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LOCAL GOVERNMENT NEW ZEALAND

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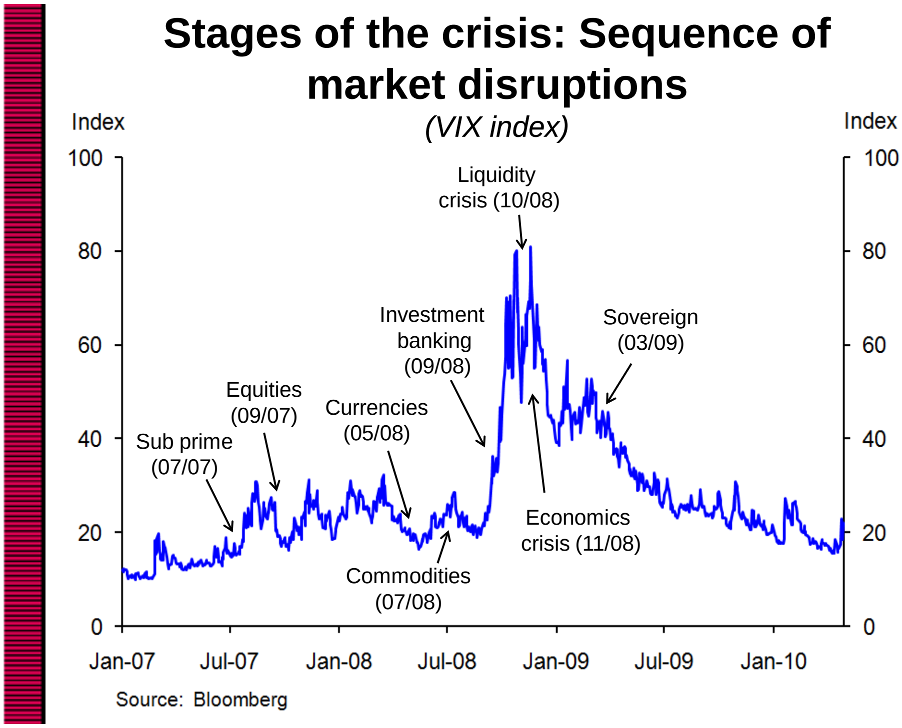
Handling our Economic Recovery

1. The Global Financial Crisis Caused Major Market Damage

We are now seeing the world pull gradually out of the Global Financial Crisis. It was an unexpected, deep and costly event, the world's worst since the Great Depression. The recovery is mixed, fragile in some places and has a long way to go. Just as we were very uncertain about the depths of recession, so no one can be sure how robust and widespread the recovery will be. Already we have had many surprises. The purpose of this presentation is to analyse New Zealand's recovery from the recession to date, and to indicate how it might proceed.

The crisis struck across almost all countries and almost all sectors. Like a virulent virus it transmitted speedily from one market to another. Some of these markets produced their own antibodies very quickly, while others sustained prolonged damage.

The figure gives an impression of when the virus hit and how it quickly passed through the world's financial and economic systems.

