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Commentary

Post-election. Pre-crisis?

Summary

Events around the world threaten another round of recession and dangerous financial turmoil. Just as in 2008, there was little debate about what parties would do if the economy plunges. The incoming government could once again plead "crisis" and change may be much deeper than National's election platform.

In the US, unemployment is still at 9 percent. A congressional committee set up to negotiate reductions in the federal government's huge deficit broke up in acrimony – a symptom of their toxic politics. If it prevents another stimulus programme, a return to recession would undoubtedly affect the world economy.

In Europe, deepening economic and financial crises are leading to severe social crises with high unemployment and steeply falling incomes for many people. They may result in attacks on wages and labour rights – hardly a recipe for recovery. If many countries cut spending and force down wages there will be recession at least in Europe and probably more widely.

The crisis was caused by irresponsible behaviour in the financial system and by governments which failed to control it. Yet it is ordinary people who are suffering the consequences. It is the 1 percent versus the 99 percent in all its brutality.

What about New Zealand? The Christchurch reconstruction will provide an economic stimulus, but its timing has receded to the second half of 2012, and risks even further delays. In a recession, the government would be foolish to stick to its debt reduction targets. It would have harsh social consequences but would also starve the government accounts of tax revenue. The government has plenty of room to move in terms of its own debt – the 6th lowest gross government debt in the OECD in 2011. The real risk is the high international, mainly bank, debt. It is not clear how National will tackle it.

We hear rumours that the government's next big idea will be "improving competitiveness". If it turns into further attacks on wages and working conditions, it will dig us deeper into a low wage economy, not out of it.

A recent Department of Labour publication stated: "The New Zealand labour market faces the risk that it will get trapped in a low-wage, low skill equilibrium, where low wages and poor productivity growth become self-reinforcing." A new IMF research report says that strengthening the collective bargaining power of workers is unavoidable: "Higher income inequality in developed countries is associated with higher domestic and foreign indebtedness". It seems that low wages are simply not sustainable.

There is potential here for a policy platform that addresses sustainability in all its aspects: social, economic and environmental. Now, that's worth thinking about. Have a good break.

This is the first Bulletin after the election and the last before the end of the year so it's a good time to do some thinking about the future.

Events around the world threaten another round of recession and dangerous financial turmoil. Just as in 2008, when an election took place under the rapidly gathering storm clouds of the worst financial crisis since the 1930s, there was little debate about "Plan B": what would parties do if the economy plunges again? The incoming government will once again plead "crisis" as it takes actions that were never put before electors. Change may be much deeper than National's election platform.

In the US, unemployment is still at 9 percent. A congressional committee set up to negotiate spending cuts and revenue increases to reduce the US federal government's huge budget deficit broke up in acrimony just a week ago. It is a symptom of the toxic politics in the US. They are not simply party politics but openly class-based politics where unaffordable tax cuts for those on high incomes given "temporarily" by the Bush administration are being defended to the point of refusing sufficient funding to the government to pay its bills. In the light of the trillions of dollars of subsidies given to privately owned financial institutions to dig them out of their own mess, it seems extraordinary that such people can continue to demand more. Injury is heaped on insult. A recent example involved a company controlled by a former chief executive of insurance giant AIG. AIG made huge profits from the toxic financial products that brought down the financial system and received US$182.3 billion in bailouts from the government when it crashed. The former boss is suing the government for US$25 billion for violating "shareholder's rights" in taking over the company as part of the bailout.

Meanwhile most of the faults in the regulation and structure of the financial system remain because of the power of the financial sector to resist change. House prices continue to fall, meaning household debt problems which underlay the 2007-08 crisis are not being resolved.

If politics prevents another stimulus programme, a return to recession would undoubtedly affect the world economy.

