CHAPTER SIX

# Current Economic Situation and Outlook

## Introduction[1]

The first part of this book begins by summarising the main characteristics of the present economic environment and backgrounds the evolution of the economy over the past few years. A brief discussion of the outlook for monetary and fiscal developments is then followed by a description of the key observations from our recent nationwide talks with businesses, which were designed to assess their experience with, and adjustment to, the new economic environment. The recent economic indicators are then presented along with a summary of the economic forecasts for 1987/88 and 1988/89. A discussion of the risks and uncertainties associated with these forecasts then follows. The second part of the book (annexed) covers the economic forecasts in greater detail, providing the projections for the various areas that underpin the major components. Additional information on the outlook for the agricultural sector and international environment is also annexed.

[1] These forecasts were prepared using information available up to early August 1987.

# Background

Macroeconomic policies are directed toward getting inflation under control and creating a more stable economic environment in the medium term. Monetary policy is a key element in this anti-inflationary strategy which is aimed at reducing the inflation rate to rates at least comparable with those of our trading partners. The fiscal strategy focuses on improving the quality of government expenditures and reducing the pressure of the fiscal deficit on financial markets.

At the microeconomic level, a series of reforms have been introduced to improve the efficiency of the market and to reduce the adjustmenr costs of the disinflation process by promoting market flexibility, improving incentives and reducing relative price distortions. These structural policy measures are designed to improve the economy's supply-side responsiveness and thereby the split between the real and inflation components of a given increase in nominal income.

The evolution of the economy reflects the cumulative impact of all these forces. Since the middle of 1784 the real economy has consistently been stronger than expected while inflation has also been consistently higher than anticipated. The recession that was forecast in the 1784 Election Briefing to occur in 1985/86 did not eventuate as high domestic confidence in the policy reforms together with the stimulus provided from earlier loose monetary and fiscal policies resulted in rapid spending growth. The latter outcome was a major contributor to consumer price inflation in 1785.

To reduce inflation, monetary and fiscal policies must act to reduce the growth of domestic expenditures. Monetary policy impacts through the effects of interest rates on interest rate sensitive expenditures and the exchange rate while fiscal policy operates directly through the effects of government expenditure on the demand for goods and services and the effects of taxation on disposable incomes. These disinflationary pressures have to be sustained over a number of years in order to be effective and may be offset by other influences in the short term.

In particular, although the Budget Table 2 fiscal deficit fell from its level of 7.0 percent of GDP in 1983/84 to a level around 4 percent of GDP in 1985/86, consumer spending held up in the face of a 2.5 percent decline in real personal disposable incomes. Part of this outcome could be attributed to the factors mentioned above and part to the effects of financial sector deregulation which enabled consumers to gain increased access to credit. Progress on disinflation was also masked by a large number of price distortions that the Government acted to remove.

Since 1985/86, even though the fiscal deficit has fallen to 3.7 percent of GDP in 1986/87, the burden of disinflation has required a greater reliance on monetary policy. This has in turn imposed a higher burden of adjustment on the tradeables sector, as a result of high interest rares and the associated pressures on the exchange rate, rather than through the effects of fiscal policy on real household incomes and spending.

The structural reforms implemented by the Government have also influenced economic activity. The reduction of protection, the phase-out of subsidies and other regulatory moves have exposed producers to much greater external and internal competition. In the short term these competitive pressures are forcing adjustments and have resulted in output and job losses in some areas as firms seek to improve their productivity. This has been offset in part by new investment and job creation opportunities in other areas. For example deregularion of the financial sector has led to significant output and employment growth as well as enhancing the quality of service provided to consumers. While investment levels have declined, albeit off a high base, the policies have recognised that the quality of investment is as important as the quantity. Therefore the policy reforms are likely to have improved the productivity of new investment as well as to have increased the productivity of the existing capital stock.

In looking ahead economic activity will continue to be influenced by the mix of disinflationary policy, which will act to slow the growth in nominal expenditure, and the ongoing effects from the liberalisation measures.

The extent co which disinflation results in further output and employment losses will depend on the extent to which inflation expectations decline. As long as inflation expectations remain high this will place upward pressure on interest rates and the exchange rate. This will blunt the gains from liberalisation which should be acting to increase New Zealand's overall competitiveness. The extent to which interest rates decline will largely depend on the rate at which inflation expectations decline and to some degree the strength of the domestic economy. The latter, in particular, depends on the extent to which consumers continue to gear themselves up in response to financial sector deregulation.

## Monetary/Fiscal Outlook

Movements in the principal indicators of the stance of monetary policy tend to supporr the view that monetary conditions were relatively firm for the first half of 1987, following the tightening of monetary policy in late 1786. The exchange rate and money market rates rose over the first quarter of 1787, with retail interest rates following the increase in wholesale rates. Anecdotal evidence from financial institutions, supported by the new credit and money aggregates recently released by the Reserve Bank, suggest that the demand for credit has weakened over the first six months of 1787.

Inflationary expectations still appear to be in the 9-l 3 percent range for 1987/88 and are clearly acting co underpin long-term interest rates. Short-term interest rates declined once the difficulties associated with the March tax flow period passed. However the need to maintain a disinflationary stance of monetary policy will mean that the interest rate yield curve should continue to remain inverted with short rates above long rates. Falls in the general level of interest rates over the next 6 months or so will depend on the extent to which inflationary expectations decline. Most indications are that the current high rate of CPI inflation will come down by the end of 1987 as the GST effect is removed and various positive influences such as car price falls, tariff reductions and the generally strong level of the exchange rate reduce the measured rate of price inflation.

After a deficit of $1.95 billion for 1986/87, a Budget Table 2 fiscal surplus of $379 million was announced in the 1787 Budget. The contributions to the anticipated surplus are a forecast increase in non-tax revenue of around $450 million, a forecast increase in tax revenues of around $2.9 billion and increased receipts from the sales of shares in state owned assets. The increase in non-tax revenue comes principally from dividends from the new state-owned enterprises, and from interest on New Zealand's overseas reserves. Further asset sales were announced in the 1987 Budget-shares will be sold in Air New Zealand, Petrocorp and the Development Finance Corporation. Because of the one-off nature of the asset sales, the financial deficit measure (which excludes net lending and financial asset sales) provides a better indicator of deficit trends. This measure is expected to show a large improvement in 1987/88. The Budget night forecast for the financial deficit was $1.3 billion, an improvement of about $600 million on the 1986/87 figure.

## Business Talks

The adjustment to the new economic environment is an ongoing process that has impacted on some sectors and particular industries in very different ways. The manufacturing sector is of particular interest because it represents one of the major sources of employment in the economy and is a sector that has been significantly influenced by the new economic environment. This section uses observations from recent discussions with businesses to shed some light on their experience with the new economic environment and the adjustment that it has induced.

Recent talks with some 25 manufacturers, retailers and financial institutions around New Zealand revealed a consistent picture of there being a two-tier structure to adjustment. The first group, consisting of those firms which had been exposed to competitive pressures early on and/or were dependent directly or indirectly on export oriented activities, had already undertaken a substantial process of adjustment and were now in a period of consolidation. These firms tended to be the regionally based, agriculturally dependent manufacturers. They had undergone various degrees of restructuring over the last 3 years or so and have achieved significant productivity improvements. Change had occurred at all levels of firms' operations; including improvements in management structures and practices, new stock management techniques and improvements in distribution methods so as to reduce the cost of inventory holdings. Several firms had diversified export markets toward those countries where exchange rate movements had improved New Zealand's competitiveness. Alterations of product mix had also been made where efficiencies could be made or where an international competitive advantage was identified.

The indications were that this first group of manufacturers were now at the tail-end of their restructuring plans, with only limited additional labour shedding and capacity reductions planned during the next year. These firms were now concentrating on identifying areas where further cost reductions could be made and consolidating their current position. A feature of these firms is that while most had reduced capacity, these decreases had been partially or fully offset by increased productivity so as to maintain output. Improved current world commodity prices and the prospect of falling domestic inflation, and subsequently interest rates, suggests that these manufacturers are now facing a more favourable outlook, and are more likely to be able to take advantage of an upturn.

The second group appeared to be made up of companies who were still subject to protection of one form or another and/or were engaged in the production of largely non-traded goods. The gradual removal of import licensing and the continuation of liberalisation signalled in industry plans -and under CER has prompted some adjustment through rationalisation of production and a shift to importing some product lines. However, buoyant residential and commercial conscrucrion in the metropolitan areas and unexpectedly strong consumer demand as a result of financial deregulation and GST, has kept domestic demand at a level which has limited the degree to which these firms have been required to adjust. Firms that were involved in a mixture of domestic/export production were able to essenrially cross-subsidise exports so as to minimise the adverse impact on overall profitability.

The outlook for this group will be largely influenced by the projected downturn in consumption demand coupled with a levelling off of commercial construction and declining residential building. Increased competition from imports will affect these companies as tariff barriers are reduced. The adjustment path for this tier of manufacturers, while likely to incorporate similar restructuring plans to the first tier, will differ in scale and nature. The impact of the domestic downturn is likely to be 1ess severe on these manufacturers than was the impact on the first tier who experienced the simultaneous removal of support measures and the freeing up of the economy 3 years ago. A projected upturn in domestic demand for 1988/89 suggests that any production cut-backs will be transitory rather than permanent. Current high levels of overtime hours being worked suggest that reductions in production can be achieved through less hours being worked rather than resorting to staff layoffs in the first instance. Therefore it is possible that labour shedding associated with this tier of adjustment may be on a smaller scale.

The overall impression from the business talks was that mosr firms have adjusted to the new economic environment in a way that has enhanced their long term viability, albeit in quite diverse ways. Within the group, attention has been directed to decreasing the level of input costs and/or improving the productivity of the manufacturing processes being operated. Import liberalisation has meant several companies have been able to source inputs more cheaply from overseas. The net result, overall, is that the companies are now more efficient and flexible, so are better placed to adjust to changes in economic conditions as they occur.

Generally the two-tier adjustment scenario also has implications for the urban/regional divergences that have developed. The outlook for the two groups of manufacturers suggests that the next phase of the adjustment process will tend to favour the regions over urban areas. The upturn in world commodity prices has improved incomes for the agricultural sector and this is likely to boost demand for products from manufacturers who service this sector. The downturn in domestic demand may cause manufacturers to reconsider the cost involved with producing in urban areas compared with lower land prices and factor costs found in rural areas. This could lead to the resiting of production activities in the regions. Furthermore, it is likely that a faster process of tariff reform would produce benefirs for the regions. This follows from the gains that would flow to the tradeables sector, which tends to be regionally based, from having those sectors which constitute much of their input costs (for example packaging) exposed to greater international competition.

## Current Economic Indicators

The most recent economic indicators point to an economy which has remained unexpectedly strong, largely as a result of continued strength in private consumption expenditures. Private investment is still falling from its high level in 1985/86 while the balance of payments on current account is steadily improving.

The quarterly index of GDP (seasonally adjusted) at constant prices increased by 1.2 percent over the March 1987 quarter. The main contributing industry groups were: fishing, hunting, forestry, mining; agriculture; construction; and trade, restaurants, hotels. The change in the first group reflects a reduction in petroleum extraction and exploration activities which have a positive influence on the index. The increases in agriculture, which follows decreases in the previous two quarters, are largely the result of stock being kept on farms in the expectation of improved returns. Both construction and the 'trade, restaurants, hotels' groups recorded increases reflecting a recovery from the drop in activity which followed the introduction of GST.

