

# New Zealand and the Financial Crisis of 2008

David Tripe  
Centre for Banking Studies  
Massey University  
Private Bag 11-222  
Palmerston North  
New Zealand

Phone: +64 6 350 5799 ext 2337  
E-mail: [D.W.Tripe@massey.ac.nz](mailto:D.W.Tripe@massey.ac.nz)

June 2009

## Keywords:

Financial crisis, New Zealand, banks and banking

## Acknowledgements:

The author would like to thank participants at a seminar at Massey University and at the workshop on the Global Financial Crisis at the Reserve Bank of New Zealand, particularly Paul Bedford, for comments on an earlier version of this paper.

## New Zealand and the Financial Crisis of 2008

### Abstract:

The financial crisis of 2008 has impacted on different countries around the world in different ways, and the impacts that it has had on New Zealand are a reflection of a number of peculiar institutional features of the New Zealand banking system and the New Zealand economy.

This paper seeks to identify these special features for New Zealand, by looking at the ownership of New Zealand's banks, the balance of payments current account and the international investment position, bank funding and the economic and financial structure of the New Zealand economy. We need a proper understanding of these factors before we can make sensible assessments of how New Zealand might work its way out of the crisis.

## (1) Introduction

New Zealand may be a small isolated country, but that does not mean that the study of its economy and banking system cannot be interesting. Not only does New Zealand have an overwhelmingly foreign-owned banking system, but it has also run current account deficits in the balance of payments for many years, so that it has built up a strongly negative international investment position (93.3% of GDP at December 2008). When one also has regard to a strong run-up in house prices through until mid 2008, New Zealand can appear very similar to a number of countries which have experienced severe economic problems in the last part of 2008, and through into 2009. A further characteristic of the New Zealand financial system is that it is strongly bank-dominated, with relatively little financial intermediation undertaken through other channels.

So far at least, however, New Zealand's economic problems seem to have been relatively mild, although the government felt obliged to join a world-wide stampede and introduce a deposit protection scheme for banks and other deposit takers in October 2008. There are still a number of issues which could be a trigger for more severe problems in due course, but New Zealand's situation needs to be looked at alongside those of other countries, both those which have got into difficulties and those which have not, to see what lessons can be learned for future economic and financial system management.

This paper ends up being more descriptive than analytical, but it should provide a foundation for further analysis, both of the New Zealand market and of other countries whose outcomes have been different. We do not provide a detailed account of the financial crisis in New Zealand, but suggest that, to the extent that it is caused by events in the New Zealand economy, the relative causative factors are in a bursting of a bubble in residential property prices, with property prices having become subject to disaster myopia. The other underpinning of the crisis was in the international financial system – banks can only operate with their typically low levels of equity if their counterparties believe that they are sound: when that belief is undermined, access to credit in the interbank market for liquidity becomes extremely problematic.<sup>1</sup>

We focus instead on exploring the risks in New Zealand's economic and financial structure, and its strengths and weaknesses. The rest of the paper therefore focuses on these risk areas, and explores

---

<sup>1</sup> For a more extensive discussion of the background to the crisis in New Zealand see Tripe (2009).

their consequences. In the next section of the paper, we look at the foreign ownership of the New Zealand banking system, while Section 3 of the paper looks at the balance of payments current account. Section 4 looks at bank funding, while Section 5 provides an overview of the economic and financial structure of the New Zealand economy. Section 6 brings these issues together, and concludes.

## **(2) The foreign ownership of New Zealand's banks**

The first bank to open for business in New Zealand, in 1840, was a branch of the Union Bank of Australia. This was a British overseas bank, headquartered in London, and ever since that time there have been foreign banks operating in the New Zealand market.<sup>2</sup> Over the next 30 years, a number of other banks were established, and although some of these were New Zealand owned (particularly in the savings bank sector), foreign-owned banks continued to play a major role. By the time of deregulation in the mid 1980s, one of the four trading banks was New Zealand-owned (by the government), two were Australian-owned, and one was UK-owned.

Following the passage of an amendment to the Reserve Bank of New Zealand Act in 1986, bank registration was opened up. Initially, a number of foreign-owned non-bank financial institutions converted to bank status, followed by many of the domestic savings banks and building societies, while a number of New Zealand owned institutions were acquired by foreign banks. Foreign ownership thus accelerated, and by June 1996, the New Zealand banking system was 99.4% foreign-owned. There has subsequently been some expansion of the New Zealand owned banking sector, particularly reflecting the establishment of a new bank, Kiwibank, by the government through New Zealand Post, and by December 2008, the proportion of the banking system that was foreign-owned had decreased to 96.1%.

A number of arguments are marshalled for and against the foreign ownership of banks.<sup>3</sup> The principal argument against foreign ownership is that the interests of the domestic economy will be made subservient to the interests of the foreign bank owners, and to the interests of the banks' home country economy. This might be reflected through events such as the actions of the Japanese banks in cutting back on lending in the United States in the 1990s as they came under pressure in their home markets (Peek & Rosengren, 1997), or the actions of some of the foreign banks in

---

<sup>2</sup> The phenomenon of British overseas banks is discussed by Jones (1993). A number of these operated in the New Zealand market.

<sup>3</sup> See Chetwin (2006) for a more extensive discussion of these.

Argentina who abandoned that market in the aftermath of the collapse of the currency board system in 2001. Some concerns have also been expressed about the impact of the current crisis on the CEE countries, which have predominantly foreign-owned banking systems. Beyond those there is the polemic argument that the banking system (and the payments system in particular) is part of a nation's infrastructure, and that it therefore ought to be under national ownership.

Unfortunately for the opponents of globalisation, these propositions do not seem to be borne out in practice, and the balance of empirical work generally finds that foreign-owned banks do not engage in excessive exploitation of domestic customers in the market that they expand into. Clarke et al (2003) found that the presence of foreign banks in local markets were generally positive. Research by Crystal et al (2002) and Dages et al (2000) showed that, in Argentina, foreign-owned banks provided a stabilising effect on the financial marketplace by providing more effective risk management practices and better access to foreign capital markets.

On the other hand, developments during the current financial crisis have highlighted issues around the regulation of foreign-owned banks in host country markets.<sup>4</sup> Although home and host country responsibility are supposedly dealt with under the Basel Concordat, challenges have been posed by the limitations of Icelandic deposit insurance in the United Kingdom, and in Latvia, by the guarantees given to Swedish banks (Mayes, 2009).

