Economic Overview

August 2012

The rhymes of history

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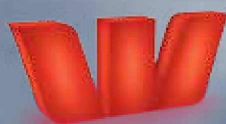

Dominick Stephens
Chief Economist

Note from Dominick

In July 2011 our main message was that the global economy would slow, but due to post-earthquake dynamics the New Zealand economy would accelerate. A year later, that does seem to be the way things are panning out.

The global economy is experiencing quite a nasty slowdown. There are tentative signs that the worst has passed in China, but for the US and Europe the situation is likely to get worse before it gets better. The "Eurogeddon" section of this *Overview* outlines what would happen to New Zealand in a scenario where Europe plunges into a full-blown banking system collapse – we don't regard that as the most likely outcome, but it is a possibility everybody should be aware of.

One thing I will be watching closely over the next few months is the US drought and emerging signs of dry weather in India and parts of Europe. A sharp rise in global food prices would be unhelpful for the world economy, but would boost New Zealand export incomes.

In New Zealand economic growth has accelerated and the housing market has warmed. But the Reserve Bank is leaving interest rates low because inflation is unthreatening and the exchange rate is uncomfortably high. This situation could persist for a while, so we now expect no change in the Official Cash Rate until July 2013. But if interest rates stay low for longer, the housing market could go from warm to positively frothy. And that would have a commensurate effect on consumer spending and debt levels. Although we don't expect a replay of the self-reinforcing spiral of house values, debt and spending that characterised last decade, we are concerned that New Zealand's economic imbalances could make a comeback of some sort. As Mark Twain once said, history doesn't repeat itself but it does rhyme.

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New Zealand Economy

Chicken or egg

Our expectation that the economy would gradually gather momentum this year is panning out, kicking off with a surprisingly strong GDP outturn in the March quarter. Activity is likely to be more domestically-focused over the next year, as export markets wither and post-earthquake reconstruction in Canterbury ramps up. The recent resurgence in the housing market has inevitably raised comparisons with the housing/spending/credit spiral of the previous decade. We believe that behavioural changes will constrain the pace of growth, but the impact of low interest rates is as potent as ever.

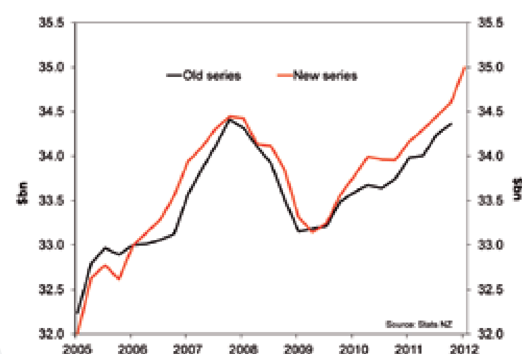
The current situation

Steady but unspectacular GDP growth through 2011 gave way to a surprisingly strong 1.1% gain in the March quarter of this year. Retail spending saw the expected letdown from last year's Rugby World Cup, but there were solid contributions from agriculture, manufacturing, and most importantly a broadening of the upturn in the service sectors that make up around 60% of the economy. Although we don't expect a repeat performance of this magnitude in coming quarters, the results fit with our view that growth would accelerate over this year.

The record of New Zealand's recent economic performance has been further shaken up by a host of revisions to the GDP series by Statistics NZ, partly reflecting improvements in how the data is prepared. Some of the notable revisions are:

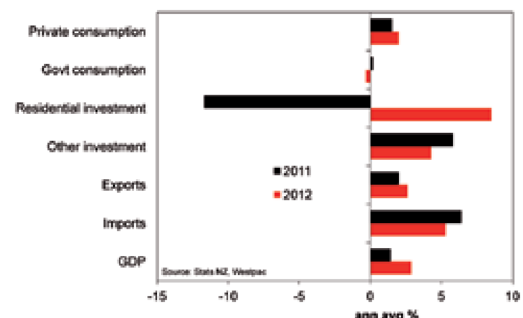
- The recession more clearly falls into two stages: a modest drought-induced downturn in early 2008, then a steeper drop as the Global Financial Crisis (GFC) hit in late 2008.
- The upturn from mid-2009 to mid-2010 was stronger than previously thought.
- The economy fell into technical recession (just) in the second half of 2010, after the first Canterbury earthquake and the announcement of tax changes aimed at cooling the property market.

Figure 1: GDP, old and new series



While the revised figures are more in accord with our assessments at the time, there are some aspects of the recovery that have fallen short of our expectations. Nationwide construction activity has barely picked up from its lows; given that there is strong evidence of an upturn in the Canterbury region, this suggests that conditions in the rest of the country have been softer than we anticipated. However, we note that the number of building consents issued has continued to rise and there is no reason to think that this won't eventually translate into actual construction activity. We continue to see housing construction as the swing factor for overall GDP growth in the next year compared to the last one.

