ARTICLES

Some perspectives on past recessions

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As the economy slows in 2008, this article sketches out some key features of past recessions in New Zealand – all the downturns since the mid-1960s, plus the Depression of the 1930s. Each recession was triggered, in significant part, by international events, but each was exacerbated, in part, by domestic pressures or imbalances. History doesn't mechanically repeat itself, but these past experiences are a sobering backdrop against which to consider the outlook for the New Zealand economy over the next year or two.

1 Introduction[1]

A recession is a material period over which the level of economic activity is falling. Understanding the events that have triggered past recessions, and exacerbated or mitigated their severity, may help to shed some light on the current situation.

We selected six previous recessionary periods in New Zealand, beginning with the Depression in the early 1930s. Our decision to examine the Depression was motivated by recent comments that the current stresses on international financial markets are as severe as those in the 1930s. Our main focus, however, is on the five main recessionary periods in New Zealand since the mid-1960s. As time has gone on, the structure of the economy and the policy framework have become progressively more similar to that today.

For each recession, we sketch out the important factors and events leading up to the recession, the likely causes of the recession, the impact of the recession on the economy, and finally the responses of fiscal and monetary policy. More in-depth formal treatments could be usefully undertaken of each of these episodes. Here, we take a more impressionistic approach – briefly highlighting key considerations, and looking for common themes and patterns across the various episodes.

† We would like to thank Andrew Coleman at Motu for compiling the house prices series.

1 To prepare this article, we have collected economic data from a variety of sources. Most data extend back to 1900. The data allows us to compare and contrast the various recessions. We hope to publish the data in the coming months. A selection of graphs from the database is provided in box 1.

2 The Depression (1930–1934)

The starting point

At this time, New Zealand's exports were highly concentrated. In 1929, around 84 percent of exports were pastoral and Britain took around 80 percent of the total. The Depression was, however, an international event and a more diversified export sector may not have significantly lessened the impact on New Zealand.

New Zealand had few of the initial imbalances that often exacerbate downturns. There had been no major credit, share price, or house price boom in New Zealand in the mid-late 1920s, no particular inflation problem, and fiscal policy was no more than mildly stimulatory. However, many New Zealand farmers entered the Great Depression with large debts, a legacy of a boom in the early 1920s following the end of World War One.

New Zealand had no central bank, and hence no independent monetary policy, until 1934. The exchange rate for the New Zealand pound had been informally fixed to sterling, but this relationship was managed by the commercial banks rather than by any government agency. Maintaining a fixed exchange rate was seen, internationally, as an important indicator of financial soundness and of a commitment to prudent economic management.

The recession

The causes of the global Depression are still debated. The stock market crash in the US beginning in October 1929, to which the Federal Reserve responded with sharp reductions in US interest rates, was certainly not the cause. However, the resulting losses and interruptions to the availability of credit were among the many factors that exacerbated the downturn.

Exchange rates and capital flows mattered a lot. For much of the 1920s, countries had focused on trying to re-establish the Gold Standard (under which a currency was convertible to gold at a fixed and pre-announced price). At the same time, much of Europe's growth in living standards was heavily reliant on short-term capital inflows from the US to finance post-war reparation payments and to service large war debts. This flow of capital was curtailed in the late 1920s when the US experienced a speculative boom (on some measures, US leverage reached levels not seen again until this decade). The rapid rise in asset prices, and higher interest rates in the US, attracted capital and drew funds away from Europe.

To limit the losses of gold reserves to the US (and to France, which was seeking to accumulate large gold holdings), many European countries had to keep their interest rates high, constraining demand and economic activity. Britain was of particular importance to New Zealand; it had rejoined the Gold Standard in 1925 at an exchange rate widely regarded as overvalued and faced constant pressure through the late 1920s to lower domestic prices and wages to levels more consistent with the exchange rate.

Closer to home, Australia faced seriously constrained access to financial markets by 1929 – following on from a large borrowing binge and serious imbalances that had built up in the mid-1920s. The disruption in Australia's access to international financial markets probably adversely affected New Zealand because many of the main banks in New Zealand were Australian-owned, and their foreign exchange receipts were to some extent managed jointly across the Australian and New Zealand businesses. The New Zealand government remained able to borrow in London until 1931, although the risk of constrained access will have shaped some of the fiscal choices made in response to the economic downturn.

The impact

Export prices were the primary channel through which the world Depression affected New Zealand. Between 1929 and 1933, international prices for New Zealand's exports fell by 45 percent. In an attempt to maintain incomes, New Zealand farmers increased production. Export volumes increased by 33 percent between 1929 and 1933. Despite this, export receipts fell by 27 percent over the same period.

As export revenues fell, farmers reduced their spending and this, in turn, lowered incomes and spending in the rest of the economy. In 1932, real GDP is estimated to have fallen by 7 percent (in these somewhat imprecise estimated historical series).

As demand fell, unemployment rose from the low levels of the late 1920s. Estimates of the peak in unemployment vary widely. The peak may have been around 20 percent (and, in addition, there was a net migration outflow, after material inflows in the 1920s). Consumer prices fell, with the annual rate of deflation peaking at 12 percent in 1932. Wages for those in employment also fell, but by less than prices. Deflation, of course, increases the real value of debt outstanding. Partly as a result, the 'interest burden' on farmers rose from about 13 percent of their gross incomes in 1928/29 to 26 percent in 1931/32.

Despite the sharp drop in export receipts, the Depression did not lead to a large deterioration in New Zealand's current account balance. In part, this was because the drop in export receipts – the main source of new funds for the banks – reduced the ability of banks to meet customer demands for credit and foreign exchange.[2] The exchange rate was informally managed by the banks, and rather than allow the impact of the fall in export receipts to show through in a sharp reduction in the exchange rate, access to funds was administratively rationed by the banks for several years. This was supported for a time by explicit government measures requiring all export receipts to be sold to the banks. If customers could not access foreign exchange or credit, they could not spend. Imports, therefore, also fell sharply.

[2] **The economic downturn in Australia was much more severe than that in New Zealand, and the Australian ownership of the banks may have reinforced limits on access to funds in New Zealand.**

Policy responses

The government went into the Depression with a large public debt – approximately 160 percent of GDP in 1930. The subsequent fall in prices and real activity led to a sharp reduction in the Government's revenues. Even if the government had been willing to increase its borrowing, access to international credit markets became increasingly constrained as the Depression went on.

At the time, it was believed important, both nationally and internationally, for a government to maintain a balanced budget so as to retain business and public confidence. Faced with a downturn in revenue and the need for some relief spending, a balanced budget could be maintained only by cutting core spending and raising tax rates. That was the approach adopted, which no doubt further deepened the Depression.

