



# BERL Monthly Monitor

## May 2010

### Tax cuts welcomed by many – but are they affordable?

The much-heralded tax cuts have been announced – welcomed by many (if not most). However, as noted in our Budget commentary available at [www.berl.co.nz](http://www.berl.co.nz), a closer look at the Budget documents leads to some concern as to their affordability. We acknowledge that a large portion of the reduction in income taxes is funded by the increase in the rate of GST. However, the extent and breadth of the tax cut package leads to the conclusion that no one is worse off, and some are better off. A logical consequence of that conclusion is that the funds required for the tax cuts are greater than those arising from the increase in GST. Consequently, it is perhaps prudent to ask whether the tax cut package is indeed affordable.

BUDGET FORECAST FOR NET INTNTNL INVTMT POSITION  
“... NZ’S LARGEST SINGLE VULNERABILITY”



In particular, the Government’s books are forecast to be in the red for the next five years at least, with a consequent increase in net Crown debt. The Government’s Operating Balance before Gains and Losses (OBEGAL) is forecast to be in deficit by \$8.6bn in the June 2011 year. This is followed by three more consecutive years of shortfalls of \$5.4bn, \$4.4bn and \$3.0bn. A further small deficit follows, before a surplus is projected for the June 2016 year.

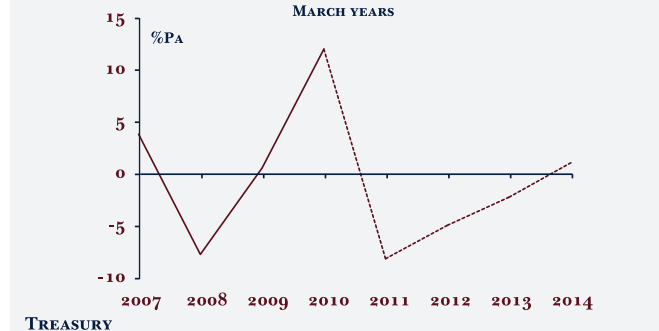
As a result, net debt (core Crown) is expected to rise from the equivalent of 14% of GDP now to over 27% by June 2015. Including the assets of the NZ Superannuation Fund, the net debt situation appear better – but still deteriorates from the current 6% of GDP to over 18% by 2015. Of course, these debt figures are a lot better than forecast a year ago. But they continue to suggest a significant borrowing requirement to fund the combination of expenditure growth and tax cuts announced this month.

Admittedly, it is not correct to suggest that governments borrow for specified items in a budget package. However, a justification for suspending contributions to the NZ Superannuation Fund last year was that government would have to borrow to maintain such contributions. We are curious why this aspect does not arise in the context of this year’s tax cut package.

From an outsider’s perspective (e.g. those we wish to borrow from), the forecast borrowing requirements would seem palatable were a significant improvement in the nation’s economic health expected. Alas, while the Budget Speech correctly acknowledges “New Zealand’s largest single vulnerability” to be its “large and growing net external liabilities”, this vulnerability is expected to worsen according to the Treasury forecasts. Currently, this vulnerability stands at approximately 90% of NZ’s annual GDP. The Treasury forecast this to progressively worsen over the coming four years to be over 99% of GDP by June 2014.

Further concern arises on inspecting the Treasury forecasts for GDP. These are a prime determinant of the expected revenue for the Crown and thereby the overall Government’s fiscal balance. And, if these forecasts turn out to be optimistic, then the extent and breadth of the tax cut package may well be viewed in hindsight as unaffordable.

