RECENT TRENDS IN NEW ZEALAND'S INTERNATIONAL COMPETITIVENESS

New Zealand's international competitiveness since 1978 has been significantly influenced by domestic economic developments. Over the period between 1978 and the first half of 1982, fluctuations in the various measures of competitiveness were relatively minor. In the subsequent period, the introduction of the wage-price freeze induced a significant improvement in New Zealand's competitive position. Further improvements occurred following the devaluation of the New Zealand dollar in July 1984. However, the level of competitiveness immediately following the devaluation was probably unsustainable and the real exchange rate has subsequently moved back towards a more appropriate longer term level.

Introduction

Over the last decade, New Zealand has experienced substantial overseas current account deficits. This external imbalance has been associated with major imbalances in the domestic economy; a subject which has been discussed in detail in recent Reserve Bank of New Zealand annual reports and Bulletin articles. In brief, these imbalances can be attributed to a permanent fall in New Zealand's terms of trade in the early 1970s and the policy response through to mid-1984 of generally expansionary fiscal deficits and accommodating monetary policy. Over the last decade these policies have encouraged excess demand for goods and services by New Zealand residents and have led to an associated excessive growth in import payments. At the same time relative prices have been distorted by an inappropriate exchange rate, inflexibility in wages, prices and interest rates, export subsidies and import protection. These price distortions have tended to encourage resources to be devoted to the production of goods which are likely to earn less foreign exchange than they would if applied to other activities. The overall deficiency in foreign exchange earnings during this period necessitated an expanded level of overseas borrowing, resulting in an increase in New Zealand's official overseas debt from $1081.2 million or 10.7 per cent of nominal Gross Domestic Product (GDP) in March 1975 to $13,959.6 million or 34.9 per cent of GDP in March 1985.

New Zealand's ability to earn foreign exchange and to reduce its demand for foreign currency is significantly influenced by its international competitiveness. This concept measures the ability of New Zealand producers to place products on foreign markets and to produce import substitute goods at prices which are both internationally competitive and generate a profit rate that compares favourably with rates of return on alternative investments.

Under the fixed exchange rate system which operated until March 1985 the state of New Zealand's international competitiveness was of major importance since the economic circumstances discussed above tended to focus considerable attention on the need to finance the overseas current account deficit. In those circumstances such deficits were usually financed by an expansion in official overseas borrowing, which represented a net increase in credit expansion to Government. Direct deficit financing by the private sector, on the other hand would have merely involved a switching from domestic to foreign based credit. The substantial growth in official overseas debt which occurred over the last few years of the fixed exchange rate system had a less restraining influence on demand, and therefore foreign exchange requirements, than would have been the case if the debt burden been carried directly by individuals and companies. This situation whereby domestic expenditure decisions were relatively insensitive to the level of official debt tended to focus the Government's attention on the ability of New Zealand to expand its export production and to increase the domestic production of import substitutes so that the need for additional official borrowing could be reduced. Competitiveness was therefore seen to be an important indicator since it was a significant measure of the ability of New Zealand to balance its overseas current account.

The move to a floating exchange rate system in March 1985 has allowed for a shift in concern to a broader definition of external balance which encompasses private capital flows as well as the current account. Under the floating rate system current account deficits must be financed by an offsetting private capital inflow. Therefore, current account deficits can occur only if the rest of the world is prepared to make its savings available to New Zealand and so long as New Zealanders are prepared to increase the size of their foreign currency liabilities relative to domestic liabilities. This facility to switch between domestic and foreign credit enables expenditure decisions which affect the current account to be made in a non-inflationary context with reference to longer term

perspectives that reflect, amongst other things, confidence in New Zealand's future, the availability of profitable investment avenues in the country, and the ability of New Zealanders to service their debt. In these circumstances, competitiveness is only one aspect (and not necessarily the most important aspect) to be considered in the short-term when evaluating developments that impact on the external accounts. For example, it may be judged entirely appropriate that New Zealand runs a current account deficit providing that there are sufficient normal or sustainable private capital flows to support that deficit.

The objective of this article is to examine the recent developments in New Zealand's competitiveness and identify factors which have contributed to its behaviour.

