Alan Bollard: New Zealand's economic recovery, external vulnerabilities and the balancing act ahead

Speech by Mr Alan Bollard, Governor of the Reserve Bank of New Zealand, to the Wellington Regional Chamber of Commerce, Wellington, 14 June 2010.

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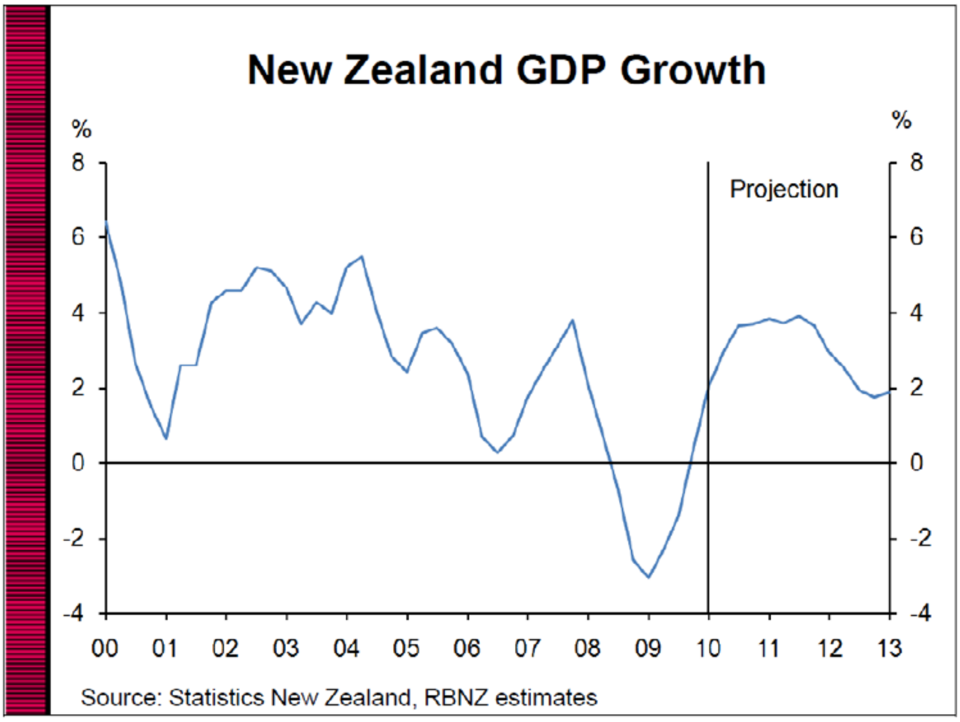
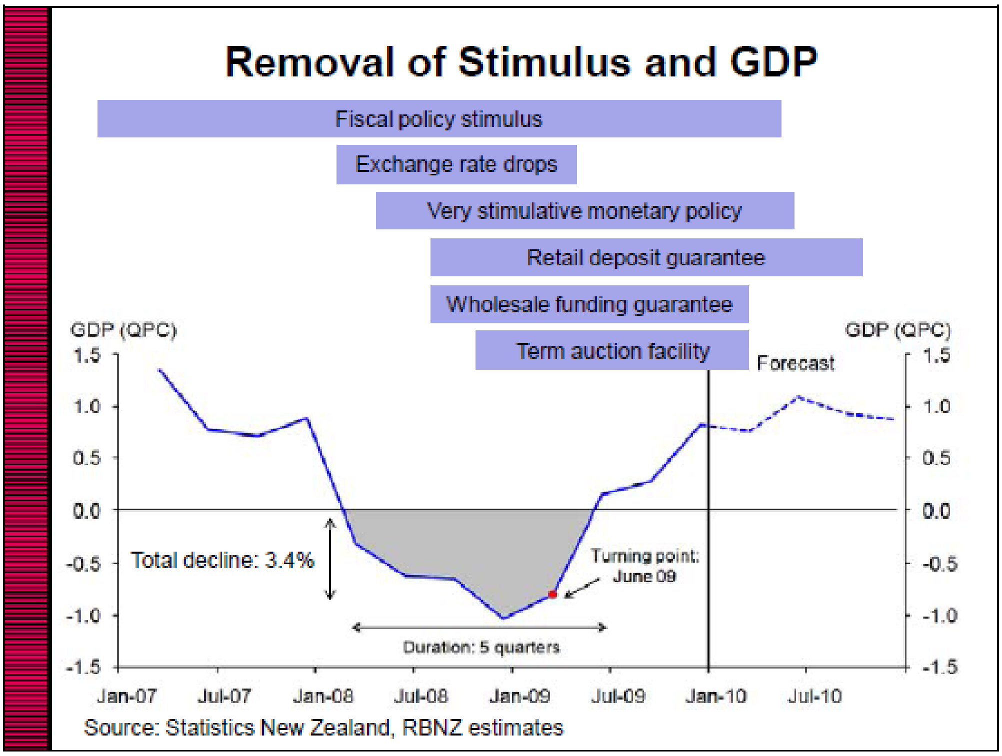
1. How is our recovery going?

