

Perspective

The emperor has no clothes:  
New Zealand's vulnerability in the face  
of the global economic and financial crisis

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## **The emperor has no clothes: New Zealand's vulnerability in the face of the global economic and financial crisis**

### **Executive Summary**

In the first article of this series 'The End of the Golden Weather' the New Zealand Institute explained the impact of the financial crisis and global recession on New Zealand. That article concluded that the world economy was undergoing a structural shift that will take some time to work through and may alter the pattern of global growth for the next decade.

Over the last decade, and more, New Zealand's prosperity has been driven by two channels: a credit channel driving consumer spending on the back of rising property values; and a growth channel based on New Zealand's traditional commodity export wealth plus other export sectors (especially tourism). This essay examines how the changes in the global economy will affect New Zealand via these two channels.

Credit fuelled growth in the past has made New Zealand more exposed to the changes in the pricing/availability of credit triggered by the financial crisis. New Zealand has been living beyond its means, and building up a large stockpile of debt to the rest of the world. Like the emperor in the Hans Christian Andersen fairy tale New Zealand was lulled into a false sense of security. The financial crisis has revealed New Zealand's exposure to the adverse shift in investor sentiment.

It may be too late to protect New Zealand from the consequences of foreign indebtedness. The financial crisis has sheeted these vulnerabilities home. There are immediate short-term credit problems calling for urgent action and a need to make New Zealand less dependent on the vagaries of international capital markets longer term.

In the short term, New Zealand faces risks of a substantial decline in business activity and investment because New Zealand companies are so reliant on bank financing and that bank financing is being severely constrained. The sharp increase in margins on overseas lending is reducing the profitability of bank lending. Further, the ongoing financial market turbulence – and the potential impact this could have on bank lending – is creating considerable uncertainty around investment decisions.

In the short term, the priority is to manage the risk of an abrupt and costly withdrawal of credit from New Zealand. Should this eventuate (primarily through foreign lenders continuing to refuse to support long term lending by the banks and major companies), the large scale contraction in credit will put strategic companies at risk. This is an outside risk that may not eventuate. The Australian parent banks of the major trading banks in New Zealand are relatively well placed internationally. They are four of only approximately 13 banks globally that still retain the highly rated AA credit rating<sup>1</sup>. The probability is not high but the consequences would be large should this eventuate. It is critical the government is ready with options to mitigate the costs.

Longer term, the credit crisis underscores the need to correct structural imbalances that have built up in New Zealand. These imbalances have skewed behaviour 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 key conclusion from this article is that New Zealand is particularly vulnerable to impacts through the credit channel on business activity and investment. In turn, this may have significant impacts on growth and employment unless policy action is taken. This helps to define the critical problems demanding a policy response – the problems facing New Zealand are less about compensating for sluggish demand and more about keeping the financing lines that fuel investment open (in the short term) and addressing the structural issues that have made New Zealand so vulnerable to foreign market disruptions longer term.

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<sup>1</sup> Reserve Bank of Australia, 'Statement on Monetary Policy', February 2009, p50.

The companion paper 'Heavy mountain weather: Funding risks for New Zealand and proposed solutions' also released today outlines the Institute's proposals for how New Zealand should respond to these challenges.

## 1. Growth channel

The first perspective in this series concluded that the next decade would be different to the last, as world growth was likely to remain subdued for some time. This section considers how the reversal in global economic conditions is likely to be transmitted to New Zealand through the growth channel. It does this by considering the sectors of the economy most exposed to international events; and how the distribution of global growth over the next decade may influence those sectors.

New research was published in January that has substantiated the New Zealand Institute thesis concerning the prospect of a prolonged period of sub-trend global growth. The eminent American economist Kenneth Rogoff and co-author Carmen Reinhart released research showing that recessions originating in financial crises such as the current global recession are generally protracted affairs associated with profound declines in output and employment. On average, real house prices decline 35 percent stretched out over six years, while the downturn in equity markets lasts for at least three and a half years. Unemployment rises, on average, by seven percentage points. The decline in economic activity is steep – an average decline of over nine percent – although output recovers more quickly than employment with recovery starting after two years.<sup>2</sup>

Applied to the New Zealand context, for example, this points to a worrying possibility that unemployment could rise from a historical low of 4.2% to a rate of 11.2% over the next two years – a rate exceeding the most pessimistic forecasts at the present time. This simple extrapolation may be misleading, however. The Rogoff/Reinhart study included all major post-war banking crises, and two major pre-war crises. Labour markets in advanced economies such as New Zealand have become more flexible over time, meaning that the unemployment impact may be less extreme today than predicted on the basis of historical averages. On the other hand, the present crisis is arguably more severe than any earlier banking crisis given its global scope, whereas earlier crises were more confined to one or more countries.

