Reflections on, and Some Lessons from, the Global Financial Crisis

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Good afternoon. Thank you to the Trans-Tasman Business Circle for providing the opportunity to speak to you, and to Minter Ellison Rudd Watts for hosting this event.

I'm here to talk about lessons from the global financial crisis for New Zealand and for the Treasury. It's almost exactly six years since the GFC started although it took a further 12 months for the collapse of Lehman Brothers. I'll outline some of the main lessons the Treasury has learned and what we've done in response. And I'd like to be clear from the start that the effects of the crisis will be with major economies for many years to come, and we have not finished learning from it.

Let me begin by putting New Zealand's experience of the GFC in the context of what other countries have gone through.

New Zealand has been bruised by the GFC but overall we're in better shape than a lot of other developed nations, particularly in Europe. Our GDP per capita, measured on an own-currency basis, fell by 1.5 percent between 2007 and 2012 but there were bigger falls in Norway (3.3 percent), in the UK (5.6 percent), in Denmark (6.7 percent) and in Ireland (10.3 percent). In Greece the fall was 21.4 percent. And since the GFC, New Zealand's economic performance has been comparatively better too: International Monetary Fund forecasts have New Zealand attaining a pre-crisis level of GDP per capita this year – six years after the start of the GFC. For the United States it's expected to be seven years, in France and Ireland nine years, and the United Kingdom more than a decade.

So why has our experience of the GFC differed from what many other advanced economies have faced? There are several factors, but I'll mention five major ones:

- First, our banks had limited exposure to global assets which were hit hard by the crisis so there was comparatively less pressure them to cut lending to local households and businesses;
- Second, we had a limited fall in household wealth as house prices held up;
- Third, the strength of demand from China and other Asian economies for our exports helped us;
- Fourth, our higher nominal interest rates and lower public debt gave us room for monetary and fiscal stimulus to offset much of the shock; and
- Fifth, a flexible exchange rate, and product and labour markets helped to cushion the adjustment.

But the fact is that the GFC has impacted on us. We need to understand what made us vulnerable to the crisis, what we can do to protect ourselves, and what will make us a stronger economy, more resilient to crises, in the future.

Interconnectedness

The first lesson I'll talk about is interconnectedness: how fundamentally important international connections are to New Zealand's economy, the fact that it's not only trade markets that are global but financial systems too, and how all aspects of macroeconomic policy are more connected than ever before.

Being half-way around the world from Europe and an ocean away from the United States didn't make us immune from the GFC. The crisis reinforced the fact that overseas shocks can be transmitted through financial markets, not just trade flows. We now have policymakers all over the world, including in the Treasury, seeking to better understand the interconnectedness of markets and the nature of the contagion of negative shocks between countries.

We managed to contain the immediate risks posed by the crisis – through action by the Reserve Bank and the Government – but the interconnectedness has emphasised that the risks we need to think about and manage are interrelated. Issues of public and private sector indebtedness, financial system resilience, fiscal and monetary policy all interact with each other, meaning that policy needs to be well co-ordinated.

Of course we should also not lose sight of the fact that our international connections have been crucial in helping New Zealand through the crisis. More importantly, being well-connected is a crucial feature of better economic performance for small, successful, open countries. Asia in general and China in particular were relatively resilient to the GFC, and their continued demand for New Zealand products has been a big positive for our economy.

Fiscal policy

The next big lesson for New Zealand from the GFC – and probably the most important lesson of all – is that a strong fiscal policy platform is essential.

The relatively healthier state of the government's books going into the GFC allowed fiscal policy to support the economy during the crisis, when private sector demand fell. We had a buffer which enabled the Government to absorb the impact of lower tax revenue and higher welfare spending that flowed from the recession. Low public debt also helped sustain confidence of external creditors in New Zealand – and helped keep external borrowing costs stable through a period of significant international financial market disruption. That was a largely unrecognised benefit of many years of reforms and sensible fiscal policy by successive governments. The buffer also played an important role in helping us manage the impact of the Canterbury earthquakes.

We now need to rebuild those buffers. As the economy has started to grow, we have moved to bring spending and revenues back into balance through reining in the growth in government spending. Compared with other countries, we are fortunate that we can make such a fiscal adjustment gradually and at a time when private sector demand is recovering, rather than having sharp government spending cuts while the private sector is weak. I'm sure you know that the Government's fiscal targets are for OBEGAL to return to surplus by 2014/15 and for net debt to fall to 20 percent of GDP by 2020.

It is worth noting that our fiscal policy platform gives governments room to move. Rather than rigid fiscal rules that can constrain unnecessarily, the Public Finance Act provides New Zealand with a flexible framework. It allows the government to set its own fiscal objectives, consistent with the principles of responsible fiscal management.

