NEW ZEALAND COUNCIL OF TRADE UNIONS
Te Kauae Kaimahi

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Commentary

The Budget: focus on debt, but at what cost?

Summary

The 2011 Budget was a victory of story-line over needs. The story was that the New Zealand government has a debt problem. When confronted with the fact that government debt is not a problem by world standards – one of the lowest in the OECD – the government acknowledges that the real problem is private overseas debt. But it says rating ratings agencies "increasingly lump private and public debt together when looking at sovereign ratings". Maybe so, but that is a long term issue. Does it mean that the government should cut spending sharply when we have not yet got out of recessionary conditions? The question is not "should we reduce debt?" but "how soon?" and "which debt – government or private?"

It is much too soon. As we said in our pre-Budget commentary, the biggest immediate danger to New Zealand as a whole is the ongoing recession – an economy with only fragile signs of recovery and continuing high unemployment. The government still has a vital responsibility to ensure through economic stimulus that the economy doesn't go downhill again and to bring down unemployment. The cuts the government has made to spending mean that the stimulus has suddenly been withdrawn, which risks continuing high unemployment and even return to recession. Meanwhile, overseas investors are queuing to lend to the government. When weighing up the risks between a high likelihood of continuing high unemployment compared to a low probability of trouble with creditors, the answer seems clear.

The Budget has no plan to put right New Zealand's social and economic imbalances, and does little to start cutting back the overseas private debt. It seems to be relying heavily on reconstructing Christchurch, catching up with backlogs in investment built up during the recession, and leaky building repairs to get the economy moving. The Budget of a thousand cuts put debt and deficits ahead of people's needs and a plan for the future.

The 2011 Budget was a victory of story-line over needs. The story was that the New Zealand government has a debt problem that according to the Minister of Finance's Budget speech "leaves the Government vulnerable and less able to meet future shocks. Its double-A plus credit rating is on negative outlook with two rating agencies." We must therefore "eliminate the deficit faster and target a lower level of public debt... Finance costs would otherwise rise unacceptably..." It was therefore a Budget of a thousand cuts, as we anticipated.

When confronted with the fact that government debt is not a problem by world standards – one of the lowest in the OECD – the government acknowledges that the real problem is private overseas debt but says rating ratings agencies "increasingly lump private and public debt together when looking at sovereign ratings". Maybe so, but that is a long term issue. Does it mean that the government should cut spending sharply when we have not yet got out of recessionary conditions? The question is not "should we reduce debt?" but "how soon?" and "which debt – government or private?"

How soon? As we said in our pre-Budget commentary, the biggest immediate danger to New Zealand as a whole is the ongoing recession – an economy with only fragile signs of recovery and continuing high unemployment. The government still has a vital responsibility to ensure through economic stimulus that the economy doesn't go downhill again and to bring down unemployment. The cuts the government has made to spending mean that the stimulus has suddenly been withdrawn. Treasury's measure of "fiscal impulse" suggests that government stimulus will have added 1.9 percent of GDP in the year to June 2011, go to neutral in the year to June 2012 and tighten by taking around 2 percent of GDP from the economy in 2012/13 and 2013/14. It is only the expected spending to repair Christchurch that will prevent the stimulus from going negative straight away. This runs significant risks of continuing high unemployment and even return to recession, especially if there is a negative surprise such as the reconstruction in Canterbury taking longer to get underway than anticipated.

So the answer is – much too soon. Is there a risk that the financial markets or their representatives, the credit rating agencies, might punish us if debt doesn't fall more quickly? There is a risk, and that is why we need to reduce that huge, almost all private, overseas debt which has been growing since financial deregulation in the late 1980s and early 1990s. But there is no sign of "punishment" happening soon. Lenders are queuing to lend to the government at (for New Zealand) attractive interest rates, despite the government being on negative outlook. Treasury aimed at doing its borrowing at less than 6 percent interest rates during the year, and achieved an estimated 4 percent according to its Budget documents. It is now taking advantage of the situation by borrowing in advance and stashing away the proceeds until it needs them. When weighing up the risks between a high likelihood of continuing high unemployment compared to a low probability of trouble with creditors, the answer seems clear.

