the next century.

Underlying expenditure pressures will increase as the "baby boom" generation retires and the population ages. This will place pressure on expenditure in areas such as health and superannuation.

At the same time, the tax base will narrow, with a decline in the relative size of the tax-paying population, creating pressures to increase tax rates.

The next decade therefore provides the Government with a good window of opportunity to make measurable progress in debt reduction. By saving over this period the Government would substantially reduce the need to increase taxes or to cut expenditure in 10 to 15 years' time.

Managing for effective results

Reducing unemployment, raising growth, assisting the most disadvantaged and increasing overall security are all large and complex issues.

OECD governments around the world have been grappling with issues like these for some decades now - with little success.

Effective policies in these areas will require a long-term strategic focus and considerable coordination across agencies.

The major issues faced are complex and will demand considerable attention by Ministers and senior officials. They will require contributions from a number of departments.

To progress the issues requires the Government to establish clear strategic priorities. These priorities need to be clearly communicated to departments and other agencies.

In focusing on these issues it will be important not to risk the gains already achieved, nor to lose sight of the importance of day-to-day management.

Lessons from the past show how easy it is for governments to heavily commit themselves to particular areas at the cost of achieving wider policy objectives.

There are a number of processes in place which can reinforce one another in achieving these strategic objectives.

The Government should ensure that its priorities drive the Budget process, and expenditure, revenue and investment decisions. This will include eliminating low-value outputs and defects in the tax base.

Chief executive performance agreements can be used to translate the Government's broad strategic goals into clear performance objectives for each department. These can then be assessed to ensure that what each department is doing adds up to a well coordinated, comprehensive response to the larger strategic goal. Once settled, these agreements can be monitored and outcomes reflected in the assessment of chief executives.

These processes should give Ministers more confidence that strategic decisions will be effectively translated into action. For their part, senior officials will have a clear idea of exactly what these decisions imply for them.

Central agencies - the Department of Prime Minister and Cabinet, the State Services Commission, and the Treasury - have a significant role to play in integrating these various mechanisms, and in providing coordinated support to the Cabinet to ensure the system as a whole delivers its strategic goals.

Together these mechanisms can provide the Government with assurance that effort is being focused on priorities, and that decisions will be put into operation effectively.

Financial reporting and management of risks also contribute to better overall management.

Fiscal management is as much about asset and liability management as it is about revenue and expenditure flows. The Pre-election Economic and Fiscal Update laid out a number of fiscal risks facing the Government.

Managing these and other risks will require regular reporting and active monitoring.

The Fiscal Responsibility Bill, if passed, will improve the quality and range of reporting. In doing so it will help broaden public understanding about the nature and extent of these risks and the potential pressures that the Government is managing.

One area where new process design may be necessary is in the review of regulatory interventions.

The Budget process does not provide the ideal framework for review of regulatory interventions that do not have significant implications for government expenditure or taxation. While it will not be simple to devise an efficient process to review interventions in a strategic manner, it would be desirable for the Government to consider options that have this effect.

Communication of the Government's objectives and intentions, the constraints it faces, and the processes and policies it intends to follow can all help shape private-sector responses.

Public consultation, the use of taskforces and direct input by private-sector representation can all help improve the effectiveness of policy design and implementation, and secure a wider ownership and understanding of the Government strategy.

2.
ECONOMIC AND FISCAL OUTLOOK

New information available since the Pre-election Economic and Fiscal Update was released on 5 October 1993 implies that GDP growth for 1993/94 will be higher than that projected in the Update.

Although the Treasury has not prepared fully revised forecasts, based on new information 1993/94 growth is now more likely to be in the range of 3½% to 4½%.

The fact that growth is currently higher than previously expected may indicate. that faster average growth can be sustained. If this is the case, employment and other outcomes would also be more favourable than projected.

However, recent growth rates may also be signalling a stronger economic cycle than projected. Growth may be surging temporarily before falling back toward the growth rates previously projected. If such a cyclical upswing is occurring, and strong demand persists for some time, it would heighten inflationary and balance-of-payments risks. It will be necessary to watch these variables closely.

The fiscal outlook is largely unchanged from that contained in the Pre-election Update. Broad fiscal balance is expected to be reached in 1995/96.