Determinants of Competitiveness

Competitiveness can be looked at from a number of different angles. One perspective involves making an assessment of trends in the nominal exchange rate and movements in relative costs/prices between countries or, in other words, trends in the real exchange rate. From another view, competitiveness may be seen as a measure of the profitability of producing tradable goods relative to non-tradable goods. Tradable goods consist of those which are exportable and those which compete on the domestic market with imports.

In a small open economy such as New Zealand's, the foreign currency price received for tradable goods will be largely determined by conditions in overseas markets. New Zealand is therefore said to be, by and large, a price taker in international markets. However, the domestic-currency price of tradable goods will be largely determined by the exchange rate, and movements in this price will depend on the degree of exchange rate flexibility. A depreciation of the nominal exchange rate will lead to a higher domestic-currency price, while an appreciation will yield a lower domestic-currency price for any given foreign currency price of a tradable good.

The price received for that part of domestic production which is not internationally tradable will be more directly influenced by domestic economic factors. As the price of non-tradable goods is able to vary in response to changing domestic demand conditions, the non-tradable sector can more easily accommodate increases in domestic costs. When domestic demand rises, the non-tradable sector is able to attract more factors of production and expand output by increasing the price it is prepared to pay these factors as the extra cost can then be offset by increasing the price of output.

If the tradables sector is to maintain its production levels and preserve its claims on factors of production in the face of increased domestic demand, it must also pay higher production costs. However, the tradable sector may be unable to accommodate these higher costs as an increase in the domestic currency price of exports is dependent on a nominal exchange rate depreciation occurring. Therefore, increased production costs associated with an increase in domestic demand can reduce the profitability of the tradable goods sector relative to the domestic non-tradable sector if the exchange rate is not sufficiently flexible.

Over recent years in New Zealand, fluctuations in demand have often been associated with economic policies which have been inconsistent with underlying economic conditions. For example, expansionary financial policies have contributed significantly to high levels of domestic demand which, in combination with high monetary growth rates, fixed exchange rates and capital controls, have damaged New Zealand's international competitiveness. Exchange controls have inhibited the ability of New Zealanders to acquire foreign assets and have allowed domestic interest rates to be held at artificially low levels. This tended to reduce domestic savings and encouraged people to use a larger part of any increase in money incomes to demand additional goods and services (including import goods). While this extra demand has been associated with rising non-tradable product prices and production costs, the fixed exchange rate system prevented the exchange rate from depreciating (as would be expected in these circumstances) and thereby prevented exporters from receiving higher domestic currency prices for their output. Consequently, exporters' profits have been squeezed, providing a disincentive to further export production. Producers of import substitutes have found their profitability similarly squeezed.

Some economic policies in the past have, however, had the effect of ameliorating the impact of declining competitiveness. The wage-price freeze which was imposed between June 1982 and August 1984 assisted significantly in improving the profitability of New Zealand's tradable goods sector since it had the effect of suppressing production cost increases. In addition, export subsidies and import quotas have helped to diminish the effect of falling competitiveness, at least in the short-term. However, subsidies and other direct interventions in the economic process are generally not the most effective way of overcoming the problems caused by declining competitiveness. These policy actions tend to distort relative prices, thereby encouraging productive effort in areas where the overall benefit to the economy is likely to be less than could be achieved otherwise. Moreover, as events leading up to the devaluation in July 1984 demonstrated, direct intervention designed to cushion the effects of an overvalued exchange rate at best tend to postpone, rather than avoid permanently, the need for a devaluation.

Many of the problems associated with direct interventions designed to reduce the effects of declining international competitiveness can be avoided if policies which allow a greater degree of price flexibility in the tradable goods sector are adopted instead. But even in an economy where all distortions are removed and relative prices across and within sectors are flexible, international competitiveness may still fluctuate over time, although such fluctuations will tend to be consistent with a longer term view of development in the economy. For example, when an economy is expanding, its investment requirements, and therefore its aggregate level of demand, are likely to be relatively high. As a result, the price of non-tradable goods and production costs will rise and the current account balance may deteriorate. However, if the higher level of demand is consistent with long-term factors, domestic residents may choose to borrow funds from abroad to finance the worsened current account position. This overseas borrowing will reduce the need for a nominal exchange rate depreciation and so the tradable goods sector will not be able to realise a higher domestic-currency price for its output to offset cost increases. As a result, profits in the tradable goods sector will be reduced relative to the profitability of the non-tradable goods sector and
international competitiveness will be eroded. At some later period, domestic residents will need to reduce demand relative to their income in order to repay their overseas debts. As a result of the associated fall in domestic demand, the international competitiveness of the domestic economy is likely to improve.