### *Agricultural exports*

New Zealand's economy continues to be reliant on the fortunes of a few key export industries, particularly agricultural exports. While the direct output of the agricultural sector constitutes only around 7% of the economy, its indirect impact is felt through the primary product processing industries and services dependent on agriculture for their existence. Dairy remains the largest single merchandise export earner with \$10.3 billion in export earnings in 2008<sup>3</sup>.

Commodity prices have been weakening for the last six months. The latest ANZ commodity price index recorded a further weakening in the prices of most major NZ commodity exports in January, except beef and lamb. The pronounced slowdown in global markets has already eliminated all of the gains in dairy prices that had occurred since mid 2007. While the New Zealand dollar has also dropped, its decline has been dwarfed by the magnitude of commodity price declines.<sup>4</sup>

The outlook is for the decline in commodity prices to continue, and to remain depressed for some time. In earlier global recessions, downturns in some regions have been accompanied by positive growth in other major markets, mitigating the impact on New Zealand. The present situation, by contrast, is one of a marked slowdown in trade that is hitting every trading region. World trade grew at a rate of 9.4% in 2006, and 7.2% in 2007. In November last year, the IMF downgraded projections of world trade growth to 2.1% in 2009. This projection has been overtaken by the sudden and precipitous collapse in global growth and trade that occurred

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<sup>2</sup> Carmen M Reinhart and Kenneth S Rogoff, 'The Aftermath of Financial Crises', Paper prepared for presentation to the American Economic Association meeting January 3, 2009.

<sup>3</sup> Total dairy exports including casein, provisional statistics year to November 2008.

<sup>4</sup> ANZ Commodity Price Index, 4 February 2009.

from October last year. On 28<sup>th</sup> January the IMF dramatically downgraded its forecast of world trade growth and now projects world trade to contract by -2.8% in 2009. This would be the first time world trade has contracted since the 1930s. The IMF notes that downside risks continue to dominate and that:

“The main risk is that...the pernicious feedback loop between real activity and financial markets will intensify, leading to even more toxic effects on global growth.”<sup>5</sup>

Asia and oil producing countries are important destinations for New Zealand’s dairy exports. The dramatic collapse in Asian markets at the end of last year has dashed hopes that growth in these markets might create a floor for dairy prices. A series of other advanced economies including Japan, and the four largest European economies posted record slumps in exports in November. Export-driven economies in Asia are experiencing severe foreign-trade declines and this is likely to precipitate a deep and prolonged recession in that region. Research from experienced observers of Asia released in January indicates Mainland China, Taiwan and South East Asia may experience a collapse in growth in 2009 greater than the Asian crisis of 97/98, and potentially the deepest recession in the post-war period<sup>6</sup>.

It is difficult, to see how New Zealand can escape from suffering the adverse impact of collapsing commodity prices internationally through 2009 and beyond, and from the prolonged weakness in global consumption. The impact of the global recession will thus be transmitted to New Zealand through income and expenditure effects as the quantity and price of New Zealand exports remain subdued for an extended period.

<b>Destination of exports by main trading partner: annual total merchandise exports 2007</b>		
	Value (\$m)	Percent of total
Australia	7,777	21.9%
United States of America	4,261	12.0%
Asia ex Japan*	7,798	22.0%
Japan	3,373	9.5%
United Kingdom	1,699	4.8%
Germany	749	2.1%
Saudi Arabia	502	1.4%
India	369	1.0%
Other	8,972	25.3%
<b>Total</b>	<b>35,499</b>	<b>100.0%</b>

Source: Statistics NZ, \*Includes: China, South Korea, Indonesia, Malaysia, Singapore, Thailand, Taiwan, Hong Kong, Philippines

### *Tourism*

Overseas tourism exceeds the dairy industry in its size as an export earner. In 2007<sup>7</sup> it contributed \$8.8 billion to export earnings (compared to dairy’s \$7.8 billion contribution). Domestic tourism is larger still generating \$11.3 billion in expenditure in 2007. Combined, overseas and domestic tourism represents around 5.0 percent of GDP.