A firm fiscal stance will minimise the risks around the outlook and help reduce the economy's vulnerability to shocks.

THE PRE-ELECTION FISCAL, AND ECONOMIC UPDATE

The economic and fiscal outlook remains favourable.

Steady economic growth, favourable movements in most economic indicators, and an improving fiscal situation are expected over the next three years. The outlook contained in the Pre-election Economic and Fiscal Update showed that:

- Barring adverse events, economic growth is likely to be sustained at rates between 2½% and 3% over the next three years.
- The initial tentativeness of the recovery has passed. Growth has broadened, with households and businesses increasing their spending. Higher domestic activity is now the main component of growth.
- Initially stimulated by income gains in the export sectors, domestic demand is now further supported by lower interest rates, a strengthening in the exchange rate, higher asset prices, and high business and consumer confidence.
- Strong profitability, lower interest rates and improved cash flow have restored balance sheets, and are supporting strong growth in private business investment.
- Export growth continues to be strong in manufacturing, tourism and forestry, but the outlook for export growth is tempered by persistent weakness in the world economy and supply constraints in agriculture.

A more resilient economy is expected, but unemployment will remain high.

While activity currently remains uneven across regions and sectors, the Pre-election Update's forecasts suggest that by 1995/96 the economy should be in a much more resilient state. By then growth will have been maintained for five years. With the exception of unemployment, which is expected to remain high, the major imbalances that threaten economic stability should all have improved to more robust levels.

The improved fiscal outlook projected in the Pre-election Update, which sees the fiscal position moving to broad balance by 1995/96, arises from:

- a strong recovery in business tax receipts, with tax losses being exhausted more rapidly than previously expected
- a substantial reduction in debt-servicing costs, reflecting lower interest rates, the appreciation of the exchange rate and a lower stock of debt
- firm expenditure control and lower forecast benefit expenditure.

NEW INFORMATION SINCE THE UPDATE

Latest economic information

New economic information implies . . .

A number of economic indicators have been released since the Pre-election Update was prepared.

GDP

... stronger output growth . . .

Economic activity appears to have been stronger in the first half of 1993 than assessed in the Pre-election Update:

- In the June quarter, seasonally adjusted GDP is reported to have increased by 1.7% and 1.3% for the production and expenditure measures respectively, although a number of special factors in the production measure suggest that underlying growth in the June quarter could have been about ½% lower than the official measure of 1.7%[1].

- March quarter GDP production growth was also revised up to 1.0%, from an earlier estimate of 0.6%.

... largely owing to higher investment.

The stronger-than-expected June quarter growth was mostly due to higher investment and construction activity. Both business (especially plant and machinery) and residential investment showed very strong growth.

Other indicators

Other recent statistics generally confirm this view:

Other indicators generally confirm this view.

- The balance of payments for the June quarter showed a current account surplus of $133 million, compared with a surplus of $479 million for the same period last year. In recent quarters, the trend in the current account has been deteriorating slightly, with a less favourable trade balance and higher profits accruing to foreigners operating in New Zealand.

1 These include the fall-off of oil exploration from high levels in the March quarter to almost zero (exploration has a negative impact on GDP as it is regarded as a business expense); an extraordinary shipment of oil exports; and a decision by Statistics New Zealand not to seasonally adjust the large increase in non-residential building activity.

- The merchandise trade balance was in deficit in the September quarter, reflecting a seasonal decline in export receipts and a record level of imports (with strong growth in capital goods, including an aircraft). The annual balance remains strongly in surplus but is down $700 million from its peak in June 1992. There are mixed signals as to whether the rate of export growth may be slowing.

- The Consumer Price Index (CPI) increased by 0.5% in the September quarter, giving an annual increase of 1.5%. The September increase was a little higher than anticipated. This reflected a faster feed-through of wood price increases into consumer prices and an increase in hire purchase charges as more firms began to charge interest.

- The Quarterly Survey of Business Opinion (QSBO) suggests that the September quarter was also a strong quarter for New Zealand businesses, with no obvious signs that the pace of growth is about to slow. Expectations for the year ahead were highly positive. Capacity utilisation was at its highest level since 1985. Investment intentions were at their highest level since 1973 for plant and machinery, and since 1984 for buildings. Employment prospects were the highest since 1985.