As noted earlier, there was no independent monetary policy. Global interest rates fell as the Depression intensified, which meant that New Zealand interest rates also tended to fall. However, as in almost every other country, the inflation rate fell further than nominal interest rates did, lifting the real interest rate. And with banks short of funds and concerned not to weaken the exchange rate further, there was little strong downward pressure on New Zealand interest rates. Governments were not indifferent to the resulting debt burden. Legislation was passed to facilitate both lower long-term mortgage rates for heavily-indebted farmers and to induce holders of government debt to convert to new lower interest rate issues.

As discussed earlier, the exchange rate had for some years been managed by the banks, which rationed access to credit and foreign exchange to maintain parity with sterling. The Depression made this unsustainable and the banks had to informally devalue the New Zealand pound by around 10 percent in 1930. Even after the UK had left the Gold Standard in mid-1931, any further depreciation of the New Zealand currency was hugely contentious: a devaluation might boost export receipts, but would also increase living costs of urban consumers. In the meantime, defending the exchange rate involved limiting domestic demand.

The worst of the Depression had already passed in New Zealand when, in January 1933, a reluctant government[3] formally devalued the New Zealand pound against sterling by 25 percent, offering indemnities to the banks to protect them from any subsequent losses. For exporters of meat and wool this was a material gain – Australia had devalued earlier – but for others the benefits were more limited. For example, Denmark, a key competitor in dairy, followed New Zealand's devaluation by also devaluing against the pound.

Ultimately, the defence of the exchange rate was the major choice that shaped the way the Depression unfolded in New Zealand. Had consensus opinion at the time allowed for the exchange rate to be floated, or even to have been devalued sharply earlier in the downturn, the recession in economic activity would have been milder. Without that flexibility, serious constraints on access to international capital markets as the crisis deepened left a heavily indebted government with few fiscal options. A less contractionary fiscal policy and any associated greater strength in private domestic demand would simply have exacerbated the demand for foreign exchange. That would have reinforced the pressure on the exchange rate regime.

3 The Wool Bust (1967–1969)

The starting point

The undiversified nature of the export sector may not have been important in the Depression, but it certainly was in the Wool Bust. In 1965/66, around 31 percent of New Zealand's exports were wool.

The early sixties was a period of strong growth. In 1963/64, world commodity prices for New Zealand's exports boomed. As incomes rose, so did expenditure on imports. Supported by relatively loose macroeconomic policy, the current account began to deteriorate and, with a fixed exchange rate, this led the nation's reserves of foreign exchange to fall. Efforts to rein in domestic demand had begun, but were to be overwhelmed by the scale of the shock.

[3] Over the opposition of its own Minister of Finance, who resigned in protest.

Box 1

Figure 1
Annual real growth

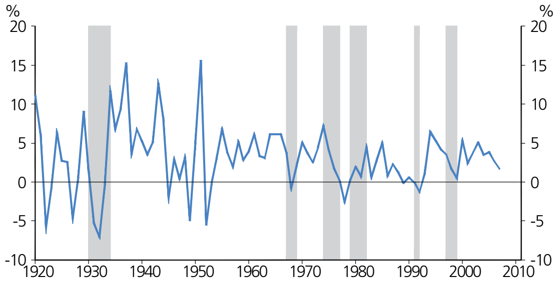


Figure 5
Annual real house price inflation

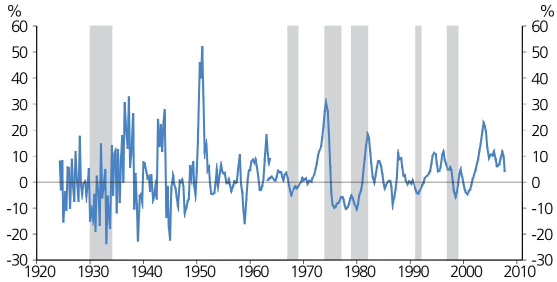


Figure 2
Annual CPI inflation

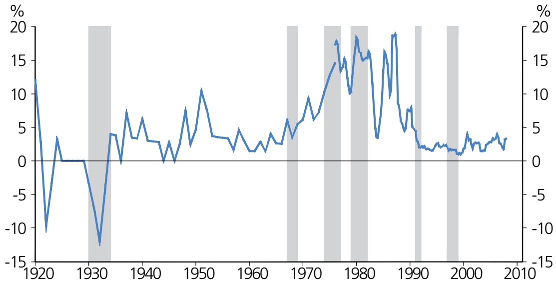


Figure 6
Annual population growth and migration

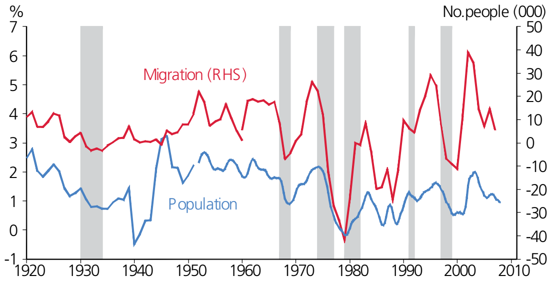


Figure 3
Nominal and real USD/NZD

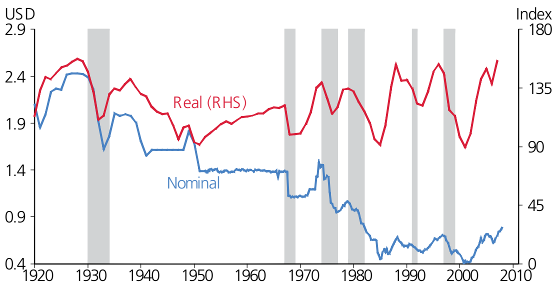


Figure 7
Unemployment rate

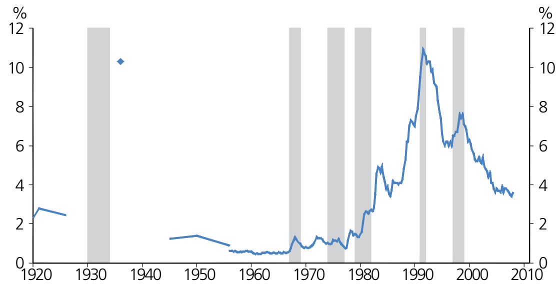


Figure 4
Real mortgage interest rate

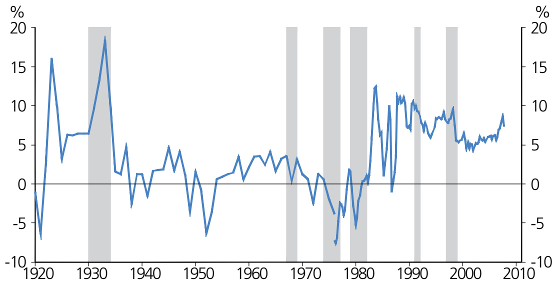


Figure 8
Government debt (as a % of GDP)

