Global Economic and Financial Crisis: Origins, Responses and Ongoing Challenges for New Zealand

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Introduction

In the well-known ancient Chinese curse one wishes one’s adversary to live in interesting times. For economic advisers and policymakers, times rarely get much more interesting than at present.

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. These pressures, and the challenges they pose to households, businesses and governments, have intensified greatly in the last three months.

Firstly and briefly I want to put the current global economic and financial stresses, and the way they are affecting New Zealand, into some sort of context. Then I want to outline some of the factors that will influence the way things will play out over the coming year and beyond.
Treasary will be releasing its latest official forecasts later this week and so I won't be getting into details today. Suffice to say, while downturns don't last forever, the economic and financial stresses globally have become so severe in recent months, and show little sign yet of receding, that we face a tough few years. Quite how tough and despite the assertions of some, no one knows with very much confidence. More than usually, in times like these, the informed judgement of experienced professionals is more useful in shaping a view than the latest individual pieces of economic data. We – governments, firms, and households – all need to be making decisions very mindful of the wide range of plausible economic outcomes here and abroad.

**Background**

One can't make sense of the current situation without recognising how we got here. Private sector credit in much of the world has boomed in the last decade or so, rising to unprecedented levels (relative to GDP) across a wide range of countries. This was made possible by relatively low interest rates, new waves of financial innovation, and more relaxed - in some cases quite complacent - attitudes to risk. And once the process got underway it tended to be self-reinforcing, with rising asset prices and buoyant moods supporting additional borrowing and additional spending.

New Zealand has long been at the forefront of this appetite for credit. Our household debt, mostly financed by short-term bank borrowing abroad, is among the highest in the world, and the appetite for new credit to bid up farm prices has been almost as marked.

In much of the West, interest rates this decade were lower than they'd been before partly because of the impact of policy choices, around exchange rate regimes, made in some of the more important emerging economies. These countries succeeded in building rapidly growing export industries, and then - in aggregate - they saved rather than spent the proceeds. To support demand and economic activity, and indeed to finance purchasing the exports the emerging countries were selling, interest rates in the advanced economies were kept lower than normal for prolonged periods.

Each country, and each individual borrower, made choices in their own interests, but together those choices led to a build-up of serious global imbalances. Those imbalances had been recognised as a growing risk for a number of years. Unusually large current account surpluses, and extraordinary accumulations of foreign reserves, offset unusually large current account deficits in many countries, including our own.

The emerging world’s export boom and easy access to cheap credit in the West helped fuel several years of strong global growth. Consumer price inflation was kept broadly in check. But the easy credit conditions and strong growth helped fuel an unsustainable, and quite unprecedented, global boom in asset prices. Commodity prices soared, and residential and commercial property prices in much of the Western world doubled in the last 5-10 years. When asset prices like these change that quickly it is usually a sign of looming troubles. Rapidly rising debt and asset prices left the world economy and financial system very vulnerable if anything - however initially small - disrupted the process.

It is striking just how far the leverage boom and resulting asset price inflation spread. Much commentary is very US-centric, and pays a lot of attention to, for example, securitisation of subprime mortgages in the United States – and to possible associated regulatory failures. Securitisation was much less important in most other countries – hardly at all in

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New Zealand. But in many of those other countries, developed and emerging, the imbalances that have built up have been at least as large as those in the United States. No doubt there have been weaknesses, and even failures, in regulatory structures in various countries, but at its heart this economic and financial crisis isn’t about the failure of regulation. Instead, it’s about accumulated excesses: excess borrowing in many countries, and excess investment in others. It has all been on a larger scale than we’ve seen before, but manias, bubbles, and resulting imbalances themselves are as old as market economies.

The excesses would have unwound - albeit less painfully - even if no bank or financial institution had failed. Asset prices had got well beyond long-term replacement cost and the ability of household incomes to support them. Business investment in some important emerging economies also went well beyond sustainable levels, supported by the export boom. None of that, of course, means that anyone foresaw quite how sudden and dramatic some of the adjustments would be.