Tourism numbers have already been affected by the global downturn. The latest statistics for November 2008 show that short term visitor arrivals to New Zealand were down four percent from November 2007. Total guest nights in tourist accommodation declined by four percent

<sup>5</sup> International Monetary Fund World Economic Outlook Update, January 28 2009.

<sup>6</sup> Wigram Capital Advisors, January 2009.

<sup>7</sup> 2007 is date of the latest Statistics NZ tourism census.

between November 2007 and November 2008, while the contribution of international visitors to guest nights declined by eight percent over this period. The domestic tourism industry is being hit by a softening of demand from New Zealand residents and overseas tourists. Domestic tourism overnight trips declined by 7% in the year to September 2008. Feedback from tourism industry contacts suggest these statistics may understate the latest extent of the downturn, particularly in overseas tourism numbers and spending patterns.

The dramatic collapse in retail spending, and employment that has occurred in the United States, and the United Kingdom since October and the sharply weaker outlook for growth in Asia points to a long term impact on the tourism sector in New Zealand as overseas consumers reduce their spend on 'luxury' products such as overseas travel. New Zealand might remain a compelling value proposition for some niche markets, but the overall trend is likely to be a contraction in tourism for a protracted period of time. This trend might be compounded by rising environmental concerns about international air travel and policy responses such as the recent decision by the UK government to introduce a 'carbon tax' on air travel to distant markets including New Zealand.

Overall, two of the key parts of our export profile are likely to encounter heavy weather over the next several years – some growth may occur, but not close to the rates observed over the past several years.

## 2. Credit channel

The credit channel is the mechanism through which capital flows into New Zealand either in the form of foreign investors purchasing direct equity stakes in New Zealand companies or in the form of loans to financial institutions, companies and the New Zealand government. New Zealand is particularly vulnerable to the transmission of international events via the credit channel because it is unusually reliant on overseas borrowing to finance consumption and investment. The discussion of the credit channel therefore begins with an exploration of New Zealand's high foreign indebtedness. The current level of indebtedness is unsustainable, and banks, households and businesses will be required to adjust their balance sheets over the next several years. This process is likely to be costly in terms of economic growth and employment.

### *New Zealand's high external debt is not sustainable*

New Zealand current account deficit currently stands at 8.6% of GDP. This is high by comparison with other advanced economies. New Zealand is one of six out of 31 advanced economies exhibiting persistent current account deficits of 8% of GDP or higher<sup>8</sup>. The other members of this 'club of six' are Spain, Greece, Portugal, Cyprus and Iceland. Earlier this year Standard and Poors downgraded the sovereign credit ratings of Spain, Greece and Portugal, whilst Iceland suffered a collapse in its currency and equity markets in 2008 and sought assistance from the IMF. Standard and Poors put New Zealand's AA+ Sovereign Credit rating on a negative outlook in January, drawing attention to its concern with New Zealand's high current account deficit as a manifestation of this country's widening external imbalances.

Persistent current account deficits over a number of years have led to an ever rising level of external debt. In September 2008 New Zealand's net external debt reached a record level of \$154.1 billion equal to 85.8 percent of GDP. New Zealand's distinction as one of the most indebted nations in the world is once again shared by a small group of advanced countries with only Iceland showing higher levels of net external debt.<sup>9</sup>

Most of New Zealand's net external debt (77.4 percent) is held by the banking sector, with around half used to finance mortgage lending to the household sector and around half lent to companies. Many New Zealand companies are too small to borrow directly from overseas debt markets, so the banks act as intermediaries for them. A few large New Zealand

<sup>8</sup> World Economic Outlook, October 2008.

<sup>9</sup> Paul Bedford 'The global financial crisis and its transmission to New Zealand – an external balance sheet analysis', Reserve Bank of New Zealand: Bulletin, Vol 71, No 4, December 2008.

companies raise financing directly from overseas markets and the corporate sector holds around 28% of New Zealand's net international debt. The government and the Reserve Bank hold net assets combined of \$8.5 billion.

