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NEW ZEALAND INSTITUTE OF ECONOMIC RESEARCH

NZ is no Greece or Italy, but needs to face up to long term issues

Like much of the world, New Zealand's economy is still feeling the lingering consequences of the global financial crisis and the hang-over of its own asset price bubble.

The economy is recovering slowly. In the last few years, households have spent cautiously and paid down mortgages. This was an adjustment that needed to happen. But net foreign liabilities are still very high and recent credit growth raises concerns that the adjustment has not been enough. Major action will be needed to contain the ageing-related growth in government spending that is about to hit us, and lift economic growth.

Steps have been made in the right direction, but further reforms are needed. New Zealanders need to be prepared to make sacrifices in the short run to make progress in the long run. The longer we delay action, the bleaker our prospects.

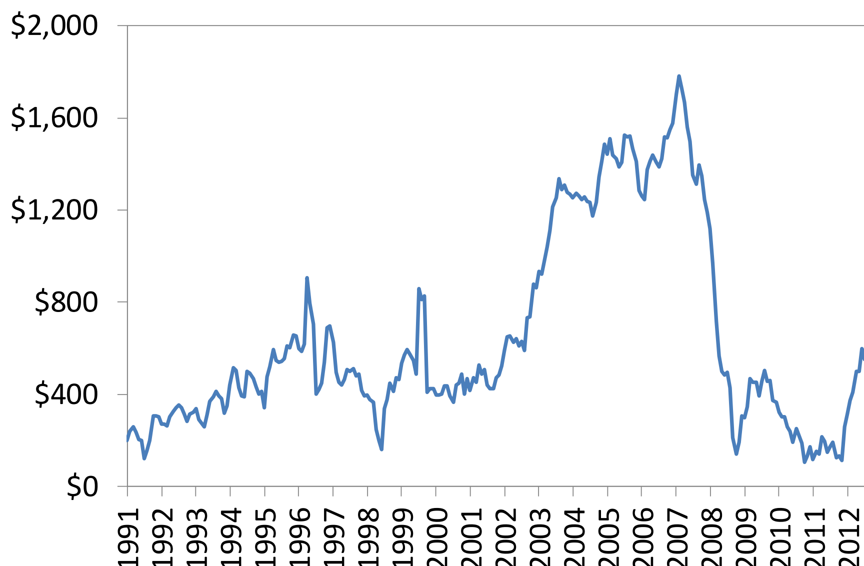
A return to bad old habits?

Household borrowing is on the rise again. Borrowing growth has accelerated sharply over the past year. Home equity withdrawals are reappearing. This reverses three years of households repaying principal to increase the equity in their homes. Is this a temporary catch up, or was the improved savings rate just a blip?

We know we need to be vigilant: our economy is imbalanced internally and externally. We have high household debt, house prices are very high compared to incomes, fiscal pressures are increasing, and foreign liabilities are of Southern European proportions.

Figure 1 Resurgent borrowing a return to old habits?

Household credit growth per month



Source: RBNZ

The European experiences in the last few years show what happens when income and spending and other macro-economic conditions get significantly out of balance. The severe economic and social pain that goes hand-in-hand with forced restructuring and austerity is evident in countries like Spain and Greece; meanwhile, Italy seems to be in denial about the need to deal with its economic problems.

Luckily New Zealand is no Greece or Italy, yet. But we need to take steps to improve New Zealand's economic growth performance, and ensure government policies do not add to imbalances, but reduce them.

New Zealand suffers from persistent economic imbalances

While the economy is now showing some more positive signs, trends in key economic indicators tell us that we have work to do.

NZIER has assembled indicators of economic risk, inspired by the European Commission (EC) monitoring report aimed at preventing and correcting macro-economic imbalances.[1] We have amended them to better suit our situation. For context, the appendix reproduces the EC table, with New Zealand's latest statistics.

To give a sense of the longer term position, we present indicators for the last decade. We chose 2000 as representing the position just before the long credit-fuelled boom kicked off; 2007 represents the peak, and 2012 shows our current position.

The table shows mixed messages. For example, the current account balance and house price index have improved somewhat. But our net foreign liability remains uncomfortably high, and is well above the comfort threshold suggested by the EC. This position makes New Zealand vulnerable to economic and other shocks.