In Europe, Italy has joined Portugal, Iceland, Ireland, Greece, and Spain (the PIGS) in severe financial trouble. Credit rating agency Moody's has warned that the rating of every European country is under threat. I wrote last month in a Dominion Post opinion piece that judging a government's policies by credit ratings is like letting bankers run the government. Greece and Italy are now almost literally in that position. Both have unelected technocratic governments (in Greece's case headed by a banker) running the country. Deepening economic crisis is leading to severe social crises with high unemployment and steeply falling incomes for many people. The OECD puts Greece's unemployment rate at 16.6 percent, rising to 18.7 percent in 2013. The "medicine" it has been given has plunged the country into severe recession. Portugal is in continuing recession with unemployment rising to 14.2 percent, and Spain is barely growing with unemployment expected to be 22.9 percent next year. Ireland has only slightly better GDP growth rates with unemployment at 14.1 percent which is not expected to fall before 2013. In sharp contrast, Iceland, which had the largest proportionate financial crash of all, is beginning to grow quite strongly with unemployment still at 7.0 percent but expected to fall to 5.3 percent by 2013. Why the difference? Its people refused to bail out the crashed financial institutions.

The crisis in the European financial system, and particularly in those countries using the Euro currency, is in a dangerous and unpredictable state. The solvency of banks which are owed money by PIGS governments is now threatened in Belgium, France and even Germany. The two largest economies, France and Germany, cannot agree on the action to take. The international agencies, the OECD and the IMF are torn between the need for governments to spend more to prevent recession spreading, and to spend less to reduce government debt. The OECD calls for the Euro powers to get their act together to prevent further bank failures. But it also calls for "sustainable structural adjustment to raise long-term growth rates and promote global rebalancing," including "deep structural reforms" in labour and product markets. This seems to be aimed at pushing down wages and weakening labour laws – hardly a recipe for recovery.

We should never forget that this crisis was caused by irresponsible behaviour in the financial system and by governments, particularly in the US and UK, which failed to control that behaviour. Yet it is ordinary people who are suffering the consequences. It is the 1 percent versus the 99 percent in all its brutality.

If many countries cut spending and force down wages – and especially if the financial crisis is not resolved quickly – then there will be recession at least in the Euro area and probably more widely. The spending cuts in the U.K. have led to very weak growth, with some forecasts of recession, and unemployment expected to rise to 9.1 percent in 2013.

Unresolved government debt and bank problems, if they led to "a large negative event" (such as a major bank collapse – not impossible) would, says the OECD, "most likely send the OECD area as a whole into recession, with marked declines in activity in the United States and Japan, and prolong and deepen the recession in the euro area. Unemployment would rise still further. The emerging market economies would not be immune, with global trade volumes falling strongly, and the value of their international asset holdings being hit by weaker financial asset prices."

If this happens (and the OECD says policy makers "must be prepared to face the worst"), it calls for stimulus "where this is practical", protecting the social safety net, further monetary loosening, and "stronger fiscal frameworks ... to reassure markets that the public finances can be brought under control". These seem impossible combinations. The result could be deeper recession than we saw in 2008-2009.

Meanwhile China, whose strong growth helped pull the OECD economies out of the 2008-09 recession, is also looking slightly weaker. It is not heading for recession, but getting to the limit of its ability to stimulate the domestic economy without unacceptable inflation and high levels of bad debts leading to its own financial fallout. It is also facing weaker export markets to Europe and the US. New Zealand's other important market, Australia, is also currently looking weaker, though the OECD still forecasts increased GDP growth in 2012 – assuming the international risks do not become realities.

So what about New Zealand? The Christchurch reconstruction will provide a stimulus to the economy. However, the timing of this has receded to the second half of 2012, and there are ever-present risks of it being pushed back even further as a result of further earthquakes, engineering complications and insurance problems – and when the new head of the Employers and Manufacturers Association, Kim Campbell, tells the Christchurch Press (26 November) that “the way the insurance companies are behaving is appalling”, the situation must be serious. When reconstruction does get under way, what its impact will be on the rest of the economy is unclear. Will it push up wages for skilled people needed for the reconstruction just in Christchurch? Will the price hikes resulting from demand for building materials, services and people be just in Christchurch or national? How will it affect other sectors of the economy not directly involved in reconstruction? It is possible we get a tale of two economies – Christchurch booming, the rest just plodding on as at present, or even stalling because resources are scarce.

If an international economic crisis arrives, the banks in New Zealand are in better shape than in 2008 because the Reserve Bank has forced them to reduce their reliance on short term overseas funding – but 38 percent of their funding is still from overseas, and it has recently been difficult or very expensive for them to fund longer term overseas loans. That would get worse if the European financial markets crash. A crash that forces the government to bail out the banks is the credit rating agencies’ greatest fear, and we should fear it too. Work is going on to limit government liability but the banks have slowed the process down. The plan is to have it in place by the end of 2012. We need to watch out for the effects on bank depositors.

