Conference on NZ's Macroeconomic Imbalance: Causes and Remedies

June 23-24, 2011

Hoe Ee Khor: Panelist Comments

Introduction

- First I would like to thank the RBNZ and the Treasury for the invitation to participate in this conference.
- Before I start, I would like to make a disclaimer – the views expressed here are my own and not to be attributed to the IMF.
- I would like to start by complimenting the RBNZ and Treasury for the excellent program that they have put together for the conference.
  - I have enjoyed very much the presentations and discussions and have learned a great deal about the New Zealand economy and more broadly about macroeconomic issues.
  - It has made me realize how rich and complex some of the seemingly simple issues can be when you start digging into them.
- I am humbled standing here before you because you all know so much more about the NZ economy than I do. I have just rejoined the IMF about six months ago. Before that I was at the Monetary Authority of Singapore. So what I'm going to try to do is to relate some of the issues to the experience of Singapore and other Asian countries.

Outline of presentation

- First I would like make some comments on the presentations in some of the earlier sessions.
- I will go on to address two major issues confronting the NZ economy
  - What should NZ do about its external vulnerability, in particular its large external debt?
  - How can NZ improve its productivity and growth performance and narrow its income gap with Australia and the other OECD countries?
- In making my comments I will try to bring in the experiences of other Asian economies in addressing similar issues.

Comment on previous presentation and discussions

- The conference started with Sebastian Edward's excellent speech which he aptly titled the "Woody Allen Syndrome"
- I come from Singapore and I can readily sympathize with the NZers' constant angst over the performance of their economy
- We Singaporeans are paranoid about our existence. We are worried that we are too small to survive as a nation, that we have no natural resources, and surrounded by neighbors who are several times bigger than us. We worry that we may not be able to compete and to survive in this highly competitive world.

- In his presentation, Sebastian challenged the conventional view (unofficial "official" view) about the nature of the problem and attributed the income gap problem with Australia as deriving from low productivity in the non-tradable sector. He also provided several options to tackle the external vulnerability problem including buying insurance which makes a lot of sense to me.
- I found John McDermott's charts on the long term trends in REER, productivity differentials and terms of trade to be very useful. They show how the REER is driven over the long term by fundamental factors. At the IMF, we have done studies of the determinants of the equilibrium REER and have come to similar conclusion, ie that the productivity differential tend to lower the REER while the terms of trade would raise it, leaving it basically unchanged in recent years. [chart]
- The following session by Peter Jarrett and Michael Reddell highlighted the important role that immigration policy and the housing market have played in the business cycles of NZ which is similar to the experience in Singapore. In particular, Michael seems to blame immigration policy for the sharp rise in housing prices and a deterioration in private saving and growth performance. This is rather interesting because our studies at the IMF suggest that one reason for the slowdown in growth in recent years could be the tight labor constraint.
- I find Craig Burnside's study on the causes of the high real interest rate in NZ rather intriguing. In particular, his attribution of the risk premium to extreme events is plausible and it complements very well Sebastian Edward's suggestion that NZ should consider buying insurance policy to protect its economy against tail risk of financial shocks.
- Prasanna Gai and Toni Gravelle's presentations provided a useful overview of the macroprudential policy framework and how such policies can help to mitigate the risk of liquidity and solvency risk in the banking system.
- Philip Lane's indepth analysis of the external imbalance of NZ and his comparison with other regions is quite revealing. In particular, he showed the stark difference between the balance sheets of Asia, NZ and other regions. I would argue that the shift in Asia's balance sheet from negative to positive balance is a direct outcome of the Asian financial crisis and the need for self insurance by the Asian countries.
- Finally Anne Marie Brook's study of the tendency of fiscal policy to be pro-cyclical during the upswing of the business cycles shows the political challenge of designing countercyclical fiscal policy.

What should New Zealand do about its external vulnerability?

- In my remaining time, I will focus my comments on two key issues:
  - NZ's vulnerability to financial shock arising from its large external debt
  - NZ's relatively low saving rate and growth performance compared with Australia and other OECD countries

- As mentioned earlier, I will draw on the experience of the Asian countries in dealing with similar challenges and issues.
- I think there is general consensus among the policy makers and analysts here in NZ that the most critical macroeconomic imbalance of the country is its large external debt, especially the short term debt of the banks. [chart] In light of the recent financial crisis, it is clear that the large external debt is a major vulnerability for the economy as it subjects the economy to the liquidity risk of a sudden stop in capital flows which can lead to a severe financial crisis and economic turmoil. [chart]
- However NZ has weathered two major financial crises (the recent global financial crisis and the Asian financial crisis) in the last 15 years relatively well, with little or no damage to its economy. Those crises are real life stress tests for the economy from which it emerged relative unscathed. So are we crying wolf? How seriously should we take this vulnerability?
- I believe we should take it very seriously. But first we need to understand why NZ had weathered the two previous financial crises so well as this will allow us to identify more precisely the measures that need to be taken.

