Graeme Wheeler: The building blocks of the economic expansion

Speech by Mr Graeme Wheeler, Governor of the Reserve Bank of New Zealand, to the Canterbury Employers' Chamber of Commerce, Christchurch, 31 January 2014.

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Introduction

Small open advanced economies like New Zealand tend to have economic cycles that are heavily influenced by developments in the global economy. We saw this when our growth rate slowed during the Asian financial crisis in the late 1990s and the collapse of the dot-com bubble in the United States three years later, and, most recently, during the global financial crisis (GFC).

Over the past two years our economy has outperformed most of the advanced economies. Our growth rate has averaged 2.7 percent, or twice the average of the group of 35 advanced economies in the IMF classification. Most of our economic indicators are positive with the terms of trade at a 40-year high, business confidence is the strongest since 1993, and consumer confidence is at a seven-year peak.

This afternoon, I would like to offer some thoughts on the reasons for our stronger economic performance, and discuss the nature of the expansion and the challenges facing the Reserve Bank in helping to ensure that the expansion can be sustained.

2008 – 2011: Four difficult years

Although New Zealand experienced a shallower recession than most of the advanced economies during the GFC, the economy has faced many difficult adjustments in recent years. These include: the liquidation of over 60 finance companies beginning in 2006 and 2007; the collapse of global trade in 2008 and 2009; droughts in 2008 and 2012; and the devastating Canterbury earthquakes in 2010 and 2011.

The earthquakes, in particular, had a profound human and economic impact that will continue to be felt for many years. On a global scale, the Canterbury earthquakes are among the 10 costliest natural disasters in recent history. Relative to the size of the economy, the earthquakes are the most severe natural disaster faced by an advanced economy in recent times (table 1).[1]

Table 1: Cost Comparisons of Natural Disasters

	Cost in billions of US dollars	Cost relative to GDP %
Canterbury	33	20
Japan – tsunami	200-250	3.5 – 4
US – Hurricane Katrina	150	1

1 Natural disasters in developing countries have in several cases been more deadly and had a larger cost relative to GDP than disasters in the advanced economies, even if insured losses have been low. For example, the 2010 earthquake in Haiti is estimated to have a death toll of over 220,000 and an economic cost of over 100 percent of Haiti's GDP.

In Canterbury, businesses closed, residents moved away, and foreign students and tourists stopped coming. Businesses that exported or competed against imported goods and services also faced the twin burdens of the high New Zealand exchange rate and more aggressive pricing by foreign competitors as global trade volumes slowed.

In order to facilitate recovery in the economy, while maintaining the Reserve Bank's obligations for price stability, we lowered the official cash rate to 2.5 percent, and helped to generate the lowest retail interest rates in 60 years.

The forces behind New Zealand's economic recovery

Several factors beyond monetary accommodation contributed to New Zealand's economic recovery. These include: the recently improved economic climate in advanced countries; high export prices for our major commodities; the strength of construction investment, particularly in Canterbury; and the range of other factors driving the increase in private consumption.