Figure 2: GDP breakdown, 2011 actual and 2012 forecast



Jobs growth has also been underwhelming, with the unemployment rate ticking back up to 6.7% in the March quarter. That's partly due to last year's soft GDP growth, but it may also reflect the fact that the mix of growth has been different to what we expected – in particular the continued weakness in the labour-

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intensive construction sector. The changing mix may have also exacerbated the problem of skills mismatches, which would fit with surveys showing that a growing number of businesses are finding it harder to attract skilled workers even as unemployment stays stubbornly high.

The agricultural sector has remained a strong contributor to economic growth to date, but the favourable La Niña weather pattern has now passed (and there is a small but growing risk of an unfavourable El Niño pattern this summer). Strong production growth has taken the edge off lower product prices for farmers, but it has also been an important factor weighing on global prices, particularly in dairy markets, at a time that global demand has been slipping.

The housing market has been the standout performer of the last year. Auckland and Canterbury continue to lead the way in terms of price growth, reflecting their respective supply constraints, but prices are now turning higher nationwide. There is no question that mortgage rates – which have fallen to new record lows in recent months – are giving the market a shot in the arm.

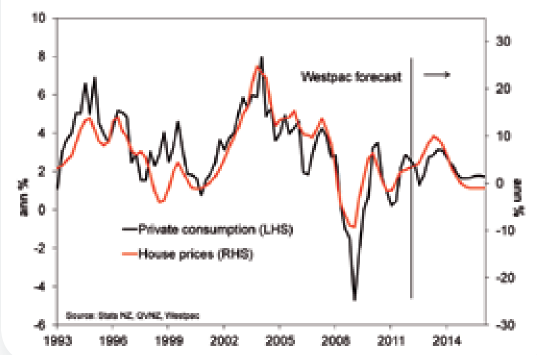
The outlook

The upgrades to our GDP forecasts since the May *Economic Overview* are partly dictated by the better than expected starting point, with strong March quarter growth and upward revisions to recent history. Our view remains for a shift to more export-led growth over the longer term, but this rebalancing process will inevitably go on hold for the next year or so – export markets are softening, while post-quake reconstruction is set to become a major contributor to growth.

The most significant development in our forecasts is that we now expect the rebound in house prices to extend further – on top of a 6.5% increase this year, we expect an 8% rise next year (previously 3%). The combination of rising house prices and a long stretch of low interest rates will have a commensurate effect on consumer spending and credit growth – and as detailed in the Financial Markets section, could lead to a growing conundrum for the RBNZ.

Our forecasts in no way suggest a replay of the upward spiral in house values, household debt and consumer spending that characterised the 2002-2007 boom. That period was driven not just by lower mortgage rates but also a favourable tax treatment for highly leveraged property investment. Easy credit and a booming economy gave people the confidence

Figure 3: Real consumption growth and house price inflation



to take advantage of these conditions, and household saving rates turned sharply negative.

The post-GFC environment is markedly different. Household saving rates have turned positive, and credit growth now lags behind income growth. Housing debt has grown just 1.5% in the last year, compared to the double-digit growth rates of 2003-2007. Some of this can be attributed to 'deleveraging', albeit mostly of the passive kind – since mortgages have a schedule for repayment of principal, deleveraging is the default setting. There is also a portion of borrowers who have kept their repayments the same in dollar terms as interest rates have fallen, so that they are repaying principal faster (though the implication is that this will reverse once interest rates rise). The greater force, though, has been the absence of leveraging: cautious consumers have held back from taking on ever-higher levels of debt against the same properties.

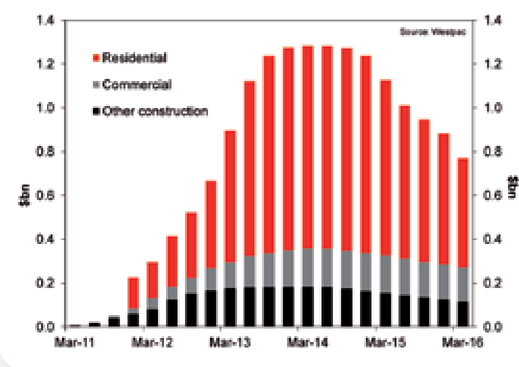
All of this shows that the causal relationships between house values, household debt and consumer spending are much more ambiguous than the experience of the previous decade might suggest. However, the chain of causation from interest rates to house prices remains very much intact. This points to substantial upside to house prices if, as we expect, the subdued outlook for inflation leads to an extended period of low rates.

Our forecasts imply a stabilisation or even a modest fall in the household saving rate – that is, growth in consumer spending will rise to be more in line with growth in actual and expected incomes. That's still a sharp contrast to the rapid spending growth during the last housing boom. Against a backdrop of increased consumer caution and tighter global access to credit, we expect house price gains to be sustained with only a modest increase in debt levels, and with

households slow to convert rising housing wealth into expenditure.