The other key reflection for fiscal policy from pre- and post-crisis experience is its stabilisation role. With hindsight, fiscal policy settings before the GFC may have been too loose. A still strong surplus as a result of ongoing revenue growth masked increased spending that put undesirable pressure on monetary policy. The Treasury can put its hand up and say we misjudged the extent to which surpluses were structural – in other words, more or less permanent. This may have contributed to the fiscal policy decisions the then Government took. Structural surplus, and indeed the surplus itself, disappeared with the GFC. We ended up with persistently lower tax revenue than we had forecast before the crisis but with largely unchanged spending patterns.

Another point to note is that strong fiscal policy also needs to take account of the contingent liabilities the Government may face such as those from the financial system. For example, although Ireland entered the GFC with low levels of public debt, the subsequent socialisation of financial sector losses overwhelmed the Irish Government's capacity to support the economy.

Financial stability

Addressing these financial system risks has brought Treasuries closer to central banks.

In New Zealand, the Treasury and the Reserve Bank have been working to provide options to deal with a situation where a bank gets into trouble. The Reserve Bank's Open Bank Resolution Policy – or OBR – is one option which aims to allow a distressed bank to be kept open for business, while placing the cost of a bank failure primarily on the bank's shareholders and creditors, rather than taxpayers.

Another response has been the development of macro-prudential tools by the Reserve Bank, which can help to mitigate the build-up of risk in the financial system. This complements the capital and liquidity requirements that have increased banks' resilience to shocks.

Together these changes help to minimise the risk of a costly bailout by the Crown, and ensure that the banks can support credit to firms and households.

Monetary policy

Let me switch the focus to monetary policy, where the key lesson has been the important role it plays in managing risk in the broader economy.

New Zealand's experience has been different to others'. The higher starting point for nominal interest rates and relatively stronger economic performance has meant that monetary policy here does not have the problem of the Official Cash Rate hitting zero. The Reserve Bank avoided the need to use unconventional methods such as quantitative easing to kick-start a sluggish economy.

But what the GFC did bring home to us was the damage that large booms and busts in asset prices such as housing can inflict on the financial system and the wider economy. It raised questions about the ability of monetary policy alone to respond to the collapse of an asset bubble.

The models used by central banks, Treasuries and others before the crisis failed to signal the risks associated with rising asset prices supported by large amounts of debt. It's also true that few of the models focussed on the financial sector explicitly, or analysed its interaction with the rest of the economy. This was based on a view that financial markets were not critical to modelling economic cycles. At the same time it was thought that, while bubbles could emerge, financial markets were in general efficient at capturing all available information on economic fundamentals. As a result, it was argued that while there was risk that asset prices could become detached from the underlying fundamentals, there was little chance that policy-makers could anticipate when this would happen and avert it effectively.

We know now that this thinking was flawed. Asset prices can grow much faster than can be justified by fundamentals, especially when the supply of credit and the appetite for taking on debt are rising sharply and investors are keen to maximise their returns by taking on more risk. When prices correct, the fallout on the financial system and the impact on the rest of the economy can be substantial, and can take many years to resolve.

We have started to address this in the new Policy Target Agreement between the Government and the Reserve Bank Governor. The Agreement more explicitly allows for the Governor to monitor a wider range of prices, including asset prices and set monetary policy accordingly, even if CPI inflation is low. We should not pretend that we can perfectly anticipate and stop asset bubbles. Most important for economic stability is ensuring that the financial sector continues to function even in the face of significant fluctuation in asset prices.

There is now a huge effort by policymakers and academics to better understand and model how the financial sector interacts with the rest of the economy. At the Treasury, we have also been reviewing the structure of our economic models, and aim to identify the gaps in our understanding of how the financial system is linked to the rest of the New Zealand economy, to help us identify emerging risks.

Strengthening the fiscal framework

As I mentioned earlier, the GFC has emphasised the importance of managing risks. We are now taking a much broader focus across risk, moving from relatively 'siloed' to systemic risk thinking, and viewing fiscal and monetary policy in a more integrated way.

Let me give a few examples of what we've been doing.

First, the Government has introduced the Public Finance Amendment Act, which strengthens the fiscal framework through new principles of responsible fiscal management. This includes the need to think about the impact of fiscal policy decisions on monetary policy. One reason is that fiscal policy can make it more costly to achieve the goal of maintaining stable prices and output. We saw that in the last economic cycle where fiscal policy generally added pressures on interest rates and the exchange rate. We expect fiscal policy over the next few years to generally lean against pressures on resources as the economy recovers and the rebuild in Christchurch gathers pace.

Second, the GFC has also taught us that maintaining macroeconomic stability over the business cycle, or following a strong economic shock, requires the various arms of economic policy – fiscal and monetary policy, prudential policy and even tax and structural policy settings - to work in the same direction as much as possible. In some cases this could involve far closer co-ordination between monetary and fiscal policy. This is reflected in the ongoing international debate about fiscal 'austerity', and role of fiscal policy especially when official interest rates are close to zero. We have not faced this situation so far; nevertheless, we are following this debate very closely and learning from it.