The financial crisis has greatly intensified in the last couple of months. Stock market falls get the headlines in the popular press – and on a worldwide basis stock market falls have been on a scale almost without precedent. But the most immediate and pressing financial sector issue has been the breakdown in credit markets. Combined with extreme volatility, the much-reduced access to finance is greatly exacerbating the global downturn. Again that should surprise no one, given the role that easy access to credit has played in supporting growth in business and consumer spending - and putting cash in government coffers - in the last decade.

Responses to the crisis

Governments and central banks around the world have moved quite quickly to adopt measures aimed to restore confidence in the financial sector and mitigate the extent of the economic slowdown.

Some of the steps that have been taken would have been inconceivable only a year ago – as just one example, the willingness of our own government to offer wide-ranging guarantees potentially covering almost all the liabilities of our banking system. The retail guarantee was designed to ensure ongoing public confidence in the soundness of the financial system. The wholesale guarantee scheme - in many ways much more important - is about helping restore the disrupted access to the vital flow of foreign credit into New Zealand.

Interest rates have been cut very dramatically in many countries. Our own Reserve Bank has cut interest rates by 325 basis points since July – including a 150 point cut just 10 days ago. In some countries, those whose normal interest rates are much lower than those in New Zealand, official interest rates are now so low that questions are now being raised as to what to do next if/when interest rates reach zero.

A business audience will be well aware official interest rates are one thing but at times like the present actual borrowing costs can be quite another. The OCR is an important indicator rate but banks actually fund themselves from markets, not from the Reserve Bank, and the overall cost of raising funds from the market has not fallen markedly to date. Indeed, it has been very difficult for the system as a whole to even roll over maturing term funding. Even with the benefit of government guarantees, international banks are finding the cost of raising term wholesale funding very high. Partly as a result, business borrowing costs facing New Zealand firms have not fallen greatly so far this year. But in other countries - including the US and UK – the rise in market interest rates has meant that in some cases the overall
cost of new borrowing has actually risen, even as the respective central banks have slashed policy rates. In New Zealand, as Alan Bollard has pointed out, lending rates need to fall in line with the cost to the banks of raising funds.

An increasing number of governments are also using fiscal policy to mitigate the slowdown. New Zealand’s actual and scheduled tax cuts, including those to be enacted shortly by the new government, mean that the fiscal stimulus being put in place here is among the largest adopted by any developed country. We are in the fortunate position of having run budget surpluses for a number of years, which meant we entered the crisis with one of the lowest levels of public debt of any OECD country.

New Zealand’s exchange rate is volatile, but the floating exchange rate has at least stood us in good stead in recent months, providing an important buffer. The exchange rate has fallen sharply - probably more so than one might have expected simply based on the difference between our interest rates and those in other countries. When economic activity in other countries is also weak, it is hard for exporters to develop new markets quickly, but the fall in the exchange rate is providing a very helpful offset for those export producers directly affected by rapid falls in commodity prices.

Economic developments

The global crisis has come in several waves since it began in July/August last year - the most recent episode in September/October was the most intense. Further periods of extreme pressure in some or all parts of the global system remain a significant risk. Very substantial real losses of wealth have occurred, and further losses are likely, especially now that corporate sector pressures are becoming more apparent. Imbalances that have built up over many years are rarely unwound either easily or painlessly – all the more so when those imbalances are not centred in a single country, but are affecting in one form or another almost every country.

New Zealand is just one among many of the developed and emerging countries that have accumulated large external imbalances in recent years. New Zealand has always been heavily dependent on foreign capital, and many of our more severe past recessions have resulted from constraints on access to finance. But even here, in recent years current account imbalances once considered almost inconceivable became for a time almost ordinary.

So far, markets haven’t “picked on” New Zealand in particular. Our exchange rate has fallen a long way, but so have those of Australia and the UK. The assets of the New Zealand and Australian financial systems are still widely regarded as among the soundest in the developed world. The four Australian banks, each with major subsidiaries in New Zealand, are among a small number of financial institutions still rated AA.

