New Year Primer 2008

Donna Wynd[1]

Introduction

Happy new year, all. Have you checked your KiwiSaver returns recently? Here's something you could do as an experiment. Look up the actual return on your fund now, and then look at it in twelve months time. Chances are it will be a stark reminder of why people put their money under the mattress. To find out why, read on.

Coming to grips with some of the larger economic forces to which your superannuation fund and family will be subject over the next year can be daunting. Although much of what follows is speculative it will give you some pointers on what to look out for in 2008.

Time to buy a bike

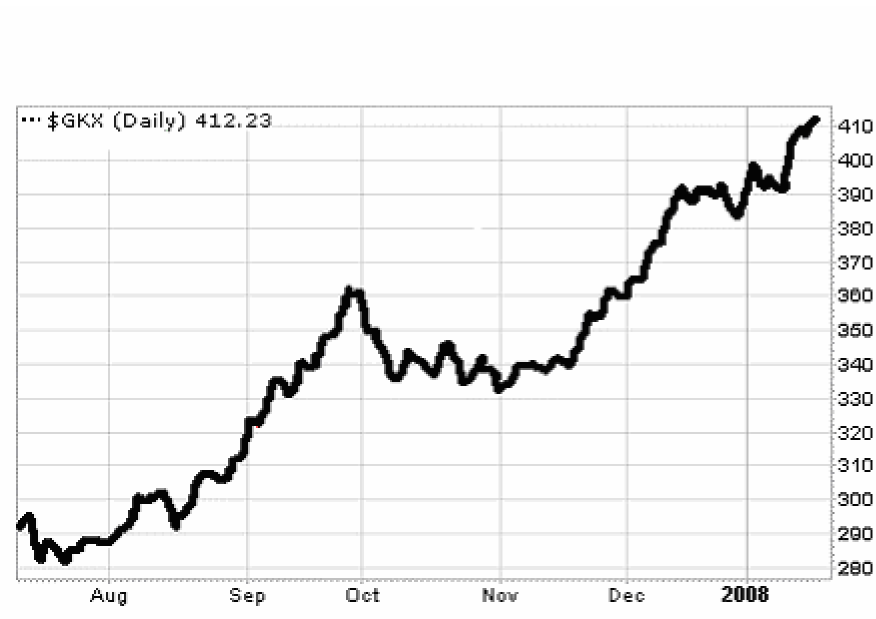
Oil prices have been rising steadily for several years and show no sign of falling soon (Figure 1). Rising oil prices directly impact on consumers through rising petrol prices. Time, perhaps, to give the planet a break and buy a bicycle.

Figure 1

Source: www.energyserve.co.uk/dailyupdate (Prices are in $U.S.)

High oil prices increase freight and manufacturing costs that are ultimately passed on to consumers. The key impact will be through rising food prices, especially for imported food. Global food prices have been rising (Figure 2) so most New Zealand families will find more of their budgets going to pay for food. Maybe it's time to learn how to garden, too. Fresh food tastes better, is cheaper and doesn't contribute to global warming.

Figure 2



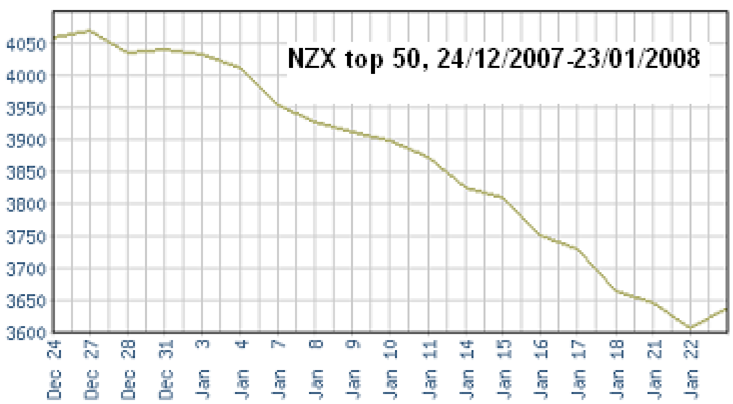
Source: Goldman Sachs Agricultural Index, derived from www.StockCharts.com

Blip or bloodbath?

Because it's usually only reported in the depths of the business section, many New Zealanders have only recently become aware of the turmoil in overseas equity markets. According to the Herald, the Dow Jones industrial average had "worst three-day start to a year since the Great Depression", and the NZX has lost 10% of its value since the start of 2008 (

Figure 3).

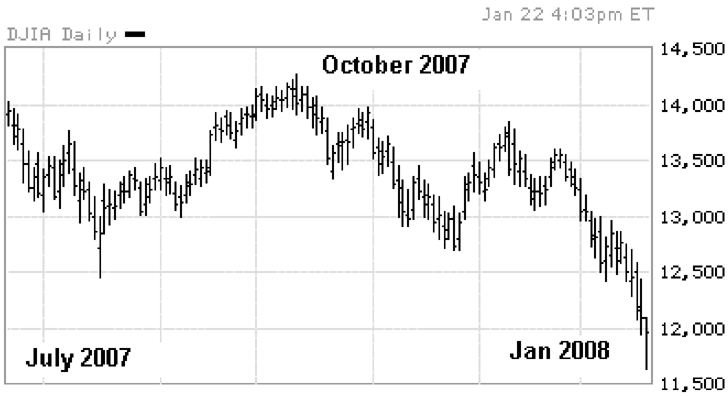
Figure 3:



Source: nzx.com

Equity markets have been volatile for some months, and while volatility has made investors nervous, the fact that the benchmark Dow has slumped since October 2007 (Figure 4) means many of the great and good are now talking openly about the possibility of a recession.

