

Essay

The end of the golden weather:  
The financial crisis, global recession,  
and what this means for New Zealand

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## The end of the golden weather: The financial crisis, global recession and what this means for New Zealand

### 1. Executive Summary

The outlook for the world economy has worsened significantly in the last month with forecasts now pointing to a protracted global recession at least as severe as 1981. We cannot rule out the possibility that this recession will be the largest in the post-war period, as global financial markets have not yet returned to normal and the continuation of the financial crisis into 2009 is likely to deepen the impact on real economies and delay a recovery.

In addition to the negative short-term outlook, a more significant strategic issue is how the financial crisis will alter the pattern of global growth over the next decade. Understanding the global economic context is important for government policy makers and for business leaders. It helps policy makers to tailor the New Zealand policy response to fit the particular challenges arising from the changing global environment, and for business leaders is an important part of strategic planning to maximise firm performance.

This paper identifies four factors that could lead to a structural downward shift in global growth over the next decade:

*Unwinding of household indebtedness.* Household debt is at historically high levels in a number of advanced economies (including New Zealand). Households will undergo a painful process of debt reduction, and this is likely to have a long term impact on household spending;

*Ongoing financial market disturbances producing a lengthy period of credit contraction leading to heightened risk aversion.* The financial crisis is far from over, and the ongoing deleveraging of balance sheets and destruction of asset values will have an extended and negative influence on risk taking.

*Worsening fiscal positions in a number of advanced economies leading to higher tax burdens with a negative impact on growth.* The cost of government interventions to stem the financial crisis combined with falling tax revenue will put pressure on government finances across the OECD. Combined with rising social security costs this may lead to higher tax burdens with resulting negative impacts on the medium term growth outlook.

*The United States is looking increasingly like Japan in the 1990s and an alternative engine of growth for the global economy is not apparent.* The medium term outlook for growth in the United States is poor, as the three structural factors above are likely to have a particularly adverse impact in the United States. With the outlook for China and the rest of Asia also deteriorating quickly, slow growth in the US is likely to have a significant impact on global demand for some time.

There are significant risks for New Zealand. These risks include:

- The end of the commodity boom will create vulnerabilities due to New Zealand's reliance on commodity exporting. More generally, export-led growth for the New Zealand economy will be challenging because of sluggish demand in overseas markets despite a weaker New Zealand dollar.
- New Zealand's high external indebtedness makes us vulnerable to sudden shifts in the sentiment and risk profile of overseas investors. We have already seen a substantial fall in the New Zealand dollar and in the New Zealand stock exchange with the New Zealand dollar falling 35% since its February 2008 high and the NZSE50 falling 37% since its May 2007 high.

- As a small market on the periphery of the world, New Zealand may find it increasingly difficult to attract foreign investment as multinational investment decisions become more risk averse.
- Difficulties accessing capital and responses to depressed demand from overseas markets may force New Zealand companies to retrench investment, with long term costs in terms of New Zealand's international presence and ability to seize opportunities such as acquisition activities.

Overall, it is likely that this recession will be protracted and the recovery will be weak and subdued – an L shaped recession – both for the world, but also for New Zealand. Indeed, New Zealand has some particular exposures in terms of its external position and its small size. This is a structural shift that will take some time to work through and may alter the pattern of global growth for the next decade. The challenge for policy makers is to ensure that the problem is properly recognised (i.e. not seeing this as simply a business cycle) and that an appropriate set of policy responses is put in place to ensure that there is an appropriate pathway back to sustained growth.

While there are challenges, there are also reasons to be optimistic about New Zealand's future. The present crisis creates an opportunity to build a national consensus on a growth strategy. The strategy needs to get the fundamentals right – but it needs to go further if New Zealand is to achieve a step-change in productivity and growth. This will require strong leadership to mobilise the country around a more ambitious growth programme.

This paper is the first in a series that the New Zealand Institute will release over the next few months on the strategic implications of the financial crisis and global recession for New Zealand. The series will identify a range of concrete actions and solutions that will have a long-term impact on New Zealand's performance. Subsequent topics will include:

### **Implications of the global crisis for New Zealand**

Paper 2 New Zealand will be affected by these global changes through the growth channel (there are implications for agriculture, tourism, immigration, etc) and through the credit channel (New Zealand is particularly exposed to changes in the pricing/availability of credit given that it has one of the largest external debt positions in the developed world). Understanding these exposures is important in identifying and prioritising policy actions, and this analysis will frame the subsequent notes focused on policy responses.

