

Looking to, and through, Budget 2009

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Good morning. You've come along this morning no doubt hoping for some insight into the Budget – that's what the invitation said so I'd better not disappoint you. But rather than start by looking ahead, I'm going to start with the past. It's only the recent past, but it's the best way of illustrating what the government and this Department have dealt with as this Budget has been framed.

I'm going to do something I've never done and quote myself – from a speech exactly five months ago:

"We are currently in the midst of the worst international financial crisis for many decades and of a rapid deterioration in the global economic outlook.

While downturns don't last forever, the economic and financial stresses globally have become so severe in recent months...that we face a tough few years.

There is no precedent for such a large and widespread leverage boom - and, hence, little basis for knowing how far the unwinding process may need to go. However, IMF analysis suggests that the effects of serious financial crises - which typically have their origins in economic imbalances - typically last for several years. Forecasters, here and abroad, are rapidly lowering their growth forecasts."

We have a lot more data now, and there are indications that some stabilisation is occurring globally - that the rates of decline are slowing. I will come back to that in a moment. But, unfortunately, those words from five months ago could still accurately be applied to the world economy now.

A simple way to illustrate that is to set out a couple of forecasts that are critical to New Zealand. In October 2008, when the Pre-Election forecasts were released, the IMF was predicting world growth would be 3% this year. In November, the month before our December update, they predicted 2.2% growth. In January, a month after the December update, the IMF's world growth forecast had been slashed to 0.5%. Last month, it said world growth this year would be negative 1.3%.

The same track applies to forecasts for the growth of our top 12 trading partners. These were cut by nearly two-thirds between November and December. Since January they have become increasingly negative, so that last month's forecast was that our trading partners' economies will shrink by 2.2% this year.

So what we now know definitely - the thing that has changed since December - is the world economy is suffering a major shock. It is contracting for the first time since World War Two, more than 60 years ago. It is easy to say "since World War Two" and not actually contemplate what that means. There are whole generations that have not experienced this kind of world economy. The Korean War, the Cold War, the oil shocks – none of them had this impact.

- Global GDP is estimated to have fallen by an unprecedented 1.5% in the last quarter of 2008 and is expected to have fallen almost as fast through the first three months of this year.
- The IMF predicts the G-7 economies will contract by 3.8% this year and have no growth in 2010. Germany, the UK and Italy are forecast to continue to contract in 2010.
- The OECD forecasts that GDP in its member countries will drop by 4.3% this year.
- GDP in the UK is expected to fall 3.7% this year, the US 4% and Japan 6.6%.
- Australia, our biggest market, had negative growth at the end of last year and is expected to shrink by 0.5% through to next March.
- In Asia, Japan's industrial production dropped 37% in February. Industrial production in South Korea and Taiwan was down 10% and 27% respectively in the year to February and this marked significant improvement from January.

Sure there is talk of "green shoots" – but unfortunately that doesn't mean spring's arrived for the world economy. There is some news that is encouraging and financial markets have been reflecting more positive sentiment, but, for the real economy and people "less bad" doesn't mean good. It's the same with "stabilisation" – it's something we want to see but it means things are still deteriorating, just more slowly.

So the two key features of the international economy remain the same as in December – it is shrinking and there is uncertainty. For all that we want the news to be good, the IMF's World Economic Outlook noted that the risks are on the downside – that there is a possibility that the policies and responses to date will fail to stop economies weakening. For example there is concern about the exposure of European banks to Central and Eastern Europe and the impacts of that on the financial sector, confidence and the real economy.

That's uplifting isn't it?

So the good news...

First, compared to a lot of Western economies New Zealand is doing well – especially when you consider we were already in recession when the shock hit. For example, Euro area and US unemployment are both currently at 8.9%. Even next year, when forecast unemployment peaks, we don't think it will be as bad as that here.

I'll stress, the good news is by comparison rather than being absolute. Of course rising unemployment isn't good news. It's awful for the people affected. But New Zealand can't escape the impact of this world situation, although these developments do underline the importance of a flexible labour market. No country can really expect to remain unscathed when its trading partners are struggling as at present. So we believe New Zealand is in its 6th quarter of recession now and there is likely to be at least one more before we get some tentative growth at the end of the year.

