

Looking into the crystal ball: A forecast and some risks for the year ahead

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Introduction:

For New Zealanders, Christmas and New Year are the times for family, relaxation and reflection on the year past. January is the month when we traditionally look ahead, and consider what the year may hold. This speech presents our economic view of 2011, and then poses a series of international and domestic risks to that forecast. Of course our forecasts will not turn out to be completely accurate. The risk analysis is a way to examine some of the complexities that may affect us.

What We Can and Cannot Forecast:

There are limits to what we, the Reserve Bank, and indeed any economists, can forecast. Like meteorologists, economists have a reasonable understanding of what might happen in the near term, but over the longer term, perhaps beyond six quarters or so, uncertainty begins to increase. We generally find we can predict movements over the business cycle but struggle to adequately deal with big changes in structures or behaviours.

Over the long term, we resort to analysing patterns and trends in the data in ways not dissimilar to how meteorologists look to la Nina and el Nino events to help understand the longer term picture. These patterns and trends do contain useful information but, like long-term weather forecasts, provide limited comfort if you want to know if it will rain on your wedding day in Christchurch in early summer.

We regularly assess our forecast performance and look for ways to improve what we do. We find our activity forecasts a year ahead are reasonably accurate and likewise, we can forecast some price information, particularly for that part of the economy little affected by international trade. However, exchange rates and international prices are much harder to forecast.

Of course forecasting has been particularly difficult as the world pulls out of the Global Financial Crisis. People's behaviours and business's behaviours have changed significantly and

we have little from history to guide us about how enduring or deep these changes may go. In addition, the recovery has been rocky and fragile. In this speech we go further and look at some “what-ifs”, identifying some economic developments that could make a sizable difference to our forecast picture. We examine a number of international and domestic scenarios that could conceivably impact us. These scenarios contain both “good” and “bad” outcomes, and some have perverse or indeterminate collateral implications that make it hard to classify them.

Moreover, these scenarios are not necessarily independent events. Interactions between shocks can be complex and important; and when it comes to the Global Financial Crisis, nothing is simple. For example, Howard Davies’ recent book documents 38 different things that went wrong during the Global Financial Crisis.¹ Many of these were inter-related, and those interrelations made the situation worse.

But before we turn to the risks to our outlook, we will focus on what we think will happen over 2011, based on our view at the time of the latest *Monetary Policy Statement*, updated for data over the last month.

What We Think Will Happen Over the Next Year:

The Global Financial Crisis was a deep and damaging event. Even in New Zealand where we have been less affected, recovery has been slow and patchy. In fact, 2010 was a disappointing year: we initially saw recovery happening, but the second half went unexpectedly soft (as it did in many OECD countries). During 2011 we expect the recovery to pick up and gradually become more secure.

¹ See Howard Davies, “The Financial Crisis: who's to blame”, Polity Press 2010.

The international outlook continues to be uneven. Growth in the Asian region has been strong but has brought its own difficulties with inflation and asset price bubbles building. The outlook for Western and developed economies is still spongy as these economies slowly recover from the aftershocks of repairing damaged bank balance sheets and ongoing government fiscal exposures. Commodity prices have reached very high levels, driven by emerging market demand. These high commodity prices generate stronger export revenue and provide a much-needed boost to incomes.

However, farmers continue to use this income boost to repair balance sheets. Indeed the business sector, broadly speaking, continues to behave cautiously, opting to rebuild company balance sheets rather than take on new investment. We think that investment will start to pick up in the second half of this year as confidence returns, but it is by no means clear how persistent business caution will remain.

The national construction market remains very soft. But the picture for the next few years is dominated by the significant impact of the Canterbury earthquake. Major damage has been done to homes, businesses and infrastructure, with a consequent significant loss of value. At the same time, there will be a big increase in economic activity as the repair work gets underway. There are many estimates, but we think that earthquake-related construction spending will add at least \$5 billion to New Zealand's nominal GDP. While essential infrastructure rebuilding will be frontloaded, our business contacts suggest much of the commercial rebuild may be a prolonged process lasting several years. All else being equal, this will add some pressure to prices and the exchange rate, but we think this is manageable.