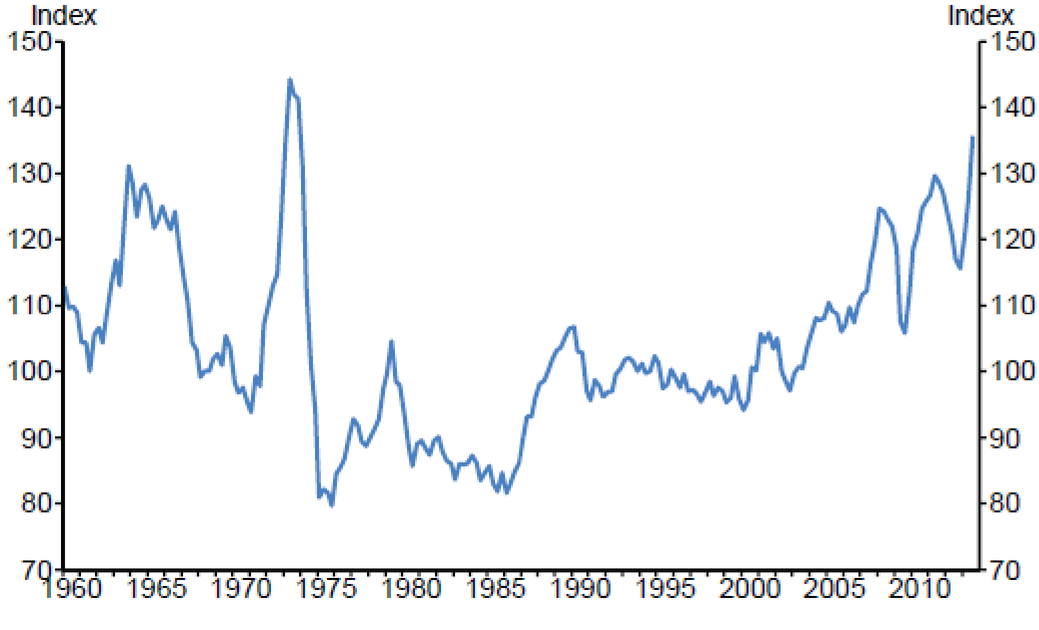
(i) The international economy

The global economy is recovering after many years of fragility and uncertainty. Output growth has increased in recent months in several advanced and emerging countries. World trade volumes are increasing and the global economy is now growing at about its average rate over the past three decades – albeit with exceptional monetary stimulus from central banks in the major economies. Business conditions have improved in the United States especially, and in Japan and in the United Kingdom. The euro area has emerged from recession but the recovery is slow and uneven. China, the world's second largest economy, is growing at around 7.5 percent.

(ii) The high terms of trade

New Zealand's terms of trade are at their highest level since 1973 (figure 1).

Figure 1 : New Zealand's Terms of Trade

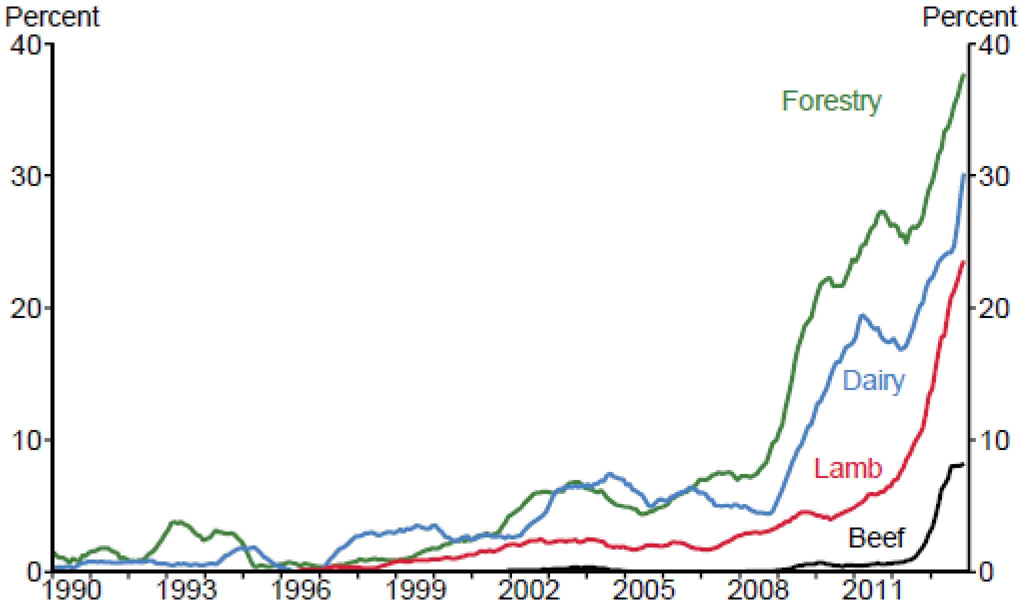


Source: Statistics New Zealand.

Our farmers, especially, are enjoying very favourable export commodity prices and an excellent season of grass growth. Considerable focus is on the extremely high international dairy prices, but aside from aluminium, all of the sub-categories of the ANZ Commodity Price Index are at or near record highs. Strength in the New Zealand dollar is distributing some of these gains to the broader spending public, but, even accounting for this, export prices in New Zealand dollar terms are well ahead of those received in the 2008 commodity price boom.

New Zealand is benefiting considerably from its export linkages with the rapidly growing economies of East Asia, especially China, and with Australia. Over the past decade China's share of our exports has increased from 3 percent to 21 percent. China is now our largest export market for all our agricultural commodities except beef, where it is second only to the United States (figure 2).

