Economic Reforms And New Zealand Agriculture

by Ron A. Sandrey

> ➢ New Zealand undertook major adjustments in their macro economic policies in the 1980s. As part of a larger program to place greater reliance on market forces, agricultural subsidies were reduced sharply.
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> The New Zealand experience demonstrates how broad economic policies can adversely affect the agricultural sector. It also demonstrates that inequities can arise if protection for some industries are continued while other sectors are exposed to liberalized policy reforms.

New Zealand was a highly regulated economy in 1984. Interest rates were tightly controlled by the government and lending policies of banks were directed by the government; the exchange rate was fixed; and wages and prices were subject to a comprehensive "freeze." At the same time, several economic indicators showed that the economy was performing poorly. Deficits of the current trade account and the federal government's budget were very high and increasing. Inflation was artificially low due to the price freeze. It was expected to accelerate sharply in 1985.

Federal assistance to agriculture had doubled over a very short three to four year period and was equivalent to 30-34 percent of the final value of output of all pastoral farm products in the country. Much of this support was directed to sheep meats. Net farm incomes, however, were falling in spite of this massive assistance.

New Zealand's relative standard of living continued to fall from its pinnacle reached in the 1950s. As the country's economic performance worsened, the impetus for change grew. A "snap" election in 1984 brought to power the Labour Party, with a Finance Minister committed to a less interventionist approach. For a traditionally left-wing democratic party, espousing free market economic policies was inconsistent with the party's earlier policies. However, this apparent contradiction indicates the degree to which previous governments had drifted into intervention in the economy, and the high level of disenchantment by the public with such policies.

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Radical Reforms

The breadth, depth and speed of the post-1984 changes were dramatic. Attention focused on

(a) stabilization: control of the inflation rate and a reduction of the government deficit and government overseas debt; and

(b) liberalization (deregulation): reforms of commercial policies, the taxation system, the financial sector and government trading activities.

The overall objective has been to create a stable macroeconomic environment to facilitate a market driven sustainable expansion of the economy in the medium to long term.

Most recognized that the removal of direct assistance would disadvantage agriculture in the short run. However, the simultaneous reform of macro economic, commercial and exchange rate policies were expected to benefit the agricultural sector. These policies in recent years had "cost" the sector. But, the costs of adjustment would precede the benefits.

The New Zealand dollar was immediately devalued by the Labour Government and, in March 1985, floated. In addition, other policy initiatives were directed towards general market liberalization, export assistance was discontinued, import protection was lowered, the tax base was widened and taxes were made more indirect. Government trading activities were privatized, and public sector efficiency was emphasized.

The new Labour Government accelerated the withdrawal of agricultural supports: concessionary farm loans were progressively brought into line with market rates, user fees were announced for agricultural product inspection and farm advisory services, and farm input subsidies were terminated. By 1991 direct assistance to pastoral agriculture had been reduced from being equivalent to one third of the total value of farm production to being equivalent to only 2 percent. Assistance for farmers is now in the form of research and extension, animal health and quarantine, and adverse events assistance.

Some tariffs on imports of products purchased by farmers were reduced. However, some tariffs remain purportedly to promote import-substitution manufacturing. These constitute an implicit tax on agriculture and limits the sector's growth. For 1991 these tariffs were equivalent to possibly five percent of the total farm production.

Full charging for product inspection, user funding of research and extension, and changes in adverse events assistance, were part of the general reduction in assistance to agriculture. Other changes, such as local and regional government reform, and community irrigation scheme ownership changes, although less direct, still have significant ramifications for the agricultural sector.

The reform of domestic marketing regulations resulted in complete deregulation of the wheat and egg industries and a partial deregulation of the town (market) milk sector.

The Consequences

Apart from a brief period after the 1984 devaluation, the benefits of reform for the agricultural sector have been very slow in coming.

During 1984 and 1985 the devaluation of the New Zealand dollar benefitted producers, world prices for beef, wool and dairy were favorable and assistance still supplemented sheepmeat prices. However, from late 1985 until 1988 the prevailing prices for meats in world markets failed to improve, the exchange rate appreciated (thus, increasing the cost of New Zealand products in terms of currencies of other countries), inflation and interest rates remained high, and output assistance was removed. The only gains to farmers were through reduced margins (processing costs) and farm costs, which increased at a slower rate than inflation, although input prices were still increasing faster than those of overseas competitors and damaging international competitiveness.

Key macro economic indicators between 1985-1988 include an appreciating real (inflation-adjusted) exchange rate, high short-term real interest rates, declining growth, rising unemployment, and an eventual fall in the inflation rate and improvements in the external account deficit.

From late 1988, prices turned to favor farmers, although they have recently trended downwards again. Farmers' terms of exchange strengthened as a result of the long awaited gains from the reforms and the stronger world prices for pastoral commodities. World prices for dairy products and wool improved, followed by prices of meats during 1989. Some depreciation of the exchange rate occurred, together with significant reductions in inflation and farm costs. As a result New Zealand farmers producing export products became more competitive against other producers in international markets.

