The rules have changed

NZ will fare better in a US slowdown than history would suggest

Introduction

After years of benign economic conditions globally, markets and policymakers are seriously spooked about the outlook for the US economy in the wake of the subprime crisis, spreading financial woes, and a collapsing housing market. Despite prompt, vigorous responses from monetary and fiscal policy, a US recession is now a run-of-the-mill forecast amongst commentators. Most are also picking marked flow-on effects to Canada, the United Kingdom, Europe and Japan.

Traditionally, such an outlook spells serious trouble for the New Zealand economy. Reduced tourism and lower prices and volumes for our exports crunch the tradeables sector, and via employment and confidence, cause a more generalised slowdown in the economy. Traditionally, when the US sneezes, the world catches a cold, and NZ, with its small size and narrow export base, tends to get pneumonia.

But times have changed. The developing world is not expected to slow to anywhere near the extent the industrialised nations are, and given changing trade patterns in commodity markets it is now the developing world that means the most for NZ's prospects. In this article we argue that NZ (and Australia) should be able to weather the storm far better than most other developed nations courtesy of the commodity-based nature of our exports. That said, uncertainty is rife – the robustness of the new world economic order to an old world slowdown hasn't yet been tested. Key to the NZ outlook will be whether China and Australia can emerge relatively unscathed. We think they can, but we will be watching developments closely.

Who grows matters

An average can hide a lot. "World" growth (typically weighted by economy size) looks likely to take a big hit this year, led by a slowdown in the US, the world's largest economy. But the US is less important for the world than it used to be. Despite a solid growth performance, the US' (and Europe's) share of world GDP has dropped since the 1980s, largely as a result of phenomenal growth in China (figure 1). However, it's not just China: almost half the world's population live in nations that grew by at least 7% last year, and developing countries currently account for around two thirds of world growth (figure 2).

Figure 1: Shares of world GDP

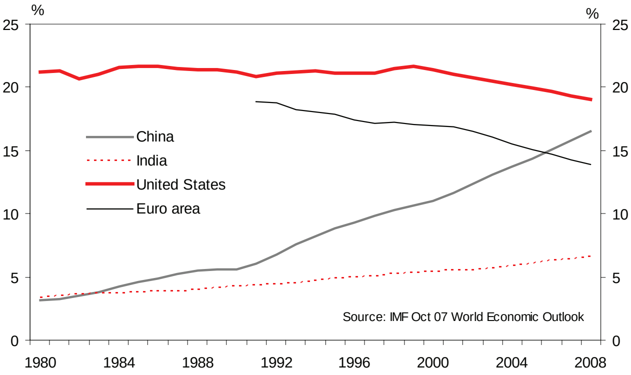
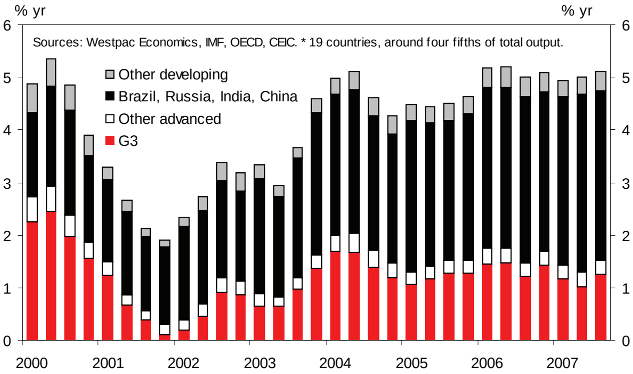


Figure 2: World growth pulse: quarterly*



Importantly, these are long-term structural trends that will outlast economic cycles (figure 3): the economic importance of "the West" has diminished and is expected to continue to do so.