### **Responding to the crisis**

Paper 3 The fiscal position: stimulus is required, but there is a need to be careful re the long-term implications, an aging population, the risk of ratings downgrades, etc. There may also be a need to preserve flexibility to engage in future fiscal action. This suggests a moderate rather than an aggressive fiscal approach.

Paper 4 Savings/capital markets: the crisis is a reminder of the risks of relying on imported capital and of an economy where behaviour is skewed towards consumption/property rather than productive investment - discuss compulsory savings, tax changes on capital (and real estate), the tax imputation system, etc.

Paper 5 Can the government use its balance sheet more actively to encourage investment in the New Zealand economy? For example, the use of the New Zealand Superannuation Fund and other Crown financial institutions, as well as the SOE portfolio.

Paper 6 New Zealand's place in the world. Can small countries like New Zealand prosper in turbulent times? Does this suggest we ought to consider currency union, more aggressive regional integration etc, in the way that small countries like Denmark are considering joining the Euro?

## 2. Background and context

The global financial crisis began more than a year ago triggered by the bursting of the US housing bubble. As early as August 2007 there were concerns that banks might have difficulty raising funds as risk premia in inter-bank and commercial paper markets spiked. From January 2008 the financial crisis intensified as successive waves of high profile credit write-downs and bankruptcies rocked confidence in key markets.

In September and October 2008 the crises deepened in the United States and Europe, as the failure of Lehman Brothers and the American Insurance Group rocked confidence further and were followed by a string of collapses of major financial institutions. By early October dramatic falls in stockmarkets around the world showed that the crisis had become truly global in nature. One estimate of global stock market capitalisation suggests global stock markets have lost US\$32 trillion in value (i.e. about a half of their value) since their highs in October 2007.<sup>1</sup>

By late October concerns about a major global recession became the focus and driver of ongoing volatility in stockmarkets. The degree of concern and uncertainty over the outlook for the global economy is illustrated by how rapidly the key international institutions have revised their forecasts for global growth in a downward direction. The table below shows the dramatic revisions in the International Monetary Fund forecasts over July, October and November of this year. The IMF has shaved almost two percentage points off its forecasts for the global economy in 2009 since July 2008. The IMF is now predicting output in all advanced economies to contract on a full year basis in 2009 – the first time this has happened in the post-war period.

IMF Projections released on November 5: Year over year percent change

	Projections				Difference from earlier IMF projections for 2009 released in:	
	2006	2007	2008	2009	October	July
World output	5.1	5.0	3.7	2.2	-0.8	-1.7
Advanced economies	3.0	2.6	1.4	-0.3	-0.8	-1.7
United States	2.8	2.0	1.4	-0.7	-0.8	-1.5
Euro area	2.8	2.6	1.2	-0.5	-0.7	-1.7
Developing countries	7.9	8.0	6.6	5.1	-1.0	-1.6
China	11.6	11.9	9.7	8.5	-0.8	-1.3
India	9.8	9.3	7.8	6.3	-0.6	-1.7

Source: IMF World Economic Outlook July and November 2008 Updates

More recently (November 25), the OECD released a bleak prognosis for its member countries. The OECD concluded this would be the most severe global recession since 1981. A normal 'v' shaped recession would see economies experience two quarters of negative growth, then stabilise and start a strong rebound from the middle of 2009. However, the OECD is predicting an 'L' shaped recovery, i.e. a slow recovery where the US and Eurozone experience four quarters of negative growth, followed by several quarters of anaemic growth in late 2009 and early 2010. Stronger growth (i.e. 2% or higher on a quarterly basis) does not return until September 2010.

The OECD forecasts assume that financial markets will resume their normal functioning early in 2009 *and* that normal credit conditions will return in late 2009. Both of these assumptions

<sup>1</sup> NZ Institute calculation: Bloomberg estimate of world stockmarket capitalisation was above US\$62 trillion in October 2007 and is now at around \$US30 trillion.

appear rather heroic.<sup>2</sup> The IMF forecasts note that “financial conditions continue to pose serious downside risks..” and “...the process of deleveraging could be more intense and protracted that included in these forecasts”.<sup>3</sup>

The financial crisis is far from over, and while a string of government interventions have *begun* to restore confidence and some functioning in short term inter-bank lending markets, other key markets (such as the US dollar term funding markets used by Australasian banks and companies to raise money offshore) are still significantly dysfunctional. In the preface to the Financial Stability Report released on November 11, the Reserve Bank governor warned that “...the global financial sector is undergoing a prolonged adjustment.....” and that “we will eventually reach the point where financial institutions are again able to support global economic growth. In the interim, the adjustment process is proving extremely disruptive and it will likely be some time before financial market conditions normalize”. Translating from the officialise, this is a remarkably frank admission that the global financial system remains on a knife-edge.