Housing turnover within the Canterbury region has been impaired, and nationally turnover remains at low levels, despite the floating mortgage market being well below historic norms. While firming over the past couple of months, we believe the current level of house sales is consistent with continued softness in house prices this year.

As forecast, the December consumer price index jumped 4% as a result of the GST increases. Despite this, we think price inflation remains comfortably under control. This is the message that was communicated in the December *Monetary Policy Statement* and repeated in our January OCR Review this week. Consequently, it now seems prudent to keep the OCR low until the recovery becomes more robust and underlying inflation pressures show more obvious signs of increasing.

Four International Risks:

The forecasts for the year are crucially dependent on a number of international risks. A number of large economies have faced very unusual conditions as they emerge from the Global Financial Crisis, and this has resulted in high uncertainty. We highlight a number of these risks.

1. US Economic Gloom or Boom:

US recovery has been quite slow overall, but the labour and housing markets have been hit particularly badly. The US labour market remains just below double-digit rates of unemployment, with over 15 million men and women unemployed. The number of long-term unemployed is particularly worrying, with over 6 million unemployed for more than 6 months. As the effects of the crisis linger, it becomes particularly difficult for the unemployed to find work. With the US housing market moribund from low household income, confidence effects, falling prices and lengthy legal delays on the mortgage foreclosure process, workers have been either unwilling or simply unable to move to seek new employment.

Moreover, in the US, both monetary policy and fiscal policy face constraints. While the Federal Reserve can pump more money into the system this risks losses on the securities they hold in return for this cash. In addition, quantitative easing no longer has the same surprise impact; reducing mortgage interest rates at the margin has little impact on households facing unemployment and unable to sell their own home. There is little room for further fiscal stimulus since Federal and State debt positions are extremely stretched. While US firms and

households continued their deleverage at the end of 2010, the US Government is still increasing its debt position.

If this US domestic gloom continues or worsens, it is difficult to see American consumers playing any part in driving world recovery. Further, it could impact equity markets, and start to focus financial markets on the size of US state and Federal debt.

But just as possible, the US may surprise us with economic strength over 2011. Many US businesses hoarded cash over 2010. But now flow of funds data show non-financial firms started borrowing again in the third quarter of last year, though retaining cash from bond issuance rather than undertaking new investment. It would not be difficult for businesses to ramp up investment quickly, and then demand for labour could increase almost as rapidly as labour was shed going into the crisis.

Under this scenario, US consumers would start to spend again, acting as an engine of growth for trans-Pacific trade. Incomes would rise, providing a much needed boost to the US housing market. Markets might even worry about a pick-up in inflation from the current extremely stimulatory settings, in which case the Federal Reserve would have to rapidly call in stimulus measures, increasing policy rates during 2011, with some consequent market disruption. In this scenario, the US dollar would presumably appreciate, taking some pressure off the New Zealand dollar and providing an improved opportunity to rebalance our economy towards export growth.

2. Sovereign Debt Reaches Crisis Point

The Global Financial Crisis cruelly exposed some governments with extended public debt positions, high fiscal deficits, inappropriate regulatory environments and low productivity environments. Stimulus packages for the economy and rescue packages for certain banks have pushed some sovereign balance sheets into crisis. Financial markets have been merciless in the way they have signalled sovereign weakness, and indicate tough treatment ahead. This has

most obviously occurred with the PIIGS group of countries in the Eurozone, pushing European authorities into the very uncomfortable positions of having to underwrite individual country balance sheets.

There is a possibility that this situation could worsen in 2011. So far, the risk spreads on sovereign bonds have stayed stubbornly high. More European countries are feeling the heat. Managed sovereign defaults could still occur, and these could impact the banking systems of core European countries. Investors continue to re-evaluate the price of sovereign debt in the euro area. Moreover the countries that have implemented austerity plans could find the terrain rougher and the recovery harder than first thought. This would imply more spill-over to the wider euro area economy. Some eastern European economies on the periphery could suffer, and countries outside the euro area might not be immune.

Renewed fragility in funding markets could have other effects. Slow growth and high debt in Japan, together with its skewed demographic profile, could worry volatile markets, and other Western countries would not be immune from this. A scenario of renewed capital market fragility would also make life much tougher for Australian and New Zealand banks, and that would be extremely damaging to our economic recovery.