Second, and the better news, is there is an opportunity for us both to manage through these times and to do better in to the future – in other words to start to close the gap with the world and have higher incomes and better services and living standards.

The fact that New Zealand is unlikely to be hit as hard as might have been expected given the effects of previous shocks points to the benefits of the structural reforms in our economy. The world situation is obviously much worse than at any other time in recent history, but the impact on us is unlikely to be as severe. The economy is more flexible and stronger: having a floating exchange rate, market-determined interest rates, more varied markets, and lower public debt really do help.

But to acknowledge what has been achieved should not distract us from the need to improve further. The world has not been standing still and New Zealand's international competitiveness has slipped on a range of measures. New Zealand had low productivity growth and serious imbalances were showing through the economy before the current shock and these need to be addressed. That is why it is so important to continue to implement policies to increase our economic performance and strength. We want to be wealthier as a country and even better placed the next time a shock happens.

The challenge is that we have to make these improvements against the backdrop of global contraction and uncertainty and its effect on New Zealand.

Putting the outlook as starkly as possible, the DEFU downside forecasts for growth showed the economy \$48 billion smaller over the four years to 2013 than was forecast at the Pre-Election Update. In real terms what that means is it will be some time in 2011 before New Zealand's economy is going to be the same size as it was at the end of 2007. We're losing four years worth of growth.

And yet through that same period we're going to do about twice as well as most other developed countries.

You can't look at any government action, in New Zealand or elsewhere, in isolation from this environment. Governments are looking back 80 years, to the lessons of the Depression, to help guide their responses. This is, globally, uncharted policy territory.

Treasury has had to provide advice within that environment. The Government has had the much harder job of making decisions.

So how do you work through it?

There are two main things: keeping a long-term perspective, particularly on growth and productivity improvement; and of course in any sphere - business, government or household, you need to manage risks.

PRODUCTIVITY GROWTH

Soon after the Budget I'm going to talk in more detail about Treasury's view on what we need to do to really drive growth. The short version is that not only do we need to keep looking at productivity improvements – in the private and public sectors and the policies businesses and organisations work with – but that the world recession actually provides some opportunity.

We have increased opportunity to do things differently and look hard at the policy settings because there's a greater need to address the hard problems. And there are opportunities vis-a-vis the rest of the world.

In the shorter run for example, the lower exchange rate and increased domestic savings will help lower the current account deficit. The relative attractiveness of New Zealand means we are likely to see more returning skilled Kiwis and migrants. There's a real opportunity to build on these skills, especially as they are connected internationally.

And our experience of the last few months reminds us that longer term being a primary sector based economy may hold us in good stead. But this does mean that we will need to think harder as a country about natural resource and environmental issues and how these link with productivity and growth. For example, the allocation of freshwater will be one of the most important things to get right over the next few years - in terms of land use, our quality of living and our country brand.

The real gains come from doing what we do best and improving productivity and competitiveness. So it's about explicitly focusing on policies - such as tax and regulatory - that reduce barriers to New Zealand individuals and firms increasing productivity. And it's about utilising New Zealand's comparative advantage around natural resources and our increasing connection to the stronger growing Asian economies.

RISKS

There are two major categories of risk:

- One is external. The world could take longer to stabilise and grow; and/or the impact on New Zealand is more pronounced. What kind of risks could cause this to happen? There are probably three main types. First, risks to the rollover of wholesale bank borrowing if the further difficulties of EU banks turn really nasty. Second, terms of trade getting hammered down to 1930s levels. And third, serious rise of protectionism.
- The second is domestic. A key part of this is that the risks around our fiscal position and external debt become too great and we find it harder both to access money and to pay for it. There are also ever-present regulatory risks - either self-inflicted or driven by the international reaction to problems that are largely not present in New Zealand.

