FOR AGENDA

SM/83/19

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January 24, 1983

To: Members of the Executive Board

From: The Secretary

Subject: New Zealand - Staff Report for the 1982 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with New Zealand.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

Other Distribution:
Department Heads

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INFORMATION

INTERNATIONAL MONETARY FUND

NEW ZEALAND

Staff Report for the 1982 Article IV Consultation

Prepared by the Staff Representatives for the
1982 Consultation with New Zealand

Approved by Brian Rose and Subimal Mookerjee

January 21, 1983

I. Introduction

Article IV consultation discussions with New Zealand were held in Wellington from November 22 to December 3, 1982. The New Zealand representatives included officials of the Treasury, other government departments, and of the Reserve Bank. The staff team consisted of Messrs. Rose, Dell'Anno, Hadjimichael, and Thakur, with Mrs. Pabst, as secretary (all EUR). Mr. Rose also met with the Prime Minister and Minister of Finance, the Rt. Hon. R.D. Muldoon.

Effective August 5, 1982 New Zealand accepted the obligations of Article VIII, sections 2, 3, and 4, of the Fund's Articles of Agreement.

II. Report of the Mission

1. Background

Since the mid-1970s, New Zealand has suffered from low economic growth and historically high and rising unemployment, as well as high rates of inflation and large external current account deficits. Sharp swings in economic activity, stemming from fluctuating terms of trade, have frequently been amplified by abrupt changes in the direction of demand management--changes which have followed rather closely the three-year election cycle. In the aftermath of the deterioration of the terms of trade brought about largely by the increase in oil prices in 1979/80 (fiscal year April-March), the authorities had begun to make some progress in modifying the stance of policies with a view to containing domestic demand and bringing about a shift of resources to the external sector. A more flexible exchange rate policy designed to offset inflation differentials with trading partners and a relatively less accommodating stance of financial policies were the main encouraging features of policy. The beneficial effects of these policies included a healthy growth of export volumes and a decline in the external current account deficit to 3 1/4 per cent of GDP in 1980/81 despite a drop of 10 per cent in the terms of trade. But inflation, at about 15 per cent, remained disturbingly high, partly as a result of impulses from abroad, but also reflecting excessive wage increases.

The stance of policies, however, shifted markedly in an expansionary direction prior to the elections in November 1981. 1/ As a consequence, an exceptionally strong boom ensued in 1981/82, with real domestic demand rising by over 6 per cent. This expansion was, however, sharply out of tune with the external environment facing the economy, and hence could not be sustained for long. This was confirmed by a swift deterioration of the balance of payments--the current account deficit rising to 5 1/2 per cent of GDP--as well as the persistence of inflation at over 15 per cent. The rising trend of unemployment, only temporarily arrested, resumed as economic activity started to slow down by mid-1982.

Increasingly concerned by the high rate of inflation and the growing cost differential with trading partners, the authorities reacted by initially attempting to achieve a consensus on incomes policy with the labor unions in the form of a tax-wage bargain. However, when these efforts failed, they declared in June 1982 a freeze on prices, wages, and other forms of incomes for a period of a year. The freeze was accompanied by a ceiling on all interest rates, and the effective (trade-weighted) exchange rate was fixed for a year at its June 1982 level. In an effort to simulate a voluntary tax-wage trade-off, the authorities also announced a cut in personal income taxes in the budget for 1982/83. The wage-price freeze was viewed as a means to achieve a quick and decisive break in inflationary expectations, and the authorities declared their intention to terminate it in the event of a substantial reduction in inflation.

2. Developments since early 1981

Following a reflationary mini-budget in November 1980, which included a reduction in income taxes and some increase in expenditures, economic activity started to pick up. The upswing in activity gained momentum in 1981/82, being sustained by a rise of 2 per cent in real personal disposable incomes; the fall in real disposable farm incomes of 9 1/2 per cent was more than offset by strong gains in nonfarm, and especially wage, incomes. Other elements of strength were gross fixed investment (up by 17 1/2 per cent) and a turnaround in the stock cycle. The rise of 20 per cent in private fixed investment reflected to some extent construction activity on large energy-based projects, and was especially welcome after a prolonged period of stagnation.

Real GDP is estimated to have increased by 4 1/2 per cent in 1981/82, despite weakening export demand. Even so, the rate of unemployment rose from 4 3/4 per cent to 5 1/2 per cent. If persons employed under special job creation programs, who are treated as unemployed in the official statistics, are excluded, the rate remained at 3 1/2 per cent. The rise in unemployment since mid-1980 reflects demographic changes as well as a slowdown in net emigration. However, inflation remained high amid growing signs of a slowdown in inflation in major trading partners (Table 1 and Chart 1).

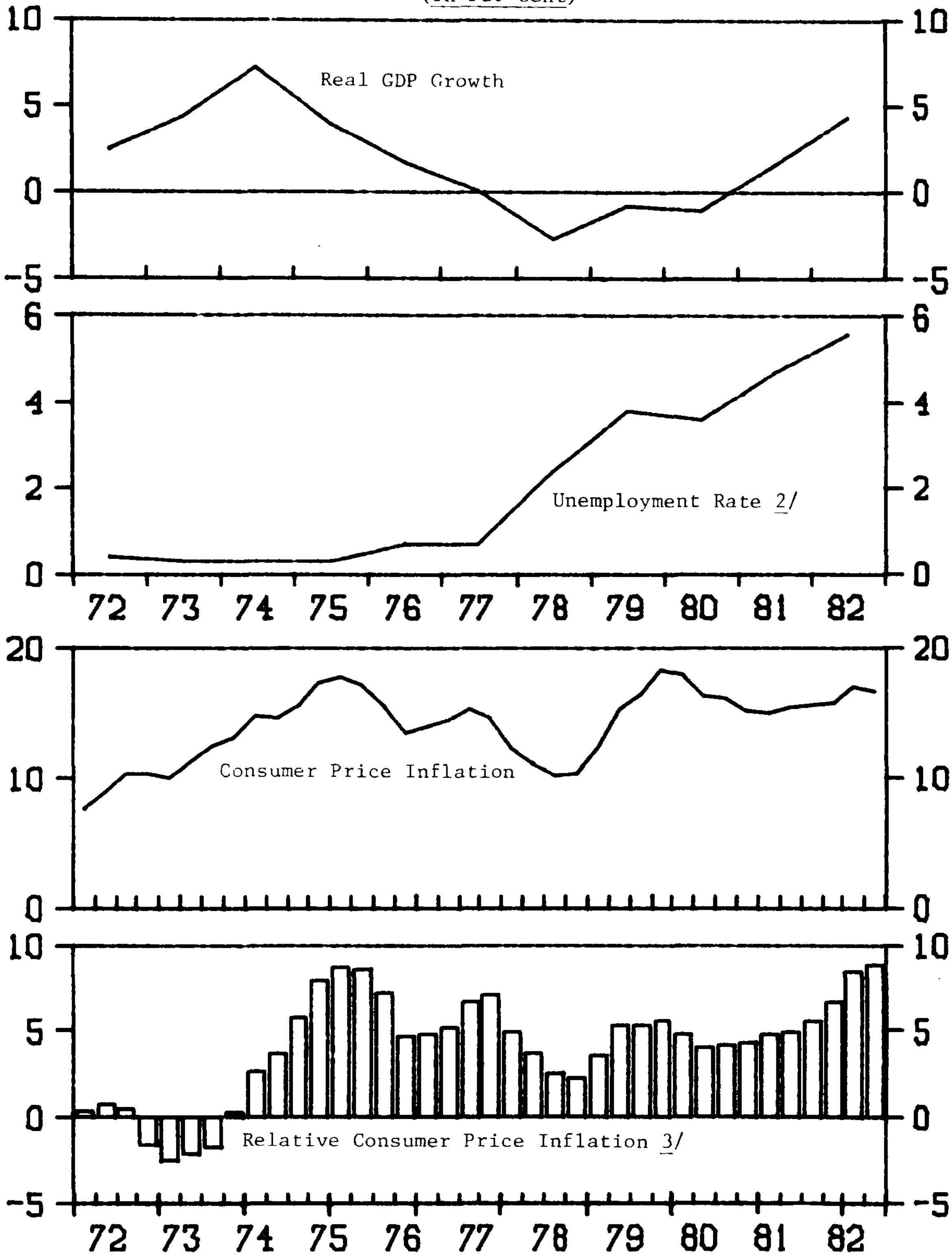
1/ The elections resulted in the National Party's return to power by a very narrow majority.