Historically, the current account deficit has been generated by deficits in the income account, as New Zealand has been the recipient of far more foreign investment than it has invested offshore. The 'income account' records dividend and interest payments owed to overseas investors who have invested directly in New Zealand companies (by purchasing equity stakes) or who have lent money to New Zealand banks, companies and the Government through debt instruments. It then compares these flows with the returns to overseas assets held by New Zealand residents in the form of equity or debt investments overseas. The balance comprises New Zealand's net external income balance.

Until recently, the 'trade account' has generally been in surplus. The 'trade account' shows the balance of goods and services exported from and imported to New Zealand. Since around 2002, however, the trade deficit has grown to reach its highest level since 1984. This growth has coincided with a rapid decline in household saving, suggesting that the growing trade deficit is indicative of a structural change in the New Zealand economy<sup>10</sup> with households increasingly spending beyond their means, financed by debt to overseas investors.

High current account deficits and large stocks of overseas debt are less of a concern when they are used to finance business investment that raises the capacity of an economy to repay its debts in the future, and when they are transitory in nature. There is a corollary with household behaviour that can be made: 'prudent' households might incur debt to finance education that increases their earning power in the future, or might incur debt during temporary periods of distress, later bringing debt down to a more sustainable level. New Zealand's external debt does not comply with either of these conditions. External debt has financed consumption and investment in residential housing rather than investment in productive areas that would raise NZ's growth capacity and its ability to repay foreign debt in the future.

New Zealand's poor savings record and the concentration of investment in areas that do not increase NZ's ability to repay external debt in the future help to explain New Zealand's persistently high current account deficits. New Zealand's external imbalances are clearly unsustainable as uncorrected they will lead to a ballooning level of external debt. RBNZ economist Anella Munro has estimated the 'sustainable' current account deficit as 3.8% of GDP, based on conservative assumptions about a steady state level of external debt at 80% of GDP.<sup>11</sup>

*The risks for New Zealand created by high levels of external debt*

In 2006, Sebastian Edwards questioned whether New Zealand's inevitable adjustment to a more sustainable current account deficit path would be gradual or abrupt and costly:

“That is, the question is whether international investors will slowly reduce the rate at which they add New Zealand securities to their portfolios, or whether this process will come to an abrupt and sudden end.”<sup>12</sup>

This question is no longer an academic one for New Zealand. Over the next few months, it will be answered as we observe the reaction of international investors and their willingness or otherwise to roll over the debt funding of the New Zealand banking system and major companies.

Disruptions in access to foreign capital due to the global financial crisis have already dramatically raised the cost of New Zealand bank funding and are hurting investment and business activity. The sections on Bank and Corporate balance sheet adjustment below

<sup>10</sup> Edwards, Sebastian, 'External Imbalances in New Zealand', Proceedings of a workshop on macroeconomic stabilization 2006, RBNZ, Treasury.

<sup>11</sup> Edwards, Sebastian, 'External Imbalances in New Zealand', Proceedings of a workshop on macroeconomic stabilization 2006, RBNZ, Treasury.

<sup>12</sup> Edwards, (2006)

explain these impacts in more detail. The risk raised by Edwards is one of a ‘sudden stop’ defined as an abrupt reversal in the current account deficit with a sudden outflow of capital as foreign investors no longer wish to roll over their lending to New Zealand banks and companies, and accompanied by a sharp depreciation in the exchange rate.

The risk of a ‘sudden stop’ is accentuated by the fact that so much of the debt is short term. The Reserve Bank estimates that around 40% of New Zealand’s external debt is scheduled to mature within three months, with substantially more than half due for renewal within a year. No more than 25% is ‘long term’ (i.e. with a maturity of more than five years).<sup>13</sup> This means New Zealand has around \$61.6 billion in external debt maturing early in 2009 at a time when overseas debt markets are barely functioning and overseas investor sentiment has turned sharply against peripheral countries, including Australia and New Zealand.