The major areas we have control over, long-term, is our own regulation, government spending and public or government debt. This is a pre-Budget speech so I'll concentrate on the latter. As you know we are facing long-term budget deficits. A smaller economy means less tax for government. Without policy change or controlling spending, our December downside forecasts were for enduring Budget deficits of around \$8 billion a year.

That would mean mounting debt. While the starting level of Government debt is low the DEFU downside scenario forecast gross debt to reach 39% of GDP by 2013 which would mean having to issue about \$50 billion extra in debt from last year's Budget. It projected debt to increase to over 75% of GDP - \$245 billion - by June 2023.

Let me put that into numbers that are smaller and more relevant. Let's assume there are 5 million New Zealanders by then. Every single one of them would owe about \$49,000 on behalf of the government. A family of four would basically have another mortgage - close to \$200,000.

The Government at that stage would be spending \$13.8 billion annually on the interest on that debt. That's more in dollar terms than we currently spend on our entire public health system. That's \$13.8 billion on interest rather than health or tax cuts or anything else. And making the same assumptions as above, it means every Kiwi - including children - would owe \$2,800 a year in interest on public debt. It's not hard to do the maths and know that four-person family's share is over \$10,000 a year. And what that really means is that New Zealanders would be looking at higher tax rates in the foreseeable future and it's hard to see how this can be other than bad for productivity and prosperity.

The latest Crown financial statements, those to the end of March, showed that deterioration in the government's books is well underway with gross debt more than \$14 billion higher than was forecast in the PREFU last October.

Government surpluses and low public debt have been an important off-set to New Zealand's large balance of payments deficits and overseas debt. Credit rating agencies and investors have noticed the projected debt and are watching to see how New Zealand responds to the impacts of the shock. They, and others, will be watching to see if New Zealand has a credible, time consistent, fiscal strategy - one that doesn't imply large future tax increases.

It's fair to ask why we should worry about what credit rating agencies and investors think.

Well, the financial crisis and economic shock mean we are competing for borrowing. The very large deficits from very large economies mean that they, like us, are looking to issue much more debt. Maintaining investor confidence, including a strong credit rating, is essential if the Government and our companies and households can access the funds they need, and do so at a reasonable cost. If we can't, it's jobs and livelihoods that will suffer.

Based on Ireland's recent experience of a credit downgrade, it would result in a 1.5% rise in interest rates in New Zealand. As a ballpark figure, that would mean another \$600 million in interest on Government debt each year – the same as two new Wellington hospitals. And the country's credit rating determines how much many of our businesses and our households have to pay. One and a half percent is another \$3,000 interest on a \$200,000 mortgage.

That debt story is one reason we need a real focus on the level and quality of government spending. Getting value for the money that the government does spend – which is always desirable – has assumed particular importance.

In dollar terms there has been dramatic growth in public sector spending in recent years – from \$37.5 billion in 2002 to \$57 billion in 2008. Clearly, in the current environment, we need to slow this rate of growth in spending and find savings and efficiencies.

These figures alone indicate that there is room to explore existing government spending to find what we can do better. Considerable effort goes into seeking upfront approval of policy and projects that require new spending – although more could be done here – but a weakness of our system is that there hasn't been the same emphasis on reviews and evaluation. What that means is we focus too much on new spending and not enough on the very significant base, even though policies introduced five, or 15 years ago, may no longer be as effective or fit Government objectives.

It's much the same as households dealing with tighter budgets. You don't just look at what you were thinking about buying: the new shoes or television. You look at what you're already spending money on and whether some things are really all that necessary.

Departments made initial steps to explore their base spending as part of this year's Budget to try to find savings, low-quality spending and areas that require greater scrutiny. We saw the number of new Budget bids halve from last year and about a quarter of these were "savings" bids. That's a significant and positive change in approach. But because of the Budget timetable and internal agency focus this necessarily identified the low-hanging fruit.

Now, there was no 5% target for reprioritisation, savings or anything else. But I don't know if any departmental or agency CE would argue that they couldn't think hard about better utilising 5 or even 10 percent of their baseline. I know I have. It may be about stopping some things; it might be about starting others. It would certainly be about new ways of working and service delivery. Across government even if we exclude the \$18 billion of spending that's about income support and \$2.5 billion interest, this would represent around \$38.5 billion of public money that could be used better.

