2011 New Zealand Budget Reflections

by Keith Rankin, 20 May 2011

Yesterday's 2011 Budget was actually quite responsible. It is really a high deficit Budget, as it should have been, while doing its best to appear otherwise to satisfy the trenchant critics who believe that everyone in New Zealand (and presumably the rest of the world) should do what is logically impossible: both save more and borrow less.

The principal challenge ahead is to reconcile the optimistic economic projections with future monetary policy.

Before commenting further on that challenge, I would like to comment on four important observations.

The first was raised by Bill English, when he noted at the beginning of his speech that average GDP per person, corrected for inflation, was less in 2010 ($43,200 at 2010 price levels) than it was in 2004. Further, the output of "goods-producing" industries is dramatically down over the last six years. With the exception of dairy farming, the NZ economy has been in recession for the best part of a decade.

The second was correctly stated on Radio New Zealand yesterday ('The Panel") by Bernard Hickey, a media-savvy financial analyst who often raises a number of interesting points, but usually offers policy prescriptions diametrically opposed to those that I would favour. He noted that, worldwide everyone is paying off debt at the moment, and that such periods of "deleveraging" can cause up to a decade of very slow economic growth.

This process is sometimes called a "balance sheet recession", and is the most convincing explanation to date for Japan's long recession (from 1991), and the Great Depression of the 1930s. Hickey failed to note that economic growth (albeit slow) during such a "recession" can only take place if governments run huge deficits to offset the substantial private sector surpluses (as the Japanese government successfully did, despite widespread domestic and foreign criticism at the time). In such a period, in which private firms and households commit to rebuilding their balance sheets by paying off debt and acquiring financial assets, the only alternative to huge government deficits is prolonged economic depression (not merely recession) with real incomes plunging rather than remaining merely static.

In New Zealand today the most obvious present feature of the balance sheet recession, as noted by Hickey, is the repayment of the massive bank debts incurred by dairy farmers around 2007. Others are equally committed to repaying debt, but find it much more difficult in practice.

The third observation, noted by Nadine Chalmers-Ross in her TVNZ "Breakfast" Budget preview (http://tvnz.co.nz/breakfast-news/budget-preview-nadine-5-23-video-4180090), related to the possibility of rising interest rates. She said: "If you were to see those borrowing costs go up ... if [the banks'] credit ratings go down then it becomes more expensive for them to borrow and so therefore what do they do? They pass it on to consumers."

The context was a possible downgrading by Standard and Poors (and others) of the credit ratings of New Zealand banks and the New Zealand government. While it's unlikely that a downgrading of these ratings would affect New Zealand's interest rates very much, given the quality of the alternative options that global savers face, she has clearly noted that rising interest rates represent a significant *cost*, and that costs faced by corporates tend to be passed on to consumers. In other

words, high interest rates are inflationary. In New Zealand in the period from 2004 to mid-2008, the New Zealand Reserve Bank raised interest rates supposedly to *reduce* the rate of inflation! In fact, the contractionary monetary policies followed both raised domestic ("non-tradables") inflation, and caused the New Zealand economy to stop growing.

The fourth observation, which I noted in Patrick Smellie's Budget response (http://www.scoop.co.nz/stories/BU1105/S00679/budget-2011-reasons-to-be-cheerful.htm), is the official projection that the New Zealand dollar exchange rate will be nearly 20% lower in 2015 than it is today. Thus the growth forecasts, which the Budget is predicated on, require that New Zealand's exchange rate should fall, thereby stimulating the goods-production sector that most dramatically declined after 2003. (Indeed we should note that the principal event that got New Zealand out of the Great Depression was a big devaluation in 1933, following on from a big depreciation in 1931 of the British pound to which the New Zealand pound was closely tied. New Zealand's Finance Minister, who had opposed the devaluation, "fell on his sword" and resigned. This devaluation stimulated the goods-production sector, and gave New Zealand such companies as Watties, Fisher and Paykel and Sleepyhead.)

The new government will need, in December 2011, to renegotiate the Policy Targets Agreement, giving the Reserve Bank a mandate to maintaining a low interest rate environment, with a stable exchange rate (in the 50s on a trade-weighted basis). In other words, the misguided inflation-targeting regime will need to be abandoned. In addition, fiscal policy (largely abandoned from 1994 thanks to Ruth Richardson's "Fiscal Responsibility Act") will generally need to be given a greater weight in the government's stabilisation regime.

Tight monetary policies do not work (because they are actually cost inflationary, as implied by Nadine Chalmers-Ross), and have terrible side effects from huge current account deficits, lending to fuel speculative bubbles in real estate and shares (in place of proper business lending), and increasing income inequality. While loose monetary policies generally do little harm - they are not actually inflationary because people's spending is determined by their incomes rather than by the quantity of money in circulation - they do little good as well. Trying to stimulate an economy with loose monetary policy has often been likened to "pushing on a string".

Tight money high interest rate policies are supposed to reduce inflation (or create deflation) because they create recessionary environments in which labour market power is ceded to employers, forcing wages down, or at least preventing wages from rising as fast as profits, rents and interest. (We should note here that the big salaries of corporate CEOs should not be thought of as wages. Rather they represent a distribution of profits that would otherwise go to shareholders.)

Textbooks generally fail to acknowledge that rising interest rates are a significant form of rising production costs. In the early parts of the last century, loans from banks or mortgage companies were much more likely to be issued at fixed interest rates for the duration of a loan. Therefore, in those days it was assumed that rising interest rates would deter people from committing to new spending, while having no effect on the costs of servicing existing debt.

This century of course it is very different. Tight monetary policy bites by raising the servicing cost of existing debts as well as acting as a deterrent to new business debt. (People are happy to borrow at high interest rates - eg 10% per year - to buy property of shares, however, so long as they believe that the prices of those assets will rise faster - eg at 15% per year.) Rising interest rates today have a similar effect on business profits as to rising wages; they represent a rising cost and are therefore inflationary.

Anti-inflation monetary policies have little effect on inflation because their demand-side effects (less spending) are countered by their supply-side effects (higher costs). Their adverse impacts on a country's trade balance, wage growth, business investment and economic growth rate are all too visible. It's critical for New Zealand, in the life of the 2011-14 government, that high interest rates arising from defunct theories about money, are not allowed to push the New Zealand exchange rate too high. The 2011 Budget projections depend on that not happening.