Figure 4



Source: www.money.cnn.com

Does the sharemarket slump mark the beginning of a slowdown or is it just a blip in a volatile market? It depends who you talk to.

Following another horror day on Wall Street and the continuation of the worst run of losses in the history of the NZX one New Zealand analyst said: “We're approaching what would be called a correction rather than a crash”. The problem with “corrections” is that real people with real families get hurt, and as Child Poverty Action Group and others have pointed out, the social security system that should be there to help them has been significantly eroded in the last twenty years. Still, most people can ride out a “correcton”.

Less blasé are some overseas commentators. The alarm was raised loudly and clearly last year by Peter Schiff of Global Pacific Capital. When it was becoming plain that the sub-prime mortgage market was collapsing, he told ABC in Australia “I mean this is the Hindenburg…It's a disaster. Not just down the road but right now, you know. Everybody is sugar-coating this and glossing over it. Look at what President Bush said today. He said all of the evidence points to a soft landing in housing. The evidence points to a crash landing.”[2]

Also concerned, but using less colourful language is the central banks’ central banker, the Bank for International Settlements. In its annual report for 2007 the BIS described the world as “fundamentally uncertain” rather than simply risky,[3] and argued that financial sector developments (for example the repackaging of mortgage debt) have clear benefits but “may also have side effects, with associated costs”.[4] This is central banker-speak for “we might be in deep shit”. Later, in December 2007 the BIS’s quarterly report noted that weak housing data, “outsized” bank writedowns and a sliding dollar were contributing to further to concerns about “broader economic weakness”.[5] This means “It might be really deep shit”.

Debt and the credit crunch

On January 22nd the U.S. Federal Reserve attempted to arrest the slide in stock markets by cutting interest rates 0.75%. This sent the Kiwi dollar spiking up as investors moved to take advantage of our high interest rates. A high Kiwi dollar will continue to make life difficult for exporters and it is likely that export industries will continue to move offshore. Unfortunately, despite the bland reassurances of mainstream economic theory, those industries seldom come back in the short or even medium term. New Zealand thus loses jobs, a means of earning foreign exchange, and, in the longer term, the capacity to manufacture goods and services.

So why have markets taken such a pounding? That's easy. Debt. In the U.S. banks looking to expand market share have been providing homeowners with mortgages they could not necessarily afford. When people started to default on their mortgages, billions of dollars of bank loans which had been recorded as an asset, including off balance sheets loans, suddenly became bad debt. Banks have written off billions of bad debt, and the house price bubble is still deflating, meaning their loan assets will continue to decline in value.

Meanwhile, Morgan Stanley and UBS have had to be bailed out by capital injections from the Chinese and Singaporean governments, respectively. In addition, Citigroup and Merrill Lynch have had capital injections from the state-run Kuwait Investment Authority. Who said the business doesn't believe in government handouts?

Inflation or bust?

What does this mean for New Zealand? Some observers are optimistic, others less so. According to one observer 2008 will not be the year the market recovers, but rather the year it gets worse: "It's 1987 all over again." The strong New Zealand dollar will protect consumers from rising oil and food prices for a while but if nervous investors start to wind back their New Zealand dollar holdings then that protection will be lost. This will add to inflation, possibly prompting the Reserve Bank to raise interest rates.

New Zealand is also vulnerable to a slowdown via the global credit crunch. New Zealand too has enjoyed a debt-fueled boom. If we can't borrow any more, or money suddenly becomes more expensive, the probability of a slowdown here increases. In this regard New Zealand resembles the U.K. "The chances of a British recession are rising, as the bills come due after a decade of dependence of on debt, a housing bubble and … levels of consumer debt and house prices that are even more out of proportion with earnings [than the U.S]".[6] Unfortunately, we have squandered the billions we have borrowed on home improvements rather than adding to our productive capacity.

Coming up in 2008

Should New Zealanders be worried about a recession? Maybe, maybe not. If this really is 1987 all over again then it won't happen straight away. We still have good economic growth and low unemployment. There's usually a lag of several years before sharemarket falls affect the real economy. On the downside capital markets are much more integrated than they were in 1987, and a slowdown in the U.S. will probably affect us much more quickly than in the late 1980s. On balance, the chances are for a slowdown in New Zealand by the end of 2008. If you've got debt, pay it off; don't take any more debt on; and don't invest in any finance or property companies.

For New Zealand families, especially the ones who have missed out on the economic boom, the chances are life will get harder in 2008. With the two main parties determined not to question the pro-market orthodoxy of the last twenty-five years, it is unlikely that assistance for families hit by a slowing economy will be forthcoming. Instead, watch out for wealthy interest groups peddling market-based solutions that will put an even greater share of the national income into their own pockets in what is potentially the biggest economic meltdown for twenty years. You read it here first.

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[1] Donna Wynd is a researcher for Child Poverty Action Group. Opinions expressed are not necessarily those of Child Poverty Action Group or any of its members.

[2] The World Today - Friday, 10 August , 2007 12:17:54, http://www.abc.net.au/worldtoday/content/2007/s2001529.htm

[3] Bank for International Settlements, 2007, *BIS 77th Annual Report* p. 139. www.bis.org

[4] Ibid, p.151.

[5] Bank for International Settlements, 2007, *BIS Quarterly Review, December 2007.* www.bis.org.

[6] James Saft (2008), *Recession risk as British bills come due*. Reuters, January 16, 2008, http://www.reuters.com/article/reutersEdge/idUSL1447890020080116