The March quarter result gave a full-year outcome for 1986/87 of 2.4 percent. Increasing levels of electricity generation accounted for the rise in the 'electricity, gas, water' group while growth in the service sectors-restaurants, transport and so on—also contributed. Agriculture grew by nearly 4 percent over the year, with this result being influenced by the 1986 mearworks strike which would have had the effect of depressing agriculture while boosting manufacturing for 1986/87. To the extent that value-added which would have been generated in 1985/86 was transferred to 1986/87, when the meat was eventually processed, real GDP in 1986/87 was increased relative to 1985/86 by the meatworks strike.

This unexpectedly strong output growth is also supported by the indicators for consumption which grew over the year. Real retail trade (seasonally adjusted, excluding the automotive group) increased by more than 3 percent over the year to March 1987 despite the fluctuations related to the introduction of GST. Real retail trade peaked in the September 1986 quarter and then fell by nearly 12 percent in the December quarter, but then recorded a bounce back of 5 percent in the March 1987 quarter. New car registrations were also volatile over the second half of 1786 as a result of GST but ended the 1986/87 year some 7 percent below the year before. The most recent monthly figures for new car registrations, however, indicate a pick up in car sales, most likely in response to price cutting as a result of the cut in excise taxes, increasing total new car registrations for the year to June 1787 to 1.4 percent above that for the some period in 1986.

While consumer spending has remained relatively strong, investment expenditures continue to be depressed. Private investment has declined largely because of falls in residential building as the high cost of new mortgage finance has deterred new dwellings construction. This is revealed in the latest new dwelling permits figures which, despite having recovered slightly in the first half of 1987, were around 12 percent lower for the year ended June 1987 than the year before. Surveyed import orders for machinery and electrical equipment, an indicator for business investment, are 18 percent lower in the 6 months to May 1987 than the previous 6 months. Similarly, other building permits for the year to May 1987 were 19 percent lower than the previous year.

New Zealand's monthly overseas balance of payments figures point to the current account balance having continued its steady improving trend which began in November 1984. On a smoothed, seasonally adjusted basis the current account deficit was $103 million for June 1787 compared with deficits of S 107 million for May 1987 and $173 million for June 1786. The balance on merchandise trade (smoothed, seasonally adjusted) for June 1787 was in surplus by S 12 1 million, an improvement of $5 million over May 1787. The deficit on current account for the year ended June 1987 (using unadjusted figures) was S 1,86 1 million and this compares with a deficit of $3,178 million for the year to June 1786.

A surprisingly high June quarter CPI movement took the annual point-to-point rate of consumer price inflation to 18.7 percent. The two main influences on the June quarter movement were further lagged effects of GST and rises in housing costs which occurred in the March quarter bur which were reflected in the June CPI result. The June quarter was the first time winter clothing items were included since GST was introduced and it has also taken time for GST adjustments to feed through to house and used car prices. Housing costs recorded in the June quarter CPI reflected interest rate changes in the 3 months to May and house price changes which occurred in the March quarter. Despite this disappointing outcome, the indications are that various positive influences such as car price falls, lower interest rates and tariff reductions will work to produce lower quarterly increases for the remainder of 1987. In addition, other indicators of price inflation suggest that the underlying rate of inflation may be somewhat overstated by the CPI. The producers price index for outputs increased by only 10 percent in the year to March 1787, while for inputs the increase was slightly above 7 percent.

# Economic Outlook

The forecasts for 1987/88 and 1988/89 have been prepared on the usual no change in policy assumption. In particular it has been assumed that:

i the fiscal position for 1987/88 will be as outlined in the Budget and a similar total impact of the public sector will be experienced in 1988/89;

ii monetary policy will remain non-accommodaring over the forecast horizon;

iii the real exchange rate is held constant from its March quarter 1987 level in relation to our main trading partners;

iv the average rate of inflation for New Zealand's main trading partners will be 3.4 in 1987/88 and 3.7 in 1988/89 while an average rate of world economic growth is expected to be 2.8 and 2.5 for 1987/88 and 1988/89 respectively.

The main features of the forecast fall-in-real-expenditures on GDP for 1987/88 are declines in both consumption and fixed investment which are partially offset by stock building and a small positive contribution from the external balance. Towards the end of 1987 the downtown in domestic expenditures is expected to halt, with a pick-up in activity then predicted to continue throughout 1988/89.

TABLE 6.1: Summary of Forecasts

| ***Real Expenditure on GDP*** | ***Estimates*** | | *Forecasts* | |
|---|---|---|---|---|
| ***(Annual Percentage Changes)*** | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| *Domestic* | | | | |
| Final Consumption | 0.1 | 2.7 | −1.2 | 1.2 |
| Gross Fixed Capital Formation | 9.3 | -9.6 | -3.7 | -2.1 |
| Change in Stocks' | (-0.4) | (-0.2) | (0.6) | (0.8) |
| Gross National Expenditure | 2.1 | -0.8 | −1.2 | 1.2 |
| *External* | | | | |
| Exports of Goods and Services | 1.0 | 4.9 | 1.6 | 3.1 |
| Imports of Goods and Services | -2.2 | -2.2 | 0.0 | 2.5 |
| Expenditure on GDP | 2.0 | 1.8 | -0.6 | 1.5 |
| *Memorandum Items* | | | | |
| Current Account Balance ($m) | -3341 | -2052 | -1853 | −1653 |
| % GDP | 7.4 | 3.9 | 3.2 | 2.6 |
| Change Employment (000s) | 25.4 | -21.8 | -6.2 | 10.0 |
| Registered Unemployment Rate | 3.4 | 4.8 | 5.5 | 5.8 |
| Consumer Inflation (point-to-point) | 13.0 | 18.3 | 8.9 | 6.9 |

'Percentage point contribution to GDP growth.

*Sources*: Real Expendirure on GDP : The Treasury
Employment and Unemployment : Department of Labour
Consumer Marion (actual) : Department of Statistics
(forecast) : The Treasury

A forecast decline in private consumption expenditures over 1987/88 is expected to be the combined result of several negative influences. In 1987/88 it is anticipated that disposable incomes will decline as the 1986/87 wage round of 7 percent is more than offset by consumer price inflation over the year. Current nominal interest rates are not expected to fall markedly in the second half of 1987/88 so that financing costs should act to restrain consumer demand. Finally, it is likely that debt accumulation by consumers will slow and the wealth influence from the stock and property markets will be neutral or negative. The forecast for 1988/89 predicts that higher disposable incomes and lower interest rates will stimulate private consumption but that the increase in demand will be tempered by the desire of consumers to rebuild savings balances rundown over previous years. Private income growth, boosted by a projected substantial recover) in agricultural incomes, is expected to exceed a significantly reduced rate of inflation so as to expand real disposable incomes by 2 percent over 1988/89. With inflation (point-to-point) forecast to be in single digits by December 1987, the likelihood is that interest rates will decline steadily over 1988/89 and impart a positive influence on consumption. Given that consumption expenditures have been maintained above disposable incomes in recent years, it is possible that consumers' concern to rebuild savings levels as incomes rise will dampen the recovery of consumption.

The contraction of gross fixed capital formation that was evident in the 1986/87 figures (partly attributable to the phasing down of major projects expenditures) appears to be slowing and, for private investment, a small degree of growth is projected for 1988/89. Private investment is primarily influenced by residential and commercial construction and plant and equipment investmenr. Residential building investment is expected to fall as lower disposable incomes, slow downwards correction of nominal interest rates and the effect of GST tend to depress investment plans. As real disposable incomes improve and nominal interest rates adjust to reflect the lower rare of inflation anticipated, residential investment expenditures are forecast to increase in 1988/89. The commercial new building boom is expected to level off in 1987/88 as financing costs and more attractive overseas opportunities discourage new starts. Total building activity is then expected to fall from this high base in 1988/89. Expenditures on plant and equipment tend to follow domestic activity fairly closely and so are expected to fall in 1987/88 and remain at around that level into 1988/89.

After having improved significantly in 1986/87, partly the result of delayed exports due to the meat-works strike in early 1986, the current account balance is expected to continue to improve in 1987/88 and 1988/89. The forecast improvement in the current account comes from a forecast increase in the trade surplus which is only partially offset by a worsening invisibles/transfers balance. Total exports are predicted to increase in volume terms but the value increase is more significantly determined by an expected improvement in prices of these exports in both years.

The changes in employment levels reflect the downturn in the domestic economy with the sharp reduction in 1986/87 revealing the effects of restructuring. Some reduction is also predicted in the 1987/88 year but as the domestic economy picks up in 1988/89 employment levels are also expected to rise. With labour force growth continuing in each year the employment forecasts imply an increase in the rate of unemployment over 1987/88 to 5.5 percent but litrle change for 1988/89.

The rate of inflation for the consumers price index is forecast to fall to single digits (year-on-year) by the end of 1987 as the bulk of the influence of GST is removed for the first time and the beneficial impact of the levelling off of mortgage interest rates, cuts in excise taxes and tariff rates, are reflected in the CPI. An assumed moderate outcome for the 1987/88 wage round and maintenance of firm monetary policy results in a forecast rate of inflation of 6.9 by March 1989.

## Risks and Uncertainties

The outlook presented here represents the view perceived as being the most likely given the available information and the assumptions made. A number of alternative scenarios can be formed if variations on the assumptions are considered. In essence the risks and uncertainties associated with these forecasts stem from possible divergences from the underlying assumptions.

In terms of economic policy, no change from the currently announced set of policies is assumed for the forecast period. In particular the fiscal impact is assumed to be consistent with that outlined in the Budger for both forecast years while monetary policy is assumed to remain non-accommodating over the period. Any discrepancies from this assumption will have implications for domestic demand conditions, inflationary expectations, interest rates and the exchange rate. Specifically, any policy changes must be assessed on the basis of the direct effects on economic activity and take due regard of their impact on the expectations of domestic agents and international investors. Moves to alter fiscal and monetary settings so as to stimulate economic activity run the risk of undermining the credibility of the overall disinflationary strategy thereby resulting in a loss of confidence in economic prospects. This could result in an upwards revision of inflationary expectations which could be expected to postpone the disinflationary process as domestic wage and price setters alter their behaviour and the loss of confidence by international investors causes a depreciation of the exchange rare. Under this scenario the adjustment to low inflation will be prolonged and the costs of adjustment increased.

Representing some 60 percent of estimated real expenditure on GDP, private consumption expenditures are critical to the outlook. The most sensitive assumption made in this regard is that consumption behaviour will revert to being determined by the traditional long-term influences, that is, disposable incomes and interest rates. However, given the overseas experience with financial deregulation, where in the US for example consumption levels remained surprisingly high for long periods, there is a risk that consumers will continue to accumulate debt despite falling disposable incomes and high interest rates. Furthermore, the most recent indicators of consumption expenditures do not suggest a rapid decline in the first half of 1987/88. The implication is that, if private consumption does not fall, domestic activity levels will remain higher but that the path to disinflation and to securing external adjustment will be slowed.

The uncertainties surrounding the international outlook appear to favour the possibility of a more pessimistic outturn than that implied by the assumptions contained in the external sector forecasts. The risk is that a contraction in world demand could lead to a lower contribution from the external accounts to real GDP and a correspondingly lower rate of improvement in the prices received for exports. Much of the international uncertainty stems from the severity of present world trade and payments imbalances. Recent forecasts from the OECD suggest that even restrictive fiscal policy in the US combined with the stimulatory steps taken by Japan and West Germany and a US real exchange rate at its current low level would not be sufficient to eradicate the imbalances. Either the US will be forced to act to reduce its budget deficit more quickly, with the consequent implications for domestic activity and world trade, or additional pressure will be placed on the US dollar as international lenders become reluctant to finance its current account deficit in the face of growing indebtedness. In either circumstance the implication for New Zealand is that there is a risk that trade conditions with the US may become more unfavourable than that embodied in the assumptions made for the external forecasts.