Figure 2 : China's share of selected New Zealand exports



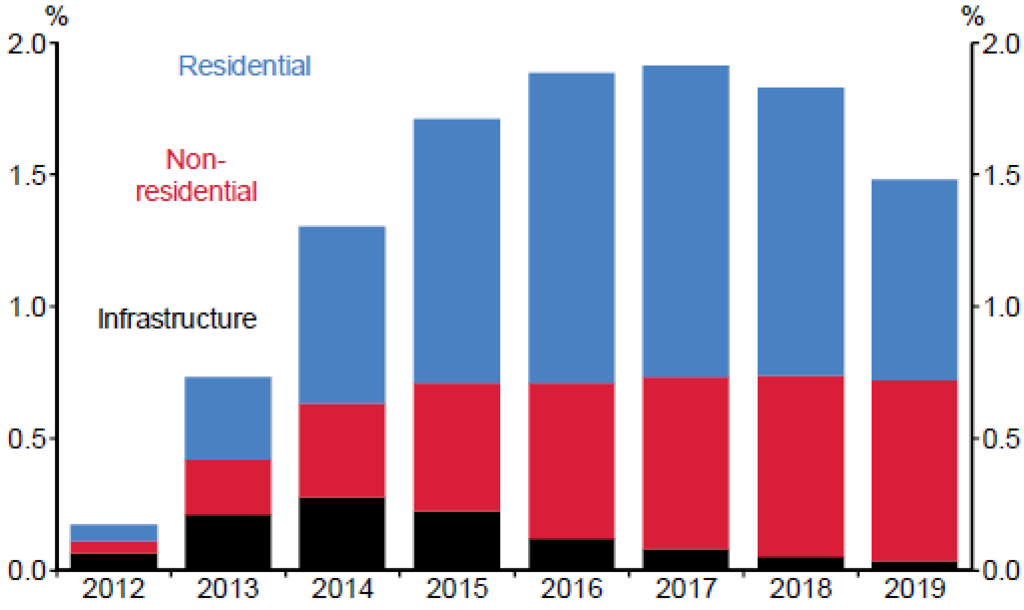
Source: Statistics New Zealand.

(iii) The strength of construction investment

Over the past two years, construction investment has increased by 40 percent, largely due to the Canterbury re-build. The cost of the Canterbury re-build is forecast to be around NZ$40 billion in current prices, or around 20 percent of annual GDP. This massive reconstruction is a unique feature of the New Zealand outlook. It will have a major impact on the local and national economy for a number of years to come.

Although there is considerable uncertainty as to the magnitude and phasing of the re-build, annual construction investment associated with the re-build is projected to peak in 2016 and 2017 at around $4 billion. In terms of its contribution to New Zealand's GDP growth, reconstruction-related investment is expected to peak in 2014, with investment doubling relative to 2013 (figure 3).

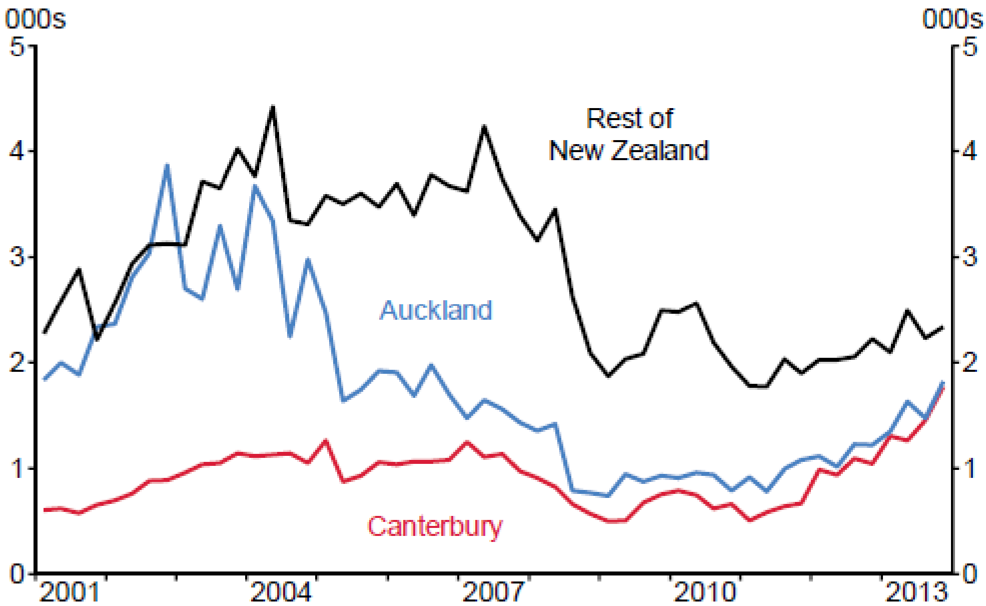
Figure 3 : Earthquake-related investment and reconstruction (annual, calendar years, share of potential GDP)