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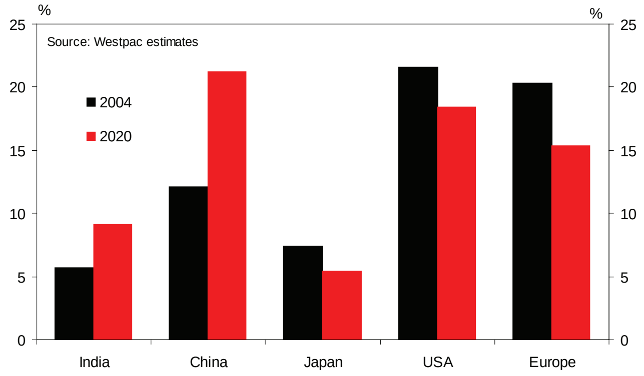
Figure 3: Shares of global output



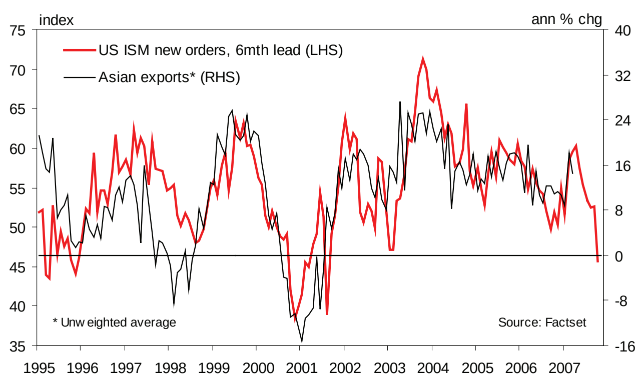
It matters for NZ where world economic growth occurs. When rich countries get richer, they buy bigger cars and faster computers. When poor countries get richer, they eat more protein and build houses. As a milk, meat and forestry exporter, New Zealand therefore does best when developing nations are growing strongly, pushing up the prices of basic commodities.

Australia remains very important for NZ's manufacturing exporters. However, Australia's economic fate hangs on similar factors to NZ's – growth in developing nations. So in sum, NZ's prospects hinge not on the US *per se*, but on whether the developing world can keep on growing at solid rates despite the US slowdown. We turn to this question in the next section.

The developing nations' growth outlook

The US remains the world's largest consumer market: a slowdown there will hurt export growth in Asia (figure 4). Although intra-regional trade has greatly increased in Asia in recent years, a good deal of this is in intermediate goods, with the final goods still going to Western destinations. We estimate that reduced growth in Chinese exports will knock around 1.2 percentage points off Chinese GDP growth in 2008. There are three key points to bear in mind as to why we aren't picking a worse outcome:

Figure 4: Any linkages here: the US and Asia?

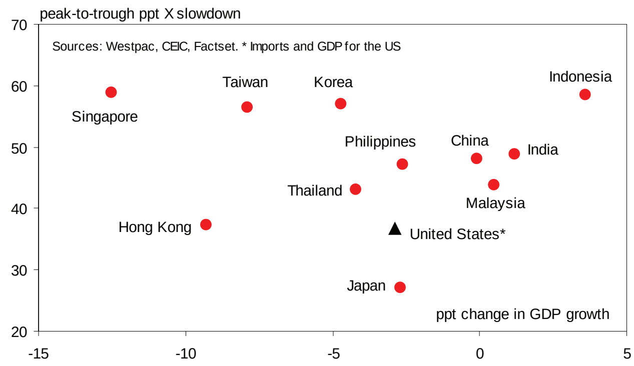


- China is huge.
- The US is less important than it used to be.
- A rebalancing of growth away from exports would be welcomed by the Chinese authorities.

Figure 5 shows that in the 2001 US recession Chinese exports fell by a startling 48 percentage points (from +47.6% to -0.6%), but overall GDP did not fall. This shows how massive the Chinese economy really is, and how important Chinese domestic demand is to overall growth. GDP will take a hit this time, but again, overall Chinese growth is likely to remain robust.