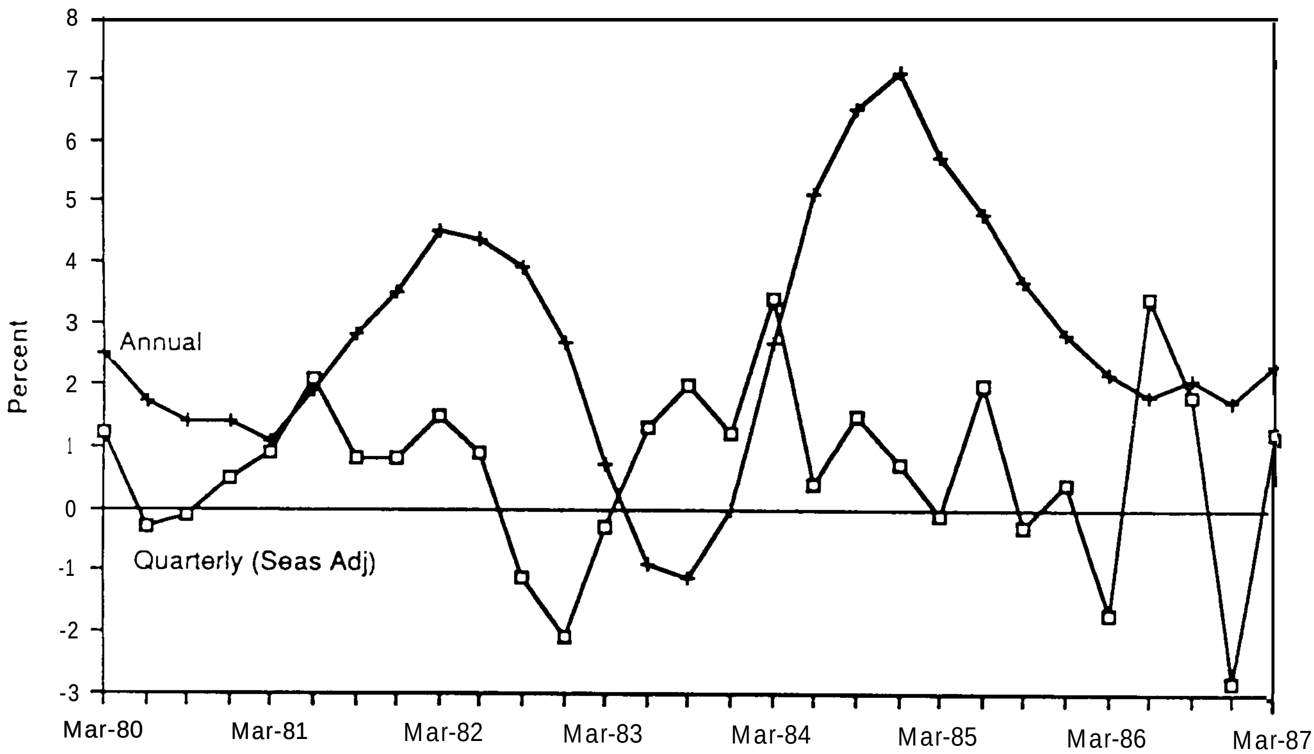
APPENDIX I

# The Forecasts in Detail

## *Gross Domestic Product*

Real GDP by industry group grew by 5.6 percent and 2.2 percent in 1984/85 and 1985/86 respectively. Underlying this strong growth, a general downward trend of quarterly changes since 1984 was reversed in the June and September quarters by pre-GST expenditures. Real GDP (seasonally adjusted) subsequently fell 2.8 percent in the December 1986 quarter but recovered by 1.2 percent over the March 1987 quarter, so that the increase during the year to March 1987 was 2.4 percent.

GRAPH Al. 1: Real GDP Percentage Changes




Source: Department of Statistics

Real expenditure on GDP, for the year to March 1987, is estimated to have expanded by 1.8 percent (Table A1.2). A pre-GST induced growth in real final consumption expenditures, partially satisfied through running down stocks of finished goods, was more than offset by a 9.6 percent drop in real gross fixed capital formation. With agricultural stocks having also fallen, following the build-up caused by the meatworks strike in early 1986, real gross national expenditure fell by 0.8 percent. A significant positive contribution from the external balance, reflecting the effect of the meatworks strike on exports, served to compensate for the domestic outcome so as to produce a positive movement for real GDP overall.

For 1987/88, real expenditures on both consumption and fixed investment are forecast to decline, while some inventory investment is expected to partially compensate for this. Net exports of goods and services are likely to make a small contribution to GDP growth in 1987/88 as low export growth is projected to exceed a constant level of import volumes. Real expenditure on GDP is forecast to drop by 0.6 percent in the year to March 1988, as the downturn in domestic consumption demand, that has been forecast to occur over the last two years or so, takes effect.

TABLE Al. 1: Real Expenditure on GDP (annual percentage changes with percentage point contributions in brackets)

| ***(Base = 1976/77)*** | *Estimates* | | ***Forecasts*** | |
|---|---|---|---|---|
| | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| *Domestic* | | | | |
| Final Consumption | 0.1 (0.1) | 2.7 (2.0) | -1.2 (-0.9) | 1.2 (0.9) |
| Gross Fixed Capital Formation | 9.3 (2.4) | -9.6 (-2.6) | -3.7 (-0.9) | -2.1 (-0.5) |
| Change in Stocks | (-0.4) | (-0.2) | (0.6) | (0.8) |
| Gross National Expenditure | 2.1 | -0.8 | -1.2 | 1.2 |
| ***External*** | | | | |
| Exports of Goods and Services | 1.0 (0.4) | 4.9 (1.7) | 1.6 (0.6) | 3.1 (1.2) |
| Imports of Goods and Services | -2.2 (0.8) | -2.2 (0.8) | 0.0 (0.0) | 2.5 (-0.9) |
| External Balance | (1.2) | (2.6) | (0.6) | (0.3) |
| Statistical Discrepancy’ | (-0.4) | – | – | – |
| Expenditure on GDP | 2.0 | 1.8 | -0.6 | 1.5 |
| Statisrics Department’ | 2.2 | 2.4 | | |

‘Represents the difference between the income and expenditure measures of GDP.

‘Based on real GDP by industry production group.

Source: The Treasury

Towards the end of 1987 the downturn in domestic expenditures is expected to halt, with a pick up in activity then predicted to continue throughout 1988/89. A recovery in final consumption expenditures is forecast to outweigh a further fall in gross fixed capital formation which, in association with a positive contribution from stock-building, results in forecast growth for domestic expenditures. Little support for this domestic recovery is expected from the external balance as increasing real exports of goods and services are virtually matched by an expansion of import volumes. The growth from domestic sources means that a significant improvement in the outlook is forecast for 1988/89, with real GDP growth forecast to be 1.5 percent.

## Final Consumption

Total real final consumption (Table A 1.3) remained relatively unchanged in 1985/86 following growth in both private and general government consumption in 1984/85. Despite falling real disposable incomes and government expenditure reviews, both components grew strongly in 1986/87 but are forecast to decline in real terms over 1987/88. With government consumption expected to be held constant in 1988/89 the recovery in total final consumption stems from a forecast expansion in private consumption.

TABLE Al .2: Final Consumption Expenditure (annual percentage changes)

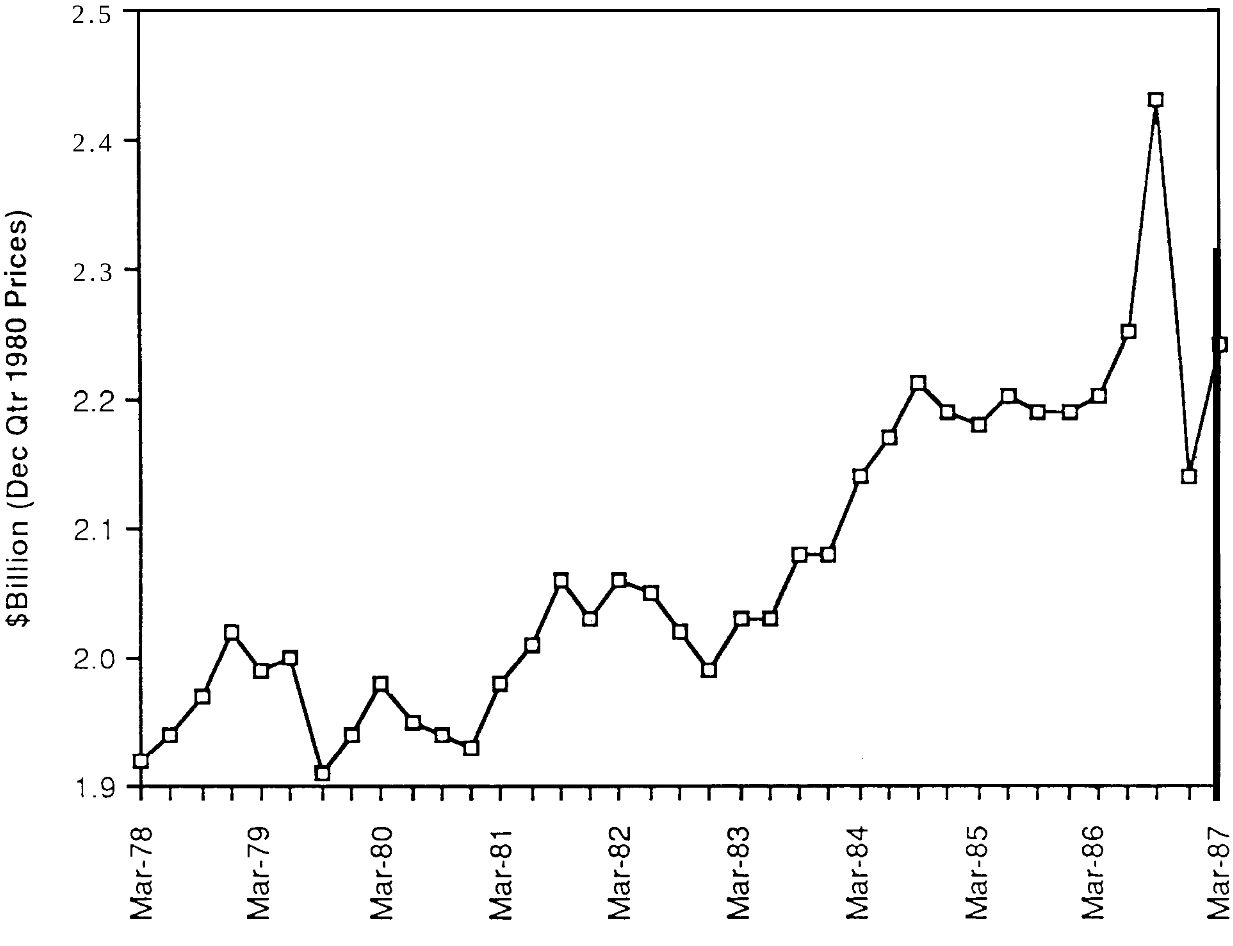
| | *Share %* | *Estimates* | | *Forecasts* | |
|---|---|---|---|---|---|
| | *(1985/86)* | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| Privare | 79 | -0.1 | 2.5 | −1.3 | 1.5 |
| General Government | 21 | 0.9 | 3.5 | −1.0 | 0.0 |
| Total | 100 | 0.1 | 2.7 | −1.2 | 1.2 |

*Source*: The Treasury

*Private consumption* expenditures (Table Al .4) have remained strong in the face of falling real disposable incomes in each of the 3 years to 1986/87. Wealth effects from the property and share markets and consumer debt accumulation, associated with financial deregulation, are likely to have underpinned the 1985/86 consumption outcome. Wage and salary earners had their disposable incomes boosted by the high 1985/86 wage round and the income support measures introduced with the GST package in October 1986. However, with a decline in farm incomes and a higher than anticipated tax collection in March 1987, real private disposable incomes fell overall in 1986/87. Continued wealth effects and debt accumulation served to finance the pre-GST expenditure boom despite high interest rates. In 1987/88 it is expected that disposable incomes will decline as the 1986/87 wage round of 7 percent is more than offset by consumer price inflation over the year. With current nominal interest- rates nor expected to fall markedly in the second half of 1987/88 and a lessening, or reversal, of the positive influence of wealth and debt accumulation, a decline in private consumption is forecast in 1987/88.