CHART 1

NEW ZEALAND

DOMESTIC ECONOMIC DEVELOPMENTS 1/

(In Per Cent)



Sources: IMF, International Financial Statistics; and data provided by the New Zealand authorities.

1/ Fiscal years ending in March.

2/ Including persons employed under special job creation schemes.

3/ Year-on-year percentage changes in the index of consumer prices in New Zealand relative to consumer prices in industrial countries.

Economic activity markedly slowed down beginning in the first quarter of 1982/83 as a natural consequence of the unsustainable expansion of the previous year. Although the slowdown did not come as a surprise to the business community, its speed and severity seem greater than expected. Surveys of business opinion suggest that manufacturers are projecting a sharp decline in demand and are planning cutbacks in output and fixed investment during 1983. Reflecting the effects of fiscal drag during the first half of the current fiscal year and the absence, as a result of the wage-price freeze, of the normal pattern of mid-year general wage increases, real disposable incomes are expected to decline significantly in 1982/83, despite the cut in income taxes which became effective October 1, 1982. As a result, private consumption is expected to decline. With a negative contribution from the foreign balance to the growth of output, real GDP is likely to fall by about 2 per cent. The rate of overall unemployment is expected to exceed 6 1/2 per cent by the end of 1982/83. The rate of inflation has slowed down somewhat from the annual rate of 16 per cent recorded in the six months to June 1982, partly under the influence of the wage-price freeze, but also reflecting the slowdown in activity.

The expansion of domestic demand in 1981/82 was supported by an expansionary fiscal stance with the budget allowing for a large rise in public expenditure. Both revenue and expenditure outturns showed faster than budgeted increases, the former reflecting buoyant activity and consumer spending, the latter, in part, increased assistance to farmers (principally producers of wool and sheepmeat) under the Supplementary Minimum Price Scheme. The budget deficit remained at about 6 1/4 per cent of GDP, despite the strong economic expansion and increased fiscal drag (Table 2 and Chart 2). The accommodating stance of monetary policy was reflected in the rates of expansion of credit to the private sector and of M3 of 30 per cent and 16 1/2 per cent, respectively, in the year ending March 1982. Demand for credit was strong throughout 1981/82, credit to the private sector reaching a peak annual growth of 33 per cent in September 1981. Monetary developments since late 1981 have been dominated by the decision in November 1981 to place a ceiling on lending interest rates--a ceiling which was extended in June 1982 to cover deposit rates as well, leading to negative real rates of interest for most categories of deposits. Monetary expansion in recent months has slowed down considerably, reflecting the downturn in activity since March 1982 as well as a sharp increase in the external deficit. In the year ending September 1982, the respective growth rates for private sector credit and M3 were 13 1/2 per cent and 9 1/4 per cent, and they are expected to decline further to 12 per cent and 8 1/2 per cent by March 1983.

The combination of the surge in domestic demand and weakness in export markets led to a sharp deterioration in the balance of payments in 1981/82. The deficit on the current account of the balance of payments almost doubled to $NZ 1.58 billion (SDR 1.13 billion), and although autonomous capital inflows rose sharply to $NZ 0.9 billion, the authorities had to resort to sizable compensatory borrowing. The current account continued to deteriorate sharply in the first half of 1982/83

(April-September), showing a deficit of \$NZ 1.45 billion, compared with \$NZ 0.89 billion in the corresponding period of 1981/82. It is expected to register a deficit of over \$NZ 2.2 billion in 1982/83 as a whole, equivalent to 7 per cent of GDP--the largest deficit in relation to GDP since the aftermath of the first oil shock (Table 3 and Chart 3). The trade account is expected to move into deficit for the first time since 1976/77, and New Zealand's traditional deficit on the invisible account is expected to widen, reflecting, inter alia, increasing debt service payments. Although the slowdown in domestic spending is dampening demand for imports, imports related to the major energy-based projects are expected to increase sharply. The terms of trade are expected to deteriorate by a further 2-3 per cent, amounting to a cumulative decline of over 15 per cent in the three years to March 1983.

In order to finance the rising levels of the current account deficit, the authorities have borrowed substantial amounts abroad in recent years. Net compensatory borrowing in 1981/82 exceeded \$NZ 700 million for the second successive year. Total official debt increased sharply in 1981/82 to reach SDR 4.7 billion (\$NZ 6.78 billion) or about 23 1/2 per cent of GDP. Interest payments on official debt are estimated to have absorbed about 5 1/2 per cent of receipts from exports of goods and services, and the debt service ratio on official debt amounted to 11 1/4 per cent. Gross official reserves rose slightly during 1981/82 to SDR 369 million, equivalent to about three weeks of merchandise imports. At end-November 1982, gross reserves were SDR 460 million, or four and a half weeks of imports.

3. Economic policies

The centerpiece of the authorities' economic strategy since June 1982 has been the decision to impose a comprehensive freeze on wages and prices. The freeze was motivated by a desire to seek a decisive break in the inflationary psychology by taking advantage of the deceleration in inflation that was under way in the main trading partner countries. The authorities explicitly rejected a resort to restrictive financial policies as the main instrument for squeezing inflation out of the system, on the ground that such policies, when tried elsewhere, had led to heavy costs in terms of unemployment and business failures--costs which they regarded as unacceptable. At the same time, they felt that the failure of their genuine efforts over an extended period to reach agreement with unions on a wage-tax trade-off left them no choice except to impose such a trade-off by legislative action.

a. Fiscal policy

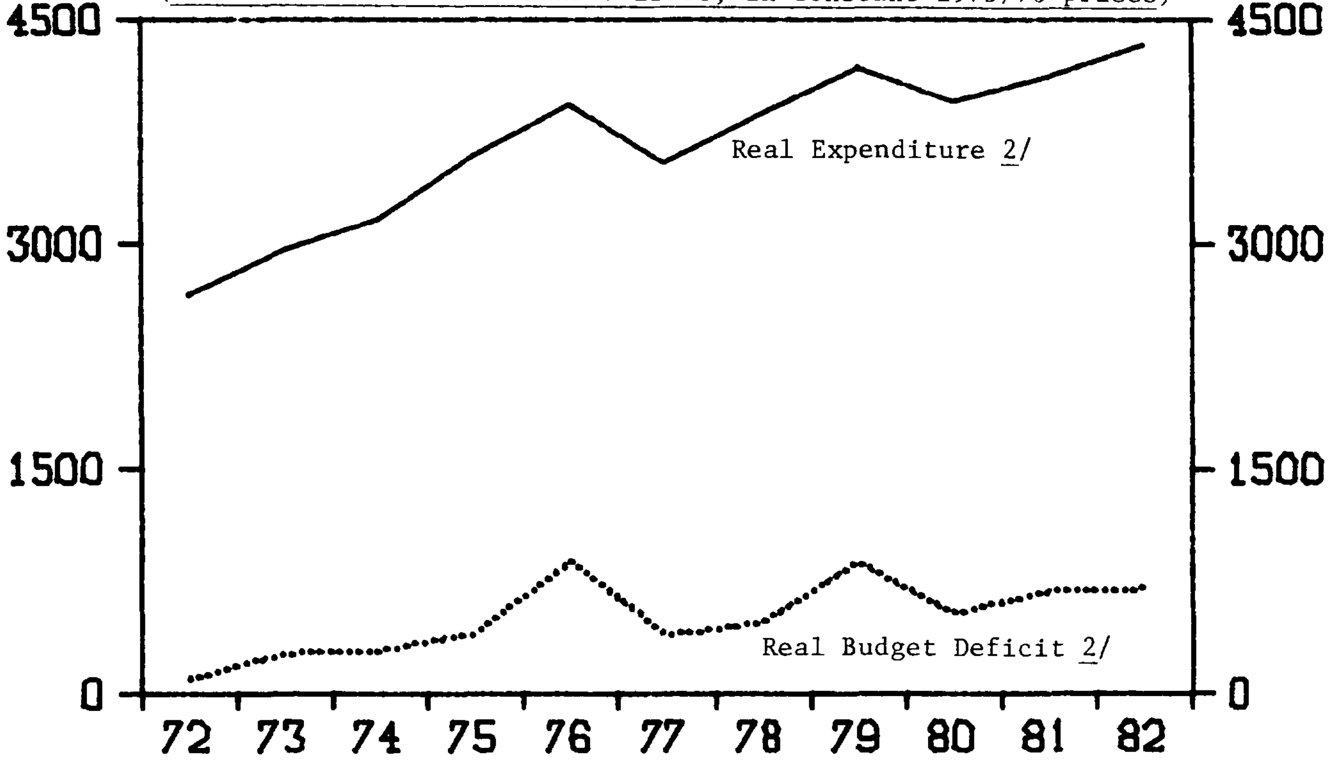
The imposition of the freeze has led to inevitable constraints on the conduct of financial policies. The budget for 1982/83, announced in August 1982, included a cut in income taxes, promised at the time of the announcement of the freeze. A major effort was made to reduce the very high marginal rates of income taxation by reducing the progressivity of the tax scale with a standard marginal rate covering the bulk of taxpayers and taxable income. The marginal rate for about 90 per cent of all