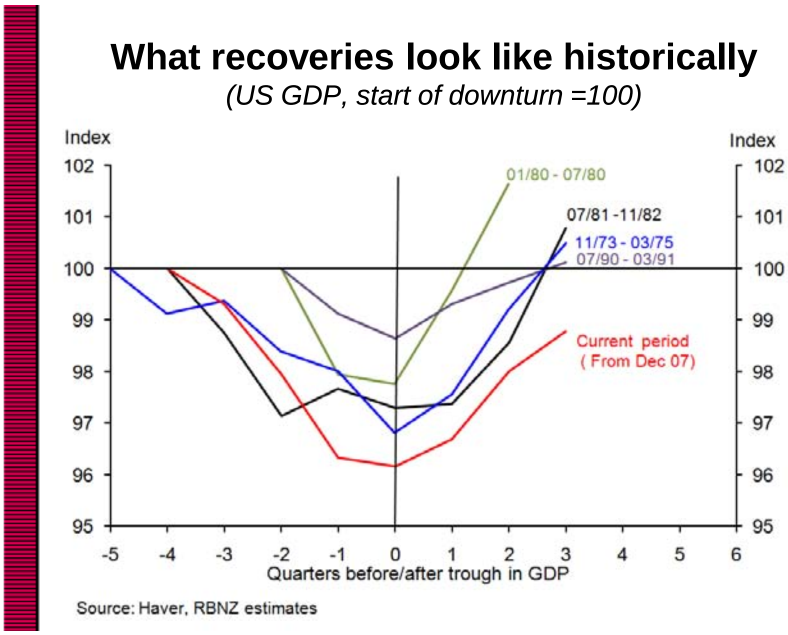


2. Economic Recoveries Can be Slow and Fragile

Recovery from a global economic recession that has been sparked by a financial crisis is particularly hard to predict. That is because established fundamental economic relationships have been put at risk and may need to be rebuilt over time.

Research into historical world crises yields some interesting results. International financial crises yield particularly deep and prolonged recessions when they are linked with banking and currency crises. A similar trend can be seen for globally synchronized recessions (IMF, 2009). Economic contractions tend to last for around six quarters, with an output loss of around 3.5 percent. Such periods are also associated with employment continuing to decline for substantially longer than GDP (Reinhart and Rogoff, 2008). On balance after a banking crisis, recoveries tend to be more gradual, and are associated with weak domestic demand, tight credit conditions, and continued contractions in residential and business investment.

In addition, recovery is not even across countries and across sectors. Typically certain parts of the economy like equities and stocks recover early. Others like the labour market can lag significantly. The figure shows the paths of recession and recovery for US GDP during past recessions over the last 40 years. It can be seen that the recovery from this Global Financial Crisis is slow and still fragile, fraught with uncertainties.

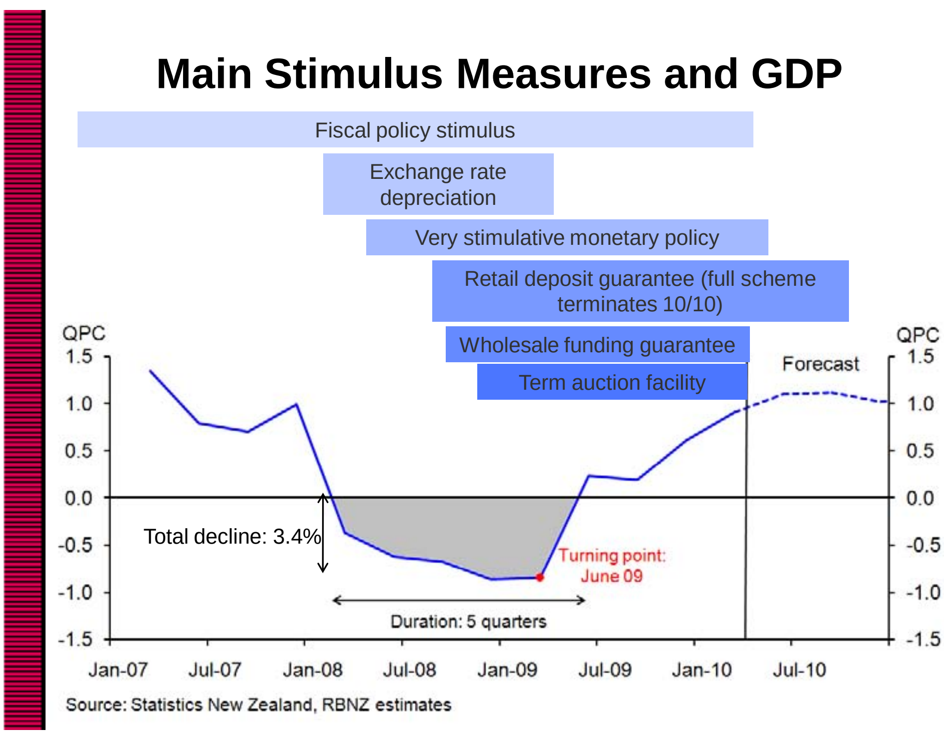


3. New Zealand Was Assisted by Significant Stimulus

Something that has marked out this global crisis as compared with the 1930's Great Depression is that we have learned the importance of government policy stimulus being applied early, forcefully and consistently. While still too early to be definitive, economists generally see government stimulatory policies as having been quite successful in stemming the recession. Of course long-term outcomes cannot be judged until we see how successful countries are at exiting their stimulus without long-term costs.