GRAPH A 1.2: Quarterly Real Retail Trade

(excludes automobiles seasonally adjusted)




*Source*: Department of Statistics

After fluctuating widely with the introduction of GST, retail trade volumes (seasonally adjusted, excluding the automotive group) grew by 3.2 percent over 1986/87. While monthly nominal figures show little sign of a decline in retail trade, it is expected that real retail trade will fall by around 3 percent in the year to March 1988. A recovery of trade volumes by 1 percent is then expected to be driven by a forecast 2 percent growth in real disposable incomes over 1988/89.

TABLE A1.3: Private Consumption (annual percentage changes with percentage point contributions in brackets)

| | *Share %* (1985/86) | *Estimates* 1986/87 | 1987/88 | *Forecasts* 1988/89 |
|---|---|---|---|---|
| Durables | 14.2 | 2.7 (0.38) | -6.0 (−0.85) | 1.0 (0.14) |
| Semi-durables | 12.2 | 6.0 (0.73) | -4.8 (-0.61) | 1.8 (0.22) |
| Non-durables | 32.7 | 0.6 (0.21) | −1.0 (-0.31) | 0.9 (0.30) |
| Services | 40.9 | 2.9 (1.19) | 1.0 (0.42) | **2.0** **(0.82)** |
| Total | 100.0 | 2.5 | −1.3 | 1.5 |

Source: Department of Statistics

The downward trend of new car registrations over recent years, which was temporarily slowed by the introduction of GST, was reaffirmed for the year to March 1987 falling some 7 percent below the year to March 1986. The latest registrarion figures suggest some slowing of the rate of decline and the 1 July reduction in the excise tax on new cars is likely to continue this improvement. It is expected, however, that total new car registrations will fall some 4 percent further over the year to March 1988 before attaining positive growth of about 1 percent for 1988/89.

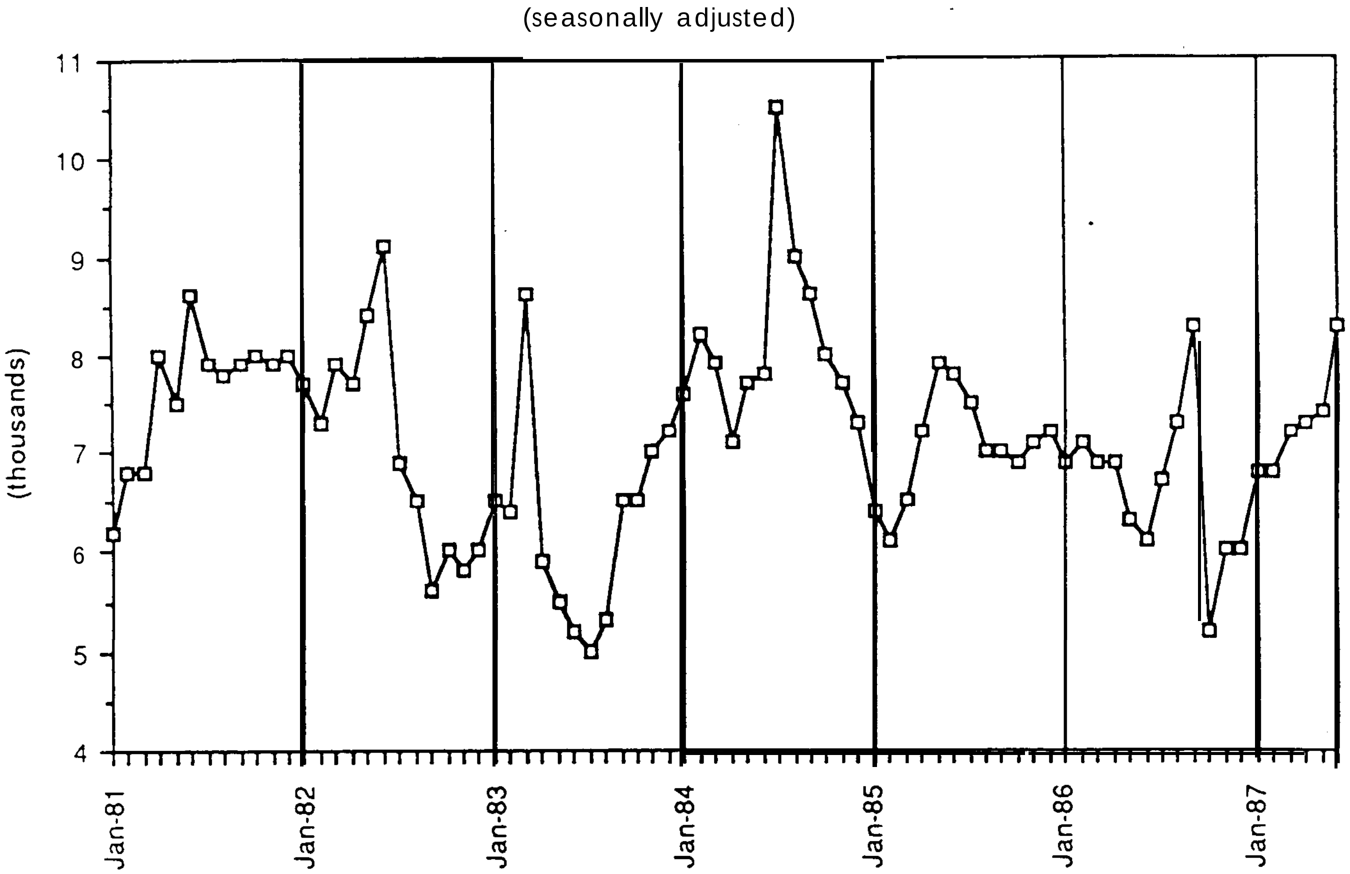
For 1987/88 the category of consumption that is expected to decline the most is durables. This category includes cars and other big ticket items which are expected to be lower as a result of consumers having brought forward purchases to bear GST. A similar, though smaller, effect is predicted for semi-durables in 1987/88, while non-durables will be more stable but influenced by the reduction in disposable incomes. Services are expected to continue to grow although by a much lower rate than in 1986/87.

The forecast for 1988/89 private consumption has been influenced by the following factors:

i disposable incomes—with a moderate wage round expected for 1987/88, employment growth in 1988/89, a substantial recovery in agricultural incomes and a significantly reduced annual average rate of CPI inflation, real disposable incomes are expected to expand by 2 percent over 1988/89;

ii interest rates—with the forecast of CPI inflation (point-to-point) being below 10 percent by December 1987, the likelihood is that interest

GRAPH Al .3: Monthly New Car Registrations




*Source*: New Zealand Posr

races will decline steadily over 1988/89. This should impart a positive influence to consumption in that year;

iii savings rates-with consumption expenditure having been maintained at a higher level than disposable incomes in recent years, it is possible that some consumers will be concerned to rebuild savings levels as incomes rise. This effect would tend to dampen the recovery of consumption as disposable incomes rise.

*General government consumption* movements reflect changes in the number of personnel employed and real operating costs in the state sector. Strong real growth in 1986/87 was brought about by the introduction of new policies which affected Inland Revenue in particular. Increased tertiary education rolls and rates of offending led to increased expenditures in the Education and Justice Departments. For 1987/88 government expenditure reviews are expected to produce a negative movement in real government consumption. Real increases in expenditures are projected for the Education, Inland Revenue, Justice and Police Departments but these are more than offset by decreases in Agriculture and Fisheries, Customs, Foreign Affairs and Transport. A constant level of government consumption is assumed for the 1988/89 year.

# Gross Fixed Capital Formation

Total gross fixed capital formation was relatively strong in 1985/86 with particularly strong general government investment being the major cause. Declines in residential investment and major projects expenditures are the significant factors explaining the falls in 1986/87 and 1987/88, while a recovery in residential investment in 1988/89 has the effect of moderating a further decline in general government investment.

TABLE Al .4: Gross Fixed Capital Formation (annual percentage changes)

| | Share % | Estimates | | Forecasts | |
|---|---|---|---|---|---|
| | (1 985/86) | 1985/86 | 1986/87 | 1987/88 | 1988/89 |
| Private | 67 | 1.5 | -6.3 | -4.6 | 0.4 |
| General Government | 33 | 29.3 | −16.2 | −1.6 | -7.6 |
| Total | 100 | 9.3 | -9.6 | -3.7 | -2.1 |

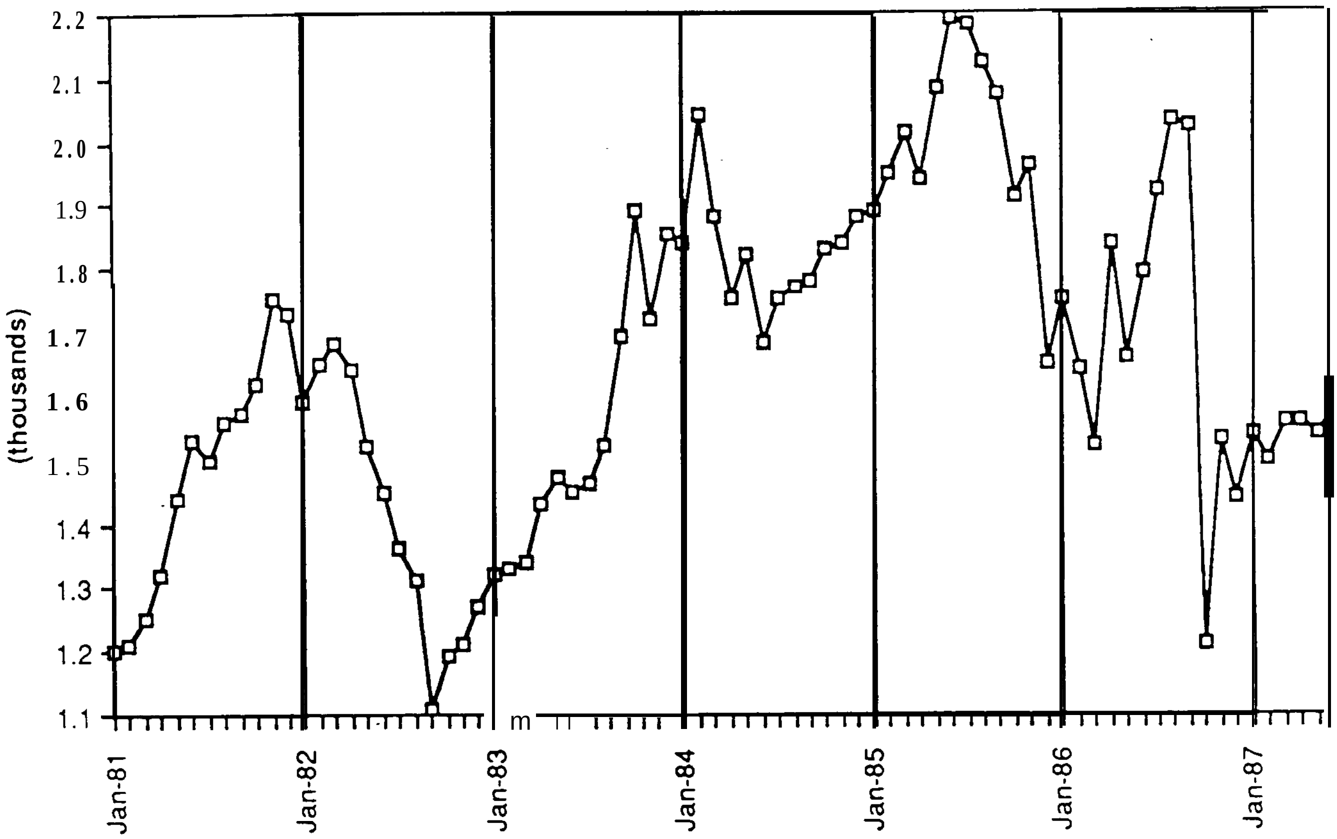
Source; The Treasury

*Private investment* is heavily influenced by fluctuations in residential investment due to the size of its share in total investment. Residential construction contracted significantly over 1986/87 although pre-GST building, and alterations and additions, tended to moderate the decline. New dwelling permits fell by nearly 13 percent for the year ended March 1787 when compared with the same period to March 1786. A further fall in permits, to around 18,000 is expected in the year ending March 1788. Falling disposable incomes, slow downwards correction of nominal interest rates during 1987/88 and the effect of GST underlie this forecast. Residential investment is expected to pick up over 1988/89 as real disposable incomes improve and nominal interest rates adjust to reflect the lower rate of inflation anticipated.