Income growth plays a major supporting role in our consumption outlook. Although it's not easy to gauge this in real time, solid growth in both retail spending and household deposits is a positive indication that income growth has picked up in the last year. The post-quake rebuild in Canterbury will provide a further 'income' injection in coming years, with much of the work being funded by payments from overseas insurers and reinsurers. While these funds are earmarked for construction in the first instance, they will flow through to other parts of the economy over time. The indications are that quake-related building activity is on track with the profile that we detailed in the May *Overview*.

Figure 4: Earthquake building activity



We also expect annual migration to shift from a net outflow to a modest net inflow of around 10,000 people by the end of next year, providing a further marginal boost to household income. There are very early signs that the outflow of New Zealanders to Australia has peaked, albeit at a higher level than we anticipated, largely due to a surprisingly resilient Australian jobs market.

Against this, we expect the fiscal position, both in terms of transfers and direct spending, to be a significant headwind to growth compared to the strong positive contribution it has made in the past. We believe the Government remains committed to returning the operating balance to surplus by the 2014/15 fiscal year; since our growth forecasts are less optimistic than the Treasury's, meeting this target will require even more spending restraint than was detailed in the Budget in May.

The lagged impact of weaker world prices – with little prospect of relief from a lower exchange rate – will remain a drag on farming incomes in coming months. The outlook for next year is more encouraging, as stimulus measures in China and other key export markets start to kick in. Lower global food production, particularly as a result of the current severe drought conditions in the US and emerging signs of dry weather in India and Southern Europe, should be an additional positive for farmgate prices.

Figure 5: Government final consumption projections

It's worth noting that our forecasts imply, to some degree, a return of the imbalances that characterised the previous decade. While there has been a modest amount of deleveraging by households, the government has become a significant dis-saver in recent years. Businesses are probably saving less on balance as well, as they catch up on investment that was delayed during the recession. Consequently, net saving at a national level is likely to decline again.

We expect the current account deficit to widen from the current 4.5% of GDP to a peak of 6.7% next year, with the imported component required for the Canterbury rebuild accounting for perhaps 1 percentage point of the widening. While high by global standards, this would be well short of the 8.9% peak reached in the previous housing boom – and just as in the last decade, there is no indication that such a deficit will harm the appeal of the New Zealand dollar as an investment destination. Nonetheless, it's a stark reminder that the need for longer-term structural changes to the economy remains undimmed by the recession or the GFC. A long period of low interest rates will only work to sustain these imbalances.

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Financial Markets

Out of sight, out of mind

With little immediate threat of inflation and a persistently high exchange rate, the RBNZ is under no pressure to signal higher interest rates, and won't be for some time. However, things are likely to look different by mid-2013, and an "on hold for longer" approach from the central bank could exacerbate imbalances further down the track.

Over the past three months New Zealand inflation has been in hibernation. Not only did headline inflation drop to 1% in the June quarter CPI report – the bottom of the RBNZ's target band and the lowest since 1999 – but quarterly consumer price rises have now come in below the RBNZ's forecasts for four quarters in a row. Indeed, a whole range of evidence argues that there's not much generalised inflation about right now: global inflation has slowed, inflation expectations continue to ease, wage growth is contained, and surveys show that fewer businesses intend to raise prices and fewer employees expect wage increases. There has certainly been evidence of a pickup in construction-related costs over the past year, but even here, the numbers have been frustratingly erratic from quarter to quarter, with sharp gains alternating with surprising softness.

Small wonder that the RBNZ sees little need to raise interest rates. In its June *Monetary Policy Statement*, the RBNZ was in fact surprisingly upbeat about the domestic economy, but felt that in view of the global risks it was appropriate for the OCR to stay at 2.5% well into next year. Perhaps more significant for the RBNZ than either GDP or current inflation has been the fact that the exchange rate has gone back to its old overvalued ways after briefly dropping in May. This will help keep imported inflation low for longer and is also likely to inhibit economic rebalancing, a long-standing concern at the RBNZ.

Figure 6: Inflation and inflation expectations

Phase shift

Over the past year our own thinking about the inflation and interest rate outlook has been divided into two distinct phases. The first phase featured accelerating growth but low inflation, very much in line with the RBNZ's current thinking. In the second phase, we expected the Canterbury rebuild to generate increasingly unambiguous inflation pressures, prompting much bigger eventual interest rate rises than the RBNZ is currently signaling or financial markets are pricing in.

Recent developments have made it clear that we're still very much in phase 1, and have prompted us to push out our expected start date for OCR hikes, to July 2013. Our latest inflation forecasts, incorporating the low June quarter CPI outturn, imply that the RBNZ won't see a headline inflation print above 2% until then. And as we explain below, the exchange rate remains overvalued and if anything is likely to appreciate further over the coming year.

Could New Zealand be the next Canada?

