

# **Heavy mountain weather: Funding risks for New Zealand and proposed solutions**

**February 2009**

## INTRODUCTION

- Experienced trampers in the Alpine regions of New Zealand come prepared for unpredictable conditions. Snow storms can hit the mountains even in the middle of Summer. The level of a trumper's preparedness often determines their survival.
- The financial crisis has unleashed a lengthy period of heavy mountain weather. Whilst the strong nor'westers at the height of the financial turbulence in October last year have subsided, it would be unwise to assume that the worst is over. This paper argues that the risk of further financial market disturbances remain. It is imperative for the country to be ready with contingency plans to protect the vital parts of our economy.
- As the Government heads into the Jobs Summit, the public debate has moved sharply to the real economy. The Summit will grapple with the challenge of sustaining employment in the face of the sharpest decline in world trade since the Great Depression.
- This paper contributes to that debate by highlighting the importance of funding issues; both for New Zealand as a country, and for New Zealand businesses. The New Zealand Institute suggests that financing constraints pose the greatest risks to employment. A company that is starved of finance will pare back new investment, downsize and restructure, negatively impacting both existing employment and the creation of new jobs.

## FRAMING THE ISSUES: FUNDING PRESSURES ON BUSINESS

- The companion Institute article released today 'The Emperor has no clothes: New Zealand's vulnerability in the face of the global economic and financial crisis' framed the issues that should determine the nature of New Zealand's response to the crisis. New Zealand is being impacted through the growth channel (especially commodity prices, tourism and other export markets). But it is the credit channel where the greatest risks remain. New Zealand is caught up in a global shift where the financial crisis has raised financing costs world wide and investors continue to be risk averse.
- Businesses are already hunkering down, feeling the storm squalls of stubbornly high financing costs. Alternative avenues for raising finance are disappearing. It is not uncommon to hear of attractive investment propositions failing to raise finance as foreign investors retrench and pullout, or domestic lenders tighten lending criteria.
- As the recession deepens, negative cash flow will make firms more reliant on bank financing. Further, funding costs may lead banks to raise the hurdle on new lending.
- While borrowing costs for companies are moving down, the costs are not coming down as much as wholesale rates. Bank funding costs are forcing them to charge a higher margin over wholesale rates. So, while companies are starting to get some relief, the overall cost structure is likely to remain higher over time that it would have before the crisis.
- Alternative funding sources such as equity, or issuing corporate debt are proving harder for companies. Those that are successful e.g. Fonterra's recent debt issuance, are raising funds at higher margins.
- All these pressures are likely to have an enduring impact on the cost structure of companies, impacting on investment, activity and employment decisions.

## FRAMING THE ISSUES: RISK OF DISRUPTION TO BANK FUNDING

- There is a risk that long term lending markets for New Zealand banks do not provide anything like the degree of funding they did in the past. We don't know exactly what probability to attach to this scenario. However, it is prudent to manage this risk, as the impact would be severe if it eventuated.
- It is estimated that around \$63B in bank funding is due to mature at some time in 2009, with a large proportion coming due over the next three months. Around half of that funding is sourced from Australia and this may mitigate the risk. However, Australia's access to funding is not completely assured at this time either.
- The Australian parent banks of the major trading banks in New Zealand are relatively well placed internationally. They are four of only 13 banks globally that still retain the highly rated AA credit rating. However, they have not yet attempted to rollover long term lending in foreign markets since the disruption to those markets in late 2008.
- Short term funding raised by the banks since October has come at a high cost. Successful raising of long term debt is likely to come at a high cost as well. This may cause banks to question the profitability of new lending.
- Even if market disruption only affected bank lending 'at the margin' this could have a significant impact on growth, as it is the marginal lending that may matter most for business investment. Bank lending to business grew at an average rate of around 12% per year in the last five years. A slackening or cessation of that growth will impact on investment and employment.

## SHORT-TERM INTERVENTIONS WHAT HAS BEEN DONE SO FAR

- The next two slides summarise the interventions already taken by the Government to stabilise the New Zealand financial system and protect jobs, and place New Zealand in an international context. These interventions may be sorted into “credit” interventions: measures taken to directly safeguard the solvency and funding of financial institutions; and “cash flow” interventions: a range of measures that will stimulate demand and thus protect the cash flows of companies.
- The Reserve Bank has reduced the Official Cash Rate by 475 basis points since July 2008 (from a cyclical high of 8.25% down to its current level of 3.5%). This is an important part of the response to ease funding pressures. Wholesale interest rates have come down over the last eight months but the margins banks are charging have increased.
- In an international context, New Zealand’s interventions total approximately 4.1% of GDP and are small in comparison to interventions in other countries (average of 11 countries considered is ~12%).