**Measures of Competitiveness**

There are many ways of measuring competitiveness (or the real exchange rate), all of which are necessarily approximate. Measures usually focus on either relative input costs or relative output prices. Neither focus can provide a fully satisfactory indication of profitability and therefore can only be considered as an approximation of the state of competitiveness. For example, measures of price competitiveness will not accurately reflect changes in profitability that result from changes in production cost. Similarly, measures of cost competitiveness may not accurately reflect changes in relative profitability that result from output price changes although, for a small 'price taking' country such as New Zealand, changes in relative output prices are less likely to be a problem. One of the more reliable measures of output price competitiveness is based on relative output price deflators (i.e. GDP deflators), which measure movements in the price received by producers for their output. These indices incorporate prices for goods sold on both domestic and foreign markets, weighted according to the proportions in which they are sold. However, quarterly observations on these data are not available from official sources for New Zealand. As an approximation to price competition, this study uses relative consumers' price indices.

This measure of competitiveness is calculated as the ratio of the consumers' price index of the foreign country to New Zealand's consumers' price index, adjusted for movement in the nominal exchange rate. It therefore measures the relationship between domestic and foreign consumer prices, each expressed in a common currency. There are, however, some weaknesses with this measure which should be noted. The most important stems from the fact that the consumers' price index does not measure the price received by producers for their output. Rather, it measures the prices paid for goods by consumers. While this price is likely to be significantly influenced by factors which determine the price of output, other factors also impact on consumers' prices. For example, import prices will influence the consumers' price index, whilst export prices, which form an important part of the price of output, will have a less immediate effect. Therefore, relative consumers' prices are likely to be a less reliable indicator of price competitiveness during periods when the terms of trade are changing. In addition, the price of existing assets such as houses, and indirect taxes and subsidies, will affect the consumers' price index but may not affect output prices.

The relative consumers' price measure of competitiveness can give a general indication of broad trends in price competitiveness in the economy as a whole but it may not provide an adequate indicator of changing trends in the cost competitiveness of specific sectors. Three additional measures have been constructed to provide specific information on competition in the manufacturing and agricultural sectors. Two measures of cost competitiveness have been generated for the manufacturing sector. The first is based on the manufacturing input cost component of the producers' price index. This indicator of competitiveness measures the cost of producing manufactured goods in New Zealand relative to the corresponding cost of their production overseas. These costs are expressed in a common currency. An increase in the ratio indicates that domestic manufacturing production costs have increased relative to the cost of manufactured production abroad. Therefore, an increase in this ratio will correspond to a fall in New Zealand's competitive position. It should, however, be noted that this measure does not include labour costs.

The second measure of cost competitiveness in the manufacturing sector is relative unit labour costs. This measure expresses the labour cost of producing a unit of manufactured output in New Zealand relative to the corresponding labour cost of production abroad. Again, each cost is expressed in common currency terms. An increase in this ratio indicates that the labour cost of producing a unit of manufactured output domestically has increased more rapidly than labour costs elsewhere. Therefore, an increase in this index also indicates a fall in the home country's international competitiveness.

When considering New Zealand's international competitiveness, it is also necessary to recognise that a large proportion of our total exports has been, and still remains, in the field of primary produce. Production of these goods tends to be less sensitive to relative cost differentials between countries than manufactured output because agricultural production is significantly constrained by biological factors and because many resources used in the farm sector are not easily applied to production in the sheltered, non-tradeable sector. Agricultural output is considered to be more significantly influenced by changes in the absolute profitability of farming. Therefore, in this study the ratio of farm costs to prices received for agricultural exports is used to assess trends in the competitiveness of the farm sector. This measure is not calculated with respect to individual countries but rather the average of the agricultural export prices received in all markets is used. When the ratio increases it indicates that costs in the farming sector have increased more rapidly than agricultural export prices and, therefore, that the profitability of farming and farm competitiveness has declined.

