

ORIGINS OF THE 'CREDIT CRUNCH' AND RECESSION

In 2007-08 the United States, followed by the rest of the world, experienced a 'credit crunch' that, by late 2008, had developed into the worst worldwide economic crisis since the Second World War. Although New Zealand was in a relatively good position, with a healthy banking system and sound economic fundamentals, the country still entered a prolonged recession.

ROAD TO THE 'CREDIT CRUNCH'

The general consensus is that the crisis unfolded as follows. Financial markets – places where loans and investments could be traded as a commodity – became highly sophisticated and expanded in depth during the last decades of the twentieth century. By this time they were computerised and linked world-wide, meaning that any incident or event could be swiftly transmitted internationally.

During the first years of the twenty-first century the world experienced a credit boom, coupled with surges in the prices of commodities, equities and housing. In hindsight, these simultaneous surges were driven by a variety of factors that came together, including very strong growth in available cash in Asia – a product of their export boom – coupled with loose monetary policy in the West, and an over-optimistic perception about the risks of lending.

All of these factors provoked growth in 'sub-prime' mortgages and 'low-doc' loans in the United States – money lent on the basis of credit checking and credit conditions that were not adequate by normal standards. In this environment of relaxed credit conditions, consumers borrowed for consumption on the security of their homes, based on rising home values. If housing values fell – as they did during 2008 and 2009 – it became possible for the loan to exceed the value of the property securing it.

The other factor behind the 'credit crunch' was that in the United States, particularly, these loans also became a tradeable commodity. Banks' loan books were 'securitised', meaning they were given a credit rating, then sold as a tradeable financial investment. This switch from 'originate-to-hold' to 'originate-to-distribute' ran well ahead of the ability of financial institutions to analyse the risks, and many of the true risks were 'lost in translation' as these loans were traded between institutions worldwide.

THE CRISIS EMERGES

By mid-2007 it had become clear that the full value of many of these loans was not recoverable. Loss of confidence in sub-prime mortgages in the United States triggered a wave of doubt regarding many of the loans, creating dysfunction through the whole financial system. Terms like 'toxic debt' became commonplace, and countries such as Iceland experienced very severe difficulties.

The housing boom, on which many loans had been made, also ended. This provoked further difficulties. Significant United States institutions began to fail, further undermining confidence. The crisis gained new severity in September 2008 when the major US institution, Lehman Brothers, collapsed. The banks themselves suddenly stopped lending to each other, undermining their ability to settle their daily business transactions. This compounded the problem, and by 2009 the crisis had affected the real world economy.

Industrial production fell as the commodities boom ended. Large-scale job losses became a reality, and there was open talk of a world-wide 'great recession'. Some commentators even warned of a 1930s-style depression, although in fact the differences between the 1930s and the 2000s were significant.

INTERNATIONAL AND NEW ZEALAND RESPONSES

Measures taken by major governments and related institutions to address the 'credit crunch' and recession that followed included nationalising failing institutions; guaranteeing bank deposits, and supporting key industries. So-called 'stimulus packages' were proposed to help kick-start a recovery. These interventions were reminiscent of the 'Keynesian' policies that had dominated Western economic thinking during the mid-twentieth century, contrasting with the emphasis on allowing market forces to express themselves, which had characterised Western thinking since the 1980s.

In New Zealand, where the major financial institutions remained in good order, this style of support was not required to anywhere near the same degree. However, the government did provide some stimulatory funding and, following Australia, instituted a bank deposit guarantee scheme. This was followed by a wholesale funding guarantee scheme, meaning that government was prepared to under-write loans obtained overseas by the main trading banks to allow them to continue their operations.

THE RESERVE BANK OF NEW ZEALAND'S RESPONSE

The Reserve Bank of New Zealand, as a full-service central bank, had a range of policy tools to hand and took steps to ensure liquidity in the financial system, as discussed in the companion sheet "Explaining Financial System Liquidity". From mid-2008 the Bank also initiated sharp reductions in the Official Cash Rate (OCR), the rate that anchors interest rates for New Zealand. This had been sitting at slightly over 8 percent, but by early 2009 had dropped to around 2.5 percent, a very rapid rate of easing of interest rates compared to normal standards.

FURTHER READING

Alan Bollard and Tim Ng, 'Coping with global financial and economic stresses', Reserve Bank of New Zealand *Bulletin*, Vol. 72, No. 1, March 2009.