CHART 2

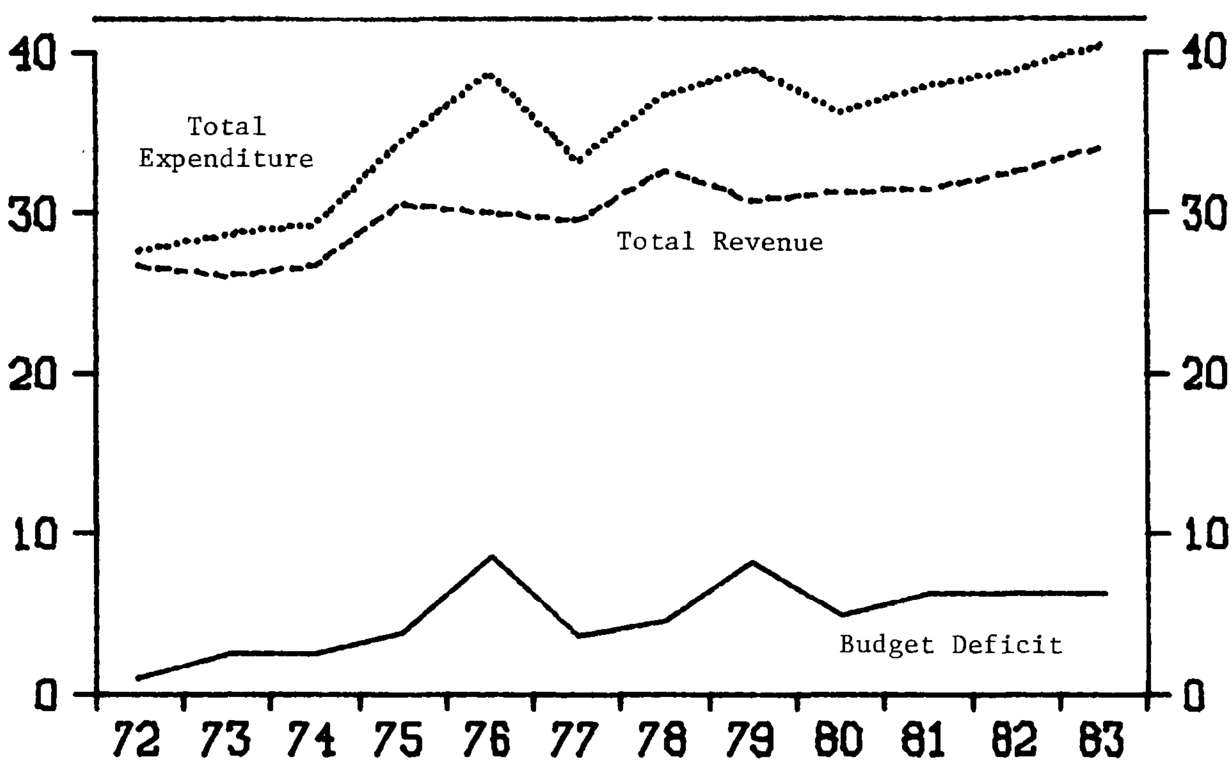
NEW ZEALAND

BUDGETARY DEVELOPMENTS 1/

(In millions of New Zealand dollars; in constant 1975/76 prices)



(Ratios to GDP; in per cent)



Sources: Treasury, Budget; and staff estimates.

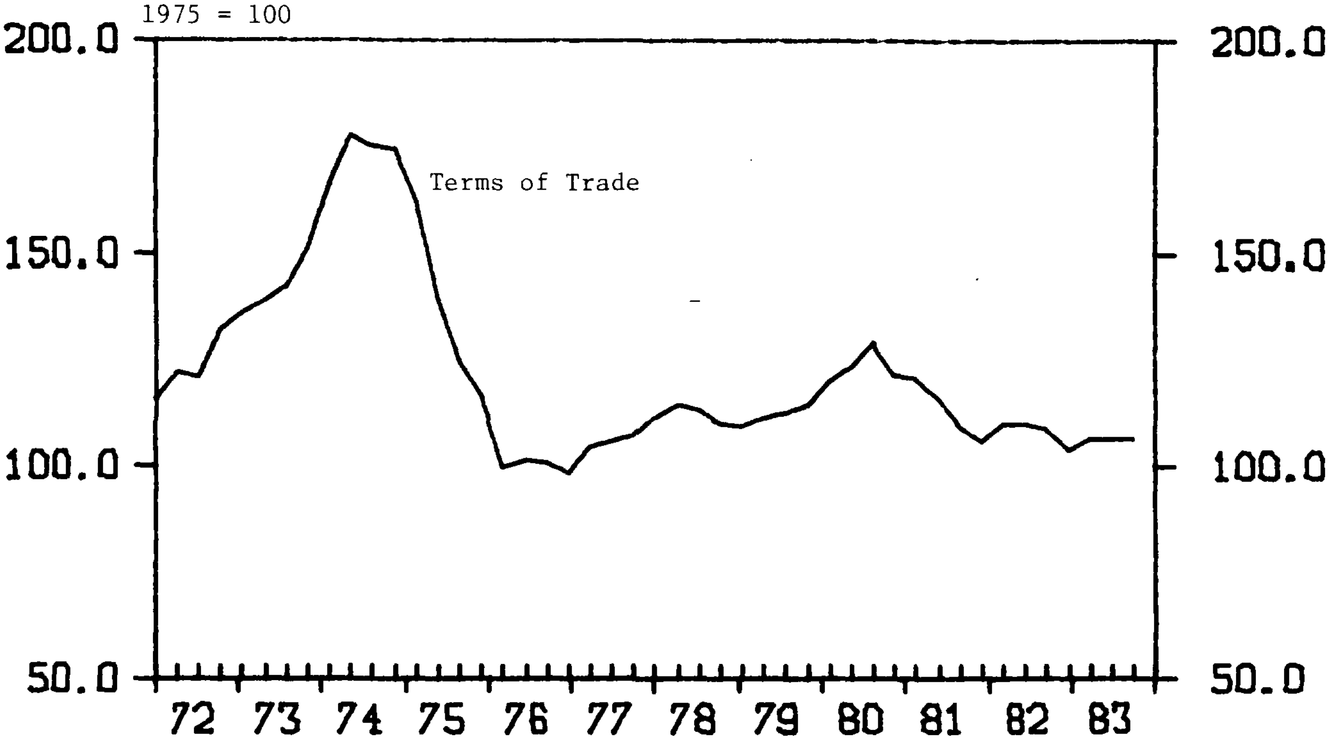
1/ Fiscal years ending in March.