In the New Zealand case, the dominant foreign owners of banks are Australian – the so-called big four, which are the ANZ Banking Group Ltd (ANZ), Commonwealth Bank of Australia (CBA), National Australia Bank (NAB) and Westpac Banking Corporation (Westpac). In January 2008, prior to the effects of the crisis being observed and prior to Westpac's acquisition of (the publicly-listed) St George Bank and the CBA's acquisition of BankWest (from HBOS), these banks held 62.8% of Australian bank (domestic) assets. By January 2009, the market share of the big four, including their acquisitions, had increased to 73.7% of total assets. This is, however, significantly less than their domination of the New Zealand market, which has seen a combined share of between 85 and 90% of assets since the ANZ's acquisition of the National Bank of New Zealand (NBNZ) in 2003.<sup>5</sup>

---

<sup>4</sup> For an earlier discussion of this, see Goodhart & Schoenmaker (2006) and Mayes (2006). See also Tripe et al (2009).

<sup>5</sup> As at 31 December 2008, these four banks accounted for 89.7% of the assets of the New Zealand banking system.

Such a concentration of ownership by banks from just one country could readily be perceived as a risk factor for the New Zealand banking system (Hull, 2002). In the context of 2008/09, however, we have been fortunate that the Australian banking system is one of the strongest internationally, with less exposure to crisis-engendering factors which have been so prevalent in the USA and Europe.

A major practical issue with this Australian ownership has been in the development of satisfactory Trans-Tasman banking supervision arrangements. This has been partially addressed by the Trans-Tasman Council on Banking Supervision, while the Reserve Bank of New Zealand also argues that it has clarified matters by requiring the Australian majors to incorporate subsidiaries in New Zealand through which they are required to conduct their retail banking business.<sup>6</sup> This latter move is intended to protect the position of New Zealand depositors relative to those in the parent bank, in the case of the parent's liquidation.

In practical terms, however, the incorporation requirement might not be as effective as is argued for protecting New Zealand depositors. The New Zealand subsidiaries receive significant funding from their Australian parents, and if a potential shortfall was anticipated, the New Zealand subsidiary could repay its parent prior finding itself unable to repay New Zealand depositors.<sup>7</sup> Beyond that, the New Zealand subsidiary could simply decapitalise itself by advancing funds to its Australian parent: although that might breach Reserve Bank of New Zealand rules on connected lending, the funds might be difficult to recover once the New Zealand subsidiary had been declared insolvent.

There are, however, some practical reasons as to why the major Australian banks might not want to unduly exploit their positions in the New Zealand market. The banks through which they operate in New Zealand have been in business for more than 100 years, and the general experience has been that these banks have traded at a significant premium over book value of net assets. Even though the extent of this might currently be reduced (reflecting the general drops in bank share prices in the face of the global credit difficulties), the banks have a significant investment in their New Zealand businesses, and they would be expected to want to maximise returns for those over a longer period of time. This is also reflected in what is understood to be a less aggressive approach to mortgagee sales during the current economic downturn.

---

<sup>6</sup> See Chetwin (2006) for a more extensive discussion of this policy.

<sup>7</sup> Some limitation on this would follow from the operation of standard insolvency procedures, but this should not be assumed to provide full protection for New Zealand depositors.

The implications of their investments in the New Zealand market can be seen in the balance sheets of the banks which have, in recent times, expanded in the New Zealand market by undertaking acquisitions. For example, the ANZ shows goodwill of AUD 2.83 billion, related to its acquisition of the NBNZ.<sup>8</sup> This represented 11.3% of the bank's total shareholders' equity of AUD 25.7 billion as at 30 September 2008. Smaller amounts of goodwill are held by Westpac, in respect of its 1996 purchase of Trust Bank New Zealand, and the CBA in respect of its purchase in 2000 of the minority interests in ASB Bank Limited.

Even if there is no direct exposure in terms of goodwill, the major Australian banks still derive a significant portion of their value to shareholders from their New Zealand businesses: the lack of a market for New Zealand bank shares means that equity is only recorded at book value, rather than at market value. When New Zealand banks have been traded on the market, they have shown as having market values substantially in excess of book values, at a ratio between 2 and 3. This means that, if an Australian bank were to abandon its New Zealand subsidiary, the economic costs might be significantly in excess of recorded book values.<sup>9</sup>

One advantage that the New Zealand banks derive from their Australian parents is their parent bank credit ratings, which for much of the current decade have been at AA (on the Standard & Poors rating scale). If the New Zealand banks had been stand-alone, it is likely that the typical level of credit ratings would have been A at best, reflecting the reduced size of the banks and their operation in a less diversified economy, assuming that they had adopted the sorts of capital structure they would have needed as stand-alone banks. In fact, as Tripe (2004b) has demonstrated, the New Zealand banks have used relatively less of capital as an input resource than have their Australian parents, which suggests that they might have had relatively lower capital levels than their Australian parents: they might have needed rather more capital to achieve that A credit rating. It is thus reasonable to postulate that New Zealand banks would have faced significantly higher funding costs if they had been domestically rather than Australian-owned.<sup>10</sup>

There may be another side to the Australian banks' strength and its reflected glow in sustaining their New Zealand operations. Their strength must have made it easier for them to borrow in

---

<sup>8</sup> See the discussion in notes 2 (iv) and 20 of the bank's 2006 financial reports.

<sup>9</sup> This value might not be lost if the bank could be sold on an open market, presuming the vendor was not distressed, but this could prove difficult because of the limited number of potential purchasers.

<sup>10</sup> During 2009, banks have often found it cheaper to fund New Zealand operations through the Australian parent banks because of Australia's stronger credit rating and the lower charge for use of the wholesale guarantee.

international markets than it would have been for the New Zealand banks on a standalone basis,<sup>11</sup> which has arguably facilitated the flow of funds into New Zealand, and into the banking system in particular. This can be argued as having contributed to some of the alleged bubble in prices of residential property, the bursting of which has contributed to the economic downturn. We will look at this inflow of funds in greater depth in the next section, when we look at the balance of payments, and in Section 4, when we look at bank funding.

### **(3) The balance of payments current account**

The sustainability of New Zealand's balance of payments position has long been a subject of discussion by politicians and economists, although it has perhaps been the subject of less debate since the deregulation of the mid-1980s, which occurred in the aftermath of a balance of payments/foreign exchange crisis in 1984. This is no doubt because, with the floating of the exchange rate and the liberalisation of financial flows, the affordability of the next few months' imports has been a much less pressing problem for governments to have to solve.

The reasoning as to why the balance of payments current account should not matter is quite straightforward. With a freely floating exchange rate, any imbalance between desired currency inflows and outflows should be remedied by a change in the exchange rate. While this was a reliable enough strand of thinking when international capital flows were minimal, this model may not work so cleanly once such flows have become more important, with investors seeking yields from wherever in the world interest rates are highest (based on assumptions that the higher interest rates do not in fact reflect an anticipated depreciation of the exchange rate). Balance of payments disequilibria may thus persist for significant periods of time.