However, our thoughts on phase 2 still stand. Indeed, as we explain in the New Zealand Economy section, the longer interest rates stay low, the more likely we are to see a stronger pickup in the housing market and an associated return of old imbalances, including a rising current account deficit. Over time this will pose a growing conundrum for the RBNZ. In our view the risk is that the central bank will get behind the curve. In some ways, the situation we're now forecasting is eerily reminiscent of the early 2000s, when the global economy was in a funk, inflation was non-existent, and the RBNZ kept interest rates low even as house prices were rising. Present-day examples of Norway and Canada – where housing markets are already frothy but inflation-targeting central banks have kept interest rates low – suggest that the parallel isn't overly fanciful.

A key difference between then and now, of course, is that the RBNZ has spent the intervening years exploring the merits of various regulatory tools that it

might direct at an unruly housing market while keeping the OCR low. Again, the Canadian example is instructive: the government there recently passed a whole range of measures to tighten mortgage lending criteria. Given the many unknowns around the RBNZ's new Governor-designate, Graeme Wheeler, we haven't built this possibility into our forecasts just yet. But even if these tools are deployed, we're sceptical of their efficacy and would still expect substantial OCR increases to be required.

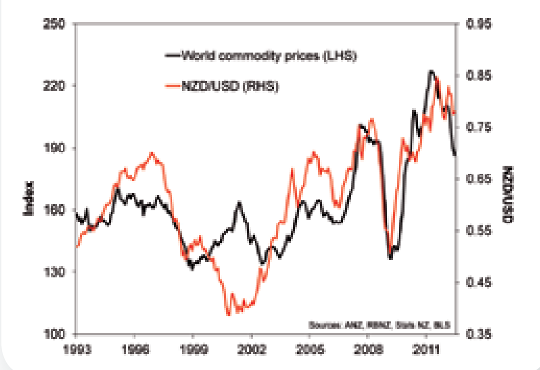
Meanwhile, we remain concerned that the RBNZ is underestimating the eventual inflationary consequences of the Canterbury rebuild: in recent decades all major New Zealand construction booms have been followed by sharply higher non-tradable inflation, lasting well beyond the peak in housing-related inflation itself. We struggle to see how the Christchurch reconstruction effort will be materially different, particularly as it's funded by billions of dollars of reinsurance payments which will end up stimulating a wide range of industries, not just construction.

An overvalued exchange rate

One of the key themes of our previous *Economic Overview* was the failure of the exchange rate to play its normal buffering role as export prices were tumbling. After we went to press it looked as if we were finally seeing a correction – the NZ dollar fell about 8% by early June – but since then the exchange rate has staged a substantial recovery, and the gap with New Zealand's commodity export prices has widened.

To some extent the exchange rate has remained at the mercy of global financial market risk appetite, falling in May amid rising fears of a Greek exit from the euro zone, and rallying in June when the EU summit promised progress. But even allowing for this the NZ dollar has been above our estimates of fair value since late last year. It's possible that euro zone troubles have prompted increased flow into the government bond markets of fiscally sound countries like Australia and New Zealand; earthquake reinsurance flows may also have played a role in keeping the exchange rate high. In any case, our global forecasts read like a Greatest Hits list of factors likely to send the NZ dollar even higher in coming quarters: quantitative easing in the US and Europe, recovering growth in China, and higher global food prices due to the US drought. We've raised our NZ dollar forecast accordingly, expecting it to push well above US$0.80 by early next year.

Figure 7: Inflation-adjusted commodity prices and the exchange rate



Financial Markets Forecasts (end of quarter)

	OCR	90 day bill	2 year swap	5 year swap	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Sep-12	2.50	2.70	2.70	3.10	0.79	0.78	0.66	0.54	60.8	72.3
Dec-12	2.50	2.70	2.80	3.20	0.80	0.78	0.65	0.53	64.0	72.7
Mar-13	2.50	2.70	2.90	3.30	0.83	0.78	0.65	0.52	69.7	74.7
Jun-13	2.50	2.90	3.10	3.50	0.83	0.79	0.66	0.53	68.1	74.7
Sep-13	3.00	3.40	3.30	3.70	0.82	0.80	0.66	0.53	66.4	74.4
Dec-13	3.50	3.80	3.60	4.00	0.80	0.79	0.66	0.51	65.6	73.5
Mar-14	3.75	4.20	3.90	4.30	0.79	0.79	0.66	0.50	65.2	72.9
Jun-14	4.25	4.50	4.20	4.60	0.77	0.79	0.66	0.49	64.7	72.4
Sep-14	4.50	4.75	4.50	4.80	0.76	0.79	0.67	0.48	64.2	72.0
Dec-14	4.75	5.00	4.70	5.00	0.74	0.80	0.67	0.47	63.6	71.3
Mar-15	5.00	5.20	4.90	5.15	0.74	0.80	0.66	0.46	63.9	70.9

International outlook

From the depths

The slowing global economy that we had warned of for some time has made its presence felt in recent months. The synchronised downturn has been widely felt amongst commodity and interest rate markets and has weighed on global inflation. While we hold little hope for a near-term improvement in the situation in the US or Europe, we suspect better prospects in China by late 2012 will spur a rebound in overall global growth next year.