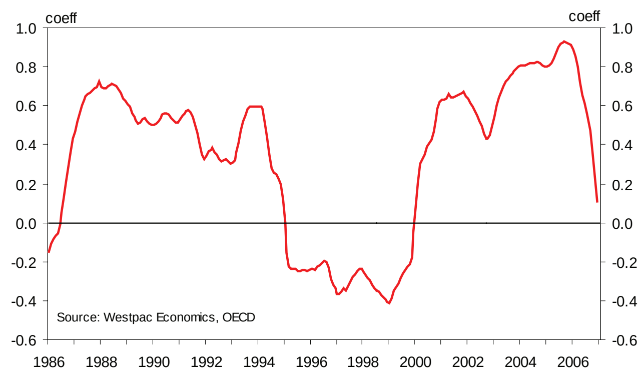
The strongly export-oriented (and richest) coastal regions will slow first, then the industrial regions, while the remaining (poorer) regions rely mostly on trade with the exporting areas. If the export slowdown is prolonged then there is therefore a risk it will have feedback effects into overall domestic demand. But the authorities should have time to see such a development coming and direct resources accordingly.

Figure 5: Growth and exports in the 2001 recession



The ECB concluded in a recent paper[1] that the Asian business cycle "appears to have moved independently [of the US cycle] in the past." And there is increasing evidence of the same in other countries: the correlations between US growth and growth in other regions have in general declined markedly in recent years (figures 6-10).

Figure 6: Rolling correlation of US and Chinese activity



[1] "The transmission of US cyclical developments to the rest of the world". ECB Working Paper 798, August 2007.