Commercial office construction in the main centres has boosted non-residential building investment over recent years. Commercial new building starts are likely to be maintained at present levels for the remainder of 1987/88, with high domestic financing costs and better overseas returns on developments discouraging further growth in new starts. Overall current high levels of private building activity are expected to fall by about 3 percent during 1988/89.

GRAPH A1.4: Total New Dwelling Permits

(seasonally adjusted)




*Source*: Department of Statistics

TABLE A1.5: Private Investment' (annual percentage changes with percentage point contributions in brackets)

| | Share % (1985/86) | Estimates 1986/87 | Forecasts 1987/88 | 1988/89 |
|---|---|---|---|---|
| Residential Building | 25.5 | -7.0<br>(−1.8) | −10.0<br>(-2.4) | 5.0<br>(1.2) |
| Non-residential Building | 16.1 | 8.5<br>(1.4) | 0<br>(–) | -3.0<br>(-0.6) |
| Land Improvements | 1.5 | −24.9<br>(-0.4) | 0<br>(–) | 10<br>(0.1) |
| Transport | 20.2 | −11.6<br>(-2.3) | -5.5<br>(-0.8) | −2.0<br>(-0.4) |
| Plant and Equipment | 33.8 | -9.0<br>(−3.0) | -4.0<br>(−1.3) | 0<br>(–) |
| Other | 2.9 | -4.8<br>(-0.1) | 0<br>(–) | 0<br>(–) |
| Total | 100.0 | -6.3 | −4.6 | 0.4 |

'The amount attributable to major projects investment became zero in 1986/87 and so is not listed separately.

*Sources*: The Treasury

Plant and machinery investment is estimated to have fallen by 9 percent in 1986/87 as a result of weak domestic demand and reduced overseas competitiveness. Continuation of these factors and high interest rates serve to further depress investment in this category. A slightly more favourable international trading environment and some modest recovery in domestic conditions, along with a reduction in interesr rates, suggests no further decline in investment in plant and equipment in 1988/89.

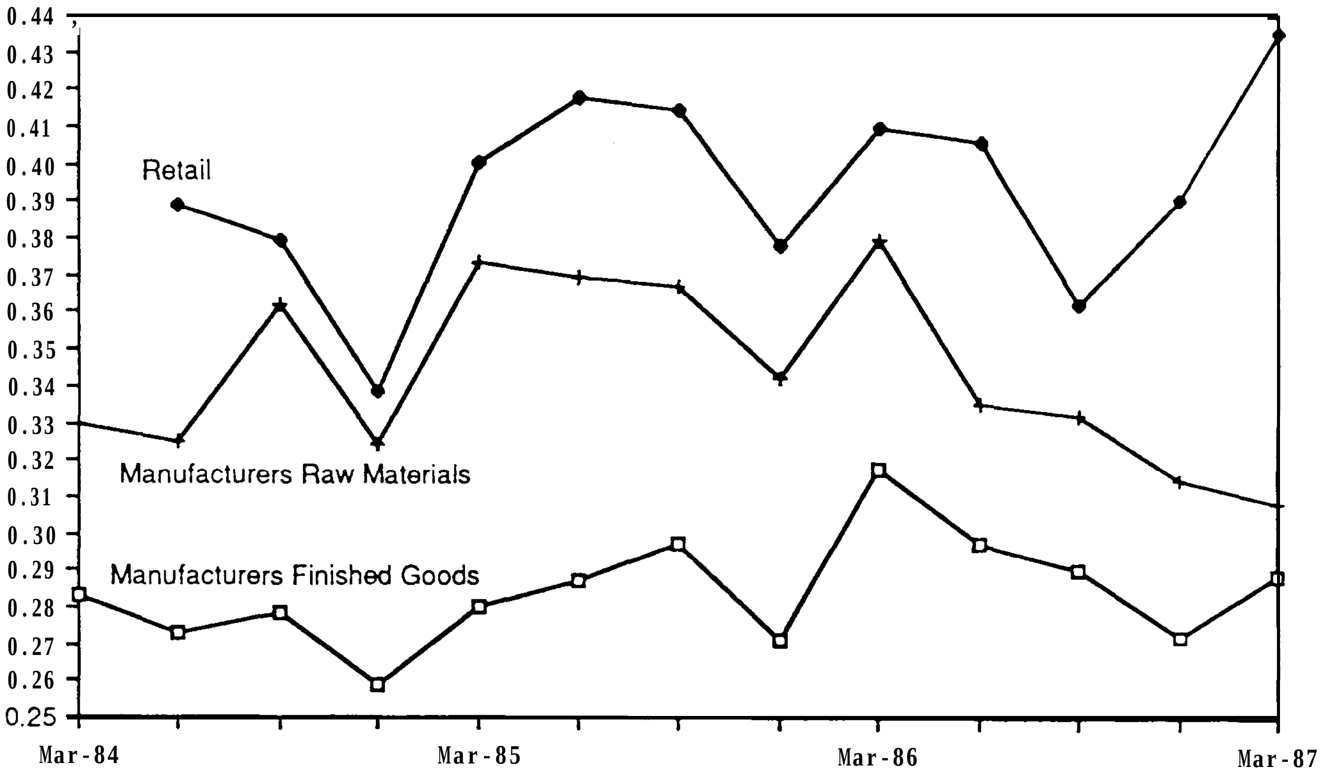
*General* government *investment* declined in 1986/87 reflecting a correction from 1985/86, when there was a group purchase of Boeing 767s by Air New Zealand, the completion of Synfuels construction and the wind down of capital formation at New Zealand Steel. Projected falls in expenditures by the Coal Corporation and New Zealand Steel largely explain the expected decline of central government investment in 1987/88 while a forecast growth of local government construction spending by around 9 percent largely offsets this. A further reduction in New Zealand Steel capital formation and a drop in Electricorp investment in addition to a lower level of local government investment combine to produce an expected faster rate of decline in 1988/89.

## Stocks

The main influence on total stock movements in 1986/87 came from the effect of the 1986 meatworks strike inflating agricultural and producer board stocks in 1985/86 which were then run down relative to normal stock accumulation over 1986/87. Positive stock growth by the retail and wholesale groups in 1986/87 reflects an unpredicted strong decline in retail sales following the pre-GST increase. The decline in the other group is largely due to destocking in the communications production group.

In 1987/88 and 1988/89 real agricultural stocks are forecast to increase as farmers continue to diversify into higher-valued goats and deer. Steady growth in forestry reflects planting and growth rates being expected to exceed the felling rate. For the commercial group—manufacturing, retail and wholesale—destocking occurs as improved stock management techniques are employed in order to reduce the high funding costs associated with holding stocks.

GRAPH Al. 5: Stocks to Sales Ratios




*Sources*: Department of Statistics

TABLE Al .6: Composition of Real Stock Changes

| (*$m, **Base** = 1976/77)* | *Estimates* (1986/87) | *Estimates* 1987/88 | *Forecasts* 1988/89 |
|---|---|---|---|
| Agriculture | 35 | 133 | 159 |
| Forestry | 163 | 175 | 194 |
| Manufacturing | −68 | -53 | −24 |
| Retail | 13 | −28 | −12 |
| Wholesale | 27 | -59 | −27 |
| Producer Boards | -67 | -2 | 3 |
| Other | -30 | 0 | 0 |
| Total | 73 | 166 | 293 |

*Source*: The Treasury

# External Balance

The external sector forecasts were made on the basis of the following assumptions:

— the real exchange rate holds constant at its March quarter 1987 level. The Reserve Bank's trade weighted exchange rate index is assumed to depreciate from its March quarter average level, of 65.3, to offset the inflation differential between New Zealand and its main trading partners;

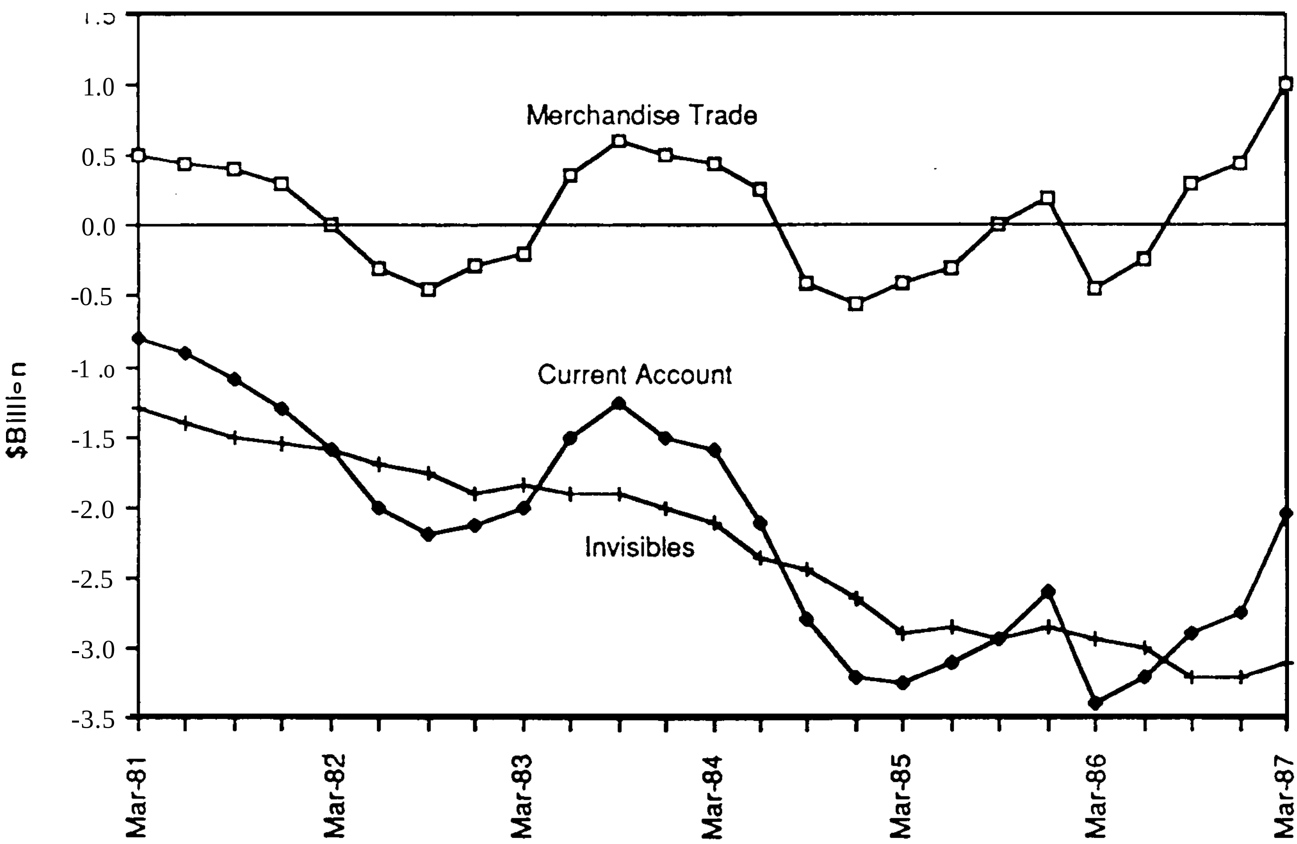
— an average rate of inflation for New Zealand's major trading partners of 3.4 percent in 1987/88 and 3.7 percent in 1988/89;

— average world economic growth of a rate of 2.8 percent over 1987/88 and 2.5 percent over 1988/89.