Economic growth is also slowing dramatically in Asia and other developing economies. Recent analysis from market analysts closely watching developments in Singapore, Hong Kong, Taiwan and China suggests the downturn in these economies is likely to be more severe than the 1997/98 Asian Crisis. Some analysts predict China’s rate of growth may slow to 5-6% (compared to 11.9% growth in 2007) – well below the IMF estimate of 8.5% growth in 2009. In an increasingly globalised world, the collapse of markets in Europe and the United States is rapidly slowing these export-driven Asian economies. The notion that growth in Asia might be “de-coupled” from growth in Europe/United States is being challenged.

### 3. Structural factors that may alter the pattern of global growth for the next decade

One of the surprising features of the current debate is the extent of focus on the depth and duration of the recession. The question being asked is “will the global economy begin to recover in late 2009 or early 2010?” But this is largely an academic question about the boundaries of the “technical recession”, given that growth will be close to zero for some time thereafter. The more important question is: “what will the growth profile of the next decade be like?” In this regard, it seems likely that there will be a structural shift to a lower trend rate of growth in global activity over an extended period of time. It is difficult to set a time period with any precision – uncertainty abounds – but it seems plausible to expect the next ten years to be quite different to the period of generally sustained, low inflationary growth we’ve experienced since the early 1990s.

Over the last decade, the global economy grew at an annual average rate of around 5%. Much of the growth in developed economies was sustained by strong retail spending as households enjoyed growing wealth from increases in the value of the equity in their homes. Many OECD countries experienced housing booms similar to the boom experienced in New Zealand since 2001. This was also a period of low inflation, partly a product of effective monetary policy in advanced economies but in a large part driven by low cost imports from the burgeoning Chinese economy. Savings of “savings surplus” economies, especially China and Japan, sought higher yielding investments in the OECD countries, including New Zealand and Australia and in emerging markets such as Latin America and Eastern Europe. This ‘carry trade’, whereby savings from low yield investment economies have sought higher returns across the globe, effectively flooded these markets with cheap credit, unleashing a wave of financial market innovation as traders attempted to find riskier, higher yielding investments.

<sup>2</sup> In the foreword to the latest OECD Economic Outlook containing these forecasts the OECD Chief Economist notes that “I would like to emphasise upfront that the uncertainties associated with this *OECD Economic Outlook* are exceptionally large, especially those related to the assumptions regarding the speed at which the financial market crisis – the prime driver of the downturn – is overcome. Specifically, we assume that the extreme financial stress since mid-September will be short-lived, but will be followed by an extended period of financial headwinds through late 2009, with a gradual normalisation thereafter.”

<sup>3</sup> IMF World Economic Outlook November 2008 Update p5

The next decade will be a period when some of the structural factors that led to high and sustained growth in the last decade unwind. The financial crisis and related destruction of asset values may also unleash other dynamics, especially related to the suppression of risk taking. These dynamics could lead to a protracted period of slow growth in business investment, and a suppression of the business dynamics that underpin productivity and growth.

The next decade will be a particularly challenging environment for the global economy. We have grouped the factors that may lead to a structural downward shift in global growth under four headings:

- Unwinding of household indebtedness across advanced economies.
- Ongoing financial market disturbances producing a lengthy period of credit contraction leading to heightened risk aversion
- Worsening fiscal positions in a number of advanced economies leading to higher tax burdens with a negative impact on growth.
- The United States is looking increasingly like Japan in the 1990s and an alternative engine of growth for the global economy is not apparent.