Where it is appropriate and where data are available the measures discussed above have been calculated on a bilateral basis between New Zealand and each of its main trading partners. In addition, effective rates which measure New Zealand's competitiveness relative to a trade weighted average of our major trading partners have been calculated. Countries included in the study are the United States, Australia, Japan and the United Kingdom and the period examined is from March 1978 to June 1985.

**Analysis of the Measures**

Each of the measures of competitiveness described above have been calculated in terms of an index presented in figures 1 to 5. The base period for these indices is March 1978 where the value of the index has been set equal to 100. This base period should not be seen as representing any sort of equilibrium position. Earlier studies which extend over a period from the mid-1960s indicate that New Zealand was in fact in a moderately favourable competitive position in March

1978 although an external imbalance associated with other factors persisted. The indices presented in figures 1 to 5 should therefore be interpreted as indicating movements or trends in New Zealand’s competitive position rather than as measures of either favourable or unfavourable competitive conditions. An increase (fall) in the real exchange rate indicates a deterioration (improvement) in competitiveness.

Effective measures of competitiveness are displayed in figure 1. It may be noted from this figure that, apart from the agricultural cost index, each of the measures were at about their base level in June 1982. Within this period the measures based on relative producers’ input costs and consumers’ prices moved in a similar manner to each other while the relative unit labour cost measure was more volatile. The relative consumers’ price and producers’ input cost measures followed a moderate downward trend between 1979 and 1981, implying that New Zealand’s international competitiveness had improved with respect to its trading partners on average. This period of improving competitiveness resulted partly from the 5 per cent devaluation of the New Zealand dollar in June 1979 and the subsequent introduction of a crawling peg exchange rate system which allowed the exchange rate to adjust sufficiently to offset the inflation rate differential between New Zealand and an average of its trading partners over the period until the first half of 1981. Nevertheless, during this period, significant external imbalances remained relatively low, leading to a decline in New Zealand’s competitiveness with respect to that country.

In the second half of 1981, world inflation rates began to decline while inflation in New Zealand increased. Although the crawling peg exchange rate system introduced in June 1979 continued in operation until June 1982, it did not provide the exchange rate with sufficient flexibility to fully offset the inflation differential that subsequently arose. Consequently, producers of most tradable goods in New Zealand were not adequately compensated for rising costs by receiving a higher New Zealand currency price for their output. As a result, their profitability and therefore the competitiveness of the tradable goods sector declined from June 1981 until late 1982. This deterioration was especially pronounced with respect to the United Kingdom where inflation had declined significantly relative to that in New Zealand. Partially counteracting this deterioration was an improvement in New Zealand competitiveness with respect to the United States which occurred as a result of the strengthening of the US dollar from late 1981.

Profits in the agricultural sector also began to improve in early 1981. This improvement occurred because the foreign currency prices of agricultural exports recovered somewhat from their former relatively low levels. However, because agricultural export prices had been so low, the improvement indicated by the farm profitability index was probably not sufficient to return the profitability of the farming sector to satisfactory levels.

Although overall competitiveness improved over the period 1979 to early 1981, real bilateral rates showed considerably divergent trends. New Zealand’s competitiveness with respect to the United Kingdom improved significantly between 1978 and 1980 as prices in the United Kingdom increased more rapidly than they did in New Zealand. However, inflation in Japan was
From late 1982 until the most recent period for which data are available, all measures of competitiveness except that for the agricultural sector tended to follow a downward trend. The downward trend, indicating a decline in competitiveness, was generally improving. A major factor contributing to this improvement, at least initially, was the wage-price freeze which was introduced in June 1982. In the first year of the freeze, the relative unit labour cost index is estimated to have declined by 6 per cent while the effective relative consumers’ price index fell by 3 per cent respectively. However, a comparison of the effective indices in figure 1 indicates that by June 1983 a new relationship has been established whereby the relative unit labour cost was significantly lower than the price measure of competitiveness. This change in the relationship between measures highlights three important points.

1. Because the unit labour cost measure is specific to the manufacturing sector while the consumers’ price index is an economy-wide measure, the larger relative decline of the unit labour cost measure suggests that manufactured exports in particular enjoyed improved competitiveness. Indeed, the profitability of agricultural exports showed no such improvement; instead, the ratio of agricultural export prices to farm costs fell by 18 per cent between 1982 and June 1984.