The mix of farm production shifted. During the assistance period, the late 1970s and early 1980s, sheep numbers rose from around 60 million head to 70 million. Much of this expansion had occurred at the expense of beef cattle numbers. In contrast, since 1984 sheep numbers have dropped back to less than 60 million head. Dairy cow numbers, meanwhile, showed a slow but variable increase. Product output levels largely mirrored these changes, with the usual short-term negative supply responses and biological lags associated with pastoral farming. Study of farming supply responses through the use of a computer-based model clearly indicates liberalization did not cause a change in producers' economic behavior. All output and inventory changes can be explained as consistent, economically rational responses to prices, costs and seasonal conditions.

Farm incomes generally declined throughout the 1984-89 period, except for the upward surge in 1985 due to favorable exchange and climatic conditions, and improved dairy farm incomes in 1989 and 1990. Farmers were caught in a classic cost-price squeeze as incomes declined and expenses increased. These expenses were dominated by debt servicing costs and the resultant crowding out of discretionary expenditures.

By 1987, nominal farmland values had reduced to below 1981-82 levels. In real terms they had decreased to only about 40 percent of the peak values. These declines, coupled with higher interest rates and lower incomes, reduced farmers' security margins and led to concerns about debt levels. Although relationships between farm incomes, expected future incomes and inflation are

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complex, the large increase in land values early in the 1980s demonstrates the way in which agricultural supports became capitalized into land values. This accentuated the debt problem later in the decade. Increases in the land value index in the last half of 1989 and the first half of 1990 were a welcome sign, as this may signal a change in the crucial debt situation of many farmers.

Employment in agriculture, agricultural services, and processing fell both in numbers and in share of total employment from 1984 to 1988. Although farming and related industries have experienced declining employment and falling real and relative wages, it is less clear whether the speed and nature of adjustment in farming differs from that of other sectors. General labor market reform may have provided the mechanism for change, but most of the shocks have been related to product markets. [Ron Consider rewording the previous sentence to help readers relate it to rest of paragraph]

The Key Lesson

The important lesson emerging from New Zealand's experience is that changes in broad economic policies can adversely affect the agricultural sector. The effects can be severe because the agricultural sector consists largely of products that are exported, and the macroeconomic policies greatly influence the structure of incentives to produce exported products. Public sector deficits and the associated capital flows over the period prior to and immediately after liberalization, the floating of the exchange rate, the liberalization of capital markets, and the tight monetary policy adopted to control inflation all led to an appreciation of the currency.

The effects included lower farm product prices which discouraged investment in agriculture and its output, and accentuated the effect of removing assistance to agriculture.

Whether or not the overall impact of these reforms could have been reduced by a different sequencing of policies is unclear. A more drawn-out programme may well have lacked the credibility necessary to sustain the impetus of reform which was a feature of the New Zealand experience. Even if a different sequencing might have been more desirable, this begs the question of planning that optimal sequence. However, the real exchange rate (expressed as the ratio of prices of tradeable to non tradeable prices of non tradeable goods, both expressed in New Zealand dollars), is of utmost importance. A low rate of domestic inflation and the avoidance of a substantial public budget deficit are necessary for growth in exports and the sectors that produce them.

One must be careful about drawing lessons too quickly. The lags associated with pastoral farming mean that the full impact of the reforms undertaken has yet to be observed. They are a function of the biological nature of pastoral livestock farming and the short run changes in livestock numbers. In the early stages of periods in which farm product prices drop, the size of flocks and herds are reduced. However, this increased slaughter leads to increased meat production. Conversely, rebuilding of livestock numbers is initially associated with a decline in output.

Unfinished Business

Six years into the liberalization program, some outstanding issues remain to be fully addressed. Clearly, the "cost excess" facing agriculture due to protection elsewhere in the economy remains an issue. Continual protection of manufacturing places an implicit tax on agriculture and other export industries. There are only two ways in which this tax can be alleviated—by direct support measures for presently unassisted exports or by reducing the protection for other parts of the economy.

To compensate agriculture to offset protection in other parts of the economy would clearly be a second best approach and raises basic questions about the rationale behind past policy changes. The negative effects of such a policy choice would be likely to far outweigh any short-term benefits.

The Prospects

As the bulk of New Zealand's agricultural production is exported, agricultural exports are largely determined by domestic production conditions, which are now driven by international market conditions. These agricultural exports account for about 60 percent of total exports, highlighting the importance of agriculture to the economy.

Prospects for recovery are restricted by reduced returns from dairy and wool products. Dairy problems stem from the excess production from subsidized products squeezing our markets. These subsidies represent a double edge sword—market access is restricted, and marginal producers remain in business with the surplus dumped into the decreasing number of "free" markets. Insult is added to the original injury. Our problems in the wool trade are heightened by the reduced sales to China and the USSR, and our high stocks of wool are cause for worry. C

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FOR MORE INFORMATION

Farming Without Subsidies: New Zealand's Recent Experience edited by R. A. Sandrey, and R. G. Reynolds and published by the Ministry of Agriculture and Fisheries, Wellington, 1990.

Copies can be obtained by writing to: MAF Bookshop, P O Box 2526, Wellington, New Zealand. The cost is NZ$39.95 plus $8.00 for overseas postage and handling. Bankcard, Mastercard, Diners, Amex and Visa are welcome.