20 August 2009

Getting more for your money

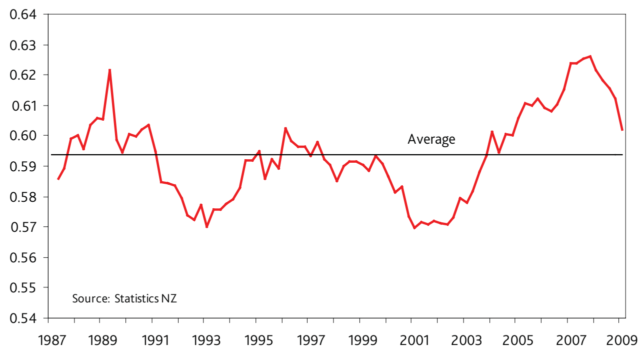
Consumers not the biggest party animals

- **Cheaper imports were a key component of consumption growth in the 2000's, not so much an over-zealous consumer.**
- **The increase in the country's debt predominantly funded a generalised asset boom.**
- **Unlike government forecasts, we don't expect consumers to materially under-perform the general economy over the next few years.**

New Zealand Inc has undoubtedly been on a debt-funded spending splurge in the past decade. Net foreign liabilities increased from around 80% to 100% of GDP. And the rapid debt build-up didn't deliver quality economic growth: New Zealand's productivity flat-lined in the 2000's. The finger of blame has often been pointed at the NZ consumer. We think this is unfair. The consumer took part in the borrow-and-spend mentality of the past decade, but not disproportionately so.

We have on occasion seen a variant of Figure 1 in official publications. It shows the size of household consumption relative to the rest of the economy, in real (i.e., volume) terms. The usual diagnosis drawn from this chart is that debt fuelled an unsustainable consumption splurge (with real consumption's share of the economy catapulting from 57% to 62.5% in just 5 years). The prognosis is that the consumer is set for numerous years of belt-tightening – more so than the rest of the economy – as payback for the years of gluttony.

Figure 1: Real household consumption as a share of trend real GDP



There is no denying that the household sector piled on debt. The ratio of household debt to disposable income increased from 105% in 2000 to 160% in 2007. However, the vast majority (94%) of that borrowing went into the housing boom, not consumption goods. Consumer debt went from 10% of income to 12% over the same period.[1] Consumption did get an indirect boost from higher house prices via housing equity withdrawal, and we discuss this channel in the 'On the house' section below.

The increase in New Zealand's debt funded a generalised asset price boom. The surge in total household borrowing was not out of proportion with what was happening in other sectors of the economy, and consumer debt was under-represented *(see Table 1)*.

Table 1. Debt owing to M3 financial institutions

	Share of Total Debt					
	Agriculture	Business	Housing	Consumer	Total Household	Total
2000	10.5%	29.8%	54.2%	5.5%	59.7%	
2007	12.7%	26.3%	56.3%	4.6%	60.9%	
June 2009	15.3%	26.1%	54.5%	4.1%	58.6%	
	Compound Annual Growth					
2000-2007	15.1%	10.0%	12.6%	9.3%	12.3%	12.0%

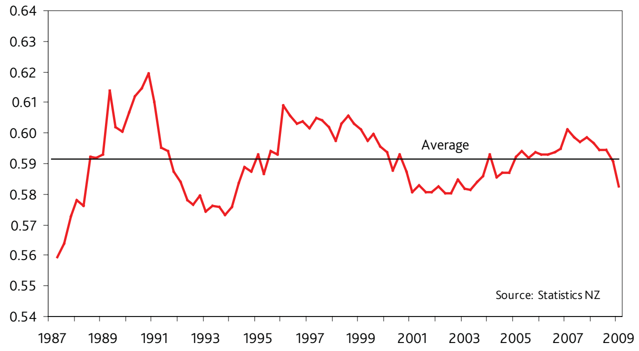
Lies, damn lies, and statistics

As we'll explain, a fairer way of expressing consumption's share of the economy is to simply do it in nominal terms. Recasting the data in this manner *(see Figure 2)*, leaves one with an entirely different perception. The relative consumption boom of 2002 – 2007 was modest by historical standards and, as a share of the economy, is now below its long term average.