#### *Unwinding of household indebtedness across advanced economies*

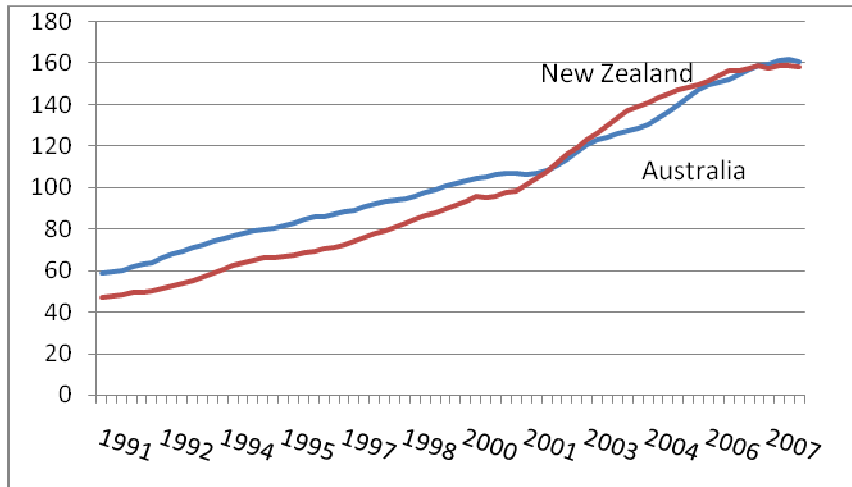
Household debt is at historically high levels in most of the OECD. Booming property markets encouraged households to further leverage their balance sheets, (i.e. to raise the ratio of debt-to-net assets) in the expectation of higher capital gains. Financial innovation, in the context of deregulation of financial markets, also led to weaker incentives on banks, especially in the United States, to adequately monitor the ability of households to service their mortgage debt.

The OECD has examined the composition of household debt and concluded that the household sectors in many OECD countries are now more vulnerable to changes in interest rates, asset prices and incomes.<sup>4</sup> Households now use a greater fraction of their income to service debt than they did prior to the 1990s. As the value of the equity in their homes decline, and softening job markets reduce earnings growth and raise unemployment, households in a number of OECD countries are increasing their savings to pay off debt, severely curtailing retail spending. The burst of housing bubbles in a range of OECD countries (including New Zealand) is likely to result in a process taking several years wherein households reduce their consumption, pay back debt and gradually rebalance their balance sheets. Despite falling interest rates reducing debt servicing costs, the sharp fall in house prices has triggered a significant process of deleveraging household balance sheets.

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<sup>4</sup> OECD Economic Outlook 2006 Ch3 Has the rise in debt made households more vulnerable?

