Economic recovery

Alan Bollard

This article reproduces the paper for a speech given by Governor Alan Bollard on 14 July 2009 to the Hawke's Bay Chamber of Commerce, Napier, New Zealand. It argues that certain basic factors will promote sustainable growth and reduce the New Zealand economy's vulnerability in the recovery phase following the global economic crisis of 2008-09. These factors are greater savings by households, to reduce the need for foreign funding of the economy; investment in the economy's productive base, particularly in the tradable sector; and greater durability and depth in funding markets, including a lengthened maturity structure for bank funding. The speech also looks at the major drivers of the crisis and world recovery, and the impact of the crisis on New Zealand.

Introduction

The global financial and economic crisis has confirmed once again that when the world is in shock, it will be turbulent for New Zealand. Good policy frameworks, policy interventions and our economy's structure can help a lot. However, they cannot completely isolate us from the turmoil.

Now, we and the world appear to be on our way to recovery. What shape will recovery take, and what will make it durable? What are the implications for policy? This speech looks at these questions for the global economy, and for New Zealand.

At least for New Zealand, certain basic factors would promote sustainable growth, and reduce the economy's vulnerability, beyond the recovery. First, greater savings by households, to reduce the need for foreign funding of the economy. Second, investment in the economy's productive base, particularly in the tradable sector. Third, greater durability and depth in funding markets, including a lengthened maturity structure for bank funding.

The speech proceeds as follows. First, I review the themes driving the current world recession, and how world recovery appears likely to proceed. Then I turn to New Zealand and look at the impact of the crisis here. Finally, I discuss the path ahead, the lessons learned, and our challenges to make the recovery strong and sustainable.

The world recession in hindsight

The story of the past decade has now been told many times.

Around the world, liquidity and credit grew hugely until the crisis. The expansion was fed by stimulatory monetary policy in the developed world responding to the 2000-01 global downturn, a 'glut' of international capital pouring out of emerging markets and oil producers, and a proliferation of new financial firms, instruments and practices seeking to ride the credit wave. Risk managers and regulators alike struggled to keep up with the growing complexity. Credit expansion and asset price inflation reinforced each other, and oil and other commodity price inflation followed.

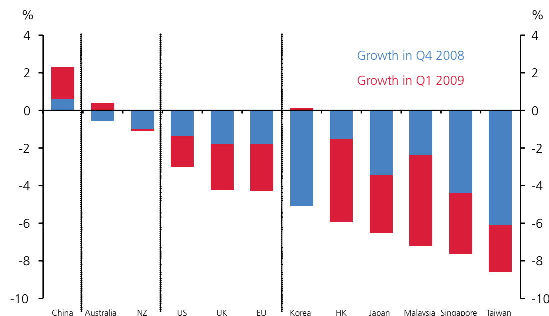
The boom proved to be unsustainable. Around mid-2007, US house prices began to fall, and impairments on mortgage loans began rising sharply. Soon, the quality of a wide range of securities and derivatives based on bank loans came under question. With growing panic about who was exposed and how badly, financial firms stopped dealing with each other in September 2008. Short-term funding markets shut down. Some very large firms, including Lehman Brothers, AIG, and Fannie Mae and Freddie Mac, failed or were restructured. The implosion of liquidity crippled the equity and term funding markets.

The widespread reduction in credit availability to the economy, massive loss of wealth, and plummeting business and consumer confidence drove economic recession. Developed-country consumers and firms slashed expenditure on big-ticket durable items such as cars and machinery. Reflecting this, exports and production in upstream economies in the

global manufacturing supply chain, particularly in East Asia, collapsed (see figure 1) – but commodity exporters such as Australia and New Zealand were less hard hit.

In the six months to March 2009, global economic activity fell more rapidly than at any time since World War II.

Figure 1
Quarterly growth in selected economies, fourth quarter 2008 and first quarter 2009



Sources: Datastream, Statistics New Zealand.

Policy responses around the world have leaned hard on all conventional measures, and many unconventional ones.

To deal with the liquidity crisis in the financial system, central banks broadened their lending facilities to banks. Governments extended bank deposit and liability guarantees, and intervened to restructure or rescue large or 'systemic' institutions. Several countries have now developed programmes to purge bank balance sheets of illiquid assets and strengthen banks' capital positions.

