Business cycle review, 1998-2011

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This article analyses New Zealand’s economic expansion from 1998 to 2007, the contraction that followed in 2008-09, and the gradual recovery thereafter. The expansion was long and large by the country’s post-war standards, while the contraction was marginally longer but shallower than the norm. An important driver of the expansion was a long and sustained rise in the terms of trade, in part reflecting expansion in the Asian region, especially China. A sharp rise in net immigration early in the period, a marked increase in the use of credit funded from offshore, and rising government spending were also important influences. The strong New Zealand dollar was another important factor, eroding competitiveness in parts of the tradables-producing sector and helping fuel demand for non-tradable goods and services. Balance sheets of households, farms and businesses became increasingly stretched over the period, a factor that has dampened the speed of recovery over the past three years.

1 Introduction

New Zealand’s small open economy is exposed to a broad range of economic forces that can cause considerable variability in output, inflation, and financial variables. Analysing the sources and consequences of the fluctuations can yield useful insights about how New Zealand’s economy responds, and important lessons for policy-makers. Of particular interest for the Reserve Bank is monetary policy’s effectiveness over the business cycle, and whether policy should respond differently if similar shocks were to arise in future.

This article analyses New Zealand’s most recent economic expansion, which ran from 1998 to 2007, the contraction that followed in 2008-09, and the gradual recovery thereafter. It focuses mainly on understanding the drivers of the expansion, while monetary policy is treated in a largely descriptive way. A forthcoming Bulletin article will discuss the natural follow-on questions about the conduct of monetary policy and what we can learn about policy from the period.

2 Cyclical developments, 1998-2011

The five identified phases of the cycle are as follows.

- 1998-2000: recovery after the East Asia Crisis (EAC)
- 2000-03: global headwinds
- 2003-06: domestic boom
- 2006-08: oil price spike
- 2007 onward: Global Financial Crisis (GFC), recovery and sovereign debt problems

Table 1 provides summary statistics on the expansion and contraction. Figure 1 is a chart of GDP growth that identifies the five phases. As background to the following discussion of economic events, Box A provides numbers on the overall size of the expansion and contraction in a historical context. An appendix contains charts that compare movements in New Zealand’s GDP growth, inflation and real interest rates with those of Australia, the UK, the US and the euro area.

In short, the economic expansion from 1998 to 2007 was long and large by the standards of post-Second World War experience. The contraction in 2008-09 was slightly longer and shallower than the post-war average. Perhaps
Table 1
Averages for expansion and contraction – main macroeconomic indicators

<table>
<thead>
<tr>
<th></th>
<th>Annual growth, pct⁴</th>
<th>Annual inflation, pct²</th>
<th>90-day interest rate, pct³</th>
<th>TWI, level⁴</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall expansion 1998Q2-2007Q4</td>
<td>3.2</td>
<td>2.4</td>
<td>6.4</td>
<td>60.6</td>
</tr>
<tr>
<td>Overall contraction 2008Q1-2009Q1</td>
<td>-0.7</td>
<td>3.8</td>
<td>7.2</td>
<td>63.6</td>
</tr>
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Notes:
1. Average of the annual percentage change, real production GDP
2. Average of the annual inflation rate, CPI (excluding credit services prior to 1999Q3)
3. Monthly average 90-day rate, nominal
4. Monthly average TWI, nominal
Source: Statistics New Zealand, RBNZ

more striking than the contraction itself are the period of slower average growth leading up to the recession and the very gradual recovery thereafter.

**Recovery after the EAC: 1998-2000**

Our review period starts with the recession and recovery following the East Asia Crisis (EAC). The effects of the EAC were relatively short-lived outside the Asian region: New Zealand emerged from recession in 1998. By mid-1999, estimates of New Zealand’s output gap – a measure of actual GDP relative to its potential or non-inflationary level – suggest that demand had already risen by enough to be placing modest pressure on supply.