One should not, therefore, be too keen to jump to the conclusion that New Zealand's balance of payments current account deficit does not matter, because it will remedy itself. The current account shows a substantial deficit (8.93% of GDP for the year to 31 December 2008), and one which has been at such levels (which would often be regarded as unsustainable) for a considerable period of time. Figure 1 shows the trend in both dollar terms and relative to GDP for the period from the September quarter of 1997 through to the December quarter of 2008.

---

<sup>11</sup> This has persisted even with the wholesale guarantee in place, since October 2008, because of the lower level of guarantee fee payable in Australia, and because of that country's higher credit rating.

[Insert Figure 1 about here]

If we examine the balance of payments current account in more detail, we find that it is the income account which is the major contributor to the deficit (we will review the significance of this later in the paper). The overall effect of the trade account is slightly negative, while the services account is more or less in balance and the transfers account shows a small surplus. The trends in the individual elements can be seen in Figure 2.

[Insert Figure 2 about here]

Woolford et al (2001) reported that, at that stage, New Zealand's cumulative current account since 1975 stood at more than NZD 75 billion. From the beginning of 2002 through until the end of 2008, a further NZD 78 billion of deficits have been incurred. These accumulated current account deficits need to be funded by corresponding inflows through the capital account, with the net effect then being reflected in New Zealand's net international investment position. As at December 2008, New Zealand's net international investment position showed a deficit of NZD 167.7 billion, equivalent to 93.3% of GDP. The trends in net inward and outward investment that contribute to this outcome are shown in Figure 3. It is this net deficit in the international investment position that leads to the deficit in the income account of the balance of payments (Tripe, 2004a).

[Insert Figure 3 about here]

The continuing current account balance of payments deficit and the size of the deficit in the international investment position (which is very high by international standards – see Bedford, 2008) highlight a risk for the New Zealand economy, one which is aggravated by the relatively higher proportion of debt (subject to repayment on maturity) rather than equity in the international investment position. Sustaining this position requires confidence on the part of the providers of foreign investment that the New Zealand economy is stable and that they have good prospects for obtaining satisfactory returns on their debt and equity investments. They are thus dependent on the (relative) good health of the New Zealand economy, while those who have invested in NZD debt instruments<sup>12</sup> will also be concerned at the possible depreciation of the currency.

---

<sup>12</sup> According to Statistics New Zealand data as at 31 December 2008, only 50% of outstanding debt was denominated in New Zealand dollars, but, for reasons we discuss further below, this would tend to understate the actual proportion of New Zealand dollar exposure.

This exposure to foreign investors is a particular issue for the banking sector (which is, of course, predominantly foreign-owned) and in the next section we explore the implications of this for bank funding.

#### **(4) Bank Funding**

An obvious question to ask in response to the preceding outline of the extent of foreign investment in New Zealand is to ask how all that flow of funds can be absorbed? Is it reflected in very substantial ownership of New Zealand firms and property? One of the areas where this funding has been absorbed has been through the banking system, which has a very substantial amount of funding by non-residents, but it is also reflected in areas such as the foreign ownership of the banks, that we discussed in Section 2 of the paper.

Figure 4 shows us the trend in total non-resident funding of the New Zealand banking system: the extent of the increase in gross non-resident funding, particularly since the beginning of 2004, is particularly striking. If we compare the increase in non-resident funding with the deterioration in the net international investment position and the accumulated deficit over the period from December 2003 through to the end of December 2008, we find that non-resident funding increased by NZD 58.9 billion, that the net international investment position worsened by NZD 61.6 billion, and that the cumulative current account deficit was NZD 67.6 billion.

A common concern with non-resident funding is that it will be denominated in foreign currencies, thereby exposing the banks to foreign exchange risk. This has been identified as a problem in a number of the CEE countries that are under stress, because of borrowings denominated in Euros. If we examine the funding of New Zealand banks in greater detail, we find that there was total non-resident funding of \$119.5 billion as at 31 December 2008.<sup>13</sup> \$37.5 billion of this was in New Zealand dollars, with the remaining \$82 billion in foreign currencies. Against that could be offset total claims against non-residents of \$15.6 billion, \$7.7 billion of which was in New Zealand dollars, and \$7.9 billion in foreign currencies. The net position with non-residents was thus \$103.9 billion (representing 26.6% of total assets), \$29.8 billion in New Zealand dollars and \$74.1 billion in foreign currencies.

---

<sup>13</sup> From the Reserve Bank of New Zealand's data table C4. This relates to M3 institutions, but this is no longer significantly different from the set of all banks.

That is not quite the end of potential foreign exchange risk exposure for New Zealand banks, however. As at December 2008, banks had foreign currency funding from New Zealand residents of \$9.1 billion, and foreign currency claims on New Zealand residents of \$4 billion.

We can in fact ascertain from banks' foreign exchange risk reporting<sup>14</sup> that the extent of their foreign exchange risk exposure is very small. It is our understanding that foreign currency funding is swapped into New Zealand dollars, generally using cross currency interest rate swaps, which also provide a hedge for banks' short to medium term fixed rate lending (which comprises a significant portion of banks' lending, particularly on housing and to the farming sector.<sup>15</sup> We will discuss this further when we look at the financial structure of the economy in the next section of the paper). The other side of much of this business relates to the issuance of Eurokiwi and Kauri bonds (New Zealand dollar bonds issued by foreign, particularly supranational, issuers in the New Zealand market).<sup>16</sup>

If the New Zealand banks are successfully hedging against the currency risks associated with this quantity of non-resident funding, the question arises as to who is carrying the relevant foreign exchange risk. A small amount will relate to foreign banks' desired holdings in their New Zealand dollar accounts with New Zealand banks and other working balances in New Zealand dollars (and a similar rationale will apply for some of New Zealand banks' foreign currency assets). Much of the banks' funding in New Zealand dollars can be associated with specific counterparties. In the case of the foreign currency funding from international financial markets, however, the parties holding the ultimate currency risk (hedge counterparty) may not be so clearly indicated. In some cases it will be holders of Eurokiwi or Kauri bonds, but other parties will include hedge funds and others holding essentially speculative positions, some of which will reflect carry trade activity. Many of these investors will be highly sensitive to changes in interest or exchange rates: any collective concerns by these investors will thus pose significant threats to bank funding and the value of the New Zealand dollar. There is a view that the sharp drop in the value of the New Zealand dollar, from USD 0.6729 on 2 October 2008 to USD 0.5415 on 28 October 2008 (with a corresponding change in the TWI from 64.6 to 55.9), which was accompanied by particular pressure on bank liquidity, was an indication of the nervousness of these non-resident counterparties in respect of their New Zealand dollar exposures in the aftermath of the Lehmans collapse in September.