The government would be foolish to stick to its debt reduction targets if recession returned. It would have harsh social consequences but would also starve the government accounts of tax revenue. Given the slow moving economy and the unknowns around Christchurch, it is taking risks in cutting expenditure in any case. The 2011 Budget forecast that falls in government spending would slow the economy in the years to June 2013 and 2014. It counted on the private sector for economic growth.

New Zealand has plenty of room to move in terms of its government debt – for 2011 it is listed as having the 6th lowest gross government debt in the OECD. The real risk is the international debt which is overwhelmingly private (mainly bank) debt. But the OECD forecasts it will increase more rapidly than Treasury’s pre-election forecasts.

The international debt is one of the most important economic challenges for the incoming government. It is not clear how National will tackle it. The rhetoric is that by reducing government spending and core public service staff numbers, improving the efficiency of government, selling assets, privatising parts of ACC and other services, yet another round of regulatory reform and negotiating a further raft of free trade and investment agreements, the right basis is established. These policies haven’t worked before. Though we would argue about priorities, there are stronger policies in infrastructure development and a moderate increase in science funding. There has been good fortune in higher export commodity prices such as dairy and meat which now show signs of levelling off and are likely to fall as economies in China, the US and Europe slow, but their effect has also been to push the New Zealand economy back towards low added-value commodity exports rather than higher value, higher wage production.

The government appears to think the savings problem has been solved, evidenced by households reducing their debt. In fact, the Reserve Bank says[1] household loan-to-value ratios (how much households owe compared to the value of their houses) have risen since 2007, not fallen. Debt has reduced but house prices have fallen faster – leaving households still at risk in a crash. High farm debt will be sorely exposed if prices fall.

In all, the package is unconvincing to turn around the international debt situation.

We hear rumours that the government's next big idea will be "improving competitiveness". While international competitiveness is needed to increase exports, if it turns into a further attack on wages, salaries and working conditions as some of their announced employment relations policies already signal, it will dig us deeper into a low wage economy, not out of it. There is increasing thinking that in fact we need greater cooperation domestically to increase competitiveness internationally. That should apply to wages and working conditions too.

A recent Department of Labour publication stated: "The New Zealand labour market faces the risk that it will get trapped in a low-wage, low skill equilibrium, where low wages and poor productivity growth become self-reinforcing."[2] While it did not go on to address the wages issue, the statement is a highly relevant one. Compared to the rest of the OECD, New Zealand is currently a low wage, low-value-added economy.

Yet another research report from the IMF[3] reinforces the view that low wages are simply not sustainable: it found that "Higher income inequality in developed countries is associated with higher domestic and foreign indebtedness". For New Zealand, add the loss of more people overseas. The report pins blame on finance being deregulated while inequalities were ignored. It says that strengthening the collective bargaining power of workers is unavoidable, and the tax burden needs to be moved off workers. It suggests a more progressive income tax system, or reducing income taxes in favour of taxes on profits from investments in land, natural resources, and the financial sector.

There is potential here for a policy platform that addresses sustainability in all its aspects: social, economic and environmental. Now, that's worth thinking about.

Have a good holiday break. The next Bulletin will be on 31 January.

Bill Rosenberg

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[1] Financial Stability Report, November 2011, p.20.

[2] "Skills Challenge Report: New Zealand's skills challenges over the next 10 years", Department of Labour, 2011, p.9. http://www.dol.govt.nz/publications/research/skills-challenge/skills-challenge.pdf.

[3] "Unequal = Indebted", by Michael Kumhof and Romain Rancière, *Finance and Development,* September 2011, Vo. 48, no.3, http://www.imf.org/external/pubs/ft/fandd/2011/09/kumhof.htm.