To deal with the economic slump, governments and central banks have rapidly deployed large-scale fiscal and monetary stimulus. The fiscal packages have been on the order of several percentage points of national GDP, while official interest rates have been cut close to zero in the major economies. Central banks in Japan, the US and the UK, among others, have taken unconventional steps to restore credit availability and reduce longer-term borrowing costs, mainly by buying financial securities in large volume on the open market.

It will take some time for the full effect of all these stimuli to come through. For now, they have at least helped to stanch the bleeding.

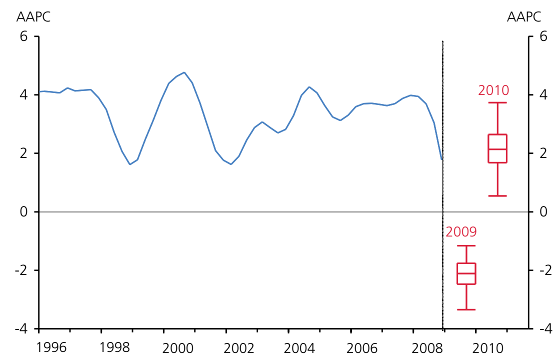
Recovery and sustainable world growth

Indeed, early signs of global recovery have now emerged. We appear to have avoided a repeat of the Great Depression. After the plummet in activity through to early 2009, production seems to be stabilising (Europe), to have stabilised (US) or even turned around (some Asian economies). The success of domestic policy stimulus has been most noticeable in China.

Business confidence surveys from the various regions suggest further improvement this year. Financial conditions and sentiment have improved perhaps the most.

Financial sentiment typically moves ahead of macroeconomic recovery, but history shows that such moves are often 'false dawns'. Medium-term forecasts for global growth remain in a wide range (see figure 2). The disruptions in the current crisis have already come in waves.

Figure 2
World growth forecasts



Sources: **DataStream, Consensus Economics Inc., RBNZ estimates.**
Note: **Forecasts shown are minima and maxima (outermost lines), upper and lower quartiles (edges of the boxes) and medians (middle lines in boxes).**

Our overall sense is that world growth will be fairly subdued for the next one or two years at least. And, with unemployment rates likely to continue rising for some months, recovery will not be obvious to many.

A lesson learnt from deep downturn experiences is that timely policy action can effectively cushion the downturn. The extreme economic weakness in much of the world means that low interest rates and fiscal stimulus are likely

to be needed for some time. But as activity recovers, the stimulus will need to be removed, possibly quite quickly. Getting the timing right is not simple – premature tightening would prolong the weakness, but late tightening would sow the seeds of later trouble.

On the fiscal side, 'fiscal consolidation' – some combination of spending cuts and tax increases – will be needed as soon as the economies concerned can bear it. The reductions in tax revenue due to the slump, and the government spending stimulus in response, have dramatically worsened the public debt outlook in almost all developed countries. The public debt outlook was already worrisome before the crisis, due to the expected large increases in public health and retirement income spending associated with ageing populations. The increased public debt servicing and deterioration in sovereign creditworthiness already risk crowding out private investment, which is sorely needed to restore sustainable growth and the national income needed to support public expenditure. Japan and the UK especially, and to a lesser extent the US, are pushing the limits of manageability in this respect.

On the monetary side, interest rates will need to rise from their current very low levels, as recovery proceeds. Otherwise, the economy may be over-stimulated, risking another credit boom or a return of inflation. In addition, this time around, the world financial system is awash with liquidity, and central banks' balance sheets are greatly expanded. The challenge will be to reduce liquidity to normal levels and contract central bank balance sheets smoothly, while policy interest rates are raised.

Sustainable world growth

Not all cyclical recoveries are equal. The form a recovery takes matters for its long-term sustainability. A healthy and long-lasting recovery this time is likely to require concerted reduction of the global savings and investment imbalances that set the stage for the current crisis. In turn, this will imply some major shifts in world trade patterns.

It is very early days in the recovery, but we can speculate about the broad shape of a more stable world. Western economies – particularly the US, as the largest deficit-running country by far – will have to shift their demand away from consumption and public expenditure, and towards exports. Reduced imports by the West means that surplus countries, particularly in Asia, will generally have to grow their own domestic demand.

With these shifts, the flow of savings will be less unidirectional from East to West, and Western economies will fund domestic expenditure with greater reliance on domestic savings. The economies most heavily exposed to the surplus countries, such as commodity exporters, will stand to benefit the most from these shifts.