Figure 7: Rolling correlation of US and German activity

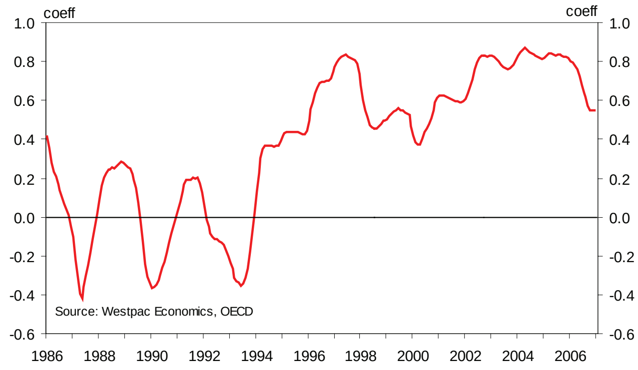


Figure 8: Rolling correlation of US and UK activity

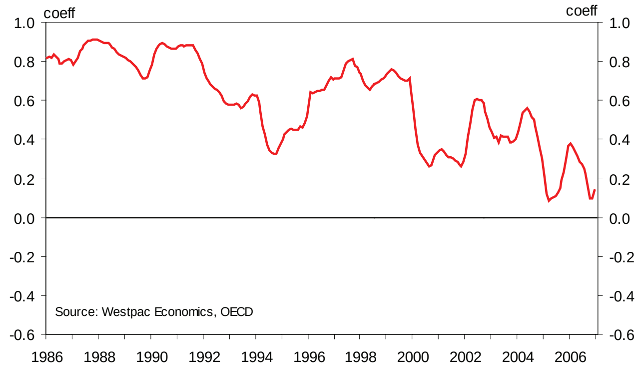


Figure 9: Rolling correlation of US and Australian activity

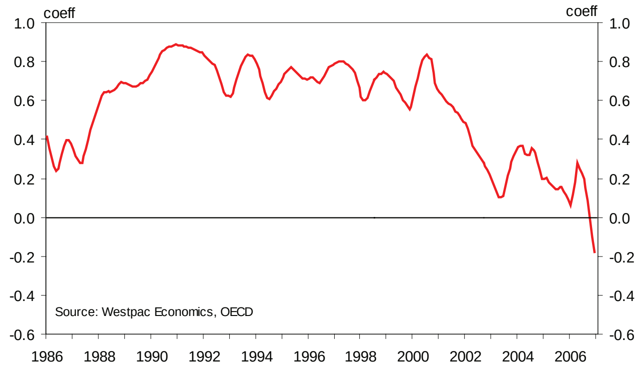
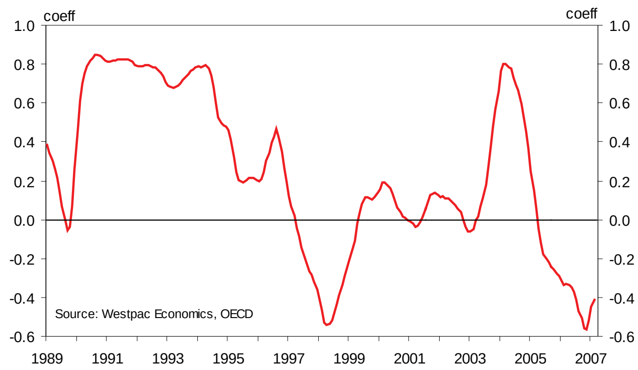
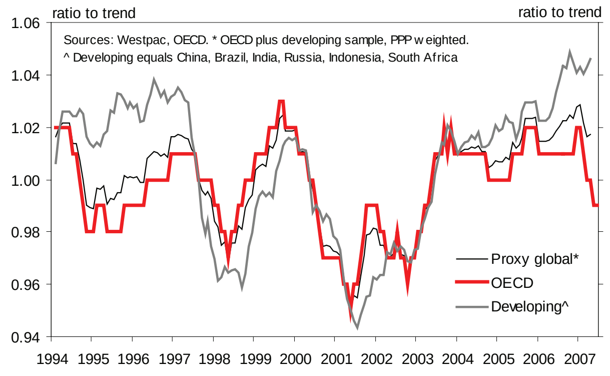


Figure 10: Rolling correlation of US and NZ activity



In line with this, indicators are so far supportive of the argument that growth rates in developed and developing nations can and will diverge in the year ahead (figure 11).

Figure 11: Leading indicators of global growth



The second key point to bear in mind is that some rebalancing in the Chinese economy away from exports may actually be helpful from a longer-term viewpoint. The hectic pace of export growth in recent years is clearly unsustainable, as evidenced by severe environmental degradation and dramatic inflation in the prices of a range of basic resources. Credit growth remains rampant despite some attempts at rationing, while the Yuan will be allowed to appreciate further this year, but probably not at double-digit rates. External factors may therefore provide a bit of a breather, lessening the chance of damaging bubbles emerging in the equity or property market, which could otherwise endanger future growth.

Prospects for the petro (oil exporting) economies are also increasingly important for New Zealand's dairy exports. Their fate will depend crucially on how the oil price evolves. The US is the world's biggest oil consumer, taking 25% of world production, more than the next five most oil-hungry countries combined. A US recession would therefore markedly reduce world oil demand. However, over the last two years, China and India have accounted for about 70 percent of the increase in world energy demand. The International Energy Agency estimates China will overtake the United States as the world's largest energy consumer soon after 2010. We can therefore perhaps expect a smaller decrease in oil prices than has traditionally been the case when the US slows, as other countries stand ready to take up the slack.

The petro-economies should therefore continue to get richer, and their demand for NZ exports should continue to grow (they now take a quarter of our dairy exports). Figure 12 shows that the importance of these economies to NZ, while small, is growing rapidly. China is also becoming increasingly important (figure 13). At the same time the share of the big G7 countries as destinations for our export basket is shrinking remarkably quickly (figure 14).