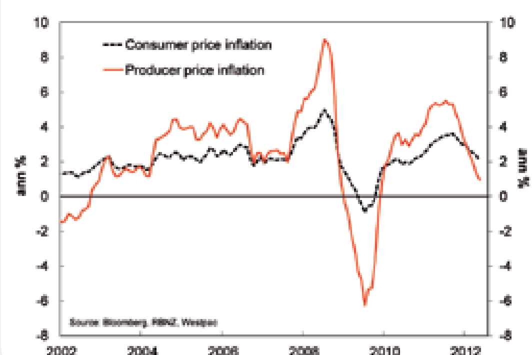


Figure 8: World inflation (weighted average of NZ's top 14 trading partners)

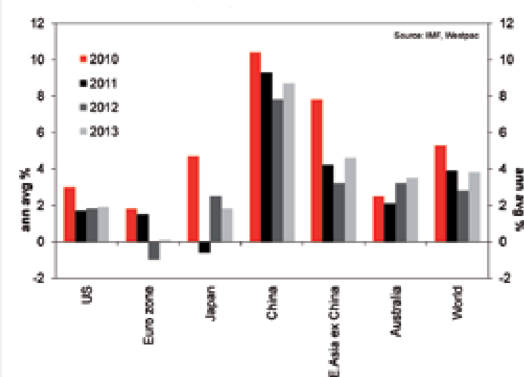


Figure 9: Key trading partner GDP growth

Since the May *Economic Overview*, global conditions have remained challenging to say the least. In Europe sentiment soured as Greek voters failed to elect a government and concerns mounted about Spain's ability to cope with its troubled banking system. And although a full blown catastrophe in Greece was once again averted at the 11th hour, Spain's escalating sovereign debt concerns present a far more frightening prospect than Greece ever did. Any period of relative calm is unlikely to last long. In the US, developments point to yet another step-down in growth in the June quarter, which led to Fed Chairman Bernanke describing recent data as having a "disappointing" tone.

But growth in China is the biggest swing factor for global growth. Although the first half of 2012 was slow, policy makers have been actively taking steps to stimulate domestic demand, measures we expect will gain traction by late 2012 and prompt stronger growth over 2013.

Underwhelming growth and falling commodity prices have conspired to produce one of the features of the current global economic environment – low inflation almost as far as the eye can see. (The notable exception being a sudden a sharp increase in global grain prices in recent weeks, due to fears of drought in the US.) The advantage of such a benign inflation backdrop is that central banks are able to undertake further stimulus measures without fear of igniting inflation. Indeed over the last few months we've seen central banks doing just that. Chinese authorities have cut interest rates and loosened the reins on credit. The Bank of England expanded its asset purchase programme to the tune of 50 billion pounds, the Federal Reserve has extended its 'Operation Twist' and the ECB has cut its policy rate to an all time low. And we expect that stimulus measures won't stop there. While the authorities may deny any plans to increase the European bailout fund's bond purchase firepower till the cows come home, we think their hand will be forced in the coming months as financial stability fears again reach boiling point. We also expect the Federal Reserve will have to provide another shot in the arm to the flailing US economy via another round of asset purchases. Closer to home we suspect the RBA's work is not done yet and that it will cut rates further eventually.

Australia

Although the Australian economy is faring better than most other advanced economies, the underlying theme of "two-speed" growth remains firmly entrenched. The mining investment boom which gathered momentum in 2011 is set to continue while

the domestic economy is left to confront a number of powerful structural headwinds. The household sector in particular remains vulnerable. Although consumer confidence has improved a little of late thanks to lower interest rates, a cash injection to many households from the government in advance of the carbon tax, and lower fuel prices, the level of confidence remains weak. A critical factor weighing on consumers' optimism (or more accurately lack of) is the state of the labour market. Quite simply, there's not much in the way of jobs growth going on outside the mining sector, and widespread job losses have been weighing on job security. Given this backdrop it is perhaps no surprise that the household sector continues to deleverage.

But the household sector is not the only clear area of weakness in the Australian economy. The high Australian dollar and sluggish global growth have weighed on exporters. Add to this weak housing construction and public investment and subdued non-mining investment, and the challenges faced by the Australian domestic economy remain substantial.

Yet despite the current challenges we do expect growth to pick up in 2013. Export prospects should get a lift as global conditions improve, and the domestic economy should garner support from lower interest rates. Already the RBA has cut interest rates by 125 basis points but we think policy wil become more stimulatory yet – we anticipate a further 75 basis points of rate cuts over the course of the final months of 2012 and the first quarter of 2013.