After having improved significantly in 1986/87, partly the result of delayed exports due to the meatworks strike in early 1986, the current account balance is expected to continue to improve in 1987/88. The forecast improvement in the current account is the product of a forecast increase in the trade surplus which is only partially offset by a worsening invisibles/transfers balance.

GRAPH A1.6 : Overseas Balance of Payments

(four quarterly running totals)




*Source*: Reserve Bank

TABLE A1.7: Balance of Payments (annual percentage changes with percentage point contributions to real GDP in brackets)

| | *Estimates* | | *Forecasts* | |
|---|---|---|---|---|
| | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| *Exports* | | | | |
| Goods-Vol | 2.4 | 5.2 | 0.9 | 2.8 |
| -Price | 1.2 | 1.3 | 7.0 | 9.0 |
| Services—Vol | −4.5 | 3.5 | 4.3 | 4.4 |
| -Price | 9.4 | 4.6 | 6.2 | 6.1 |
| *Imports* | | | | |
| Goods-Vol | −1.5 | -4.0 | −0.3 | 2.5 |
| -Price | 3.7 | --7.7 | 5.8 | s.1 |
| Services—Vol | -4.6 | 4.4 | 1.0 | 2.3 |
| -Price | 4.4 | 5.2 | 4.8 | 6.8 |
| External Balance | (1.2) | (2.6) | (0.6, | (0.3) |
| Current Account Balance | -3341 | −2052 | −1853 | −1653 |
| % GDP | 7.5 | 3.9 | 3.2 | 2.6 |
| Terms of Trade | 71.5 | 74.0 | 74.9 | 75.5 |

*Source*: Reserve Bank

The *terms of trade* to March 1987 rose 3.6 percent over the previous year as export prices rose marginally while import prices fell, largely as a consequence of a fall in the price of imported oil. The terms of rrade are expected to increase by around 1 percent in 1987/88 and 1988/89 as both export and import prices rise strongly but with export prices rising slightly faster than import prices. Oil prices are assumed to average US$18 per barrel over the forecast period, some 30 percent higher than the average over 1986/87.

Meat prices fell over the 2 years to March 1787 but are expected to recover in the forecast period. Wool prices improved over 1986/87 in response to world demand and a further strong increase is anticipated for 1987/88, while a smaller rate of increase is expected in 1988/89. Dairy product prices are also expected to rise in 1987/88 but are forecast to benefit by a substantial increase in 1988/89 as a projected world shortage of dairy products is reflected in prices.

The *trade balance* improvement which underpinned the current account improvement in 1986/87 is expected to continue on inro 1987/88. The main factors behind the 1987/88 increase in export receipts are significant volume increases for dairy and other primary (for example fish, apples and pears, kiwifruit) products associated with an improved outlook for the prices of those products. In 1988/89 these same products also contribute to a further increase in export receipts while being joined by meat and manufacturers which are expected to have improved price prospects in that year.

The *invisibles deficit* is forecast to deteriorate over 1987/88 as debt servicing is projected to rise. Little increase in this component in 1988/89 and a relatively favourable outlook for the tourism industry, and therefore for the services balance, results in only a slight deterioration in the invisibles balance in 1988/89.

## Consumer Inflation

The rate of inflation for the consumers price index is forecast to fall to single digits (year-on-year) by the end of 1987 as the bulk of the influence of GST is removed for the first time. Because of the magnitude of the increase in the CPI in the December quarter 1786, CPI inflation, point-to-point, will remain stubbornly high until the September quarter and then fall by some 8 percentage points for the year to December. The point-to-point inflation rate is then expected to decline further to reach 8.7 percent for the year to March 1988.

TABLE A 1.8: CPI Inflation

| | | | *Forecasts* | |
|---|---|---|---|---|
| | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| Point to Point | 13.0 | 18.3 | 8.9 | 6.9 |
| Annual Average | 15.2 | 14.6 | 13.2 | 7.4 |

*Sources*: Actuals: Department of Stnrisrics. Forecasts: The Treasury

The forecasts for consumer inflation are based on the following factors:

— monetary policy is assumed to remain non-accommodating over the forecast horizon;

— no change in the rate of GST or other indirect taxes;

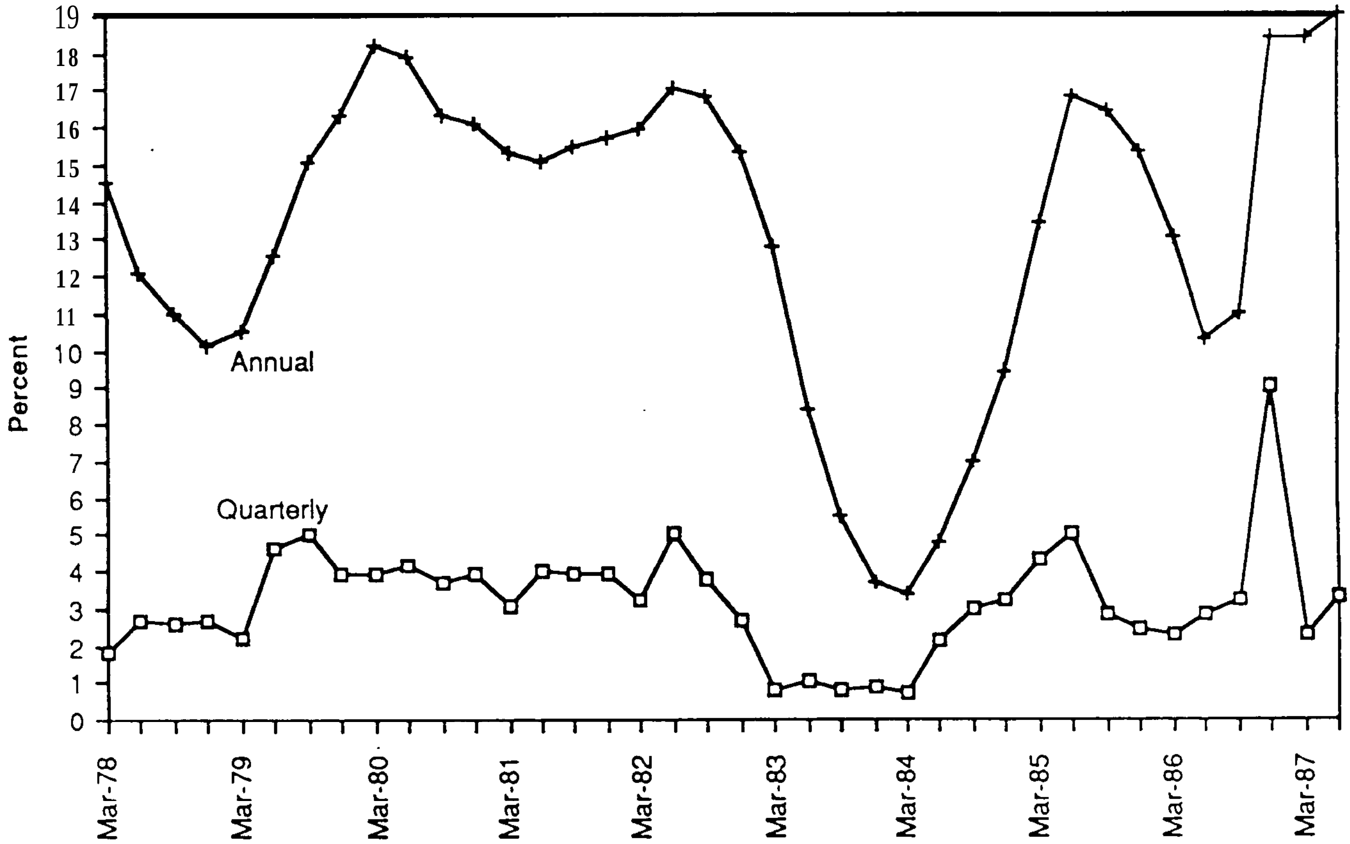
— import price changes reflect the real exchange rate and overseas inflation rate assumptions made in the external forecasts.

While the main impact of GST was experienced in the December 1786 quarter several additional effects have been felt in recent quarters. The March quarter 1987 was influenced by the effect of GST on new house prices which enter with a 3-month lag. The June quarter figure was higher because the effect of GST on new season's clothing was included for the first time while higher new house and car prices began to be reflected in higher prices for the stock of existing houses and second-hand cars. To the extent that the complete flow-on to the entire stock of existing dwellings and used cars might nor be complete some further influence from this source may be possible.

For the rest of 1987 it is anticipated that the levelling off of mortgage interest rates, the cuts in excise tax and tariff rates on 1 July, and the absence of specific increases, such as electricity prices, will result in quarterly CPI increases below 2 percent for the September and December quarters, and hence result in single digit annual inflation by the end of the year.

GRAPH A 1.7: Consumers Price Index

Percentage Changes




*Source*: Department of Statistics

# Employment

The natural *increase* in the labour force (Table A 1.10) is estimated to be 1.4 percent of the previous year's labour force. This is based on the average natural increase between the 178 1 and 1786 census.

*Net migration* is derived from actual changes in the actively engaged series. During 1985/86 there was a net loss of New Zealand's actively engaged population overseas. Large outflows continued until September 1786 but since then the number of departures appears to be decreasing relative to the number of arrivals. Several factors may be contributing to this:

— although New Zealand's rate of unemployment has been increasing, unemployment has also been rising in Australia. The current unemployment rate is around 8 percent and it is forecast to continue to rise over the rest of 1987 and the first half of 1788;

— real wages in Australia have been falling over the past three years. The expected increase in award wages (from OECD forecasts) is 6.5 percent compared to an expected inflation rate of 7.3 percent. Over 1985/86 real wages in New Zealand increased considerably. In the 1986/87 wage round, wages rose by about 7 percent, and inflation is currently running at an annual rate of 17-18 percent (including GST). However, the GST component has been offset by recent tax curs;

— lagged migration: the considerable outflows of people which occurred during 1985/86 tend now to be reflected in increased inflows;

— exchange rate: the strong New Zealand dollar against the Australian dollar is expected to remain relatively firm over the short-term;

— changes in the law governing the availability of the unemployment benefit in Australia could have a disincentive effect on New Zealanders.