**Box A**

New Zealand GDP: this cycle compared with post-war experience

New Zealand’s economic expansion from 1998 to 2007 was long and large by the standards of post-war experience.¹ The expansion lasted 38 quarters and GDP rose by a total of around 39 percent or by 25 percent in per capita terms.

By comparison, other expansions since World War 2 averaged 21 quarters in length and closed with GDP around 26 percent higher. Two other post-war expansions lasted longer than 30 quarters: 1959-66 with a 39 percent rise in GDP, and 1968-76 with a 32 percent rise in GDP.²

The 2008/09 contraction was 5 quarters long. GDP shrank by just under 4 percent, or 5 percent in per capita terms. The contraction was slightly longer but shallower than the post-war average (figure 1). Importantly, there was a period of slow average growth each side of the recession while population growth continued. This left GDP per capita in 2011 around the levels of 2004 and only 15 percent higher than at the start of the expansion in 1998.

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¹ This takes the expansion as starting in the June quarter of 1998, the first quarter of positive quarterly growth after the 1997-98 recession, and finishing in the December quarter of 2007 before the economy entered recession in 2008.
² For these summary statistics on post-war business cycles, see Hall and McDermott (2009).
capacity (figure 2).6 By the start of 2000 growth had reached an impressive 6.5 percent.

Figure 2
Output gap (December 2011 estimate)

Through the EAC, the Reserve Bank implemented monetary policy using the Monetary Conditions Index (MCI). The MCI signalled the Reserve Bank’s preferred level of monetary conditions, treating short term falls (rises) in the currency and rises (falls) in interest rates as offsetting each other.

Consequently, when the currency dropped following the EAC, markets pushed up interest rates. Higher interest rates persisted until the Reserve Bank eased monetary conditions from mid-1998 after the severity of the EAC became clear. The easing caused 90-day rates to fall from 9 percent to just over 4 percent by early 1999 (figure 3). The sharp fall in short-term rates reduced their spread over offshore rates to a very low level, and this gap stayed small even as New Zealand monetary policy began tightening later that year. Combined with a weaker growth outlook for New Zealand, the relatively low short-term interest rates encouraged a drop in the New Zealand dollar. It continued falling until mid-2000 (figure 4).

While the EAC lowered Asian demand for New Zealand’s exports, the country’s growth picked up strongly soon afterwards.7 Export incomes rose from mid-1999 after the New Zealand dollar fell sharply and advanced Western economies’ growth continued. Investment as a share of GDP grew, partly in response to the Year-2000 computer problem (Y2K) and Auckland’s hosting of the America’s Cup.

CPI inflation was modest immediately after the EAC, reflecting weak demand and low oil prices (figures 5 and 6). CPI inflation then climbed from mid-1999, and peaked at 4 percent at the end of 2000: the fall in the currency, a subsequent rise in oil prices and growing demand pressure were behind the rise, as was an increase in the excise tax on tobacco.8

The Reserve Bank tightened monetary policy in response to growing demand and inflation pressure. This was achieved using the Official Cash Rate (OCR) – the new main instrument of monetary policy introduced in March 1999 to replace the MCI.9 The OCR was raised

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6 This article refers to the output gap estimates from the December 2011 Monetary Policy Statement (Reserve Bank of New Zealand, 2011d) rather than contemporary estimates.
7 By the late-1990s, the Asian region took around one third of New Zealand exports.
8 The Reserve Bank’s target was measured according to CPI excluding credit services in 1998 and the first two quarters of 1999, and headline CPI inflation thereafter.
from 4.5 to 6.5 percent in late 1999 and the first half of 2000 (figure 7).

After the sharp pick up, growth slowed from the middle of 2000. While the next section focuses on the offshore reasons for this, some transitory domestic factors were also relevant in late-1999 and early-2000. Droughts in the summers of 1997-98 and 1998-99 hurt agricultural production and primary exports into 2000. Investment spending fell after the pre-Y2K and pre-America’s Cup strength. Business and consumer confidence dipped briefly, though the reasons proved short-lived.  