We have been out of recession for a year now, and we can take stock of the recovery so far. We hit a trough in the New Zealand economy in the second quarter of 2009, marking a turning point after a year during which we contracted a total 2.2 percent. This was a long and deep recession by our standards, but compared with other OECD countries, we got through reasonably lightly. A period of fragile stimulus – assisted growth followed.



We have now removed most of the temporary liquidity measures that we introduced during the crisis. We believe we are in a more robust growth situation, and that is why we have judged this to be the right time to start removing monetary policy stimulus and move towards more normal policy settings.



The recovery has been assisted by strength in our Asian-Australian trading partners, and in our international commodity prices. We have been enjoying very strong export price growth by the standards of the last two decades. While it will take time to confirm this, there is evidence that we have moved to a stronger terms of trade track, and this is clearly good for our growth future.

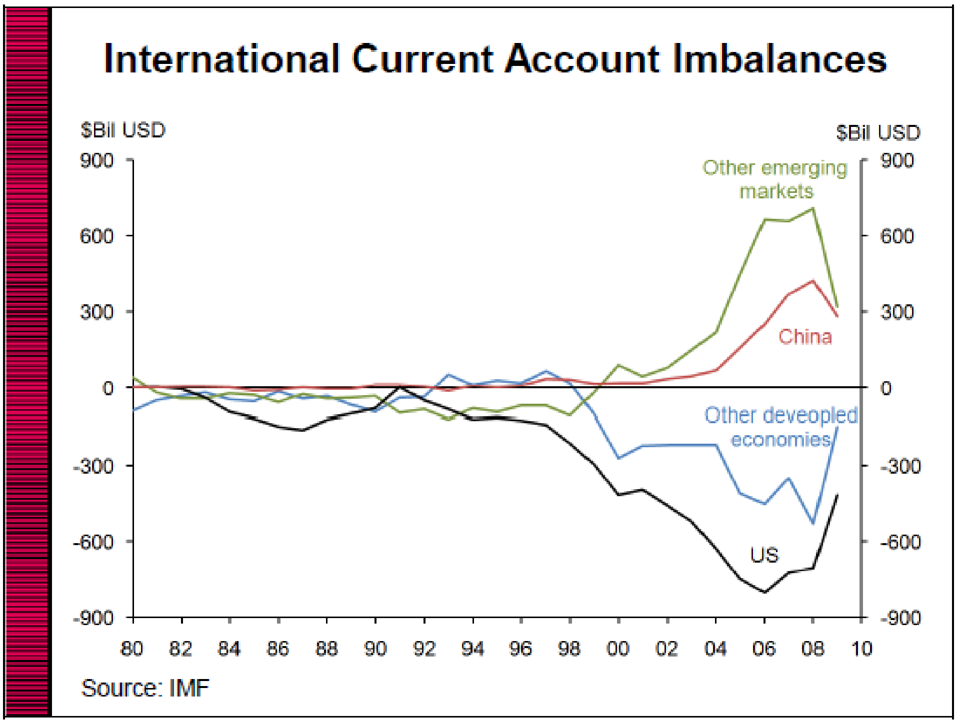
The domestic recovery has been much more muted. Both the business and household sectors have been through harsh times and this has changed their behaviours – they are reducing debt and reassessing their spending. Understanding how much these are temporary or enduring behaviours, is complicated by the tax and spending changes announced in the recent Budget. These will likely rebalance investment from property to other assets but it is too early to be clear about this. In addition, the indirect tax changes will offset the pattern of consumption. The overall effect is that we expect a gradual recovery in business investment, housing and general consumption, but off a low base, and less funded by debt than in the past.

The Greek fiscal crisis, the subsequent European support package, and the resulting financial market concerns have not changed our central view about economic recovery, but they have certainly given us food for thought about the strength of European markets for our exports, about the robustness of the term funding markets for our banks, and about financial market tolerance for fiscal deficits. We will keep watching these developments closely.

