The Countercyclical Contribution of the Not For Profit (NFP) Sector

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Using the Christchurch earthquakes as an example of a situation in which the NFP can play a significant role, in principle (but not always in practice) it's easier to get the required resources at a time in which the general economy is in a phase of slow growth or recession. In principle, central government can act as guarantor so that the NFP sector can receive funding in recessions on concessionary terms, enabling the NFP sector to become a significant employer at times of otherwise high unemployment.

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Inter-sector analysis is a way of understanding the financial relationships between the major sector groupings of an economy. It is always simplest to start with the global economy, because it has no external (ie foreign) sector.

The five main sector groupings here are **Households**, non-financial **Businesses**, central **Governments**, a melange that includes the **Not For Profit (NFP)** organisations, plus a connecting financial sector (Banks). For simplicity, we can assume that all financial transactions (lending, borrowing) pass through banks, and can thus ignore banks from this discussion.

Sectors of Global Economy

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Non-Financial **Businesses**	Cental **Governments**
	BANKS	
Creditor Sectors	Private **Households**	**Not For Profit** & Local Government & Insurers

starting point for inter-sector analysis

Businesses and governments operate from a debt base, meaning that businesses and governments are net borrowers. On the other hand, households and NFP organisations are net lenders. The business and government sectors are in debt to banks, while households and NFP organisations are, net, in credit to banks.

Sectors of Global Economy
standard story

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** deficits (-)	Cental **Governments** balanced budgets
	BANKS	
Creditor Sectors	Private **Households** surpluses (+)	**Not For Profit** & Local Government & Insurers balanced budgets

Surpluses mean saving or repaying debt;
Deficits mean borrowing or running down savings.

Zero Sum

If, over a year, any sector spends more than it earns, then it runs a deficit. Any sector that earns more than it spends runs a surplus. Thus, a sector runs a deficit if it is either adding to its debt or running down its savings. A sector runs a surplus if it is either adding to its savings or paying down its debt. The systemic <u>zero-sum constraint</u> is that total deficits must equal total surpluses. If one sector sells more than it buys (surplus), then, by definition, all other sectors, taken together buy more than they sell (deficit).

Sectors of Global Economy
standard story

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** deficits (-)	Cental **Governments** balanced budgets
interest ↓	BANKS	
Creditor Sectors	Private **Households** surpluses (+)	**Not For Profit** & Local Government & Insurers balanced budgets

Households fund business deficits to generate growth.

The standard economic story is that the business sector runs perpetual deficits, and that households, through saving, run perpetual surpluses. Businesses spend their deficits on investment goods such as factories and machinery, and the economy grows. A more correct story of long-run balance, however, is that of each sector being in balance – no surpluses or deficits – with interest flowing from the debtor sectors to the creditor sectors. It also means that all sectors must at times run deficits, and at other times run surpluses.

more correct version of long-run balance

- perpetual expansion of business debt is not sustainable
- each sector group in balance
- <u>Note</u>:
  - interest (or equivalent) flows from debtor to creditor sectors
  - "surplus" means to acquire *fewer goods and services* than a sector's income entitles it to, making the surplus (remaining goods and services) available to a deficit sector
    - intended surpluses in any sector means goods and services are claimed or unclaimed by other sectors
    - claimed surplus goods are "free" (from societal viewpoint)
  - pro-cyclical sectors correlate spending with income
  - counter-cyclical: spending negatively correlated with income

A surplus actually means a flow of goods and services from the surplus sector to another sector, with a return obligation. A surplus can only exist as a surplus if the recipient sector agrees to that return obligation. If an intended surplus is unclaimed by another sector, then there will be no surplus, and the resources that produced that surplus will likely become unemployed. This means that these surplus goods and services are "free", in the sense that they will go to waste if not acquired by a deficit sector.

We are accustomed to thinking that the time when we earn more is the right time to spend more. Sectors that do this can be labelled as pro-cyclical. These sectors – businesses and households – are most inclined to incur deficits when their incomes are rising. Thus the other sectors, Government and NFP, will need to be running surpluses at such "expansionary" times. Indeed that's exactly when government revenues grow faster than government spending; likewise these are favourable times for NFP revenue-raising and times in which the services provided by many NFPs (especially those classed as charities) are in least demand.