- Why did the NZ weather the previous crises so well?
    - Strong economic fundamentals – healthy economy, sound corporate sector, strong fiscal position, and prudent monetary policy. But this is also true of some of the Asian economies which were badly affected by the Asian financial crisis.
    - In my view, the main reason NZ had done so well compared to the other Asian countries is its floating exchange rate regime. Because of its floating exchange rate, almost all of its external debt are fully hedged and this eliminated the currency mismatch risk.
        - The currency mismatch risk was one of the key weaknesses of the Asian countries and a contributing factor to the Asian financial crisis. Before the AFC, the banks and corporates in the region (Thailand, Indonesia, Korea) were borrowing abroad in US$ at lower interest rates and lending domestically in domestic currency at much higher interest rates on the assumption that the exchange rate would remain stable. When the crisis erupted and investors panicked and pulled out their money, the exchange rates depreciated sharply and, overnight, the banks and corporate became insolvent.
        - Here in NZ, there is very little currency mismatch as practically all borrowings are hedged. This is because the exchange rate is floating and volatile and the banks and corporate are wary of the currency risk. Hence even if the exchange rate were to depreciate sharply, the banks and corporates's balance sheets would be unaffected.
        - During the recent global financial crisis, the two countries in Asia that were most badly affected were Korea and

Indonesia. Just before the crisis erupted, the Korean won was on an appreciating trend and Korean SMEs, corporates and banks were borrowing abroad in Yen and US$ to take advantage of the lower interest rates. In particular, the banks were borrowing abroad in US$ using the shipping industry's forward receipts as collateral. They sell the proceeds from the loans in the spot market to the central bank for Korean won which they used to lend or invest domestically. When the crisis broke, Korea suffered a major run on its foreign reserves (US$65 bn) and needed a swap line with the US Fed to shore up its reserves position.

- NZ also had a swap line with the Fed but it was more precautionary. Unlike Korea, the banks hedged the exchange risk abroad and your liabilities are in NZ$ and hence, you don't need to worry about not having enough foreign reserves. Your main concern was the risk of a cut off in wholesale funding which can lead to a credit squeeze for the local economy but the RBNZ can mitigate that by providing NZ$ credit to the banks. However, that did not happen although the cost of funding went up. Instead, your exchange rate depreciated and your current account deficit narrowed sharply.
- These two episodes highlight the major difference between NZ and the Asian countries. NZ has a floating exchange rate regime and because of this, most of its external debt is fully hedged. Asian countries have managed exchange rate regimes and this provides an incentive for their banks and corporates to borrow funds abroad unhedged when the exchange rates are relatively stable or appreciating. Of course, the exchange rates are now a lot more flexible than before the AFC but very few are freely floating.
- The main reason for this choice of exchange rate regime by the Asian countries is the structure of their economies. NZ is rich in natural resources and most of its exports are commodities whose prices are determined in the world market. It makes sense for the exchange rate to be freely floating because it helps to absorb the shocks from the swing in commodity prices.
- In contrast, Asian countries are mostly manufacturing exporters. For them, the exchange rate is a critical price in terms of competitiveness. They cannot afford to allow the currency to become overvalued for too long as it would undermine their competitiveness, lead to a hollowing out of their manufacturing industries, and damage their growth prospects.
- Singapore went through that experience after the Asian financial crisis when its exchange rate appreciated sharply against the regional currencies. At that time, the exporters, supported by the analysts, were clamoring for MAS to

depreciate the exchange rate, but the MAS held firm because it was of the view that it was important for the S$ to be a strong currency if Singapore is to be a regional financial centre. Otherwise, there could be a major outflow of funds. As a result, the economy suffered a major hollowing out in the manufacturing sector as firms relocate to cheaper production zones in China, Vietnam and Malaysia.