The progress of countries such as Australia and New Zealand, for example, will probably be relatively steady. We are much less geared towards the export of high-tech manufactured goods to Western markets (and, moreover, do not have enlarged financial services sectors). At least in the early stages, it looks as though Australia, with its industrial commodity emphasis and hence greater exposure to China, will be somewhat better positioned than New Zealand to benefit from the world recovery.

Getting to this more stable world will not be simple. It is likely to require substantial, coordinated government effort, on sensitive matters such as exchange rate alignments, to re-orient the structure of world demand.

Nor will the economic environment be especially conducive to adjustment. The cost of risk capital relative to risk-free rates is likely to be higher than in the lead-up to the crisis, reflecting better risk assessment, greater investor risk aversion and increased financial regulation. Also, the recession has caused deep losses of wealth and skills, and large-scale scrapping of investment. Together, these factors make it likely that the trend rate of world growth will be subdued for some years.

There are some early signs of rebalancing in the US, with their current account deficit declining sharply and the household savings rate having risen from its very low levels. Financial firms are reducing their leverage and their exposure to risky assets. However, the adjustment will need to continue for some years, as significant imbalances remain and the pressure on incomes is limiting the ability to repay debt.

Moreover, as the recovery proceeds, an additional challenge will be for the Western world to resist the temptation to return to debt-funded consumption, and for the emerging world to avoid excessive emphasis on export-led development. Without the continuation of the adjustment, there would be a recovery that is cyclical only, rather than structural and enduring. This would leave the US and world economy susceptible to future shocks.

For now, financial market prices are promoting the continued rebalancing and adjustment of the US economy. The US dollar is under generalised selling pressure. Its weakness against most other floating currencies is encouraging the US current account deficit to shrink – and before those of other deficit countries that trade with the US, such as New Zealand. Similarly, rising US government bond rates are signalling the need for fiscal consolidation.

Large shifts in the geographic structure of world financial and economic activity along these lines will probably shift the balance of global politics and leadership. It is rather early to say exactly how. Commentators have raised issues as diverse as the status of the US dollar as world reserve currency, the risk of a return to financial and economic protectionism, and whether liberal capitalism has had its day. Such debate can only grow louder as the role of populous Asian and other emerging economies, particularly China, in the global economy continues to grow.

The New Zealand recession in hindsight

The international financial crisis actually played little role in the early part of New Zealand's economic recession. Rather, it was drought, falling house prices and high petrol prices that dragged New Zealand GDP growth negative over the first three quarters of 2008.

Most people anticipated that the crisis would have strong effects on us, but the effects became apparent only late in 2008. The most obvious signs were the elevated risk to bank funding, the increased cost and reduced availability of credit, and the increased pressure on manufactured and services exports. By the end of the year, the contraction in activity in New Zealand had become very broad-based.

On our current projections, this recession will be the second- longest for 50 years – second only to the mid-1970s recession. However, we do not expect it to be significantly deeper than average. New Zealand is fitting the pattern seen internationally where economies without large high-tech manufacturing sectors have held up better than economies heavily dependent on those sectors, such as Singapore, Taiwan and Japan.

Nevertheless, everyday New Zealanders have suffered. The unemployment rate is likely to rise above 7 percent by the middle of next year, for an increase of nearly 90,000 in the number of unemployed from its trough in late 2007. And, house prices have fallen by at least 10 percent, with some further limited declines expected over coming months. This translates to a reduction in aggregate household wealth of about $90 billion – or roughly $80,000 per home-owning household.

The increase in unemployment reflects the stress on business also. Reduced demand has constrained cashflow and lowered revenue prospects, leading businesses to cut investment considerably. Further declines are expected over the coming quarters.

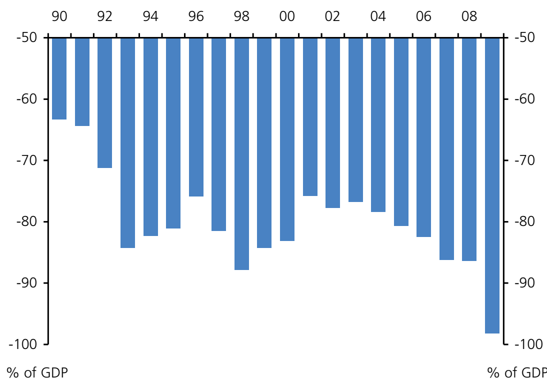
New Zealand in recovery

New Zealand will enter the recovery phase without the burden of an enlarged financial sector (as in the US and UK), and without an overhang of inventory in the construction industry (as in the US). However, as elsewhere, the global and domestic recessions will still take their toll on trend growth. A rate close to 2 percent per annum is likely over the next few years, as against around 3 percent over the past ten years.