BUDGET FORECAST  
NET EXTERNAL TRADE CONTRIBUTION TO GROWTH  
MARCH YEARS



However, while we wouldn’t label the Treasury forecasts as optimistic in the short run, we question the rapidity of the rebound in business investment. We focus on this item, as it appears to be the foundation of the Treasury’s recovery scenario. As the picture shows, external trade is definitely not the primary engine driver of the Treasury forecast. So, without a 6.2% recovery in this business investment spending in this current March year, followed by further annual expansions of 10.3%, 4.7% and 3.0%, the GDP forecasts would be much weaker. We see

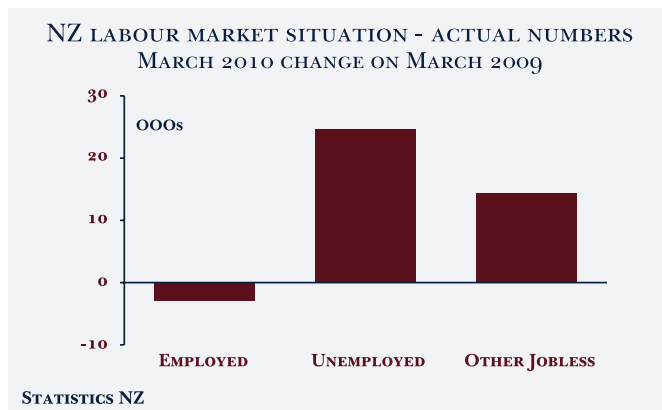
little evidence at present that this rebound is imminent, which leads us to further question the affordability of the Budget package.

In their defence, it is argued that the tax cuts will make New Zealanders more eager to work, which will thereby improve our productivity and our earnings potential. Furthermore, so it is said, New Zealand households are now more cautious than in the past, and will look to save a greater proportion of their tax cuts. These textbook arguments seem convincing. However, it would seem that even the Treasury has misgivings in that they themselves don't appear to see the package making significant improvements to our earnings or our productivity, nor to our "largest single vulnerability".

## Employment numbers not as good as the headlines

As noted in our commentary earlier this month, the Household Labour Force Survey (HLFS) employment numbers for the March 2010 were nowhere near as good as portrayed by some headlines.

Such headlines focussed on the improvement in the seasonally-adjusted unemployment rate from 7.3% in December to 6.0% in March. However, this welcome improvement is masked by the story reflected in the actual numbers. Comparing the situation in March with that of a year ago, the total number employed was down 2,900, the number officially unemployed was 24,700 higher, and the number of other jobless (i.e. in addition to the officially unemployed) was up 14,300. Consequently, the actual unemployment rate in March was 6.6%, compared to 5.6% in March 2009.



Also troubling was the reported pattern of employment change. Comparing industry employment in March with that of a year ago, jobs in agriculture, forestry & fishing are down by 1,400, those in manufacturing have slumped 8,000, while construction employment is 5,700. These industries are core indicators of investment and export activity. These numbers definitely do not bode well for any hopes of a sustained export-led recovery.

Of note from the HLFS data, was a fall in the participation rate from 68.5% in March 2009 to 68.1% this latest March. The converse, or reflection, of this move is a 2.8% (or 29,000) rise over the past year in those 'not in the labour force'. This increase comprised an increase in those studying (+6,500), in those retired (+5,500) and those at home looking after children (+3,100). This leaves

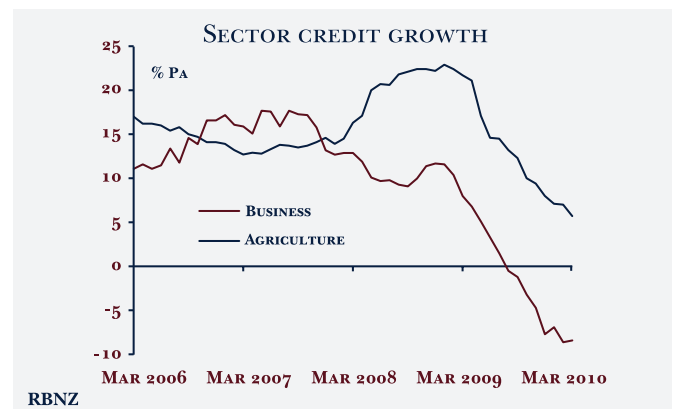
an increase of 13,800 who fell in the 'other' category of not employed, not officially unemployed, not studying, not retired, and not looking after children. Part (if not the majority) of this group will represent disillusioned individuals who withdraw from active participation in the labour force. As is the norm during an economic downturn, this group grows in number. We will be looking for a significant turnaround in the growth in this number before proclaiming the labour market situation to be back in robust health.