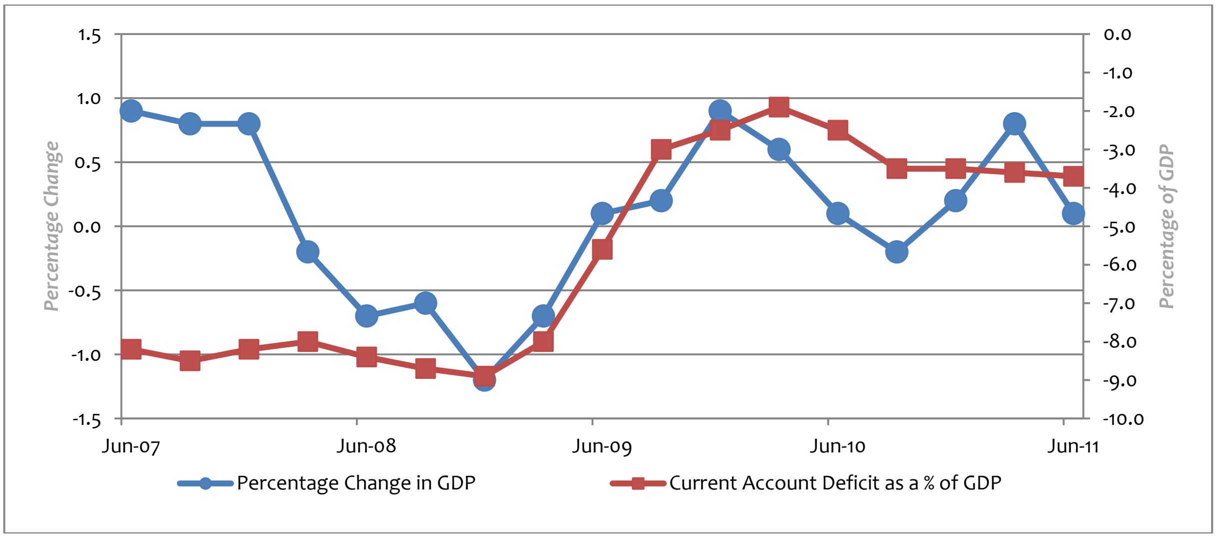
Forecast

★ This NZIER consensus forecast was published on 19 September 2011.

Annual Percentage Change (March Year)	**2011-12**	**2012-13**	**2013-14**
GDP	2.6	3.7	2.9
CPI	2.8	2.6	2.7
Private Sector Wages	3.2	3.5	3.8
Employment	1.7	2.5	1.7
Unemployment	6.0	5.2	4.8