Source: RBNZ estimates.

Construction activity is also increasing in Auckland. Residential consent issuance is running at 6000 per year – double the rate of mid 2011 (figure 4). The Auckland Accord set a target of 39,000 new housing consents over a three-year period and the Government, together with the Auckland Council, recently designated special housing areas for fast-track resource and building consent with capacity for 15,500 new homes.

Figure 4 : New dwelling consent issuance (quarterly, seasonally adjusted)



Source: Statistics New Zealand.

If these targets for Auckland are met over the next three years, and if 12,000 new homes are constructed in Christchurch, as predicted, then construction volumes would need to be 10 percent higher than in 2004, which represented the peak of the last building boom. This estimate, however, assumes no growth in home building in the rest of the country. Pressures on the construction industry will also increase with New Zealand's infrastructure needs and repairs on the remaining 42,000 leaky buildings nationwide.

(iv) Growth in private consumption

Real private consumption has been growing at an annual rate of around 3.5 percent in 2013 as a result of many factors: the high terms of trade, the 40,000 person increase in employment, the 20,000 person increase in permanent and long-term immigration, the 9.5 percent increase in house prices, strong consumer confidence and low real interest rates. Private sector consumption and investment have driven the recovery and accounted for much of New Zealand's economic growth over the past two years.

Can the economic expansion be sustained?

In small advanced open economies, expansions usually come to an end for one or more of the following reasons: growth in the global economy slows; the nation's terms of trade decline significantly; a major policy correction is needed to address a deteriorating fiscal or current account deficit; or interest rates rise significantly in order to moderate rising inflation pressures associated with growing supply and demand imbalances. The economic slowdown is intensified if the adjustment is accompanied by a sizeable decline in house prices.

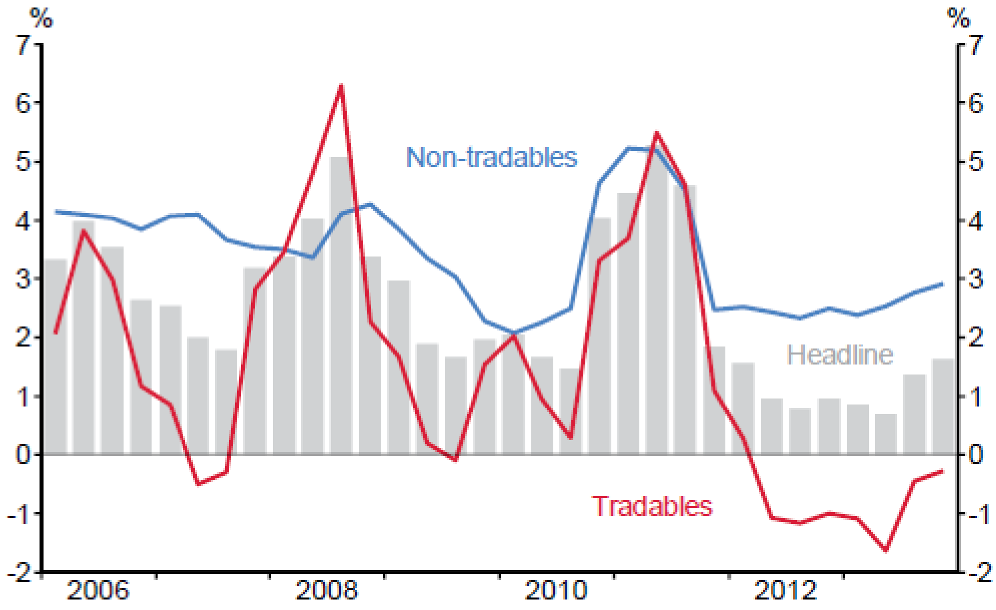
Are any of these factors likely to end New Zealand's current expansion?