## Market turmoil ahead of June monetary policy statement

The past month's international market turbulence has been attributed largely to excess government deficits in Greece, Portugal, Spain and Ireland, but it was also because we are amidst a fairly major realignment of currencies and capital flows. Thus the Euro against the US\$ is down about 5% but the US\$ itself, on a trade weighted basis, has appreciated by about the same amount so the movement of the Euro against most other currencies has not been remarkable.

The more important changes, indeed, have been significant appreciations of the US\$ and Yen against all currencies due to capital outflows from those financial centres having declined or been reversed. Close to home, the A\$ has declined 10% against the US\$ and the Yen and the NZ\$ is down by 4%. While it is good news for NZ exporters to the US, Japan and countries such as China with dollar-linked currencies, the accompanying 6% appreciation of the NZ\$/A\$ rate is bad news for those exporting to Australia.

More importantly, it has signalled a likely tightening of credit availability to our financial system which will be reflected in lending conditions at the retail level.



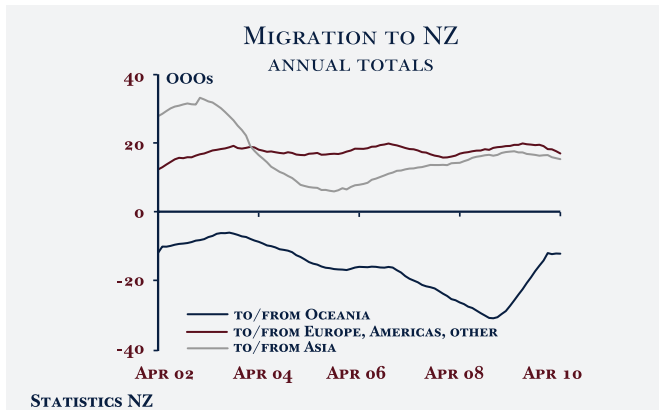
In addresses on May 6 and May 19 the Reserve Bank Governor signalled a possible lift in the OCR at an early date. The market has responded with a rise in the 90 day rate from 2.78% to 2.92% but the 10-year bond rate, in line with bond rates abroad, has declined steadily from 5.93% to 5.55%. The expected 25-points rise in the OCR at the next review on 10 June may be delayed till late July if turmoil remains on European markets. Irrespective of the short-term decision, the Governor has hinted that further increases may tend to be at infrequent intervals given credit availability concerns, as well as ongoing uncertainty as to the global situation.

At the retail level, latest data show credit to business to be contracting and we expect banks to continue to be highly selective in the foreseeable future. With a higher OCR leading to higher interest rates, borrowers could therefore be faced with both increased cost and tighter availability. Calls for investors to increase investment in productive enterprise may, therefore, fall on deaf ears.

## Migrants voting already?

The volatile migrant flows are now showing a new trend of more people voting to stay away. More of them are staying put in Europe, instead of migrating here. The change is not massive – the number arriving in New Zealand from Europe is down from 26,000 in calendar 2009, to 24,500 for the twelve months to April. Add to that drop by 1,500 about as many from other source regions of the world, and you get a decline in the rate of arrivals by 3,000 in the first four months of the year.

Earlier, the net migrant flow was boosted by a reduction in the numbers leaving NZ. The number leaving dropped from 84,000 in 2008 to 65,000 in 2009. That dropped to 63,000 in the 12 months to January 2010, and has stayed at that level. So, in the last four months the number coming to NZ has dropped by about 3,000 and the number leaving stopped declining and stayed flat. Consequently, the growth in our net inflows shuddered to halt at an annual rate of 23,000, and the flow is now passing through the 20,000 rate on the way down.