New Zealand like Australia has been fortunate in several respects: the crisis did not hit deep, the financial sector stayed broadly sound, and recovery is being helped by strong commodity markets. That has meant we did not have to stimulate the New Zealand economy by anything like the levels in Europe and the US. Nevertheless we have just been through the biggest co-ordinated stimulatory programme involving monetary policy, fiscal policy, liquidity assistance and government guarantees since World War II. These look to have been relatively effective in their timing and design, and are not expected to have left big public costs behind.

The graph of GDP shows that the New Zealand economy went in to recession in Q1 2008, although this was initially triggered by an unusually-severe drought, rather than the Global Financial Crisis. The figure also summarises the main stimulus measures that were put in place, together with another important market insulator, the exchange rate reaction during the crisis. It shows that many of the measures were implemented fairly quickly. The economy contracted 3.4 percent over the period, reaching a trough around March 2009, and back to fragile growth later in the year. By the time we received the last quarter 2009 GDP data we were in a position to say that recovery was firming and we would need to exit much of the stimulus. Most but not all of the special liquidity measures have now been terminated, leaving conventional monetary policy to guide the stages of recovery.



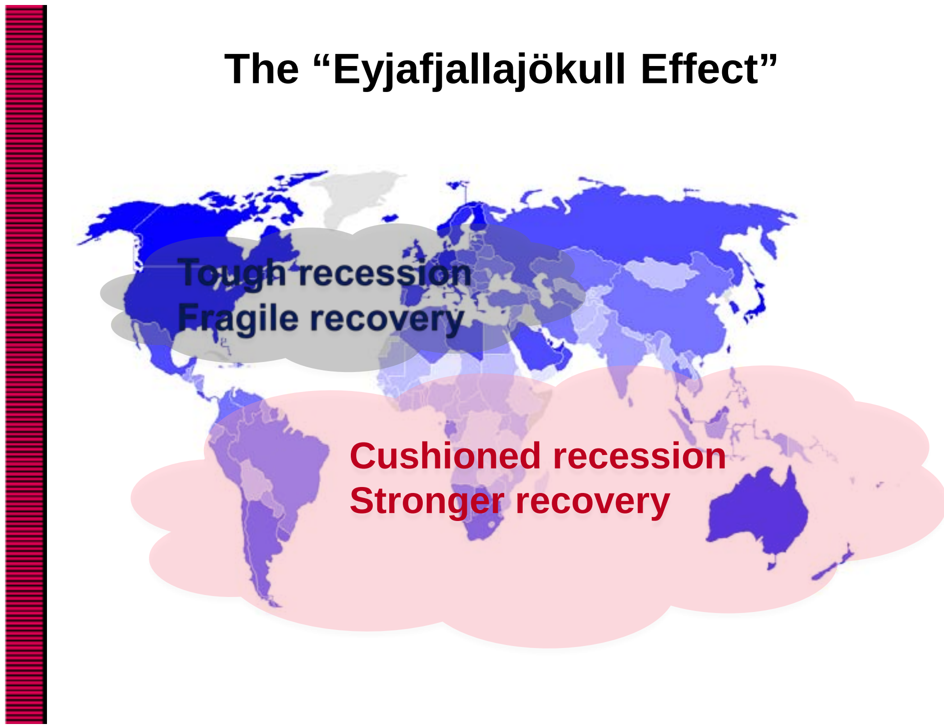
Note:

- Fiscal policy stimulus defined as significant increase in fiscal impulse measured, New Zealand Treasury in Half-Year Economic and Fiscal Update, December 2009.
- Exchange rate depreciation is the major fall in the New Zealand TWI from March 2008 to March 2009.
- Very stimulative monetary policy refers to the major reduction in OCR from 8.25 percent to 2.5 percent followed by a conditional undertaking to hold the rate low.
- Retail deposit guarantee refers to the original scheme, terminating in December 2011. The extended scheme is likely to have much less impact.
- Wholesale funding guarantee has now expired.
- Term auction facility relates largely to the acceptance of residential-mortgage-backed securities.