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

Economy

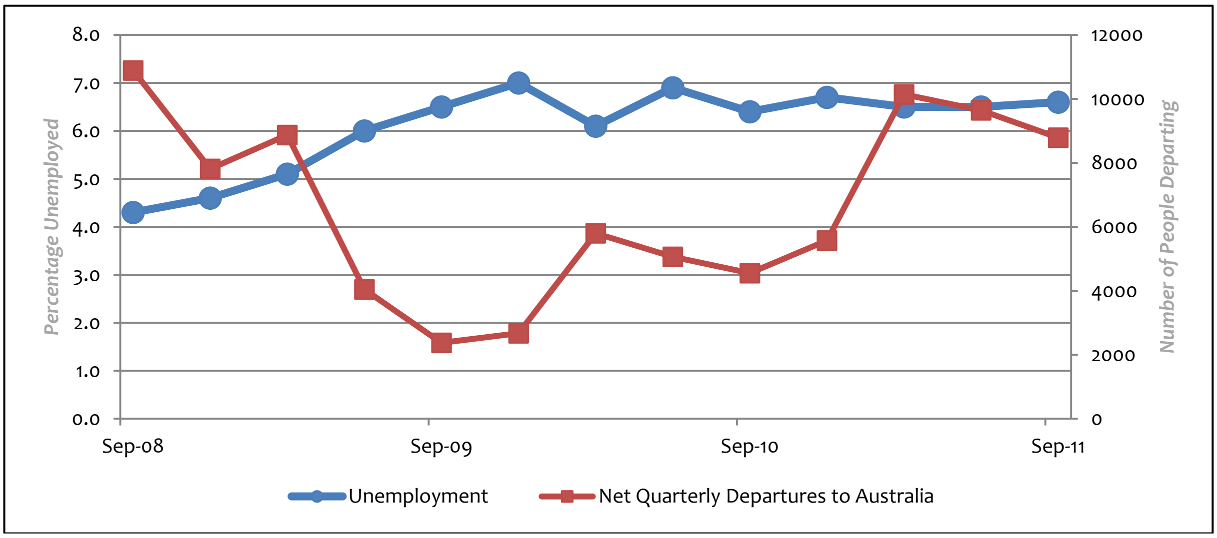


- Gross Domestic Product was up 0.1 percent in the June 2011 quarter, leaving GDP growth for the year to June 2011 at 1.5 percent.
- New Zealand recorded a Current Account deficit of $2.0bn for the June 2011 quarter and a deficit for the year to June of $7.5bn (3.7 percent of GDP). This compares with a current account deficit of $4.7bn (2.5 percent of GDP) for the year ended June 2010. The annual deficit is mainly due to profits and interest going to overseas investors ($9.7bn deficit) plus a deficit in services trade ($0.9bn) partially offset by a positive balance on goods trade ($3.5bn).
- The country's Net International Liabilities were $140.2bn at the end of June 2011 – 70.0 percent of GDP and $4.1bn more than at the end of March 2011. In June, the government was still not a contributor to the net international liabilities – it had $4.0 billion more overseas assets than liabilities. International assets have been significantly revised (with revisions going back to 2000) by including an estimate for prevous under coverage of New Zealand portfolio investment in Australian companies, assets held overseas by small fund managers, and student loans owed by non-residents. This has resulted in a reduction in recorded Net International Liabilities by an average of $9bn over the decade and $12.2bn in March 2011 – an improvement of 8.2 percent. Along with the $12.0bn due for outstanding reinsurance claims from the Canterbury

earthquakes, net international liabilities appear to have undergone a miraculous improvement from a peak of 90.2 percent of GDP in March 2009 to 70.0 percent in June, 15 months later, but this is not due to any change in the balance of the economy. The peak has now been revised to 84.6 percent of GDP, and the reinsurance from the intervening earthquake completes most of the improvement.

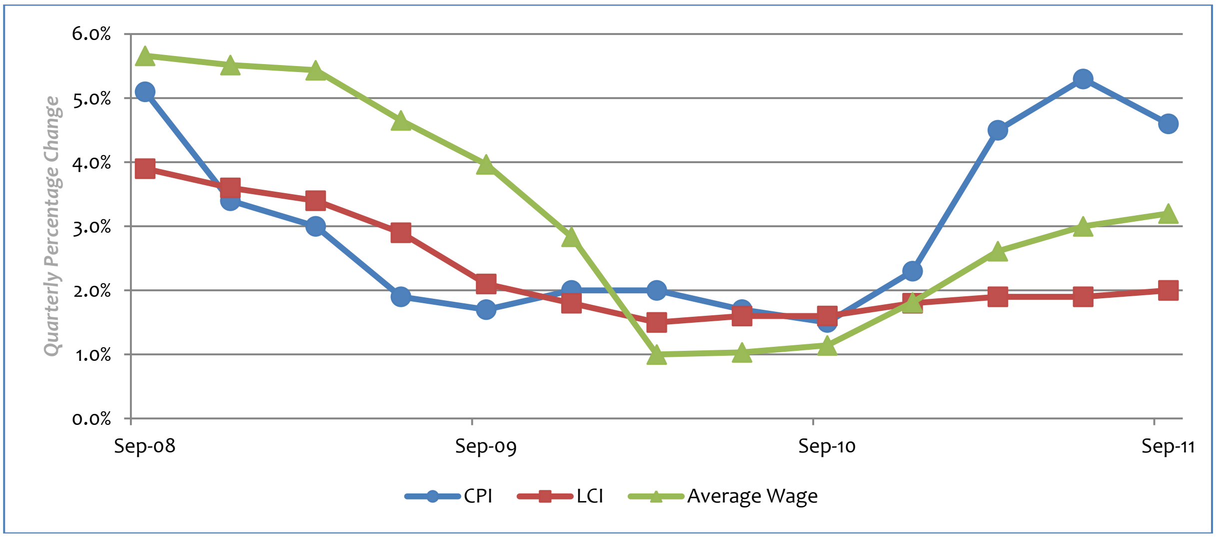
- For October 2011, Overseas Merchandise Trade recorded a $282 million deficit – 7.3 percent of the value of exports for the month. For the year to October 2011, New Zealand recorded a surplus of $627 million (1.3 percent of exports). Comparing the month of October 2011 with 2010, exports were up $195 million (5.3 percent) to $3.9 bn and imports up $257 million (6.6 percent) to $4.2bn. Import increases for the month were led by intermediate goods, while consumer goods were flat. Increases were highest in processed industrial supplies (mainly fertilisers), crude oil, and processed fuels and lubricants excluding motor spirit. Mechanical equipment, electrical equipment, passenger motor vehicles, petrol and avgas also increased. Export increases were led by meat (up 22 percent), crude oil (up 37 percent) and ships up $21 million, led by fishing vessels of over 50m. The greatest increase in imports was from Saudi Arabia, followed by the Singapore, Qatar, Malaysia, Germany, and Hungary. The greatest increases in exports were (in decreasing order) to Australia, the US, Japan, South Korea and China.
- The Performance of Manufacturing Index for October 2011 fell further to 46,5[1] from 50.5 in September, hitting the lowest level since June 2009. The employment sub-index also fell: to 48.6 from 50.9 in September, the lowest it has been since October 2009.
- The Performance of Services Index for October 2011 was 50.6[1], down from 52.9 in September. The employment sub-index fell to 49.5, after a sharp rise in September to 53.5 from 49.4 in August.
- The Retail Trade Survey for September 2011 found retail sales were up 2.2 percent by volume and 2.1 percent by value between the June and September 2011 quarters, the largest quarterly increase since December 2006, largely due to the Rugby World Cup. They were up 3.9 percent by volume and 6.3 percent by value compared to the September quarter in 2010.
- On 27 October 2011 the Reserve Bank left the Official Cash Rate unchanged at 2.50 percent. The next review will be on 8 December 2011 and will include a Monetary Policy Statement.
- The REINZ Housing Price Index recorded a 0.3 percent fall in house prices for the month of October 2011, but the median house price was up $9,000 to $359,000. The House Price Index was up 3.4 percent for the year to October.