A large portion of New Zealand’s external debt is held by Australian parents of New Zealand banks (around half). In the past, this has been viewed as a factor that would reduce New Zealand’s exposure to the risk of sudden capital withdrawal as it was thought that Australian parent banks would support their New Zealand subsidiaries in such a scenario. In the present circumstances, the implications are unclear. Australian parent banks are also vulnerable to disruption in offshore debt markets. Should Australia suffer a capital withdrawal in tandem with New Zealand, it is almost certain that New Zealand will suffer a hard landing and abrupt current account reversal.<sup>14</sup>

*The adjustment process will be costly*

This section explains how the credit channel may impact on growth through a contraction in credit to the business and household sectors. The adjustment process already appears to be costly as companies and households face stubbornly high costs of finance. The risks are for a more abrupt and dramatic contraction in credit should the ‘sudden stop’ scenario eventuate during 2009. The potential costs of the economic adjustment that would follow a sudden outflow of capital are known to have a long term impact on a country’s growth prospects. Reductions in investment are the main route through which a sudden reversal in capital inflows would affect economic activity.

*Bank balance sheets*

Registered trading bank sector balance sheets are healthy with robust capital ratios and low levels of provisioning for bad debts. The Australian and New Zealand banks have not been exposed to the credit losses arising from subprime mortgage backed securities that have plagued many financial institutions in the United States and Europe. While National Australia Bank (the parent bank for BNZ) suffered some exposure, the amount of losses was a tiny fraction of the institution’s tier 1 capital. The healthy state of bank balance sheets is the result of sustained profitability over a number of years. After tax profits for the banking sector as a whole rose 13.4% in the year to June 2008. The returns on equity for the major trading banks are shown in the table below:

<b>Return on equity: top four trading banks by market share</b>			
	<b>Market share</b>	<b>2007</b>	<b>2008</b>
ASB	17.30%	21.30%	18.40%
Westpac	14.80%	23.50%	23.10%
BNZ*	17.50%	22.97%	19.61%
ANZ National*	33.40%	19.65%	19.57%

Source: Individual bank disclosure statements and \*New Zealand Institute calculations

Despite high profitability, the banks’ vulnerability to disruptions in offshore funding markets has recently been exposed. Key offshore funding markets were closed in September and October

<sup>13</sup> Bedford, (2008).

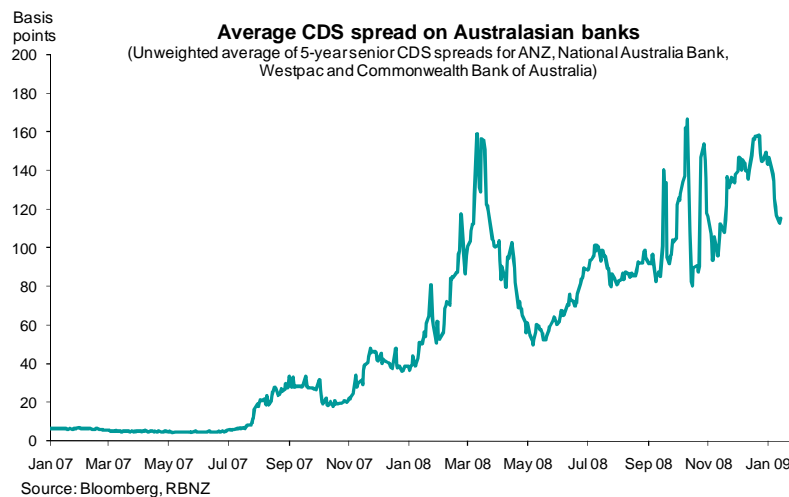
<sup>14</sup> Edwards, (2006).

last year, and most long term debt markets are still closed for business, while there is limited activity in short term commercial paper markets. With around 42% of bank funding sourced from offshore and of that funding 63% maturing within a year, the banks are under intense funding pressure.

*Banks short and long run funding costs*

The funding costs for all financial institutions globally have risen dramatically following the bankruptcy of Lehman Brothers and the ensuing worsening of the financial crisis from October 2008. The funding costs for New Zealand banks have been rising with banks paying a substantial and growing margin over swap rates. The rise in funding costs has occurred despite the Reserve Bank reducing 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%). Wholesale interest rates (measured by swap rates) have come down over the last eight months but the margins banks are paying have increased. The widening spreads reflect risk aversion amongst international investors in response to the global credit crisis, and the small volume of trading activity in these markets.

