An imminent recession? Be prepared.

by Keith Rankin, Unitec Business School, 26 March 2008

To ask the question "Is a recession imminent?" is much like asking a meteorologist whether we should expect a "weather bomb". The answer will be "yes, sometime", But she would not be able to say when the bomb will strike.

The question that really matters is: "Are we prepared for a recession?" I think the answer is "no". We have few systems in place for managing recessions. Many of the systems we once had we have since dismantled.

All recessions are a bit different. In the 1990s we were worried about "jobless growth"; expansion of output while still having high unemployment. When the next recession strikes, we may for a while have the opposite: "job-full slowth". Indeed real gross national income per person – our best measure of growth of living standards – has grown by only just over one percent per year since 2004.

New Zealand's best bet for a quick exit from a recession this decade would be through its tradable sector; a fall in the exchange rate accompanied by an expansion in the kinds of exportable primary, manufacturing and service activities that received a boost early in the decade.

Such a recovery would inevitably be accompanied, for maybe two years, by inflation rates above four percent. In 2001 the labour market was not as tight as it is now. Unemployed and underemployed workers were able to be recruited into those growth activities.

Today, in a recession with relatively low unemployment, the recovery sectors will have to attract workers away from today's bloated non-tradable services sectors. That will happen more easily in an environment of reduced interest rates and rising output prices in those tradable sectors.

(Up until the 1960s, economists called the tradable sector plus construction and utilities the "productive sector" and most non-tradable services the "unproductive sector". While there were problems with that taxonomy, a more widespread use of the term "unproductive sector" today would help us to see our current problems more clearly.)

Would the Reserve Bank be prepared to facilitate a recovery process that might see inflation rise to say eight percent for a couple of years? I fear not. Their mandate is to keep inflation below three percent, even if they have to stifle an export-led recovery.

I believe that monetary policy in New Zealand is not flexible enough to deal with a recession if confronted by such an event. The greatest weakness lies in the Policy Targets Agreement, which requires a government to explicitly "go soft on inflation" before the Reserve Bank can give priority to recession-fighting policies. Our situation contrasts with that of the United States, where the Fed is able to make its own reprioritisation decisions.

A recession in New Zealand, whenever it might happen, may be accompanied by a financial crisis in Australia. A disproportionate amount of the world's money has sloshed into both New Zealand and Australia in recent years, pushing both countries' currencies to 25-year highs against the greenback. And giving both countries similar balance of payments' headaches, despite high world prices in traditional export commodities.

What will happen to New Zealand's Australian-owned banking system in the event of an international run on the Australian banks? (There was such a run in 1893.) Even if such a crisis in Australia seems unlikely, we need to be able to think through the possible scenarios of contagion arising from a financial crisis across the ditch.

John Key says that, while a recession is unlikely, personal income tax cuts today will help us prepare for a possible recession tomorrow. This may or may not be true, depending on whether the resulting tax scale is more progressive or more regressive.

New Zealand currently has one of the least progressive tax scales, meaning that average tax rates are comparatively high for low-income recipients and comparatively low for high-income recipients.

Progressive income-tax acts as a powerful "automatic stabiliser" to the business cycle. If average tax rates decline as incomes fall, then households are better-placed to maintain their spending, and therefore to keep businesses in business and workers employed.

The whole issue of automatic stabilisation is best understood by considering income taxes and social welfare benefits as a single system of "net taxation". Thus, in this macroeconomic context, <u>all</u> cash benefits can be understood as tax credits or negative taxes. A beneficiary household therefore has a negative average tax rate.

A society with powerful automatic stabilisers – a comprehensive progressive system of net taxation – is able to ride out a recession with little difficulty, while also having fewer inflationary pressures during a period of expansion. It is the government's Budget that automatically takes up the slack and the burden, by automatically moving into quite large deficits during a recession and into quite large surpluses during an expansion.

In the 1970s and 1980s New Zealand did have a powerful system of automatic stabilisation. That system did work to limit the social costs of the recessions of 1977/78 and 1982/83. It also worked well in the late 1980s, despite a flattening of the income tax scale. And in 1998, helped in part by tax cuts to middle-income recipients.

Since 2000, new philosophies have undermined the capability of the welfare net to cushion the effects of a recession. These changes to welfare payments have never been road-tested by as much as a simulated recession.

The principal shift has been the process of paying more benefits to low- and middle-income employed households with children, while allowing the erosion through cumulative inflation of payments to persons who live in households where nobody is employed.

Working for Families (WFF) makes payments specifically to employed households with children. WFF targets single-earner households, given that households with two incomes on the average fulltime wage would only qualify for a non-trivial payment if they had at least three children. We should note though that many households benefiting from In-Work Tax Credits (IWTCs) have one-and-a-half earners. One parent, more likely the mother, is employed part-time.

We now consider the impact of a recession on these households. A common scenario would be that, after the full onset of recession, a household falls from one or one-and-a-half incomes to zero incomes or half an income.

Such households lose their IWTCs as well as losing most of their income. This is a process of automatic <u>de</u>stabilisation!

(The problem will be compounded if that household was in receipt of Child Support income, in the event that at least one of the children was the natural child of someone not living in the household. In that case, if this becomes a beneficiary household, three sources of income will have been lost, in return for a paltry benefit that has a number of humiliating conditions attached to it.)

If our example household, which contains a couple (married, civil union, or de facto partnership), now has just one breadwinner, working short-time or part-time, then the reduced hours of work disqualify them from their IWTC. There will be two ways to re-qualify. The first will be to somehow get their combined hours of work up to 30 per week.

The second way to regain the IWTC will be for the couple to separate. This is because a single-parent only needs to work for 20 hours to qualify for this peculiar tax credit. Do we really want to have to deal with a spate of family splits when a recession leads to a rise in the unemployment rate, as most likely will happen one day?

If the remaining part-time or short-time worker (of a two-parent family) works less than 20 hours per week, another set of perverse incentives will apply. The family will be forced to apply for an unemployment benefit. Or, if the parents separate, the parent in part-time work could then apply for the less ungenerous domestic purposes benefit. Indeed, a woman working 15 hours and earning $180 per week would be significantly better off financially if her partner was to leave the household; more money and one less mouth to feed.

In the last decade we have created a system of automatic destabilisers that will significantly aggravate the negative multiplier effect that takes place during a recession. This is compounded by the comparatively high rates of income tax that part-time workers in New Zealand are obliged to pay.

(Further, socially divisive incentives will add to the cost of a renewed bout of unemployment. In the 1880s, many unemployed fathers had to desert their wives to ensure that their families would qualify for charity.)

If we do have a recession soon, it would be preferable by far to have a period in which price signals enable a smooth transition to export-led growth, with unemployment increases confined to the frictional category of unemployment. Such a realignment of relative prices would need to be accompanied by falling interest and exchange rates, and by a couple of years of annual inflation well above three percent.

I believe that, in practice, we will be quite clueless about how to manage our next recession. We have simply not addressed the issue, preferring to believe we are somehow immune from the travails of our economic past. Some time in the next ten years, an economic inconvenience will, I believe, escalate into an unnecessary social tragedy.

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