- The value of building permits issued in August was 31% higher than in August 1992, with residential consents particularly strong.

- Monthly retail trade for August showed a 3.7% seasonally adjusted decline from July sales, but was 10.8% higher than the same period last year, yieldi-ng a small increase in the trend estimate.

- The sharemarket has reached a four-year high, after weakening in late September and early October.

- Domestic interest rates have declined, after firming somewhat during October. Ninety-day bills are now at 5.2% and lo-year bonds are under 6%, compared with 5.4% and 6.2% at the time of the Pre-election Update.

- For much of October the Trade Weighted Index was close to the level of 55.5 assumed in the Pre-election Update, but more recently has been at or above 56.

Latest fiscal information and outlook

Fiscal projections are largely unchanged . . .

The fiscal outlook remains largely as projected in the Pre-election Economic and Fiscal Update.

Since the Pre-election Update forecasts were finalised, the fiscal outturn for the September quarter has become available. The outturn showed the adjusted financial balance to be $183 million better than expected on the basis of the fiscal forecasts released in the Pre-election Update. Lower-than-expected expenditure was the reason for the lower deficit. However, at this stage, the Treasury does not believe that the better-than-expected outturn for the September quarter is indicative of the likely outturn for 1993/94. The lower expenditure track appears to be largely due to timing factors. These are expected to reverse later in the financial year.

... with both expenditure . . .

At this stage, the Treasury has no information leading to a changed view on the expenditure forecasts presented in the Pre-election Update. With the exception of the timing factors mentioned above, expenditure trends generally appear to be in line with the forecasts. Policy decisions with expenditure implications since the Pre-election Update forecasts were finalised have been minor. In total, projected expenditure is around $10 million higher in 1993/94 than projected in the Pre-election Update, and is unchanged in the following two years.

.. and tax receipts close to forecast.

September quarter tax receipts proved very close to forecast levels. On the basis of banking flows, October tax receipts also appear to have come in reasonably in line with the levels expected in the Pre-election Update forecasts.

There may be some upside risk for tax revenue.

The higher-than-expected economic growth now likely in 1993/94 suggests tax revenues may be higher than forecast. However, it is just as likely that the revised economic outlook is now conforming better with the strength already observed in recent company tax flows (and which determined the sharp upward revision to the tax forecasts in October) - rather than implying any further upward revision. High business investment is consistent with the strong financial positions implicit in high company tax payments. GST tax receipts showed only slow growth during the September quarter, but appear to have recovered in October.

Source deduction (PAYE) receipts have also been close to the forecast track in the first three months. However, if the stronger economic growth translates into higher employment than expected, then there could be some upside to the source deduction forecasts. At this stage, no revision to the tax forecasts is envisaged.

GROWTH OUTLOOK

Short-term GDP growth may be higher than forecast.

The new information available - particularly the June and revised March quarter GDP figures - implies that GDP growth for 1993/94 will be higher than projected in the Pre-election Update. Although the Treasury has not prepared fully revised forecasts (and assuming no significant revisions to previous statistics), 1993/94 growth is likely to be in the range of 3½% to 4½%.

Higher-than-expected business and housing investment are the main contributors to this stronger outlook, although some leakage into higher imports is occurring.

While the short-term outlook is clearly stronger than previously projected, this does not necessarily imply a change in the medium-term outlook.

This could reflect cyclical factors or a higher growth trend.

There has been a general consensus that New Zealand's economic growth in the 1990s is shifting towards a higher average rate than prevailed in the past 20 years. The current upswing in growth is seen as part of the shift to this higher growth trend, but there is also a cyclical component.

Assessment of trend and cyclical elements

Recent projections incorporate a view that trend growth for the New Zealand economy is likely to be around 2½% to 3% per annum. This reflects:

- projected labour-force growth of around 1% per annum and expected productivity gains of 1½% to 2% a year

Trend growth will depend particularly on trade performance . . .

- consolidation of competitive and productivity gains and a larger capital stock, which are expected to maintain rapid export growth in non-commodity manufacturing (averaging 13% per year), forestry (5%) and tourism (7%)

- much slower growth in agricultural livestock exports (1% per year) which constrains total export growth since they comprise over 30% of exports.