The estimate for net migration of actively engaged persons for the year ended March 1788 is an inflow of 1,000. This reflects the forecast of fairly flat economic growth over the year. The forecast of a net loss of 6,000 to March 1989 assumes that although some recovery in economic activity is expected for 1988/89, New Zealand's position relative to other countries may still be less favourable.

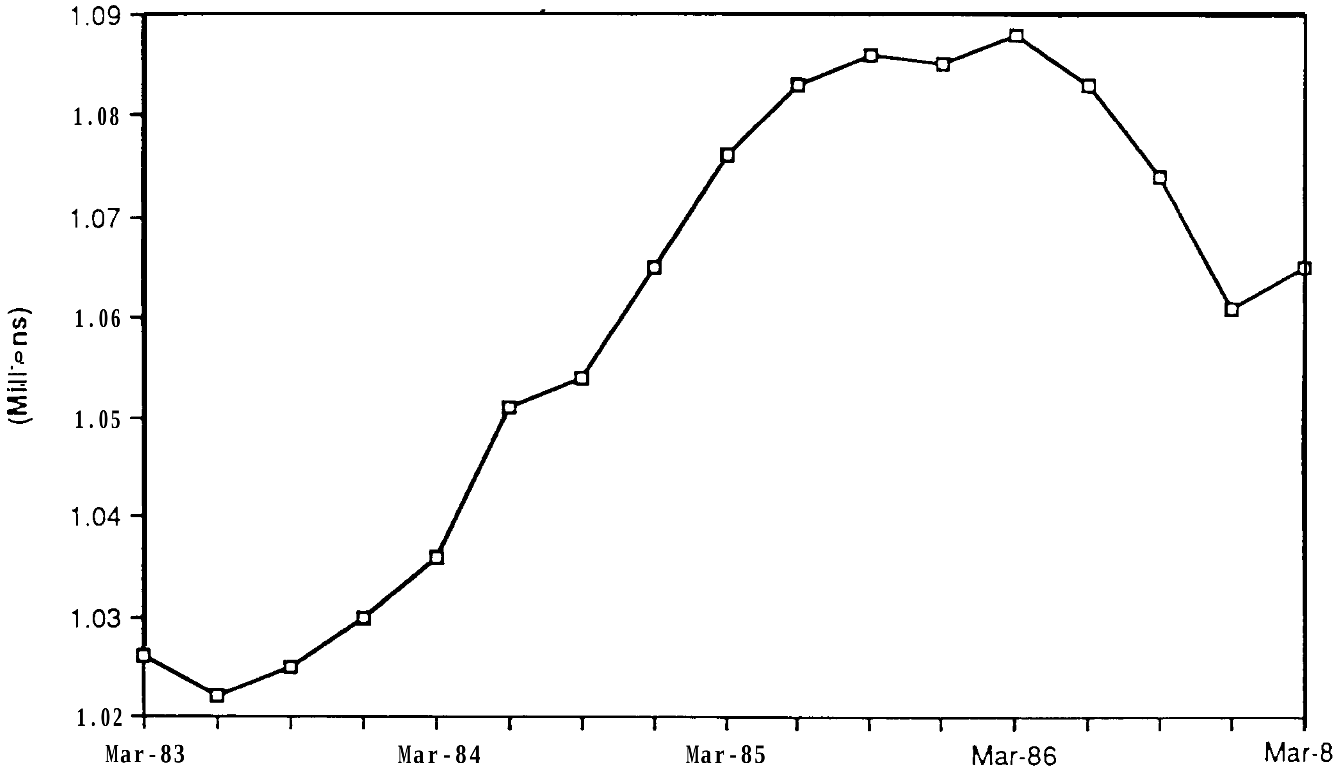
TABLE Al .9: Employment and Unemployment

| | | | *Forecasts* | |
|---|---|---|---|---|
| ***Year Ended 31 March** (000s)* | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| *Changes in People Seeking Work* | | | | |
| Natural Increase | 21.9 | 22.5 | 23.1 | 22.5 |
| Net Migration | − 14.5 | − 5.4 | 1.0 | -6.0 |
| Participation | 33.3 | 8.5 | -4.7 | 5.5 |
| Change in Labour Force | 40.7 | 25.6 | 19.4 | 22.0 |
| *Changes in Available Work* | | | | |
| QES Surveyed Employment | 17.9 | − 17.4 | -4.6 | 8.0 |
| Non-Surveyed Employment | 7.5 | -4.4 | − 1.6 | 2.0 |
| Registered Unemployment | 4.0 | 23.3 | 12.8 | 6.0 |
| Total Registered Unemployed | 54.9 | 78.2 | 91.0 | 97.0 |
| Registered Unemployment Rate % | 3.4 | 4.8 | 5.5 | 5.8 |

Source: Department of Labour

GRAPH A1.8: Total Surveyed Employment

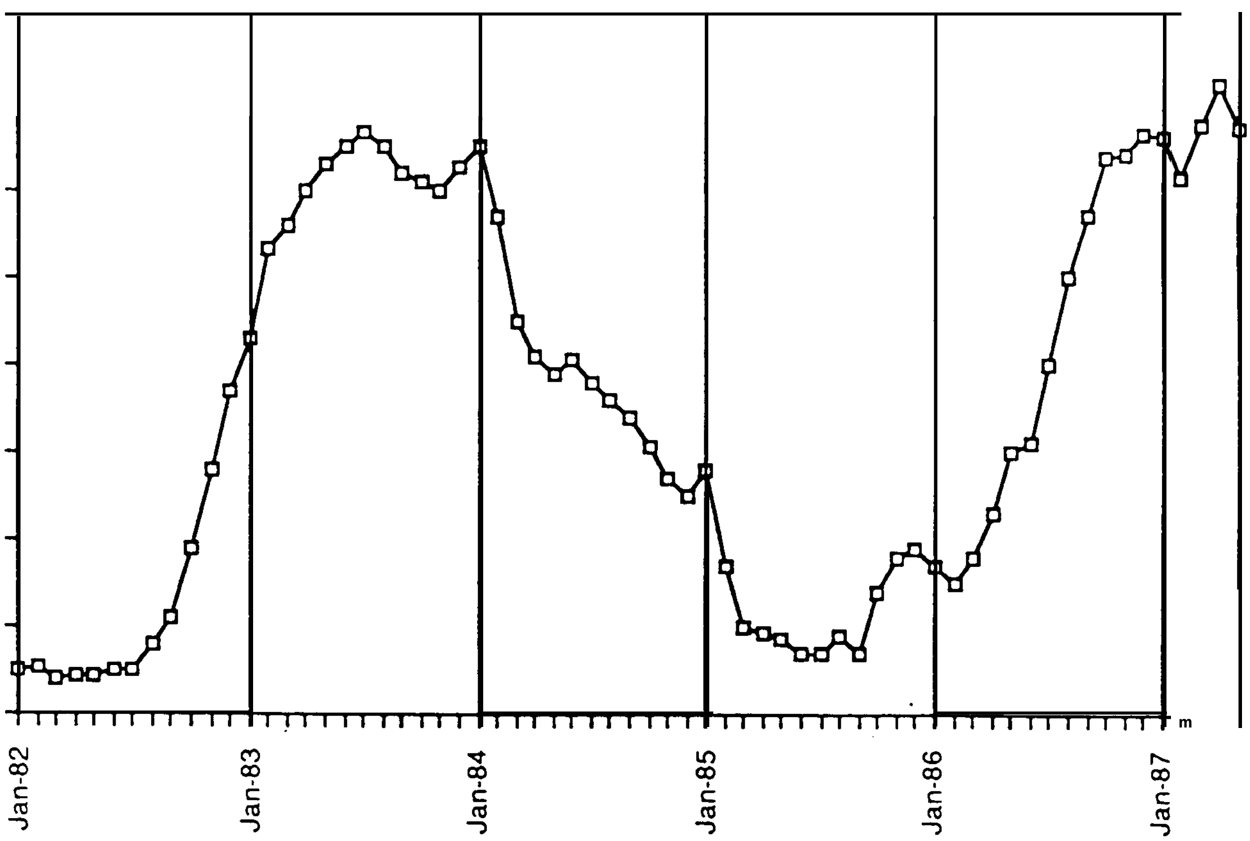
(full-time equivalents, seasonally adjusted)




*Source*: Department of Labour

GRAPH A 1.3: Registered Unemployed

(excludes vacation workers, seasonally adjusted)




*Source*: Department of Labour

*Participation* was relatively high over 1985/86 reflecting growing economic activity but then decreased over 1986/87. As unemployment rises, some people will become discouraged and leave the labour market while female participation, which has been increasing over the last 30 years, tends to impart a steady positive influence. Participation is forecast to fall during 1987/88, and to increase again with the expected recovery in 1988/89.

Quarrerly Employment Survey (QES) surveyed employment decreased by 17,400 and non-surveyed employment by 4,400 over 1986/87. For 1987/88 QES surveyed employment is forecast to fall by 4,600 and non-surveyed by 1,600. When forecasting these changes in employment the following factors were taken into account:

after the 1985/86 wage round it appeared that many employers were shedding labour. With the lower outcome from the 1986/87 wage round this effect is not expected to continue;

— the wind-down of the fully subsidised schemes is nearing completion;

— manufacturing and other industry groups are showing a decline;

— falling real GDP;

— decreases in employment in the state sector partly reflecting corporatisation;

— high overtime hours in the first quarter of 1787 suggest that employers are working existing staff harder rather than taking on new staff. If output falls, employers are likely to respond by adjusting overtime levels down rather than laying off workers;

regional disparities in employment levels. Despite some areas of growth, other regions are experiencing declines in employment;

— mismatch between vacancies for skilled workers and the largely unskilled unemployed.

For the year ended March 1789, QES surveyed employment is forecast to increase by 8,000 and non-surveyed by 2,000 reflecting the forecast of relatively strong real GDP growth.

*Registered unemployment* increased by 23,300 over 1986/87 bringing it to a total of 78,200 in March 1987. For 1987/88 a further increase of 12,800 registered unemployed is forecast, bringing it to a total of 91,000 in March 1988. This reflects the outlook of a flat economy and some of the effects of restructuring. For the year ended March 1787, an increase in registered unemployment of 6,000 is forecast. This takes account of the forecast increase in participation of 5,500 and the inflows into the labour force through natural increase. Despite the expected recovery in economic activity to March 1989, employment may not grow strongly at first. Some of the continued growth in the labour force that is forecast over this period will therefore be reflected in the unemployment estimate.

# Incomes

Nominal GDP at market prices (that is, inclusive of GST) is estimated to have grown by 16.6 percent in 1986/87 and is forecast to grow by 12 percent in 1987/88 and 7.5 percent in 1988/89. Both compensation of employees and operating surplus are expected to decline slightly as a share of GDP in 1987/88 as a full year's GST collections swell the indirect taxes component of nominal GDP relative to the other components.

*Compensation of employees* is estimated to have grown by 16 percent over 1986/87, being the net result of the high 1985/86 wage round, increased overtime hours around the time of GST and a sharp downturn in employment. The average increase in awards during the 1986/87 wage round was 7 percent for both the state and private sectors. This outcome, with a small decline in employment levels for the year produces a forecast 6.4 percent increase in compensation of employees for the 1987/88 year. With real GDP growth forecast for 1988/89, total employment is expected to increase by nearly 1 percent. Assuming a moderate 1987/88 wage round, compensation of employees is expected to increase its rate of growth to 7.7 percent in 1988/89.

The impact of the new Labour Relations Act, which comes into effect on 1 August 1787, proposed amendments to the state wage fixing system and the negotiations with the newly formed SOEs mean that there is a substantially greater degree of uncertainty associated with the wage bargaining patterns in 1988/89.