2. The price of New Zealand’s manufactured exports has followed foreign price levels much more closely than have our consumers’ price index. This suggests that the gains in cost competitiveness have resulted in increased profit margins for exporters.

3. Even if improvements in New Zealand’s cost competitiveness are translated into lower export prices, one would not expect the relative consumers’ price index to fully reflect this improvement because this measure includes non-traded goods as well as imported goods whose prices would not be affected.

Despite the improvement in competitiveness during the period of the wage-price freeze, there remained clear evidence of major external imbalances in the economy which were associated with imbalances in the domestic economy. On taking office in July 1984, the new Government considered an overvalued exchange rate as one of the fundamental causes of New Zealand’s external imbalance and devalued by 20 per cent. That decision, of course, was also heavily influenced by the foreign exchange flight which occurred in the period just prior to the election. The 20 per cent nominal devaluation resulted in a competitive gain as measured by relative consumers’ prices of around 15 per cent in the September quarter 1984, while the relative unit labour cost measure of competitiveness showed an improvement of 23 per cent.

Over subsequent quarters, this advantage has been eroded as domestic prices and wages have increased more rapidly than foreign prices and wages and, more recently, as the New Zealand dollar has strengthened. Partly as a result of the wage round in late 1984, which lifted domestic wages by between 5–7 per cent, the relative unit labour cost advantage derived from the manufacturing sector immediately after the devaluation had been eroded by 5 per cent by March 1985. Competitiveness as measured by relative consumers’ prices deteriorated by a smaller 1.7 per cent over this period as higher costs associated with both the devaluation and the wage round were passed on in price rises. Nevertheless, New Zealand’s international competitiveness still showed a strong gain in March 1985 relative to the position immediately prior to the devaluation. With relative unit labour costs and relative consumers’ prices indicating improvements of 15 per cent and 13.4 per cent respectively.

Each of the bilateral measures of competitiveness were affected in a similar way by the devaluation in July 1984. Relative consumers’ prices suggest that, while New Zealand has lost only some of the competitive advantage gained by the July devaluation over the United Kingdom, the United States, and Japan since September 1984, this advantage has been more significantly eroded in the Australian market. However, New Zealand’s competitive position in Australia in late 1984/early 1985 was probably an unusual one. In retrospect, it appears that the Australian dollar was probably unsustainably high during that period. For that reason the immediate post-devaluation exchange rate with Australia does not represent an appropriate benchmark for comparisons with subsequent developments.
The limited availability of data beyond March 1985 has restricted the analysis of competitiveness in the June quarter 1985 to the relative consumers’ price index. In this quarter, consumers’ prices continued to rise following the July 1984 devaluation. Although the exchange rate was floated in March 1985, it did not adjust to fully compensate domestic producers of tradeable goods for these higher domestic prices and New Zealand’s competitive position continued to decline. Despite this deterioration the effective relative consumers’ price measure still showed an improvement in competitiveness of 8.5 per cent in the June quarter of 1985 when compared with its level immediately prior to the devaluation.

**Implications of the Measures**

The analysis presented above suggests that an improvement in competitiveness should lead to an increase in the domestic production of tradeable relative to non-tradeable goods and a relative decline in domestic expenditure on tradeable goods. Therefore, the analysis implies that improved competitiveness should be associated, *ceteris paribus*, with a fall in the current account deficit. However, while substantial improvements have been experienced in New Zealand’s international competitiveness since the July 1984 devaluation, an examination of the statistics presented in Table 1 indicates that the current account deficit has in fact widened as a percentage of GDP.

Such a deterioration in the external balance can occur despite the improvement in the real exchange rate because the current account is influenced by a number of other factors. For example, trends in imports will be related to domestic expenditure and income developments, and trends in exports will be similarly related to expenditure and income developments in foreign countries. Although the longer term trends in income and expenditure will be reflected in the measures of competitiveness, this will tend not to be the case with short-term movements in relative cyclical positions. Moreover, these shifts in income and expenditure may dominate the current account in the short-term.