Negative outlook means the rating agencies may lower the government's credit rating a notch within the next two years. Even the effect of a rating drop is overstated. A recent International Monetary Fund study of credit rating agencies[1], as well as listing their numerous failures in rating countries, concluded that ratings influence interest rates "more through credit warnings [such as New Zealand's negative outlook] than through actual rating changes". Actual rating changes do matter – but only when they have sunk so low as to go below the investment-grade threshold, which New Zealand is nowhere near. In other words, any effect on interest rates would have come from the "negative outlook" – and the effect is not apparent. With continued financial and economic uncertainty in Europe and Japan, and even the US government now on negative outlook, New Zealand looks very attractive to investors as we have seen from recent Chinese interest.

As well as adding to its poor management of the recession by withdrawing the stimulus too early, the Budget presents no plan to right New Zealand's social and economic imbalances. Growing income equality will if anything be exacerbated. There is nothing that will make a significant change to the overseas debt, other than reducing government debt – and not much more than half of that is owed overseas. The self-contradiction of talking about reducing private debt while reducing Kiwisaver incentives was well heralded, but the size of the combined increase in tax-take and cut in tax credit (which will mean many people will be seeing their Kiwisaver funds rising more slowly than their own increased contributions – the increased employer contribution is more than gobbled up by the tax changes) is a worry even to the rating agencies.

[1] "The Uses and Abuses of Sovereign Credit Ratings", Chapter 3 in Global Financial Stability Report, IMF, October 2010.

The only plan seems to be reduce the size of government and help rebuild Christchurch. The plan is for government expenditure to reduce as a proportion of GDP from 36.4 percent in the year to June 2011 to 31.3 percent of GDP in the year to June 2015 – about where it was in 2007 (or 2006 when finance costs are taken into account). That means real cuts in government expenditure out to 2014. If we get falling unemployment and rising wages then some of the reduction will be through reduced costs of benefits and Working for Families, but that is a big "if". Post-Budget announcements make it likely that some will be in cuts to social welfare and in government departments.

To its credit, the government has allocated $5.5 billion for the reconstruction of Christchurch (including $0.5 billion to bail out AMI Insurance if needed), but of that, about $0.7 billion will come out of the reducing government expenditure, forcing cuts elsewhere. The remaining $4.8 billion will be borrowed. In another of the strange contradictions of the Budget, the Minister of Finance stated that "debt funding is both the quickest and fairest way to pay for it". Second best actually – a fairer and more prudent way, if and when the economy does start to fire, would be a targeted levy aimed at those who can best afford it. Some of the debt will be raised by Canterbury Earthquake Kiwi Bonds – an idea that could be used elsewhere for infrastructural development.

The forecasts in the Budget of stronger GDP growth in the year to March 2012 (3.1 percent) and the following year (4.1 percent) and wages growing at 4 percent or more a year for the next four years therefore must be based very heavily on the effects of the Canterbury reconstruction, the effect it will have on economic activity in Christchurch and the demand for skilled labour. However there are forecasts of huge growth in housing construction – a 53.5 percent increase in the year to March 2013, and 17.4 percent the following year – and large growth in business investment – 13.0 percent and 9.8 percent respectively in those two years. Some of that is Christchurch, but some is catching up with backlogs built up during the recession, and leaky building repairs.

A big question will be how much we will have two economies: a few years of frenetic activity in Christchurch, and in the rest of the economy strong building activity but not much else. At the other end of the forecasts, GDP growth returns to a mediocre 2.6 percent in the year to March 2014 and 2.8 percent the next year. There seems to be little in the growth other than riding on crises of nature and regulatory failures.

And of course some cuts also come from people who shouldn't have to take them. The changes to Working for Families affect households with incomes as low as $35,000 (less than half the median income for a household with two parents and dependent children). We are told that at $2.8 billion a year, Working for Families is unaffordable. Considered as a tax cut mainly benefiting lower income households with dependents, it is hard to see why it is unaffordable at $2.8 billion a year where tax cuts mainly benefiting the top 10 percent of households costing over $5 billion a year are affordable. The design of the programme could well be improved, but affordability is not the issue.

We outlined other Budget measures in our Budget-day special Bulletin and will be releasing a report on the Health budget later this week showing the extent of the real cuts there. The Budget of a thousand cuts put debt and deficits ahead of people's needs and a plan for the future.

Bill Rosenberg

Is government debt as bad as it makes out?