2. Is our economy rebalancing?

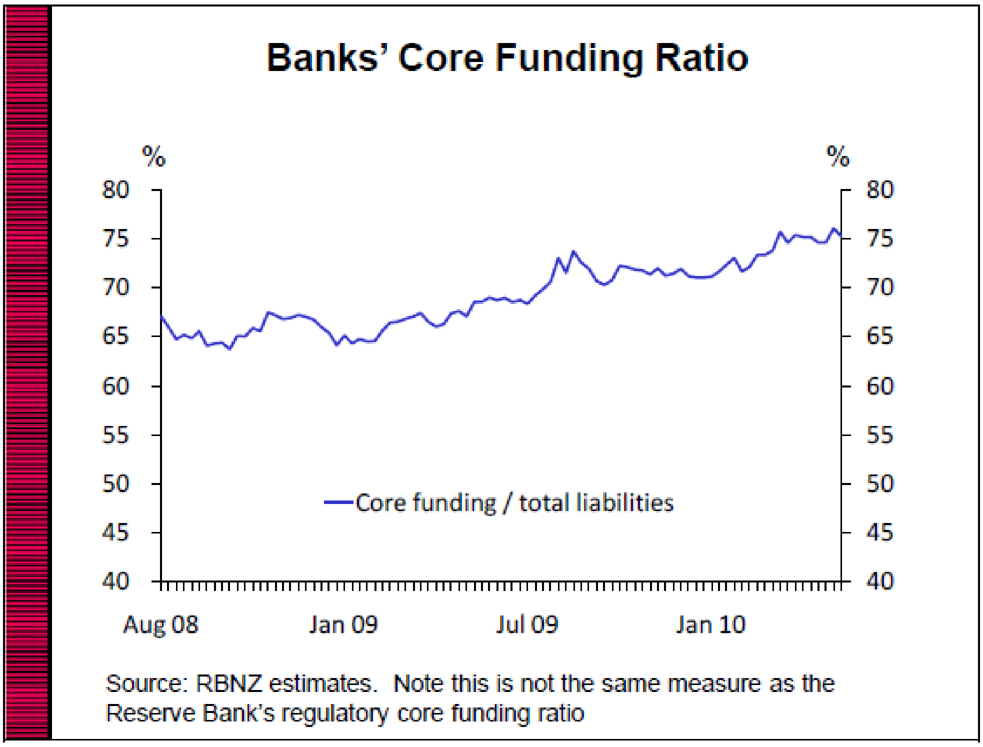
There has been a lot of discussion about the big global imbalances that had been allowed to develop over the last decade, and the extent to which they contributed to the Global Financial Crisis. More importantly we are all keen to see how much global rebalancing is now underway with the recovery. So far the answer is that some rebalancing has happened, but it is still quite unclear whether this will be lasting or sufficient.

What about New Zealand? Here we are seeing strong improvements in export prices, but they are not yet translating into strong domestic consumption or strong investment. Instead households and businesses are using extra income to stabilise their balance sheets.

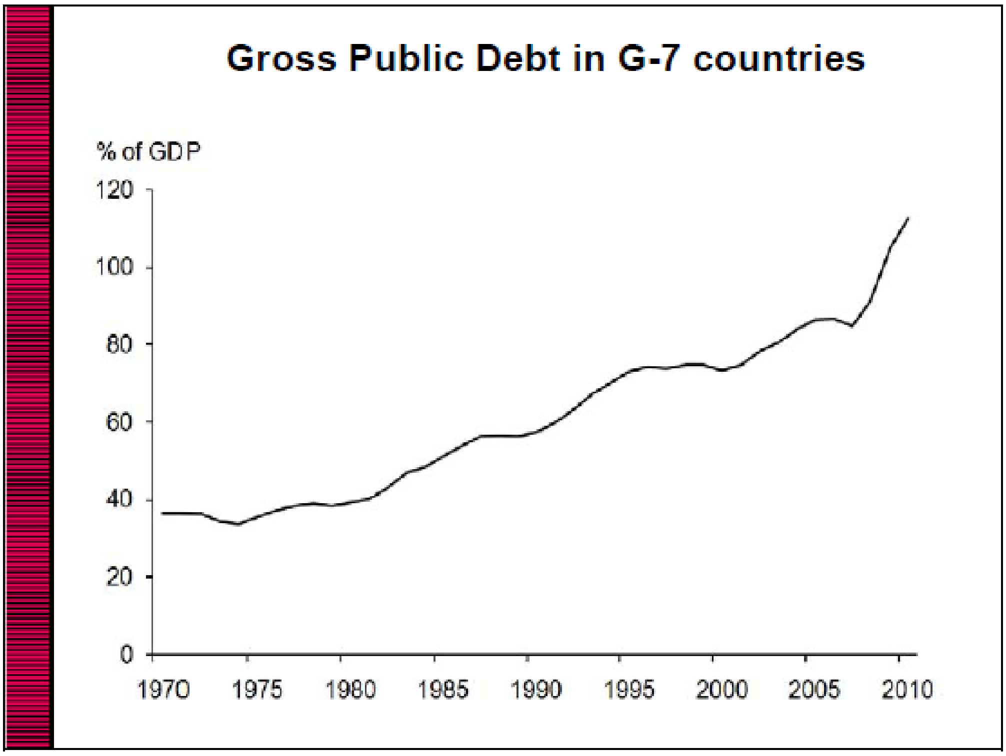


In assessing the state of balance of the New Zealand economy, we might view it through four different lenses: funding imbalances for banks, fiscal imbalances on the government account, savings imbalances on the household account, and external imbalances. These are all inter-related, though in complex ways.