Employment



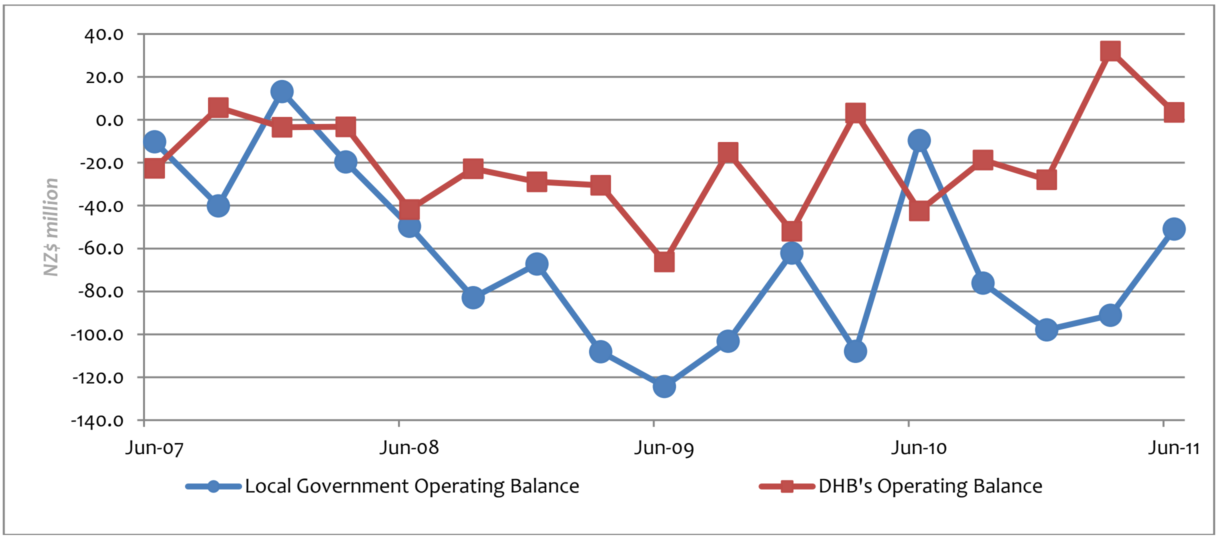
- According to the Household Labour Force Survey the unemployment rate in the September 2011 quarter was 6.6 percent, up slightly from 6.5 percent in the June quarter. The participation rate was 68.4 percent – up 0.1 percentage points on June. There are 157,000 people unemployed. Māori unemployment was 15.1 percent, Pacific unemployment was 13.8 percent, Asian unemployment was 7.8 percent and European/Pakeha unemployment was 4.3 percent. Youth unemployment (15-19 year olds) was 23.4 percent.
- At the end of October 2011 there were 54,932 people on an Unemployment Benefit, a decline of 789, or 1.4 percent, from September 2011. (Quarterly figures on Unemployment Benefit numbers are available from the MSD website.)
- In October 2011 Job Vacancies Online fell by 4.5 percent for all vacancies and 3.3 percent for skilled jobs in seasonally adjusted terms.
- International Travel and Migration figures show 6,587 permanent and long-term arrivals to New Zealand in October 2011 and 5,763 departures. There was a net loss of 103 migrants in the year to October 2011, the first annual net loss since the September 2001 year. Net migration to Australia in the year to October was 34,957 departures. The number of departures from Christchurch since the 22 February earthquake was 2,300 higher than the same period last year, but there was an increase of 14,500 departures to Australia from New Zealand nationally from October 2010 to October 2011.