Figure 12: Petro-economies share of NZ exports

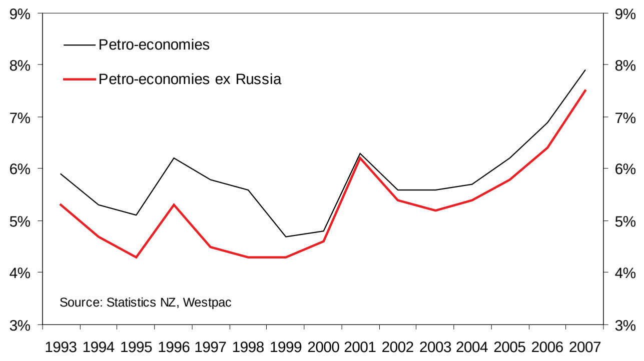


Figure 13: China's share of NZ exports

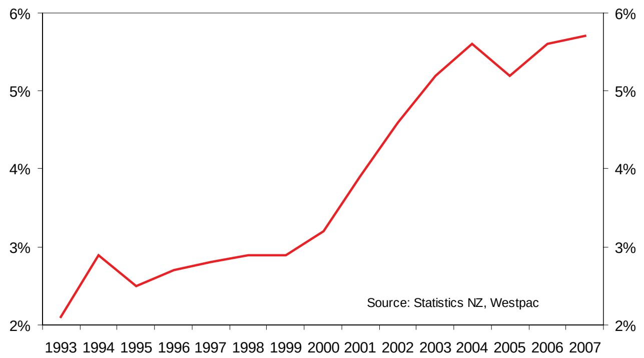
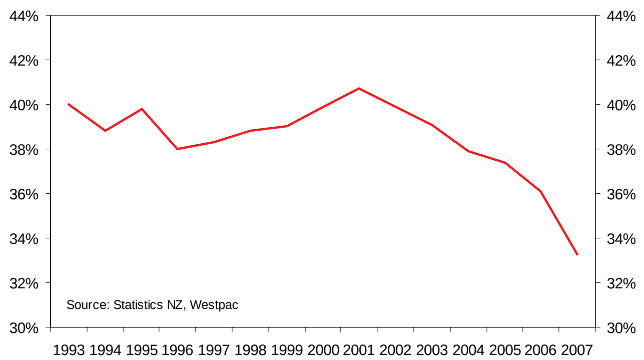


Figure 14: G7 share of NZ exports



One implication of the new importance of petro-economies among NZ's trading partners is that high oil prices are no longer purely bad news for our economy. High oil prices increase incomes and hence food demand in the petro-economies, boosting NZ's export prices and volumes. In addition, New Zealand now has oil in its export basket, courtesy of the Tui field. But this is a relatively small field and is not anticipated to do much in the longer term to reduce New Zealand's oil dependence.

Why broader Asian growth should prove robust

As argued above, Asian economies are likely to suffer a cyclical slowdown in exports as a result of the US problems. However, how much will a cyclical slowdown hurt around a strong upward growth trend? There are reasons to believe that the structural uptrend in Asian growth will remain on track. The Asian nations are in a much more robust position than they were in 1998, when the excesses of the middle years of the decade came home to roost. The differences could not be more marked:

- Current accounts are in surplus, not deficit. The savings surplus makes these countries relatively immune to the squeeze in wholesale funding (figures 15 and 16).
- Exchange rates are undervalued, not overvalued.
- Fiscal positions are sounder.
- Investment has been in more productive assets.

Figure 15: Asia ex Japan foreign reserves

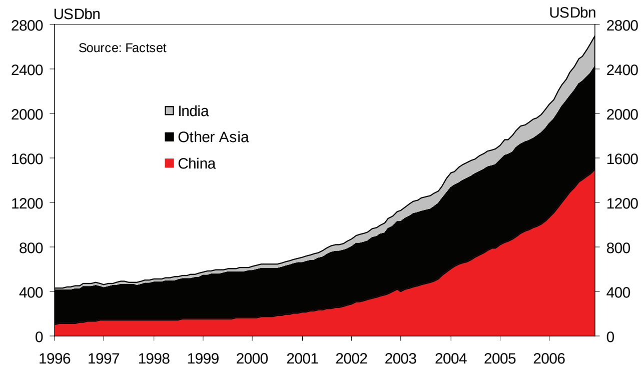
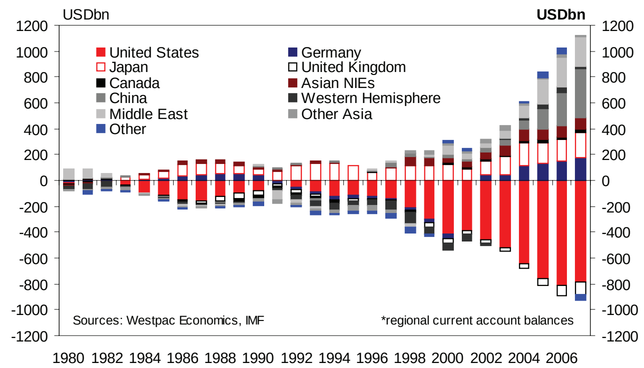


Figure 16: Supply and use of world savings*



In short, the Asian nations are well positioned to continue to enjoy a secular upward trend in their economic fortunes. And the second point is that they still have a long way to go: indicators such as electricity and steel intensity per capita (figures 17 and 18) indicate that a good deal of catch-up remains. Chinese urbanisation is expected to continue, fuelling steady growth in the non-agricultural labour pool that will last until 2015-2020, when the implications of the long-lasting one-child policy begin to come to bear in the stark reality of a falling working age population. This will be offset to a degree by a convergence in participation rates to more normal levels. It may not matter much though, as India will just be coming into the peak years of its demographic and urbanisation dividend.