Sectors of New Zealand Economy

standard story

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** deficits (-)	Cental **Governments** balanced budgets
	BANKS	
Creditor Sectors	Private **Households** surpluses (+)	**Not For Profit** & Local Government & Insurers balanced budgets

Foreign sector surplus (+) (because NZ has Current Account deficit);

Households, foreigners fund business deficits to generate growth.

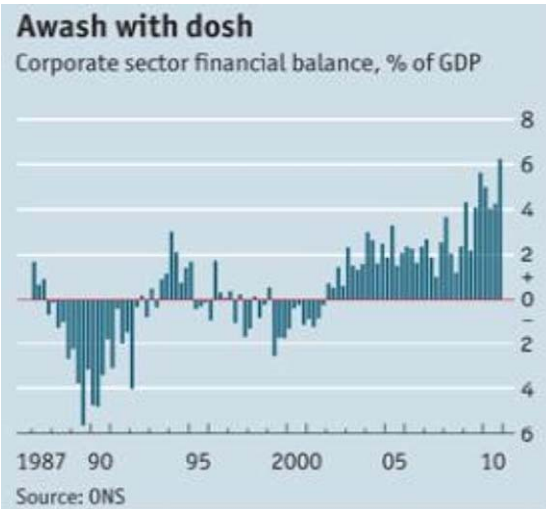
For an individual country, the foreign sector also forms part of the mix. In New Zealand, the constant story since 1974 is one of current account deficit, which means that the rest of the world is running a surplus with respect to New Zealand. This situation is highly unlikely to reverse any time soon. The standard story for New Zealand is one of business deficits funded by surpluses arising from both domestic households and foreign lenders. Hence the argument that New Zealand households should save more, so that New Zealand businesses could borrow less from foreign sources.

The actual story of the global and New Zealand economies in the last decade has, however, differed markedly from the standard story. In the world as a whole, at least in the western world and Japan, there was a pattern of businesses running surpluses instead of deficits, as shown for the United Kingdom by *The Economist*.

Sectors of Global Economy
actual story 2002-07

	Pro-Cyclical	**Counter-Cyclical**
Debtor Sectors	Private **Business** surpluses **(+)**	Cental **Governments** balanced budgets
	BANKS	
Creditor Sectors	Private **Households** deficits **(-)**	**Not For Profit** & Local Government & Insurers balanced budgets

UK example of Business saving



source: http://www.economist.com/node/18713516

What was happening is that households began running substantial deficits. With businesses repaying debt or accumulating reserves, banks increasingly lent to households instead. Hence world economic growth, driven by household rather than business borrowing, and the resulting booms and crashes in residential property prices and mortgage markets.

This all changed in 2008 after the global financial crisis (GFC). Business surpluses became even larger, while the household sector returned to running surpluses. This left the government sector accepting very large deficits as the only way of keeping the world economy afloat. In addition, the NFP and related sectors found themselves running deficits, meaning a substantial withdrawal of their saved reserves. The world had entered a "balance sheet recession", a term first coined to describe the experience of Japan in the 1990s.

Sectors of Global Economy
actual story 2008-11

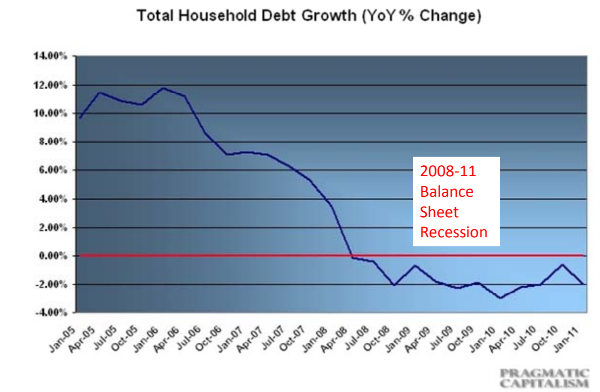
	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** surpluses **(+)**	Cental **Governments** deficits **(-)**
	BANKS	
Creditor Sectors	Private **Households** surpluses **(+)**	**Not For Profit** & Local Government & Insurers deficits **(-)** *

"Balance Sheet Recession"

* Deficits for NFP mean running down savings.

