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Westpac Institutional Bank

Eurogeddon

What it would mean for New Zealand

- **This bulletin investigates what would happen to New Zealand in a scenario of financial meltdown in Europe**
- **A sharply lower exchange rate would be New Zealand's main mechanism for adjustment**
- **Mortgage rates would be more likely to rise than fall**
- **The economy would tip into recession, albeit less savagely than 2008/09**

Financial markets are beset with uncertainty about Europe. The worry is that a sovereign default or a bank run might set off a chain of events that ends in Europe's banking system either freezing or collapsing. The outcome might be similar to the Global Financial Crisis that began in the United States in 2008.

Nobody really knows whether Europe's travails will end in crisis or not. Our published forecasts are based on our perception of the *most likely* outcome, which is that Europe avoids banking system collapse and muddles through with years of mini-crises followed by grudging bailouts. But businesses and financial markets must look beyond the *most likely* scenario in their planning. Ships carry lifeboats not for the most likely scenario, but because disaster is possible. In that spirit this bulletin looks at what would become of New Zealand in the possible but unpalatable scenario of a full-blown banking crisis in Europe.

For the purposes of illustration, we have made our "what if" scenario rather extreme (and nick-named it Eurogeddon). The scenario assumes a full-blown banking system collapse in Europe, in which some banks fail and global cross-border finance seizes up for a number of months. We further assume that, when cross-border finance recommences New Zealand banks find that they must pay an extra 200bp interest rate premium to borrow from overseas. We assume that the global economy goes into recession, and that the subsequent global recovery is less vigorous than 2009.

Two chinks in our armour…

New Zealand would face two vulnerabilities in this Eurogeddon scenario. First, the terms of trade would fall, removing a key pillar of support for the economy. Exporters of food commodities (milk, meat etc) would face sharply lower prices on global markets, tourist arrivals would fall, and demand for non-commodity exports would plunge. Consumers would find some solace in lower global prices for oil and other imported products, but that would be only a partial offset.

The second problem would be our large debt to the rest of the world. At present, New Zealanders' loans from banks exceed their deposits with banks. To make up the shortfall, banks borrow in overseas wholesale markets. But in the Eurogeddon scenario, banks would lose access to those wholesale markets for a time, and any restored access would come at a hefty interest rate premium.

New Zealand banks would be well-placed to weather the period of closed wholesale funding markets, because in recent years they have borrowed ahead of their immediate needs.[2] New Zealand would avoid going into a crisis of its own. But the gradual adjustment to higher bank funding costs would still be taxing for the economy.

With overseas debt so expensive to roll over, New Zealand banks would have to compete more fiercely for local deposits. This would drive term deposit rates higher. And higher deposit rates would be passed on to borrowers in the form of higher mortgage and business lending rates. Credit conditions may also tighten as banks sought to limit lending. Essentially, New Zealand would transition towards a situation in which national savings more closely matched national lending. Low confidence might discourage borrowing and encourage saving, but would not be enough. Higher interest rates would be the market's way of simultaneously incentivising less borrowing and more saving.

RBNZ all out of ammo

The Reserve Bank would attempt to offset this market pressure for higher mortgage rates by reducing the Official Cash Rate (OCR). But the Reserve Bank's latitude to do so may be limited, so mortgage rates could actually rise slightly from today's level. As we explain below, the exchange rate would fall very sharply after Eurogeddon, causing a spike in inflation that could prevent the OCR from dropping very far.

This is a key difference between small open economies like New Zealand and large economies like the United States or Japan, where interest rates have fallen to zero and stayed there. In those enormous economies the exchange rate tends to *rise* during global crises, as investors pour into perceived safe havens. This hurts growth and worsens the threat of deflation. After interest rates fall to zero, the remaining options for avoiding deflation are quantitative easing and fiscal stimulus.

By contrast, in small open economies with floating exchange rates the role of stabilising the economy and inflation falls mainly on the exchange rate.

1. Available at: http://www.westpac.co.nz/business/economic-updates/economic-research-and-strategy/Economic & Financial Forecasts
2. See the Reserve Bank of New Zealand's Financial Stability Report, May 2012, http://www.rbnz.govt.nz/finstab/fsreport/fsr_may12.pdf, pp 26 to 28 for the RBNZ's assessment on this.

A lower exchange rate: white knight or harsh medicine?

The New Zealand dollar has reached lofty heights on the back of high global food prices and the carry trade (through which foreigners lend New Zealand dollars to New Zealanders). Both would evaporate in Eurogeddon. The New Zealand dollar would plunge. During the 2008/09 Global Financial Crisis, the NZD bottomed out around 50 cents against the US dollar and 51 on the Trade Weighted Index – it could easily re-test such levels in Eurogeddon.