With the termination of these special programmes, the Reserve Bank does not feel it needs quite as much risk-based capital on its own balance sheet, and consequently has returned $45 million to the Crown.

4. The World is on two Different Recovery Paths

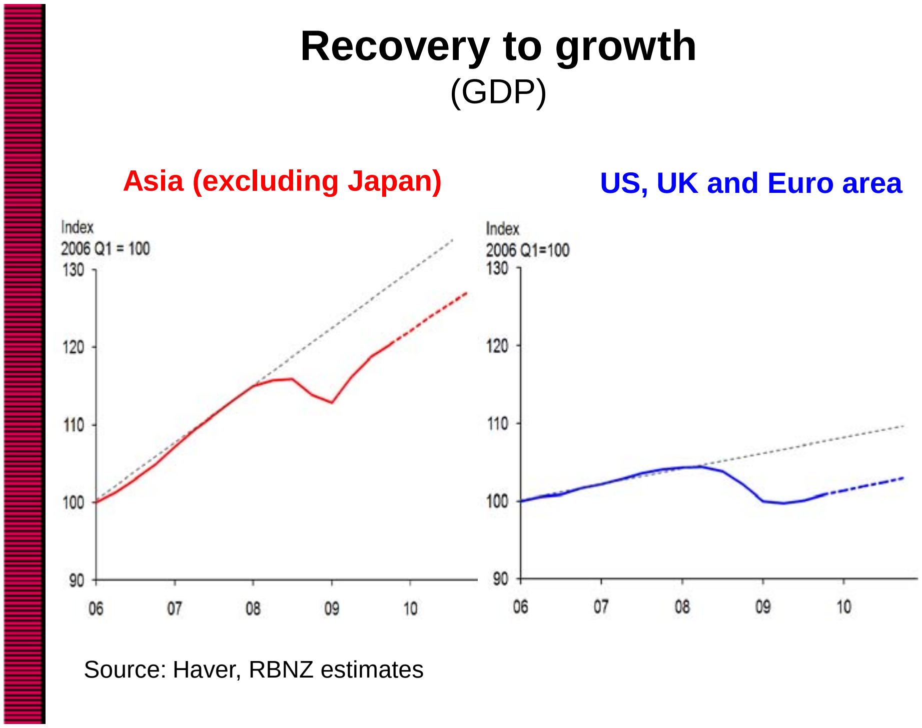
A feature of this recession is that we are seeing quite different troughs and recoveries in two regions of the world, as shown in the figure.



In the "East", defined as emerging market economies and commodity exporters, the cycle has been more shallow, and a very strong "V-shaped" recovery is underway. Of most relevance to us, China and Australia are both in this group, but also other Asian economies, and oil exporters and commodity exporters from Latin America, Southern Africa, South-East Asia and Australasia.

In the "West", an Icelandic-style cloud of despondency still settles over the old Northern economies with large financial sectors and high production costs. In the US, Eurozone, and particularly UK and Japan the cyclical trough was historically deep, and the recovery looks slow and fragile.

The difference in these two zones shows up clearly in the figure. The Eastern region lost 2.5 percent growth through the crisis, but is now back on to a pre-crisis growth trend, and has clearly passed pre-crisis income levels. The Western region lost a lot more income through the period – around 4.5 percent and is struggling to resume its (much lower) pre-crisis growth trend, and has not yet made up for lost income.