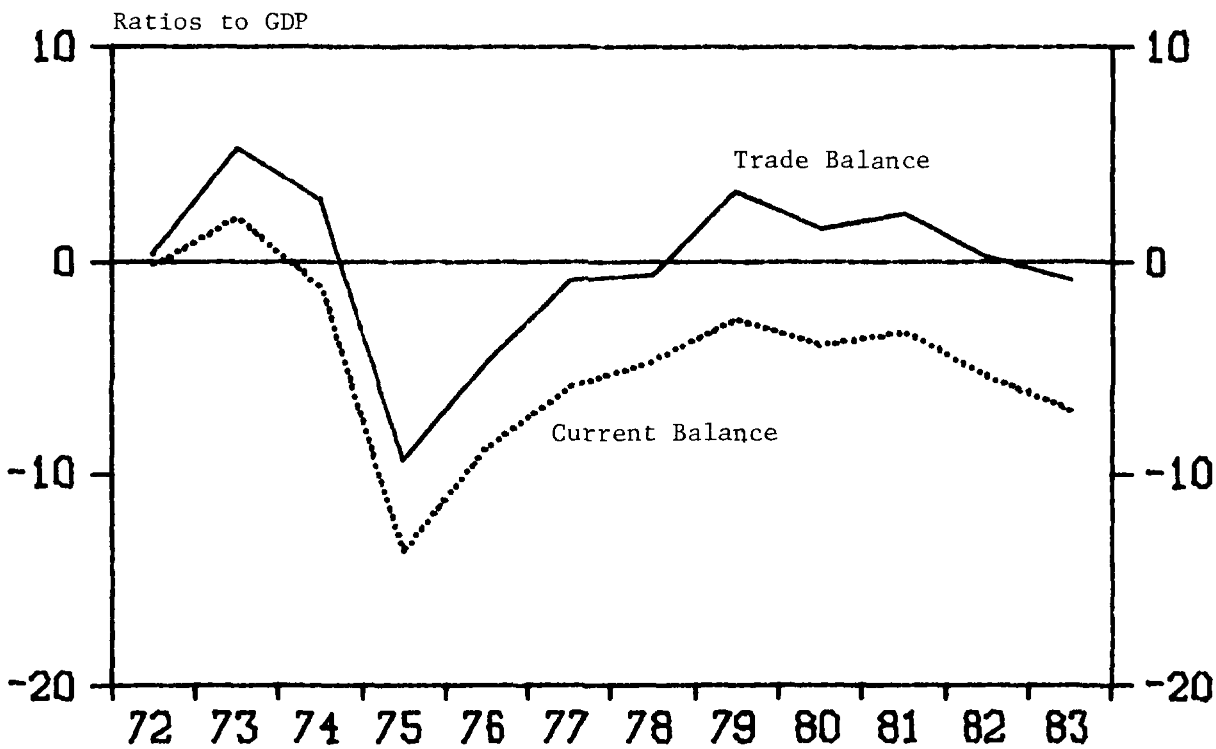
2/ Deflated by the consumer price index.

CHART 3

NEW ZEALAND

TERMS OF TRADE AND THE CURRENT EXTERNAL BALANCE 1/





Sources: Department of Statistics, Monthly Abstract of Statistics; and IMF, International Financial Statistics.

1/ Fiscal years ending in March.

taxpayers is 31 per cent or less under the new tax scale, compared with rates of up to 60 per cent faced by over 60 per cent of all taxpayers under the old scale. The average tax rate is reduced from 30 per cent to about 26 per cent, and the elasticity of personal income tax revenue from 1.55 to 1.3. Although some indirect taxes were raised, no progress toward a more broadly based indirect tax system was made, since it was felt that a major switch to indirect taxation would be inconsistent with the commitment to reduce the rate of increase in prices.

The combined effect of the tax measures was to limit the estimated increase in budgeted revenue to 16 per cent. With expenditures budgeted to rise by 13 per cent, a deficit of about $NZ 1.9 billion (6 per cent of GDP) was projected. Latest estimates are that the outturn is likely to exceed $NZ 2 billion (about 6 1/4 per cent of GDP), partly as a consequence of sluggish revenue growth, reflecting the greater-than-expected speed and severity of the downturn in activity (Table 2). The New Zealand representatives noted that the profile of the fiscal position during the two semesters of 1982/83 reveals a significant shift, with the deficit rising from 5 1/2 per cent of GDP in the first half to an estimated 7 per cent of GDP in the second half of the year. This shift stems principally from the decline in the buoyancy of nominal personal incomes between the two semesters, reinforced by the reduction in the income taxes effective October 1, 1982.

The main concern of the authorities for 1983/84 is to consolidate any gains made on the inflation front during the freeze period. They recognize that the extent to which these gains can be secured in the longer term would depend critically on the credibility of the firmness of financial policies. The New Zealand representatives said that without corrective action, the profile of a widening fiscal gap evident in 1982/83 would extend into 1983/84, with a budget deficit of possibly as high as 8 1/2 per cent of GDP. Such an increase in the budget deficit would place heavy constraints on the ability of monetary policy to contain inflationary pressures when the freeze ends or else result in excessive upward pressure on interest rates. They therefore accepted the necessity of fiscal action. However, at the time of the discussions, they did not think that such action could be justified when the economy was experiencing a sharp cyclical downturn.

The New Zealand representatives felt that, given the difficulty in realizing significant spending cuts in the short term, relatively greater weight would have to be placed on the revenue side. They noted that the tax options were also constrained by the ongoing talks with the labor unions on the postfreeze system of wage determination. Since indirect tax increases were widely perceived to be regressive in their impact, it was thought that unions might perhaps be more amenable to an increase in income taxes.

The staff representatives noted with concern the rising trend of the ratio of government expenditure to GDP. This ratio had increased steadily over the decade to 1981/82 from 28 per cent to about 40 per cent, with expenditure in real terms growing at an average annual rate of 5 per cent, compared with revenue growth of only 3 1/2 per cent. Social welfare expenditures, accounting for 28 per cent of total spending in 1982/83, have doubled in real terms since 1971/72, reflecting a rise in the number of beneficiaries as well as increased real rates of benefits. The New Zealand representatives agreed that the upward trend in expenditures needed to be arrested. They, however, felt that crash programs of spending cuts were not desirable, especially during a recession, since such cuts were difficult to sustain. Over the medium term, the main thrust of the policy to control public spending, in their view, had to be directed at more fundamental reductions in specific programs, rather than across-the-board cuts, if the authorities' goal of reducing the fiscal deficit to 3-4 per cent of GDP was to be achieved.

b. Monetary policy

The authorities' approach to monetary management has undergone an important shift since the last consultation. Between 1976 to early 1981, steps had been taken to increase the flexibility and efficiency of the financial system and to make monetary policy more reliant on market-oriented instruments and less on direct controls. The cornerstone of this approach was the thrust toward a more flexible interest rate policy through a progressive removal of controls. This policy was supplemented by an increased reliance on borrowing from the nonbank private sector at competitive rates to finance the budget deficit. Beginning in early 1981, the Government shifted the emphasis of monetary policy toward avoiding increases in interest rates. The controls on interest rates currently in place are more comprehensive in their scope than those attempted in the past. The New Zealand representatives pointed out that, although interest rate controls had an earlier and separate genesis, they had become caught up in the wage-price freeze and were now widely viewed as an integral part of the freeze.

In view of the concern over the level of interest rates, active use of monetary policy instruments has been severely constrained over the last year and a half. Although inflation-adjusted saving bonds and premium government stock with a higher return than that carried by ordinary government stock proved attractive to the nonbank public in 1981/82, their sales have weakened in recent months. The absence of a competitive government stock without restrictions as to eligibility and amounts has limited the development of active markets for new issues or secondary sales of public debt. The proportion of the budget deficit financed by sales of debt to the nonbank public, after rising in 1981/82, is expected to decline markedly in 1982/83. Moreover, a sizable amount of the sales are to "captive" buyers, viz., financial institutions which are compelled to hold a proportion of their assets in the form of government securities. The New Zealand representatives agreed that development of competitive debt instruments was urgently needed, especially in view of the growing size of the budget deficit. The staff representatives stressed that a prolonged period of interest rate controls was bound to create increasing distortions in the financial markets. Disintermediation out of the banking system was bound to increase over time, undermining the progress made since 1976 in fostering the dynamism and efficiency of the financial system.

c. Wage-price policies

The wage determination system in New Zealand reflects the interplay between market forces and strict horizontal relativities in the wage structure, involving linkages within the private sector as well as between the private and public sectors. The general wage increases have been augmented by increases negotiated by individual unions in different industries. Public sector wages are governed by annual general adjustments aimed at catching up with wage increases in the private sector, under the principle of "fair relativity with the private sector." In recent years, wage determination arrangements have changed repeatedly, reflecting the authorities' efforts to moderate wage increases in the face of these strong linkages. The Government has intervened in the wage determination process selectively, in order to reduce trend-setting awards as well as generally, through the General Wage Orders. In April 1980 the authorities had initiated talks with the social partners with a view to improve the wage determination system. In 1981 the focus of these talks shifted to the government proposal for a tax-wage trade-off. The deadlock in the talks led to the imposition of the wage-price freeze, which, under the circumstances, was viewed as the most equitable way of implementing the anti-inflationary program.