Strong future income growth is therefore unlikely to solve the private debt problems accumulated in New Zealand up until the crisis. During the credit boom, New Zealand households accumulated considerably more debt than other developed Western economies. New Zealand's private borrowing has been so strong that it has offset our good performance on public saving compared to other countries, such that New

Zealand's net external liabilities now approach 100 percent of GDP (see figure 3). This external liability position is one of the largest among developed countries.

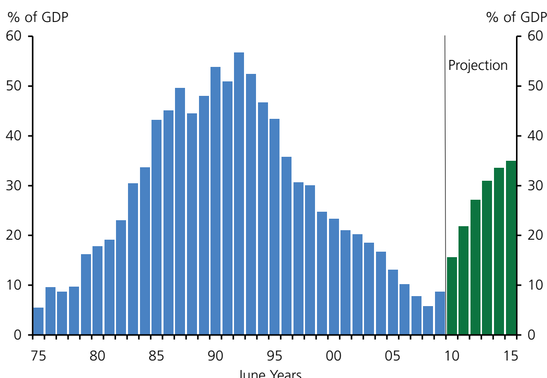
Figure 3
International investment position



Source: Statistics New Zealand.

The reduction in future national income prospects also means that the outlook for New Zealand's fiscal position has deteriorated considerably. The Government's latest *Budget* projections show net government debt increasing by about 30 percent of GDP over the next few years – similar to increases projected for many other OECD economies – before starting to decline thereafter (see figure 4).

Figure 4
Net government debt
(percent of nominal GDP)



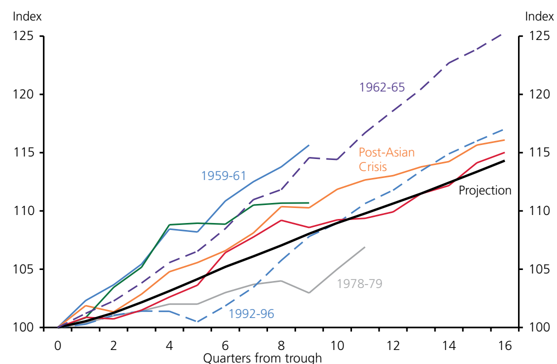
Source: the Treasury.

An important difference is that the New Zealand fiscal position is starting from a much stronger position than many other developed economies. The New Zealand business sector also generally has relatively healthy balance sheets and sound risk management, despite strong credit growth over recent years. And, New Zealand banks, in contrast to many of their Northern Hemisphere counterparts, are in good shape.

The soundness of the banking system is one reason why monetary policy in New Zealand has been quite effective in cushioning the economy. Interest rates faced by most borrowers have fallen quite markedly over the past year and private sector credit has largely kept flowing. Official interest rates remain well above zero and there has been no need for unconventional monetary policy operations to influence monetary conditions.

Overall, the onus on households to constrain their spending and repair their balance sheets, and limited scope for additional government spending, suggests that the New Zealand recovery is likely to be gradual and fragile by our own historical standards (see figure 5). However, we expect it to be somewhat stronger than those recoveries of many of our developed trading partners.

Figure 5
Economic recoveries in New Zealand since 1960
(quarterly GDP, level at start of recovery = 100)



Source: Hall and McDermott, RBNZ estimates.

Our status as a deficit country with a particularly large net foreign liability position means that, more than for most other countries, our recovery depends on a sustained pickup in net exports. Such a pick-up, and reduction in the net external liability position, would of course best be facilitated by recovery in global demand and a weak New Zealand dollar, especially against the surplus countries that appear most likely to grow strongly out of this crisis. A weak exchange rate would not only improve export revenues, but also push

up import prices, which would encourage households to switch away from purchasing imports.

A weaker currency is, of course, needed by most deficit-running Western countries to assist in reducing their imbalances. To date, the New Zealand dollar has not shown particularly convincing signs of weakness, like most other floating currencies apart from the US dollar.

What are the lessons for sustained New Zealand recovery from this world recession?