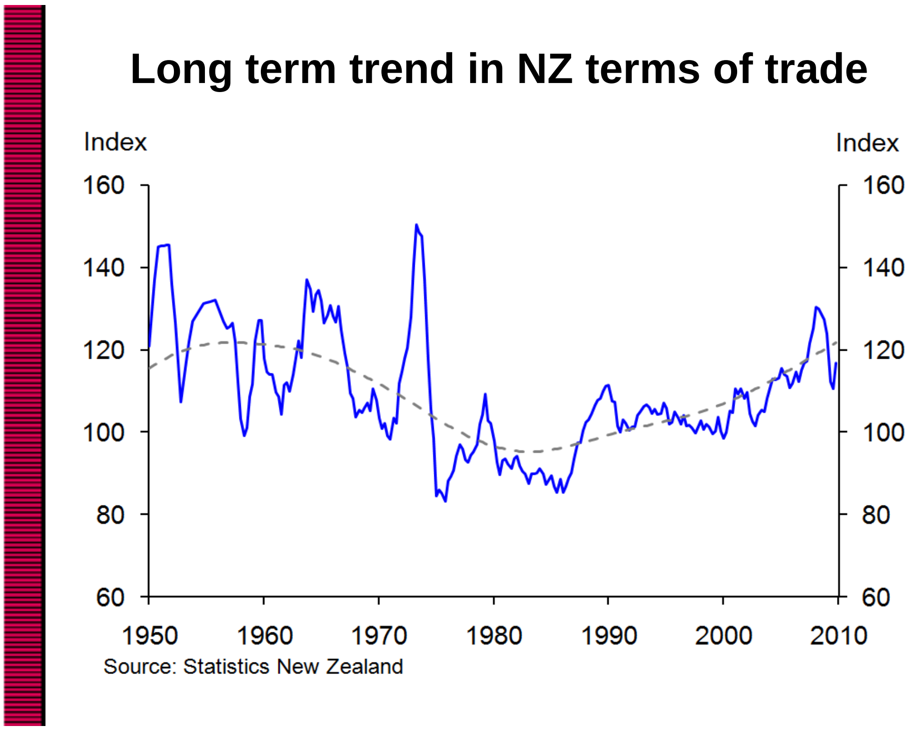


The economic recovery is involving some degree of global rebalancing. The huge current account deficits of the West and surpluses of the East have been partly reduced as a result of a rebalancing of consumption and savings. The broader economic and geopolitical implications of rebalancing are only now starting to be seen in the G-20 and in bilateral negotiations.

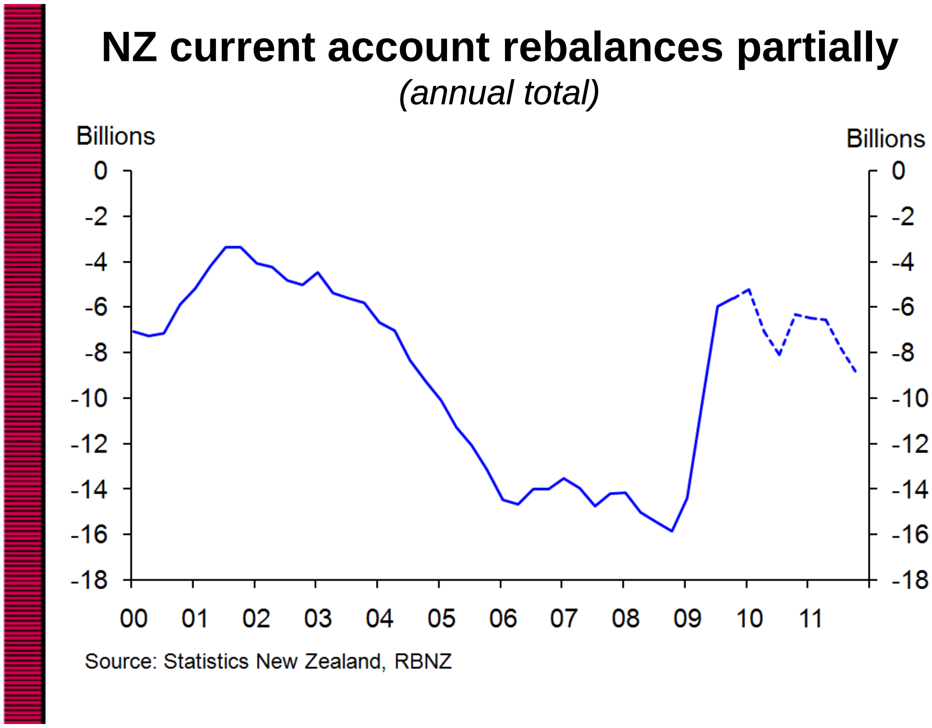
5. Our Own Recovery is Externally-Driven