---

<sup>14</sup> This is in accordance with the method outlined by Harrison (1996), which banks are required to adopt. The total of open foreign exchange positions will be 12.5 times the reported foreign exchange risk exposure number reported in the market risk category.

<sup>15</sup> This means that the functional currency of this debt, and of the interest rates applying to it, is New Zealand dollars, whereas Statistics New Zealand data record it in its original currency.

<sup>16</sup> See Drage et al (2005) for a discussion of Eurokiwi bonds and Groom (2008) for a discussion of the Kauri bond market.

This also underpins the New Zealand government's concerns about the possibility of a country downgrade for New Zealand, which would be expected to have negative consequences for the cost of debt servicing. The liquidity pressure posed by non-resident counterparties with reduced willingness to roll existing funding for the same maturity can be referred to as rollover risk (Bedford, 2008). Further issues could arise in this context from a bunching of maturities for Eurokiwi or Kauri bonds, and from the relatively short maturities of non-resident funding (in both New Zealand dollars and foreign currencies).<sup>17</sup>

Reflecting the net international investment position discussed in the previous section, the New Zealand dollar is perceived as being a higher risk currency (Hawkesby et al, 2000; Rose, 2008), which is an explanation for the relatively higher levels of interest rates observed. If we did not have predominantly foreign-owned banks, it would be significantly more difficult to gain access to the funding which has allowed the banks to keep on meeting borrowers' demands for funds, without even higher interest rates.

Some of the extent of the risk exposure is mitigated by banks channelling funding through their overseas parent banks. At the end of December 2008, banks were receiving \$55.5 billion of funding from associates (the amount of this that relates to New Zealand-owned banks is trivial) against \$6.3 billion of claims on associates. A small portion of this will relate to New Zealand dollar funding from across the whole of international banking groups being reflected in balances in their New Zealand operations, but the major part will relate to decisions on the part of the parent bank to provide support for their New Zealand business. This can be seen in the disclosure statement reporting of the Australian-owned banks in particular, although the amount of such funding is constrained by APRA rulings (APS 222) which limit the amount that can be lent to 50% of the banking group's Tier One capital. The relative financial strength of the Australian parent banks provides some protection for the New Zealand operations in this context.

Note that there is a further element of funding provided to the banks through the value of equity that they have invested, which for the four major banks stood at \$17.3 billion as at 31 December 2008. This equity exposure is not in general subject to any currency hedging (Chi et al, 2007).

---

<sup>17</sup> See Reserve Bank of New Zealand data table SSR part B1.

Within the core New Zealand dollar funding of the banking system, the major sources as at 31 December 2008 were households (which accounted for 38%), finance (22%) and non-residents (17%).<sup>18</sup> As we can see in Figure 5, and as we will discuss further in the next section of the paper, although funding from households was steadily increasing until late 2008 when New Zealand households began to try and reduce debt, it did not increase as fast as lending to households.

[Insert Figure 5 about here].

## (5) The Financial Structure of the New Zealand Economy

Figure 5 showed how rapidly banks' lending on housing has grown, and this is a major impact on the financial structure of the New Zealand economy. In part this is because of banks' large share of overall financial intermediation, where New Zealand's share and bond markets are both relatively small, but it also reflects the structure of household balance sheets.<sup>19</sup>

Prior to the deregulation of the 1980s, the banks could be perceived as disadvantaged relative to other channels for financial intermediation, as the regulatory structure was inclined to be more restrictive on banks than on other classes of financial institutions.<sup>20</sup> As a consequence, once financial markets were deregulated, banks were able to expand into lines of business in which their participation had previously been restricted, and a number of other classes of institutions were squeezed out of the market, notably the official short-term money market dealers, which no longer had any role to play.<sup>21</sup> We also saw the larger building societies converting to bank status and the finance company sector shrinking as banks were able to undertake the same business as banks (and some finance companies became part of the banking sector).

The structure of New Zealand's financial system was also impacted by what happened in the share market, particularly in the aftermath of the 1987 crash which ended an earlier speculative boom. This has had an effect in undermining public confidence in the share market (Burns & Dwyer, 2007), and we now find that the capitalisation of the New Zealand market is very small relative to the size of the economy, when compared with other OECD countries. Shares are thus a particularly small portion of household asset portfolios, as can be seen when we look at the structure of these in

---

<sup>18</sup> Data are from the Reserve Bank's data table C8.

<sup>19</sup> The dominant role of banks is evident in tables A1 and A2 of the May 2009 Reserve Bank of New Zealand Financial Stability Report, available at <http://www.rbnz.govt.nz/finstab/fsreport/3631105.pdf>.

<sup>20</sup> An alternative view would be that other classes of financial institution prospered because of the regulatory restrictions which hindered banks ability to compete with them.

<sup>21</sup> See Nicholl & King (1985).

Figure 6. There is also an indication that New Zealanders display less interest in and enthusiasm for share market investment than do households in other countries, preferring to hold a higher proportion of their financial assets in cash and bank deposits. This likely reflects limitations in financial literacy among the population at large.

[Insert Figure 6 about here]

Figure 5 showed the growth in housing lending while Figure 6 showed us how the value of household assets had increased. If we adjust the holdings of financial assets for household financial debt, to get a figure for net financial assets, we get the position highlighted in Figure 7, where, at least through until the end of 2007, household net financial wealth was in decline.<sup>22</sup>

[Insert Figure 7 about here]

Household wealth is thus overwhelmingly concentrated in housing, rather than in other classes of assets, and there is thus a potential shortage of funding from households to support investment in other areas of the economy (apart from farming).<sup>23</sup> This is consistent with the story that the balance of payments current account is telling us, in that the deficit suggests that New Zealanders collectively are spending more than they earn, and that the overall savings rate is negative (Briggs, 2007), with dis-saving financed by increased borrowing (facilitated by financial deregulation). It is also consistent with the continuing import of capital (as seen in the balance of payments capital account surplus to fund the current account deficit).<sup>24</sup>

The growth in housing lending has also contributed to the problem through its having supported increased housing prices. The corresponding increased levels of household wealth have made households more willing to spend, promoting dis-saving and aggravating the balance of payments current account. This contention is supported by aggregate data on the value of housing and savings flows (Hull, 2003).

---

<sup>22</sup> We do, however, have a problem with the housing debt figure as it also includes funding raised by small business proprietors collateralised against the family home. There may also be a distortion from borrowing to assist investment in residential property.