The crisis has demonstrated again New Zealand's heavy exposure to shocks to the world economy. The most immediate markers of exposure this time have been the sharp fall in commodity export prices, the contraction of demand for manufactured and services exports, and the choppiness of financial conditions.

Let me return to the challenges posed to our economy in the coming recovery phase, to make it as strong and durable as possible. Again, many of these are very similar to those faced by other developed Western countries.

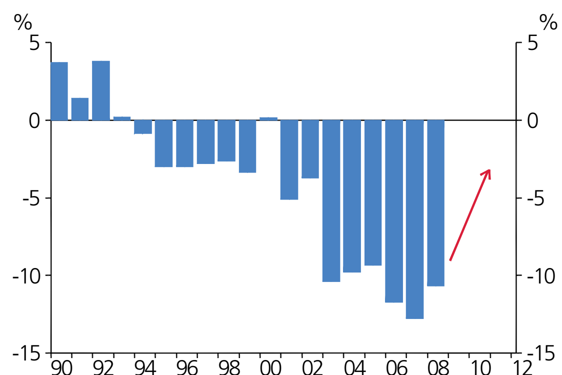
Promoting recovery

Over the near term, the immediate priority remains to lift the economy out of recession and back towards normal levels of output. As noted, current monetary policy settings are very stimulatory, in view of the downward forces still weighing on activity. Effective interest rates are falling in response. With the improvement in bank funding conditions, we expect any further monetary policy adjustments to be transmitted quickly in lending rates to the economy.

Beyond recovery, household behaviour needs to refocus on saving

Once recovery is under way, broader structural adjustments will be necessary to promote sustainability and reduce vulnerability in the future. The household sector most needs to modify its behaviour in this respect. Reliance on past experience of strong house price inflation and easy credit will be untenable. Leading up to the crisis, the household saving rate plummeted (see figure 6), and falling house prices have left households with a very large debt overhang. This will need to be worked off through lifting the saving rate for some time into the future. Moreover, lower trend growth over the next few years means that the adjustment is going to have to happen mainly via moderating spending, rather than income growth.

Figure 6
Household saving rate
(percent of household disposable income)



Source: Statistics New Zealand.

A clear risk beyond near-term recovery is that households resume their 'borrow and spend' habits before bringing their debt levels back to more prudent levels. A premature resumption of strong growth in household spending could be triggered, for example, by renewed moderate house price inflation. This needs to be avoided. Although some lift in spending is to be expected during the early part of recovery (as precautionary savings built up during the recession are unwound), a structural improvement in the household debt position will require a sustained change in household behaviour towards increased saving.

Increased household saving not only reduces the household sector's vulnerability to shocks, it also provides funds for business investment and expansion and reduces the economy's reliance on foreign funding. Both of these effects would, all else equal, mean a lower cost of capital to business. Investment in the economy's productive base, particularly in the tradables sector and oriented towards the medium-term sources of world growth, is especially important given the debt constraints on household and government sector

spending. Increased investment in income-earning activities will raise New Zealand's trend growth – which will not only relieve the burden of debt, but of course increase our living standards.

The role of government saving

In contrast to the household sector, New Zealand's public finances are starting from a much stronger position, meaning that fiscal policy has been able to provide increased assistance to the economy during the recession. However, as with households, the growth outlook for the New Zealand economy is such that significant fiscal consolidation will be needed once the economy regains its footing. As is the case in most developed economies, the need for fiscal consolidation in New Zealand is increased by the ageing population, which is expected to put considerable strain on the fiscal position over the coming decades due to the associated rise in health and superannuation costs. Private savings plans will need to take account of these pressures in the future.

Increased national saving – the sum of public and private saving – is critical to achieving a sustained improvement in New Zealand's current account deficit and net external liability position. Until this is achieved, New Zealand will remain very vulnerable to changes in the willingness of foreign investors to invest in New Zealand.

The high levels of the current account deficit and net external liabilities were major factors cited by Standard and Poor's when they placed New Zealand's foreign currency credit rating on negative outlook in January. This negative outlook was revised to stable in May following the fiscal consolidation plans set out in the Government's Budget, illustrating that the combination of public and private savings is what matters.