Table 1 Economic indicators point to imbalances

	EC's threshold	2000	2007	2012	
Current account balance (% of GDP)	-4%/+6%	-4.7%	-8.1%	-5.4%	
Net international investment position (% of GDP)	-35%	-79%	-74%	-73%	
Real effective exchange rate index	n/a	71	99	101	
Real house price index	n/a	98	177	157	
House price to income ratio	n/a	3.6	5.5	5.1	
Private sector debt (% of GDP)	160%	105%	146%	148%	
Public sector debt (% of GDP)	60%	33%	21%	40%	

Source: Statistics NZ, European Commission Macroeconomic Imbalance Procedure Scorecard

[1] European Commission. 2012. *Alert Mechanism Report. Report prepared in accordance with Articles 3 and 4 of the prevention and correction of macro-economic imbalances*. COMS (2012) 68 Final. Brussels. 14/2/2012

The exchange rate is high by historic standards. This reflects the relative strength of New Zealand's economy compared to other advanced economies mirrored by real interest rates that are higher than elsewhere.

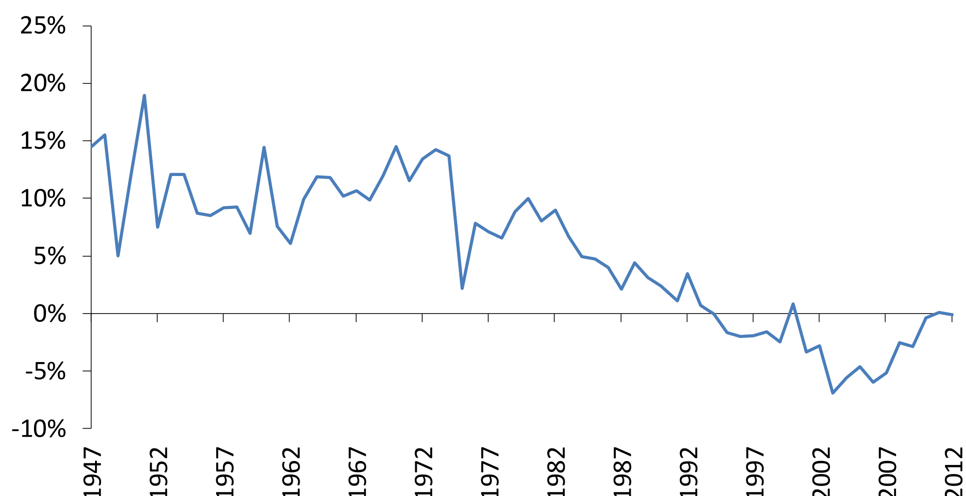
Private sector debt, after a short period of improvement, is again being added to and will contribute to the current account deficit. In the next few years, the current account deficit is forecast to again exceed the uncomfortably high 8% of GDP.

It is not that debt is necessarily bad. But it is not obvious that all this borrowing is used to boost our productive capacity that will allow us to repay the debt and permanently lift living standards. The concern is that the vast majority of private sector credit growth is occurring in the household sector, rather than for business investment.

We have not yet resolved the long-standing imbalance between domestic saving and investment. There are signs that the very recent improvement in household savings may not have been lasting. It has not been sufficient to turn around almost 40 years of current account deficits.

Figure 2 Recent improvement in household savings is evaporating

Household savings rate 1947-2012



Source: Statistics New Zealand, NZIER

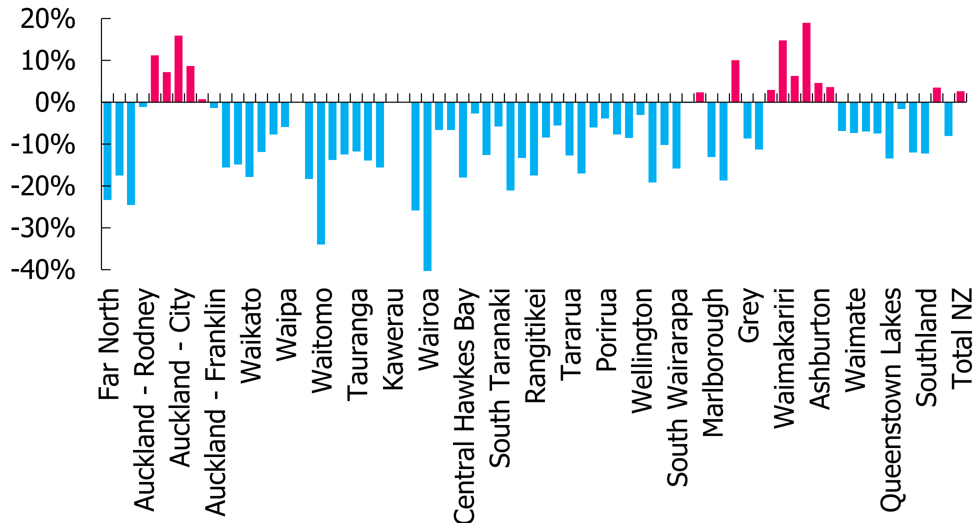
House prices have fallen in real terms. But the house price to income ratio is still very high by historical standards, and prices have recently started to rise, particularly in Auckland and Canterbury. Whether this situation reflects regulatory distortions, or temporary localised supply pressures, this asset class still appears overvalued, exposing owners in the long run.