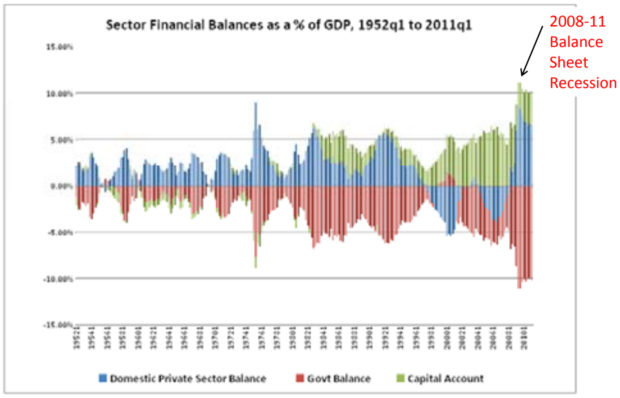
The problem can be seen from the United States' data on the growth of household sector debt, which reversed in 2008. It can also be seen in the chart in inter-sectoral balances, in which the private deficits (largely household deficits as shown in the previous chart), give way to private surpluses and large government deficits. (The "capital account" in this chart represents foreign sector surpluses with respect to the US economy.)

US Household Balances 2005-10



source: http://www.businessinsider.com/the-balance-sheet-recession-continues-2011-6

US Intersectoral Balances 1952-2010



source: http://www.businessinsider.com/the-balance-sheet-recession-continues-2011-6

In New Zealand the story is similar to that of the United States, except that the government was running surpluses rather than deficits in the years 2002-07. In the recession years after 2008, the New Zealand Government and the NFP and related sectors moved into deficit mode, as households and businesses switched to surpluses; to saving more, and to repaying debts. The switch from government surpluses to deficits was dramatic.

Sectors of New Zealand Economy

actual story 2002-07

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** balanced	Cental **Governments** surpluses **(+)**
	BANKS	
Creditor Sectors	Private **Households** deficits **(-)**	**Not For Profit** & Local Government & Insurers balanced budgets

Foreign sector surplus (+)

Sectors of New Zealand Economy

actual story 2008-11

	Pro-Cyclical	Counter-Cyclical
Debtor Sectors	Private **Business** surpluses **(+)**	Cental **Governments** deficits **(-)**
	BANKS	
Creditor Sectors	Private **Households** surpluses **(+)**	**Not For Profit** & Local Government & Insurers deficits **(-)**

Foreign sector surplus (+)

eg **(+)** → Christchurch

Spending in the business and household sectors is pro-cyclical – is positively correlated with earnings – which means that there is a surplus of goods and services available to the counter-cyclical government and NFP sectors, so long as the counter-cyclical sectors are willing to spend counter-cyclically, which means running combined deficits as large as the combined surpluses of the business, household, and foreign sectors. (The foreign sector surplus is closely related to a country's exchange rate – a lower exchange rate can turn it into a deficit – but that story is outside the scope of this presentation.)

If the deficits the counter-cyclical sectors are willing to run are smaller than the attempted surpluses of the pro-cyclical sectors, then those surpluses will not be achieved; unemployment thus results from society's unwillingness to accept the surpluses that are being offered. We can note that natural disasters, such as the Christchurch earthquakes of 2010 and 2011, provide straight-forward outlets for those surplus, but still require the counter-cyclical sectors, including the NFP sector, to run financial deficits.

Pro-Cyclical and Counter-Cyclical

- Expansion: period of falling unemployment
  - can be regarded as 3+% economic growth
  - Businesses and/or Household **deficits** drive expansion
  - generates Government **surpluses**; eg 2002-07
  - favourable conditions for NFP sector fund-raising
- Recession: period of rising unemployment
  - can be regarded as 2-% economic growth
  - opposite tendencies; eg 2008-11
    - eg private sector surpluses drive contraction

Periods of cyclical expansion, in New Zealand, can be regarded as those in which the annual economic growth rate is three percent or higher. And, for our purposes, periods of recession are those in which annual growth is less than two percent. Thus the recessionary environment persists into 2011, despite small positive rates of growth.

