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Commentary

There is a lot going on. The earthquake continues to take its heavy toll on the quality of Christchurch people's lives, and will come on top of the continuing recession to slow the economy in the coming year. Many aspects of the government's low-road approach to employment relations take effect including the bare 25 cent increase in the minimum wage to $13.00, making 90-day "fire at will" trial employment available to all employers, reductions in worker bargaining power in personal grievance cases, and more restricted access to workplaces for union representatives. The 2011 Budget is in eight weeks, and promises to focus on saving, the welfare working group's recommendations, and further cuts in government services in order to reduce government debt. Our commentary this month focuses on why that is the wrong thing to do.

Debt: why the government is different

Summary

It's common sense isn't it? In hard times like these, just as you and I have to cut our spending to balance our budgets, so must the government. The government is just like any household or firm.

Sorry, but common sense is wrong. The government is not like any household or firm.

First, it is a very large part of the economy whose spending and revenue gathering greatly affects the rest of the country. While individuals can do what is best for themselves, the government must do what is best for the country.

Second, it will for practical purposes live indefinitely.

Third, and most importantly, the government can both levy taxes and create money. No household or firm can do those things.

When Bill English says there is a "need to get the budget back into surplus, to start paying down our rapidly rising debt burden", that is a political judgement on the size of government more than an economic one. The continuing high unemployment, low wage growth and low business investment need government spending to stop them lingering and getting worse. The government's debt situation is not a good reason to avoid that responsibility. New Zealand's international debt – in net terms, all of it private debt – adds complications but is not the central issue. It does not outweigh the needs of New Zealanders in getting through the recession and reconstruction after the Christchurch earthquake.

It’s common sense isn’t it? In hard times like these, just as you and I have to cut our spending to balance our budgets, so must the government. The government is just like any household or firm. It must urgently reduce its debt and return to a budget surplus.

Sorry, but common sense is wrong, just as it is wrong when it tells us the earth is flat. The government is not like any household or firm. That is particularly important at times of recession when government action can play a powerful role in preventing the economy from diving more deeply into a hole which it might take years to recover from.

When Bill English says “The Prime Minister and I have both spoken at length this year about the need to get the budget back into surplus, to start paying down our rapidly rising debt burden”, that is a political judgement on the size of government more than an economic one. Even if we are not technically in a “double dip recession”, the continuing high unemployment, low wage growth and low business investment are no different from a recession. They need government spending to stop them lingering and getting worse. The government’s debt situation is not a good reason to avoid that responsibility. In addition, there are the costs of the Christchurch earthquake to meet.

Why is the government different? There are several reasons.

First, it is a very large part of the economy whose spending and revenue gathering greatly affects the rest of the country. While individuals can do what is best for themselves, the government must do what is best for the country.

Second, it will for practical purposes live indefinitely. People and households don’t – so at some point they or their estates have to repay any debt. Most firms don’t either, and there are limits on even old established ones that do not apply to governments.

The New Zealand government has been in debt virtually since colonisation by Britain (Statistics New Zealand provides estimates going back to 1858). The last two decades of reducing gross and net debt have been unusual in our history. Gross government debt rose in real terms 103 out of the 142 years from 1859 to 2000. As a proportion of the size of the economy, it peaked at 249 percent of GDP in 1933, and fell almost constantly from that point apart from the Second World War and the period 1981 to 1987 with another blip in 1992. The current level of gross government debt (33.1 percent of GDP at 31 January) is higher than it was in the 2000’s but lower than at any other time since the 1860’s.

Third, and most importantly, the government can both levy taxes and create money. No household or firm can do those things. The government can, within reason, increase taxes to pay off debt. For example it could introduce an earthquake levy or cancel the reduction in company taxes (as the Japanese government is considering). It can also increase the supply of money, though increasing it too much will lead to inflation.

The US and UK have been increasing their money supplies with gusto to both bail out their crashed banks and stimulate economic activity. New Zealand, with an independent currency, has similar options – unlike Greece, Ireland, Spain and Portugal for example who use the Euro. We could increase the money supply for more productive purposes than bailing out banks: for example by making money available for new housing, fixing leaky homes or the Christchurch reconstruction. In current circumstances where there is unused capacity in the economy, that can be done without risking inflation if done in the right amounts: it would mobilise unused resources.