    - The government decided to restructure the economy by moving the economy up the value chain into areas where it can compete. The government set up the Economic Review Committee to undertake a systematic and comprehensive review of the strategies, policies and regulatory regimes in each sector of the economy. The Committee came up with a long list of recommendations to restructure the economy. Basically, the thrusts of the recommendations were to diversifying the economy into new areas of growth such as pharmaceuticals, health services, and asset management; moving into industries which are higher up in the value chain such as semi-conductors and high end consumer products; and improving productivity by deregulating the economy.

  - But let me come back to NZ. New Zealand doesn't have a large export manufacturing sector. It doesn't need one. It is a major commodity producer. It is blessed with rich fertile agricultural land which can be used to rear sheeps and cattles and grow all kinds of crops. It doesn't make sense for NZ to go into manufacturing industries which rely on cheap labor to compete. It is better for NZ to leverage on its comparative advantage and develop the industries where it can be competitive.
  - This means that NZ can continue to maintain its free floating exchange rate regime which is a major strength for the economy in dealing with external shocks.

- What measures can NZ take to reduce its external vulnerability, mitigate the risk of a sudden stop, and strengthen its resilience?
  - First, it is clear that the risk that NZ faces is a liquidity or funding risk because its debt is fully hedged. Hence the issue for NZ is whether the size of the debt is too large, how it can minimize the risk of a sudden stop, and how it can improve its robustness to such a shock.
  - I would agree with the assessment by many analysts that the debt is too large and it would be prudent to reduce the size of the debt further by reducing the current account deficit through an improvement in the national saving rate. NZ has one of the lowest national saving rates in the OECD and it should increase its saving rate by at least 2 percentage points of GDP. [chart] The surest way to do this is to consolidate the fiscal position by moving to a fiscal

surplus over the next few years which the government is committed to do. It can do this through a combination of tax and expenditure reforms. According to an IMF study, every one percentage point improvement in the fiscal balance is likely to raise the national saving rate by about ½ percent of GDP.

- The consolidation of the fiscal position will not only result in a reduction in external debt but it will also enhance the robustness of the economy to shocks by allowing the government to undertake expansionary fiscal policy to offset the adverse impact on the economy of an adverse shock. NZ has one of the strongest fiscal position in the OECD which is a major strength for the economy. [chart]
- Second, the Reserve Bank can increase its core funding ratio further to encourage the banks to reduce their reliance on short term wholesale funding. This will help to reduce the short term external debt to below 50% of GDP. [chart] Another prudential measure that New Zealand can consider is to impose a ceiling on the loan to deposit ratio of banks to force the banks to rely more on domestic deposits to fund their lending although this may lead to higher cost of funds and lower growth, at least in the short run.
- New Zealand can also take measures to reduce the risk of a sudden stop and mitigate its impact on the economy. It can do this by arranging bilateral swap lines with major central banks that it can draw upon in the event of a liquidity shock. It can also buy insurance by entering into a precautionary arrangement with the IMF through the newly established facility, FCL.

How can NZ improve its productivity and growth potential and narrow the income differential with Australia and other OECD countries?

- As Craig showed in one of his charts, NZ's growth rate is not bad when you compared its growth rate with the other OECD countries using 1990 as the base year instead of 1960. In fact, NZ's growth rate was one of the highest from 1995 to 2004 and it has only slowed down since 2005 in part reflecting tighter labor constraint.
- A recent study by one of my colleagues at the IMF on the potential growth of NZ and Australia in the aftermath of the global financial crisis estimated the potential growth rate of New Zealand at 2 1/3 percent, and 3 percent for Australia. [chart] These growth rates will be among the highest in the OECD. Hence NZ's income differential with the OECD countries should narrow in the medium term. Unfortunately its income differential with Australia is likely to widen further and the angst will remain. However a decomposition of the sources of growth shows that much of the higher growth of Australia is derived from higher rate of capital formation and higher growth in its labor force while the contribution of total factor productivity growth is the same for both countries. [chart]
- Although these studies show a relative improvement in NZ's growth performance, it doesn't mean that the economy cannot do even better. In particular, New Zealand can try to improve its total factor

productivity growth by undertaking micro reforms of the various sectors of the economy. As Sebastian Edwards pointed out, there may be scope for productivity improvement in the non-tradable sector to bring its productivity up to the level of Australia. In addition, New Zealand may want to consider how it can attract more FDI into its economy to increase its rate of capital formation.