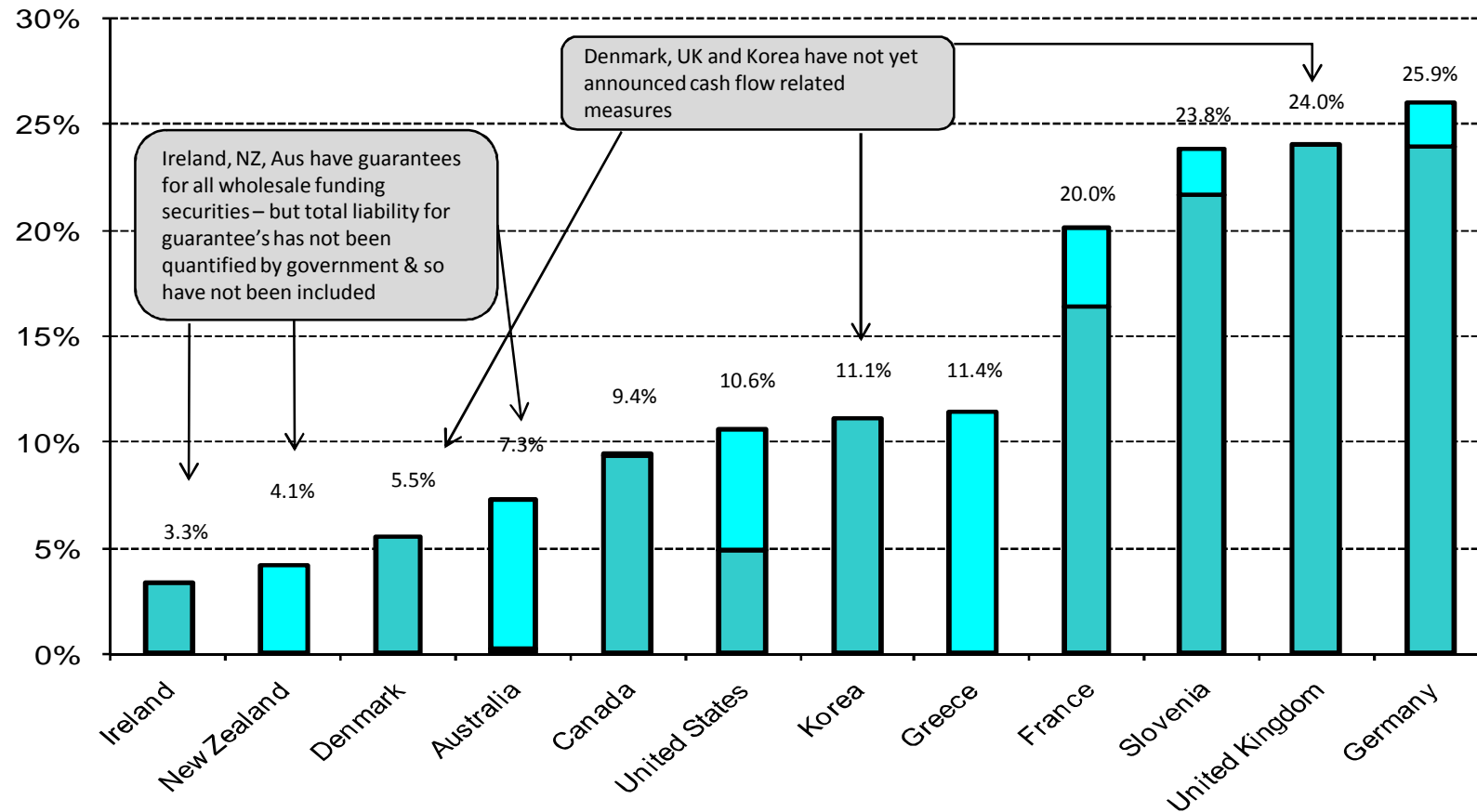
# SUMMARY OF NEW ZEALAND'S INTERVENTIONS TO DATE