While there is no hard limit to government debt, it is obviously not wise to increase it indefinitely. The interest on it becomes unaffordable and prevents spending on more useful things. But the bottom line is that the government has much more flexibility than any household or firm and is far from that limit.

Of course not all increases in government debt will stimulate the economy equally well. If the private sector simply reduces its debt, we may still be in trouble in the short run because we don't get the "virtuous circle" we need of jobs being created by people buying New Zealand goods and services or investing. That appears to be what is happening. Many households and firms are focusing on reducing debt. The 40 percent of households with the highest incomes owed about three-quarters of all the mortgage debt in New Zealand in 2007. Those were the same people the tax cuts most benefited. In effect we may be seeing government debt being created so that the (high income) private sector can reduce its debt – but insufficient stimulus to the economy.

That suggests that the government's stimulus programme was badly designed. It was too much about tax cuts and not enough about direct spending in the economy. Tax cuts are not only less effective, but they create a structural problem for the government accounts from insufficient revenue. It would be easier to cut back new spending as we come out of recession.

Another problem is the international position. Some of the increased private sector spending may be on overseas goods and services (such as imports and travel) rather than stimulating the local economy. Further, the government's increasing indebtedness may increase New Zealand's international debt – though it may allow private borrowers to pay off some of their overseas debt and leave the overall position unchanged. At this point, only about half of the government's current borrowing is owed overseas, and in December it still had more overseas assets than overseas debt.

But the most important aspect of overseas debt at present is not directly related to the government's deficit. It is that New Zealand's international debt is very high by world standards – at the end of last year, 128 percent of GDP gross ($248 billion) or 79 percent of GDP in net terms ($153 billion). All of the net debt was private debt and three quarters (76 percent) of that was owed by the banks. None was owed by the government. Why should the private debt be a problem for the government? As Bill English put it recently, "because most developed countries guaranteed their banks, financial markets increasingly add private and public debt together to assess credit risk". In other words, the money markets and credit rating agencies are afraid that the banks will get into trouble again – as they did in 2008 – and the government will bail them out, transferring their problems to the government (and us).

The solution should not be to cut public services. That would put threats and "might happens" ahead of the certainties of high unemployment, the generosity needed in the reconstruction after the Christchurch earthquake, and other social needs. Instead we should isolate the government finances as far as possible from risky bank behaviour. The Reserve Bank has done some of this by requiring banks to reduce their short term overseas borrowing. We need to reduce their overseas borrowing overall, and make clear the limits to government guarantees (if any). In the longer term we need to reduce our reliance on overseas investment by strengthening our export and import-competing sectors, and increasing saving (including government saving).

But in the short run, the government can afford to increase its debt. It is the right thing to do.

Bill Rosenberg

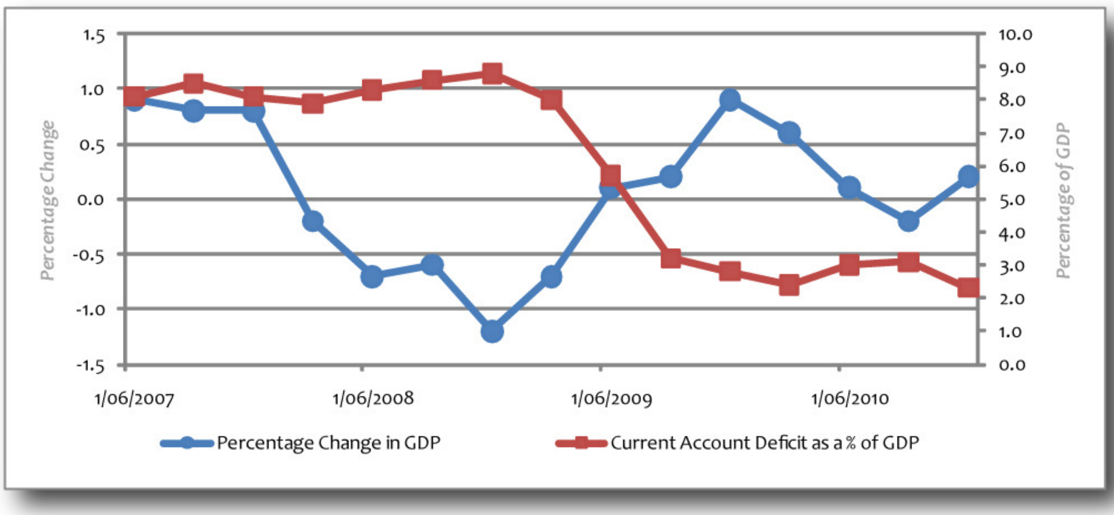
Forecast

This NZIER consensus forecast was published on 21 March 2011.