The freeze is expected to result in a decline in real disposable incomes in 1982/83. Nonetheless, with the downturn in the economy and high and rising unemployment, overt resistance to the freeze seems to have remained limited so far. The main concern is the danger of a scramble for catch-up increases in wages in the wake of the termination of the freeze, if inflationary expectations are not dampened sufficiently. The authorities are expected shortly to begin talks with the trade unions and employers' federation on the postfreeze wage determination system. The private sector wage round in 1983/84 is expected to be influenced by the uneven impact of the income tax cuts on different labor groups and the possible spillover effect of higher wages for skilled workers on the major projects. The New Zealand representatives emphasized that a return to free collective bargaining was not considered an option, since the authorities believed that it would lead to large and potentially crippling wage increases.

The persistent difficulties in the wage determination area are highlighted by the fact that over the decade of the 1970s, the growth of real wages has exceeded the amount warranted by changes in productivity and terms of trade. When the terms of trade rose steadily, wage earners shared fully in the income gains; however, when the terms of trade fell sharply in the 1970s, real wages were maintained. The resulting sizable "real wage overhang" (by some estimates, amounting to over 12 per cent over the decade to 1980/81) has meant that the share of wages in national output has increased, squeezing private sector profits. The difficulty of preventing excessive wage increases is exacerbated by rigid horizontal relativities in the wage structure. The New Zealand representatives said that there was widespread agreement on the need to break down these rigidities, but this was difficult in a small, relatively homogeneous country, and perhaps a certain rigidity in relativities would be a price that had to be paid if a consensus on wage determination could be achieved.

The price freeze covers about 80 per cent of the goods and services entering the consumer price index. However, its impact is limited by provisions allowing for the passing on of increases in import prices, government charges, and indirect taxes. The initial extent of the slowdown in the rate of inflation is also limited by the six-month lag between changes in import prices and in housing costs and their reflection in the consumer price index. The authorities intend to continue to exercise surveillance over prices even after the freeze is lifted, although a return to a system of extensive controls on prices prevailing some years ago is not considered likely.

c. External policies

(1) External adjustment

The New Zealand representatives acknowledged that New Zealand faced a significant problem of external adjustment. The current external deficit, which had declined from its peak of almost 14 per cent of GDP in 1974/75 to under 3 per cent of GDP in 1978/79, has risen substantially since then to an estimated 7 per cent in 1982/83. Over the decade of the 1970s, New Zealand's long-term average terms of trade are estimated to have declined by between 20 and 30 per cent. The persistence of sizable current account deficits in a period of rising unemployment suggests that the economy's adjustment to this trend decline in the terms of trade has remained incomplete. Based on past experience, a current account deficit of 2-3 per cent of GDP was thought to be sustainable in the sense of being easily financeable by autonomous capital inflows. However, in view of the dim prospects for a rapid world recovery and the impact of the major energy projects on imports, a somewhat higher level of deficit was considered acceptable over the next few years. The New Zealand representatives agreed that successful external adjustment required firm financial policies, including in particular a reduction in the rate of growth of government spending, and the fostering of a competitive environment in order to facilitate a transfer of resources to the external sector.

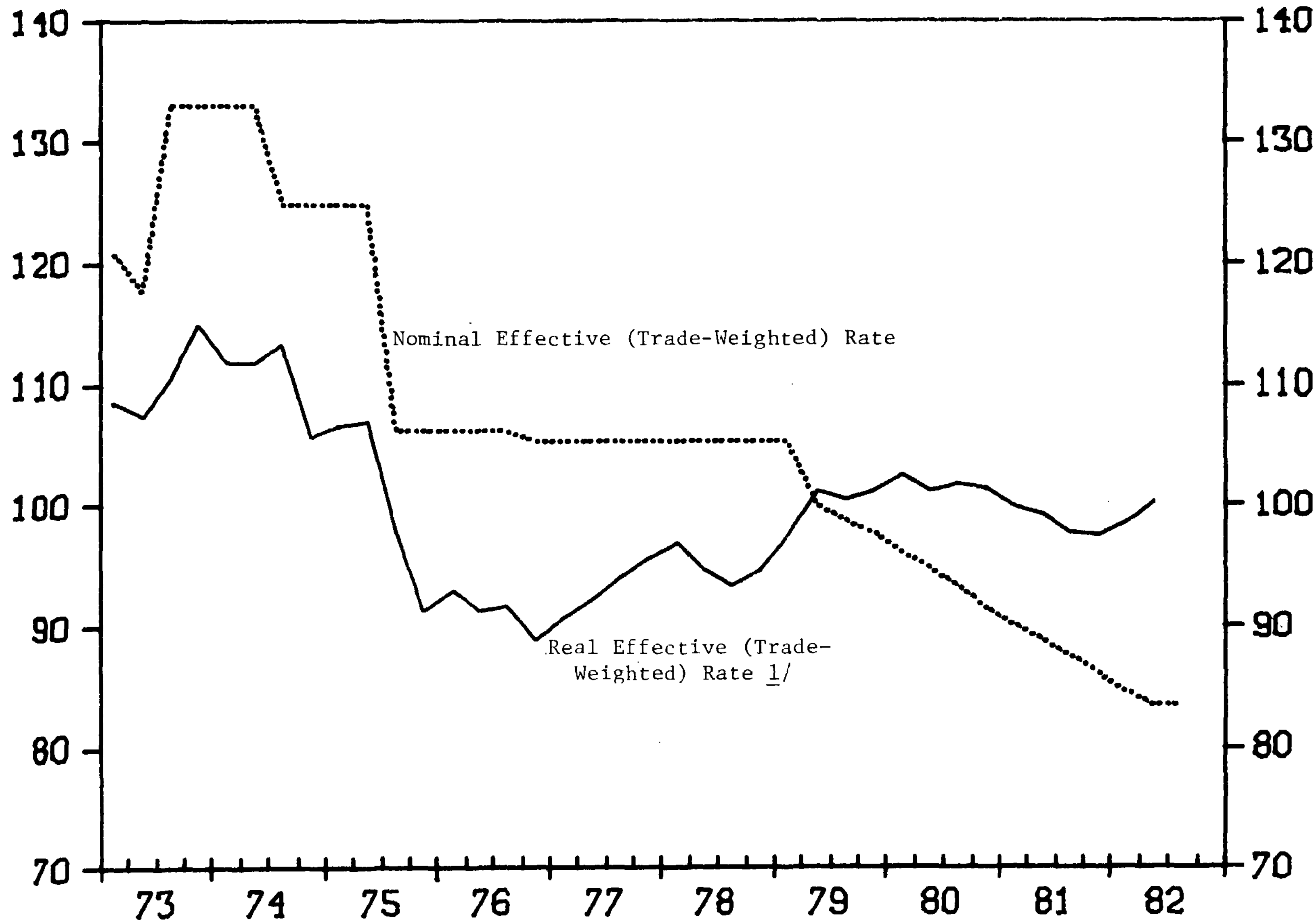
For a period of three years to June 1982, New Zealand's exchange rate was governed by flexible arrangements under which the peg to a basket of currencies of the main trading partners was changed frequently in small steps, mainly on the basis of divergence in relative costs and prices. Under this system, the New Zealand dollar depreciated at an annual average rate of 6 per cent, broadly offsetting the relative inflation differentials. Subsequently, the nominal effective exchange rate has been frozen at its end-June 1982 level (i.e., 83.4 on an index scale with June 1979 = 100) as an adjunct to the freeze (Chart 4). The authorities initially hoped that during the period of the freeze, the relative inflation differential of about 8 per cent prevailing around mid-1982 would decline. However, the New Zealand representatives acknowledged that, given the rapid and substantial decline in the inflation rate in

CHART 4

NEW ZEALAND

NOMINAL AND REAL EFFECTIVE EXCHANGE RATES

(1979 = 100)



Source: Reserve Bank, *Bulletin* and staff calculations.