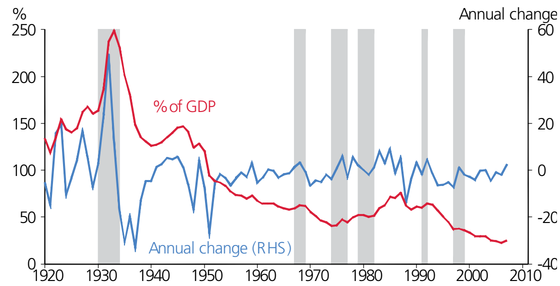


Figure 9

Southern oscillation index

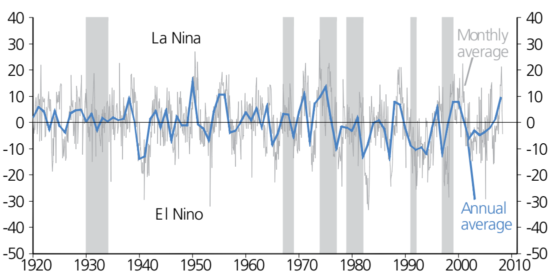


Figure 10

Real spot oil price (West Texas Intermediate)

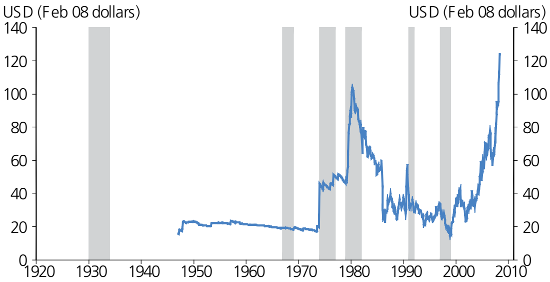


Figure 11

Annual real foreign GDP growth

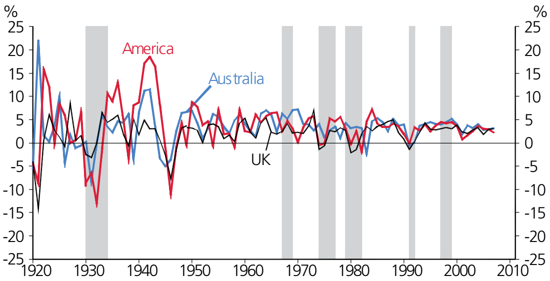


Figure 12

Terms of trade

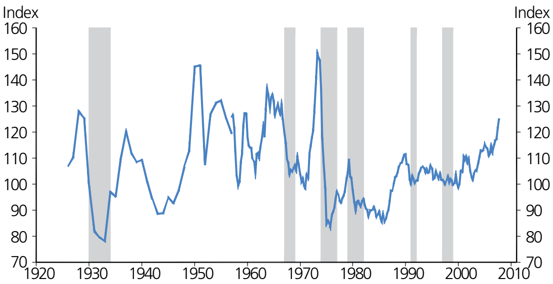


Figure 13

Trade balance and current account balance

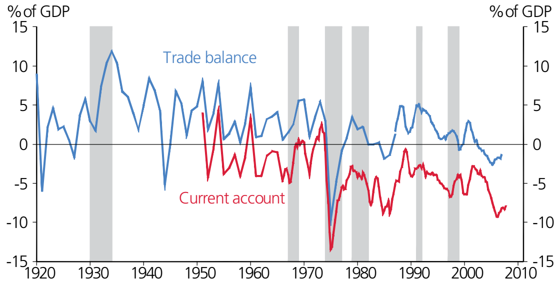
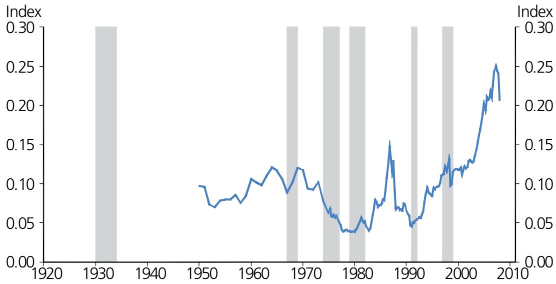


Figure 14

Real share price index



Sources: American Bureau of Economic Analysis; Australian Government Bureau of Meteorology (http://www.bom.gov.au/climate/current/soihtm1.shtml); Australian Bureau of Statistics; Federal Reserve Bank of St. Louis; International Monetary Fund; Motu Economic and Public Policy Research; New Zealand Institute of Economic Research (http://www.nzier.org.nz/includes/download.aspx?ID=26894); Quotable Value Ltd.; RBNZ; RBNZ (1963) Money and Banking in New Zealand, Wellington: Harry H. Tombs Ltd; Statistics NZ; Statistics NZ Long-Term Data Series (http://www.stats.govt.nz/tables/ltds/default.htm); United Kingdom Statistics Authority.

Exchange rate stability was a feature of the 1950s and 1960s. Controls on private capital flows that had emerged internationally in the wake of the Depression helped to support the Bretton Woods system of pegged exchange rates. The New Zealand exchange rate had not, by this time, been altered since 1949, and in real effective terms had probably become somewhat overvalued.

The recession

On 24 November 1966, three days before the general election, the wool market collapsed and New Zealand lost an eighth of its total export income overnight. Overall, wool prices fell by 20 percent in 1967 and a further 20 percent in 1968. These price falls understate the severity of the shock, as the Wool Commission – acting with a price stabilisation mandate – ended up buying more than 700,000 bales of wool. That action helped to sustain farmers' incomes, and associated import demand, but of course there were no matching foreign exchange earnings. Stabilising the wool market aggravated the balance of payments pressures, which saw the current account deficit widen further to around 5 percent of GDP by 1967.

There was no global recession at the time, which makes this New Zealand slowdown unusual. However, the sharp fall in the wool price was no doubt exacerbated by the tightening in credit conditions in the US and in the UK going on at the time.

The impact

Between 1966 and 1968, GDP growth fell by 2.9 percent. Adjusting for terms of trade effects, income per head may have fallen by as much as 5 percent. Unemployment remained very low in absolute terms, and rose by less than 1 percentage point, but for a country used to two decades of extremely low unemployment the change was noticeable.