Annual Percentage Change (March Year)	**2010-11**	**2011-12**	**2012-13**
GDP	0.8	2.0	3.9
CPI	4.6	2.6	2.6
Private Sector Wages	1.7	2.9	3.2
Employment	0.8	1.8	2.6
Unemployment	6.7	6.4	5.5

A ★ indicates information that has been updated since the last bulletin.

Economy

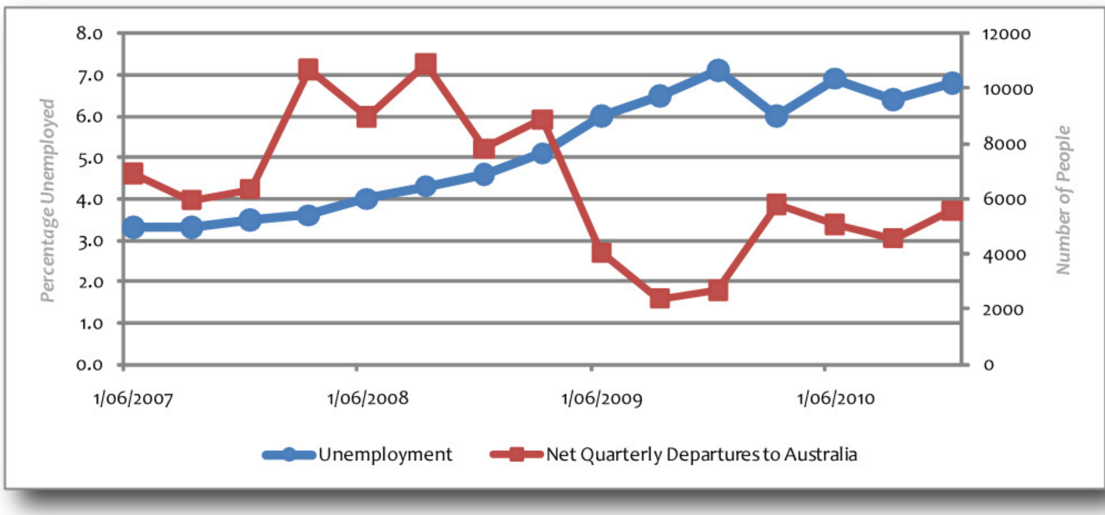


- ★ Gross Domestic Product was up 0.2 per cent in the December 2010 quarter, leaving GDP growth for the year to December 2010 at 1.5 per cent.
- ★ New Zealand recorded a Current Account deficit of $2.8bn for the December 2010 quarter and a deficit for the year to December of $4.4bn (2.3 percent of GDP). This compares with a current account deficit of $5.2 billion (2.8 percent of GDP) for the year ended December 2009.
- ★ The country's Net International Liabilities were $159bn at the end of December 2010 – 81.7 percent of GDP and $1.3bn less than at the end of September.
- ★ For February 2011 Overseas Merchandise Trade recorded a $194m surplus – 5.0 percent of the value of exports for the month, and $1.1bn better than the deficit for the same month in 2010. For the year to February 2011, New Zealand recorded a surplus of $758m (1.7 percent of exports). The value of dairy products, crude oil and timber exports all rose significantly in February, while a one-off importation of aircraft (worth $233m) and petroleum products were the biggest increases in imports.
- The Performance of Manufacturing Index for January 2011 increased to 53.7[1], up from 53.2 in December showing stronger expansion. The employment sub-index also showed improving expansion at 52.8, up from an adjusted 51.3 in December. Note: A PMI figure for February was

not published due to disruption caused by the Christchurch earthquake. March figures will be released in April.