1/ Relative consumer prices adjusted for effective exchange rate movements.

the major trading partners, it was not realistic to expect the differential to decline significantly over the period of the freeze. They noted that the benefits of downward flexibility in the exchange rate were now more widely appreciated in the community in view of the adverse impact of the exchange rate freeze on exporters' profit margins. They stated that, although no decisions had been made in this respect, the expectation was for a resumption of the policy of gradual adjustment of the exchange rate.

Official external debt has increased sharply since 1974, as substantial current account deficits were financed partly by official borrowing. Following a period during 1978-81, when the debt/GDP ratio stabilized, the oil price increase of 1979/80 and the world recession combined with a domestic boom in 1981/82 to boost the level of the current account deficit and of official borrowing, resulting in a sharp rise in the ratio of official debt ($NZ 6.8 billion) to GDP in the year ended March 1982 to 23 1/2 per cent of GDP. The debt/GDP ratio is expected to rise during the next year or two from its level at the end of 1981/82, and the ratio of interest payments to exports of goods and services is also projected to rise to about 7 1/2 per cent in the year to March 1983 and to 7 3/4 per cent in 1983/84. The debt service ratio in 1983/84 is expected to be about 12 1/2 per cent, assuming that certain drawings on banking lines of credit can be rolled over. Despite the current constrained international financial situation, the New Zealand representatives did not anticipate any difficulty in meeting their borrowing needs, although the terms of borrowing could harden, if lenders developed doubts about the determination with which adjustment efforts were being pursued. The authorities were aware that continuation of heavy official borrowing would eventually increase the costs of external adjustment.

(2) Trade policies

The import licensing system, covering 22 per cent of total imports in 1981/82, continues to be operated in a flexible manner. The system of tendering for allocation of licenses initiated in 1980 has been extended to include a wider range of goods. Imports under tendering in 1982/83 are estimated at about $NZ 50 million (3 per cent of licensed imports). Tendering has helped put pressure on producers and importers to increase efficiency and its extension would facilitate the process of liberalization of licensing and a switch to tariffs. The New Zealand representatives agreed that progress in extending the scope of tendering had not been as speedy as initially intended. The Government had declared its desire to move from import licensing to lower and more uniform tariffs and had initiated a series of industry studies aimed at reviewing the levels of protection. Under a recent decision, licensing for the plastics industry is to be phased out over six years. Industry studies under which decisions are still to be taken include those for footwear, electronics, and motor vehicles.

New Zealand continues to operate an extensive system of export supports, the primary justification for which is the need to compensate exporters for the high costs they face as a result of the protection accorded to domestic industry. The so-called performance-based export incentives are estimated to be equivalent to 9-10 per cent of the relevant f.o.b. export value and to about 25 per cent of the pre-tax value added of qualifying exports. New Zealand became a signatory to the GATT Code on Subsidies and Countervailing Duties in September 1981 and in doing so undertook to bring its export incentives into conformity with the Code within a reasonable period. The Government is currently reviewing the export incentive measures with a view to ensure that the bias against the export sector does not increase as a result of any new international commitments.

The agreement on Closer Economic Relations (CER) with Australia, which became effective on January 1, 1983, is expected to have a significant impact on New Zealand's system of protection and export incentives. The CER arrangement is a comprehensive free-trade agreement with provisions designed to eliminate progressively tariff and nontariff barriers to trade between New Zealand and Australia. Under the agreement, New Zealand has undertaken to phase out by March 1987 tariffs on imports from Australia and its performance-based export incentives on products traded between the two countries and to eliminate import quotas on Trans-Tasman trade by 1995. The agreement is to be implemented in an outward-oriented spirit, with a view to avoid possible trade-diversion effects. The authorities hope that the agreement, over time, would make a major contribution to the process of liberalization of New Zealand's protective system and to improving the competitive climate in the economy.

New Zealand's agricultural exports continue to face a number of restrictions in major export markets. 1/ In view of the seeming intractability of the problem, medium-term policies have been directed at diversification of products and markets. While these policies had met with considerable success, the viability of New Zealand's main meat and dairy industries continues to hinge on markets of the major developed countries. The New Zealand representatives noted that the nontariff barriers faced by their farm exports had been on the increase and were preventing the country from fully exploiting its comparative advantage. They believed that access to stable export markets would give considerable impetus to a gradual shift from an inward- to an outward-looking development strategy that was already under way in New Zealand.

(3) Foreign aid

Official development assistance (ODA), all of which is in grant form, amounted to $NZ 63 million (0.22 per cent of GDP) in 1981/82, an increase of about 10 per cent over 1980/81. The 1982/83 budget sets aside $NZ 65 million for aid, representing a decline in terms of GDP. New Zealand's assistance is concentrated in countries of the Pacific region.

1/ For a detailed description, see Appendix of the recent economic developments paper which is to be issued shortly.

4. The outlook for 1983/84

The downturn in economic activity now under way is expected to extend well into 1983. However, the depth of the downturn will depend upon a number of factors, including the impact of the decline in household real disposable incomes on consumption and the timing and strength of any upturn in the major trading partners. A recovery in the major economies, even if it were to begin by mid-1983, would not to be reflected in an improvement in New Zealand's terms of trade and demand for its exports until early 1984. Any forecast going beyond the middle of 1983 must take a view of wage developments beyond the freeze--including the danger of a "catch-up" and of the tightness of the financial policies that will be in place. On the whole, the New Zealand representatives expected a fall in private consumption and further destocking in 1983/84, but an increase in investment related to the major projects. Domestic demand is expected to decline moderately and GDP to remain virtually stagnant. Assuming that financial policies will be tight enough to prevent an immediate catch-up of wages and prices after the termination of the freeze, the New Zealand authorities believe that the rate of inflation might decline to a level well below that recorded in 1981/82.

The trade balance is expected to improve in 1983/84 as a result of a reduction in import volumes, despite the increased imports related to the major projects. However, the improvement in the trade balance is projected to be more than offset by a deterioration in the deficit on investment income, caused mainly by increasing debt servicing relating to the major projects and other government borrowing. The current account of the balance of payments is projected to increase to about $NZ 2.4 billion, but to decline slightly as a proportion of GDP to 6 3/4 per cent.

5. Medium-term outlook and issues

New Zealand faces a significant problem of structural adjustment over the medium term. Assuming a transition from the wage-price freeze to more market-oriented policies for resource allocation, the principal medium-term structural changes which the authorities would like to pursue are: a shift of resources from the nontradable, including the public, sector to the tradables sector; liberalization of the system of import protection; development of export-oriented resource-based industries; and promotion of competition in the transport, distribution, and financial sectors. A major medium-term objective in the public finance area is the reform of the taxation system.

New Zealand remains one of the most highly protected of the developed economies. The system of protection of import-competing manufacturing is characterized by the use of import quotas as the main protective instrument and by a vertically escalating tariff structure leading to extremely uneven rates of effective protection. The authorities acknowledge the heavy costs of the protectionist regime and their medium-term objective is to bring about a substantial import liberalization. They, however, regard a major effort to reduce rapidly the level of protection as impractical and have, therefore, adopted a gradual approach. The New Zealand representatives acknowledged that the industry studies program was rather slow and piecemeal; however, they believed that it was effective *effective in developing a consensus in the community regarding the* desirability of reducing protection and in moderating the transitional costs of industrial restructuring.

The system of protection has played a critical role in raising the domestic cost structure and creating a strong bias against the export sector, thereby generating pressures for support to export industries. A faster dismantling of the protection system would make a major contribution to improving efficiency and reducing inflation. The New Zealand representatives, while agreeing with this assessment, emphasized the extreme difficulty of developing a popular consensus on this issue in a situation of rising unemployment and a climate of worldwide protectionism. *Although the high premiums on licenses revealed by the tendering system* had raised the community's awareness of the levels of rent implicit in the licensing system and its effects on the distribution of income, the interest groups opposed to tendering remained powerful. The New Zealand representatives expressed confidence that the CER agreement with Australia would assist the restructuring efforts, especially because it had the advantage of containing an automatic and predictable process of import liberalization.