**Household debt as a percentage of disposable income: New Zealand and Australia**



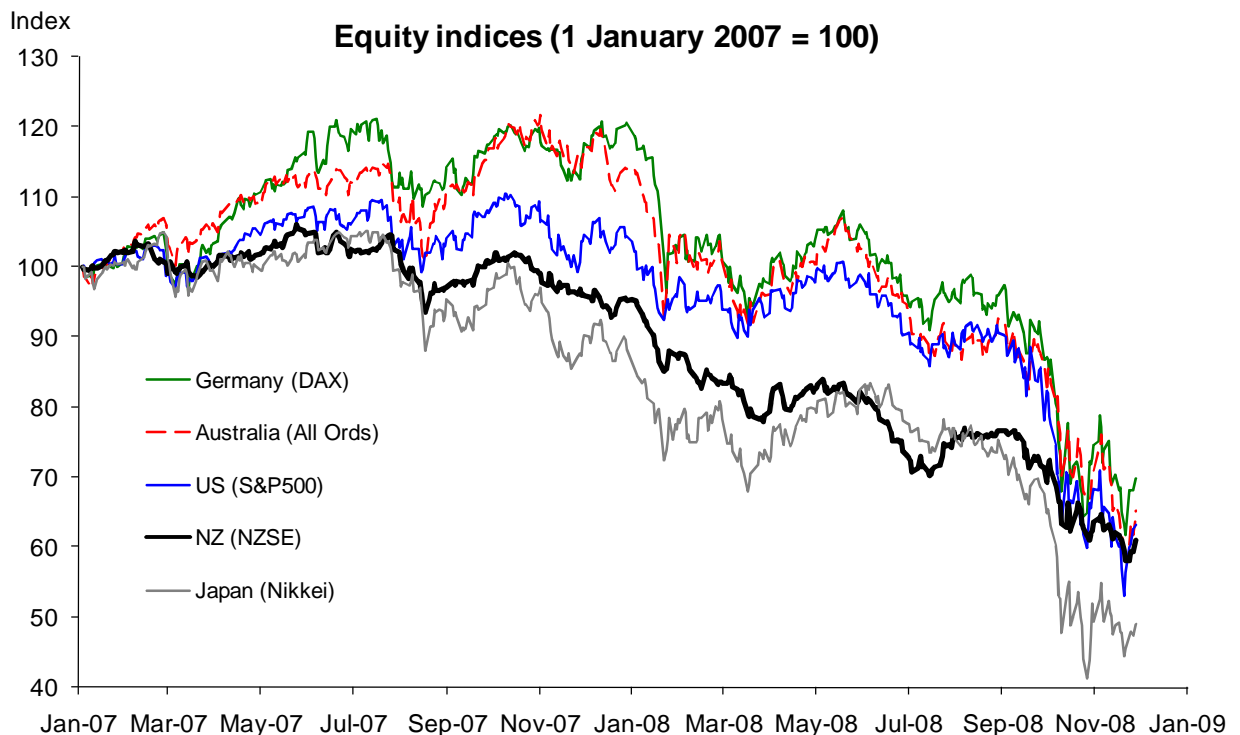
Sources: RBNZ, RBA

*Ongoing financial market disturbances produce a lengthy period of credit contraction leading to heightened risk aversion*

The past fifteen years were characterized by high levels of risk taking driving investment and entrepreneurship. The willingness of households, businesses and financial institutions to take risk (often by leveraging their balance sheets to fund increasingly larger investment portfolios) stemmed from expectations that revenue growth, asset appreciation and consumer appetites for luxury goods would be sustained into the future. The risk attitudes of major players in the global financial system were insufficiently tempered by regulatory oversight, and some attenuation of the more extreme risk taking behaviour is clearly necessary and overdue. Further, there were elements of unsustainability driving spending and investment through this period that created a certain inevitability that it would be followed by a period of adjustment. Unfortunately the cycle of risk taking is likely to swing well beyond moderation, becoming a dramatic reversal in general attitudes to risk taking. The downswing is likely to be more than a process of rebalancing, moving to a period of risk averseness that is sub-optimal for the global economy. This reverse risk cycle is likely to place a drag on productivity and growth for some time.

The immediate reversal of risk taking is already apparent as financial institutions reduce lending to repair balance sheets and companies sell down assets, retain cash and retrench investment. The Boston Consulting Group recently estimated that financial institution losses will reach at least \$1.5 trillion worldwide. "At a 12.5:1 ratio of capital to assets, that loss would mean a \$19 trillion decline in credit capacity – a net contraction representing about 7 percent of current global credit levels."<sup>5</sup> It is plausible that the sheer magnitude of this credit contraction will affect investment decisions and business confidence for a protracted period of time. It is difficult to predict exactly how long it will take for investment sentiment to rebound to the levels that carried the US economy into the tech boom, for example. The dislocations in financial markets are, however, likely to lead to a protracted reversal in general attitudes to risk taking well beyond what might be considered optimal for the global economy. The stock market may provide the most graphic insight into how the loss of wealth may influence risk appetites for some time. The current stock market decline is the steepest and fastest destruction of stock market value since 1950.

<sup>5</sup> 'Collateral damage: what the crisis in the credit markets means for everyone else' David Rhodes, Daniel Stelter, Shubb Saumya, Andre Kronimus, The Boston Consulting Group October 2008



*Worsening fiscal positions in a number of advanced economies leading to higher tax burdens with a negative impact on growth*

The financial crisis and global recession will lead to a worsening in fiscal positions across advanced and developing countries over the next few years. This will arise from two factors:

- Direct fiscal costs i.e. the fiscal cost of stimulus packages and other measures taken to relieve the financial crisis; and
- indirect fiscal costs related primarily to reduced tax revenue as slowing economic activity reduces the rate of growth in some revenue bases whilst falling property and asset values lead to declines in the absolute level of other revenue bases.

The direct fiscal costs of the financial crisis will not be clear for some time. The direct costs include fiscal stimulus programmes; the costs of recapitalising banks in the United States and Europe; the costs of lending by national treasuries to fund central bank liquidity programmes, bank guarantee programmes, the US \$700 billion Troubled Asset Relief Programme as well as various other bail-out programmes such as that recently mooted for the US auto industry. Some costs are extremely difficult to estimate where they depend on the likelihood of a bank guarantee being realized; or on the price a government may later obtain for the sale of troubled assets purchased during the crisis.