The lower New Zealand dollar would cushion the blow for exporters. It would also ease New Zealand's difficulty with funding its external debt. New Zealand banks would need to borrow fewer US dollars in order to raise a given quantity of New Zealand dollars. If the New Zealand dollar fell far enough it might even lure overseas investors back into our debt market, as they might anticipate an eventual appreciation in the value of the NZD (just as a low-enough share price eventually lures buyers back after a company announces bad news).

Over time, the lower exchange rate would help with economic rebalancing by discouraging consumption and imports, and encouraging production and exports.

And the lower exchange rate would transfer some pain away from New Zealanders and onto foreigners who have lent to New Zealand. In effect, New Zealand would repay its large external debt with money that is now worth less in terms of international purchasing power.

Economists and politicians occasionally slip into language that seems to suggest exchange rate depreciation would be a painless "get out of jail free card" should the economy get into trouble. In truth, a lower exchange rate would be very painful for many New Zealanders. Internationally traded goods and services would become less affordable. Any income earned in New Zealand dollars would have less international purchasing power. It is worth bearing in mind that a lower exchange rate would "make exporters more competitive" by reducing the standard of living of New Zealand wage and salary earners – hardly a good thing.

The strange behaviour of inflation

We suspect that inflation in New Zealand would spike higher soon after Eurogeddon. Falling global oil prices may cause an initial dip in inflation, but this may soon be outweighed by the effect of the sharply lower exchange rate, which would push up the price of internationally traded products. The United Kingdom's experience is instructive – inflation has been quite elevated since the GFC, partly due to the low exchange rate. Iceland's collapsing exchange rate led to almost 20% inflation in 2008.

As the influence of the low exchange rate wanes, we would expect inflation to eventually moderate. The weak housing market would keep domestic demand subdued, meaning low domestically-generated inflation.

The housing market

Eurogeddon would create an unfriendly environment for New Zealand house prices – low confidence, recession, and possibly higher mortgage rates. Starting as they are from a high multiple of incomes, New Zealand house prices would probably fall, just as they did in 2008 – we've pencilled in an 8% decline, but that is fairly speculative. Farm prices could fall further than house prices, as farmers would also be facing reduced incomes. Falling house and farm prices would be a further catalyst for tighter credit conditions.

Government debt

Rising unemployment and falling tax revenues would worsen the government deficit and lead to higher debt levels. What happens to government bond yields is highly uncertain. If the New Zealand government continued to be viewed as a safe credit, bond yields would probably fall. But the merest whiff of difficulty servicing the national debt could be enough to see global investors flee the NZ government bond market, causing a sharp increase in yields.

Given the risk of higher bond yields, the Government would probably react to Eurogeddon in a conservative manner – no "fiscal stimulus package". But neither would the Government respond with growth-strangling austerity. Rather, we'd expect a continuation of the recent run of "zero budgets", with no new spending. The government's books would remain in deficit for a while, but to satisfy markets and ratings agencies, the Government would continue to articulate a plan to eventually get back to surplus.

The bottom line: another recession (and then a recovery)

From what we've written above, it should come as no surprise that Eurogeddon would mean recession for New Zealand. However, we'd expect the drop in GDP to be less savage than the 2008/09 recession, partly because the economy is less inflated now than it was in 2007, but mainly because of the Christchurch rebuild. To be sure, construction sector activity outside of Christchurch would slip back to ultra-low levels in a Eurogeddon scenario. But quake-related construction activity would forge ahead, just as Napier was rebuilt during the Great Depression of the 1930s. So even in the Eurogeddon scenario we would forecast double-digit growth rates in residential investment (house building). This would prevent GDP growth from slipping very far into negative territory. The quake rebuild would act rather like a massive growth stimulus package (another reason not to expect fiscal stimulus this time).

We have pencilled in three quarters of falling GDP, and then a halting recovery. Low global commodity prices would stimulate development outside of Europe, although we assume that the global recovery would be slower after Eurogeddon than it was in 2009. The recovering global environment combined with a relatively low exchange rate would support an export-led recovery in New Zealand. Outside of Canterbury, we would expect the domestic economy to recover even more slowly than in our central scenario.