<sup>23</sup> Some caution has to be applied with the Reserve Bank data on household assets and liabilities, as it does not include the value of household investments in small and medium businesses (except for residential property investment). It is, however, broadly consistent with other data (except that we cannot really be sure as to the extent to which small business is starved of investment).

<sup>24</sup> Negative savings rates are also evident from the Household Income and Outlay Account published by Statistics New Zealand.

It is also of note that this flow of funds into housing and stimulus to house values has occurred without many of the incentives to promote home ownership that exist in some other countries.<sup>25</sup> There would be clear risks to the economy in implementing such measures, despite the difficulties often experienced by prospective first home buyers in getting started on property ownership. The flow of funds to housing generally reflects a belief by households that this is a preferred asset class (Burns & Dwyer, 2007), while borrowing capacity has been enhanced by interest rates that are lower than they were prior to the early 1990s.

This concentration on housing rather than on financial assets, and the limited levels of household savings has obvious consequences in terms of the structure of the financial system and the ownership of the New Zealand economy. The limited size of the New Zealand share market is one obvious consequence, and this in turn has consequences in terms of the ownership of firms in the New Zealand economy. Reflecting the international investment position, larger firms operating in New Zealand are much more likely to be owned by non-residents. If firms are owned by New Zealand residents, the New Zealand share market is not necessarily an attractive vehicle, because of its small size, while there is also significant foreign ownership of shares on the New Zealand exchange. We thus see significant numbers of firms being removed from New Zealand share market listing, sometimes because companies move to other countries (mainly Australia), but also as a result of acquisition. There is a feedback effect in this: the relative unattractiveness of the New Zealand market to companies is associated with its also being perceived as unattractive by potential investors. It can also be argued that foreigners' willingness to buy New Zealand assets and New Zealanders' relative reluctance to retain ownership of them are a consequence of the need to finance the balance of payments deficit and the consequent negative international investment position (as discussed above in Section 3 of the paper).

## **(6) How will we work our way out of the crisis?**

What we have done so far is to describe the predicament that New Zealand finds itself in as we face up to dealing with the global financial crisis. We have a predominantly foreign-owned banking system, which may be both a strength and a weakness: although it has allowed access to funding, if we had not had that access to funding we might not have had the same explosion in the values of

---

<sup>25</sup> The key incentive that exists in New Zealand is tax-deductibility of interest incurred for business purposes, which benefits small business proprietors and investors in residential rental properties.

residential property and the housing bubble which has been a major contribution to the crisis in New Zealand.<sup>26</sup>

The more important problem however, is the enduring current account balance of payments deficit and the effect of that on bank funding. The balance of payments deficit is driven largely by the income account, and the income account deficit is largely driven by debt service and the profits earned by banks (which are specified, for balance of payments accounting purposes, as being fully remitted to the country of ownership of the assets). A resurgence in the growth of house prices, which would be supported by increased housing lending, funded by non-residents through the banking system, is unlikely to provide a viable exit from this predicament for New Zealand. There would also have to be serious questions as to whether it would be funded by those same non-residents in the same apparently carefree way as they have funded New Zealand banks' lending growth in the past. Indications are that banks have faced increased challenges in rolling over non-resident funding since the Lehmans collapse in September 2008.

It is probable, therefore, that we will not get a stable solution to New Zealand's predicament until we have started to see some real progress towards a more credible equilibrium in the balance of payments current account. It is hard to see this happening without a significant downward adjustment in the exchange rate for the New Zealand dollar.

It's certainly not obvious that new more stringent regulation of the banking sector will provide a solution to the crisis. The history of regulation in New Zealand has been that when new regulations are imposed, a process such as Ed Kane's "regulatory dialectic" comes into effect, and markets will find their way around limits on what banks are allowed to do (Kane, 1981). In the New Zealand case, this might well be to institutions that have been subject to even less regulation, and where difficulties have tended to accentuate problems in the financial sector, as with finance companies since 2006. There are no simple strategies for solving the crisis.

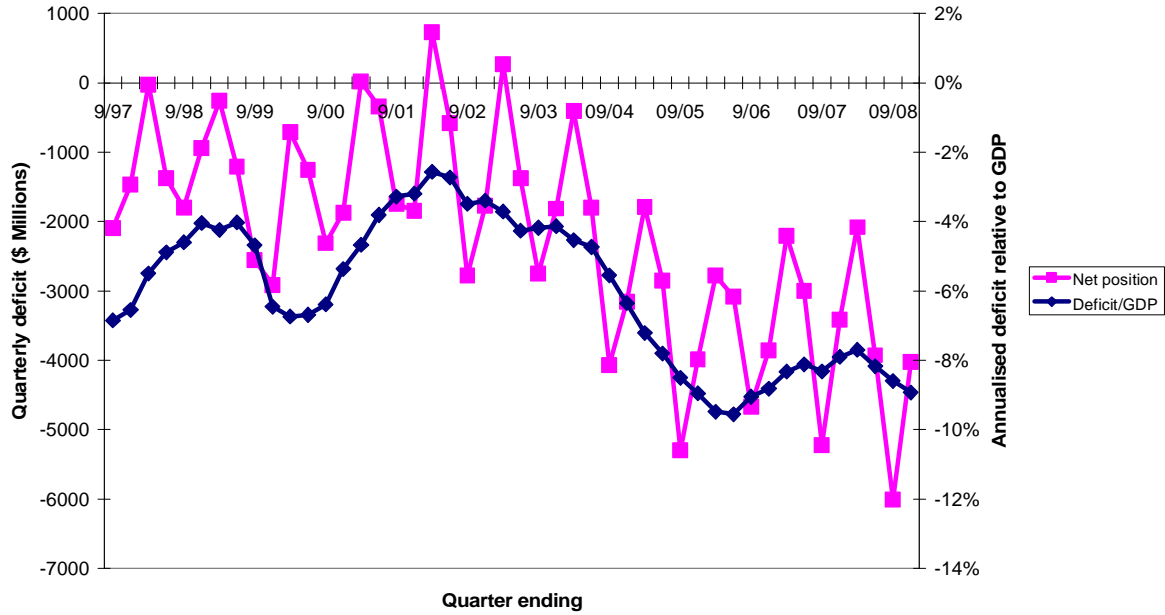
In the longer run, promotion of Kiwisaver is likely to be more successful in changing patterns of asset ownership, reflecting the finding by Burns & Dwyer (2007) that households generally save more effectively when contracted to do so on a regular basis. This presumes, of course, that such saving is not merely a switching of funds from other savings channels. Kiwisaver will not, however, lead to any

