25 November 2009

# This time is different

## Eight decades of economic recoveries

- **New Zealand tends to experience very high GDP growth in the years following recession. There is no reason to suppose this time will be different.**
- **On average, NZ GDP growth peaks at 6% per annum nine quarters after recession has ended.**
- **Westpac's GDP forecast of 3.5% growth in 2010 and 3.8% in 2011 is the highest in the market, but the historical record suggests even we are too pessimistic.**

Westpac is forecasting 3.5% NZ economic growth in calendar 2010. This is the highest of 16 economic forecasters by some margin. The next highest forecast is 3.0%, the mean is 2.4% and the lowest is a measly 1.3%. The RBNZ has plumped for a middle of the road 2.5%. A valid question is whether we are being realistic or delusional!

In recent times there has, not surprisingly, been plenty of work looking at the nature of economic downturns but precious little on the nature of recoveries. In this note, we examine the speed of recovery from past NZ recessions and give a stylised outline of a standard economic recovery. Recoveries from past recessions have tended to be very strong, and an equally valid question is why forecasters think this time is going to be different and the recovery so timid!

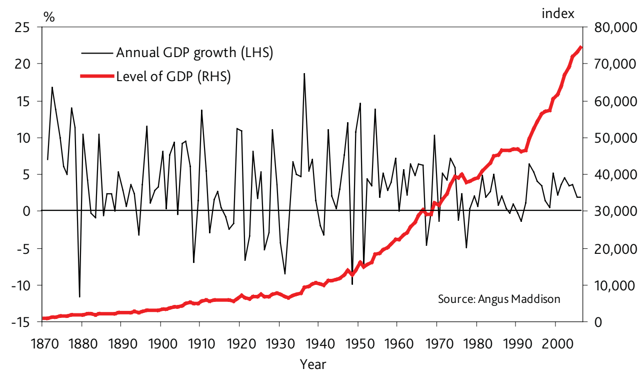
We have paraphrased the title of this bulletin from that of a recent book by Reinhart and Rogoff: *"This Time is Different: Eight Centuries of Financial Folly"*. They suggest that "the pervasive view that 'this time is different' is precisely why it usually isn't different, and catastrophe eventually strikes again". Perhaps we collectively perpetuate the same misperception on the flip side when looking at economic recoveries: this time is different and the recovery will not be as robust as past recoveries. How wrong that collective wisdom usually is.

### Previous recoveries

We'll have a look at two data sets. The first is from a widely-used database developed by British academic Angus Maddison, and has annual NZ GDP back to 1870 *(see Figure 1)*.

In this sample we identify 23 recessions[1] (prior to the current one). The average size of the economic rebound, in the year after recession, is 6.4%. Since WWII it is 4.8%. Of itself, this doesn't necessarily say a lot. NZ economic activity used to be wildly volatile and the depth of recession influenced the strength of recovery. Nonetheless, robust recoveries – once they take hold – have been the norm, not the exception.

**Figure 1: NZ real economic growth**




On seven occasions the economic expansion in the year following recession was less than 4%. And in two of these seven instances (1908 and 1990/91) it was only a matter of timing: double digit growth was in evidence within two years of recovery. There were five occasions out of 23 where the economic rebound was truly anaemic (post the 1885, 1912, 1975, 1977/78, and 1988 recessions). Interestingly, the 1970s were associated with disastrous terms of trade shocks (the twin oil shocks of 1973/74 and 1979, and Britain joining the EEC in 1973 – imposing quota limits on NZ meat and dairy exports). New Zealand's two exemplary periods of systemic banking crisis occurred in the late 1880s/early 1890s and in the late 1980s/ early 1990s[2]. The recession of 1912 followed three years of spectacular growth (cumulative growth of 22%, of which only 3% was retraced) and the recovery ran into the brick wall that

[1] We defined recession for this dataset as whenever year-on-year growth was zero or below.

[2] *"Banking crises in New Zealand: an historical overview"*, Chris Hunt (RBNZ), Paper prepared for the RBNZ/VUW Professorial Fellowship Workshop, Wellington, June 2009.