Funding imbalances – Australasian banks have relied heavily on short term foreign funding, and that proved a vulnerability in the crisis. For that reason we have put in place a liquidity policy requiring banks to hold longer-term foreign funding plus retail deposits to meet an increasing core funding ratio. That has already contributed to longer duration funding. This recently proved its worth during the Greek crisis when there were renewed signs of fragility in international funding markets.

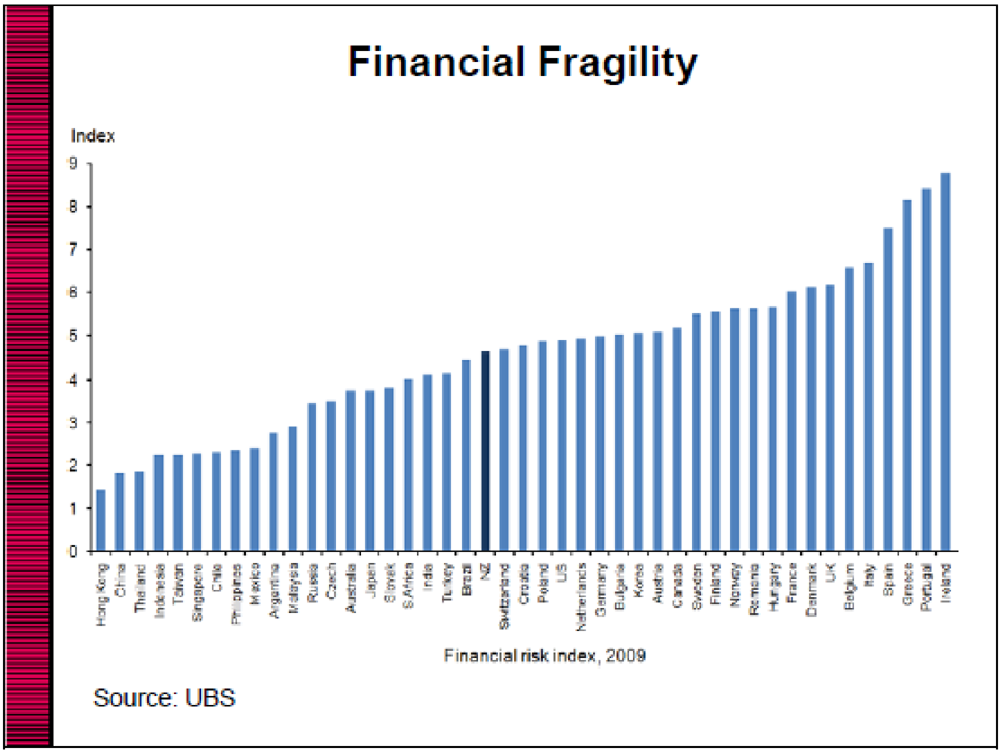


Fiscal imbalances – The Greek crisis also focussed attention on to government funding deficits. The Global Financial Crisis led to many governments assuming the costs of rescue packages and the risks of the financial sector more generally, during the recession at a time when their tax revenues were falling and social expenditures rising. The result has been some very unattractive fiscal deficit positions and forward projections that will strain available funding. The markets have focussed on cases like Greece with no independent exchange rate or monetary policy. However as the Bank for International Settlements shows, the issue of fiscal sustainability goes much wider. They show rapid growth in public debt to GDP ratios for the next 30 years, even under an assumption of fiscal retrenchment, resulting in interest payment to GDP ratios that could go as high as 20 percent or more. Many OECD countries would need to run at least 2–3 percent budget surpluses consistently for several decades just to stabilise their public debt ratios at pre-crisis levels.