Annual inflation also began to rise and in 1967 inflation rose above 5 percent for the first time since the Korean War boom in the 1950s. The rise in inflation reflected a combination of factors: the direct price effects of fiscal measures discussed below, but also 'cost-push' pressures, stemming in part from large increases in wages.

Partly in response to the reduction in job vacancies, emigration increased substantially, so that New Zealand experienced a significant net migration outflow for the first time since the Depression. The impact on demand of the unexpected migration outflow was visible most immediately in the housing sector.

Policy responses

The deterioration in the current account led to a fall in reserves of foreign exchange and placed pressure on the New Zealand dollar.[4] To ease this pressure, the government drew on some of its borrowing facilities at the International Monetary Fund, but also took a wide range of measures to significantly reduce demand for imports.

In February 1967, consumer subsidies on food were removed, and State Housing rentals and Post Office charges were increased. Electricity and rail charges were also increased. In May 1967 there were sharp increases in a number of indirect taxes. On the expenditure side, public works expenditure was cut.

At the time, interest rates were under heavy administrative influence, and there was a greater willingness to rely on quantitative limits on credit growth, rather than interest rate adjustments. Hire purchase regulations were tightened and in May 1967, the trading banks were directed to effect a 10 percent reduction in each customer's overdraft limit (the main form of borrowing from banks)[5] within two months.

The option of devaluing the New Zealand dollar began to come into focus. Most orthodox thought favoured fiscal and monetary restraint to defend the longstanding exchange rate parity. Some also worried that devaluing would place pressure on Britain (whose currency was under constant pressure) to devalue sterling. Access to credit markets was also a consideration – in particular, the authorities found it difficult to roll over maturing loans in London,

4 As it became on the conversion to decimal currency on 10 July 1967.

5 Housing finance was largely provided by trustee savings banks, building societies, and the State Advances Corporation.

and the government was forced to borrow again from the International Monetary Fund.

In the event, it was British choices that finally triggered a New Zealand exchange rate adjustment. In November 1967, the British Government devalued sterling (in terms of the US dollar) by 14.3 percent. The New Zealand Government followed, devaluing by 19.45 percent, achieving a 5 percent gain in competitiveness relative to both the UK and Australia (which had also devalued), with the aim of improving returns to farmers and reducing import demand.

4 The First Oil Price Shock (1974 –1977)

The starting point

In the early 1970s, the world experienced a broad-ranging commodity price boom. Between March 1971 and June 1973, New Zealand's terms of trade rose by 53 percent. The current account moved into surplus, where it had been rarely, and foreign reserves passed one billion dollars (around 16 percent of GDP).

From 1970 to 1973, net immigration rose sharply, reaching 26,000 in 1973, equivalent to 0.86 percent of the total population. The large inflow of migrants, the strong terms of trade and low real interest rates led to a very rapid increase in credit growth and property prices. M1, a measure of money supply, increased by 25 percent between March 1972 and March 1973 and by a further 14.5 percent in the next 12 months. Real annual house price inflation reached 30 percent in June 1974. From 1970 to 1974, real house prices rose by approximately 62 percent.

Inflation had been rising gradually around the world from the late 1960s. In general, governments and central banks were reluctant to tighten monetary policy sufficiently to offset the rising inflation, and in several countries (including New Zealand, the UK, and the US) attempts were made to use unorthodox approaches to keep the pressures in check. These measures included direct price and wage restrictions.

Internationally, easy global credit conditions, prolonged growth, and low (often negative) real interest rates saw global stock markets become severely overvalued. Through this period, the international exchange rate regime was in transition, as the post-war Bretton Woods fixed exchange rate regime broke down and most major developed countries ended up floating their exchange rates.

The domestic boom reached its peak in 1973. New Zealand made several attempts to reduce the inflationary pressures that were building. The New Zealand dollar, which was now pegged to a basket of currencies, was revalued three times in 1973, and the real exchange rate reached a 34-year high (against the US dollar). A wage freeze and a property speculation tax were imposed. Nonetheless, the rate of CPI inflation reached 10 percent by 1974.

The recession

OPEC began to flex its muscles in late 1973 following the Arab-Israeli war. After two decades of relatively flat oil prices, against a backdrop of an increasingly tight supply situation (ie excess production capacity had shrunk dramatically) the price of oil more than doubled between December 1973 and January 1974 from USD4.31 per barrel to USD10.11 per barrel (West Texas Intermediate).[6] In addition, actual oil exports were physically restricted.

The rise in oil prices and temporary reduction in supply, at a time when the oil intensity of production was much greater than it is today, together with the not-entirely successful efforts by many countries to rein in the inflation pressures that had built up over the previous few years, led to a sharp slump in share prices and a world recession. Between January 1973 and December 1974, for example, the Dow Jones lost more than half its value in real terms, while in the UK, the FT30 fell over 90 percent in real terms.

Locally, an El Niño weather event drove the country into drought in 1972/73 – New Zealand's second-driest year on record.

6 In real terms, prices rose from USD19.79 to USD45.92 per barrel (West Texas Intermediate, Feb 2008 prices).

The impact

In the year to March 1975, New Zealand's terms of trade fell by 38 percent; the largest fall ever recorded in a single year. The fall was only partly due to the direct effects of the rise in oil prices. Over 1974, as world economic activity slowed and the commodity boom came to an end, world export prices fell by around 12 percent and export volumes also fell. The economic effects hit New Zealand badly for several years following.

The current account balance deteriorated very rapidly, from a surplus of 2.5 percent in June 1973 to its largest ever deficit of 13.4 percent in March 1975. Annual growth fell from 7.2 percent in 1974 to a trough of -2.6 percent in 1978.[7] Unemployment rose but remained below 2 percent. New Zealand share prices fell by about 47 percent in real terms. As economic conditions in New Zealand deteriorated, the contraction was amplified by a massive turnaround in migration. From the peak inflow of 26,000 in 1973, migration fell to an outflow of 42,000 in 1979.

As growth slowed, there was a sharp squeeze in credit. Real house price inflation fell quickly, from 31 percent in June 1974 to -10 percent in December 1975. From 1975, real house prices fell every quarter for the following five-and-a-half years, as the migration outflow reinforced the correction from the previous extreme overvaluation.

Despite lower growth, monetary policy was insufficiently firm to prevent inflation rising: annual inflation reached 17.8 percent in 1976 and double-digit inflation increasingly came to be factored into the behaviour of firms and households. This pattern was far from unique to New Zealand – in the US, UK and Australia, inflation also tended to settle at new higher levels.