---

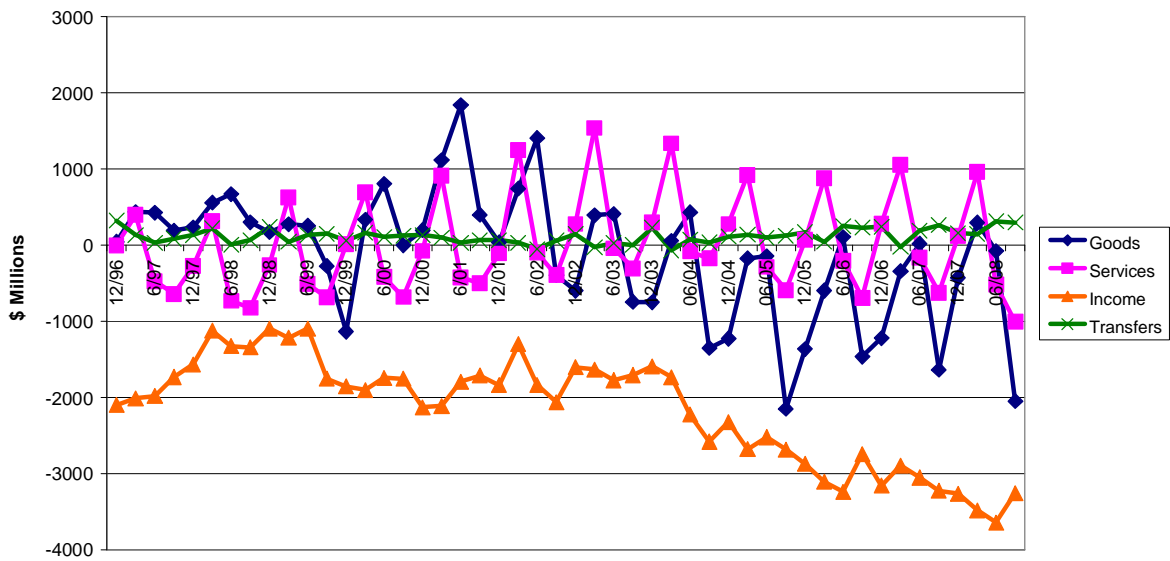
<sup>26</sup> One advantage of the relatively small size of the New Zealand share market is that it has not had the same scope to contribute to the economic slowdown, compared with, for example, Australia, where Brown & Davis (2008) have suggested that the share market has been the main transmission mechanism for the crisis.

sudden or dramatic changes in the financial structure of the New Zealand economy, and the deficit is unlikely to disappear quickly, meaning that the threat of higher interest rates on non-resident funding will persist. This is not an optimistic prognosis!

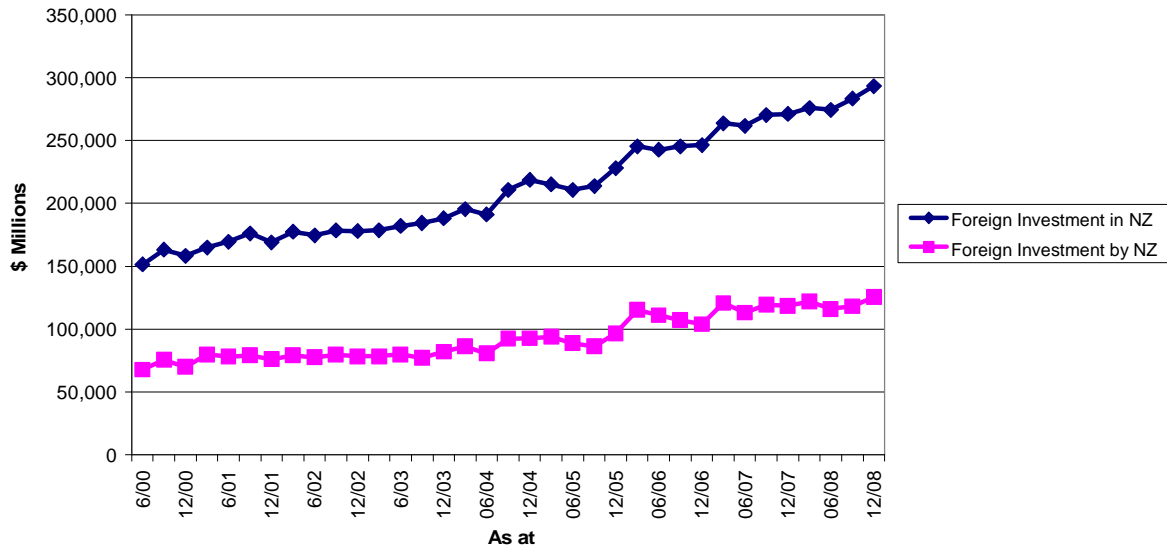
**Figure 1 - BALANCE OF PAYMENTS CURRENT ACCOUNT**



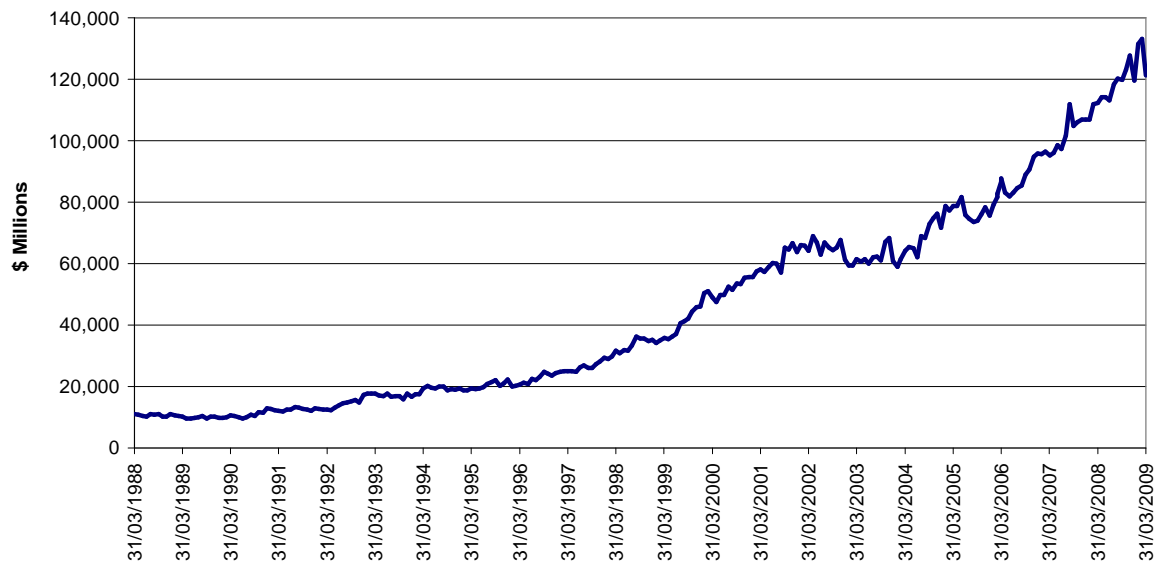
**Figure 2 - NEW ZEALAND BALANCE OF PAYMENTS CURRENT ACCOUNT - INDIVIDUAL COMPONENTS**



