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Big bang vs creationism

Implications of the credit crisis

- **The credit crunch will send USA and Europe into recession, and cause a slowdown in Asia.**
- **New Zealand will be hit by less access to credit and lower commodity prices.**
- **The exchange rate will act as the buffer.**
- **The end game is an adjustment where New Zealand will have to live within its means.**

Any number of adjectives can be applied to events occurring in global financial markets: jaw-dropping, unbelievable, spooky, unprecedented, meltdown, implosion, wild-fire, panic, capitulation, contagion, pant soiling, and plain old scary. The big bang in financial markets has meant credit creation in developed economies has slowed to a trickle.

The events of the past couple of weeks, in particular, have been revelational. It is telling that equity markets keep capitulating, and credit markets remain frozen, despite the passing of the $700bn US mega-bailout proposal, bank nationalisations, massive injections of liquidity, promised deposit guarantees and co-ordinated interest rate cuts by central banks.

Up until now, the world had been slowing in slow motion. A positive net export position saw the US post robust economic growth in H1 2008 despite the woes in its housing, financial, consumer and automotive sectors. Growth in developing economies had proved resilient and commodity prices kept rising until early July.

No longer. Although international credit markets will eventually resume some semblance of function, problems will persist, as we are yet to see the impact of recession on consumer, credit card, student loan, and business debt / defaults. Credit creation in the developed world will be weak, sending the world's two biggest economic blocs into twin recessions. That would undermine Asia's exporting base and cause a slowdown there. The Asian slowdown, while nasty, will be more moderate than the developed world's since Asia has no debt problem and could get a boost from falls in commodity prices.

Impact on New Zealand

So far New Zealand has suffered falling share prices, falling house prices and failing finance companies. An additional double-whammy lies ahead. Previously high export commodity prices are starting to drop rapidly and they will probably fall further (although not as low as previous world downturns thanks to Asian urbanisation and tight supply).

An Achilles Heel for New Zealand is our reliance on foreign lending. For many years we have spent far more than we earn and borrowed the difference from offshore. This was always unsustainable in the long run. A correction of some sort was long overdue, but we didn't know when it would come or what form it would take. We have a better idea now.

At the time of writing US lending markets are virtually closed. When those markets re-open, New Zealand banks may find that the terms for borrowing money from offshore will be much tighter, and the loans more expensive. This will particularly be so if NZ deposit guarantees are not extended to wholesale funds, as is being mooted in Australia. If so, the banks would increase interest rates and tighten credit standards for New Zealand customers. Firms would find it harder / more expensive to borrow money for investment. New home buyers and investors would find it tougher to borrow, which would cause house prices to decline more rapidly. Homeowners could find that their falling house price prevents them from topping up the mortgage to finance renovations. The resulting disruption to economic activity would cause job losses, which would further disrupt economic activity, and so forth.

But for every action there is a reaction. The first consequence of foreigners' reluctance to lend to New Zealand will be a much lower New Zealand dollar (already in train). That's because a major source of demand for NZD – the "carry traders" who lend to us – will evaporate. We expect a further decline in the New Zealand dollar over coming months. Trying to pick the bottom is tough, but at this point it could get to somewhere in the low 50's against the USD.

A lower NZD would go a long way towards effecting the inevitable rebalancing. It would make imports more expensive and encourage New Zealanders to consume less. It would protect agricultural exporters from falling world commodity prices and would be a comfort to other exporters. Fewer imports and more

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exports would repair the yawning current account deficit. Lack of access to credit is not something that can be directly addressed through the currency, but as part of the adjustment process, the currency can undershoot its long-run 'fair' value, to the point where lenders can be lured back by the prospect of an exchange rate re-appreciation as well as the usual yield pickup.

Reserve Bank liquidity measures and monetary policy will be the reaction to tighter overseas credit markets. The RBNZ made it clear in the September *Monetary Policy Statement* that they intend to reduce the OCR to offset bank's rising cost of funding and prevent increases in mortgage rates. With the OCR so high now, the RBNZ has heaps of ammo.

The RBNZ has repeatedly expressed confidence in New Zealand's banking system. There is very little direct exposure to toxic mortgage-backed securities in the US. New Zealand's banks have been far more prudent than American or European ones. "Low-doc" and "sub-prime" loans are virtually non-existent, and the maximum loan-to-value ratios were 95% or 100%, whereas more was lent in USA and Europe. Securitisation, where banks on-sell mortgages in order to free-up capital and lend more money out, and which caused so many problems in the US, is rare in New Zealand (approximately 99.2% of bank-originated mortgages are held by the banks).

Falling house prices and a more cautious attitude toward risk have already encouraged less demand for borrowing in New Zealand, and more saving. A lower exchange rate will erode our purchasing power so that demand for credit could remain subdued. New Zealand's "funding gap" (the shortfall of domestic saving relative to lending) is rapidly shrinking.

The worst case scenario for New Zealand would be a sustained shutdown of overseas lending before we are ready to balance our own saving and lending. The RBNZ is very well prepared for this unlikely event. Measures are in place for New Zealand's banks to borrow directly from the Reserve Bank, using supranational, corporate or bank bonds, or even mortgage backed securities as collateral. These amount to loans, not gifts for banks. The loans would eventually be repaid via mortgage repayments. Extending government guarantees to wholesale deposits, as in Australia, is also required.

One way or another New Zealand now faces a painful adjustment towards spending being more akin to what we earn. The mechanism for adjustment will be a lower exchange rate, tighter lending standards, and reduced credit creation. Possible long-term side effects will be greater banking sector regulation and more stringent capital requirements. This is the long-overdue cure to the economic ill of excessive borrowing. Like many cures, it will be painful but ultimately restorative to our long-term health.

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