Policy responses

Initially and in contrast to past recessions, the government implemented expansionary fiscal policies to promote growth and employment. From 1973 to 1976, total government expenditure rose by around 10 percent of GDP.

The exchange rate was devalued three times in an effort to boost exporters' incomes; in September 1974 by 10 percent, August 1975 by 15 percent and November 1976 by 2.75 percent. From 1975, the government also began to expand subsidies for farmers (and the Wool Marketing Corporation, successor to the Wool Commission, again engaged in purchasing wool at a price floor). The aim was to support production, to maintain foreign exchange earnings and to meet rising import costs.

The expansion in spending and decline in real revenue led, of course, to a deterioration in the Crown's accounts. The Government's deficit turned out to be more than twice what had been budgeted, as income and tax revenues fell. The current account also deterioriated further as the expansionary policies supported expenditure on imports. Growth in credit leapt upwards and M1 grew by almost 20 percent in the year to March 1976.

To fund the current account deficit and gather sufficient foreign exchange to pay for imports, the government undertook very substantial borrowing overseas, both commercially and from the IMF and the Bank of International Settlements (BIS). Globally, credit remained quite readily available through this period, as the huge surpluses run up by oil-producing nations were recycled through Western banking systems. Moreover, New Zealand had entered this period with public and external debt levels the lowest they had been in many decades. Official advice was broadly supportive of using some borrowing to help maintain living standards. The widespread view was that the slump in the terms of trade would prove to be temporary.

In 1976, the newly elected government took a different tack and introduced a number of measures to dampen down activity in an effort to lower inflation. The government exercised significant budgetary restraint and also took some substantial steps to liberalise the financial markets and allow interest rates to rise. The efforts had some success – inflation fell from around 17.8 percent in 1976 to 10.0 percent in 1978. However, the contractionary policies exacerbated the severity of the downturn, and as the 1978 election approached the budgetary restraints were relaxed.

[7] On some measures, growth in real per capita consumption fell from around 14 percent per annum in 1974 to around -9 percent per annum in 1975.

5 The Second Oil Price Shock (1979–1982)

The starting point

The New Zealand economy was only beginning to recover from the first oil price shock and the limited disinflationary adjustment. Real house prices were still falling despite low or even negative real mortgage interest rates, the terms of trade remained relatively weak, net migration outflows were continuing, and unemployment was beginning to trend upwards. Economic growth had recovered only modestly. The global backdrop was brighter, but not markedly so, as countries grappled with persistently high inflation and an apparent decline in the potential rate of growth.

The recession

Oil prices more than doubled following the Iranian revolution and the start of the Iran-Iraq war, both of which materially disrupted the supply of oil. Prices rose by 150 percent between April 1979 and April 1980 (from USD15.85 to USD39.50 per barrel, West Texas Intermediate).[8] The rise in oil prices helped push the world economy back into a recession. It did so through two channels. First, higher oil prices represented a significant tax on economic activity in the Western world, and boosted inflation across the world in the short term. But second, through a combination of circumstances, 1979 marked a turning point in the Anglo world's willingness to pay the price of lowering inflation. Rising inflation and a weakening US dollar saw Paul Volcker lead a marked change in the Federal Reserve's direction, pushing up the federal funds rate to 19 percent in early 1980, which dampened economic activity and eventually lowered inflation markedly. On the other side of the Atlantic, the Thatcher government, elected in May 1979, adopted a similar approach, at the short-term cost of a deep recession. The US recession in particular weakened activity, and export commodity prices, across much of the world.

The impact

The second oil price shock meant that the economic recovery stalled. The conventional effects of the oil price shock on activity were amplified by measures such as carless days and weekend closures of petrol stations, designed directly to reduce oil consumption and the borrowing required to finance the widening current account deficit. The terms of trade fell, although by far less than the decline that followed the first oil price shock. Net migration outflow reached an unprecedented peak of over 40,000 in the year to December 1979.

Unemployment rose quite rapidly, from 1.3 percent in December 1979 to a then-unprecedented level of 4.9 percent in June 1983. Measures to boost domestic demand (rather prematurely) in 1981, which seem to have finally triggered a recovery in the housing market, led to a balance of payments blow-out in 1982. The associated pressure on liquidity and access to credit reinforced the upward trend in the numbers of those unemployed.

Policy responses

The exchange rate was quite quickly devalued, cut by 5 percent in mid-1979 and then set on a crawling peg – designed to maintain the real exchange rate by devaluing the nominal exchange rate each month by the difference between domestic and foreign inflation rates.

The government also sought to use relatively expansionary fiscal policy – both directly, and by encouraging, as part of an economic transformation agenda, the 'Think Big' energy projects.[9] Investment boomed as these projects got under way, although the domestic demand effects were more muted, because the investment was very import-intensive. Export incentives to manufacturers and subsidies to farmers were also stepped up. Through this period, the measured fiscal deficit remained quite large, although real interest rates were mostly low or negative so that real servicing costs

8 In real terms, prices rose from USD47.72 to USD103.79 per barrel (West Texas Intermediate, Feb 2008 prices).

9 The 'Think Big' projects were predicated on the assumption of continuing high and rising real oil prices, although were also influenced by a 'take or pay' agreement in respect of Maui gas that had been signed by a previous government in the early 1970s.

were not high, and for a time the debt-to-GDP ratio did not increase particularly sharply.

Overall, policy struggled to juggle objectives – maintaining living standards, limiting the rise in unemployment, limiting the rise in interest rates, while also trying not to let inflation get out of hand. With the latter objective in view, the crawling peg was abandoned in mid-1982 at the same time a wage/price/interest rate freeze was imposed.

6 The 91–92 Recession

The starting point

By the mid-1980s, Western economies were well into recovery phase. Oil prices were falling, interest rates were falling in many countries as inflation dropped away sharply, and increased credit availability was spilling over into a widespread boom in equities and commercial property in particular.

The effects of the boom were exaggerated in New Zealand by the wide-ranging deregulation of the financial sector and the abolition of exchange controls implemented over a relatively short period in 1984/85. From December 1984, for the first time since the 1930s, there were no material restrictions on portfolio inflows and outflows of capital.

Deregulation gave financial institutions the freedom to create credit, without much experience in actually doing so. A significant portion of the new credit, fuelled by the inflows of foreign funds attracted by New Zealand's relatively high interest rates, was used to finance speculation in the share market and the property market. Numerous entrepreneurial companies joined the stock market, and from some of the rhetoric one might have supposed that New Zealand in fact had a comparative advantage in takeovers. Talk of New Zealand becoming the Switzerland of the South Pacific went hand in hand with fevered speculation around the first unsuccessful tilt at the America's Cup.