Intervention Type	Intervention Description	Status	\$NZDb (% GDP)	International Example	
<b>Credit – Guarantee</b>	<ul style="list-style-type: none"> <li>Wholesale funding guarantee facility offered by Crown (opt-in basis). New debt issues are eligible. Crown requires level of Tier 1 capital in the institution (at 6%) (Nov 08)</li> </ul>	<ul style="list-style-type: none"> <li>No issues under the guarantee scheme Treasury: “banks had been able to raise short-term funding abroad”</li> <li>Fee reduced Jan 09</li> </ul>	<ul style="list-style-type: none"> <li>\$0 b (0%)</li> </ul>	<ul style="list-style-type: none"> <li>Australia has a similar guarantee - cost neutral as risk of payment is “remote”</li> </ul>	
<b>Credit – liquidity measures</b>	<ul style="list-style-type: none"> <li>An extended group of securities eligible for acceptance in Reserve Bank liquidity, discount margin and extension to Overnight Reverse Repo Facility (May 08)</li> <li>US reciprocal swap lines (Oct 08)</li> </ul>	<ul style="list-style-type: none"> <li>First changes in Jun 08</li> <li>Recent update in securities eligible for RB liquidity (Dec 08)</li> <li>US Swap lines extended to Oct 09 (Feb 09)</li> </ul>	<ul style="list-style-type: none"> <li>\$0</li> <li>(0%)</li> </ul>	<ul style="list-style-type: none"> <li>US Federal Reserve allows banks to borrow from each other in short-term markets if commercial credit not available – swap lines.</li> </ul>	<ul style="list-style-type: none"> <li><b>NZ's interventions: (approx) 4.1% of GDP -</b></li> <li><b>Average of 11 countries: ~12% of GDP</b></li> <li><b>Total cost of measures/value of interventions may be higher if NZ needs to fulfill guarantees</b></li> </ul>
<b>Cash flow – general</b>	<ul style="list-style-type: none"> <li>Nov 08 – part of stimulus package</li> </ul>	<ul style="list-style-type: none"> <li>Announcement expected soon</li> </ul>	<ul style="list-style-type: none"> <li>\$7 b (4%)</li> </ul>	<ul style="list-style-type: none"> <li>Australia, Germany, US have launched stimulus packages</li> </ul>	
<b>Cash flow – Business Tax</b>	<ul style="list-style-type: none"> <li>Feb 09 Small business tax changes includes: reduction in provisional tax rate/penalty interest rate on underpaid provisional tax, reduction in compliance costs for PAYE, FBT and GST returns, changes in deductibility of legal expenses</li> </ul>	<ul style="list-style-type: none"> <li>Provisional tax changes scheduled to be in legislation Feb 09 and in place April 09</li> <li>Implemented over 4 years</li> </ul>	<ul style="list-style-type: none"> <li>\$0.48 b (0.26%)</li> </ul>	<ul style="list-style-type: none"> <li>Australia and Canada have announced tax cuts:                             <ul style="list-style-type: none"> <li>- Australia's 2<sup>nd</sup> stimulus has \$2.7 b (0.21%) for small business</li> <li>- Canada to lower corporate taxes to 15% by 2015</li> </ul> </li> </ul>	
<b>Cash flow – Personal Tax</b>	<ul style="list-style-type: none"> <li>Election pledge - reduce personal tax over 3 years</li> <li>Cuts expected to reduce personal taxes by \$1.1k to \$2.9k pa</li> </ul>	<ul style="list-style-type: none"> <li>Legislation introduced Dec 08 cuts take effect Apr 09</li> </ul>	<ul style="list-style-type: none"> <li>\$10.6 b over 4 yrs (5.6%)</li> </ul>	<ul style="list-style-type: none"> <li>Almost half of US \$819b stimulus is for personal tax reduction</li> </ul>	

# TO DATE MOST OF THE RESPONSES HAVE BEEN AROUND THE PROVISION OF CREDIT

**Different interventions by country , % of GDP**

■ Cash flow based measures  
■ Credit based measures



## SHORT-TERM INTERVENTIONS: NEXT STEPS

- The New Zealand context is different and demands a different response to that of other countries:
  - New Zealand's banking system is sound and has not required the bank bailouts that have been a major factor in credit measures overseas.
  - New Zealand is a small open economy where fiscal stimulus is more likely to simply leak out into higher imports without protecting jobs in New Zealand.
- The latest fiscal forecasts show New Zealand's gross government debt increasing to 33.1% of GDP by 2012/13 and it is projected to then increase to around 57% by 2022/23 in the absence of any policy changes.
- While other countries will also experience sharp increases in government debt, New Zealand faces more constraints on its ability to run high government debt levels due to our overall indebtedness as a nation. Net foreign debt is now 85% of GDP.