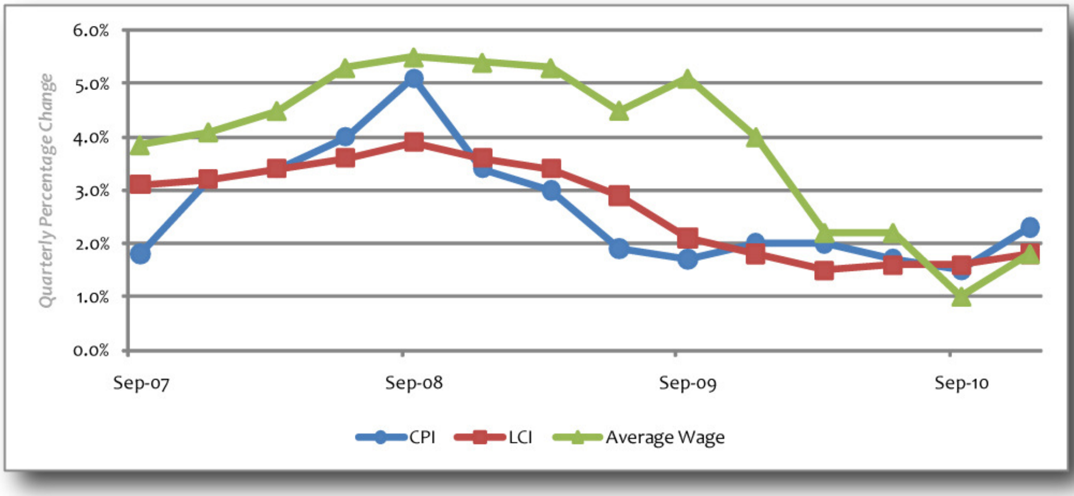
- The Performance of Services Index for January 2011 was 50.8[1], down from the adjusted December figure of 52.1. The employment sub-index contracted further to 47.8, down from 49.3 in December. Note: A PSI figure for February was not published due to disruption caused by the Christchurch earthquake. March figures will be released in April.
- The Retail Trade Survey found retail sales were down 0.1 per cent between the September and December 2010 quarters but up 1.5 percent on the December quarter in 2009.
- On 2 January 2011 the Reserve Bank reduced the Official Cash Rate 50 basis points to 2.50 percent. The next review will be on 28 April 2011.
- ★ The REINZ Housing Price Index recorded a 2.3 percent increase in house prices for the month of February 2011, with the median house price rising $8,225 to $359,675. However house prices are still down 0.7 percent for the year to February.

Employment



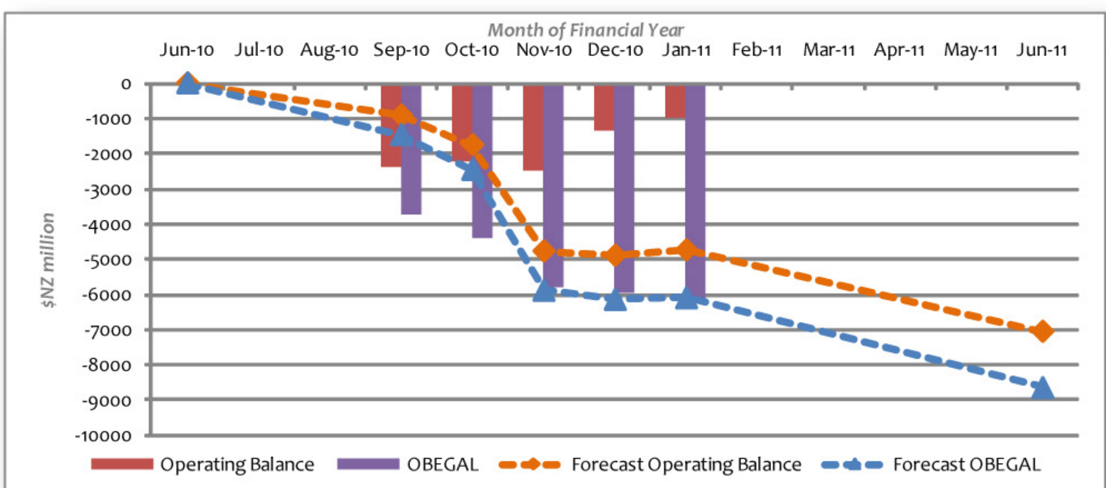
- According to the Household Labour Force Survey the unemployment rate in the December quarter was 6.8 percent, up 0.4 per cent on the September quarter. The participation rate was 67.9 percent – down 0.4 per cent on September. Māori unemployment was 15.5 percent, Pacific unemployment was 13.5 percent, Asian unemployment was 9.3 percent and European/Pakeha unemployment was 4.6 percent. Youth unemployment (15-19 year olds) was 25.5 percent.
- ★ At the end of February 2011 there were 64,371 people on the Unemployment Benefit, an decline of 3780, or 5.5 percent, from January 2011. (Quarterly figures on Unemployment Benefit numbers are available from the MSD website.)
- ★ In the three months to the end of February 2011 Job Vacancies Online increased 4.6 percent and advertised vacancies for skilled jobs increased 5.7 percent.
- ★ International Travel and Migration figures show 9,238 permanent and long-term arrivals to New Zealand in January 2011 and 8,461 departures. Net migration in the year to January 2011 was 8,689 arrivals. Net migration to Australia in the year to January was 22,378 departures.