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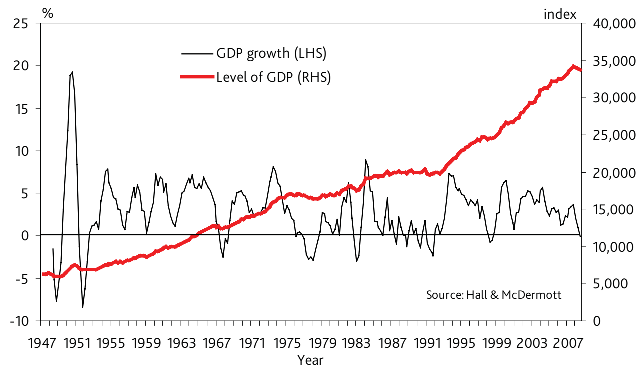
was WW1. Thus, New Zealand's historical examples of anaemic economic recovery were mainly associated with periods of domestic banking crisis or extreme adverse supply shocks.

The second data set is that of Hall and McDermott, presenting quarterly economic activity since Q2 1947 *(see Figure 2)*. In this data set we identify 11 recessions[3]. That's a remarkable average run rate of around 1 recession every 5½ years!

**Figure 2: NZ post-WW2 economic growth**




However, in this paper we are interested in the recoveries from recessions. For recovery, we have arbitrarily set the requirement that there are at least 3 out of 4 quarters of positive growth. We do this as we are trying to identify periods of sustained recovery from recession. This definition effectively turns the 1975 and 1976-78 recessions into one long recession, and collapses the 1988, 1989-90, and 1991 recessions into one.

We have identified seven periods of sustained post-recession recovery. Our current GDP forecast has growth hitting 3.5% seven quarters after the end of the 2008/2009 recession (which we expect has finished). Table 1 compares that to the growth rates that prevailed seven quarters after each historical recession. It also shows the peak growth rate during each recovery, and the number of quarters taken to reach the peak. Peak year on year growth rates tended to occur around nine quarters after the end of recession.

The general findings are the same as for the long-run Maddison time series: the recoveries are relatively robust with the exception of the negative supply shocks of the 1970s and the systemic banking crisis of the late 1980s/early 1990s. It is worth remembering that in 2008/09, New Zealand did not suffer a banking crisis and the terms of trade remained at or above its historical average.

Our top of market forecast of 3.5% GDP year on year growth for end 2010 is below what history would suggest. Even excluding the massive post war rebound in activity, the average 7 quarter ahead growth in previous recoveries was 3.7%. If we further exclude the negative supply shocks of the 70s and the banking crisis of the late 1980s, average growth was 4.7%. Peak growth rates in past recoveries tend to be around 6%.

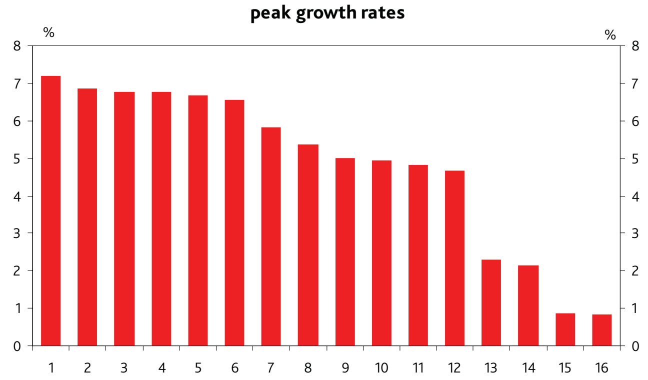
[3] We use the rule of thumb of two consecutive quarters of negative quarterly growth denoting recession. On each occasion annual growth also turned negative.

**Table 1: Growth rates in post WW2 sustained recoveries**

| | Growth 7 quarters after recession | | Peak growth rate in recovery | | | |
|---|---|---|---|---|---|---|
| Recovery from Recession | Ann % chg | Ann avg % chg | Ann % chg | Qtrs after recession | Ann avg % chg | Qtrs after recession |
| 1948 | 19.2 | 14.6 | 19.2 | 7.0 | 16.8 | 8.0 |
| 1950/51 | 5.4 | 3.0 | 7.9 | 9.0 | 6.8 | 10.0 |
| 1967 | 5.2 | 4.5 | 5.3 | 8.0 | 5.0 | 9.0 |
| 1975-77 | 1.6 | 2.1 | 2.8 | 4.0 | 2.1 | 7.0 |
| 1982 | 5.1 | 6.9 | 8.9 | 4.0 | 6.9 | 7.0 |
| 1988-91 | 2.0 | 1.1 | 7.3 | 9.0 | 6.8 | 12.0 |
| 1997 | 6.2 | 4.3 | 6.5 | 8.0 | 5.8 | 9.0 |
| **Averages** | | | | | | |
| All recoveries | 6.4 | 5.2 | 8.3 | 7.0 | 7.2 | 8.9 |
| Ex '48 | 4.3 | 3.7 | 6.5 | 7.0 | 5.6 | 9.0 |
| Ex '48, '75, '88 | 5.5 | 4.7 | 7.2 | 7.3 | 6.1 | 8.8 |