A potentially significant contribution to the restructuring efforts is expected from the major energy-based projects. The projects, by exploiting the country's considerable energy resources including large reserves of natural gas, are expected to reduce dependence on imported oil. The economic benefits of several of the major projects--especially of the synthetic gasoline plant--are directly tied to the world price of oil. While concerned about the recent decline in the real price of oil, the Government believed that the long-term economic viability of the major projects was assured, although some changes--such as the recently announced postponement of the second aluminum smelter--would need to be made in the original plans.

Latest estimates suggest that by 1986/87, the major projects would begin to make a positive contribution to the balance of payments and this contribution would rise to an annual rate of over $NZ 800 million (in 1982 prices) by the end of the decade. However, in the next few years, the projects will lead to sizable imports and they also involve indirect costs in terms of pressures on domestic resources, especially those of skilled labor, and in terms of the spillover effect of high wages for skilled workers on the domestic wage structure. In the absence of a reform of the protection system, there is also considerable risk that such adverse effects would be borne heavily by sectors exposed to foreign competition and therefore unable to pass on the cost increases.

A major medium-term issue in the fiscal field is that of tax reform. The Commission on Tax Reform has suggested the introduction of either a value-added tax or a more broadly based sales tax. Past experience suggests that an ad-hoc approach to tax reform has not been successful in addressing the main problem of an inadequate revenue base in relation to the size of public spending. The desired relative shift from direct to indirect taxes has also failed to occur. It is now widely recognized in New Zealand that real progress in this area can be achieved only by an overhaul of the tax system and by measures to broaden the tax base. It is also recognized that, if taxation is to be reduced in order to encourage initiative and ease the problems of tax avoidance and evasion as well as those of wage-push pressures, it is imperative to slow the rise in public spending.

III. Staff Appraisal

New Zealand's economic situation has worsened in some significant respects since the last consultation and, in response, the authorities have made major changes in their economic strategy. The current economic difficulties can be traced to a sharp expansionary shift in the direction of financial policies in 1981. As a result, a strong economic expansion took place in 1981/82 with domestic demand increasing by over 6 per cent. However, this expansion could not be sustained, especially since it was sharply out of tune with the external environment facing New Zealand. The current account deficit rose to 5 1/2 per cent of GDP, and inflation remained at 16 per cent, with wages and other money incomes rising at an excessively fast pace. During 1982/83, economic activity has slowed markedly, with a resumption of the rising trend of unemployment.

The authorities' initial reaction to the economic deterioration was to attempt to arrive at a consensus with the social partners in the form of a tax-wage trade-off. When these efforts failed, they imposed a freeze on prices and wages for one year and also froze all interest rates and the effective (trade-weighted) exchange rate. The authorities view the wage-price freeze as a means to break the entrenched inflationary expectations. Although defensible as a temporary expedient which can provide some breathing space to develop a more durable set of anti-inflationary policies, the efficacy of wage-price controls is open to serious doubt. They entail considerable costs in terms of distortions of markets and misallocation of resources and severely constrain the use of conventional tools of economic management. Public acceptance of the controls is also likely to decline over time, the longer they remain in effect.

Under the influence of the freeze and also of the slowdown in activity, the rate of increase in prices has begun to decline, and the authorities hope that by mid-1983 it will fall to a high single digit. There is, however, a clear danger that inflationary pressures will re-emerge after the end of the freeze, especially if the stance of financial policy is not sufficiently tight. In this respect, the decision to control interest rates as part of the freeze was especially unfortunate since it has impeded the authorities' ability to operate monetary policy. With negative real rates of interest for most categories of lending and deposits, financial savings are being discouraged, and it seems almost ironic that interest rates are being held down when the need for noninflationary financing of the budget deficit is becoming ever more urgent.

An early termination of interest rate controls would not only ease the task of monetary management, but would also make it possible to resume and carry forward the considerable progress made up to 1980 in liberalizing the financial system.

In the absence of corrective action, the fiscal deficit threatens to rise in 1983/84 to 8 1/2 per cent of GDP from its expected level of 6 1/4 per cent of GDP in the current year. The authorities should give high priority to the goal of reducing the budget deficit in order to ease pressures on monetary policy. In view of the steep rise in government expenditure over the past decade, the need to contain its growth has assumed increasing urgency. Given their large size and rapid expansion, measures to slow the growth of social expenditures may well need to be considered along with steps to contain the growth of the public sector wage bill. However, expenditure restraint may turn out to be inadequate in the short run, and the authorities, therefore, need to address the issue of tax reform without undue delay. The suggestion of the Commission on Tax Reform to introduce a value-added tax or a more broadly based sales tax deserves early consideration. Over the longer run, it is essential to raise the community's awareness of the conflict between the goal of reducing the tax burden and that of safeguarding long-standing social preferences for income equity and high levels of welfare.

If adequate financial policies are put in place, the chances of securing some more durable arrangements for the determination of incomes should be greatly improved. It would, however, be a matter of concern if a dialogue with the social partners comes to be regarded as promising an incomes policy which, by itself, would promise wage and price stability. It is to be hoped that all parties will strive to break down the rigidities in the system of income determination. There is no area in New Zealand where a more market-oriented approach would contribute more to greater efficiency and indeed greater employment.

New Zealand faces a significant problem of external adjustment, with the deficit on the current account of the balance of payments expected to increase further in 1982/83 to 7 per cent of GDP. Admittedly, external adversities such as stagnant world demand, problems of access to export markets, and a decline in the terms of trade, have played an important part in this deterioration. However, domestic macroeconomic policy has not been sufficiently supportive of the required external adjustment. Even if some wage restraint is achieved during the freeze period, there is a clear possibility, given the rapid deceleration in costs in the major countries, that the competitive gap between New Zealand and its main trading partners would remain wide and would need to be corrected. It is desirable to return as soon as possible to an exchange rate system which is sufficiently flexible to permit the correction of any deterioration in relative costs. There remains the question of whether an improvement in competitiveness is needed to facilitate external adjustment. In this respect, the existence of large current account deficits in a period of rising unemployment and the sizable worsening of the terms of trade of the recent past are significant pointers. An adjustment in cost competitiveness would also be necessary if progress toward a more liberal import regime and reduced reliance on export incentives is to be possible.

The need for external adjustment is also underscored by the size of the official debt, which has risen in relation to GDP through most of the period since 1973/74. While foreign borrowing to finance economic projects is justified, it is clear that official compensatory and other borrowing has increased rapidly in the last few years. New Zealand continues to enjoy high credit rating in international financial markets. Nevertheless, the authorities should be watchful of the evolution of the foreign debt, given the increase in the servicing burden of the debt.

A relatively speedy removal of the system of import restrictions would make a major contribution to the structural adjustment of the New Zealand economy. Indeed, it can be argued that a reduction of protection is fundamental to raising the efficiency of the economy and enhancing the effectiveness of other instruments of macroeconomic policy. While major progress in this area is difficult in a period of high unemployment, the adverse economic conditions might perhaps serve to focus the community's attention on the urgency and potential benefits of accelerating the program of structural adjustment. As an interim step, the system of tendering of import licenses should be extended from its present small basis to cover a far larger number of imported goods. It is to be hoped that over the medium term the agreement on Closer Economic Relations with Australia will provide an opportunity to accelerate the process of removal of protection.