## SHORT-TERM INTERVENTIONS : MANAGE THE RISKS TO STRATEGIC BUSINESSES

- The Institute encourages the Government to place maximum effort on managing the risks to strategic businesses from a sudden contraction in bank lending, and other finance sources. This suggests a focus on:
  - Preparing options for the Government to provide direct financing to New Zealand companies in the event that other financing channels are suddenly closed to them.
  - The following criteria should guide how the government intervenes:
    - The focus should be on supporting companies whose loss would result in the greatest collapse in employment, ancillary industries and a snowballing loss of activity.
    - Support should only be given as a last resort where the company has tested all reasonable alternative capital market funding sources.
    - The trigger for the funding problems are events that could not reasonably have been foreseen and managed within the business's own planning processes (i.e the 'one in one hundred years' element of the present financial crisis).
    - The present owners of the companies should bear some cost in return for the Government support and the investment should deliver value to tax-payers over time. Government capital injections in return for minority government shareholdings (that dilute the interests of present shareholders) would achieve this.

## SHORT TERM INTERVENTIONS: USE THE GOVERNMENT BALANCE SHEET TO INVEST IN STRATEGIC NEW ZEALAND COMPANIES

- **How should the Government finance its intervention?**
- The New Zealand Institute recommends the Government look first to its own balance sheet to finance investment in strategic New Zealand companies. The alternative (an increase in Government debt) may risk New Zealand's Sovereign debt rating.
- The government's balance sheet contains over \$190 billion of assets (120% of GDP). The largest financial components are the NZ Superannuation Fund (\$12.8B) and the ACC portfolio (\$10.4B). Total SOE financial assets comprise \$14B.
- Although budgetary allocations and fiscal policy settings get most of the attention, there is considerable potential for the government's balance sheet to be used in a more aggressive manner.

The options for using the Government's balance sheet range from:

- **Leveraging individual SOE balance sheets** through cash withdrawals that could then be used for strategic investments. If no new sources of SOE financing are drawn on, this would entail trade-offs with lower funding for existing SOE investment plans. Alternatively, SOEs could raise new debt financing or the Government could use partial listings to attract new equity finance.

## SHORT TERM INTERVENTIONS: USE THE GOVERNMENT BALANCE SHEET TO INVEST IN STRATEGIC NEW ZEALAND COMPANIES CON'T

- **Encouraging the NZSF to invest more actively** in New Zealand companies: this would require some changes in Governance at the Fund. It would be critical for the Fund to lead this process rather than being directed by Government. Any investment decisions would need to be consistent with the Fund's mandate.
- **the creation of a Sovereign wealth fund** (the New Zealand Growth Fund) to leverage the Government balance sheet and invest strategically in New Zealand companies. This would create the conduit for Government to support companies.
  - The Fund would be modeled on those used by nations such as Singapore to successfully invest in growth companies. However, the model can be further with transparent governance.
  - The New Zealand Growth Fund would own the majority of the SOEs (probably about \$14 billion) and would be a fully commercial operation, actively managing the SOEs in its portfolio for growth. It would have the ability to sell down stakes in the SOEs to create a fighting fund able to be invested in New Zealand growth companies (and asset classes).

## **SHORT-TERM INTERVENTIONS : ENCOURAGE BUSINESS INVESTMENT AT THE MARGIN**

- The second priority should be on encouraging productivity enhancing business investment at the margin. One option is for the Government to underwrite a portion of bank lending to push more projects over the line in an environment of tightening credit policies. This would have to be tightly targeted (given fiscal constraints) at projects that support New Zealand's long term competitive position.
- Large companies and banks also have a role to play in stabilising the economy. The Institute is aware of some large corporates who are helping business partners manage through the recession, recognising that long term shareholder value is linked to the viability of related businesses. The Institute encourages particularly the major trading banks to look at what they can do to support New Zealand through the crisis.