China

Chinese GDP growth slowed to 7.6% in the June quarter (compared to 9.3% during 2011). Although decidedly slower growth was not unexpected, the reality of the situation has some commentators fretting that China is headed for a "hard landing". Although this is a risk, particularly given the ongoing turmoil in Europe, our own position is that the fear underestimates the substantial stimulus measures policy makers have taken to reverse the tighter monetary policy measures they put in place in 2011. The most recent moves have included two interest rate cuts as well as measures which widen the degree of discounting lenders can offer to borrowers. This has clearly increased the supply of credit to the Chinese economy, although admittedly demand for credit is yet to improve to the same extent.

Overall Chinese authorities have demonstrated the capacity, and willingness (within a policy stance which is still characterised as "prudent") to support domestic demand. Given this, our view is that the first half of 2012 marked the bottom in the domestic demand cycle. By late 2012 we should see these policy measures starting to pay dividends, pushing annual growth to 8.7% in 2013.

Japan

Japan's GDP growth surged 4.7% in annualised terms in the March quarter, and survey data for the June quarter suggests business conditions continued to improve. Of course, this counter-point to an otherwise dour global environment is mainly a function of post-earthquake recovery and reconstruction activity, which won't last forever.

Europe

Indications are that the Eurozone has now been in recession for the better part of a year. This is an unsurprising outcome considering the background of turmoil in financial markets and ongoing uncertainty over the outlook for the monetary union as a whole.

The situation took a turn for the worse in May and June when Greek elections failed to produce a new government and Spain was forced to approach other European leaders for help recapitalising its stressed banking system. As has been the case almost countless times during the life span of the European debt crisis, despite the bleakest of predictions suitable bandaids were once again hauled out of the well-used first aid kit to avert complete meltdown: in this case, promises to use the Euro zone's new permanent bailout fund to recapitalise Spanish banks. That brought brief respite to markets, but doubts remained about execution, and about whether the bailout fund was big enough in the first place. These doubts are now turning back into fear as Spanish regional governments have started asking for bailouts, and as new questions have emerged over whether the Spanish government will remain on the hook for bailouts provided to Spanish banks.

Our core view is that Europe will remain locked in its dreadful cycle of brinkmanship followed by band-aid solutions, but that a full blown catastrophe will be avoided. But the possibility of a much worse outcome is definitely live – we illustrate what might happen to New Zealand in a "Eurogeddon" event on page 11.

United States

The United States economy has once again lost momentum over the second quarter of 2012. While the housing market is stabilising and the scars of the financial crisis are gradually healing, the growth

outlook remains weak due to the pressing requirement for all levels of government to reduce expenditure to a level more in line with revenue. Indeed, the main difference from some prominent European sovereigns is that the US can set its own monetary policy and the US dollar remains unchallenged as the world's pre-eminent reserve currency. Consequently, markets appear willing to let the country's dire fiscal situation slide. Just how long this will remain the case is anyone's guess. And the politics of the situation are creating a lot of uncertainty around what the eventual combination of higher taxes and spending cuts will look like. One worry right now is that the country could be staring down the 'fiscal cliff' of a whole swathe of automatic tax increases and spending cuts at the end of this year if Congress can't agree on extensions.

With no space for fiscal stimulus to provide a spark to ignite growth in the US economy, the onus remains on the Federal Reserve. For its part, the Fed has elected to extend "Operation Twist" but in his most recent testimony to the US Congress, Chairman Bernanke gave few hints that further stimulus measures were on the cards. To our mind, the fundamentally weak growth outlook for the US will eventually force the Fed's hand. Following on from further labour market weakness, we expect the case for QE3 to be made in the second half of this year.

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2008	2009	2010	2011	2012f	2013f
New Zealand						
Real GDP % yr	-0.2	-2.4	1.8	1.4	2.9	3.6
CPI inflation % annual	3.4	2.0	4.0	1.8	1.5	2.7
Unemployment %	4.5	6.9	6.7	6.4	6.2	5.0
Australia						
Real GDP % yr	2.5	1.4	2.5	2.1	3.2	3.5
CPI inflation % annual	3.7	2.1	2.7	3.1	2.1	2.2
Unemployment %	4.3	5.6	5.2	5.1	5.4	5.5
United States						
Real GDP %yr	-0.3	-3.5	3.0	1.7	1.8	1.9
Consumer Prices %yr	3.8	-0.3	1.6	3.1	2.0	2.0
Unemployment Rate %	5.8	9.3	9.6	9.0	8.3	8.3
Japan						
Real GDP %yr	-1.7	-5.7	4.7	-0.6	2.5	1.8
Consumer Prices %yr	1.4	-1.3	-0.7	-0.3	0.1	-0.2
Unemployment Rate %	4.1	5.2	5.1	4.5	4.3	4.3
Euroland						
Real GDP %yr	0.3	-4.2	1.8	1.5	-1.0	0.1
Consumer Prices %yr	3.3	0.3	1.7	2.7	1.5	1.2
Unemployment Rate %	7.5	9.5	10.0	10.4	11.4	12.0
United Kingdom						
Real GDP %yr	-1.1	-4.4	2.1	0.8	-0.4	0.7
Consumer Prices %yr	3.6	2.2	3.2	4.0	2.0	1.5
Unemployment Rate %	5.6	7.6	7.8	8.4	9.0	9.2
China						
Real GDP %yr	9.6	9.2	10.4	9.3	7.8	8.7
Consumer Prices %yr	5.9	-0.7	3.3	5.4	2.7	3.4