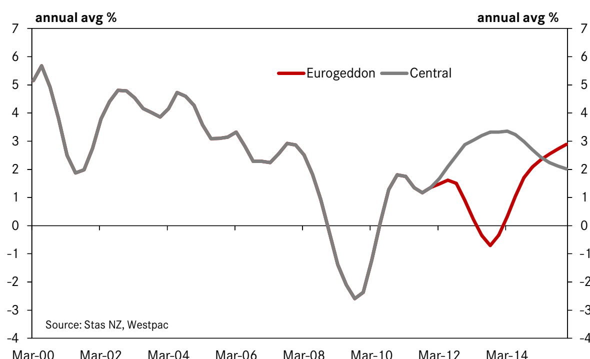
Dominick Stephens

Chief Economist

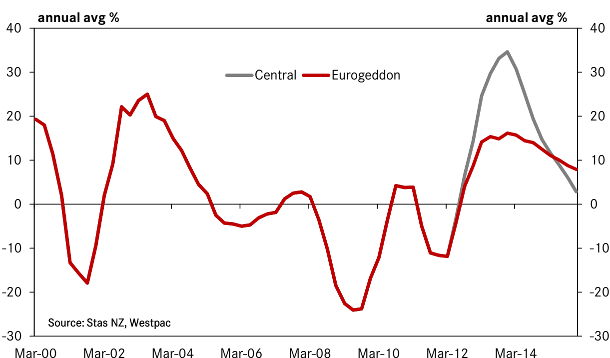
By the numbers

Indicative forecasts in European banking crisis scenario, versus Westpac central forecasts

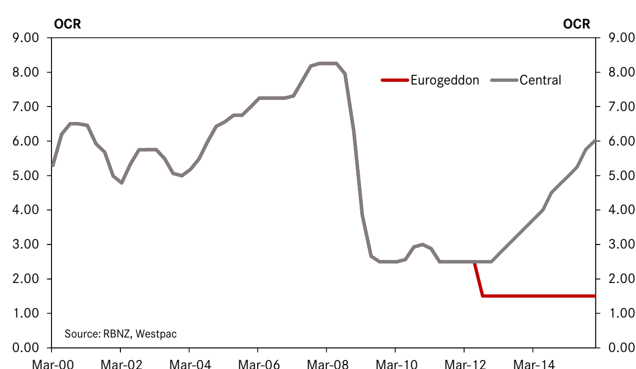
GDP growth (annual avg %)



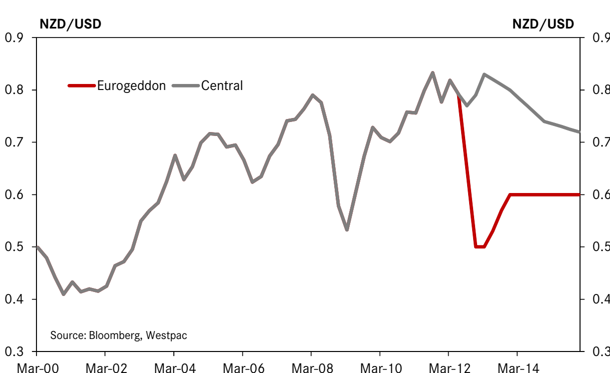
Residential Investment (annual avg %)



Official Cash Rate



NZD/USD exchange rate



	History				Westpac Central Forecast				Alternative Scenario			
Calendar Years	2008	2009	2010	2011	2012	2013	2014	2015	2012	2013	2014	2015
GDP (ann avg % chg)	-0.2	-2.4	1.8	1.4	2.9	3.3	2.7	2.0	0.9	-0.3	2.1	2.9
Residential Investment (ann avg % chg)	-18.5	-16.8	3.8	-11.7	11.1	33.5	14.7	2.8	8.7	16.1	12.5	7.9
Unemployment Rate (year avg)	4.2	6.1	6.5	6.5	6.5	5.5	5.0	5.0	6.6	6.8	7.3	7.0
Inflation	3.4	2.0	4.0	1.8	2.2	2.5	2.6	2.5	2.2	4.5	3.0	1.5
House prices (ann % chg)	-8.9	5.2	-1.6	2.8	6.0	3.0	-0.5	-1.0	0.0	-8.0	0.0	0.0
OCR (year avg)	7.7	2.9	2.8	2.6	2.5	3.1	4.3	5.5	2.0	1.5	1.5	1.5
Floating mortgage rate (year avg)	10.0	6.2	6.2	5.9	5.9	6.4	7.1	8.0	5.8	6.2	6.1	5.9
NZD/USD exchange rate (year avg)	0.71	0.63	0.72	0.79	0.79	0.82	0.76	0.73	0.69	0.55	0.60	0.60
NZD/AUD exchange rate (year avg)	0.84	0.80	0.79	0.77	0.78	0.79	0.80	0.80	0.75	0.71	0.72	0.72

Westpac Economics Team Contact Details

Dominick Stephens, Chief Economist Ph: (64-9) 336 5671 dominick_stephens@westpac.co.nz

Michael Gordon, Senior Economist Ph: (64-9) 336 5670 michael_gordon@westpac.co.nz

Felix Delbrück, Senior Economist Ph: (64-9) 336 5668 felix_delbruck@westpac.co.nz

Anne Boniface, Senior Economist Ph: (64-9) 336 5669 anne_boniface@westpac.co.nz

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