Turning back to the global picture, it is impossible to determine quite how far the process has to run. 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 for the coming year, including those for developing countries. The idea that economies such as China’s might, in some sense, “decouple” from the developed world’s slowdown now has little credence. And as economies weaken in many countries, new credit losses, and new stresses on financial institutions are likely to become apparent.
As just one example, it is hard to imagine that corporate Australia can have gone through such a huge commodities and investment boom without serious corporate losses beginning to emerge at some point. Reports suggest that it is really only in the last couple of months that the severity of the slowdown has begun to impinge on corporate Australia. And in New Zealand, the volume of credit extended to support the dairy land boom has been highlighted as a risk by the Reserve Bank. The conversations Treasury has with businesses to inform our forecasts showed a marked change in tone across sectors between August and late October.

It is a difficult balancing act for firms. On the one hand, there is the pressure for retrenchment and caution, and near-term self-preservation. But to be kept in tension, on the other hand, is the risk of missing out on future opportunities if competitors move ahead and regain confidence or market access more quickly. Many investment projects have long lead times and choices made today will have implications, for individual firms and for national economies, for years to come.

Individuals face similar uncertainty. While most households will be happy to see lower mortgage rates and petrol prices right now, these reflect weak markets and conditions. Job losses will happen in a slowing economy. Many mortgaged householders will be finding that, even if their mortgage interest rate is actually finally beginning to drop, the value of their house is a lot less relative to the size of their mortgage debt than they would have liked. Negative equity is becoming more widespread - unsurprisingly when credit indicators suggest that house prices here are falling in excess of 10 per cent per annum.

And banks, even well-managed ones with sound asset books are likely to remain more cautious. Access to wholesale market funding for Australian and New Zealand banks remains a significant constraint. As the wholesale guarantee scheme is deployed, we expect that banks will be able to obtain some term funding. But that funding is likely to be expensive, and remain scarce: globally there is a huge backlog of debt that needs to be refinanced next year, and Australasian borrowers are unlikely to be at the front of the queue. To the extent that the foreign credit can’t be rolled over at reasonable prices, domestic access to credit could be even more constrained than it is at present. More generally, it is hard to envisage much growth in bank balance sheets in the next few years. Banks value long-term relationships with good customers, but their business models depend on access to capital and secure medium-term funding.

Looking beyond the next six to 12 months, attitudes to risk, and to extending and taking on credit, are likely to have been changed markedly, and enduringly, by the experience of this crisis. Firms, households and financial institutions will all behave differently as we emerge from this than they did before. Neither investment nor consumption spending seem likely to be anything like as robust in the years ahead as they have been in the last half decade.

That could mean that potential economic growth rates are materially impaired for several years to come. That will make it a difficult time for everyone, and re-emphasises the importance of lifting productivity growth. Treasury published a series of papers in the past 12 months around the constraints to productivity, and have been discussing these views with our contacts in business and academia. This has influenced the way in which we have talked with the new government.
New Zealand’s policy response

For us in the Treasury the prospect of weaker growth also poses significant challenges in advising the government on how to conduct fiscal and macroeconomic policy. Going forward, the economy is going to be smaller than appeared likely even a few months ago, which means there will be less revenue available to meet the commitments and aspirations of governments and citizens. Similarly, existing spending plans were set when there was a far stronger growth outlook. In fact there will be pressure on spending from increased expenditure on benefits. Taken together, the government’s debt position will deteriorate in the next few years. This deterioration will also reflect lower nominal growth and increased finance costs from deficits and rising debt. As a consequence, while we are likely to see lower rather than negative economic growth over the next two years, we will see significant fiscal deficits that will be projected to go on for some years. This will result in an increase in public debt, the extent of which may be a surprise to those who have got used to the run of surpluses in recent years.