Depending on whether or not there is a reaction to the Budget from potential migrants here and overseas, we may see the volatile net migrant flow back down to a 15,000 net inflow by the end of the year.

But what about a new influx caused by the melt-down in Greece and growing uncertainty as to who is next in the Europe fiscal scene? The indications at present are that all of that sentiment was worked out in 2009 and now more people are risk averse. They are sitting on their hands, staying put in their present homes!

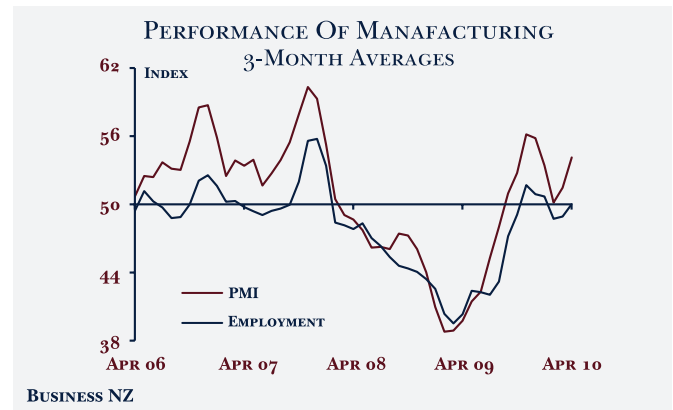
## Manufacturing confidence rising but production signals not as rosy

The Business New Zealand Performance of Manufacturing Index (PMI) stood at 56.3 in March, while the latest New Zealand Manufacturers and Exporters Association (NZMEA) Survey of Business Conditions

shows total sales in March down by 0.5% on those of the previous March.

The PMI result this month is a marked improvement - up from the 53.3 recorded in February and 52.0 recorded in January. As an early indicator of manufacturing activity, the PMI is at its highest level of overall activity since November 2007, as a PMI reading above 50 indicates manufacturing activity is expanding.

All five of the seasonally adjusted sub-indices measured recorded expansion. Production recorded the highest value at 59.4, followed by deliveries at 57.0, new orders at 56.9, finished stocks at 52.8, and employment at 50.1. Between February and March, the production measure increased by 6.1 points, while the deliveries and finished stocks measures increased by 4.1 points and 2.5 points, respectively. The employment index stayed above 50 for the second month in a row, but it continues to be well below the other sub-indices of the PMI.



The sector is recovering from a very low base and while future expectations and some business confidence surveys may be showing improvements, actual production, sales and employment numbers remain sluggish. As noted earlier, NZMEA Survey sales for March are down 0.5% on year earlier. A notable distinction here is between markets, with domestic sales up 11% but export sales down 13% on year earlier. The current performance index (a combination of profitability and cash flow) stood at 103.5 in March, down from 105.5 in February, while employment numbers remained down on year earlier.

From the HLFS, total employment in the manufacturing industry has declined 3% between March 2009 and March 2010. Within manufacturing, full-time employment in food, beverage and tobacco manufacturing rose 10% over the year to March 2010. This means employment in the non-food manufacturing sector slumped by more than 8% over the same year.

Across the various sectors, metal product manufacturing recorded a large decline in employment –down nearly 15%. Another large fall was recorded in textile, clothing, footwear and leather manufacturing – down nearly 29%.

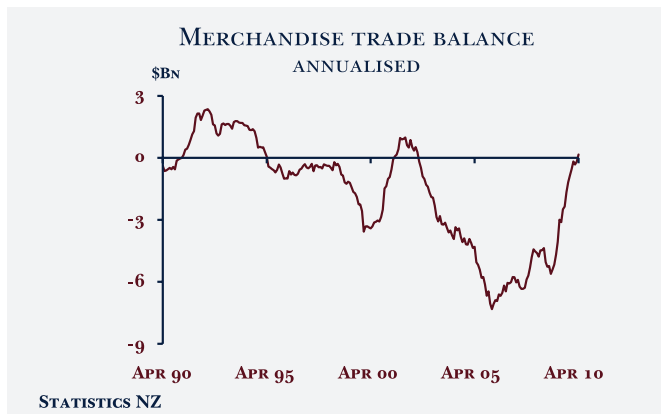
## Trade figures better, but ...