New Zealand has been considerably helped during this recovery period by a strong China and emerging market growth in consumption, a strong minerals-driven Australia, and some other market and climatic factors. We saw a commodities boom in the pre-crisis year, but few people expected to see it repeated immediately post-crisis. Most would be aware that world dairy prices have recovered significantly over the past year. But in addition, beef, forestry and aluminium prices have also risen to very high levels. These high world prices have not completely benefitted New Zealand growers because of the relatively strong $NZ. (Of course these high commodity prices are themselves one of the drivers of the strong $NZ).

Interestingly when we look at longer-term movements in New Zealand's export and import prices, we can see the origins of our country's post-war strength, followed by some very difficult decades of declining terms of trade through the 1970's and 1980's reflected in slower growth relative to the OECD. Now we might speculate whether we are on a gradually improving trend in the terms of trade, one that has shown itself very resilient to the global crisis.



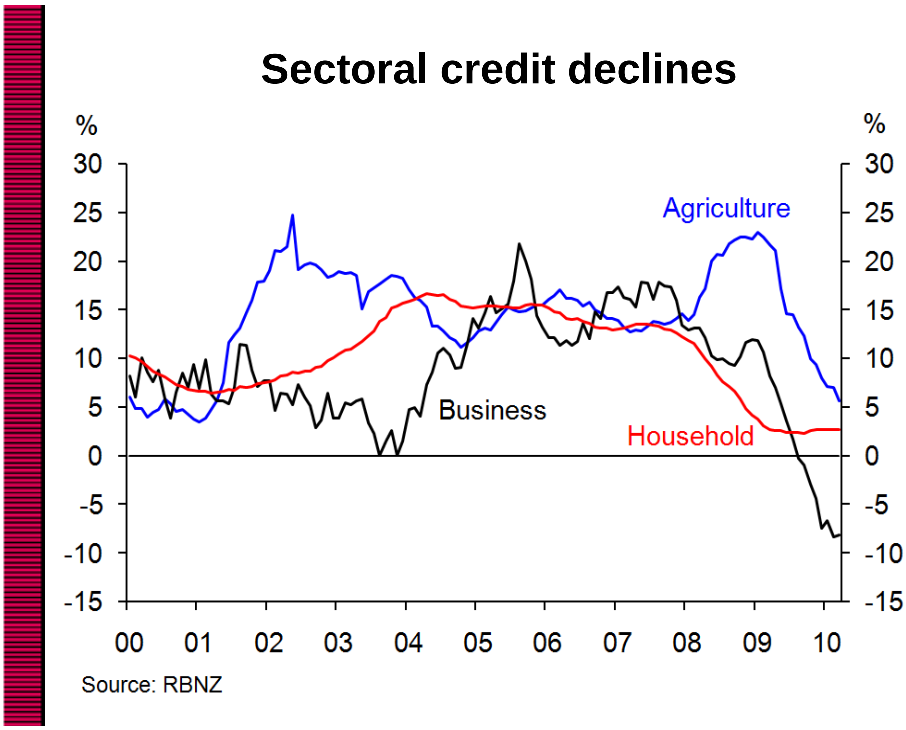
Overall, we are emerging from the crisis with some reconstruction of our external deficit as a result of strong exports, weaker import growth, suppressed domestic profits, and some consolidation of balance sheets. This too is a desirable trend, although it is still unclear how much will be an enduring development.