A few days before the Budget, the Prime Minister told the country that the government was now borrowing $380 million a week. In 2009 and 2010 government ministers were regularly quoting figures of $240 million a week. In fact, the $380 million and $240 million figures are not comparable.

In late 2009 the CTU provided an analysis of the $240 million that showed that it was an average over four years and was a gross figure – that is, before refinancing of older debt was deducted. A net figure shows genuinely additional borrowing and that was only $130 million because $110 million was used to repay older debt. Nevertheless the government continued to use the $240 million figure.

In contrast, the new $380 million figure is for one year only: the financial year ending next month, 30 June 2011. It is now a net figure. However it is boosted by a significant amount of borrowing which is not yet needed but is being undertaken because investors are exceptionally keen to lend to the New Zealand government, leading to lower interest rates. Treasury is in effect putting the extra borrowed money in the bank until needed.

This was always going to be one of the biggest years for borrowing. The borrowing programme is a multi-year one and should be judged on that basis. Its benefit to New Zealand is multi-year, to help the country get through the recession conditions of high unemployment and low investment and consumption levels which are now into their fourth year.

The figure that is comparable to the $240 million value – a rolling four year average, gross of any repayments – would be $274 million, only $34 million higher than the old number.

The fairest basis to judge the borrowing if we are worried about its effect on the government's finances is on a net basis over four years. That is $176 million compared to the $130 million previously. It has risen, but not nearly as steeply as the government's $380 million figure might make us believe.

All these numbers camouflage the fact that New Zealand does not have a significant government debt problem. It is one of the lowest in the OECD and well below danger levels. New Zealand's biggest debt problem is private debt owed overseas, three-quarters of which is owed by the banks. Just over half of the government's debt is owed to overseas residents. The rest is owed to domestic lenders.

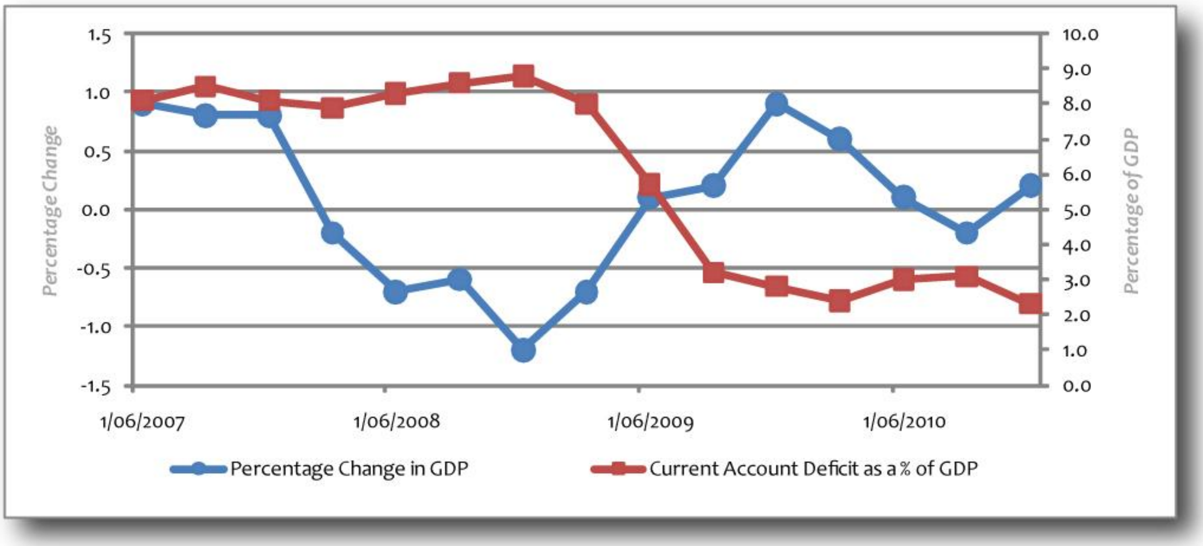
Forecast

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.

