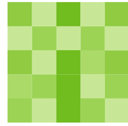

INFOMETRICS

newsletter

January 2010

From the beach 2010

The coming year is shaping as a watershed year for the New Zealand economy. The short-term picture will be defined by tightening monetary and fiscal policy, both here and overseas, and anticipating the economy's response to those necessary changes will be at the forefront of executives' minds over the next 12 months. But arguably even more important is the longer-term potential growth of the economy. A number of taskforces and working groups have made policy recommendations to the government over the last couple of months. Some changes will be made, but the extent of these will determine whether any significant progress is made towards addressing some of the fundamental imbalances and shortcomings of the New Zealand economy.

Time to tighten?

Analysts appear to have settled on the June quarter for the likely start to the monetary policy tightening cycle in New Zealand. Rising interest rates will have undoubted effects on the New Zealand economy, perhaps most notably the housing market. But it will be offshore monetary settings that have the most potential to derail the recovery in New Zealand.

America was at the heart of the financial crisis, and despite the continuing emergence of China as an economic powerhouse, the US will be at the heart of any global upturn as well. Although it's been almost a year since share markets started becoming more optimistic about corporate America's prospects, improved earnings expectations have yet to be realised or translated into stronger economic data.

It is clear that monetary settings will tighten this year as the Federal Reserve stops printing money and then looks to start raising interest rates. It is less clear what ability US households yet have to cope with even a gradual removal of the ultra-easy monetary conditions that have been in place over the last year. Retail spending volumes are still down 9.8% from their peak in late 2007. The unemployment rate is 10% and is forecast to remain around that level this year. These figures suggest that a significant tightening in monetary policy would not be prudent anytime soon.

Compared to fiscal policymakers, Ben Bernanke's job is easy. Without any significant inflation concerns (which would be largely tied up with the economic growth outlook), he has no real binding constraint that requires him to tighten monetary policy to a definite timetable. The burgeoning government debt in the US makes fiscal policy another matter. The OECD estimates that the American government's gross debt will climb from 62% of GDP in 2007 to 100% by 2011, with net debt surging from 42% ot 72% of GDP. The government deficit will be around 11% of GDP this year, and the government will feel considerable fiscal pressure to withdraw its economic stimulus as growth becomes self-sustaining. Judging the appropriate timing of that shift will be crucial to minimise the chances of the US relapsing into recession. Japan's increase in consumption tax in 1997 provides an obvious example of the detri-

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mental effects of a premature tightening in fiscal policy.

China has encouragingly withstood much of the global downturn – the latest GDP figures showed economic growth running at 8.9%pa in the September quarter. But a renewed deterioration in America's performance would have flow-on effects for Europe, China, and ultimately New Zealand. It's worth remembering that a good chunk of China's pick-up over 2009 has been driven by government money pouring into new infrastructure. So if things start to turn pear-shaped again in America, the Chinese government may find itself under pressure to stump up with more cash for roads to keep the Chinese economy rolling.

Bold, bland, or backward?

The current National government's first budget, in 2009, was disappointing for its lack of bold response to the financial crisis. Health and education spending, for example, which grew by 9.2%pa between 2005 and 2009, was still expected to grow another 5.7% in the 2009/10 fiscal year. Given the pressure from credit ratings agencies, there was little sign of any concentrated effort to turn around the government's fiscal position or foster an environment for higher potential economic growth in New Zealand.

The second half of last year was all about working groups and taskforces. Don Brash's prescription for catching up to Australia by 2025 was quickly dismissed as being too much of a throwback to Rogernomics: slashing income tax rates, reducing the minimum wage, selling state assets, cutting social services, raising the superannuation age, and opening schools to competition.

The Capital Markets Development Taskforce (CMDT) presented the government with suggestions such as partial privatisation of state assets (along the lines of the Air New Zealand model), funding research on small companies to enhance investor information levels, and improving the transparency for investors around investment advice. None of the CMDT's recommendations were particularly earth-shattering, but they do contribute to the environment for change that developed throughout 2009.

The CMDT didn't shy away from talking about tax either, despite that field primarily being the responsibility of the Tax Working Group. Of the TWG's recommendations, the government has only shied away from a capital gains tax on family homes. With all other possibilities still on the table, we could see some of the following changes announced at this year's budget in May.

- There will be changes made to try and capture some of the "missing" tax revenue from rental property. Investment property owners may no longer be able to offset losses against other income, have the depreciation on buildings removed, or face much tighter enforcement of the current provisions for capital gains tax. On top of these changes, the introduction of a land tax is possible (as much as 0.5%pa).
- Corporate tax rates may be lowered – watch for Australia's Henry report to be made public in March for an indication of where business tax rates are headed across the Tasman.
- GST could be increased, possibly to 15%, with an (almost) commensurate reduction in income tax rates right throughout the scale.
- The government may commit to a future alignment of the top income, trust, and company tax rates, possibly outlining a timetable for future income tax cuts starting in 2012 after the next election.
- Some effort is likely to be made to cap future growth in certain areas of government spending, such as the health budget.

Businesses must be prepared for some policy change this year – tax changes will have discernible effects on specific parts of the economy such as the housing market. Equally important are the longer-term effects on the economy's potential for growth. National failed to strike while the iron was hot at last year's budget, but the iron is still warm enough this year to make a decent mark.

New Zealand's size and geographic location work against us naturally remaining relevant in the global economic environment – smart and innovative government policies are necessary to help us stay competitive. If the National government doesn't have the courage to embark on a programme of change now, it is doubtful that it ever will, and New Zealand will continue to drift further into economic mediocrity. Without policy changes, the hallmarks of the New Zealand economy will continue to be overinvestment in property, a lack of available capital for businesses, and the ongoing drift of workers overseas due to higher incomes.

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