Global headwinds, 2000-2003

From mid-2000 and on into 2003, the prominent economic theme was one of economic shocks from abroad. The shocks turned out to be individually short-lived, but collectively their threat to demand continued for a longer period. That threat had a significant bearing on views among businesses and forecasters, including the Reserve Bank, about the outlook for New Zealand’s external sector. While New Zealand had little direct exposure to the sources of these offshore shocks, the risk was that export demand and prices would weaken with global growth.

In the first part of the 2000-03 period, the main events threatening the outlook were the burst of the dotcom bubble in the second quarter of 2000 and terrorist attacks in the US on 11 September 2001. Later, oil prices rose from 2002 and the outbreak of the SARS virus began disrupting travel and economic confidence from March 2003.

In response, the Reserve Bank twice eased monetary policy quickly as insurance against the economic risks. The OCR was cut by one percentage point in late 2001 after the terrorist attacks in the US. The policy rate was lowered by 75 basis points (bps) in response to the economic threat posed by SARS and, to some degree, rising oil prices.

On each occasion the insurance was found not to be needed, and the Reserve Bank started raising the OCR again within six months of the last rate cut. The weakening in export demand and prices (figure 8) due to global events...
proved smaller than initially feared, and domestic demand and inflation pressure were building. Consequently, the New Zealand policy rate and short-term interest rates fell by less than rates in the US and Europe during this phase (figure 7).

Figure 8
Terms of trade and real commodity prices

Growth was returning in the domestic economy, after the slow-down during 2000, and remained quite robust to international events. Adding to the local momentum was a strong boost to population growth from net migration, which would last until late 2003 (figure 9). Net migration rose suddenly and sharply from late 2001, with outflows falling and inflows climbing. Behind the increase in net migration were perceptions that New Zealand was safe and had relatively good economic prospects. The extra population growth added materially more to demand than to aggregate supply in the short term: the extra demand for housing and the ‘set-up’ consumption by new arrivals more than offset the boost to supply from new entrants to the labour force.\(^{11}\)

Strong domestic demand pulled up GDP growth, which sat near or above four percent from late-2001 until 2004 (figure 1). This was enough to bring a return of growth in per capita GDP, even with the faster-than-usual population growth (figure 10).

The rapid growth led to the emergence of excess demand in the economy, as indicated by output gap estimates and survey measures of capacity pressures, and this situation continued to intensify (figures 2 and 11). By late 2000, the unemployment rate had already fallen below its lowest level of the 1990s, and it continued falling in the following years (figure 12). Strained capacity along with the strong currency and falling international prices for investment goods, led to a sharp lift in real business investment.

As discussed in the next section, the domestic demand pressure that started building in the current phase would underpin inflation through until the recession of 2008-09. Domestic (‘non-tradables’) inflation began climbing from late-2001, though at that time falling oil prices and a rising New Zealand dollar had lowered the CPI headline rate (figure 5). CPI non-tradables inflation remained strong, sitting above 3 percent from mid-2002 until 2009.

With New Zealand’s short-term interest rates falling by less than those in the US and Europe, foreign funding became increasingly available to New Zealand as

\(^{11}\) For further discussion of the demand and supply effects, see Box 3 of the March 2003 Monetary Policy Statement (Reserve Bank of New Zealand, 2003).
international investors sought higher risk-adjusted yields. Credit growth had picked up from around 2000, and the banks’ ability to readily access offshore funding allowed credit – particularly in the household sector – to accelerate further (figure 15). The household savings rate became increasingly negative, although the effect on national saving was offset by higher government savings. The rise in credit growth, use of fixed-rate mortgages and fall in private savings were all important parts of the domestic economic story in the following years (figure 13).