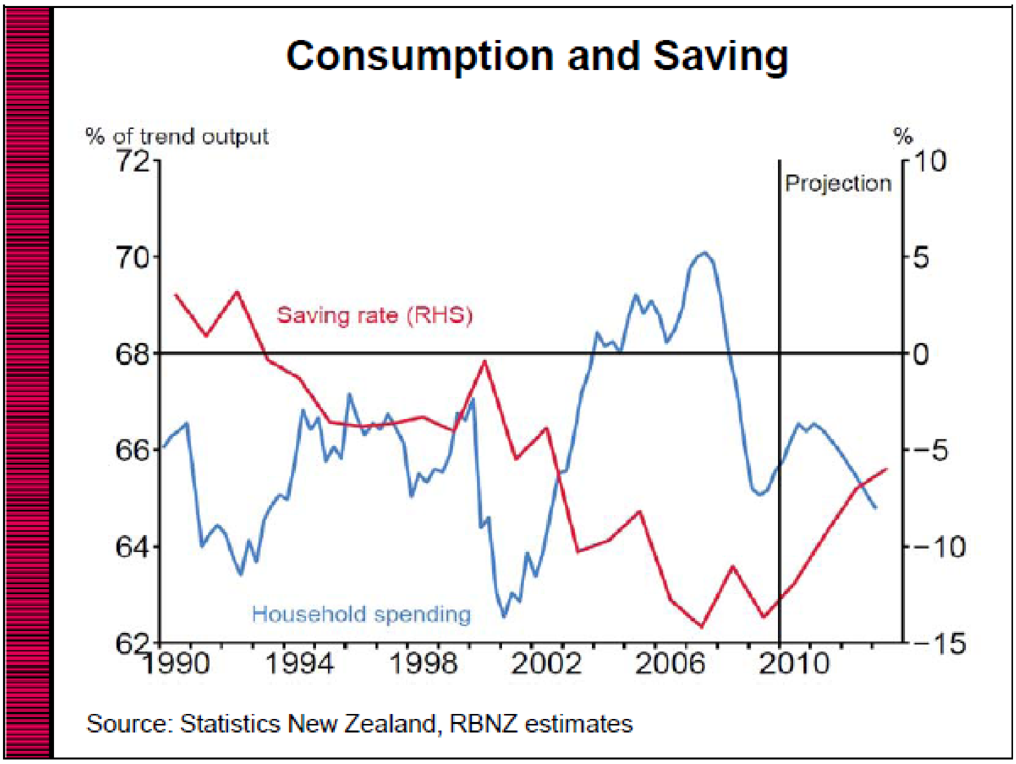


The New Zealand fiscal accounts continue in deficit, but with a credible and improving track going forward. The recent budget confirmed this. The financial markets have seen this as very credible, and New Zealand is generally rated very positively for its fiscal approach. This is shown in the following international estimates of financial fragility by the UBS, an index that includes public sector debt and private credit. New Zealand is rated in the middle of the pack.

Household balance sheet – The household sector has been the most obvious source of imbalance in New Zealand with balance sheets heavily skewed to housing, high debt ratios, and very low traditional savings via financial instruments. By comparison with other OECD countries New Zealand households are very low savers, on average consuming around 9 percent more than they earned over the past decade, according to Statistics New Zealand estimates. Figures like these may over-state Kiwi households' vulnerability and there are other data that present a less worrying picture, but by any standards New Zealand household balance sheets do not look healthy. This was one reason why we have had such high levels of the OCR over the last decade.



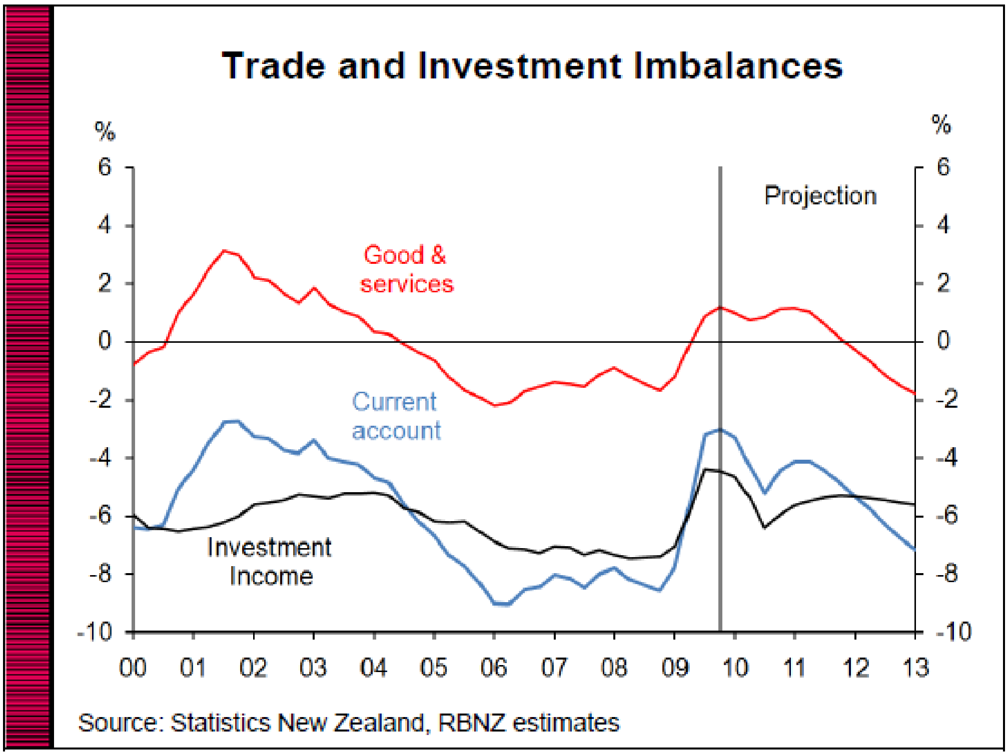
Based on our Monetary Policy Statement, we forecast New Zealand household savings to improve from a very poor position to one that has improved, but is still insignificant deficit. We believe that since the crisis, New Zealanders have decided they are over-exposed to property assets and to high debt, and they are prepared to constrain consumption to improve their savings. But we are unclear how much rebalancing they contemplate, and for how long.