6. Domestically Cautious Rebalancing is Underway

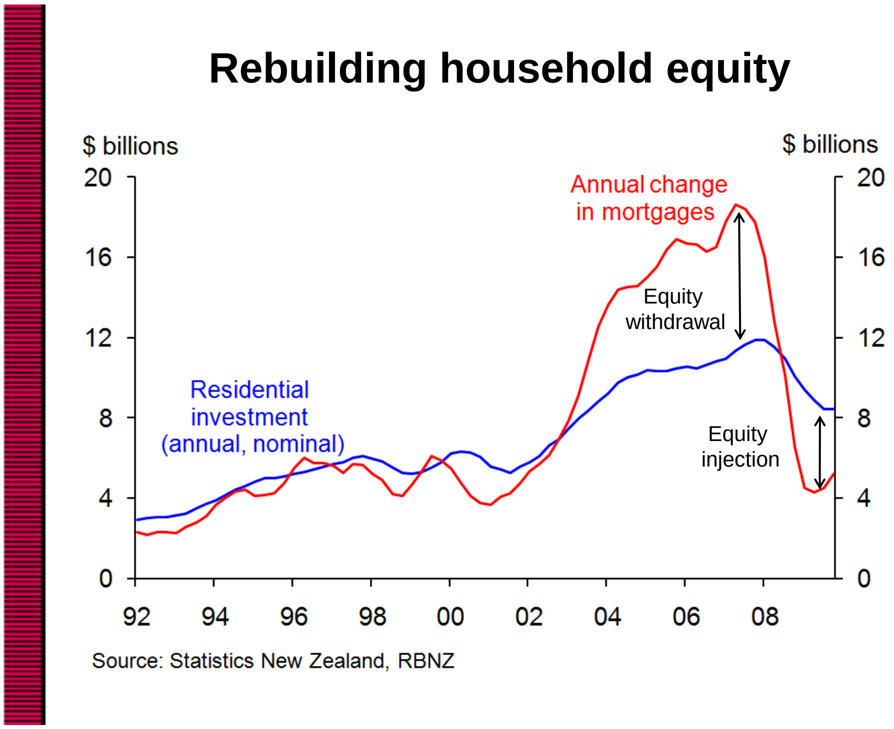
While the export sector has strong drivers, the domestic sector is seeing much more fragile recovery. There are no strong drivers here. Businesses and households have been through a harsh experience and they are responding very cautiously, deleveraging their balance sheets. Balance sheet adjustment can take some time. We have not been through an adjustment quite like this before, so there is considerable uncertainty in the minds of households and business people, and also in how we interpret their behaviours.

The business sector has emerged from the crisis bruised but not permanently scarred. In general, businesses went into the period with healthy balance sheets, in contrast to the 1990-92 recession. However they are now behaving very cautiously and as a generalisation, are still not looking to invest in plant and equipment or re-employ staff. Together with the deleveraging taking place, that means they are not undertaking new borrowing. Indeed the banking sector credit data continues to be extraordinarily restrained. This is probably an unusual combination of demand weakness and supply constraint. Whatever the explanation we certainly wish to see credit available for all sound business ventures. In the meantime business credit growth continues to contract by 8 percent (as can be seen in the figure), a most unusual situation and one that contributes to our monetary aggregates showing no growth over the past year.



The household sector looks correspondingly soft. House prices and activity contracted markedly through the recession, although they ended up a little more robust than we had feared. However, as we now record positive growth again, we have seen only a very soft pick-up in house prices, new building and sales, despite moderate demographic growth. Despite this, rather than building up housing assets, so far in this recovery, householders are concentrating on reducing their mortgage borrowing sharply, and hence building up housing equity. Another way to see this is as householders building up savings and reducing debt.

This is happening through borrowers not taking on new mortgages as in the past, and using lower interest rates with constant repayments to reduce the size of outstanding loans. The net effect can be seen in the figure.