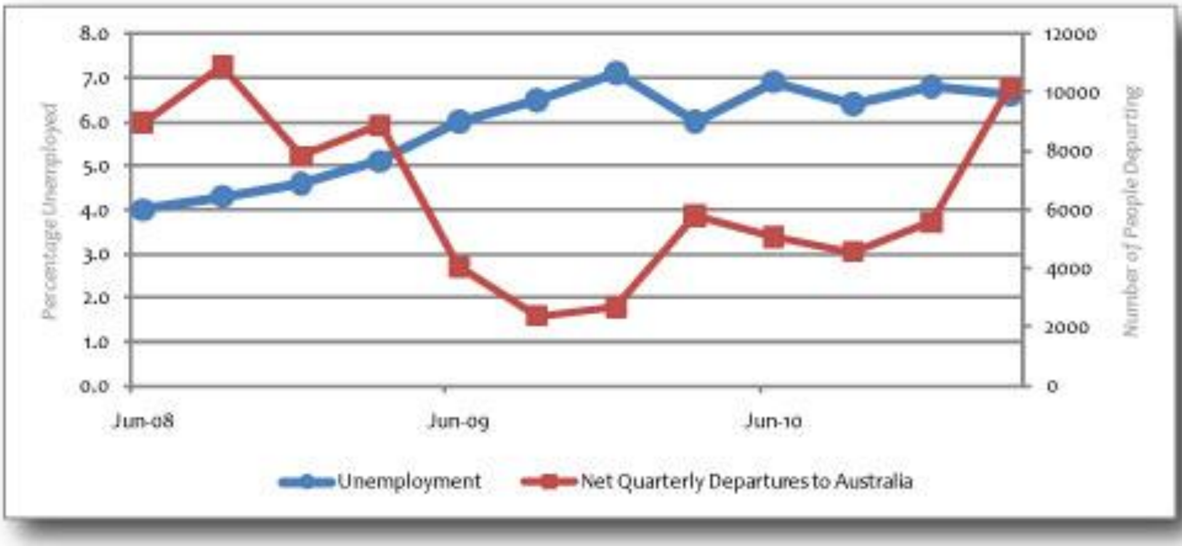
Economy



- Gross Domestic Product was up 0.2 percent in the December 2010 quarter, leaving GDP growth for the year to December 2010 at 1.5 percent.
- 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 April 2011 Overseas Merchandise Trade recorded a $1.1bn surplus – 24.0 percent of the value of exports for the month, which is the highest monthly surplus ever recorded and the highest since May 1993 as a percentage of exports. For the year to April 2011, New Zealand recorded a surplus of $1.2bn (2.6 percent of exports and the largest surplus for a year ended April since 1994). Again dairy products were the biggest factor in the increased value of exports and petroleum products were the biggest factor increasing import costs.
- ★ The Performance of Manufacturing Index for April 2011 rose to 51.5[1], up from 50.1 in March. The employment sub-index was the only one to record a sub-50 result – down to 49.9.

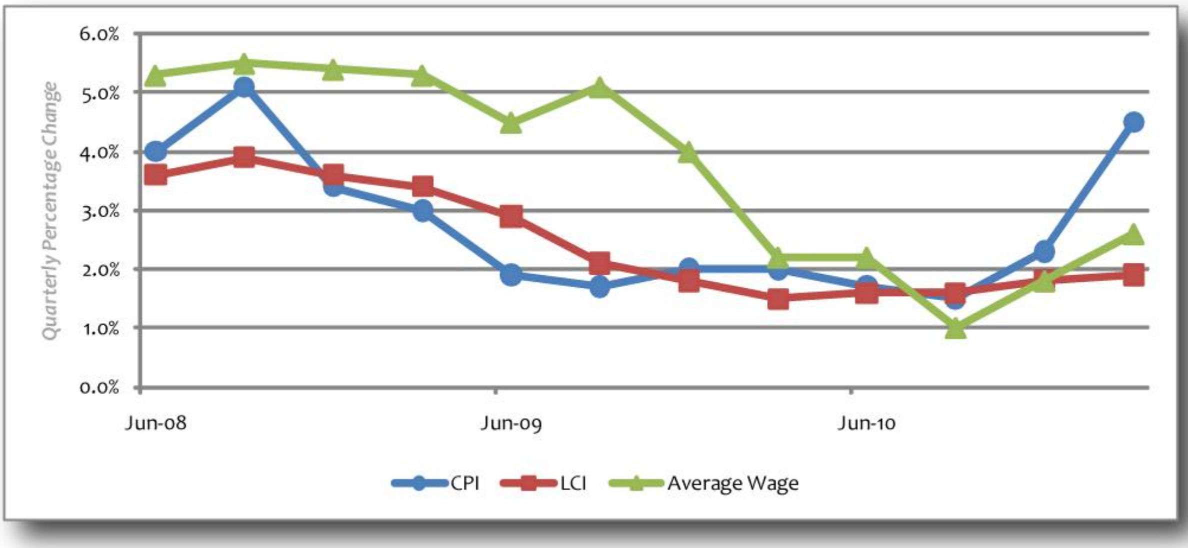
- The Performance of Services Index for April 2011 was 52.6[1], up 1.8 from March. At 53.0, the employment sub-index was up 2.6 on the previous month.
- The Retail Trade Survey found retail sales were down 0.1 percent between the September and December 2010 quarters but up 1.5 percent on the December quarter in 2009.
- On 28 April 2011 the Reserve Bank left the Official Cash Rate unchanged at 2.50 percent. The next review will be on 9 June 2011.
- The REINZ Housing Price Index recorded a 1.2 percent increase in house prices for the month of April 2011, but the median house price actually fell $5,000 to $360,000. House prices are also still down 0.4 percent for the year to April.