By 2003, domestic momentum was very strong and fears about the world outlook were receding as advanced economies returned to growth. Domestic credit was expanding quickly, funded increasingly from abroad, and private savings rates were falling (figures 13 and 16). Credit extension supported rising property prices and consumer demand, even as the earlier strength of business investment levelled-off over 2004-07.12

Growing world demand added to domestic momentum, boosting the terms of trade and pushing up incomes for commodity exporters. Rising incomes in China, and the Asian region more broadly, contributed significantly to this demand growth. Meanwhile, producers in the non-commodity tradables sector lost competitiveness as the exchange rate rose and prices for imported manufactures fell (figure 8).

Imbalances in the domestic economy became more and more apparent during this phase. Demand and resources – including new investment – were increasingly focused on commodity production and on the production of non-tradable goods and services. In marked contrast, the non-commodity tradables sector was suffering, and there was a growing external trade deficit.

Fiscal policy played a significant role in driving domestic demand, and in doing so added upward pressure to the New Zealand dollar. Government spending rose rapidly

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12 For further discussion of the consumption story, see De Veirman and Reddell (2011).
from 2005, becoming highly stimulatory at a time of excess demand in the economy, as it had in the 1990s economic expansion (figure 14).\textsuperscript{13} While the core operating balance was in surplus by around 7 percent of GDP until as late as 2006, partly reflecting strong economic performance, it fell from there to a deficit of greater than two percent of GDP in 2009.

Figure 14
Annual sum of consumption and investment (percent of annual GDP)

The private sector was dis-saving, and borrowing was being used to finance property purchases more than consumption (figures 13 and 15). Supporting this borrowing was a continued increase in the banking system’s use of funding from offshore (figure 16).\textsuperscript{14}

Figure 15
Annual lending growth to households and national excess credit growth (nominal)

Adding to the credit being made available, domestic finance companies were competing aggressively for business in the property development sector. In particular, finance companies lent on more-marginal, and riskier, housing projects. This buoyed some parts of the property sector, but also sowed the seeds of the finance company failures from 2006.\textsuperscript{15}

Along with strong growth in credit came a rise in leverage in the private sector, notably on farm and household balance sheets. The combination of leverage and rising property prices further illustrated the growing domestic imbalances.

High labour incomes and domestic confidence about the outlook contributed to the strength in private demand and property markets. Greater use of fixed-rate mortgages helped provide certainty for borrowers, insulating for a time those with existing loans from a tightening in monetary policy as inflation pressure increased.

In total, house prices grew for nine years before they ultimately started falling in 2008. The fall in property prices from 2008 came from levels that had increasingly appeared overvalued.\textsuperscript{16}

The average annual rise in house prices over that period had been 8.6 percent.\textsuperscript{17} Adding to the effects of

\textsuperscript{13} A contemporary view on fiscal policy over the period to 2007 is in Reserve Bank of New Zealand (2007a).
\textsuperscript{14} An important source of that funding stemmed from foreign institutions issuing bonds in New Zealand dollars – eurokiwis and uridashis – and swapping the New Zealand dollars for foreign currency. See Drage, Munro and Sleeman (2005).
\textsuperscript{15} Reserve Bank of New Zealand (2007c), section 4.2, discusses some of the background to, and effects of, finance company failures.
\textsuperscript{16} At the time, the Reserve Bank commented that while the available evidence on valuation was inconclusive, ‘... in our judgement house prices are stretched beyond levels that economic fundamentals can sustain over the longer term’. See the May 2007 Financial Stability Report for the background to this assessment (Reserve Bank of New Zealand, 2007b).
\textsuperscript{17} By comparison, the 1990s boom was concentrated in urban areas, lasted around seven years and average price growth was 5.5 percent.
strong demand in the housing sector, limitations on the availability of new land appear to have helped sustain the rise in section prices once the upswing had started.  

From 2003 to 2006, house prices outside the main urban areas grew even more rapidly than in the large cities, partly fuelled by strong rural incomes. The pattern of price inflation moved similarly across housing, commercial and industrial property and rural property (figure 17).