The OECD has started to estimate the impact of the crisis and global recession on fiscal positions in OECD countries. On these measures, the United States experiences the greatest deterioration in its fiscal position to the end of 2010. Moreover the “underlying deficit” for the US worsens – this is a measure of the impact of policy changes, defence spending and other drivers unrelated to the state of the economy. The fiscal position of the Euro area also worsens, but to a lesser extent and the worsening is entirely due to the state of the economy (i.e. the OECD estimate of the underlying deficit actually improves).

These estimates make rather modest assumptions about the scale of direct fiscal costs. For instance, they assume the US government does not introduce a second fiscal stimulus

package next year. We know, however, that President Elect Obama's transitional team is already working on a sizable package. Similarly, the estimates do not include fiscal stimulus packages already announced by Germany and some other European countries.

**Fiscal positions are worsening: OECD estimates**

	2006	2007	2008	2009	2010
<b>United States</b>					
Actual fiscal balance	-2.2	-2.9	-5.3	-6.7	-6.8
Underlying fiscal balance	-0.7	-1.0	-3.1	-3.3	-3.0
<b>Japan</b>					
Actual fiscal balance	-1.4	-2.4	-1.4	-3.3	-3.8
Underlying fiscal balance	-3.7	-3.1	-2.7	-3.1	-2.7
<b>Euro area</b>					
Actual fiscal balance	-1.3	-0.6	-1.4	-2.2	-2.5
Underlying fiscal balance	-1.2	-0.9	-1.2	-1.0	-1.0
<b>OECD</b>					
Actual fiscal balance	-1.3	-1.4	-2.5	-3.8	-4.1
Underlying fiscal balance	-2.1	-2.0	-2.9	-3.1	-3.0

Source: OECD Economic Outlook November 2008

Rising longevity, falling fertility and retiring baby boomers are predicted to increase fiscal spending in a number of advanced economies to 2040, with cost impacts beginning to be felt by as early as 2015. The next five years had been considered the golden opportunity for economies to get government spending under control and thus limit the impact of rising age-related costs on their economies.

The financial crisis and global recession will force countries to delay adjustments that would otherwise have helped them to reduce the cost of demographic changes on their economies. The IMF has estimated that such a delayed adjustment in G7 nations entails lower economic growth over the next 10 years owing to increasing crowding out effects and a large rise in payroll taxes.<sup>6</sup>

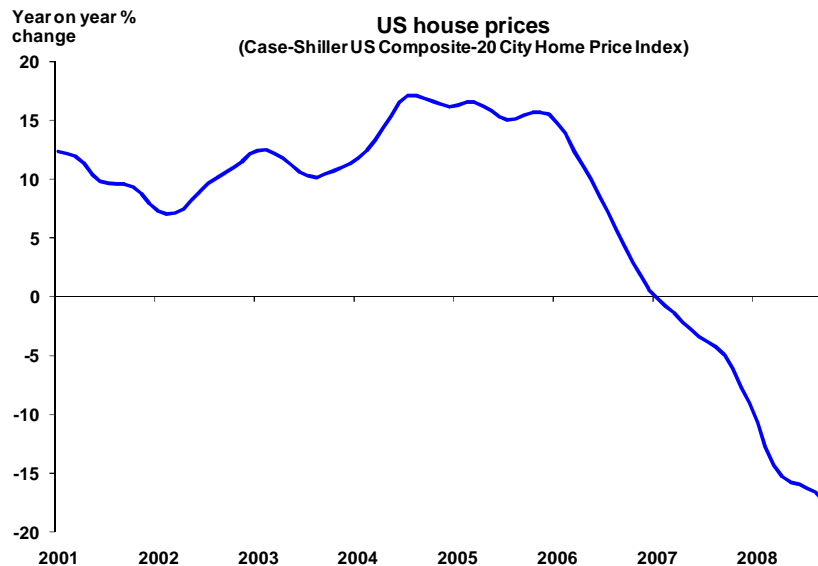
*The United States is looking increasingly like Japan in the 1990s and an alternative engine of global growth is not apparent*

The medium term outlook for growth in the United States is poor, as the three structural factors above are likely to have a particularly adverse impact in the United States.

- US households are some of the most indebted in the world, and the US housing market is falling hard – house prices fell 17.4% in the last year, and the trend appears to be accelerating (see figure below). This follows a long period of rising house prices since at least the early 1990s (when there was a brief period with house prices falling in the region of 3% per annum).
- The loss of asset values and erosion of confidence has been centred in the US. Globally, write-downs and credit losses totalling US\$966 billion have been announced and of this US\$664 billion have been lost by US financial institutions.