In addition much will depend on how these extra savings are invested, and whether this is domestically or internationally. Financial markets do not judge our savings balance directly, but rather through its funding implications and its contributions to the external balance.

Balance of Trade – Strong export prices for much of our primary products (somewhat muffled by the strongish exchange rate) have been yielding improved export returns. At the same time consumers, farmers and businesses are all moderating their demand for imports. The result has been a quick and significant improvement in the direction of trade, recording positive balances once again. However we forecast that only part of this improvement is permanent, as import growth will revive. Were the New Zealand dollar to drop improving our competitiveness, export prices would improve in local currency, and there would also be a positive supply response in some products.

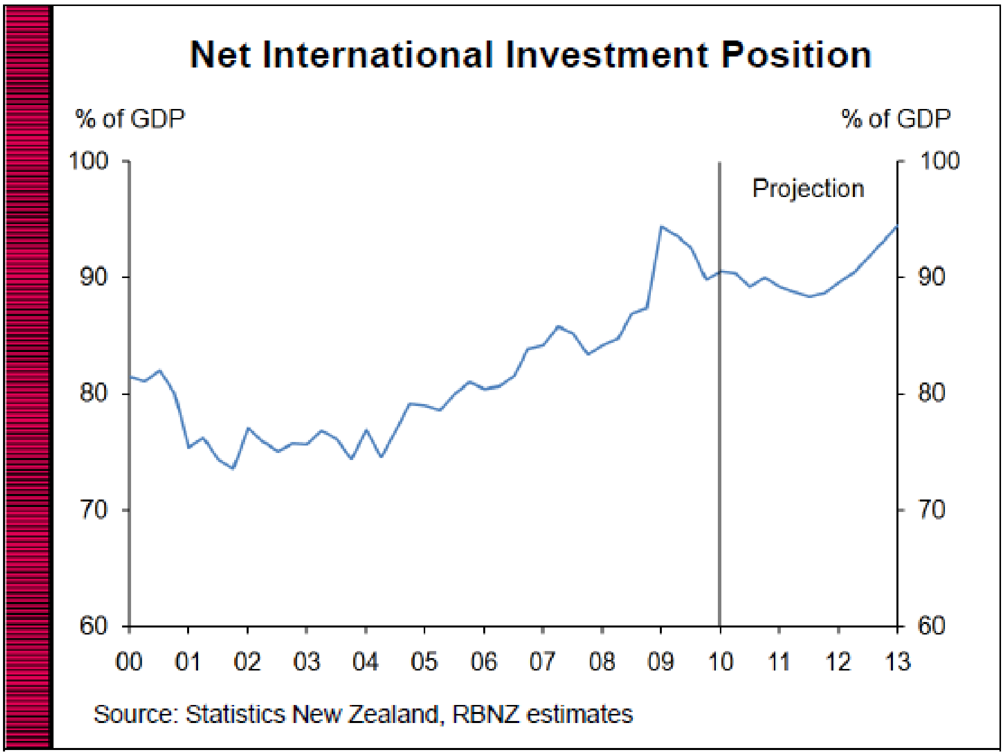
Investment Income – While the trade component in our balance of payments has improved, the other major component is far more problematic: that is the investment income balance. This measures incoming earnings from the very limited amount of New Zealand investment abroad against outgoing earnings from the much larger stock of foreign investment in New Zealand. New Zealand runs a large investment income deficit of around 6–7 percent of GDP, which is showing little sign of enduring improvement. Indeed it will be difficult to improve this metric as that would require us to get our net external debt position on to a downward trend and that would require a significant change in historic patterns of inward and outward investment.