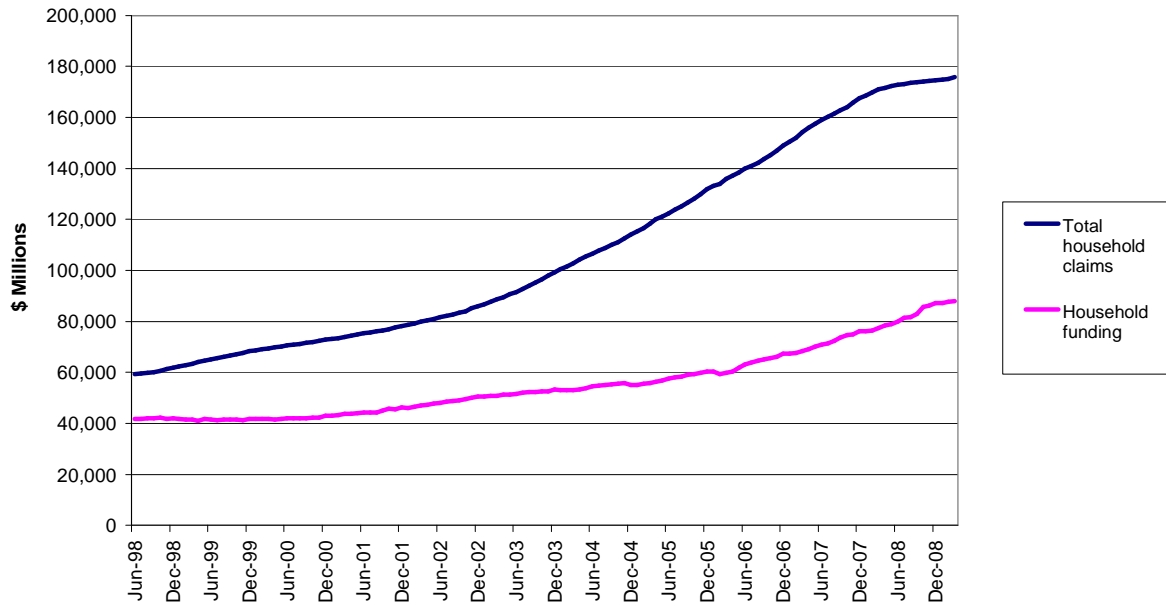
**Figure 3 - STOCK OF FOREIGN INVESTMENT INTO AND OUT OF NEW ZEALAND**



**Figure 4 - TOTAL NON-RESIDENT FUNDING OF THE NEW ZEALAND BANKING SYSTEM**



**Figure 5 - BANK CLAIMS ON & FUNDING FROM HOUSEHOLDS - NEW ZEALAND**



**Figure 6 - NEW ZEALAND HOUSEHOLD ASSETS (Including equities)**

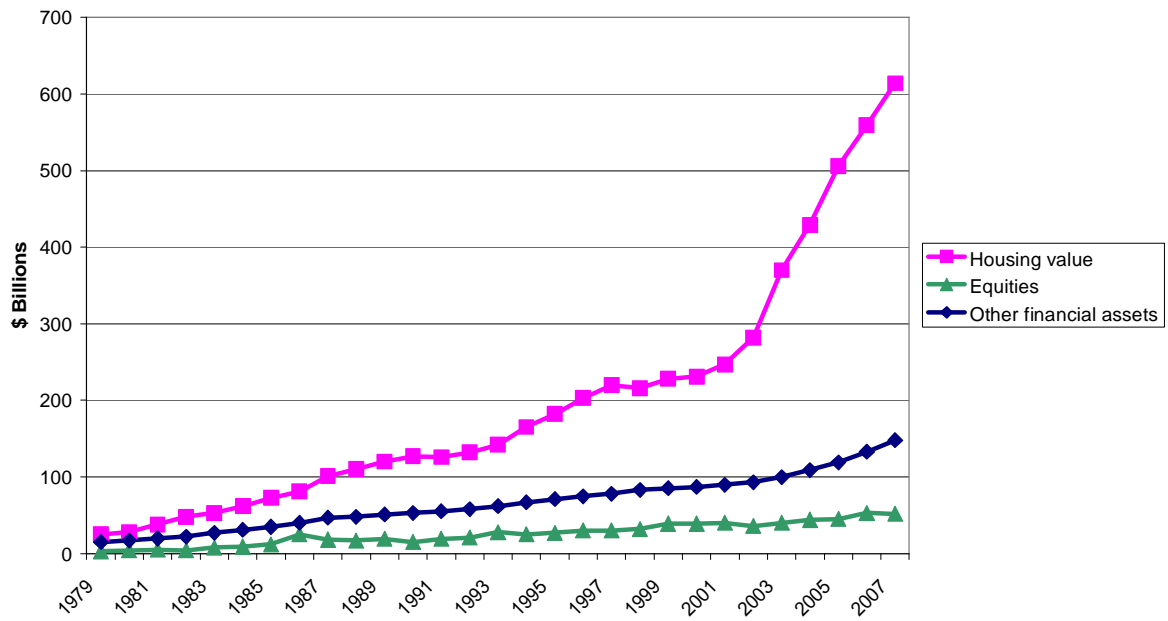
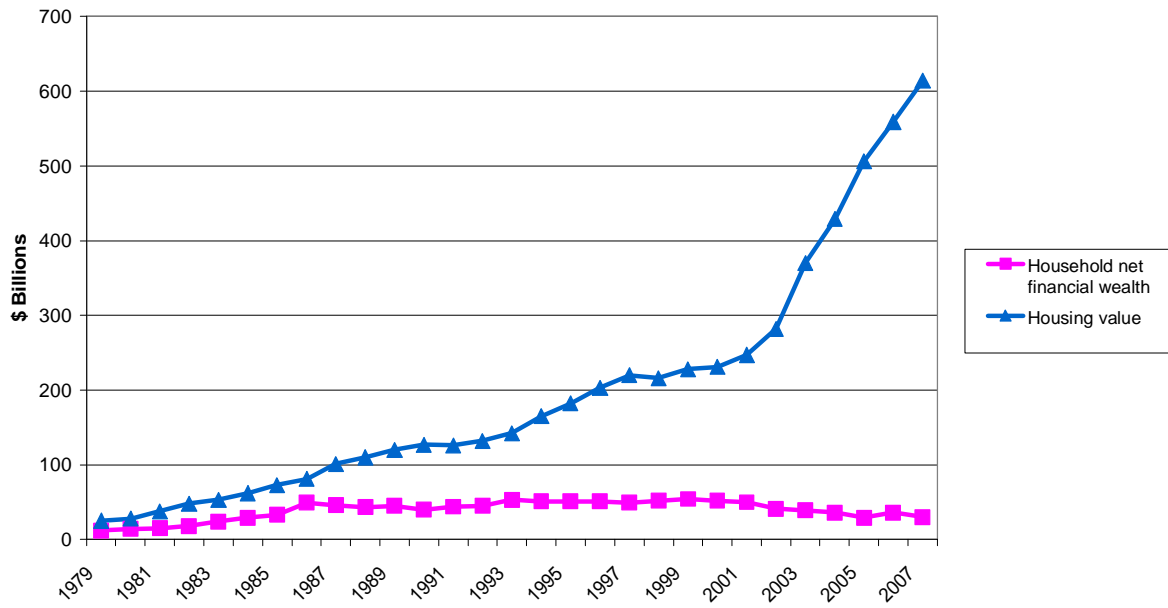