<sup>6</sup> "Preparing for the Jump in Age-related Spending", David Hauner, Daniel Leigh, and Michael Skaarup, IMF Fiscal Affairs Department.

- The long term fiscal outlook for the US is extremely unfavourable and the US will be among the most heavily indebted countries in the OECD within a decade.<sup>7</sup> Even before the financial crisis, the US deficit was forecast to worsen to 2020 and beyond due to the sharply rising costs of age-related health care spending.



Added to these factors is the disturbing feature that the US looks increasingly like Japan in the 1990s. Japan experienced a “lost decade” of economic stagnation and deflation from 1991, following a property and asset boom. Some key similarities between Japan in the 1990s, and the US today are<sup>8</sup>:

- The US is experiencing the same balance sheet dynamics as Japan experienced in the 1990s: businesses are focused on minimizing debt rather than investment. Efforts to sell assets as part of cleaning up balance sheets leads to further falls in asset prices and a vicious cycle leading to further debt minimization and so on;
- Monetary policy is relatively ineffective in this environment: the US Federal Reserve’s Fund rate is already at 1%, so the US has little room to loosen monetary policy. Moreover consumers and businesses are not likely to respond to a lower cost of funds as the value of their collateral is disappearing and reducing their appetite for lending or borrowing at any price.

There are also some important differences between the US today and Japan in the 1990s. The US has the opportunity to learn from policy mistakes in Japan. While the Japanese government was slow to use capital injections and liquidity injections, the US government has already been using these tools to some effect. The US government is more likely to use fiscal stimulus to boost demand – another lesson from Japan’s experience. Another key difference is that corporate balance sheets outside the financial sector in the US are generally in a healthier state than in Japan of the 1990s. Nonetheless, the similarities with Japan add to the prospect of a prolonged sub-trend growth period in the United States.

<sup>7</sup> OECD Economic Outlook November 2008, p57

<sup>8</sup> “The Age of Balance Sheet Recessions: What Post-2008 US, Europe and China Can Learn from Japan 1990-2005” Presentation by Richard Koo of the Nomura Research Institute, Tokyo, October 2008

With the US economy slowing over the next decade, there are no obvious candidates to replace it as the engine of global growth. Hopes that growth in developing economies – especially China and India – would be ‘de-coupled’ from the US economy appear to be fading fast. The early signs are that growth in these export driven economies is slowing dramatically as consumer markets in the US dry up.

#### 4. Implications for New Zealand

The financial crisis has already had a major impact on New Zealand. The New Zealand stock exchange index has shed 37% of its value since its May 2007 high; the New Zealand dollar has fallen by 35% against the US dollar since its February 2008 high and business confidence has plunged. We believe the consequences of the global recession for New Zealand are just beginning to be revealed and have a long way to run.

##### *The end of the commodity boom?*

After enjoying a commodity boom for the last six years, the outlook for New Zealand’s commodity exports is suddenly extremely uncertain. New Zealand’s reliance on commodity exporting creates vulnerabilities should an environment of extreme weakness in consumer markets continue for an extended period.

There has been a dramatic slowdown in global trading conditions to levels not seen since the beginning of this decade. The most widely used indicators of the general state of global commodity trade: the Baltic Dry Index and the CRB commodity index – are now at their lowest levels in five years, having sunk in value by 91% and 48% respectively since the beginning of July this year. The Baltic Dry Index tracks the cost of global freight shipping, while the CRB is an index of globally traded commodities.

The medium term outlook for commodities is unclear: will this be a short term cyclical swing or will we see commodity prices shifting down to a new and lower trend path? For New Zealand, the outlook for our agricultural commodities depends in part on supply responses (such as a reduction in land use for dairy production in the US in response to falling prices). Another factor is whether continued growth in Asian markets might provide a floor for dairy and other New Zealand commodities. This now looks optimistic given that the Chinese economy is slowing surprisingly quickly with growth predictions being revised down to 5-6% following the double digit growth in 2007.

Aside from the dairy sector, tourism is New Zealand’s biggest “export earner”. The slump in consumer demand in advanced economies and Asia is likely to hit discretionary spending such as overseas holidays especially hard. This is already coming through in visitor arrivals data and passenger volumes on airlines servicing New Zealand. While a falling New Zealand dollar cushions New Zealand farmers and other producers to some degree from the impact of falling commodity prices, it does little to moderate the impact of a substantial and prolonged slump in the volume of demand from overseas markets. Anecdotally there are already companies reporting that the United States is essentially “closed for business”.