Figure 17: Electricity consumption and level of development

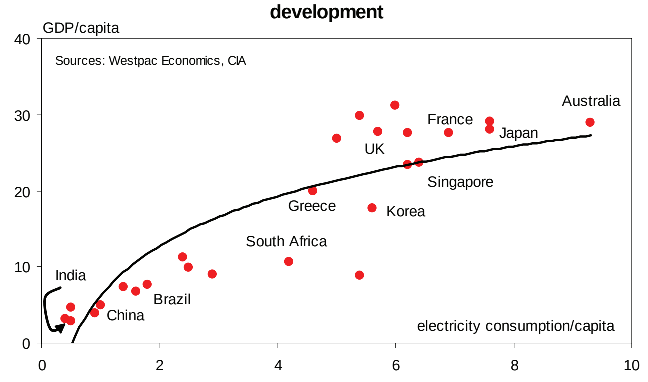
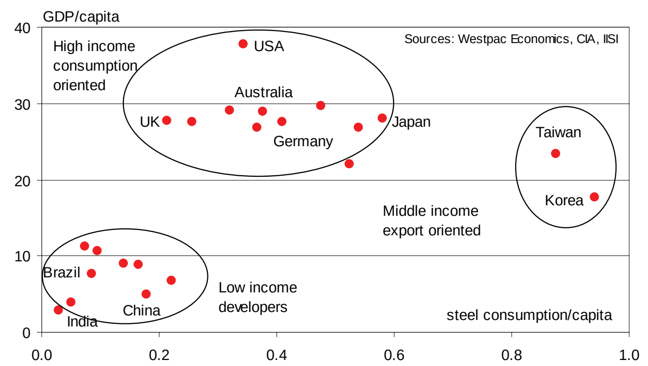
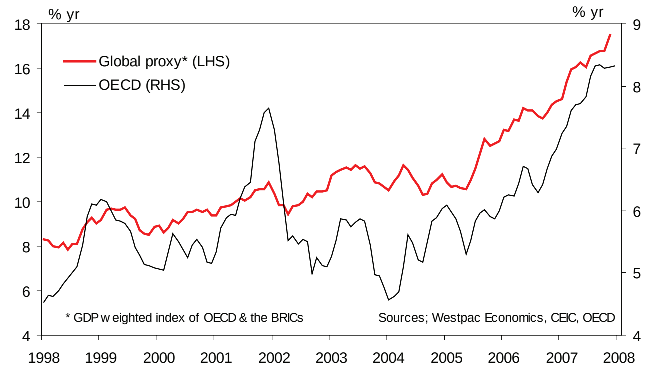


Figure 18: Steel consumption and level of development



It has been estimated that if the entire world were to reach the US level of consumption per capita, four planet Earths would be required to meet the demand on resources (United Nations). Clearly, China will not find it as easy to grow as Japan and Korea did, for example, by nature of its vastness. The stage is set for a long-running battle for basic resources over coming decades. New Zealand, with its low population density and good natural resources, stands to do very well (as long as the battle is waged with prices rather than bullets!)

Figure 19: Liquidity remains easy around the globe



In addition to long-run structural trends, several cyclical factors will buffer growth in Asia:

- Real interest rates are very low (and have been driven lower by aggressive Fed easings).
- Credit growth remains strong.
- Liquidity remains easy around the globe (figure 19).

