Forget the boom and get ready for some gloom.

by Keith Rankin, 20 April 2007

In August 2000 The Herald published an article of mine headed Forget the doom and get ready for a boom.

I am proud to record that my optimistic prediction proved to be on the mark. The low dollar that year (44 US cents in August, falling to 39 cents in November) proved to be a springboard for the revitalisation of New Zealand's manufacturing, and the vitalisation of tradable services such as international education. The receipts that flowed into this country generated a spell of continuous economic growth above three percent for four consecutive years (December 2001 to December 2004).

That growth would have continued for much longer, had it not been for the inexorable rise of the New Zealand dollar, which hit 70 US cents in December 2004, and is currently 74 US cents. Since December 2005, growth rates have been significantly curtailed. Economic growth per person was close to zero in 2006. The high New Zealand dollar - a result of the speculative "carry trades" rather than of economic fundamentals - has made New Zealanders dependent on imports to an unprecedented extent.

It is the easy money arising from this carry trading activity that, when on-lent, is boosting the New Zealand housing market.

Free markets are supposed to align interest rates in different countries to eliminate the easy profit-taking opportunities that arise when speculators borrow in a low-interest currency and supply funds to a country like New Zealand with high interest rates.

However, because interest rates nowadays are largely set by central banks rather than by free markets, the speculators' opportunities are kept open when central banks such as the Reserve Bank of New Zealand maintain (even extend) New Zealand's interest rate premium. Today the New Zealand dollar rises whenever the carry trade speculators sense that there is an increased probability that the Reserve Bank will raise interest rates.

The political-economic environment today reminds me of 1987. In 1985 and especially 1986, massive speculative activity (especially in banking, shares and in commercial property, following the 1985 deregulation of financial markets) had placed the New Zealand economy in a precarious position.

In January 1987, interest rates were at 23 percent and rising (reaching 31 percent on overnight money in April). From January to May the sharemarket plunged, losing a quarter of its value. By May the political opinion polls showed that National would easily win the 1987 election.

The Labour Government, especially in its highly political June 1987 budget, misrepresented the state of the country's economy. By May the sharemarket dive had stabilised, and high interest rates attracted foreign "investors" back into the New Zealand market. In the lead-up to the general election in August 1987 the New Zealand banks were bursting at the seems with overseas hot money, and the New Zealand exchange rate was appreciating rapidly.

The banks started lending this hot money at an ever-greater pace after May 1987, to the extent that by September, the January-May sharemarket plunge had completely reversed. In August the

government was re-elected comfortably, a complete turnaround from the May polls. Even Remuera nearly came close to electing a Labour candidate.

From September, everything fell apart. The years from 1987 to 1991 constituted the worst financial crisis of our country's history since the time of Governor Fitzroy in the 1840s. The economic crisis that followed meant that the New Zealand economy did not grow for five years, at a time the Australian economy was booming.

Events in the mid-2000s represent a slow-motion repeat of the 1986-87 debacle, with the ongoing residential property bubble taking the place of the commercial property boom of the mid-1980s. All of the ingredients are the same: high-interest monetary policies making New Zealand the darling of international speculators, excessive bank-lending to risky customers, a rising exchange rate, a ballooning balance of payments deficit, and a government pretending that the economy was performing brilliantly when in reality it was in deep trouble.

Today's reality is a slow-motion version of the mid-1980s boom and bust. So it may take longer before the inevitable "correction" takes place. Indeed, a controlled reversal of today's macroeconomic policies still gives us a chance of experiencing a "soft-landing" followed by a growth surge in 2009.

The signs are not good however. The Reserve Bank continues to ignore the fact that, since 2000, rising interest rates have preceded rises rather than falls in domestic (ie "non-tradable") inflation. The "anti-inflation" policy that the Bank continues to pursue simply doesn't work. It makes the problem worse.

If we use the 1980s as a guide, then my prediction today is that New Zealand will face a severe financial crisis after the next election. I also suspect that the election will be held early, for example June 2008. Like 1987, it might be a good election to lose.

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