Wages



- The [Labour Cost Index (Wage and Salary Rates)] (LCI) rose 2.0 percent for the year to September 2011 and 0.6 percent for the September quarter for salary and ordinary time rates. It rose 1.8 percent in the public sector and 2.0 percent in the private sector for the year. For the 56 percent of those surveyed who received an increase in their salary or wage rate during the year, the median increase was 3.0 percent.
- The September 2011 Quarterly Employment Survey found the average hourly earnings for ordinary-time work was $26.53, up 1.2 percent on the June quarter and 3.2 percent over the year. The average ordinary-time wage was $24.52 in the private sector (up 1.3 percent in the quarter and 3.4 percent in the year) and $33.52 in the public sector (up 0.9 percent in the quarter and 2.8 percent in the year). Female workers (at $24.63) earned 87.4 percent of what male workers earned (at $28.17) for average ordinary time hourly earnings.
- The Consumer Price Index for the September 2011 quarter rose 0.4 percent, and 4.6 percent for the year to June. For the quarter, food costs were up 1.7 percent, insurance and credit services were up 2.4 and 2.3 percent respectively, transport costs were down 1.0 percent and communications down 3.6 percent.
- The Food Price Index fell 1.3 percent in the month of October, leaving a 1.1 percent increase in food prices between October 2010 and October 2011. The lower annual increase than previous months (it was 4.7 percent in the year to September 2011 for example) is largely due to the GST increase which occurred in October 2010 dropping out. This had contributed an annual increase of 2.2 percent to food prices. Between September and October, Fruit and Vegetable prices fell 6.1 percent, Grocery Food fell 0.3 percent, Meat, Poultry and Fish fell 1.5 percent, Non-alcoholic Beverages fell 0.9 percent, and Restaurant Meals and Ready-to-eat Food prices rose 0.1 percent.

Public Sector



- According to Treasury's Financial Statements of the Government of New Zealand for the three months ended September 2011, government revenue was down $320m (2.2 percent) on the forecast in the 2011 Pre-Election Economic and Fiscal Update (PREFU) (mainly due to tax revenue down $301m) and expenditure was up $115m (0.7 percent) on forecast. The operating deficit before gains and losses (OBEGAL) was $2.5bn, $0.2bn worse than forecast. The operating deficit was $7.0bn, $12 million worse than forecast. The Government's net debt is 22.6 percent of GDP, 0.2 percentage points better than budgeted in the PREFU.
- District Health Boards recorded an operating deficit of $3.5m for the June 2011 quarter compared to a surplus in the March 2011 quarter of $32.1m. Employment costs were $1.24bn, up 4.0 percent for the quarter, compared to total expenses of $3.33bn, up 4.8 percent.
- Local Government recorded a 2.3 percent increase in operating income and a 0.1 percent increase in operating expenditure for the June 2011 quarter compared to March, resulting in an operating deficit for the quarter of $91.0m, all in seasonally adjusted terms.

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.

This bulletin is available online at http://www.union.org.nz/economicbulletin130.
For further information contact Bill Rosenberg.