Share prices more than doubled between July 1984 and the end of 1986. Commercial property prices rose very substantially in the four years to June 1988 (on one measure around 45 percent in real terms) and commercial building activity boomed. The move to introduce GST in October 1986 probably reinforced the rush to buy physical assets (property and shares).

After the 20 percent devaluation in 1984, once the exchange rate was floated and interest rates rose to the sort of levels needed to get inflation back under control, the real exchange rate appreciated substantially between 1985 and its peak in 1988. Interest rates were high but volatile, with 90-day rates still above 20 percent at times in 1987.

On 19 October 1987 ('Black Monday'), global share prices collapsed. In three-and-a-half months, the value of the New Zealand share market halved. The share market crash in New Zealand was part of a de-leveraging process that wiped out huge amounts of wealth, brought down several major corporations and some financial institutions, and severely impaired the health of the entire Australasian banking system. It did not, of course, do this overnight. It took years for the full effects to become apparent. Indeed, for a time many were quite blasé about the likely impact. Ongoing economic restructuring, in the state and private sector, reinforced the fragility. Fiscal deficits remained quite large, and perhaps more importantly a shift to financing more of that debt onshore and a marked rise in real New Zealand interest rates saw the public debt become increasingly burdensome. The 1990 Budget, in particular, took a relatively expansionary route, with projections of increasingly large deficits in subsequent years.

By late 1990, the accumulated effects of five years of anti-inflationary policies, with real short-term interest rates still around 8 to 10 percent, the exchange rate still relatively high, and three years of increasingly constrained access to credit, meant that the economy was relatively weak and quite exposed to any further negative shocks.

In December 1990, however, and in line with the campaign promises of the incoming government, the target date for the achievement of price stability (0 to 2 percent inflation, as then defined) was pushed back from December 1992 to December 1993.

The recession

Global contribution

Although the 1987 share market crash had been a global event, it had a particularly significant impact in New Zealand. Interest rates fell back somewhat in New Zealand immediately following the crash, but in a range of other developed countries (including the US, UK and Australia) monetary policy had been loosened markedly. Global demand recovered rapidly and with it inflationary pressures. Eventually, central banks in these countries needed to move to bring inflation back under control, which helped to induce the 1991 global downturn. This downturn appears to have been exacerbated by a six-month surge in oil prices, beginning in the second half of 1990 and associated with the first Gulf War. The price of oil rose by 32 percent between August and October in 1990 (from USD27.17 to USD35.92, West Texas Intermediate).[10]

Fiscal policy

The newly-elected government in late 1990 discovered that it had inherited something of a fiscal 'crisis'. Net public debt sat at 50 to 60 percent of GDP, and forward forecasts – not then published in the way they are now – revealed a deteriorating outlook. Moreover, the government faced the pressing need to recapitalise the largely state-owned Bank of New Zealand (for the second time since 1987). Credit-rating agencies indicated that they were considering a double downgrade in New Zealand's sovereign credit rating, which could have materially increased the cost of funds as well as undermining investor confidence in New Zealand. In some quarters, at least, there were worries that New Zealand's ability to continue to borrow abroad might be jeopardised if early and dramatic action was not taken.

Against this backdrop, in late 1990, the government announced large cuts in income support entitlements to welfare beneficiaries and the establishment of reviews to reduce expenditure in other areas. The 1991 Budget (described by its author as the 'mother of all budgets') continued the sharp fiscal contraction.

[10] **In real terms, prices rose from USD43.89 to USD57.24 per barrel (West Texas Intermediate, Feb 2008 prices).**

The impact

GDP growth had been subdued (at best) since around 1988, but took a further sharp step down in 1991. Confidence fell away sharply, as did real activity in both the business and household sectors. On our current estimates, the output gap is estimated to have fallen to -3.7 percent in September 1992[11] (quarterly activity itself is now estimated to have reached a trough in March 1991). Many would probably judge the overall level of spare resources in the economy was even greater than suggested by that output gap number. The unemployment rate rose from 7.0 percent in March 1990 to peak at 10.9 percent in September 1991.

The rise in unemployment, in particular, and fall in GDP caused expenditure on social security to increase as a percentage of GDP as the automatic fiscal stabilisers cut in. This mitigated somewhat the short-term demand effects of the substantial contraction in discretionary fiscal expenditure. Gross public debt did not fall below 50 percent until 1996; however the threat of a double downgrade in the sovereign credit rating was averted.

House prices fell, with real prices declining by 4.7 percent over 1991. These falls occurred even though interest rates were falling throughout 1991, banks were becoming increasingly keen on housing loans in preference to commercial loans (after the experiences of the late 1980s) and the initial degree of overvaluation had not been large (at least by comparison with the current situation and that in the 1970s).

Policy responses

Monetary policy was held tighter than was strictly necessary for much of 1991. At the time, monetary policy was not implemented by formally setting an official interest rate, but the Bank nonetheless on various occasions sought to slow the speed at which interest rates, especially the key 90-day bank bill rate, were falling. Even though the inflation target date had been extended from December 1992 to December 1993, inflation actually fell into the target range in late

[11] **Exacerbated by the impact of very low hydro lake levels, and associated reductions in electricity production and consumption in the winter of 1992.**

1991, something that was not forecast by the Bank until very late.

The speed of the fall in inflation was missed largely because the recession itself was a surprise (as it was to many other forecasters). Quarterly forecasts from that period are hard to track down, but the falls in GDP during 1991 took the Reserve Bank by surprise. Indeed, in its published August 1991 Economic Forecasts, it was estimated that annual growth was around 1 percent in the March 1990/91 year. In fact, based on the latest GDP estimates, annual growth was actually close to -1 percent for the year to March 1991. Although interest rates were progressively falling, monetary policy was not finally explicitly eased until September 1991, and by the end of that year 90-day rates were under 8 percent, down from rates in excess of 14 percent that had prevailed for much of 1990. Even then, the Bank expected inflation would temporarily rebound outside the target range, before settling back by the formal target in 1993. There was, in fact, no material rebound in inflation.