New Zealand's External Vulnerability and Growth Performance

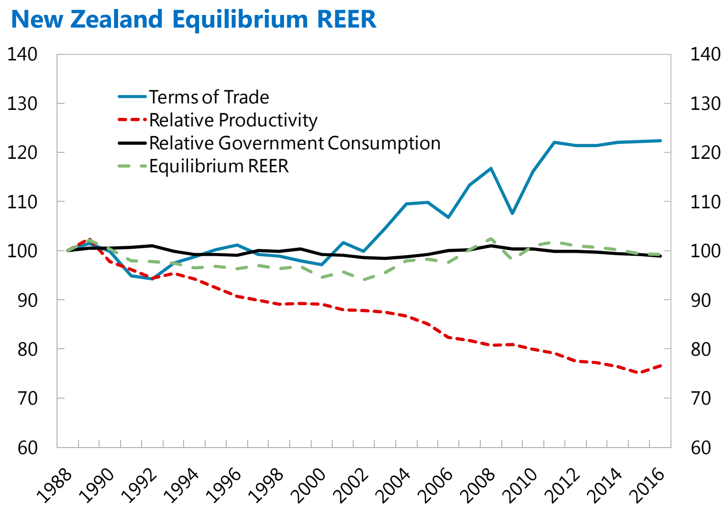
Hoe Ee Khor

June 2011

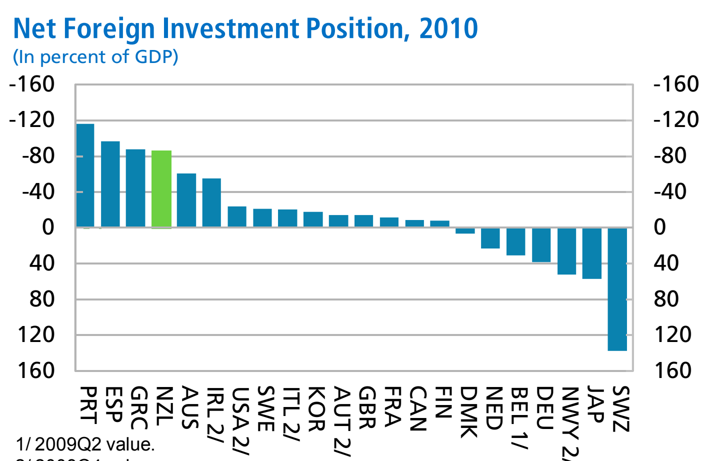
Plan of the Presentation

- Review of earlier sessions and takeaways
- What should New Zealand do about its external vulnerability?
- What can New Zealand do to raise its saving rate and growth performance?

Fundamental determinants of Equilibrium REER

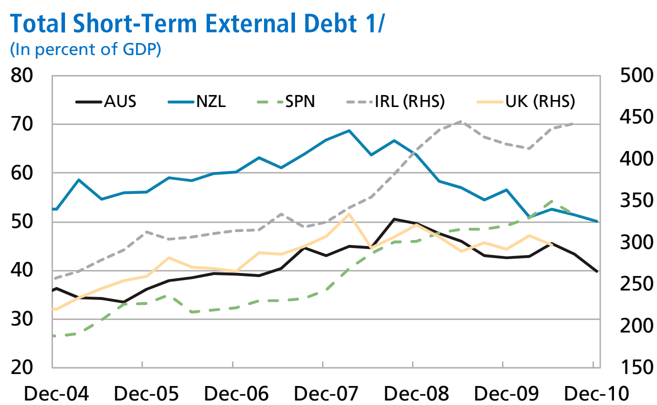


New Zealand’s net foreign liabilities are high…



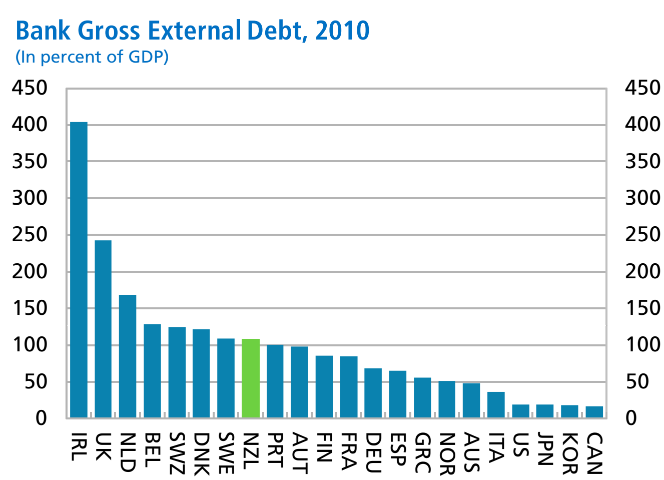
1/ 2009Q2 value.
2/ 2008Q4 value.