Public sector debt is still manageable compared to international standards. The recent deterioration is explained by the recession and the response to the Canterbury earthquakes. The short run position is of limited concern, particularly given the clear commitment to return to surplus and manage down debt.

The longer term fiscal pressures from an ageing population set off alarm bells, however. Difficult decisions need to be made to constrain what otherwise will be unsustainable growth in total spending. The worry is that, given the demographics, the necessary decisions will be seen as political suicide and deferred until New Zealand too is in the no-choice position that Greece, Spain, Portugal and others have found themselves.

Figure 3 Local house price rises risk exacerbating overvalued market

House price change from peak in 2007 to January 2013 by Territory authority



Source: QVNZ (not all TLA names listed in graph)

The way out

The Global Financial Crisis presented the impetus for New Zealand to tackle its fundamental economic imbalances. We have made some progress, but internal and external vulnerabilities to worsening conditions remain a real concern.

While households did pull back on 'borrow and spend', there are emerging signs this may not have been the permanent change in behaviour that is needed. Proposals have been made to improve household saving, for example by reducing tax distortions and improving financial literacy.[2] But the impact of such changes will only be gradual.

It is therefore all the more important that actions are taken on the policy front to reduce exposure.

Recent announcements on tools for the Reserve Bank to help it dampen housing bubbles or credit booms, through higher loan-to-value ratios or requiring banks to hold more capital, will help. But those deal with symptoms rather than the disease, and raise their own efficiency problems.

Major action will be needed to contain the ageing-related growth in government spending that is about to hit us; there is no evidence yet that sufficient steps are being taken on this front. More generally, government spending needs to be well-targeted, offer high value for money and not crowd out private enterprise.

More action is also needed to lift economic growth, to provide the means to pay for debt and more headroom to save. In this area the best government can do is to make sure incentives and institutions reward skills and enterprise. The tax and regulatory environment needs to again be world-beating and open to business investment, to overcome New Zealand's small scale and distance to markets.

The government has made steps to improve tax and policy settings. These picked up on a number of the recommendations made by working groups on productivity, tax, investment and savings.

[2] See, for example, Tax working Group and Savings Working Group reports.

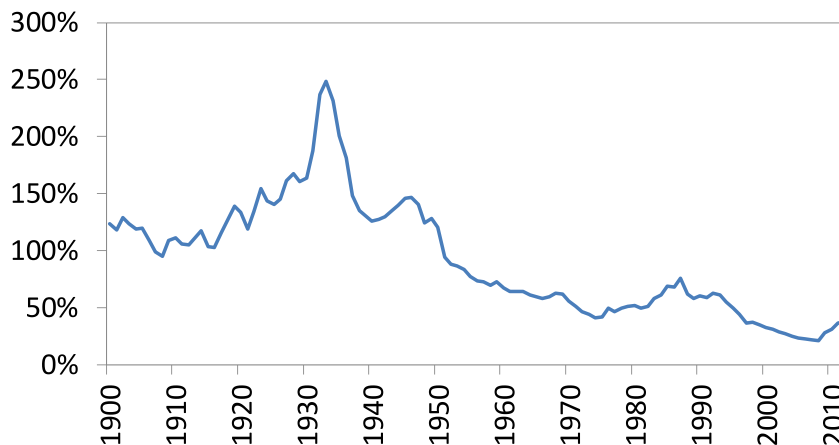
The programme of reforms set out in the Business Growth Agenda, and opportunities for reform presented through the Productivity Commission's reviews, all have potential to make a further contribution to improve economic performance. None are game changers.

But there is a risk that meaningful reforms that help address imbalances will not be attempted. These are the reforms that involve sacrifices in the short run to make progress in the long run. There are reforms that tackle some of the holy cows, like restrictions on foreign direct investment, the age of eligibility for NZ Superannuation, and interest free student loans.

The politics might be stacked against action on holy cows like these. But if New Zealanders want a better New Zealand, they need to accept that not everybody can be a winner or that the rewards are immediate when it comes to meaningful reform. The longer we delay action, the bleaker the long-term prospect for living standards and the more vulnerable we are to major social and economic disruption.