The government will rightly want to do what it can to support economic activity through the difficult year ahead - and our relatively high interest rates and low starting level of government debt provide a little more leeway than many other countries have. While we will need to monitor closely the economy’s reaction over the next year to policy easing, our judgement at this stage is that easing fiscal policy further than planned by the government is not warranted. Monetary policy easing will provide further stimulus, and there is still some scope left for further easing if necessary. As a number of commentators have noted recently, we also need to be mindful that further fiscal stimulus will lead to larger operating deficits, which would increase funding pressure in an environment where it is likely to be difficult to raise funds. We also recognise that the fiscal pressures associated with an aging population are drawing ever closer every year and will need, at some point, to begin to adjust to the worsening debt position and re-establish the prudent levels of debt that help act a shock-absorber. In this environment getting value for the money that the government does spend – which is always desirable – now assumes particular importance.

Sustained recovery will eventually get underway as the imbalances are worked through and policy measures help reinforce tentative recoveries in confidence. When that happens, it will be equally important that central banks and governments around the world move in a timely fashion to ensure on-going price stability and long-term fiscal sustainability. That will be particularly important for New Zealand – as an erstwhile motorcyclist I know that when your skull has been saved by your crash helmet, the first thing you should do is replace your helmet

The aftermath of this crisis is likely to see a major global reassessment of the way in which governments and financial markets interact. That may pose particular challenges for regimes such as those in New Zealand that put considerable emphasis on the role of market and self-regulatory discipline. As the Prime Minister noted in his recent address at APEC, there may also be a need to stand back and look again at the question of whether monetary, fiscal and prudential policy can play more active roles in countering cyclical excesses, especially when they involve a sharp rise in asset prices.

Internationally, preserving an open international trading system is critical for New Zealand and for other countries. Growing world trade, and deepening New Zealand’s international connections, are vital foundations for improving our living standards. Putting up protective barriers was one of the huge policy mistakes of the 1930s. We must not let that happen again. The crisis heightens the need for an effective rules-based multilateral trading system, and strengthens the case for redoubled efforts to conclude the WTO Doha Round.
Domestically, the rapid growth in credit in recent years has masked some of the longer-term challenges facing the New Zealand economy. New Zealand’s productivity and investment performance has been poor, and while improved labour force participation helped arrest the decline, our incomes still languish well behind those of our developed country peers. One strength in our favour is that we have a track record of being able to make good decisions in difficult circumstances and have strong monetary and fiscal institutions. But more is needed. Treasury recently offered some thoughts on how governments might best respond to these challenges over time:

- Improved access to markets and connections between NZ firms and the rest of the world
- Incremental changes over time to address weaknesses in our tax system that harm growth
- Building institutions and systems that improve the quality of regulation, and maintaining a stable environment for investment
- Shifts towards more effective investment across the education sector to get sustained increases in skill levels
- Developing mechanisms, like water pricing, to manage increasing natural resource pressures and
- More effective and efficient public spending by aligning spending with government priorities; and strengthening the assessment of the quality of services and spending.

Some of these suggestions have been welcomed and some not. But if we are serious as a country about the incomes we aspire to - and the social and environmental objectives we desire – then it is vital that we debate these ideas and others that are put forward maturely and sensibly. While the government will not always agree with Treasury’s advice or ideas it has made it clear that it wants us to put ideas forward and encourage such debate.

**Conclusion**

The scale of the shocks the world has faced in recent months means that the economic outlook over the next few quarters, here and abroad, remains very uncertain. Sustained recovery will get underway as the imbalances are worked through and policy measures help reinforce tentative recoveries in confidence. Our judgement is being exercised around when, and in the short term there is the risk of further shocks.

However, while there are undoubtedly tough economic times ahead, we believe that there is scope for the right policy choices to lift New Zealand’s economic performance. I’m one of those who are incredibly positive about New Zealand’s prospects. Our low government debt levels provide us the flexibility to take actions that other countries would find far more difficult. And the impact of changes in asset and credit prices should help with structural imbalances in the economy over time. Managing the immediate challenges, without losing sight of the longer-term imperatives, will make possible the sort of prosperous society we all aspire to - and requires creative and courageous responses from us all - firms, households, public servants, and governments. Let’s embrace that opportunity.