Despite recent declines, short-term debt in New Zealand remains high at 50 percent of GDP...



1/ Short-term debt is on a residual maturity basis for Australia and New Zealand and on an original maturity for other countries.
Sources: ABS, EconData, WB JEDH, and IMF staff estimates.

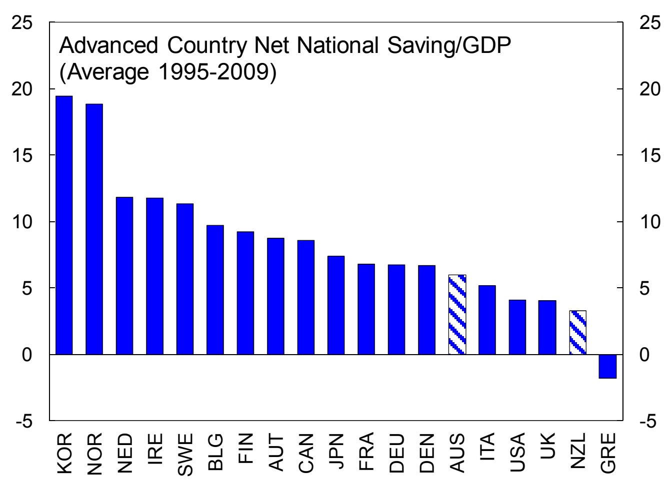
… and bank debt is relatively high among advanced economies, exposing the economy to funding risks.



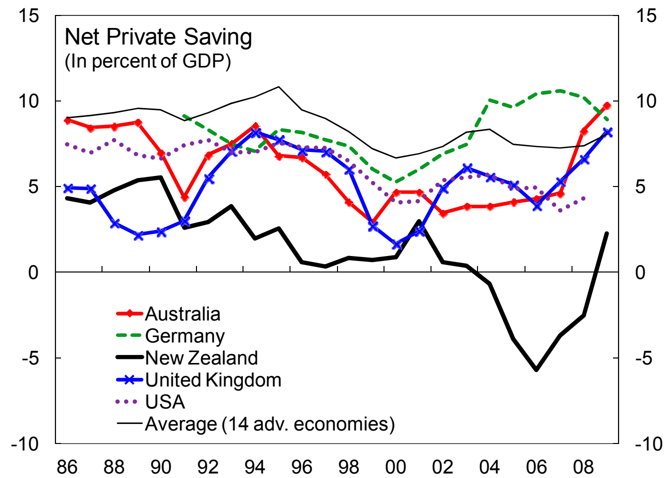
Risks from New Zealand's high net foreign liabilities

- High exposure to disruptions to global financial markets (e.g., if Eurozone sovereign debt problems worsen)
- Higher cost of capital for the whole economy
- High short-term debt and rollover risk, requiring a painful, large adjustment of the current account balance if the debt is not rolled over.
- Bank debt presents a potential fiscal liability if banks falter.

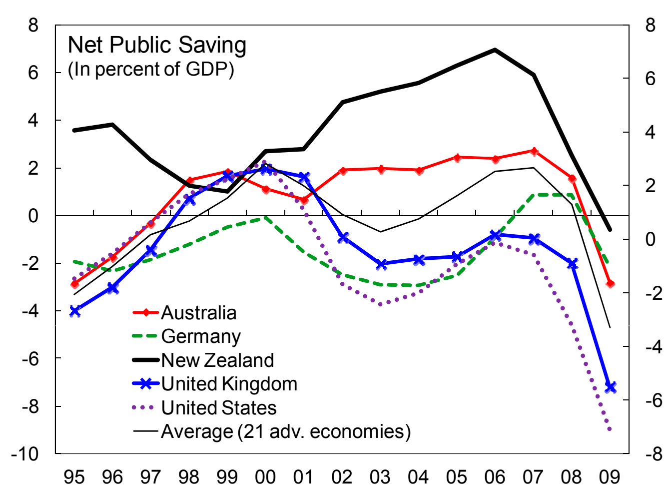
Net national saving in New Zealand was about 5 percent of GDP below the average for advanced countries over the past 15 years.