Table 1. New Zealand: Domestic Developments and Forecasts

	1981/82	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84
	In millions of NZ dollars; current prices	Percentage changes from previous year; in constant 1976/77 prices				Preliminary official forecast	
Demand and output							
Final consumption	22,233	...	1.1	1.4	1.6	-1.5	-1.6
Private	17,203	1.2	1.4	1.6	2.1	-1.7	-2.0
Public	5,030	...	...	...	-0.5	-0.4	0.1
Gross fixed investment	5,929	...	...	...	17.5	2.9	3.6
Private	4,004	-7.7	2.1	1.8	20.1	-2.1	-2.6
Public	1,925	(2.1) 1/	(-7.6) 1/	(-3.1) 1/	12.4	13.6	15.0
Changes in stocks 2/3/	1,559	-2.2	3.7	-2.2	1.4	-0.6	-1.4
Total domestic demand	29,702	-1.9	2.9	-1.6	6.1	-1.1	-1.7
Exports of goods and services	8,212	3.4	2.8	2.8	4.5	3.9	1.8
Imports of goods and services	-9,101	-0.6	15.8	-6.6	9.7	5.9	-2.4
External balance 3/	-889	1.1	-3.9	3.2	-1.8	-0.8	1.5
Gross domestic product	28,832	-0.8	-1.0	1.6	4.4	-1.9	-0.3
Prices and incomes							
GDP deflator		12.3	18.4	15.2	14.5	12.8	9.2
Consumer prices							
Year-on-year		12.4	17.9	15.1	15.8	14.0	11.9
Through-the-year		10.9	15.7	16.4	15.5	15.7	11.1
Compensation of employees 4/	16,202	5.6	1.0	2.5	4.4	-4.8	-3.7
Farm operating surplus 5/	1,657	23.0	17.6	-24.9	-13.1	...	...
Unemployment rate (per cent of labor force) 6/		3.8	3.6	4.7	5.5	6.8	7.9

Sources: Data provided by the New Zealand authorities; and staff estimates.

1/ Total public expenditure (consumption and investment).
2/ Including statistical discrepancy.
3/ Changes expressed as a percentage of GDP in the previous year.
4/ Deflated by the consumer price index.
5/ Deflated by the farming cost price index.
6/ Including persons employed under special job-creation schemes.

Table 2. New Zealand: Fiscal and Monetary Developments

(In millions of New Zealand dollars)

Years ending March	1978/79	1979/80	1980/81	1981/82	1982/83 1/
1. Government expenditure	6,848	7,587	9,134	11,197	12,766
(Percentage change)	(20.8)	(10.8)	(20.4)	(22.6)	(14.0)
2. Government revenue	5,403	6,560	7,609	9,378	10,766
(Percentage change)	(8.6)	(21.4)	(16.0)	(23.2)	(14.8)
3. Budget deficit	1,445	1,027	1,525	1,818	2,000
(In per cent of GDP)	(8.2)	(4.9)	(6.3)	(6.3)	(6.3)
4. Borrowing from non-bank private sector	489	473	460	944	610
5. Monetary financing of deficit					
a. Overseas borrowing	444	328	754	401	1,350
b. Bank credit to Government	512	226	311	473	40
6. Reserve Bank credit to marketing and stabilization authorities	105	-7	71	105	215
7. Bank credit to private sector	1,087	1,171	1,350	2,386	905
(Percentage change)	(25.0)	(21.5)	(15.7)	(30.0)	(8.7)
8. Domestic credit expansion (5b + 6 + 7)	1,704	1,390	1,732	2,964	1,160
(Percentage change)	(21.0)	(14.1)	(15.5)	(22.9)	(7.3)
9. Change in foreign assets	28	-26	140	-796	...
10. Change in other items (net)	-17	107	-336	-103	...
11. Change in M3 (8 + 9 +10)	1,715	1,471	1,536	2,065	1,245
(Percentage change)	(22.5)	(15.8)	(14.2)	(16.7)	(8.6)

Sources: Reserve Bank of New Zealand, Bulletin; and data provided by the New Zealand authorities.

1/ Official projections.

Table 3. New Zealand: External Developments and Forecasts

	1979/80	1980/81	1981/82	1982/83 1/	1983/84 1/
	(In millions of New Zealand dollars)				
Balance of payments					
Exports, f.o.b.	4,885	5,692	6,591	7,313	-7,853
Imports, f.o.b.	-4,568	-5,127	-6,546	-7,600	-7,980
Trade balance	318	565	45	-287	-127
Invisibles and transfers (net)	-1,149	-1,361	-1,626	-1,944	-2,253
Current account balance	-832	-795	-1,583	-2,231	-2,380
Autonomous capital balance 2/	472	74	916	...	...
Balance for official financing	-360	-721	-665	...	...
Compensatory borrowing	322	709	728	...	...
Change in reserves (increase -)	38	12	-65	...	...
Other external indicators					
Current balance					
In millions of SDRs	-635	-595	-1,129	-1,506 3/	...
In per cent of GDP	4.0	3.3	5.5	7.0	6.8
Balance for official financing					
In millions of SDRs	-275	-540	-474	...	...
In per cent of GDP	1.7	3.0	2.3	...	...
Official reserves (in millions of of SDRs)	379	339	369	460 4/	...
	(Annual percentage changes)				
Merchandise exports					
Volume	...	5.0	3.6	4.4	1.6
Price	25.9	11.0	12.0	7.0	6.5
Merchandise imports					
Volume	17.5	-10.5	9.5	6.0	-2.4
Price	34.0	23.0	14.3	9.5	9.5
Terms of trade	-5.8	-10.0	-2.0	-2.3	-2.7
Effective exchange rate	-8.4	-6.3	-6.2	...	...
Memorandum item:					
SDR per New Zealand dollar	.7633	.7490	.7134	.675 5/	...

Sources: Department of Statistics, Monthly Abstract of Statistics; IMF, International Financial Statistics; and data provided by the New Zealand authorities.

1/ Official forecasts.
2/ Including net errors and omissions.
3/ Using average exchange rate for the period April-September.
4/ End-November 1982.
5/ Average for April-September 1982.

Fund Relations with New Zealand 1/

Status	Article VIII.
Quota	SDR 348 million.
Fund holdings of New Zealand dollars	SDR 353.8 million, or 101.7 per cent of quota.
SDR position	SDR 1.7 million, equivalent to 1.2 per cent of net cumulative allocation.
Purchases outstanding	SDR 5.8 million in respect of drawings under the oil facility.
Exchange system	From June 1979 to June 1982, the effective exchange rate of the New Zealand dollar was subject to small and frequent adjustments, mainly on the basis of the costs and prices in New Zealand relative to those in its main trading partners. In June 1982 the effective exchange rate was frozen at its end-June 1982 level of 83.4 on an index scale with June 1978 = 100.
Last consultation	The Staff Report for the 1980 Article IV consultation (SM/81/12, 1/16/81) was considered by the Executive Board at EBM/81/19 (2/9/81).

1/ As of November 30, 1982.

New Zealand - Basic Data

Area and population

Area	269,000 sq. km.
Population (1981)	3,175,737
GDP per capita in 1981/82 (in U.S. dollars)	7,571

	1979/80	1980/81	1981/82
	Percentage change from previous year 2/		
Domestic economy			
Gross domestic product			
In nominal terms	19.5	15.1	19.5
In real terms	-1.0	1.6	4.4
Unsubsidized employment	1.8	-0.7	0.6
Unemployment rate 3/ (in per cent)	3.6	4.7	5.6
Consumer prices			
Year-on-year	17.9	15.1	15.8
During year	15.7	16.4	15.5
Compensation of employees	16.9	19.3	20.6
Government accounts			
Revenue	21.4	16.0	23.2
Expenditure	10.8	20.4	22.6
Budget deficit (in per cent of GDP)	4.9	6.3	6.3
Balance of payments			
Volume of exports	...	5.0	3.6
Volume of imports	17.5	-10.5	9.5
Unit export value	25.9	11.0	12.0
Unit import value	34.0	23.0	14.3
Terms of trade	-5.8	-10.0	-2.0
Current balance			
In millions of SDRs	-635	-595	-1,129
In per cent of GDP	4.0	3.3	5.5
Official external debt (in per cent of GDP)	20.5	19.9	23.5
Official gross reserves at end of period (in millions of SDRs)	379	339	369
Effective exchange rate (per cent change)	-8.4	-6.3	-6.2
Money and credit (changes during the year)			
Narrow money (M1)	5.5	14.2	17.4
Broad money (M3)	15.7	14.2	16.8
Domestic credit	14.1	15.5	22.9

Sources: Department of Statistics, Monthly Abstract of Statistics; and IMF, International Financial Statistics.

1/ Fiscal years, ending March.
2/ Unless noted otherwise.
3/ Registered unemployment and persons employed under special job creation schemes.