Figure 17
Annual property price inflation

![Annual property price inflation graph](source: Quotable Value New Zealand, RBNZ calculations)

The economy’s productive capacity and demand were becoming increasingly mismatched, with excess demand putting intense pressure on productive resources through to 2008. Output gap estimates show GDP at least 1 percent above potential output over the entire period from 2002 to 2008, at times reaching nearly 4 percent (figure 2). The unemployment rate dropped as low as 3.4 percent – more than two percentage points under the lowest rate in the 1990s – and sat at or below 4 percent for four years (figure 12). Survey measures of capacity constraints similarly show a tight labour market and stretched physical capital (figure 11).

Consequently, the main source of upward pressure on inflation was strong non-tradables sector inflation, leading CPI inflation to average close to 3 percent from 2003-06 (figure 5). Surveyed inflation expectations rose steadily, if gently (figure 18). From 2006, in the next phase of the review period, oil prices rose and added to price pressure and inflation expectations. As in the 2000-03 phase, tradables inflation was relatively weak through these years, particularly because of the strong exchange rate.

Despite strong domestic activity, the Reserve Bank and other forecasters saw credible risks to the outlook during this phase. These threats influenced views on how much monetary tightening was needed to offset inflation pressure.

In the external sector, the uncertainty came from volatility in the terms of trade, the strong New Zealand dollar and the outlook for foreign demand. The concerns became stronger in 2005 and beyond, and continued into 2007.

In the domestic economy, there was an expectation of a braking effect from the cumulative monetary tightening, high leverage on private balance sheets, the risk of a fall in overvalued property prices, and labour shortages and capacity constraints. Finance company failures from 2006 were highly visible and posed a risk of denting domestic confidence to some degree, even if the failures were small relative to total wealth in the economy.

Despite these perceived headwinds, the Reserve Bank raised the OCR from 5 percent through the second half of 2003 to 7.25 percent at the end of 2005. By 2006, growth in the economy did indeed appear to be cooling, with GDP growth falling sharply to around zero. The OCR was therefore held at 7.25 percent through 2006. However, in the first part of the next phase – 2006-08 – it became evident that the slow-down had been short-lived and, following a sharp rise in the terms of trade, the Reserve Bank raised the OCR further to lean against inflation pressures.

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18 Reserve Bank of New Zealand (2011a).
19 Wage inflation, according to the Labour Cost Index (LCI) which excludes rises in compensation for productivity growth, rose from 2.2 percent in early 2003 to 3.1 percent in late 2006. The rate peaked at 3.7 percent in 2008, compared with the 1990s peak of 2.2 percent.
Oil price spike, 2006-2008

In late 2006, against a background of resurgent domestic demand and inflation pressure, world oil and food prices spiked. Oil prices rose from an already high level to peak in mid-2008 at just over USD130 per barrel, roughly double their level of a year earlier. Higher world food prices were positive for New Zealand export incomes, but added to inflation. Higher oil prices combined with other factors weighing on activity would tip the economy into recession in 2008.

CPI inflation rose sharply, and with domestic inflation and demand pressure already high, there were concerns about the potential for the rise in inflation to become persistent. This played off against signs of weakening demand, leading the Reserve Bank to hold the OCR unchanged through 2006 while watching the opposing forces on inflation play out.

The other factors weighing on New Zealand’s outlook were the very strong New Zealand dollar, the cumulative effect of several years of monetary tightening combined with high leverage on balance sheets, and in 2007 the early signs of financial stress abroad. To a lesser degree, a drought in the summer of 2007-08 also weakened confidence and activity. These, combined with higher oil prices, ultimately tipped New Zealand into recession in 2008. These other events – and particularly the worsening outlook for the US and Europe with the growing financial disruption – are discussed in more detail in the next section.

Why oil and food prices rose so sharply remains the subject of debate. For oil, explanations include tension in the Middle East, speculative pressure, market concerns about ‘peak oil’, and tight supply because of a shortage of extraction capacity. For food, the stories include climatic factors, growing Asian demand, higher oil prices affecting production costs, and a substitution towards producing agricultural products for biofuels instead of food.  