The approach we take above discards a lot of information. Instead of looking only at recoveries from recession, we can examine recoveries from any significant economic slowdown. On this basis, there are 17 periods of 'recovery' post WW2. The average peak year-on-year growth rate across all the recoveries (excluding the immediate post war whopper) is 4.8% and the median 5.2%. Excluding the periods of severe supply shock and banking crisis, the average is 5.7% and the median 5.8%. In fact, excluding those periods, the peak growth rate in every other instance of recovery was above 4.5% *(see Figure 3)*. Whichever way you cut it, the standard economic recovery is fairly strong, and much greater than what nearly all forecasters are picking for the current rebound.

**Figure 3: Distribution of post-1950 economic recovery peak growth rates**




## A stylised recovery

Generally a modern day NZ economic recovery has its origins in the low interest and exchange rates emanating from the previous slowdown. Economic agents anticipate a recovery, and the higher inflation that will accompany it. Combined with current low interest rates, this leads to an upwards re-rating of asset prices. This occurs before there is any growth in credit. Rising asset prices result in a resurgent consumer, and an inventory cycle that reinforces the general economic recovery. A low exchange rate results in improved competitiveness and growth in export and import competing industries. The recovery is then (a year or so down the track) reinforced by increased employment/incomes, a turnaround in the credit cycle, and increased investment. Often NZ's recoveries have been turbo-charged by migration and a residential construction boom, and recovery from drought.

**Same, same but different**

There are a number of aspects of this economic cycle that people could point to as being different.

1. The exchange rate (TWI) didn't stay low for long.
2. We've experienced a dramatic global financial crisis (GFC) and are yet to see the full regulatory response.
3. NZ Inc has a record level of indebtedness.
4. The secondary finance sector has been decimated, limiting availability of property and equipment finance.

However, there have been a number of offsetting factors. The exchange rate is higher because commodity prices have rebounded much more quickly than they normally do after a global downturn. The world is no longer so US-centric, with strong growth in demand from emerging markets. NZ has been in a period of substantial trade liberalisation, with numerous free trade agreements being signed. The response to the GFC has been extraordinary fiscal and monetary policy stimulus around the world (and a record low OCR in NZ and strong fiscal/infrastructure stimulus). And lack of mezzanine finance may be a temporary problem: history repeatedly shows that where there is a will (and more particularly, a dollar), there is a way.

What is startling is how many factors are currently behaving similarly to precursors of past strong recoveries.

1. Asset prices (particularly housing and equities) have rebounded strongly.
2. We are experiencing a mini migration boom.
3. Forecasts of global activity continue to be revised upward.
4. There is a dramatic shortfall of houses being built (which will be a multi-year source of economic growth in the nascent recovery).
5. The inventory cycle is at extremely low ebb, and restocking will reinforce the economic recovery.
6. Leading indicators (e.g., yield curve, business and consumer confidence) are, if anything, stronger than in most other economic recoveries.

Those looking at credit, employment, mortgagee sales, and business defaults will find that they miss the first year of economic recovery: these are all classic lagging indicators. It is one of the quirks that default rates (consumer and business) tend to keep rising during an economic recovery. The reasons are two-fold: time and the level of activity. Time is the enemy in a downturn – some firms and individuals can hang on for only so long. And even when economic growth returns, the level of economic activity can still be very weak (e.g., in the June quarter, the volume of construction activity was 15% below cycle peak, manufacturing was 17% down, and trade 7% lower). Acute financial pain tends to continue to be experienced by many through the preliminary stages of economic recovery.

In all recessions and economic recoveries, people tend to say this time is different. In the absence of 1970s style supply shocks or late 1980s/early 1990s systemic banking problems, we'd hazard to say that this time will not be different! Weighing it all up, we feel the risks to our forecast next year are to the upside, not the downside as indicated by Consensus Forecasts.

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