3. Emerging Markets Out-Perform and Bubbles Burst

One feature of the post-crisis world has been the ability of emerging markets, characterized by the BRICs grouping of Brazil, Russia, India and China, to recover rapidly from the massive fall in global demand during the recession. This suggests that these countries now contain many of the institutional features, some put in place in the Asian region as a result of the Asian crisis, that will foster growth and provide more resilience to shocks that may hit the global economy across 2011 and beyond.

This group of countries has managed to finally attain their place at the world table as the new G-20 order is hammered out. This change in the underlying geopolitik will be complex and not

just occur over 2011, but during the next decade. But in the short-run strength in the BRICs is underpinning the global recovery and this could intensify further. If this happens, it will boost New Zealand's trading prospects. At the same time there is a real risk of over-heating.

Much of the strong growth in China was driven by the extension of credit through the latter part of the crisis. This helped China to post double digit growth rates for most of the past year. But now there are general signs of over-heating through Asian economies, risking asset bubbles: Chinese asset prices, Hong Kong and Singaporean property, capital inflows into other East Asian economies, inflation in India, and house prices in Australia. A worse scenario for New Zealand would see the Asian banks, which until now largely have been insulated from the Global Financial Crisis, affected by deflating asset prices. Domestic demand could slow, Asian countries turn protectionist, and current account surpluses rise.

A material slowing in Chinese growth appears a likely scenario. After recent extended efforts to moderate this economy, policymakers might need to apply the brakes in response to rising consumer prices. This could be very disruptive, risking loan defaults, poor bank balance sheets, capital controls, exchange rate tensions, import protection and a regional slowdown.

One effect would be to hit industrial commodity prices. A disruption of this magnitude would have another undesirable effect: knocking Australia's terms of trade, and exposing rising imbalances in that country. New Zealand would lose the advantage of the China/Australia growth locomotive that has helped drive our own export demand over the last twelve months. In such a situation, some of the shock would likely be offset by a lower New Zealand dollar, though this would have to be balanced against higher imported inflation.

4. The Commodity Boom Intensifies

One possibility for 2011 is that the commodity boom could intensify, surprising us with stronger export prices for primary exporters, continuing the theme in 2010. With a strong dollar hurting manufacturing exporters, so far the boom has been widespread across most commodities. This

includes hard commodities, like the coal, copper and iron ore used to help fuel China's growing economy, and also soft commodities like dairy, meat and fish, as food demand grows throughout the Asian region.

Over the long term, the infrastructure construction in China is likely to sustain high prices for hard commodities, while rising demand by emerging middle classes in Asia suggests increased demand for protein and soft commodities. Moreover, as the global economy settles into a new post-crisis order, many long held structural supply chain relationships are changing, often exacerbated by weather-related shocks. In the last year we have seen the effects of Ukrainian drought, Russian log taxes, US oil spillages, Chilean earthquakes, and Brazilian and Queensland floods on primary production and prices. La Nina weather conditions could suggest more volatility ahead.

New Zealand farmers are still recovering from the last commodity boom when some over-committed, and are still looking to reduce the debt they built up. A more measured reaction this time is important. New Zealand stands well placed to benefit from some of these changes through 2011. As oil prices rise, Western governments encourage bio-fuel conversion which exacerbates the soft commodity price pressures. New Zealand Inc.'s import bill rises, but farmers and primary exporters do well. But as oil prices rise, this places pressure on inflation not just in New Zealand, but globally, risking a bursting of the commodity boom just like the 2007-08 event. Indeed if oil prices escalate beyond \$100 for long, growth in much of the world will suffer again.

As trade relationships change this creates opportunities for New Zealand exporters. For example, Australia supplying meat to Asia and Russia leaves a gap for New Zealand to export beef to the US market; while prices for New Zealand forestry have benefitted from regulatory controls implemented in the Russia Federation that have created a shortage of logs for Chinese markets, increasing the price of New Zealand logs.

However, high commodity prices put upward pressure on food prices and any intensifying of the boom will generate potentially severe inflation in the Asian region in particular. Additionally, over the past two or three years many financial market participants have looked to build a position in commodities as a new asset class in its own right, alongside more traditional assets, such as stocks. The extent of these positions and how this might play out if the boom intensifies is yet to be determined but it constitutes a key risk for 2011.