Government spending remained stimulatory, with discretionary spending having risen sharply from 2005 (figure 14). This offset the effects of “automatic stabilisers” – the increases in tax revenue and reductions in welfare payments that tend to happen during an upswing. As noted above, the core Crown surplus started falling after 2006.

With the spike in oil prices, CPI inflation rose from late 2007 to reach 5.1 percent by the September quarter of 2008. Offsetting this were the slowing growth and non-tradables inflation, discussed in the next section.

Looking at inflation expectations data, the oil-driven spike in inflation proved transitory and does not appear to have become embedded in inflation expectations (figure 18). Part of the reason is likely to be the contemporary slowing in activity and the subsequent recession.

After pausing its OCR rises in 2006, the Reserve Bank started raising the policy rate again in 2007 as activity picked up again and the inflation risks once again appeared to be rising. The OCR was lifted from 7.25 to 8.25 percent in the first half of 2007. Short-term wholesale rates rose even further as international markets became nervous around the start of the GFC. The OCR was held at 8.25 percent until July 2008, at which point the Reserve Bank started lowering the policy rate.

Continuing the trend from previous years, interest rates on new mortgages rose largely in line with wholesale rates for similar terms. However, the weighted average rate on existing mortgages continued to rise more slowly than wholesale rates, because of the high proportion of existing fixed-rate mortgages.

GFC, recovery and sovereign debt problems, 2007-

In 2007, the early stages of the GFC began playing out. Stress rose in world financial markets and funding on international markets became more expensive for banks, relative to more normal conditions. This came on the back of the oil price spike and growth of domestic imbalances in New Zealand. Along with the corresponding slow-down in world demand, was an important factor contributing to New Zealand’s economic contraction in 2008-09.

The early signs of the GFC became apparent in the US, with the housing market weakening dramatically and foreclosures mounting. As the year progressed, financial stress increased. In the US and Europe, there was a string

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20 Briggs, Harber, Ng and Yao (2011) provides a detailed discussion of movements from 2000 to 2008 in world prices for oil, dairy, beef and lamb.
of failures of housing lenders that had investments in sub-prime mortgages. By August 2007, liquidity pressures were emerging in financial systems internationally.

Central banks around the world, including the Reserve Bank, provided additional liquidity support to offset pressures in interbank markets. One effect of market nervousness was a rise in interest rates relative to policy rates, having the effect of tightening monetary conditions. The Reserve Bank, in July 2008, lowered the OCR from 8.25 percent to 8 percent to offset this rise in spread. As the world outlook worsened and inflation risks fell, the OCR was cut by another 50 bps in September.

The global outlook subsequently weakened further and nervousness in markets rose following the collapse of Lehman Brothers in the US in September 2008. Liquidity flows in interbank markets fell sharply. Central banks began rapidly lowering policy rates. The Reserve Bank cut the OCR from its level of 7.5 percent shortly before the Lehman Brothers failure to 2.5 percent by April 2009.

While policy easing brought down the level of short-term interest rates around the world, reduced risk appetite and liquidity meant banks seeking funding had to pay higher spreads over benchmark rates. In spite of the fact that New Zealand banks and their Australian parents had little direct exposure to the initial sources of the GFC, they, too, faced a sharp rise in funding spreads. Governments around the world, including New Zealand’s and Australia’s, used retail deposit and wholesale funding guarantees to support confidence.

Higher spreads for wholesale funding meant banks in New Zealand increased competition for retail deposits and tightened their lending standards. Retail deposit rates and lending rates rose relative to what would be expected in more normal conditions. Credit growth slowed, reinforcing the slow-down in property markets.

The finance company failures that started in New Zealand in 2006 continued. This reduced access to credit for more marginal property development projects, and added to broader nervousness among depositors and investors in New Zealand.