Forecasts finalised 25 July 2012

Eurogeddon

What would happen to New Zealand?

Westpac's forecasts are predicated on Europe escaping a full-blown banking system collapse, but that doesn't mean businesses and financial markets should ignore the possibility. Ships carry lifeboats not for the most likely scenario, but because disaster is possible. In that spirit, we recently published an alternative "Eurogeddon" scenario detailing what might happen to New Zealand if Europe did plunge into a banking system collapse.[1] Here we summarize the main ideas.

New Zealand would obviously face a sharp drop in the global price of its export commodities. But the biggest problem would be New Zealand's large debt to the rest of the world. Overseas lenders would demand a higher premium before agreeing to lend to New Zealand banks. With overseas debt so expensive to roll over, New Zealand banks would have to compete more fiercely for local deposits, putting upward pressure on deposit interest rates. And this would be passed through into upward pressure on mortgage and business lending rates.

The RBNZ would attempt to offset this market pressure for higher mortgage rates by reducing the OCR. But it may not be able to cut the OCR all the way to zero, because a sharp decline in the exchange rate could prompt higher inflation (similar to the experience of the UK since the GFC, or the rather more extreme case of Iceland since 2007). Due to the tension between higher bank funding costs and the lower OCR, it is not clear which direction mortgage rates would go in Eurogeddon, but we suspect they would be more likely to rise than fall.

The behavior of the exchange rate is clearer – it would plunge. After the 2008/09 GFC the NZD reached 50 cents against the USD. It could easily re-test such levels after Eurogeddon. This would cushion the blow for exporters, ease New Zealand's difficulty with funding its external debt, and transfer some pain onto foreign lenders. But the lower exchange rate would also be painful for consumers, as it would drive up the NZD price of internationally traded goods and services.

Eurogeddon would mean recession for New Zealand. However, the drop in GDP would probably be less savage than in 2008/09, due to the stimulatory effect the Christchurch rebuild. In our scenario we penciled in three quarters of falling GDP, and then a halting recovery. House prices would probably fall, although the extent of decline is unknown. The likely Government reaction would be "zero budgets" rather than stimulus or austerity.

1. See http://www.westpac.co.nz/assets/Business/Economic-Updates/Eurogeddon.pdf

Eurogeddon scenario compared to central forecasts

Figure 10: GDP growth

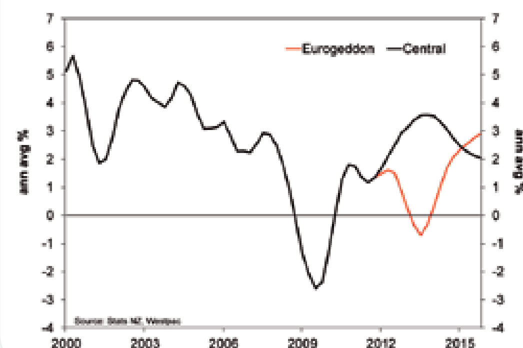


Figure 11: Official Cash Rate

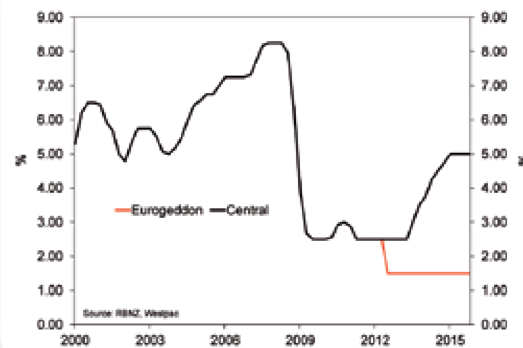
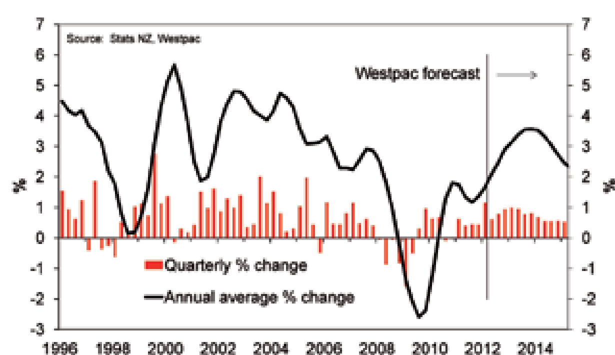