Employment



- According to the Household Labour Force Survey the unemployment rate in the March quarter was 6.6 percent, down 0.1 percent on the December quarter. The participation rate was 68.7 percent – up 0.8 percent on December. Māori unemployment was 16.1 percent, Pacific unemployment was 14.0 percent, Asian unemployment was 9.3 percent and European/Pakeha unemployment was 4.9 percent. Youth unemployment (15-19 year olds) was 27.5 percent.
- At the end of April 2011 there were 58,194 people on the Unemployment Benefit, a decline of 1,149, or 1.9 percent, from March 2011. (Quarterly figures on Unemployment Benefit numbers are available from the MSD website.)
- In the three months to the end of April 2011 Job Vacancies Online increased 4.2 percent and advertised vacancies for skilled jobs increased 5.1 percent.
- International Travel and Migration figures show 5,700 permanent and long-term arrivals to New Zealand in April 2011 and 7,339 departures. Net migration in the year to April 2011 was 5,508 arrivals. Net migration to Australia in the year to April was 26,979 departures.

Wages



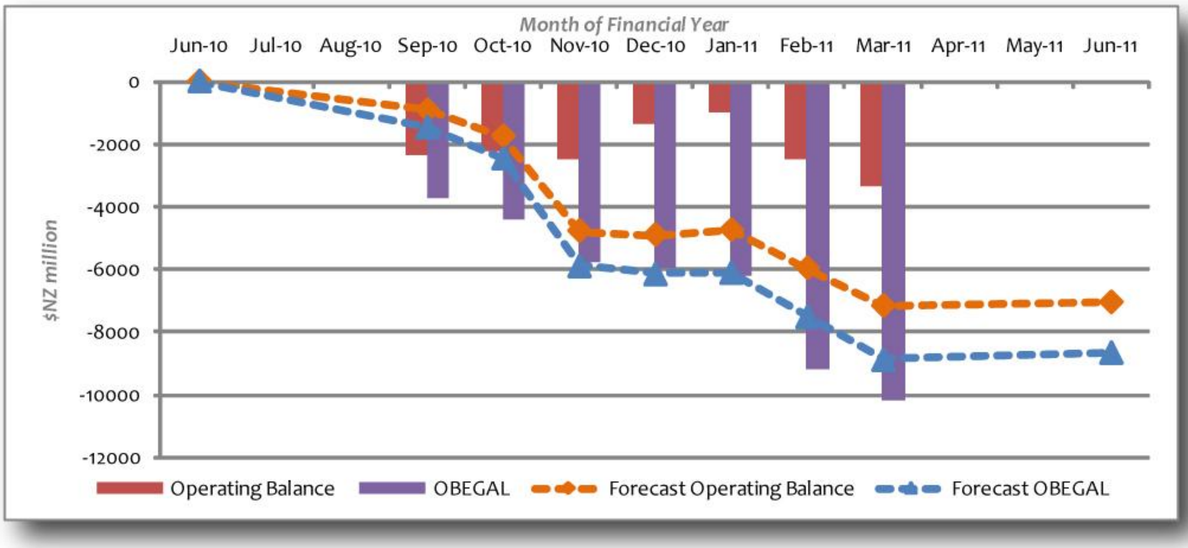
★ The Labour Cost Index (Wage and Salary Rates) (LCI) rose 1.9 percent for the year to March 2011 and 0.5 percent for the March quarter. For those surveyed who received an increase in their salary or wage rate during the year, the median increase was 3.0 percent.