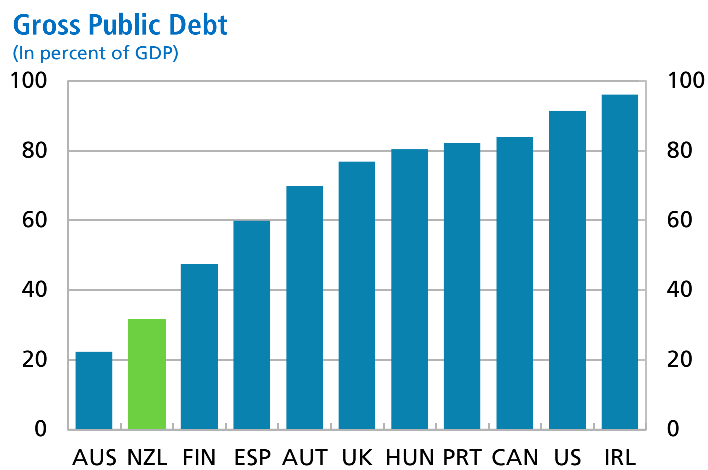
But private saving (particularly household saving) in New Zealand was below the average of the late 1980s and lower than in other advanced countries, resulting in New Zealand's high NFL.



Net public saving in New Zealand was consistently higher than in most other advanced economies…



… so New Zealand's public debt is lower than in most other advanced countries.



Macroprudential measures

- The RBNZ requires banks to maintain a core funding ratio above 60 percent which has reduced the short term debt.
- The RBNZ required banks to assume higher rates of loss-given-default than in many other countries

Fiscal consolidation

- Fiscal consolidation to raise national saving
  - A 1 percent of GDP increase in public saving would raise national saving by 1/2 – 2/3 percent of GDP.
  - Support the government's plan to return to fiscal surpluses by 2014/15

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Mitigating Factors

- Free-floating exchange rate regime providing a buffer against shocks, including disruptions to offshore funding
- Government's firm commitment to fiscal consolidation, which will build a buffer against future shocks and help raise national saving
- Macro-prudential measure – core funding ratio
- Swap lines and insurance

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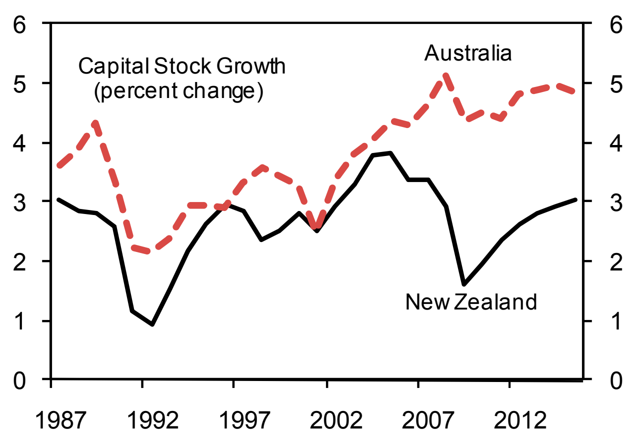
Contribution to potential growth in 2015

Australia and New Zealand: Contribution to Potential Growth in 2015
(In percent)

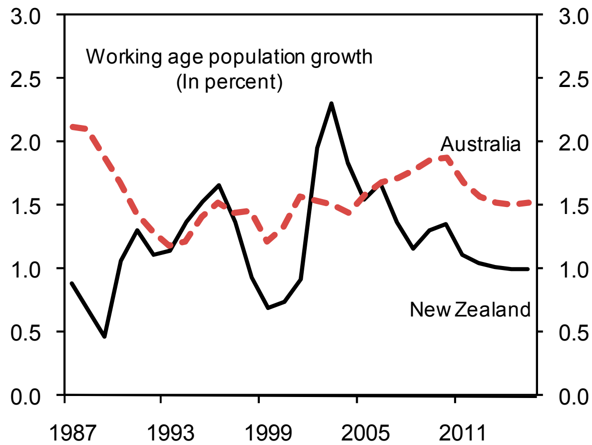
	Australia	New Zealand
Potential Growth	3.1	2.3
Capital Services	1.9	1.2
Stock of capital	1.9	1.2
Capacity utilization	0.0	0.0
Labor Services	0.8	0.7
NAIRU	0.0	0.1
Labor force participation rate	0.1	0.2
Average hours worked	-0.2	-0.2
Working age population	0.9	0.6
Total Factor Productivity	0.4	0.4

Sources: author's calculation.

NZ's capital stock accumulation is significantly lower than Australia's…



Australia's labor force is also expected to grow faster than New Zealand's…



Sources: ABS; Statistics New Zealand; and author's calculation.

Thank you