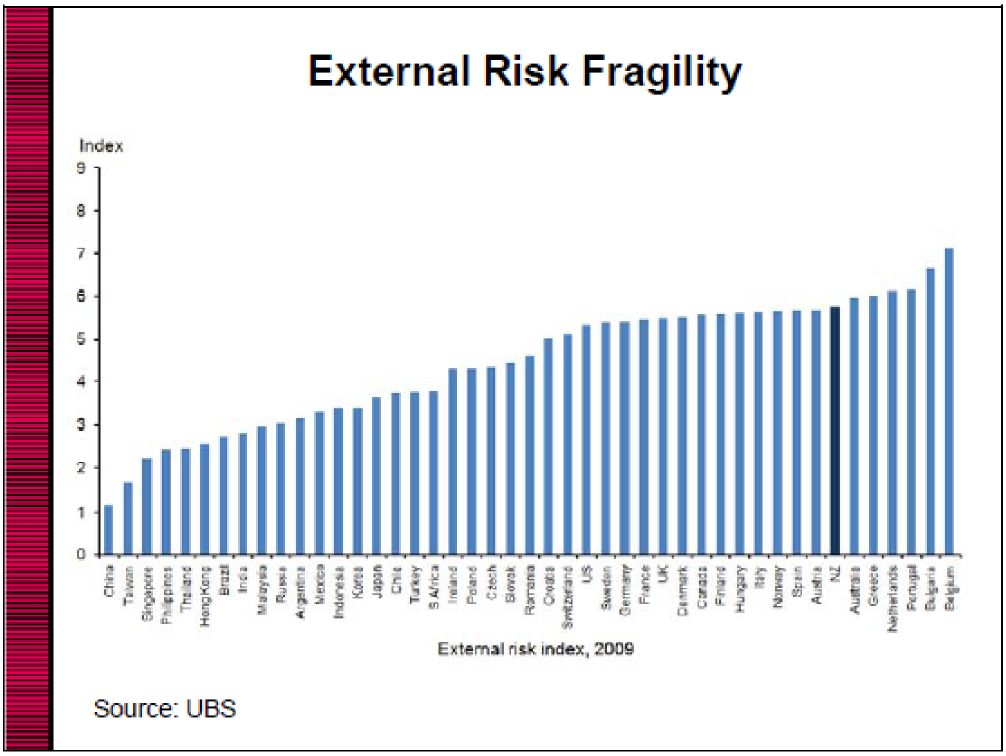
These two components combine into the current account, which has been in significant deficit in New Zealand for 40 years. That is not problematic in itself, but if it is consistently funding consumption rather than investment, then that cannot continue. The deficit worsened during the housing boom years of 2005–2008, sitting near 9 percent, a very deep deficit by OECD standards. Interestingly, throughout the crisis we experienced little sign of financial market discomfort with that position. We are now experiencing a big improvement in the current account, reducing the deficit to 3 percent, but we believe it will deteriorate again as the recovery picks up.

3. Our overall external imbalance

Years of running these external deficit flows means that we are now significantly in debt to foreigners: in plain terms, they have more than twice as much invested in NZ ($290 billion) as we have invested overseas ($125 billion). This means the country is running a sizeable net investment deficit of around 90 percent of GDP. Most of the debt inherent in this position is in the private sector, not the public sector. A significant proportion of this relates to the banking system which does most of the country's offshore borrowing, effectively on behalf of households and businesses. Most of it is currency-hedged, so we do not suffer major currency risks from it. The graph shows how the position has grown over the last decade. Our forecasts see this external deficit continuing to grow.



Financial markets and credit rating agencies use a range of indicators to form their assessment of a country's viability or fragility. At the moment most of the focus is on sovereign debt and the fiscal accounts. However as the recent credit downgrade of the Government of Spain showed, overall external indebtedness can play a role in this. New Zealand is one of the very few developed counties with net external liabilities so high. The UBS country risk index mentioned above rates us rather higher in terms of external fragility (an index based on exports, current account, external debt, and foreign exchange cover).



This external deficit cannot keep increasing with impunity. Ultimately the markets would penalise the large external liabilities and deficit position by requiring a larger premium for its continued funding, and the sheer size of servicing our obligations could become an intolerable burden to the country. Already we spend around 6–7 percent of GDP servicing debt and returning profits off-shore to owners of New Zealand domiciled businesses.