A further slowdown in global growth remains possible given the vulnerabilities in several major advanced economies due to low productivity growth and high levels of public and private sector debt. The areas of greatest risk lie in a potential faltering of momentum in the euro area, and the rapid build-up in debt levels in China, part of which originated in the shadow banking sector. However, international financial institutions such as the IMF and World Bank have recently increased their central forecasts for global growth and the sentiment at the World Economic Forum in Davos earlier in the month was generally more upbeat, despite market jitters around some emerging market economies.

Some reduction in the terms of trade might be expected in light of their high level and the projected increase in world dairy supply. But any decline in export prices is likely to be moderated by the improving outlook for global growth and world trade. The current account deficit is expected to deteriorate with increased imports, but not to provoke a severe adjustment. Nor are major changes in fiscal policy envisaged. The Treasury's forecasts suggest that the fiscal outlook is for a small surplus in the 2014/15 financial year and surpluses of around 2 percent of GDP in 2017/18.

An important risk to the expansion lies in the increase in inflation pressures, and the rise in interest rates necessary to contain them. Annual consumer price inflation is currently 1.6 percent. As shown in figure 5, inflation in the tradables sector has been negative for the past 21 months, mainly due to the high exchange rate, and intensive international competition associated with the global oversupply of manufactured goods. Non-tradables inflation is currently increasing at an annual rate of 2.9 percent and is expected to rise towards 4 percent as the labour market tightens and capacity bottlenecks increase, especially in the construction sector.

Figure 5 : CPI, tradables and non-tradables inflation (annual)



Source: Statistics New Zealand.

Some increase in inflation pressure is inevitable as the economy is growing more rapidly than potential output.[2] Potential output growth slowed in the recession of 2008/9 and has not regained its pre-recessionary rate. We estimate that over the last two years potential output has grown by a little over 2 percent annually, compared with average GDP growth of 2.7 percent. This gap between the actual growth rate and the potential growth rate increases pricing pressures in the economy.

Some factors are constraining the recovery in potential output growth. While New Zealand's labour force participation is close to its pre-recession peak and the unemployment rate is falling, data suggests that skilled labour is becoming more difficult to find. The share of investment in GDP fell sharply in the recession and is now only back to its pre-recession level. Labour productivity only surpassed the pre-recession level in 2011 and OECD data suggests that multifactor productivity fell during the recession and has been slow to recover.

Price pressures are particularly apparent in the construction sector as resources are reallocated to Canterbury and Auckland from other regions and activities, and spare capacity in the economy is being absorbed at a rapid rate. Such cost pressures could spill over into broader consumer price inflation, particularly if the construction sector reaches capacity constraints (employment in the sector is currently 9 percent below its 2006 peak). Household debt is rising again and households are forecast to spend more than they earn in 2014. Stronger inflation pressures and the increase in interest rates that would accompany them could put pressure on New Zealand's real effective exchange rate and reduce the competitiveness of our export and import-competing industries.[3]

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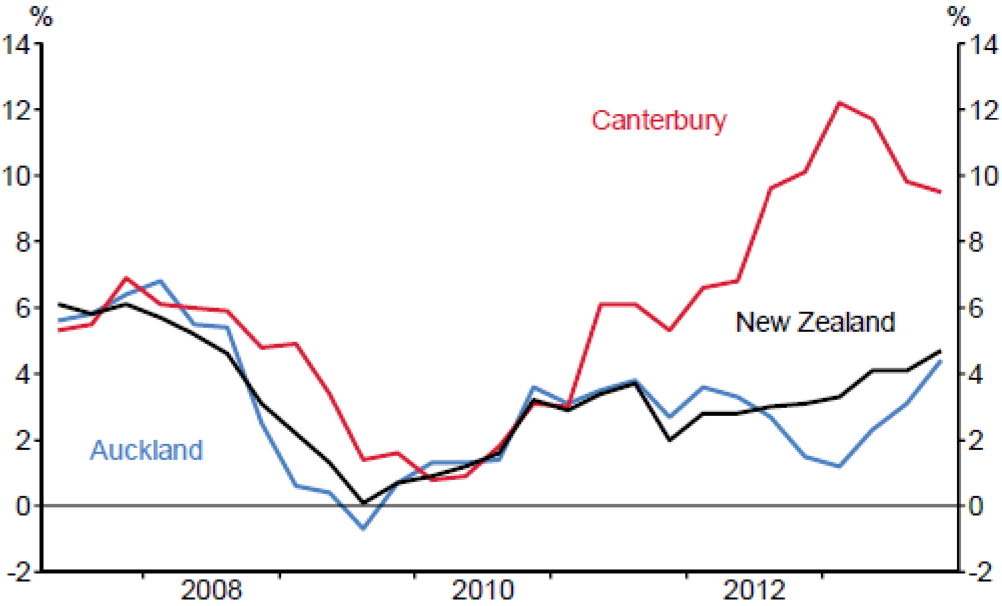
[2] Potential output is the rate of growth that the economy can sustain at full employment without generating inflationary pressures.