There are few reliable direct indicators of the margins banks are currently paying for overseas debt funding. This is primarily because there has been so little activity in offshore markets. There are, however, measures that indicate the likely direction of funding costs. A key indicator of the rise in margins being paid by Australasian banks is the spreads on credit default swaps (see chart below). Credit default swaps show the price traders are demanding for selling insurance on the risk of debt default by Australasian banks. In early 2007 traders paid a margin of less than ten basis points on debt default swaps (as has been the case with other financial institutions globally). The spread blew out at the height of financial market disturbance in early October, and has remained at a high level since (narrowing but stayed elevated in early January 2009.)



Citigroup banking analysts quoted in the Financial Times in January<sup>15</sup> said that Australian banks were paying about a 180 basis point margin for debt funding (including the 70 basis point cost of the Government guarantee). That compared with an average 200 basis point margin in December. This suggests that banking funding costs are even higher than the levels indicated by CDS spreads. While margins have come back slightly since December it is worrying that funding costs remain so high despite the existence of the government guarantee that was designed to ease international investor fears of bank default.

The fees for the Government wholesale funding guarantee scheme will add to the margins on bank funding. These fees were recently reduced but are still slightly higher than the fees paid by Australian parent banks. Banks are charged 90 basis points for term funding of longer than 1 year duration compared with the 70 basis points charged by the Australian government.

<sup>15</sup> Financial Times, January 9, 2009.

*The risk of ongoing disruptions to the banks' ability to raise debt financing from overseas*

There has been a general disruption in global bank lending markets since the bankruptcy of Lehman Brothers in October 2008. These markets have started to unfreeze in the last two months. Some Australian banks were able to raise around AUS\$50 billion in the last few months through issuance of Australian government guaranteed bonds in Australian debt markets and in global debt markets. Even in a scenario where New Zealand banks are successful in rolling over debt financing in early 2009, the risk of further market disruptions is likely to remain. Financial market disturbance has abated somewhat since November 2008 but confidence remains fragile. Recent analysis and commentary has confirmed that mending the financial infrastructure will take time, and there may be further waves of market disruption to come.<sup>16</sup>

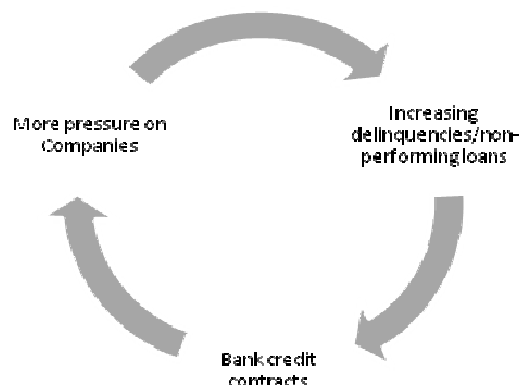
*Impact of rising funding costs and risks of market disruption on bank lending*

The latest available bank lending statistics do not yet show a marked decline in lending to the business sector. The Reserve Bank nonetheless expects business lending to slow considerably in coming months.<sup>17</sup> The extreme financial market disruption experienced at the time of the Lehmann Brothers collapse in early October was a watershed event that is expected to create a break with the historical trends in credit markets. Statistics on bank lending are disguising the extent of contraction that has already occurred. There has been "churn" with banks picking up lending from failed finance companies, and lags with agricultural lending reflecting loans that were approved 12-18 months ago and are only now being drawn down. Companies having difficulty raising debt funding directly from issuance of securities are leaning more heavily on bank lines of credit. In combination these factors have disguised the contraction in non-agricultural lending that has already occurred.

*Business balance sheets*

The latest business confidence survey<sup>18</sup> shows sharply plunging profitability, employment and investment intentions. As the recession deepens, negative cash flow will make firms more reliant on bank financing just as banks tighten credit policies in the face of wholesale funding pressures. Further, as declining profitability leads banks to raise the hurdle on new lending, even companies with positive cash flows may have difficulty obtaining new lines of credit to finance investment. A key objective of government policy at the present time should be to prevent a negative credit contraction spiral as, unchecked, this dynamic would have serious consequences for employment and the economy.

**Credit contraction spiral**



The pressure on business balance sheets is heightened by a recent tilt in the playing field in favour of financial institutions competing with companies for retail funding in New Zealand.