The exchange rate played an important role in the Reserve Bank's thinking, from two angles. First, direct price effects on inflation from exchange rate changes were still thought to be quite large. With inflation expectations still not clearly anchored on price stability, excessive falls in the exchange rate posed medium-term inflation risks. On the other hand, the Bank was firmly of the view that the exchange rate was materially overvalued, and that external adjustment would require a substantial fall in the currency.[12] Making room for this fall was one reason the Bank had supported extending the price stability target date to 1993. The exchange rate had fallen somewhat in 1988 but remained overvalued. In fact, despite the weak economy and the marked falls in interest rates, the TWI remained firm through much of 1991, only finally falling by around 10 percent in the wake of the explicit policy easing in September.

In the end, markedly lower real interest rates, a significant reduction in the exchange rate, a waning of the first intense contractionary pressures from fiscal policy, and a gradual recovery in the world economy laid the ground for economic growth to recover in 1992.

[12] **These issues were highlighted quite explicitly in the Bank's published 1990 *Post-election Briefing* for the incoming government.**

7 The Asian Crisis and drought (1997–1999)

The starting point

Domestic growth recovered quickly from the downturn in the 1991/92 recession. Annual growth peaked at 7.3 percent in September 1993. At the same time, unemployment fell, from 10.9 percent in September 1991 to 6 percent in September 1995.

In the early 1990s, there was a significant upsurge in net immigration. Annual permanent and long-term migration rose from 4,500 in 1992 to 29,000 in 1995.

The sharp rise in immigration, along with a gradual recovery in household incomes, a return of confidence, and much easier access to credit for households, combined to produce a significant house price boom. Real house prices rose every quarter for what was then a record of five-and-a-half years, leading to a cumulative rise of 36 percent between 1992 and 1997. Real house price inflation peaked at just under 12 percent in June 1996. Credit growth reached 4 percent per quarter in December 1995 – growing at an annual rate of around 15 percent at a time when nominal GDP was growing at around 7 percent.

In line with world interest rates, New Zealand's 90-day rate rose sharply in 1994, and was above 6 percent for all of 1995 and 1996. Signs of a resurgent housing market led the Reserve Bank to allow or encourage 90-day bill rates to rise to 10 percent in 1996 and stand back as the TWI moved materially higher (finally reaching its peak in early 1997).

Accumulated domestic demand pressures meant that inflation was around, or just outside, the top of the target range for much of 1996, while the government, now running large budget surpluses, was planning significant personal tax cuts that were expected to boost household demand. Immediate pressures on monetary policy were eased somewhat when the inflation target was revised, with the target ceiling being lifted to 3 percent in December 1996. Short-term interest rates began to fall quite materially, but the exchange rate remained very high.

The recession

The Asian financial crisis, beginning in July 1997, saw a number of important Asian economies forced to float their exchange rates, which then fell very sharply, leading to serious losses in the corporate and banking sectors, and some very large falls in GDP. Around one third of New Zealand's exports were destined for Asia – and much of Australia's trade was also with Asia.

Just as the Asian crisis was easing, the world was convulsed by two other financial shocks in 1998: Russia's default on its domestic and external debt, and then the collapse of Long-term Capital Management (LTCM) (a large highly-leveraged US hedge fund). Neither of these had too much direct economic effect on New Zealand, but they accentuated global financial nervousness and risk aversion, and contributed to a further weakening in the New Zealand dollar. International market liquidity and access to credit was somewhat impaired for a time.

The New Zealand economy faced two successive severe droughts in 1997/98 and 1998/99. In 1997/98, an El Nino weather event brought drought conditions to the eastern regions of New Zealand and was New Zealand's driest year on record. In 1998/99, a La Nina event prolonged the drought in North and Central Otago and brought drier than normal conditions to western districts and Southland. These droughts substantially cut agricultural output, with flow-on effects through the rest of the economy.

The impact

In the March quarter of 1998, the seasonally adjusted value of merchandise exports to New Zealand's main Asian trading partners outside of Japan fell by over 26 percent – equivalent to a 1 percent fall in New Zealand's GDP. The monthly value of log exports from New Zealand and short-term visitor arrivals from Asia outside Japan both fell dramatically.

The direct impact of the drought-induced fall in supply was estimated to account for 0.4 percent of the total 1 percent fall in GDP growth over the March 1998 quarter.[13]

[13] This does not take into account any second-round effects on the rest of the economy.

Net migration fell as sharply as it had risen. The combination of falling net migration, falling consumer confidence and continued high levels of interest rates produced a sudden drop in private residential investment in 1997/98. Credit growth fell to around 1.5 percent per quarter by the second half of 1998.

Annual growth, based on current estimates, fell steadily from 6.4 percent in 1994 to 0.5 percent in 1999. There was a small tick up in unemployment.

Policy responses

The Reserve Bank (along with many other forecasters, here and abroad) was slow to recognise the full impact of the Asian crisis and the first drought through late 1997 and early 1998. This was the first economic slowdown and financial crisis forecasters had ever had to deal with emanating from Asia, and it was unclear quite what it would mean for New Zealand – although it was worth noting that our ties to Asian central banks meant that we were lowering our projections for foreign growth more rapidly than the international *Consensus* forecasts that were usually used.

The policy response problem was compounded by difficulties with the new policy implementation approach the Bank had introduced in early 1997 – centering policy statements around desired levels of the Monetary Conditions Index (MCI). With hindsight, it was clear that the Bank did not have a good grasp on how this system would work faced with major changes in the exchange rate, or in the appropriate level of interest rates.

Once the Asian crisis was under way, the New Zealand dollar began to fall quite rapidly. In the way the MCI system was used, the Bank ended up treating much of the fall as something that needed to be offset by higher interest rates. The Bank saw itself as easing monetary policy in response to the Asian crisis, and then the drought by lowering the published desired level of the MCI, but doing so in a form that involved a much lower exchange rate and somewhat higher interest rates. Short-term interest rates had fallen materially in the first six months of 1997, but this fall was quickly reversed. For a year or so after that, short-term interest rates were higher than they had been in mid-1997 and very volatile. This is likely to have compounded the falls in business and consumer confidence and, hence, in economic activity.

Even as late as May 1998, when the June *Monetary Policy Statement* forecasts were finalised, the Bank was still projecting quarterly growth to trough at just 0.2 percent. Based on the latest estimates of GDP, New Zealand had already had three quarters of negative growth. As the recession became apparent, interest rates were allowed to fall markedly, reaching just below 5 percent by the end of the year. Cuts in international interest rates following the LTCM failure also supported a rebound in global growth.