[3] The real effective exchange rate provides a more accurate picture of competitiveness than the nominal effective exchange rate as it corrects for differences in relative inflation rates (or relative unit labour cost movements) between New Zealand and its major trading partners.

Increases in the price of construction services in Canterbury are needed to attract resources to the re-build, but a key issue is whether they are spilling over into other sectors and regions. There are signs that this is starting to happen. Annual construction cost inflation in Auckland and the rest of the country has risen steadily over the past 12 months and is currently running at 5 percent (figure 6).

Figure 6 : Construction cost inflation (annual)



Source: Statistics New Zealand.

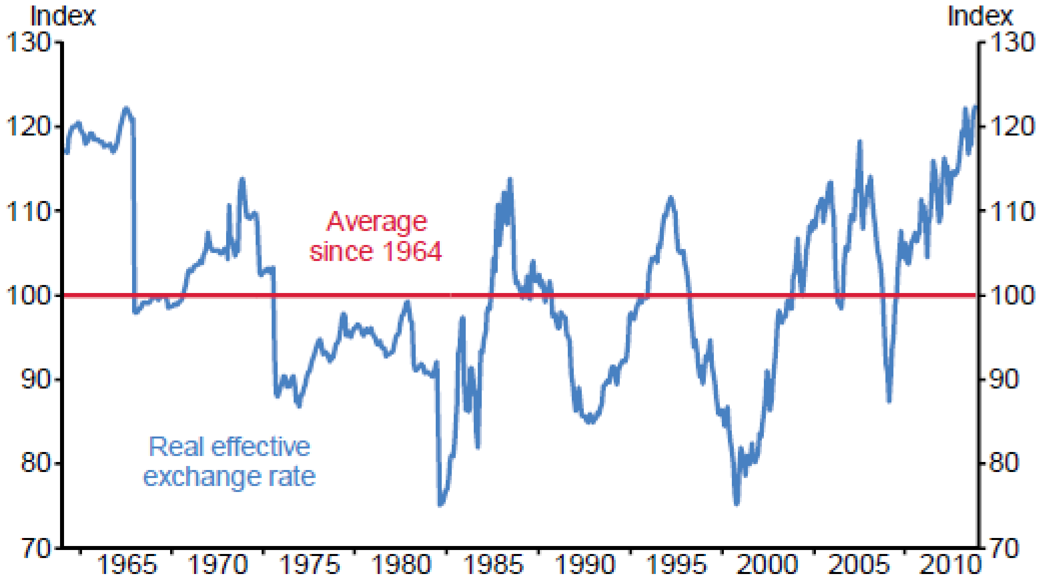
Inflation pressures may also intensify if there is a rapid fall in the exchange rate. Exchange rate corrections can never be ruled out, especially when the exchange rate remains close to historic highs on a TWI basis and in the top decile of historic experience against the major currencies, including the Australian dollar. The New Zealand exchange rate has experienced rapid and prolonged falls on several occasions over the past 30 years (figure 7).

The monetary policy response to a sudden correction in the exchange rate would depend largely on what triggered it. An interest rate response might be warranted if it were driven, for example, by portfolio investors reducing their exposure to New Zealand with few real economic factors underpinning it. It may not be needed if the decline in the exchange rate was driven by a sharp fall in the terms of trade.

A further risk to the expansion is the level of house prices. By historic and international comparisons, New Zealand house prices are overvalued. A recent OECD study indicated that house prices in relation to income are 25 percent above their long-term averages, while rents are 60 percent above.[4] The situation is exacerbated by household debt levels of around 150 percent of household disposable income that are again on a rising trajectory.