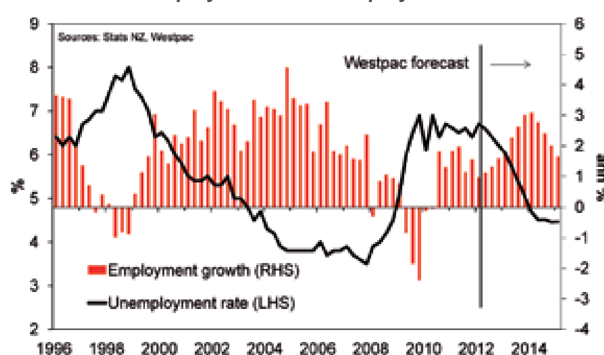
Figure 12: Exchange Rate

Annual Average % change	March years				Calendar years			
	2011	2012	2013f	2014f	2011	2012f	2013f	2014f
Private consumption	1.6	2.0	2.0	2.9	1.5	2.0	3.0	2.1
Government consumption	0.3	0.3	-0.8	-0.8	0.2	-0.3	-1.0	-0.2
Residential investment	3.8	-11.9	16.7	31.8	-11.7	8.5	33.9	14.6
Business investment	6.9	2.4	6.4	8.2	5.8	4.3	8.6	5.3
Stocks (% contribution)	1.2	0.7	0.1	0.0	-0.2	0.6	-0.1	-0.1
GNE	2.6	2.2	3.8	4.3	1.7	3.7	4.4	2.8
Exports	2.1	1.9	2.7	3.2	2.0	2.6	2.8	3.8
Imports	11.1	6.0	4.6	5.2	6.4	5.3	4.9	3.8
GDP (production)	**1.7**	**1.7**	**3.1**	**3.5**	**1.4**	**2.9**	**3.6**	**2.7**
Employment (% annual)	1.8	1.0	1.7	3.1	1.5	1.6	3.0	2.0
Unemployment rate (% s.a. end of period)	6.6	6.7	6.0	4.7	6.4	6.2	5.0	4.5
Labour cost index (all sectors, % annual)	1.9	2.0	1.5	1.8	2.0	1.7	1.6	2.4
Inflation (% annual)	4.5	1.6	1.6	2.6	1.8	1.5	2.7	2.5
Current account balance (% of GDP)	-3.7	-4.8	-6.7	-6.5	-4.2	-6.4	-6.7	-6.1
Terms of trade (% annual)	6.7	-2.1	-4.9	3.1	1.0	-8.1	3.1	2.5
90 day bank bill (end of period)	3.00	2.74	2.70	4.20	2.71	2.70	3.80	5.00
5 year swap (end of period)	4.54	3.59	3.30	4.30	3.62	3.20	4.00	5.00
TWI (end of period)	67.2	72.5	74.7	72.9	68.7	72.7	73.5	71.3
NZD/USD (end of period)	0.76	0.82	0.83	0.79	0.78	0.80	0.80	0.74
NZD/AUD (end of period)	0.75	0.78	0.78	0.79	0.77	0.78	0.79	0.80
NZD/EUR (end of period)	0.55	0.62	0.65	0.66	0.58	0.65	0.66	0.67
NZD/GBP (end of period)	0.47	0.52	0.52	0.50	0.49	0.53	0.51	0.47

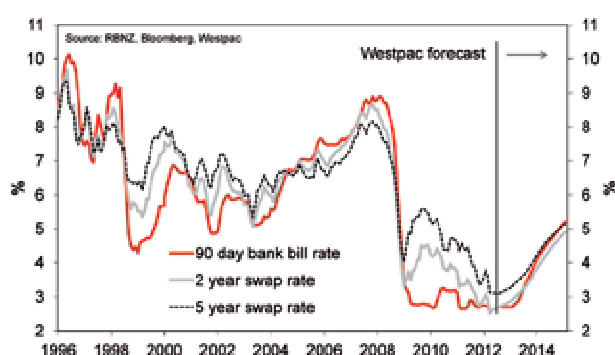
New Zealand GDP growth



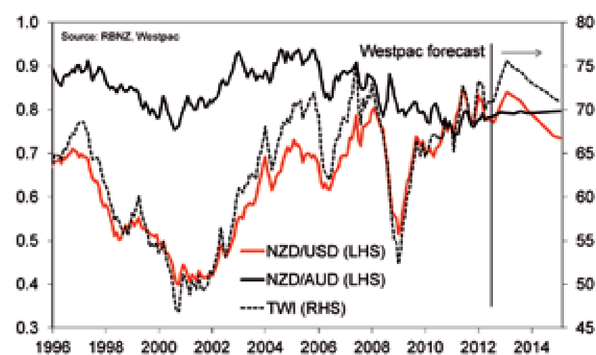
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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