Third, there is a greater focus now – across the globe – on the size of the contingent liabilities facing governments. That, and the need to maintain stable and prudent debt levels, has meant that we are taking a much closer look at the Crown's balance sheet. The Crown currently owns around \$240 billion of assets funded by \$180 billion in liabilities, leaving \$60 billion in equity. Apart from improving our ability to manage risk, the effective and efficient use of these resources plays a critical role in the performance of the economy. Even small improvements to the management of the balance sheet could both free-up capital that could be shifted to priority areas and generate efficiencies. The next Investment Statement – to be published later this year – will shed further light on the management of the Crown's balance sheet.

Fourth, two weeks ago we published our latest Long-Term Fiscal Statement which looks at the challenges we will face as the structure of our population changes. Although there is no short-term crisis, early action to meet the challenges will always be helpful in ensuring we maintain the strongest possible fiscal platform.

Secular trends

The fiscal policy and monetary policy lessons from the GFC are probably what you'd expect the Treasury to learn from and respond to, because they're obviously in our patch. But the GFC has taught us a few other important things by highlighting and exposing a number of what economists call 'secular trends' in the background – those persistent issues that may have long-term causes and long-term effects. I want to mention two of these.

The first is the growing impact of Asia, and in particular China, on the global economic stage. Since the beginning of its liberalisation in the late 1970s, Chinese economic growth has averaged around 10 percent per year. In 2010 the Chinese economy surpassed Japan to become the second largest economy in the world after the United States.

New Zealand has done very well from this growth. China is now one of our largest export markets, and in the long run there is even more potential for New Zealand to expand its exports of agricultural products plus services such as tourism and education.

More recently, Chinese growth has slowed. There is some debate about the extent to which this reflects temporary or more persistent factors, and that's an important debate for our economy. Analytical work done at the Treasury suggests a 1 percent fall in China's growth rate could reduce New Zealand's growth rate by around 0.2 or 0.3 percent.

How we position ourselves to take advantage of this secular trend is obviously critical to our future living standards.

The second trend that has received significant attention internationally is the widening distribution of income. This has been of particular concern in the United States where most of the benefits to economic growth have accrued to very high income earners. While New Zealand's distribution of income has remained at similar levels since the mid-1990s, we have been following this debate closely.

We've published a background brief on the issue, which tries to draw lessons from the international debate for New Zealand. In our view well-managed economic growth continues to be a critical foundation for better outcomes for New Zealanders at all income levels. Stronger income growth is associated with jobs and it also enables individuals and governments to have more choices. But economic growth is not sufficient to deliver higher living standards by itself. It needs to be supported by an education system that supports all children to have the skills and capabilities that they need to succeed, an active safety net for those that need it and a state sector focused on what matters.

Humility in complexity

As Olivier Blanchard said recently, the first lesson economists should learn from the GFC is humility. The twenty years leading up to the GFC persuaded us that large economic crises – such as a banking crisis – were a thing of the past, that we had learned from history, that macroeconomics had solved the problem of how to prevent depressions (as Nobel Prize winner Robert Lucas famously declared). But it wasn't true: history does repeat itself and excessive growth in debt – whether by governments or households – is one sure sign of trouble ahead.

So the other lesson that we should learn is not necessarily a new one. The world is more complicated, more volatile and changing faster than ever before. It makes effective policy-making more challenging than ever before. But the basics don't change: good policy needs to be based on solid evidence and quality analysis. It also requires us to be adaptable and open to fresh ideas and new thinking, testing and updating our analysis in the light of new evidence. It needs to deliver solutions which are proportionate to the problem and avoid adding to the complexity of what is already a complex world.

In New Zealand we are absolutely focussed on delivering good policy advice to ensure our regulatory settings are fit for purpose. But in the international arena, we tend to be rule-takers and we need to encourage the wider community of rule-setters to reflect on the complexity of the rules they are contemplating. Simplicity helps transparency and improves the quality of policy-making and risk management. Complexity by design helps no one.

Conclusion

To sum up, the GFC has served up some very important lessons for New Zealand and the Treasury. It has demonstrated how fundamentally important international connections are to New Zealand's economy. It has reinforced the need for a strong fiscal policy platform. It has highlighted the important role monetary policy plays in managing risk in the broader economy. It has emphasised the importance of identifying and managing systemic risks. It has brought to the surface some important secular trends. And it has shown the importance of thinking and acting differently.

In the final analysis, a very good way to manage risks is to maintain a strong balance sheet underpinned by a strong economic performance. That is why the Treasury is also focussing on how to lift New Zealand's productivity growth and raise living standards over the long term.

On that last point, I am hugely optimistic for New Zealand and think this is a fantastic moment in time for our country. For starters, the New Zealand economy has demonstrated significant flexibility and adaptability in responding to the large shocks it has faced in recent years. And looking at the bigger picture, there are trends that point to big opportunities: we are now part of the region that is the centre of global economic activity; demand from the middle classes in Asia for our products and services will grow as they grow in number; and technology – in particular broadband – means we are getting closer to the rest of the world.

All of these factors represent a huge opportunity for New Zealand, and the final lesson I'll leave you with is that we have to seize that opportunity while it's in front of us.