NFP Funding: Aggressively Counter-cyclical

- raise as much as possible in expansionary periods with view to heavy counter-cyclical spending in recessionary periods
- avoid placing savings in places that have high recessionary risk:
  - such as shares, property, finance companies
- develop credit facilities in expansionary periods
- recessionary debt options for NFP sector
  - look at options for government guarantees
  - better for government than bigger deficit on its books
  - bond options in line with US Municipal Bonds
    - eg tax breaks
  - Reserve Bank might on-lend banks' excess reserves

Periods of expansion are driven by the willingness of households (as in 2002-07), or, preferably, businesses to incur deficits. It is in these periods that the NFP sector naturally accumulates its surpluses; these are the most favourable times for NFP fund-raising.

Pressures on Government during recession

- Pressures to reduce Government deficit
- Exacerbates recession/unemployment unless
  - NFP (etc.) sector moves into bigger deficit
  - or (domestic option only), foreign sector moves into deficit
- Note that conventional Keynesian solution is for Government to increase deficit sufficiently to induce Business to plan deficit expansion
  - conventional classical solution is for Business to plan deficits through faith in recovery; lower costs

Under times of greatest pressure, in recessions, for governments to reduce their deficits, then the NFP comes under the greatest pressure to acquire goods and services for the communities that they serve. It is also the time of greatest financial pressure for the NPF sector, especially if it has invested its past surpluses in outlets that carry significant recessionary risk (eg finance companies; property and share markets).

Thus for an NFP to be effective at the times that its contribution is most needed, NFP organisations, collectively (eg through some kind of "community chest") or individually should have access to pre-arranged credit facilities. This is a process that would be best served with central government support, enabling options such as government-guaranteed loans and bonds with tax concessions. A community chest could have access to direct Reserve Bank funding, much as some programmes did in the late 1930s, and as organisations such as producer marketing boards did before the 1980s.

Economists generally agree that recessions persist until the business sector becomes motivated to expand by shifting into deficit mode, and investing in new plant, equipment and systems. The disagreement is about how that transition to deficits takes place. The "Keynesian" approach emphasises the necessity of strong spending in the counter-cyclical sectors as a source of confidence for businesses, which need to believe that deficit spending will prove to be profitable. Thus the failure of the NFP sector to play its part can only delay the expansion that it requires to repair its own balance sheets.

The solution of classical economists is quite different. They see business costs as the problem, and regard most government activity as a business cost. Nevertheless, classical economists see a significant role for the NFP sector ("civil society") to keep economic activity alive in a recession. Indeed some classical economists, such as the late Roger Kerr (chief executive of the NZ Business Roundtable), see government welfare programmes as an impediment to the creation of a direct philanthropic relationship between the business sector (and the rich in general) and the NFP sector.

Philanthropy

ref.: Radio NZ; Sundays; 6 November 2011

- late Roger Kerr argued that Government welfare programmes removed the moral obligation of the rich to fund charitable welfare
  - he was wrong, but interesting
- welfare is insufficient to recycle unbalanced market incomes, creating a need for charity or debt to recycle the income to the non-rich that industrial capitalism requires if it is to survive
  - modern capitalism ***requires*** the non-rich to spend and the rich to give (giving may take the form of debt forgiveness)
- the NFP sector, as the recipient of such giving, is an essential bulwark of capitalism

Finally, some notes on Christchurch. The earthquakes represent significant losses that can most easily be made good during a recession, precisely because that's when the business and household sectors (and, for New Zealand, the foreign sector) have surplus goods and services looking for users who will acquire them.

Christchurch Earthquakes 2010-11

- Earthquake represents a major loss of physical capital during a recessionary phase of the economic cycle.
- Net saving on the part of the pro-cyclical Business and Household sectors (domestic and global) makes otherwise unclaimed (ie "free") goods and services available for repair and reconstruction.
- Government has high financial/political sensitivities re increasing deficits.
- It's up to the NFP sector, local government entities, and insurers to provide the required deficit spending, through debt if necessary.
- The opportunity cost of reconstruction is substantially higher if such events occur in an expansionary phase.

Nevertheless, governments in particular retain high sensitivities to increasing financial deficits. The NFP and related sectors thus must play a substantial role in acquiring and delivering the services that Christchurch requires. Further, the sympathies arising from a disaster facilitate fund-raising, despite the recession environment. Household and business will increasingly give rather than lend.