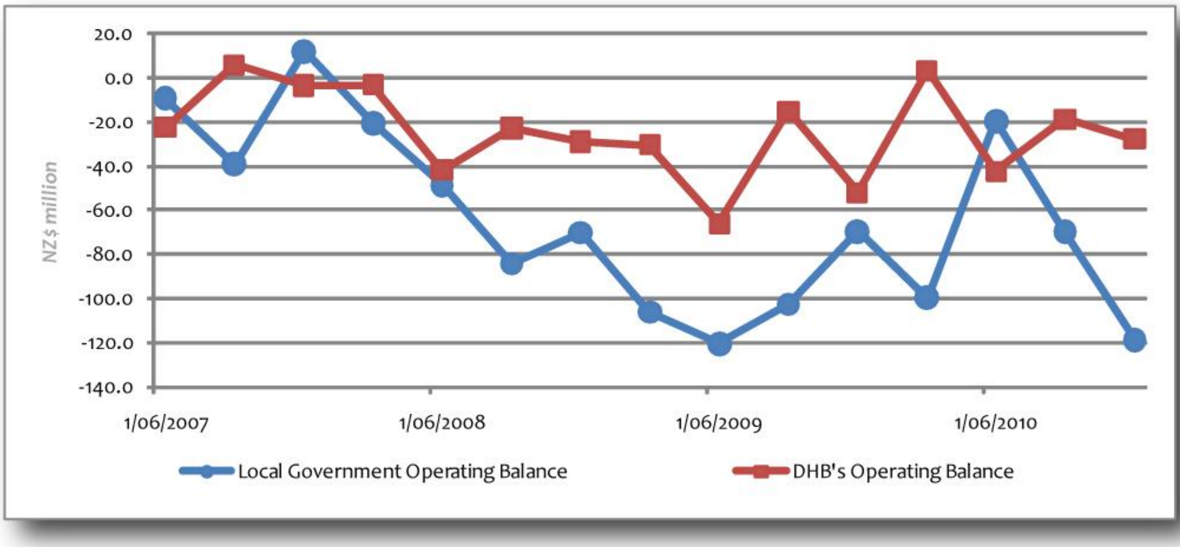
★ The March 2011 Quarterly Employment Survey found the average hourly earnings for ordinary-time work was $25.93, up 0.4 percent on the December quarter. The average ordinary-time wage was $23.93 in the private sector (up 0.3 percent in the quarter and 2.5 percent in the year) and $33.46 in the public sector (up 2.3 percent in the quarter and 2.8 percent in the year). Per hour, female workers earned 87.5 percent of what male workers earned.

- The Consumer Price Index for the March 2011 quarter rose 0.8 percent, and 4.5 percent for the year to March.

★ The Food Price Index rose 0.1 percent in the month of April, contributing to a 6.1 percent increase in food prices between April 2010 and April 2011.

Public Sector





- According to Treasury's [Month End Financial Statement] for the nine months to the end of March 2011, government revenue was down $466m (1.1 percent) on the forecast in December's Half Year Economic and Fiscal Update (HYEFU) and expenditure was up $422m (0.8 percent). The operating deficit before gains and losses (OBEGAL) was $10.2bn, $1.3bn higher than forecast mainly because of EQC's estimated $1.5 billion share of the 22 February earthquake in Christchurch. The operating deficit was $3.3bn, $3.8bn below forecast due to gains in value in the ACC and NZS investment funds and ACC "actuarial gains". The Government's net debt is 20.2 percent of GDP, 0.1 percentage points better than budgeted in the HYEFU.
- District Health Boards recorded an increased deficit of $27.9m for the December 2010 quarter compared to the September quarter's deficit of $18.7m. Employment costs were $1.2bn, up 1.0 percent for the quarter, compared to total expenses of $3.2bn up 0.1 percent.
- 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 $118.8m.

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.

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