Following the GFC there was a major drop in world trade, and so in demand for New Zealand’s exports. The New Zealand dollar fell sharply from 2008 with the country’s growth and export outlook, but rebounded similarly quickly in 2009. The rebound limited the benefits for farmers of the higher commodity prices that came with the return of Asian and Australian demand. Demand from the US and Europe also remained weak. With weak income growth and high debt ratios, farmers became increasingly cautious about new spending.

As Asian demand continued to grow and the world outlook more generally improved through 2009, commodity prices rose in 2010. Prices of New Zealand’s export commodities – particularly dairy – ultimately reached record levels in early 2011, and the New Zealand dollar TWI returned to a level near its 2007-08 peak.

Helping the world outlook to improve in 2009 was support, to the financial sector and through economic stimulus more broadly, from governments and central banks. Uncertainty in markets remained high, however. While central banks started withdrawing part of the liquidity support, the degree of extraordinary support remained considerable. In the US, UK and euro area, central banks used various forms of ‘quantitative easing’, injecting liquidity to help the effectiveness of monetary policy. Direct assistance to the banking sector remained important for market confidence.

Growth in government spending helped sustain New Zealand’s domestic demand through this phase, particularly after private investment plunged from mid-2008. The level of government spending as a share of GDP remained high at the end of our review period, but a growing deficit and rising debt were increasing the imperative for fiscal consolidation. The cost of responding to earthquakes had added to the deficit.

In 2010, concerns grew about high levels of sovereign debt in parts of Europe and about the need for fiscal consolidation there and in the US. Market nervousness and funding spreads for financial institutions rose sharply once more, and financial sector support from the official sector took on renewed importance. Uncertainty about a solution to the sovereign debt problems remained through to the end of our review period. So, too, did higher funding spreads for banks.
Domestically, a series of major shocks came late in 2010 and through 2011 with a series of large earthquakes hitting Christchurch. These caused significant damage to the capital stock and so production, consumer confidence and business confidence.

Shortly after the February 2011 earthquake the Reserve Bank initially estimated the likely cost of reconstruction at around 8 percent of nominal GDP, or NZ $15 billion. Around NZD9 billion of that was seen as being in the residential sector, with NZD3 billion each in non-residential construction and infrastructure. While much of the cost of reconstruction was expected to be covered by insurance, continuing quakes and the difficulty of insuring new buildings created uncertainty about the timing of reconstruction and repair.

The events described above help explain the relative slowness of New Zealand’s recovery since the GFC. The strong currency has dampened export incomes. High funding spreads for banks, combined with highly geared balance sheets in the household and farm sectors particularly, have slowed credit and spending growth. The household and private savings rates have risen (figure 13), but efforts to reduce leverage have, so far, halted the rise in debt ratios without lowering the numbers significantly. Property markets have remained weak.

Looking at overall performance since the GFC, real GDP fell through 2008 and into the first quarter of 2009. Per capita GDP fell from the second half of 2008 to mid-2010, and from there grew at only a slow rate. By the end of the review period, per capita GDP was around the levels seen in late 2004 (figure 10).

The recession meant that GDP fell to around 2 percent below potential output from 2009 onward. Survey-based indicators of capacity pressure also suggest a considerable release of the earlier strain (figure 11). Aside from a transitory spike in 2011, inflation has been easing.

The OCR has remained at very low levels through the post-GFC period. It was lifted by 50 bps in two steps in 2010 as the world and local outlook improved, but this was reversed after the Christchurch earthquakes and the rise of sovereign debt problems abroad.

By comparison, the Australian policy rate was raised from 3 to 3.25 percent in October 2009 and reached 4.75 percent in November 2010. The rate was then lowered gradually from late 2011 as the world outlook weakened and domestic momentum eased. Policy rates in the US, euro zone and the UK have all remained at the lows they reached in late 2008 and early 2009. As noted above, the very low interest rates have been assisted by other tools that seek to enhance the effectiveness of monetary easing.