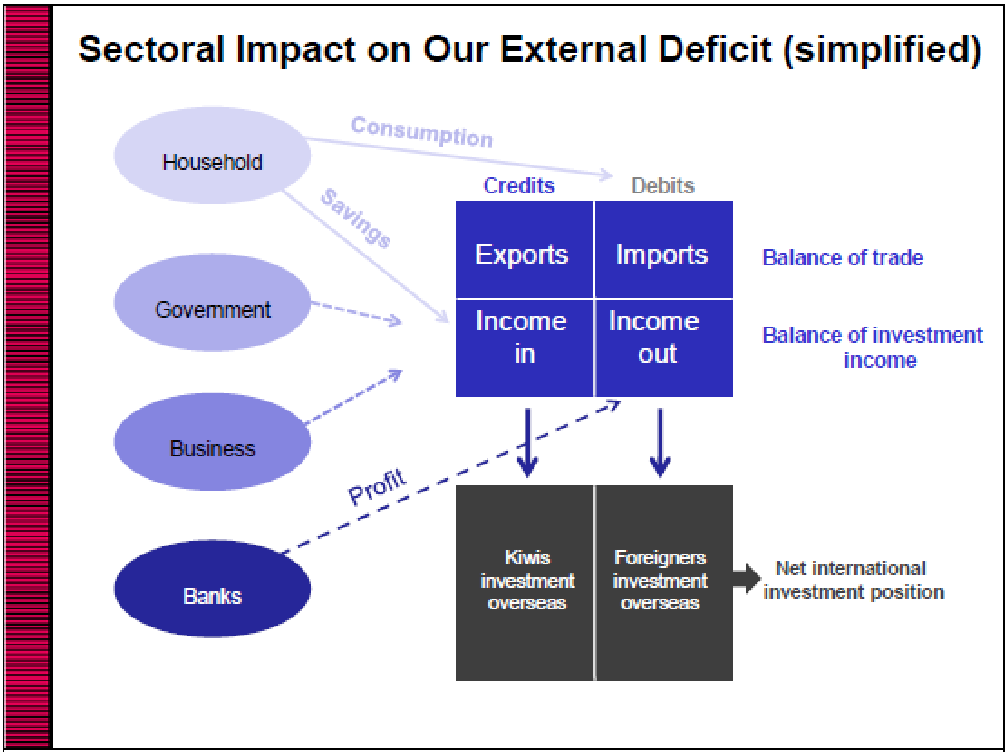
As the recent IMF Report on New Zealand makes clear, there are a number of aspects of our external position that are unusual by world standards:

- We have relatively high foreign investment here, but we do not do much investment overseas.
- We have high levels of private debt, predominantly overseas funded, short-term, but fx hedged.
- Almost all of this debt is channelled through bank lending.
- We do not save much, with very limited financial savings and stocks and shares.
- Overwhelmingly our household assets are invested in housing and other property.

4. How to reduce our vulnerability

If this growth in our external indebtedness cannot continue, then it will not. But rather than await the market descriptions noted above, are there proactive steps that can improve the situation?

The diagram shows a highly simplified picture of how the actions of households, businesses, banks and government feed into our balance of payments, in a way that over time drives our net international position. While the actions of government and businesses can be significant, the real impact comes from household consumption and savings, and from the actions of banks.



With this is mind, how can we see this external position best being controlled and improved?

Reducing our external vulnerability is a long-term proposition that would mean running lower current account deficits than we have in the past and sustaining them over an extended period, not just one or two years. Our calculations suggest that reducing current account deficits to no more than about 5 percent of GDP on average is necessary to stabilise the Net Investment Position as a share of GDP, while reducing that share over time would require lower deficits to be run.

There are many factors that can influence the size of our deficits, some of which are within New Zealand's control and some that are not. Changes in national savings, the terms of trade, exchange rates, interest rates, and the fiscal balance can all affect New Zealand's external vulnerability. Most would take some time to have an effect on the external balance sheet.

From a policy perspective, there are no magic bullets for running better current account balances. However, there are a range of policy areas underway that can certainly make a positive difference:

- Continuing to move New Zealand's tax system in favour of saving rather than consumption.
- Ensuring fiscal policy remains focused on achieving a conservative path for the public debt.
- Ensuring that our framework for financial regulation discourages excessive rates of credit expansion and excessive leverage. The core funding requirement for banks is already resulting in a lengthening maturity structure for their offshore borrowings which has helped them reduce their exposure to recent financial market volatility.
- Continuing to search for ways to help ensure that monetary policy adjustment is not borne excessively by the tradables-producing industries. However some of this will continue to be dependent on how other countries run their exchange rate policies.

- Ensuring that public policy facilitates investment activities that achieve sustainable real returns and does not inadvertently encourage activities that are of little lasting economic value.

But this challenge is not primarily up to the Government. It mainly requires the changes that we are seeing in household behaviours to continue. Helping them are higher returns for bank deposits, revamped regulation of financial advisors, investment offers and finance companies, more attention to financial literacy, and a rising interest rate track which favours savers. More of these savings will be in asset areas other than property and some of them will be in overseas investments. Ultimately the onus is on households to continue the current trend of saving more and investing better.