These projections take the view that New Zealand's strong trade performance - import substitution as well as exports - will continue to sustain growth averaging 2½% to 3% a year. Failure to compete internationally would mean that expanding domestic demand inevitably implies fast import growth and a deteriorating current-account position. This would ultimately feed back into poorer growth performance.

As always, our actual growth performance will also depend heavily on international economic factors. For example, a favourable GATT outcome could well produce a stronger international economy than assumed or there could be favourable shifts in demand for our products. Both these factors would lift growth beyond that projected.

... and productivity growth.

Higher productivity (perhaps enhanced by the investment now taking place), faster innovation, and smarter marketing will determine the trading success of New Zealand firms, and are necessary to sustain the average growth projected.

However, to obtain higher trend growth would require even greater improvements in these factors than assumed.

To identify with some certainty whether there is a change to the trend growth rate will require the accumulation of much more evidence about productivity gains, export performance and understanding of business strategies and behaviours.

But current growth may have a large cyclical component . . .

Since it is too early to tell if the new GDP figures reflect stronger trend growth or simply a stronger cyclical component, it is more prudent to assume that the current high rate of growth reflects some cyclical factors. The implication is that these will weaken at some point and the rate of economic growth will fall back toward an average level of 2½% to 3%. This could happen because:

- Current growth rates may reflect some special timing factors. For example, in recent years many investment decisions have been deferred, notably by some large corporates. The exhaustion of this backlog could mean that the very rapid investment growth this year may slow over the next year or so (back to the 7% level forecast in the Pre-election Update).

- The cyclical weakening foreshadowed in the Pre-election Update for 1994/95 may eventuate, following slower growth in export earnings. (Some weakening in the prospects for export earnings is apparent already. Lower dairy payouts are being signalled and some meat companies are reporting lower profitability).

- Macroeconomic conditions may firm, reducing the risks of overheating.

Risks around the outlook

... which presents challenges for economic management.

The prospect that current growth contains a significant cyclical element makes it all the more difficult to predict the strength of activity over the next few years. It also makes economic management more difficult.

Domestic demand cycles can fuel themselves for a number of quarters. For example:

- Higher demand feeds business and consumer confidence, which generates higher spending and higher income, in turn raising confidence, and so on.

- Higher demand tends to raise asset prices, especially land, house and share prices, increasing perceptions of wealth, which may further stimulate demand.

Inflationary and/or current-account pressures could develop.

There is scope for domestic activity to gather quite considerable strength. If the upswing intensifies to unsustainable rates, this is likely to make itself apparent through increases in inflationary pressures and/or through a deterioration in the current account.

Inflationary pressures might arise because:

Higher profit margins, . . .

- Higher domestic demand may encourage some firms to increase output prices in order to lift profit margins. For example, the contribution to the September quarter CPI from higher credit charges can be interpreted as reduced discounting, since fewer interest-free deals were offered.

*... **wage pressures . . .***

- Skill shortages may become more acute, putting pressure on wages for the skilled. In the past, this would have been quickly translated into higher wage costs across the board and subsequent price pressures. By increasing competition for some jobs, high unemployment is likely to dampen wage offers. Recent policy changes have made both output and labour markets more competitive and less rigid. Moreover, current monetary policy arrangements mean that firms are unlikely to expect to be able to pass on high wage settlements into prices without facing a reduction in sales. These factors mean that wage pressures at the skilled end are now much less likely to be translated into inflation. However, the new regulatory arrangements have not yet been tested in a strong growth environment.

*... **and asset price-rises could emerge.***

- Rising house, land and share prices may stimulate demand and become a source of inflationary pressure. Over a reasonable period of time, asset prices reflect the yields from those assets, and can be expected to rise broadly in line with income, without having much inflationary impact. However, sometimes increases in asset prices appear to create expectations of further increases. BY raising perceptions of wealth they provide support for credit expansion, and fuel higher demand for assets and for other goods and services. If demand rises too fast then other prices may rise as well, igniting inflation. In addition, house prices have a direct impact upon the CPI. By conditioning expectations against widespread price movements, current monetary policy arrangements are designed to prevent asset and other specific price movements flowing into across-the-board pressures.

But at present such inflationary pressures appear weak.