<sup>16</sup> See for example the International Monetary Fund, 'Global Financial Stability Report', January 28, 2009.

<sup>17</sup> See the RBNZ, Financial Stability Report, November 2008.

<sup>18</sup> Quarterly Survey of Business Opinion for December, Released January 2009, NZIER.

The Government's retail deposit guarantee scheme has distorted risk/return relationships, putting companies in competition with 'guaranteed' deposits in finance companies. This competition is likely to raise the cost of corporate debt issuance, and make it difficult for companies to fill debt subscriptions. These factors impose two costs on businesses:

- 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<sup>19</sup>.
- Some companies will not be able to roll over their debt financing. 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.

Both these pressures are likely to have an enduring impact on the cost structure of companies, impacting on investment, activity and employment decisions. In the medium term, companies may adjust by changing their financing structures with less weight on debt financing and increasing equity financing over time.

#### *Household balance sheets*

New Zealand's recession began in March 2008, earlier than other countries and driven by domestic factors –the combined impact of drought and the bursting of the housing market bubble. Household balance sheets have been contracting over the last year as households adjust to falling asset values. Households are reacting to declines in the value of share market portfolios. The decline in house prices has been the primary driver for households to review their spending and borrowing patterns. Declines in share market portfolios and in the value of debenture investments (most profoundly for those affected by problems in the finance company and mortgage trust sectors) have also driven balance sheet adjustment.

Falling food and petrol prices and tax cuts will provide some relief for households, but their impact is now likely to be overwhelmed by negative employment and earnings news flowing from the worsening global environment for New Zealand businesses. Consumer confidence plunged again in the December quarter of 2008 after a slight rebound in confidence in September.<sup>20</sup> Recent falls in mortgage rates will take time to feed through into relief for households. Drops in mortgage rates have a very gradual impact because so many households have been locked into fixed term mortgage rates at the peak levels prevailing in early 2008. Households with mortgage loan-to-value ratios of over 80% will get less relief as tightened bank credit policies have made them ineligible for the lowest rates. The extent of mortgage relief may improve as more households roll over onto variable or shorter term rates. In the latest Monetary Policy Statement the RBNZ estimated that the average interest rate paid on outstanding mortgage debt will decline by 150 basis points over the next two years.

The outlook is for households to continue the process of retiring debt and retrenching spending for at least another two years. House prices are expected to decline by 16 percent (24% in real terms) by the end of 2010 since their highs, with ongoing impacts on consumer confidence and savings behaviour. The RBNZ projects the households savings rate (currently showing a rate of dis-saving of -10.6 percent of disposable income) to track up towards -2.4 percent by March 2011.

<sup>19</sup>Recent data on business funding costs are not available for New Zealand. In Australia, NAB's executive general manager of business and private banking, Joseph Healy, recently estimated that margins had doubled for borrowers in those sectors most exposed to the slowdown such as retail, leisure, hospitality and some areas of transport; basically any sector dependent on discretionary consumer expenditure. Such trends are expected to be followed in New Zealand.

<sup>20</sup>Westpac McDermott Miller Index of Confidence December 2008.

### 3. Conclusion

Bank finance will not provide anything like the sort of growth push that has been available in the last decade. The outlook is for the end of the high rates of bank lending growth seen in recent years, resulting in a contraction in rates of business investment. Further, while wholesale interest rates have come down with reductions in the Reserve Bank's official cash rate, the margins banks are paying above these rates means that companies are only slowly getting relief through lower borrowing costs.

New Zealand's high level of foreign indebtedness is the result of structural imbalances: primarily policy weaknesses that have led to low rates of household saving and a lack of investment in productive activity. With foreign investor sentiment moving against New Zealand, these vulnerabilities create a risk of a sudden outflow of foreign capital that would have a disastrous effect on investment and economic activity, as well as hurting New Zealand's long term growth prospects.

Weak domestic demand - as households continue to adjust their balance sheets, by reducing debt and curtailing spending - will continue. The outlook for New Zealand's key export industries has worsened, and is likely to be a drag on New Zealand's growth rate for some years to come.

While sluggish demand is likely to be a serious obstacle to growth, the conclusion is that the credit channel poses the most critical threat to New Zealand's growth prospects unless measures are taken to address short term risks, and longer term challenges.