Strong banks are necessary, but not sufficient, for stability

The strength of the banking sector is a key plank in the economy's resilience to future shocks. A large part of New Zealand's gross external liabilities are the result of New Zealand banks borrowing in offshore markets – which they have had to do as a result of the persistent shortfall of domestic savings. The exposure due to these banking system obligations showed in stark relief late last year, when the banks could no longer borrow in offshore markets for terms longer than a few days. A priority over the coming year or so will therefore be for New Zealand banks to diversify their funding sources more, by increasing the proportion of long-term international funding and building their domestically-sourced funding base. The Reserve Bank's recently released prudential liquidity policy for banks will provide guidance here.

Also, just as households will need to resist a return to 'borrow and spend' as the recovery proceeds, so will banks need a renewed focus on the need to avoid another damaging credit cycle. This is not just a matter of prudent lending by individual banks to individual borrowers, though that is of course always important. New Zealand banks generally have done reasonably well on that score, with the accumulated risk in their loan books well short of the levels afflicting Northern Hemisphere banks. However, the credit surge here leading up to the crisis still caused major macroeconomic stability problems, both at the time in the form of overheated house prices, and in the aftermath with the elevated level of household debt relative to income and now-lower asset prices. A future challenge will be how to feed back systemic stability concerns into individual institutions' lending behaviour, rational and prudent as it may appear at the micro level.

The role of financial markets

Financial markets have an important role to play in promoting rebalancing and sustainable recovery. In an ideal world, exchange rates and the price of risk capital move to correct the vulnerabilities caused by unbalanced spending. Very broadly speaking, this is what has happened in New Zealand since the crisis, with the trade-weighted exchange rate currently down around 20 percent on year-ago levels and thus substantially buffering the New Zealand economy against the internationally-sourced shock. However, day to day and month to month, movements in the exchange rate and other financial prices can be very noisy and unhelpful,

as has been the case in recent weeks.

As noted above, what is needed is for the New Zealand dollar to be persistently weak over the coming years, to encourage the needed business investment to be export-oriented and supportive of improvement in New Zealand's external liability position.

Over coming quarters, it may be the case that the exchange rate will be 'corrected' to weak levels if the financial markets reappraise its appropriate level in light of our imbalances relative to our trading partners, and the outlook for those imbalances given the fundamentals. This is much as the US dollar is being reappraised currently.

However, history shows that the financial markets cannot necessarily be relied upon to focus on New Zealand's case relative to other economies in a timely and finely-tuned way, and price the New Zealand dollar accordingly. All that can be hoped is that, in the next phase of recovery in financial market sentiment and return of risk-seeking, the markets will be more discriminating about New Zealand. In the meantime, the onus on us is even greater to shift domestic savings behaviour in the right direction.

The Reserve Bank will contribute by keeping the macroeconomy and the financial system stable

Sustainable recovery, with rebalancing in demand and the economy's productive base, is mostly a microeconomic matter. This means households, firms, banks and investors making the right decisions about where to allocate land, labour, capital and funding.

The Reserve Bank's role in this is essentially facilitative.

The global events have seriously challenged beliefs that the stabilising mechanisms in the economy and financial system will work in a crisis, and that risk tends to dissipate, rather than concentrate in markets. But certain principles of monetary management remain proven. Our focus will continue to be on keeping the macroeconomy stable, keeping inflation expectations anchored, keeping system liquidity ample and the financial system stable, so that funds keep flowing and relative price signals work.

Though monetary policy has been an effective way of achieving price stability, it cannot achieve financial stability and economic recovery on its own.

Prudential policy offers a more direct approach to constraining excessive or misdirected borrowing and lending behaviour. The crisis has added a great deal of impetus to the international policy work programme focused on reducing the tendency for financial activity to exacerbate macroeconomic booms and busts. This work programme involves, among other things, attention to minimum capital and other prudential requirements as potential tools to dampen business cycles, the impact of smaller and peripheral financial institutions on financial system behaviour, how cross-border financial activity should be monitored or regulated, and bridging the gap between the micro and the macro consequences of strong lending growth.

The Reserve Bank will be closely following the debate in these areas for insights into improving our own framework. At this point, we are reasonably well positioned to adapt in light of the new thinking, with a conservative approach to bank capital adequacy, the new legislation bringing the regulation of non-bank deposit takers into our responsibilities, and long experience in managing macroeconomic stability, financial stability and prudential policy functions under one roof.

The crisis has left many challenges and many lessons. The New Zealand economy has taken knocks, but some form of recovery is now on the horizon. It is not going to be easy, but it does offer a chance to get New Zealand onto a more economically sustainable track.