[4] OECD Economic Outlook, Volume 1, May 2013.

Figure 7 : New Zealand's real effective exchange rate



Source: Bank for International Settlements

While a substantial fall in New Zealand house prices is unlikely, such a fall could happen if there was a marked deterioration in the household sector's ability to service its mortgage debt due to a sharp rise in unemployment, falling incomes, or very high domestic interest rates. A sharp correction of the type seen in several advanced economies in recent years would likely be accompanied by a domestic recession. The housing market poses risks to financial stability and the broader economy, and is a major reason why the Reserve Bank introduced speed limits on high loan-to-value ratios for residential mortgages in October 2013. At present, we have limited data relating to the post-LVR period. The information to date suggests that housing turnover and the rate of house price inflation may be easing, but this could be due either to LVR restrictions or other factors such as house affordability. It will be some time before we can gauge the overall effect of the measures.

Monetary policy going forward

The Reserve Bank's goal under the policy targets agreement is to keep future average inflation near the 2 percent target midpoint. Achieving this will help to ensure that economic activity is kept more in line with the potential growth of the economy, thereby promoting a more sustainable growth path.

Further, price stability itself has benefits for long-term economic growth. It enables households, businesses, and governments to plan with greater certainty; it facilitates long-term contracting; lowers the inflation risk premia embedded in interest rates; and enables producers, consumers, and investors to respond to opportunities created by changing relative prices rather than diverting resources to hedge against inflation. These benefits are eroded when inflation and inflation expectations become excessive.

If actual inflation and expectations of future inflation were to rise significantly, competitiveness and real income growth would decline. The Bank's subsequent efforts to maintain price stability by raising nominal and real short term interest rates would be more disruptive, the further inflation was allowed to deviate from target.

Assessing the timing and magnitude of increases in the OCR involves difficult judgements because changes in interest rates tend to affect the rate of growth of output and inflation with a 12 to 18 month time lag, although it can be more rapid if the main transmission effects operate through the exchange rate. This means that interest rate judgements need to assess the degree of inflationary pressure in the economy throughout the forecast period and how inflation expectations and pricing behaviour might change in response to different levels of the OCR. These are judgements we face all the time. The complexity of them is increased in current circumstances by the fact that New Zealand's terms of trade are at a 40-year high; our exchange rate remains close to historic highs on a TWI basis; the economy is reallocating resources to meet construction needs in Christchurch and Auckland; rising house price inflation is adding to consumer demand; net migration is increasing rapidly; and the United States is cutting back the scale of its quantitative easing.

The Reserve Bank's approach in assessing interest rate responses is driven by a combination of models, data, and judgement. We assess new economic information and whether it is different from the assumptions built into our published economic forecasts and interest rate projections. In the past six weeks for example, indicators on New Zealand's economic growth and inflation have been stronger than those built into our December projections, but the exchange rate has also been stronger and initial indications are that house price inflation may be starting to moderate, although it is too soon to draw firm conclusions. The exchange rate remains a considerable headwind for the economy, and the Bank does not believe its current level is sustainable in the long run.

We will undertake a comprehensive assessment of the outlook in the next Monetary Policy Statement in March when further information will be available.

The Reserve Bank's projected path of interest rate rises contained in the December Monetary Policy Statement suggests that the OCR will need to rise by around 2 percentage points over the next two years. Yesterday we kept the OCR unchanged at 2.5 percent, but signalled that inflation pressures are rising and that interest rates will need to return to more normal levels in order to keep future average inflation near the 2 percent target mid-point. We also indicated that the scale and speed of the rise in the OCR will depend on future economic indicators.

Conclusion

This afternoon, I have outlined the factors behind New Zealand's strong economic growth, and the challenges facing the Reserve Bank in helping to ensure that the expansion can be sustained.

We have supported the recovery through low policy rates. We recognise that the economy has been growing faster than potential growth for some time. Although headline inflation has been moderate, inflationary pressures are building and are expected to increase over the next two years. In such an environment, there is a need to return interest rates to more-normal levels and the Bank expects to begin this adjustment soon.

Achieving this will help to ensure economic activity is kept more in line with the potential growth of the economy, thereby promoting a more sustainable expansion.