Four Domestic Risks:

Of course, just as there are international drivers and risks to the outlook, there are several key risks and drivers to New Zealand's growth path on the domestic front. One overarching theme for the domestic economy is the extent to which households, firms, and even the government want to keep reducing their respective debt position, and how much they are able to do so.

1. New Zealanders Save But Don't Spend

One possibility we could confront during 2011 is that the cautious household reaction we saw over 2010 turns out to be a structural change in behaviours rather than a cyclical response to a marked recession. House prices could be forced to drop much further to reach true economic values. This would cast a pall of gloom over the market, with homeowners keeping houses off the market, not re-building, and trying to pay off mortgages faster, saving more, and spending less. The construction and retail sectors would suffer as a result. Under this scenario, the Reserve Bank might have to reconsider some further monetary policy stimulus. Such restrained spending would keep domestic demand in check for 2-3 years, constraining growth short-term but building a stronger base for long-term growth.

The positive side of this risk is that it would accelerate New Zealand's much discussed rebalancing, reducing the current account deficit, improving competitiveness, reducing exchange rate pressure, relieving pressure on funding markets, and reducing our external

vulnerability generally. The negative side is that New Zealanders would have to reduce their consumption compared with pre-GFC years, and that could create an emigration exodus.

2. Financial Market Fragility

Another negative scenario would be if financial markets, scarred by European debt, were to become more allergic to indebted small countries generally. In that situation local banks could find their funding markets increasingly fragile, and with an overly cautious eye on Basel III, and more interesting expansion opportunities elsewhere, the cost and availability of credit would tighten for New Zealand business. This would limit business re-investment and mean some businesses might hit capacity bottlenecks later in the year when demand starts to recover.

In addition, funding market fragility would be bad news for our public debt. If participants in fragile sovereign funding markets were to form a view that New Zealand exposure is less attractive, credit rating agencies might re-assess New Zealand sovereign debt, meaning that debt servicing costs could rise. If the market were to form the view that the government deficit was increasingly structural and hard to correct, and if the New Zealand Government were forced to consolidate faster, this could generate a contractionary effect on consumption, which would be difficult to counter with monetary policy. And in such an environment, looser fiscal policy would not be a serious option.

3. Construction Boom

While we have outlined a number of negative risks to the business environment, one that could be more positive would be a large pick-up in construction this year. There are two obvious drivers. Firstly the Canterbury earthquake: our estimates suggest that the \$5 billion rebuild added to nominal GDP comprises about \$1 billion of damage to infrastructure and about \$1 billion to commercial buildings, with the remaining \$3 billion comprising residential claims. In itself this is very big by New Zealand standards, indicated by the fact that it will add one

percentage point to growth each of the next two years. However, these estimates are uncertain and damages from ongoing aftershocks, suggest the extent of the ultimate rebuild could be significantly larger.

In addition the relatively strong inward migration, the limited investment during the last few years, growing demand in the Auckland region, and leaky homes rectification means that the stock of housing could be falling behind demand. Rectifying these would put additional pressure on resources, increasing prices already lifted by GST and other taxes/charges. Households might start to ratchet up their expectations about future inflation and in such a case the Reserve Bank could be confronted with the need to increase policy rates to dampen the accelerating inflation outlook.

4. The Rugby World Cup

One driver of growth over 2011 is, of course, the Rugby World Cup. We think the event will add about \$700 million to the New Zealand economy over the six weeks of the event, contributing approximately a third of a percent to GDP. More optimistic assumptions about multiplier effects would suggest a stronger impact, during months which are normally a tourist down-time. Winning the World Cup would also boost general confidence.

How likely is it that New Zealand will win? We have asked our expert team of forecasters to answer this question. They have pointed out several solid facts: we have always won the World Cup at home; we will have a Cantabrian leading the team and another directing the back-line. Our expert team of forecasters predict that on average, the All Blacks will beat Australia in the final at Eden Park, by 23.9 to 15.6.

How to Plan Your Business for Whatever 2011 Brings:

Sorry, that's your job! Good luck for the year!