[1] Of course mortgage borrowing can be used to finance consumption, but the data does not make the distinction.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bodonovan@westpac.co.nz

Figure 2: Nominal household consumption as a share of trend nominal GDP

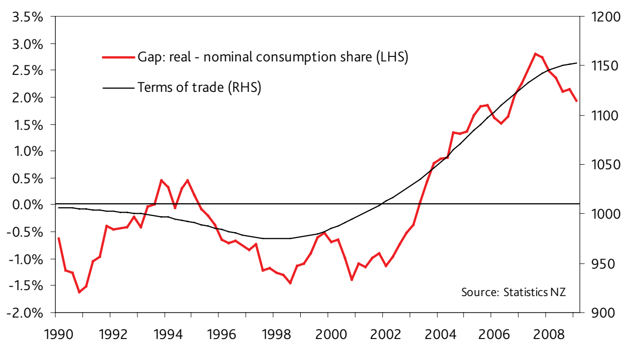


ToTing it up

So why the massive divergence between consumption's share in nominal and real terms? In pure accounting terms, the explanation lies with the deflators. Inflation of consumer goods prices was less than average inflation in the rest of the economy – particularly from 2002 to 2007. But the reason is the terms of trade (ToT).

In Figure 3 we overlay the gap between real and nominal consumption shares (i.e., Figure 1 minus Figure 2) against the ToT.

Figure 3: Real minus nominal consumption shares versus trend terms of trade



The ToT is the ratio of export prices to import prices, both expressed in NZ dollars. For a given volume of exports, the ToT measures how much by way of imports we can afford. A rise in the ToT basically means NZ gets more for what it produces. So we can consume more, without producing more.

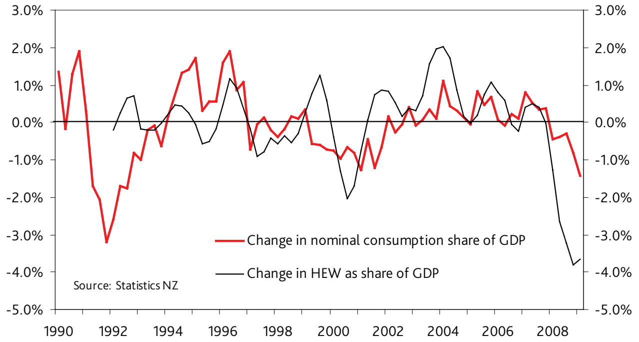
Between 2002 and end 2007, New Zealand's ToT rose around 20%. That represented a massive relative price shock to the benefit of the NZ economy. A big part of the story has been the China factor: China's rapid growth has helped push up NZ's commodity prices and the integration of their manufacturing capacity into the global economy lowered the price we pay for many imported consumer goods.

On the house

Debt did have some role in (indirectly) boosting nominal consumption's share of the economy. As house prices surged, homeowners tapped into their increased equity and used part of it to bolster consumption. On the flip side, when house prices fell consumption was slammed.

In Figure 4, we map the change in the share of nominal consumption against the change in Housing Equity Withdrawal. We assume a constant 20% of HEW goes into consumption. At face value, it seems reasonable to conclude that the most recent house price cycle (with massive Housing Equity Withdrawal[2] savagely switching to Equity Injection) had a strong influence on the variation in consumption's share of the economy.

Figure 4: Change in nominal consumption share and housing equity withdrawal



Conclusion

An adjustment to NZ's outsized debt has already begun, and will likely continue. There will be slower growth in the economy (compared to 2000 – 2007) as increased leverage will not play as big a role as it has in the past decade. But the point of this note is that NZ Inc has to do that adjustment, not just the consumer.

Looking at the share of real consumption to trend GDP, with the popular perception that the increase in consumption was mostly debt funded, the natural conclusion would be that the consumer is going to relatively under-perform the general economy over coming years. Both Treasury and RBNZ forecasts are for real consumption growth to way undershoot real GDP growth over upcoming years. A negative ToT shock is most likely required for this to happen, rather than the modest corrections incorporated.

Looking at the consumption share on a nominal basis, and recognising that the consumer has experienced a very favourable relative price shock, implies that the consumer sector does not have further big adjustment ahead of it. The sector is likely to perform on a par with the broader economy (or better if there is a further improvement in the terms of trade and housing wealth). Cheaper imports were a key component of the consumption growth in the 2000's, not so much an over-zealous consumer. The increase in the country's debt predominantly funded a generalised asset boom.

Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250
Doug Steel, Senior Economist, Ph: (64-4) 470 8251

[2] See our Bulletin, *"The return of HEW?"*, 10 August 2009