The final point I would stress here is this is about effectiveness and efficiency, and it's about growth. The state sector is a very large part of the economy - central and local government combined represent about 40% of GDP - so it is hugely important that it works as efficiently as possible to support the private sector. We cannot afford to crowd out private enterprise or impose unnecessary costs on people and businesses.

To have a more productive economy and better fiscal outlook the state sector has to take a different, more entrepreneurial approach in some areas. This means innovation, delivering services that work and focussing on things like customers, standards, price and quantity continually, some competitive pressure and, where sensible, exiting activities too. It also means getting institutional arrangements and incentives right. For example not many private sector businesses would want to get rid of their profits by the end of the year; but the year-end spend up is still a feature of the public sector.

CONCLUSION

So the focus has to be on lifting growth and halting the rise in debt. Importantly, as I've described, the two aren't mutually exclusive.

But I'm not glossing over the tension between the need to deal with the short-term issues rising from economic shock and the longer term issues around fiscal consolidation. All major developed economies are facing this issue of when to stimulate and then when, how and how quickly to consolidate to recover that stimulus. And the stimulus countries provide need to generate better prospects in the future- if people see it as money down the drain they'll look through it to higher taxes in the future and the stimulus may ultimately fail.

These tensions are demonstrated in the British and Australian Budgets. The UK has seen a huge fiscal stimulus, like the US aimed at dealing with a failing financial sector as well as bolstering the economy. But the Budget was already trying to deal with the consequences of that - a huge projected increase in debt, to 79% of GDP in 2013 - by winding back spending and increasing taxes.

In Australia much of the budget commentary has highlighted these apparent contradictions. To quote the Sydney Morning Herald: *"This is the budget of the Treasurer who has everything... increases in government spending, cuts in government spending, tax cuts and tax increases."* The balance is different for each country. New Zealand has good factors: room to move on monetary policy; a low debt starting point, and no need for bank bail-outs; and bad factors: a high current account deficit, structural higher spending rather than temporary fiscal stimulus, expressed rating agency concern and a greater need for external investment. This means we simply cannot afford, even if it were desirable from a policy perspective, to carry high levels of public debt.

As I said earlier, there is still considerable uncertainty about the economic outlook and it is right for the Government to be cautious. It needs to balance these issues and of course continue to look at improving long-term economic growth.

That requires a different way of thinking about Budgets - one that recognises the Budget process is about much more than new initiatives and new spending. We've, unfortunately I think, become

used to Budgets being dissected on the basis of “what’s in it for me” with spending tables and supposed winners and losers.

Taxpayers need to know what is happening to their money. But I believe New Zealanders don’t just want to know what might change on Budget Day. They want to know what might happen in a year, and 10 years from now, and how the future looks for them and their families.

Again, on a household basis we don’t look at our overall situation - our house and mortgage, our salary and what we think might happen with it, what our children might need and our bills - then get terribly excited because we’ve seen a TV on special for a week. Most people actively think about all their assets and their debt and their income and their bills and ensure that short term needs are balanced against long-term progress. Or at least if we’re wise we do so.

From my perspective it’s about looking at Budgets in terms of investing instead of just spending. Treasury has said for a little while that its key focus is productivity growth. It makes it reasonably simple to set criteria for a successful response to the situation we’re in as a nation: a response of which this Budget must be a key part.

On the economy:

- Taking a long-term view, and
- Supporting growth through measures that increase flexibility and remove the barriers to bolstering productivity and competitiveness

And with the Government’s books:

- Does it focus on improving the performance of the whole of government and not just marginal spend;
- Does it focus on how the public sector can best contribute – and be least drain on – that productivity and competitiveness, and
- Does it focus on controlling debt.

This is a time to invest in our futures and those of our children. That’s in keeping with our values as a nation and it’s ultimately how New Zealanders, over time, will be better off.

Thank you.