4 Conclusion

New Zealand’s economic expansion from 1998 to 2007 was long and large by post-war standards. The 2008-09 contraction was marginally longer and deeper than the norm, was preceded by two years of slower average growth, and was followed by a very gradual recovery.

After recovering from the post-EAC recession, New Zealand avoided the recession that subsequently hit the US and euro area economies in 2001. The country entered 2002 in what seemed good shape for a sustained period of growth. Inflation pressure was limited; the unemployment rate was low; the fiscal position was strong; house price inflation was still modest; the terms of trade were high compared with the previous two decades; and the currency was relatively low.

As it turned out, this picture of a balanced economy changed quite quickly. Large domestic imbalances developed: the non-tradables sector faced strong demand while competitiveness fell for non-commodity tradables producers; and property markets boomed, with balance sheets becoming stretched across the household and farm sectors in particular. While private savings rates fell as households borrowed, national savings did not fall by much overall – the government accounts were in surplus until the last couple of years of the decade.

Early in the 2000s, a large and unanticipated rise in net migration came when activity was already picking up. This added a boost to consumer and housing demand and so domestic momentum. The migration rise was transitory.

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21 Reserve Bank of New Zealand (2011c)
with the higher inflows lasting only until 2003, but other factors took over to sustain momentum.

Important for sustaining that momentum, and the growth of domestic imbalances, was easy access to credit through the mid-2000s. This financed property investment especially – in the household sector, for example, housing loans grew much more quickly than consumer loans while consumption rose largely in line with GDP. It also supported growth in broader investment. Property prices climbed sharply for several years in all of the housing, rural and commercial sectors.

Relatively cheap funding from abroad led to growth in the use of longer-term fixed-rate loans. This helped insulate holders of existing loans from subsequent rises in the OCR. The Reserve Bank increased the OCR significantly through the mid-2000s because of strong inflation pressure.

New Zealand’s terms of trade climbed during the review period and have remained high by historical standards, reaching levels last seen in the early 1970s. World demand for commodity exports was important, as were falling world prices for imported goods. Strong growth in the Asian region contributed to both of those phenomena.

With high terms of trade, a relatively good growth outlook and high interest rates, the New Zealand dollar was strong for a long period. This, together with a tight labour market, further reduced competitiveness in the non-commodity tradables sector. Investment was increasingly directed to the non-tradables sector and commodity exports.

The strong domestic activity brought a high degree of capacity strain and inflation pressure. Excess demand in the 2000s was consistently, for around five years, at levels near the peaks reached in the 1990s. Inflation expectations rose, but remained generally consistent with the Reserve Bank’s inflation target despite the sharp rise in oil prices from 2006.

The GFC has had a major bearing on New Zealand’s economic performance in recent years. Following the GFC, the striking feature of New Zealand’s experience has been the slowness of the recovery. The OCR has consequently remained very low for an extended period with inflation pressures relatively contained.

Strong demand from some regions – Asia particularly – caused New Zealand’s terms of trade to rise again from 2009. With this has come a rise in the New Zealand dollar against trading partners in other regions, offsetting some of the gain from strong terms of trade. Balance sheets, especially in the household and farm sectors, remain stretched. Spending has consequently been cautious, and recovery in asset markets slow. To date, the limited appetite for debt has only really stalled the rise in debt ratios rather than reducing leverage. Earthquakes in Canterbury have been a setback to economic confidence as well as the capital stock in that region. Rebuilding is, however, expected to underpin a strong recovery in domestic demand over coming years.

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Appendix

Cross-country charts

Figure A1
GDP growth rates (annual percentage change)

Source: Haver Analytics, Statistics New Zealand

Figure A2
Annual CPI inflation

Source: Haver Analytics, Statistics New Zealand

Figure A3
Real 10-year rates (CPI-deflated)

Source: Haver Analytics, Reuters, Statistics New Zealand, RBNZ calculation

Figure A4
Real 90-day rates (CPI-deflated)

Source: Haver Analytics, Reuters, Statistics New Zealand, RBNZ calculation