*Operating surplus*, which grew by an estimated 12.3 percent over the year ended March 1787, is forecast to grow by 7.3 percent in 1987/88 and 8.6 percent in 1988/89. The most significant factors in this result are declining rates of growth for the 'other private' group, a recovery in the agricultural sector and a negative, then strongly positive, movement for general government.

With the volume of retail trade (excluding the automotive group) having grown by over 3 percent in the 1986/87 year, the 'other private' production group, which has trade and services as its major sectors, is estimated to have experienced a 19 percent growth in operating surplus. The forecast downturn in retail trade in 1987/88 serves to reduce operating surplus growth for the group significantly in 1987/88. High earlier increases in margins in the other private group are expected to be reflected in a subdued increase of operating surplus in 1988/89.

The outlook for the agricultural sector is improving for both the forecast years (see Appendix 2 of this chapter for details). Improving prospects for product prices point to a recovery in operating surplus for the sector. Agricultural sector incomes are also expected to increase, especially in the 1988/89 year as debt servicing costs fall in line with declining interest rates.

The manufacturing sector benefited by the boost in production associated with GST so that operating surplus growth in 1986/87 was estimated to be around 11 percent. The relatively high current exchange rate and increased international competition are, however, expected to dominate the 1987/88 year so that operating surplus is forecast to grow by a more modest 6 percent.

Movements in general government operating surplus are expected to have a strong influence on overall operating surplus levels in 1987/88 and 1988/89. Revaluations of assets of the newly formed SOEs are expected to result in a much larger allowance for depreciation in the 1987/88 year. This has the effect of significantly reducing operating surplus in the year. Conversely, in 1988/89 several of the corporations are expected to show much improved performance so that operating surplus is relatively high in that year.

TABLE A 1.10: **Personal Incomes (annual percentage changes)**

| | *Estimates* | | *Forecasts* | |
|---|---|---|---|---|
| | *1985/86* | *1986/87* | *1987/88* | *1988/89* |
| Compensation of Employees | 16.5 | 16.0 | 6.4 | 7.9 |
| Farm Income | -30.5 | − 15.4 | 20.3 | 48.7 |
| Transfers | 14.6 | 14.0 | 11.3 | 8.6 |
| Net Other Income | 27.5 | 15.7 | 5.6 | 7.0 |
| Total Personal Income | 15.7 | 14.8 | 7.4 | 8.7 |
| Less Income Tax | 26.2 | 19.9 | − 1.7 | 6.5 |
| Personal Disposable Income | 12.3 | 13.0 | 10.9 | 9.5 |
| Annual Average CPI | 15.2 | 14.6 | 13.2 | 7.4 |
| Real Personal Disposable Income | -2.5 | − 1.4 | -2.0 | 2.0 |

*Source* The Treasury

*Real* personal *disposable incomes* are influenced by both compensation of employees and incomes derived from business (Table Al. 11). Transfers from government, many of which are indexed to the CPI, are expected to increase in both years of the forecast horizon while the full year effect of the October 1986 income tax cuts is projected to produce a decline in the total tax take from the private sector in 1987/88. The forecast of a sharp downward movement in inflation by the end of 1787 means that the annual average CPI movement in 1988/89 produces a 2 percent expansion in real disposable incomes.

APPENDIX II

# Agricultural Outlook
# Forecasts for the Agricultural Production Account

*Estimate for 1987/88*

Gross Output The total value of gross output is estimated to rise by 13 percent in 1987/88. Significant contributing factors are:

- a 12 percent increase in wool prices received at auction while wool production volumes decline slightly because of falling sheep numbers;
- meat production volumes are down significantly in 1987/88, reflecting a return to a normal meat processing season. Lamb slaughterings are 19 percent lower, cattle slaughterings are 17 percent lower;
- sheep meat price estimates have risen because of expected higher exports to the UK market and less reliance on disposal markets in the 1986/87 September year. This is a consequence of the effects of industrial action in the previous year, which saw shipments to the UK curtailed during the normal seasonal peak in prices;
- beef prices are estimated to rise by 15 percent from 1986/87. This assumes little carry over of the effects of the US dairy herd buyout scheme into the 1986/87 September year, and increasing cows retained on US feedlots because of lower grain prices;
- meat price estimates for 1987/88 are all affected by the assumption of a weaker New Zealand dollar compared to 1986/87;
- dairy output is expected to increase in 1987/88, due mainly to a return to normal per cow production levels after the 1986/87 season was effected by drought. March year prices are estimated to increase 1.7 percent. This assumes an increase in world prices, and moderate support by the Dairy Board;
- output from agricultural services is estimated to increase in 1987/88 in line with increased returns to farmers, and increasing confidence with an assumed falling nominal exchange rate. These factors have also led to an estimated increase in livestock sales;
- the value of livestock change is again positive. This reflects a return to more normal livestock numbers at the open and close of the year.

Intermediate Consumption The estimate for intermediate consumption in 1987/88 allows for an average price increase of 8 percent, and a 9 percent increase in volume. This still leaves inputs at low levels and reflects an assumed reluctance by farmers to raise investment in agriculture.

Operating Surplus The net effect of a 17 percent increase in borh intermediate consumption and a 13 percent increase in gross output, with less adjustmenr in other expenditure items, is that operaring surplus increases by 10 percent. This estimate is heavily dependent on farmers' attitudes to maintaining relatively, low input levels, which could change once income is realised.

## *Forecast for 1988/89*

Gross Output The forecast for the 1988/89 season is for a 9 percent increase on 1987/88. The underlying assumptions are:

- a further 1 percent decline in total sheep numbers (to 66 million) and a 1 percent rise in total cattle (to 9.1 million);
- a small rise in dairy production as farmers increase output to compensate for a downturn in prices;
- wool prices remaining strong, reflecting continued strong demand. Farm gate prices set at 525 cents per kilogram (up 9.7 percent on 1986/87);
- beef prices to remain firm, in light of continued herd build-up in the US.

Intermediate Consumption With a projected increase in gross output and lower input price rises, the sector is likely to continue moves to compensate for deferred maintenance over the previous three seasons. A 5 percent increase in real inputs has been forecast which along with a 5 percent price movement results in a 10 percent nominal change.

Operating Surplus Operating surplus is forecast to be 14 percent up on the 1987/88 year. This is largely the product of the projections for gross output and intermediate consumption although a small decline in the allowance for depreciation-as maintenance expenditures pick up-tends to boost operating surplus.

## APPENDIX III

# International Outlook

A more pessimistic outlook has emerged for economic conditions in the OECD for 1987 and 1988. Expectations of real GNP growth have levelled out to 2.3 percent for both 1987 and 1988 following real growth of 3 percent in 1985 and 2.5 percent in 1986. The slowdown of growth is not uniform throughout the OECD, however, with growth differentials being expected to widen in 1987. Growth in the US is faster than the OECD average, yet growth is slower than average in Japan and Europe, particularly Germany. Economic growth in the US is being stimulated in part by a lower real trade deficit and increased stock building while lower real trade surpluses have had a depressing effect on Japanese and German economic growth. Although domestic demand has been weak in Germany and France, demand in other European countries remains strong. Higher domestic demand had been expected due to declining oil prices in oil importing countries. The actual growth has not been as high as anticipated. One reason is that a considerable part of the terms of trade improvement did not reach final consumers but rather went into profit margins or government revenue instead.

A major issue during 1987 continues to be large imbalances in trade and payments, particularly the US deficit and the surpluses of Japan and Germany. In volume terms, the Japanese and German surpluses are estimated to have fallen slightly in 1786 and some further contraction is likely. In nominal terms the imbalances continue to expand. Calls have been made for the Japanese and Germans to intervene to assist growth in domestic demand to remedy the trade imbalance. Japan has made greater moves to implement expansionary policies leaving some pressure on Germany to follow their lead. The rising value of the deutschmark and the yen over the past two years has meant export profit margins have had to be squeezed to prevent large declines in export volumes. Smaller profit margins and exchange rate uncertainty have impacted on the domestic economies of Japan and Germany through lower investment in manufacturing and lower domestic demand.

The declining path of inflation in the OECD is being reversed in 1987. Consumer prices increased at a slightly stronger rate in early 1987, reflecting a severe winter in the Northern Hemisphere and an upturn in oil prices towards the end of 1986. Inflation for the first half of 1987 is estimated at an annual rate of 3.8 percent compared to a 2.8 percent average for 1986. A higher rate of inflation is expected in North America reflecting exchange rate developments and stronger economic growth, but the rate should be markedly slower in other major economies like Germany and Japan. Over the next 18 months inflarion is expected to stabilise at about 3 to 3.5 percent for the OECD area.

Rises in nominal wage rates were greater than the inflation rate in 1786 and this trend is expected to continue in 1787 and 1988 with the implication of lower profit margins. Employment growth is expected to be slow in the nest 18 months especially in Europe and Japan. Unemployment rates should, however, remain static given the projected rate of expansion in the overall labour force. The current rate of unemployment for the OECD area is 8.3 percent. Reductions in unemployment are anticipated in North America and the UK while increases are expected in most other major OECD countries.

Monetary conditions have remained relatively easy in many OECD countries in response to both weaker than expected economic activity and the steep decline of the US dollar. By contrast the US has adopted firmer monetary policy with lowered monetary targets. The overall stance of fiscal policy in the OECD is expected to remain relatively contractionary. This tight fiscal stance is reflected in predictions of an improved fiscal situation in the US. Other major countries except Germany are expected to show similar budget balance improvements over 1787 and 1988. After cyclical and inflation factors are considered, the fiscal stance in 1987 and 1988 appears to be contractionary. In many countries, the contractionary stance is in reaction to concern about growth of government debt.

## Australian Outlook

Major economic policy initiatives were introduced prior to the Australian election in the May 1987 mini budget. Moves to reduce the fiscal deficit aim to achieve a deficit of less than 1 percent of GDP for 1987/88. The mini budget contained major rationalisation of social spending with means testing for benefits, reductions in youth unemployment payments and reductions in health benefits. The government also moved to sell some state owned assets and to reduce defence spending.

The OECD expects the slow real GDP growth of 1.4 percent in 1986 to pick up to $2\frac{1}{2}$ percent in 1987 and $1\frac{3}{4}$ percent in 1988. Part of this increase will be driven by a reversal of stock rundowns. If there is slower employment growth, unemployment could reach $8\frac{1}{2}$ to 9 percent by the end of 1988. Private consumption growth may recover by the second half of 1987 through tax cuts and higher real wages. Investment may recover if nominal interest rates fall. After an increase in the CPI in 1986 due to a depreciation in the Australian dollar, inflation is expected to decelerate in 1987 and 1988 with OECD predictions of $8\frac{1}{2}$ and $6\frac{1}{4}$ percent for each of these years. Decelerating inflation should permit some fall in nominal interest rates. Compensation per employee is projected to rise by around 7 percent in both 1987 and 1788 and unir labour costs by about 5 ½ to 6 percent.

The OECD still sees need for greater deregulation of the Australian economy.. Barriers to trade are considered too high and rigidiries in the labour market too great.

## Summary

The prospects for growth in the OECD area are for 2-2 ½ percent in 1987 and 1988. Employment growth is projected to be sufficient to just absorb the increase in workforce numbers leaving the unemployment rate at 8 ¼ percent for the OECD area as a whole. While satisfactory, the inflation outlook has worsened slightly. Inflation may run at 3 ½ percent in 1987 with marginal acceleration possible in 1988. Exchange rate changes have arrested further widening of trade imbalances between Japan, Germany and the US but no major correction of international imbalances appears likely in the near future.