Outlook for NZ commodity prices

New Zealand has just as much ugly adjustment to do as other Anglo-saxon nations: our savings rate has been abysmal in recent years, our current account deficit is hair-raising, and our housing market is amongst the world's most overvalued. A sound fiscal position is the one bright spot. An adjustment period is required – and will inevitably come – during which we spend less than we earn. Such phases tend to be a lot less fun than the running-up-debt chapters that precede them. However, Australia and New Zealand are lucky in that we may be saved by commodity prices keeping our incomes high, enabling a less painful adjustment period than in the US or UK for instance. New Zealand, Australia and Norway are unique amongst OECD nations in having experienced improving terms of trade in recent years. We are in quite a different boat to the US, UK or Euro-area.

So far, world spot and futures prices for New Zealand's main export commodities have held up pretty well in the face of the global growth fears. Dairy prices are down only around 7% from their peaks so far, while other prices are strengthening, such as meat and seafood. For hard commodities the story is quite mixed. Oil has been volatile, and metals prices have diverged from each other depending on whether they are considered most sensitive to investment cycles or industrial production. But in aggregate, commodity pricing seems to be assuming continued robust demand looking forward.

If we are right that growth in Asian and petro-economies will continue to truck along, then the outlook for NZ's commodity prices (and therefore economic growth) is good. It would be unreasonable to hope for much more upside, but if we can hold onto anything like even half of the spectacular increase in dairy prices, NZ can count itself very lucky indeed. And why not? All the dairy supply-side factors haven't gone away! Yes, US production is ramping up quickly, but we are still seeing severely drought-affected production in Australia (and unfortunately, New Zealand), and expensive grain feed thanks to ethanol production giving grass-fed NZ a comparative advantage. Developing nations are big dairy customers. So given that we expect Asian and petro-economies to outperform, there is no reason at this point to expect our commodity prices to fall off a cliff.

The situation is fluid and uncertain, and we'll be watching a number of indicators closely, in particular:

- Lead indicators for growth in developing nations.
- Commodity prices, especially for dairy products and oil.
- Business and consumer confidence in Asia and Australia.

Both business and consumer confidence in Australia have weakened recently in their usual response to the actual and threatened interest rate hikes. We'll be interested to see if the indexes bounce back as quickly as they typically do. In terms of GDP growth, the ECB found that a negative US shock transmits to other countries in 1-3 quarters, versus 2-10 quarters for a positive shock. US import growth has in fact been contracting for the last two years, with 2007 the third weakest year for US import growth in the last 18 years, behind only the recession years of 1991 and 2001. If growth in Asia and Australia is going to fall over, we should therefore start to see evidence of it fairly soon, if not now.

Conclusion

The US economy is clearly at a vulnerable point, and is likely to slow markedly this year, even if a recession is avoided, as we forecast. However, the world has changed. The US no longer has the importance for NZ that it once had. Growth in developing nations will have much more impact on our commodity prices (and increasingly, our tourism) and hence our economic prospects.

And the outlook for developing and oil-exporting nations is much rosier than for the US, UK, Japan or Europe. Liberalisation, more robust economic policies, and funding self-reliance have set many developing nations on a structural uptrend, a situation which could not be more in contrast to the vulnerabilities that led to the Asian Crisis in 1998.

The current divergent outlooks for emerging and developed nations will only accelerate a process which has been in train for years, as emerging economies outperform and demand a greater share of world resources. Fortunately for New Zealand, a more even distribution of world wealth – and therefore protein consumption – is to our advantage as an agricultural commodity producer.

While there are reasons to be optimistic about NZ's relative performance, risks clearly abound. Key for the NZ outlook is whether we are right in our assertion that Asian and Australian growth can hold up, supporting our commodity prices. We believe they can. But we'll be keeping a wary eye on leading growth indicators and commodity prices. It could yet be the case that a broader world slowdown does the Reserve Bank of NZ's braking work for it, in which case interest rate hikes would be firmly off the agenda. For now, the RBNZ sounds relatively sanguine on Asian and Australian prospects (as does the Reserve Bank of Australia), describing the risks around rates as balanced. Only time will tell which way the see-saw tips, but for now we're in the "she'll be right" camp, and therefore expect two more rate hikes in NZ this year. Inflation will loom front and centre once growth fears recede.

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