At this stage, inflationary pressures appear to remain weak. The September QSBO suggested little upward drift in selling prices, while lower imported inflation, the lagged impact of mortgage-rate falls, and rising productivity suggest the CPI movement should remain comfortably within the target range. An encouraging feature is that there appears to have been little feed-through of large increases in wood prices into general cost and price movements.

Current-account pressures might arise because:

- Imports may surge on the back of strong domestic demand, especially if heavily weighted toward investment which is import-intensive, or if productivity gains by New Zealand producers are inadequate for them to successfully compete with imports.

- Given the weak international outlook, firms may switch their attention from exporting back to the expanding domestic market without replacing imports.

- Competitiveness may decline because of rising costs, slow productivity growth, or a sharp tightening in monetary conditions which appreciates the exchange rate.

The current-account position is relatively stable.

The current period of growth differs from past periods in that the current-account deficit has been relatively stable, and is projected to decline gradually over the next few years, even as growth continues. Recent trends in the current account have been slightly less favourable than expected, but at this stage do not provide cause for concern.

The slight deterioration mostly reflects higher investment, which should help sustain growth, and earlier recovery in New Zealand than overseas.

Other risks to sustained growth performance arise from:

- the economy's vulnerability to external shocks, through movements in the terms of trade or interest and exchange rates
- a prolonged period of political uncertainty following any change in electoral systems.

Managing risks

Managing risks will require monitoring of...

In managing the economy through this period, it will be important to monitor key indicators which might point to signs of imbalances arising or, alternatively, give comfort about the sustainability of the faster growth New Zealand now seems to be experiencing.

Positive signs that might suggest greater sustainability of current higher growth rates would include:

... trade performance, . . .

- strong trade performance, particularly:

  ongoing gains in competitiveness which protect the profitability of exporting or of domestic production relative to imports

  ongoing strong export growth, particularly in new markets and products, and with an export orientation continuing to spread across the business sector

  moderate growth in imports, with the composition of imports favouring capital goods and industrial supplies rather than consumption goods.

... investment . . .

- continuing strong growth in the quantity and quality of investments, which would be more likely if:

    investment is driven by the business sector and has a long-term focus

    physical investment is complemented by investment in market and product development and in skills

    confidence remains high and business profitability is maintained

    regulations and cost structures promote competition and support strong trade performance.

... and inflationary pressures.

- confirmation that the economy is far less indexed than in the past, so that changes in supply or demand conditions in any one market produce relative price movements that are not simply translated into general wage and price pressures.

At this stage, there is no suggestion of serious imbalances eventuating, but a close watch will need to be kept on the inflation and current-account indicators identified above.

To minimise these risks it is essential that the fiscal position stays on track.

Nevertheless, in order to minimise such risks and to prevent belated - and possibly large - policy corrections if they do occur, it is important that the fiscal position continues to improve in line with current projections.

- This would ensure that fiscal policy helps prevent domestic demand overheating.

- It would reduce the risks of serious imbalances appearing or an abrupt change in confidence arising. Lower deficit and debt levels will reduce the economy's exposure to adverse movements in interest and exchange rates, and increase investors' confidence about the sustainability of the outlook.

- It would avoid placing undue pressure on monetary policy to deal with adverse events. Many risks will show up initially as exchange-rate and price pressures, which can be expected to cause some tightening in monetary conditions. The need for - and extent of - such tightening is likely to be diminished if the fiscal and debt positions are strengthening.

Maintaining robust, consistent institutional arrangements, including the Reserve Bank Act and the Fiscal Responsibility Bill, is likely to promote confidence in the overall stance of macroeconomic policy and, therefore, is extremely important in containing the risks discussed in this chapter.

Pre-Election Update Projections

Economic Projections

percent change March Years	1992/93	1993/94	1994/95	1995/96
GDP	2.8	2.9	2 to 3	2% to 3½
Current account[1]	-1.2	-0.8	0 to -1	0 to -1
Employment	0.9	1.6	1 to 2	1 to 2
Unemployment[2]	9.9	9.8	9 to 10	9 to 10
CPI inflation	1.0	1.4	½ to 1½	1 to 2

1. Percent of GDP
2. Percent of Labour Force

Fiscal Projections

$million June Years	1993/94	1994/95	1995/96
Expenditure	30,070	30,643	30,485
Revenue	28,628	29,449	30,431
Adjusted Financial Balance	-1,442	-1,194	-54

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