The one bright light in this dreary story is the turnaround in the merchandise trade balance. The nation recorded a trade surplus for the year to April 2010 of \$161m. As



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the chart shows, this is the first positive annual trade balance since mid-2002, and definitely more welcome than the \$4bn deficit recorded for the year to April 2009. With BERL's historic focus on the fortunes of the external sector, you would be right to ask why we haven't led with this story.

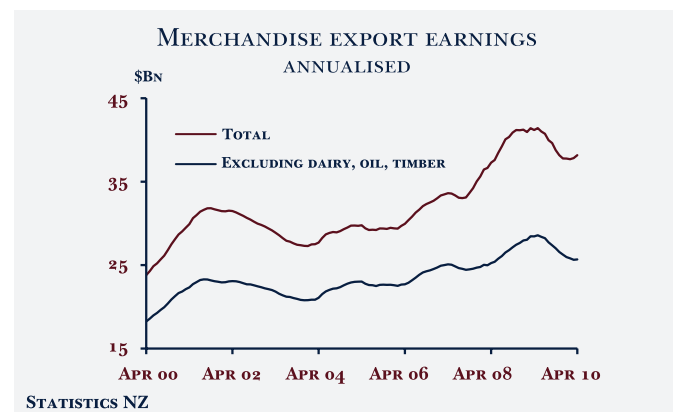


Unfortunately, this story is not as promising as it appears at first blush. It is the norm for a downturn that an improvement in the trade imbalance is almost inevitable, as households and businesses retrench into survival mode reducing spending and postponing any growth plans. This is what has happened again. The trade balance improvement has not arisen because of increased income, productivity or competitiveness. Rather, it has occurred due to reduced spending on imports on both consumer and capital equipment, with the latter more worrying in that consequences for longer-term productivity improvements are not bright.

Merchandise import payments for year to April have plummeted by 16%. However, the rate of decline has eased, with the latest three months being less than 2% below year-earlier levels. Of significance, imported plant and machinery for the year was down more than 17%, with the latest three months still over 14% below year earlier. In contrast, motor vehicle imports for the year are down only 3%, with the latest three months having recovered to be more than 78% up on year earlier. This latter figure is broadly consistent with new car registration data, with numbers for the latest three months running at 34% above year-earlier levels.

The export side of the equation is only marginally brighter. Total merchandise receipts for the year to April were down 7.3%, although the latest three months

signalling the beginnings of an upturn at 3.8% up on year earlier. Within the revenue figures the upturn is heavily dominated by increased receipts from three categories. In particular, oil receipts for the latest three months are 40.2% up, logs & timber receipts up 41.5% and dairy receipts up 16.8%. The dominance of these three commodities in our export performance is overwhelming. Take away these three categories and there really is nothing to left in the export recovery.



Excluding these categories, receipts for the latest three months are down 3.7% on year-earlier levels, with the year to April year down 9.7%. Meat exports, the second biggest earner amongst the merchandise categories, earned in the April year 8% less the previous year with the latest three months still more than 2% down on year earlier.

And both kiwifruit and apple exports have made a sluggish start to their season. April is the first of the two biggest months for kiwifruit exports, and in this season April recorded volumes and prices both down on last year. April is also important for apples, with that month accounting for about a quarter of annual apple export receipts. However, April 2010 saw volumes down 20% on the previous April and prices down 7%, leading to receipts down by 25%. Similarly, fish export revenues for the latest three months are down by more than 9% on year earlier.

These figures do not bode well for export returns for the coming year, with only wine and wool amongst the larger categories recording noticeable increases on year earlier receipts.

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