The fiscal consolidation of the early 1990s and a period of strong growth had produced substantial actual and prospective fiscal surpluses. Debt levels remained higher than the medium-term desired level, although by this stage all net debt outstanding was in New Zealand dollars. Substantial personal tax cuts had occurred in 1996 and were planned again for 1998. The Asian crisis and the associated recession appeared to unnerve some decision-makers, and in the midst of the downturn, some contractionary fiscal measures were implemented (such as cuts to future National Superannuation payments). These measures probably had relatively little impact on demand at the time, but did reflect a reluctance to allow the automatic stabilisers to operate untrammelled through what was a relatively mild downturn, which New Zealand entered with a fairly healthy fiscal position.

8 Characteristics of recessions in New Zealand

Table 1 briefly summarises the pre-existing imbalances, triggers and exacerbating events and structural factors that have characterised each of the recessionary periods we have looked at in this article. Dark blue squares denote features critical to the recessionary period, light blue squares denote factors that were less significant, while white squares denote factors that were not relevant to the period. This exercise obviously demands a certain amount of judgement. The shadings of some squares are, of course, open to debate.

Box 2
The 2001 global slowdown

The 2001 global slowdown did not lead to a domestic slowdown. This example adds weight to the idea that it usually takes both domestic and global factors to align, in some form or another, to produce a recession in New Zealand.

In 2001, the Dotcom crash in technology stocks, and the associated sharp fall in computer and telecoms technology led to a sharp downturn in world growth. Annual growth for New Zealand's trading partners fell below 2 percent and reached a trough similar to the Asian crisis. Facing the risk that the weakness in the world economy would drag down activity in New Zealand, the Bank cut the Official Cash Rate (OCR) progressively from March 2001 – and then instituted further precautionary cuts following the 11 September terrorist attacks, for a total of 175 basis points of cuts.

In contrast to past global slowdowns, the 2001 slowing had a rather muted impact on New Zealand and Australia (although our output gap measure shows a material narrowing in 2001). There seem to have been several reasons for this. First, international prices for our export commodities remained quite buoyant. Second, the overall starting level of interest rates was low by historical New Zealand standards (cuts were from a starting OCR of 6.5 percent). Third, the real exchange rate had reached its record low in late 2000, providing a considerable buffer for the traded goods sector. Finally, there were no significant domestic imbalances – the housing market, for example, was still working through a gradual adjustment downwards following the mid-1990s boom.

Table 1

The characteristics of recessionary periods

			Recessionary periods					
			Depress.	Wool Bust	1st Oil Shock	2nd Oil Shock	91-92	Asian Crisis
Pre-existing imbalances	Rapid credit and asset price expansion:	Global	A critical factor		A critical factor			A contributing factor
		NZ			A critical factor			A contributing factor
	Well above trend:	Commodity prices			A critical factor			
		Real exchange rate	A contributing factor	A contributing factor	A critical factor	A contributing factor	A contributing factor	A critical factor
		House prices			A critical factor			A contributing factor
		Real interest rates					A critical factor	A critical factor
	Unusually large current account deficit			A contributing factor				A contributing factor
	Large public debt		A critical factor			A contributing factor	A critical factor	
	Inflation problem			A contributing factor	A critical factor	A critical factor	A contributing factor	
	Domestic financial fragility						A critical factor	
Triggers and exacerbating events	World downturn		A critical factor		A critical factor	A critical factor	A critical factor	A contributing factor
	Global credit/asset price squeeze		A critical factor		A critical factor			A contributing factor
	Large fall in export commodity prices		A critical factor	A critical factor	A critical factor		A contributing factor	A contributing factor
	Large rise in oil prices				A critical factor	A critical factor	A contributing factor	
	Drought				A critical factor	A contributing factor		A critical factor
	Contractionary discretionary fiscal policy		A critical factor	A critical factor			A critical factor	A contributing factor
	Tightened monetary policy/ interest rates rose after the downturn was under way		A contributing factor	A critical factor				A critical factor
Exacerbating structural factors	Fixed or pegged exchange rate		A contributing factor	A critical factor	A contributing factor	A contributing factor		
	Capital controls in place		A contributing factor	A critical factor	A critical factor	A critical factor		

Key: A critical factor A contributing factor Not a factor

9 Conclusions

History doesn't repeat itself. Shocks differ, policy frameworks differ, and so do the markets in which firms, markets and financial institutions operate. But useful perspectives can be gained from past economic slowdowns here and abroad. The range of New Zealand experiences briefly sketched out in this note highlight a few of those:

- Material global slowdowns almost always lead to marked slowdowns in the New Zealand economy. The recent exception (2001) highlights the way in which pre-existing domestic conditions matter – undervalued exchange rates, healthy financial sectors, rising commodity prices and relatively low interest rates can provide meaningful buffers.
- No major domestic slowdown or recession in the last 40 years has been triggered by domestic factors alone.
- Financial excess reflected in overvalued asset prices, or indeed the subsequent financial fragility, often seems to be associated with some of the deeper recessions here and abroad. Doubts about continuing access to credit markets can exacerbate any downturn.
- Substantial slowdowns tend to lead to net migration outflows, which in turn deepen the downturn. The effects of fluctuations in migration are most immediately apparent in the housing market.
- Sharp increases in oil prices have often been associated with recessions.
- Resisting falls in the exchange rate usually exacerbates the downturn.
- Forecasters, at the Bank and outside, typically have little idea how deep any slowdown will be until we are well into it.

Where then does this leave us in thinking about the current situation? The Bank's current central economic forecasts were outlined in the June *Monetary Policy Statement* published earlier this month. As those forecasts indicate, the New Zealand economy has already slowed markedly and growth is expected to remain quite weak for some time. There is nothing in the material in this article to suggest greater reason for optimism. World growth is easing, and very large credit booms here and in many Western countries look to be unwinding. This de-leveraging is occurring at a time when oil prices are at record highs and inflation in much of the emerging world appears to be becoming increasingly problematic. This is linked in part to a period of prolonged fixed exchange rates and rapid accumulation of foreign reserves in a number of countries.

Locally, real interest rates and exchange rates have been quite high for a protracted period, and inflation has not been quiescent. International financial fragilities have increased domestic interest rates further at the same time as economic activity has begun to slow. Finally, the summer's drought and low lake levels may act as a material short-term drag on growth. There are mitigating factors of course – in particular, the healthy overall fiscal position, the fiscal stimulus already in train including the tax cuts announced in Budget 2008, and the possibility that the prices of New Zealand's commodity exports could be carried higher in the current global commodities boom. But it appears that these factors have much to mitigate.

10 Recommendations for further reading

For those interested in exploring New Zealand's previous recessions further, there are a number of books and papers worth reading. No publication is comprehensive, and in particular, there appears to be little in-depth treatment of the two most recent recessions.

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