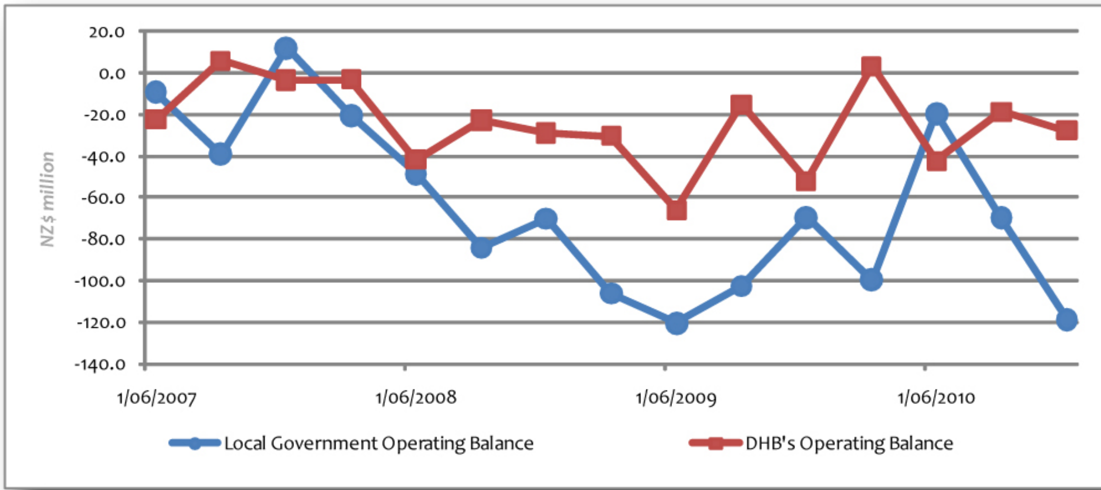
Wages



- The Labour Cost Index (Wage and Salary Rates) (LCI) rose 1.7 percent for the year to December 2010 and 0.5 percent for the December quarter. For those surveyed who received an increase in their salary or wage rate during the year, the median increase was 2.9 percent.
- The December 2010 Quarterly Employment Survey found the average hourly earnings for ordinary-time work was $25.83, up 0.5 percent on the September quarter. The average ordinary-time wage was $23.87 in the private sector (up 0.6 percent) and $32.71 in the public sector (up 0.3 percent). Per hour, female workers earned 87.7 per cent of what male workers earned.
- The Consumer Price Index for the December 2010 quarter rose 2.3 percent, and 4.0 percent for the year to December.
- ★ The Food Price Index only rose 0.1 percent in the month of February, but food prices were still 5.3 percent higher in February 2011 than in February 2010.

Public Sector





- ★ According to Treasury's Month End Financial Statement for the seven months to the end of January 2010, Government revenue was down $659m (2.0 percent) on budget figures, but expenditure was also down $367m (0.9 per cent). The operating deficit before gains and losses (OBEGAL) was $6.2bn, and the operating deficit was $998m, $3.7 billion less than forecast. The Government's net debt is 19.4 percent of GDP, 0.1 percentage points better than budgeted in the Half Year Economic and Fiscal Update.
- ★ District Health Boards recorded a $27.9m deficit for the December 2010 quarter, down from a deficit of $18.7m in the September Quarter. Employment costs were $1.2bn, up 1.0 per cent for the quarter, compared to total expenses of $3.2bn up 0.1 per cent.
- ★ Local Government recorded a 5.7 percent increase in income and an 8.1 percent increase in costs for the December 2010 quarter, resulting in a deficit for the quarter of $118.8 m.

Notes

1 For the Performance of Manufacturing Index (PMI) and Performance of Services Index (PSI) a figure under 50 shows the sector is contracting; above 50 shows that it is growing. Previous month's figures are often revised and may differ from those published in a previous Bulletin.

An online version of this bulletin is available at www.union.org.nz/economicbulletin122
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