## SHORT TERM INTERVENTIONS: ATTRACTING NEW FUNDING TO NEW ZEALAND

- The solutions discussed so far are targeted at filling the existing funding gap for New Zealand businesses. Now it is time to turn to options that involve attracting new funding to New Zealand.
- Many of the traditional sources of foreign direct investment are withdrawing from investment in small countries such as New Zealand. Multinationals are divesting rather than expanding acquisitions.
- Despite the general contraction in global business investment, there are pools of wealth seeking greenfield investment in safe, politically stable economies like New Zealand – this is the time to lay the ground work and build relationships that will help New Zealand bring these projects on stream.
- Risk averse international investors will invest in New Zealand if they are convinced by the underlying level of return on the investment. Asian Sovereign wealth funds have been burnt by investments in Western financial institutions that have turned sour. Yet this may be an opportunity if New Zealand can offer investments with compelling and above average rates of return.
- There remains potential for public/private partnerships to attract foreign investment into infrastructure projects. This should be a particular priority for the Government to harness global expertise and cost efficient methods, and accelerate New Zealand infrastructure programme.

## LONGER-TERM INTERVENTIONS

Any response to the crisis should be structured so that it contributes to a long term game plan for the country. This requires a view on the long term imperatives for New Zealand.

The companion New Zealand Institute article ‘The Emperor has no clothes: New Zealand’s vulnerability in the face of the global economic and financial crisis’ explains how policy imbalances have contributed to New Zealand’s indebtedness as a nation and increased our exposure to an adverse shift in foreign investor sentiment.

There is a need to correct structural imbalances that have built up in New Zealand.

These imbalances have skewed behavior towards consumption and away from savings, and made us one of the most indebted nations in the world. They have also made investment in residential property more attractive than investment in productive activities that would enable New Zealand to pay its way in the world in the future.

The long term interventions should therefore create a policy environment where:

- Savings is encouraged, capital markets deepen and New Zealand becomes less indebted as a nation.
- Investment decisions favour productive investment (and especially capital deepening to address New Zealand long standing lack of capital investment that is holding back our productivity performance) rather than property investment.

## LONGER TERM INTERVENTIONS: TAX AND SAVINGS POLICY

- The Government should commit to a long term strategy to create a tax and savings policy environment that will build a larger pool of domestic savings, deepen capital markets and reduce New Zealand's indebtedness as a nation.
- The KiwiSaver scheme should continue to be a central component of the New Zealand savings architecture, however, it could be reviewed with the aim of increasing savings incentives. A move to a compulsory KiwiSaver scheme is one option that should be considered.
- The long term tax strategy should clearly lay out a plan for a radically different tax mix in ten years time and the steps New Zealand will take to get there. The plan should aim to make New Zealand an attractive destination for firms and entrepreneurs, and have the following objectives:
  - Lowering the rate of taxation on capital (savings, and profits). There is a large body of research showing that capital is increasingly mobile, and thus the costs to New Zealand of high capital tax rates is correspondingly higher (as capital will simply move offshore if overtaxed).
  - Increasing the relative rate of taxation on immobile factors such as land and property.
  - Lowering the rate of tax on hours worked and entrepreneurial income .
  - Opening the debate about whether New Zealand needs an imputation system, given that the system appears to discourage companies from locating their head-offices in New Zealand and is now out of step with the rest of the world.

## CONCLUSION

- New Zealand is being impacted through the growth channel (especially commodity prices, tourism and other export markets). But it is the credit channel where the greatest risks remain.
- New Zealand is different to the rest of the world. We have some advantages (a stronger banking system) but different vulnerabilities (dependence on offshore funding). New Zealand faces tighter fiscal constraints that limit options that involve increased government spending.
- New Zealand's response must include an ability to support strategic New Zealand businesses, should they face funding difficulties that threaten their viability or makes them vulnerable to foreign take-overs.
- The response should leverage the Government balance sheet and create a conduit for Government strategic investment in companies, should this be required. The response should also include: leveraging private sector investment through a government underwriting function; and measures to attract overseas funds to invest in high return projects.
- A range of options should be considered; including the creation of a New Zealand growth fund that would leverage SOE assets, invest in other companies and run on a clear commercial basis with transparent governance.
- The rest of the response should contribute to a long term game plan for the country: to position New Zealand ahead of other countries in seizing opportunities as the world emerges from the global recession.
- The long term game plan should also correct the policy mistakes that have left a legacy of very high indebtedness to the rest of the world and increased New Zealand's vulnerability in the present crisis.