Figure 4 Public sector debt position manageable for now

Core Crown debt



Source: RBNZ, The Treasury

1900–1970 gross debt: Reddell and Sleeman (2008). 1970–current for all indicators: Historical Fiscal Indicators 1972–2012, published by the Treasury at www.treasury.govt.nz/government/data

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Appendix A How do our imbalances compare to Europe?

The EC scores its member states on indicators of external imbalances and competitiveness and internal imbalances.

External imbalances

Current account balance – the balance between investment and saving. A deficit may reflect rational decisions, such as investment in productive capacity to raise future incomes. But persistent deficits are associated with financial crises.

Net international investment position – the sum of current account balances over time. A high negative position is associated with crises, as a country becomes vulnerable to investor willingness or ability to lend. Debt is unsustainable when a country finds it even struggles to generate the income to service only the interest.

Real exchange rate – one (imperfect) indicator of a country's competitiveness. A high real exchange rate relative to that of trading partners could indicate a relative loss of productivity or competitiveness.

Export share – another indicator of competitiveness.

Nominal unit labour cost – changes in nominal unit labour costs indicate wage rises that are not explained by productivity changes, and thus a country's competitiveness.

Internal imbalances

House prices – as households' most significant real asset, significant changes in house prices are linked to households' consumption decisions (wealth effect) and investment decisions. Distortions in this market can lead to boom and bust cycles and broader macroeconomic imbalances.

Private and public sector debt – while there is no optimal level of debt, high levels of debt make a country vulnerable to economic shocks. The sum and composition of debt affects risk and prognosis for action.

Unemployment rate – an indicator of the flexibility of the labour market and economy. A persistently high unemployment rate would suggest a mismatch of resources, and barriers to structural adjustment.

Summary assessment: on the metrics below, New Zealand compares reasonably well, except for our international indebtedness and private sector borrowing.

New Zealand's current account deficit is on the margin of the EC's comfort zone. The net international investment position is more than double the EC's threshold.

Private sector debt remains uncomfortably high. This source of vulnerability is partly offset by a (still) relatively low public sector debt and a relatively modest unemployment rate (as one indicator of the ability to service debt)

	3 year average **Current Account Balance** (% GDP)	**Net international invesment position** (% GDP)	% change (3 years) in **real effective exchange rate**	% change (3 years) in **Export Market Share**	% Change (3 years) in **Nominal unit labour costs**	%yoy change in **deflated house prices**	**Private sector debt** (% GDP)	**Public Sector debt** as (% GDP)	3 year average **unemployment rate**
Thresholds	-4/+6%	-35%	+/-5% & +/-11%	-6%	+9% & +12%	+6%	160%	60%	10%
NZ (latest)	**-4**	**-73**	**16**	**3**	**7**	**3**	**148**	**40**	**7**
Europe (2010)									
BE	-1	78	1	-15	9	0	233	96	8
BG	-11	-98	10	16	28	-11	169	16	8
CZ	-3	-49	13	12	5	-3	77	38	6
DK	4	10	1	-15	11	1	244	43	6
DE	6	38	-3	-8	7	-1	128	83	8
EE	-1	-73	6	-1	9	-2	176	7	12
IE	-3	-91	-5	-13	-2	-11	341	93	11
EL	-12	-93	4	-20	13	-7	124	145	10
ES	-7	-90	1	-12	3	-4	227	61	17
FR	-2	-10	-1	-19	7	5	160	82	9
IT	-3	-24	-1	-19	8	-1	126	118	8
CY	-12	-43	1	-19	7	-7	289	62	5
LV	-1	-80	9	14	0	-4	141	45	14
LT	-2	-56	9	14	1	-9	81	38	13
LU	6	97	2	3	17	3	254	19	5
HU	-2	-113	-1	1	4	-7	155	81	10
MT	-5	9	-1	7	8	-2	212	69	7
NL	5	28	-1	-8	7	-3	223	63	4
AT	4	-10	-1	-15	9	-2	166	72	4
PL	-5	-64	-1	20	12	-6	74	55	8
PT	-11	-108	-2	-9	5	0	249	93	10
RO	-7	-64	-10	21	22	-12	78	31	7
SI	-3	-36	2	-6	16	1	129	39	6
SK	-4	-66	12	33	10	-5	69	41	12
FI	2	10	0	-19	12	7	178	48	8
SE	8	-7	-3	-11	6	6	237	40	8
UK	-2	-24	-20	-24	11	3	212	80	7