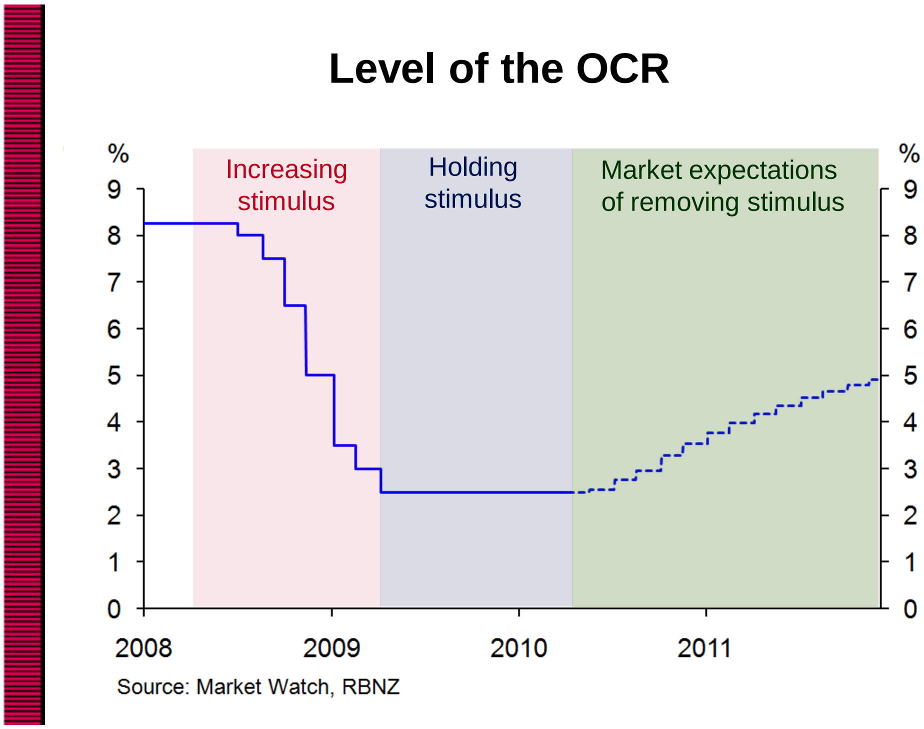
7. Our Focus is How to Reduce Monetary Stimulus

With unconventional stimulus programmes now largely terminated, the stage is set for us to influence the pace of recovery through more conventional discretionary monetary policy. This should be more comfortable ground for us all.

In our official cash rate review last week we noted: “As previously indicated, we expect to begin removing policy stimulus over the coming months, provided the economy continues to evolve as projected.”

We used the words “begin removing stimulus” deliberately. With an official cash rate at an historically low level of 2.5 percent we are clearly in a very stimulative position. Using a truck driver analogy, our foot is strongly on the accelerator. Over coming months we expect to reduce the pressure on this pedal, but in effect to keep some throttle going. Truck drivers know they must reduce acceleration long before the corner. We are not talking about tightening policy yet. We do not expect to have to touch the brake pedal for some time.

Analysts differ in their views as to what level of the OCR implies moving the foot from accelerator to brake. Actually, given the behavioural changes that are in place due to financial market pressures, it is unclear exactly what the "neutral" official cash rate is, something that can only be established incrementally over time.



Financial markets currently expect the Reserve Bank to begin raising the official cash rate around the middle of the year and continue to do this in small steps for some time. This is broadly in line with our current views as outlined at last week's OCR Review. However, the timing and pace of returning the OCR to less stimulatory levels will ultimately depend on economic developments.

Both markets and ourselves foresee that the official cash rate will not need to rise as far in this cycle as it did in the last one. There are a number of reasons for this, none of them individually definitive, but all pointing in the same direction: in brief the financial markets have already effectively tightened conditions as a result of more costly funding; the New Zealand private sector is reducing debt and cautious about new borrowing; most borrowers are on shorter duration mortgages and the steeper yield curve does not much encourage lengthening this; increasing policy rates in the shadow of Australia should be easier than being a world leader; and, finally, we believe there may be alternative ways of influencing over-exuberant bank lending through macrofinancial policies.

Our economic recovery is out of its first stage of intense fragility, and into a new phase of rebalancing growth. But a final caution: recovery so far has been full of surprises. There will be more to come!