Another important factor which will determine the effect that an improvement in competitiveness has on the current account is the degree of substitutability between tradeable and non-tradeable goods production. When there is a high degree of substitutability between sectors, resources can be easily moved to those activities which yield the greatest return and, therefore, the current account is relatively sensitive to competitiveness. However, as noted earlier, a large part of New Zealand’s tradeable goods production is undertaken in the agricultural sector. Since there is likely to be a relatively low degree of substitutability between the agricultural sector and other sectors, the responsiveness of New Zealand’s current account balance to competitive conditions is somewhat constrained, particularly over the shorter term.

Nevertheless, the importance of international competitiveness can be seen from the relationship between the competitive indices in Figure 1 and the export volume figures reported in Table 1. In the year ending March 1983, when New Zealand’s international competitiveness had been significantly eroded, total export volume growth was only 1 per cent and manufactured export volumes declined by 3.2 per cent. Following a period of significant improvement in New Zealand’s competitive position, export volumes expanded strongly by 10.3 per cent in 1984 and manufactured export volumes grew by 19.5 per cent. This strong growth continued in 1985 following further competitive improvements.

Expectations also play an important role in determining trade flows as well as the structure of the production process. This factor can have a significant effect on imports in particular because New Zealanders who expect an exchange rate change may want to either delay, or bring forward their purchases of imported goods. By adjusting their imports in response to expectations, importers may be able to reduce the cost of their transactions. At the same time, this process will disturb the relationship between the measures of competitiveness discussed earlier and the import data in Table 1.

Expectations can also affect the export response to changes in measured competitiveness. Because it is likely to be costly to adjust productive activities, producers may not be willing to alter their output if they expect the measured change in competitiveness to be temporary. Some producers may respond only after some time has lapsed with the new competitive conditions and only when they are confident that the change will endure. In this sense then, producers are likely to be more sensitive to underlying trends in their international competitiveness rather than short-term changes. Various hedging options have been developed in the market to assist traders in avoiding the costs associated with such short-term fluctuations in the nominal exchange rate. These methods include the forward foreign exchange market in which traders can enter into a contract that establishes the price that they

<table>
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<th>March Year</th>
<th>Export Receipts</th>
<th>Export Volumes</th>
<th>Manufactured Export Volumes</th>
<th>Import payments</th>
<th>Import Volume</th>
<th>Current Account as a % of GDP</th>
<th>Official Overseas Debt as a % of GDP</th>
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*Source: Department of Statistics and Reserve Bank of New Zealand.*

can buy or sell foreign exchange at some future date, thus reducing one element of uncertainty in their future trading activities.

**Conclusion**

The last few years have seen significant improvements in the international competitiveness of New Zealand's tradeable goods sector. Major factors contributing to these competitive gains were the wage-price freeze introduced in June 1982, and the July 1984 devaluation. Between June 1982, when the wage-price freeze was introduced, and March 1985 New Zealand's competitiveness as measured by relative unit labour costs improved by 26.5 per cent while relative consumers' prices indicated an improvement of 17.6 per cent. The devaluation in July 1984 had the immediate effect of improving relative unit labour costs in the manufacturing sector by 18.7 per cent while the improvement in overall price competitiveness as measured by relative consumers' prices was 15 per cent. Since the devaluation these gains in competitiveness have been partly eroded as domestic costs and prices have risen, representing to some extent, a bounce back effect from the wage-price freeze.

The interpretation of trends in competitiveness has changed significantly with the introduction of the floating exchange rate system. Prior to the float much of the analytical work undertaken with respect to the exchange rate focussed on the competitiveness of New Zealand's tradeable goods sector and the level of the exchange rate which would be consistent with producing a sustainable position in the current account of the balance of payments. This framework was used in the context of a centrally determined exchange rate system, and reflected the Government's concern to achieve a tolerable situation with respect to its external borrowing programme.

With the floating of the exchange rate and the freeing up of exchange controls, the private sector can now borrow directly from abroad and the Government need not undertake any overseas borrowing to finance a current account deficit. In this environment where the Government no longer operates an exchange rate policy, the current account/competitiveness framework has become of less direct relevance for policy. However, this form of analysis clearly continues to have relevance for the Government's domestic financial policies in that sustained external imbalances tend to reflect imbalances in internal savings-investment flows.