##### *Credit contraction hitting investment by New Zealand companies and New Zealand’s ability to attract foreign investment*

New Zealand businesses are already facing increases in financing costs, tighter credit terms and difficulty obtaining new finance whether through the banks, debt markets or equity markets. These pressures are only likely to increase in 2009, as financial market disturbances continue. The high cost and scarcity of capital will raise the bar by which New Zealand companies evaluate investment opportunities, leading to a retrenchment in domestic and foreign investment by New Zealand companies.

Foreign investors are already pulling back from investment in 'peripheral' economies such as New Zealand and seeking "safe haven" investments such as United States and Japanese government bonds. Deleveraging of balance sheets by multinationals and the upswing in risk aversion will make it even harder for New Zealand to attract overseas investment over the next few years.

*New Zealand's high level of debt to the rest of the world creates vulnerabilities*

The New Zealand economy has been suffering from substantial macroeconomic imbalances for some time – especially high levels of debt to the rest of the world. The financial crisis is the "perfect storm" that may expose these vulnerabilities. In briefing papers on the design of the wholesale funding guarantee scheme for the banking system, officials advised the Government that New Zealand's high accumulated external imbalances created risks of a more severe economic dislocation should international funding markets remain closed.<sup>9</sup>

New Zealand is in an uncomfortable 'club' with other highly indebted countries. The case of Iceland is an extreme case study in the dangers of high external indebtedness but still a cautionary tale for New Zealand. In 2008 Iceland had one of the largest current account deficits in the world (16.7% of GDP) and was in debt to the rest of the world to the tune of over 400% of the Icelandic GDP. In the course of a week in September three Icelandic banks collapsed, the Krona's value plunged by more than 70% and the stockmarket lost more than 80% of its value. While New Zealand's position is not as extreme, we are still one of the most indebted countries in the world with our net international debt equal to over 80% of our GDP. The shift to risk aversion amongst international investors will reduce New Zealand's ability to use foreign savings to finance our current account deficit. The implications are that this creates even more urgency behind the agenda to 'fix' New Zealand's macroeconomic imbalances.

*There may be some upside for New Zealand over the next decade, but this depends on a careful balancing act.*

New Zealand's fiscal position is worsening but still looks relatively strong given that many OECD countries are facing higher fiscal deficits and more rapidly growing debt burdens. This gives New Zealand some scope to make itself 'stand out from the crowd' through tax and infrastructure policies. The next few years may be a better environment for government infrastructure investment as inflationary pressures, skill shortages and other capacity constraints on investment ease.

The challenge for the government is to strike the right balance – it is important not to give away the sound fiscal position that has held New Zealand in good stead during the crisis (particularly as a counterpoint in the eyes of international sovereign credit rating agencies against New Zealand's unfavourable overseas debt position). The key is to use the fiscal position and the Government's balance sheet to support policies that ultimately enhance productivity and bring New Zealand back to a sustainable growth path in the medium term.

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<sup>9</sup> Treasury briefing paper 'A wholesale guarantee facility: detailed design issues and an overall assessment' released on the Treasury website Dec 2

## 5. Conclusion

New Zealand is already facing headwinds from the financial and economic storm that is engulfing the globe. If financial markets take longer to recover than expected, the world may be facing the worst recession in the post-war period. Moreover, we expect the recovery from the global recession to be slow and tortuous – an ‘L’ shaped recovery that leads to anaemic growth over an extended period, rather than the ‘V’ shaped sharp rebound we experienced coming out of the Asian crisis in 1999.

Notwithstanding the seriousness of the immediate situation, we see a storm brewing that will influence the course of New Zealand’s economic performance over the medium term. A decade of subdued global growth as foreshadowed in this paper would impact on New Zealand through three main channels:

- a reversal of the commodity boom and subsequent impacts on rural incomes and the rest of the economy;
- Credit contraction hitting investment by New Zealand companies and New Zealand’s ability to attract foreign investment; and
- Difficulties for New Zealand in continuing to finance our large overseas debt as foreign investors become more risk averse.

The Government has announced that it is preparing a major stimulus package (to be released before Christmas). The Government should be congratulated for acknowledging the seriousness of the economic situation and moving quickly to take action. This paper shows that the challenge extends beyond managing through the next 12-24 months. The challenge is also to position New Zealand to cope with a starkly different global environment over the next decade. It is the end of the golden weather.