Figure 7 - NEW ZEALAND HOUSEHOLDS' ASSETS



## References:

- Bedford, P. (2008, December). The global financial crisis and its transmission to New Zealand – an external balance sheet analysis. *Reserve Bank of New Zealand Bulletin*. 71 (4). 18-28.
- Briggs, P. (2007). Lessons from the Economic Department's work on household balance sheets and related issues. *Reserve Bank of New Zealand Bulletin*. 70 (4). 5-24.
- Brown, C. & Davis, K. (2008, Spring/Summer). The Sub-Prime Crisis Down Under. *Journal of Applied Finance*. 18 (1). 16-28.
- Burns, J. & Dwyer, M. (2007). Households' attitudes to saving, investment and wealth. *Reserve Bank of New Zealand Bulletin*. 70 (4). 25-38.
- Chetwin, W. (2006). The Reserve Bank's local incorporation policy. *Reserve Bank of New Zealand Bulletin*. 69 (4). 12-21.
- Chi, J.; Tripe, D. W. L. & Young, M. (2007). *Do exchange rates affect the stock performance of Australian banks?* Paper presented at the 12<sup>th</sup> FINSIA-Melbourne Centre for Financial Studies Banking and Finance conference, available at [http://www.melbournecentre.com.au/Finsia\\_MCFS/2007/JingChi\\_DavidTripe.pdf](http://www.melbournecentre.com.au/Finsia_MCFS/2007/JingChi_DavidTripe.pdf)
- Clarke, G.; Cull, R.; Peria, M. S. M. & Sanchez, S. M. (2003). Foreign bank entry: experience, implications for developing economies, and agenda for further research. *World Bank Research Observer*, 18, 25-29.
- Crystal, J. S.; Dages, G. B. & Goldberg, L. S. (2002). Has foreign bank entry led to sounder banks in Latin America? *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, 8, 1-6.
- Dages, B. G.; Goldberg, L. S. & Kinney, D. (2000). Foreign and domestic bank participation in emerging markets: lessons from Mexico and Argentina. *Federal Reserve Bank of New York Economic Policy Review*, 6 (3), 17-36.
- Drage, D.; Munro, A. & Sleeman, C. (2005, September). An update on Eurokiwi and Uridashi bonds. *Reserve Bank of New Zealand Bulletin*. 68 (3). 28-38.
- Goodhart, C. & Schoenmaker, D. (2006). Burden sharing in a banking crisis in Europe. *Sveriges Rijsbank Economic Review*. (2). 34-57.
- Groom, J. (2008). *The Development of the Kauri Bond Market*. Paper presented at Capital Markets Workshop, 20 June. Available at <http://www.rbnz.govt.nz/research/workshops/capitalmarkets20june2008/3345557.pdf>
- Harrison, I. (1996, June). Disclosure of registered banks market risks. *Reserve Bank Bulletin*. 59 (2). 146-154.
- Hawkesby, C.; Smith, C. & Tether, C. (2000). New Zealand's currency risk premium. *Reserve Bank of New Zealand Bulletin*. 63 (3). 30-44.

- Hull, L. (2002). *Foreign-owned banks: implications for New Zealand's financial stability*. Reserve Bank of New Zealand discussion paper DP 2002/05. Available at [http://www.rbnz.govt.nz/research/discusspapers/dp02\\_05.pdf](http://www.rbnz.govt.nz/research/discusspapers/dp02_05.pdf)
- Hull, L. (2003). *Financial deregulation and household indebtedness*. Reserve Bank of New Zealand Discussion Paper, 2003/01. Available at [http://www.rbnz.govt.nz/research/discusspapers/dp03\\_01.pdf](http://www.rbnz.govt.nz/research/discusspapers/dp03_01.pdf)
- Jones, G. (1993). *British Multinational Banking 1830 – 1990*. Oxford: Clarendon Press.
- Kane, E. J. (1981). Accelerating inflation, technological innovation, and the decreasing effectiveness of banking regulation. *Journal of Finance*. 355-367.
- Mayes, D. (2006). Cross-border financial supervision in Europe: Goals and transition paths. *Sveriges Rijsbank Economic Review*. (2). 58-89.
- Mayes, D. (2009). *Problems with the treatment of cross-border banks in the financial crisis: some lessons for Australasian financial institutions*. Paper presented at the 14<sup>th</sup> Melbourne Money & Finance Conference, 1 June.
- Nicholl, P, W. E. & King, M. F. (1985). Financial institutions and markets in New Zealand. Chapter 3 in Skully, M. T (ed), *Financial Institutions and Markets in the Southwest Pacific*. (pp 160-244). New York: St Martins Press.
- Peek, J. & Rosengren, E. (1997). The international transmission of financial shocks: the case of Japan. *The American Economic Review*. 87 (4). 495-505.
- Rose, D. (2008). *The influence of foreign assets and liabilities on real interest rates*. Paper presented at 6<sup>th</sup> INFINITI Conference on International Finance, Trinity College, Dublin.
- Tripe, D. W. L. (2004a). *The New Zealand banking system and the balance of payments*. Paper presented at the 8<sup>th</sup> New Zealand Finance Colloquium in Hamilton. Available at [http://centre-banking-studies.massey.ac.nz/fileadmin//research\\_outputs/BalanceofPayments.pdf](http://centre-banking-studies.massey.ac.nz/fileadmin//research_outputs/BalanceofPayments.pdf)
- Tripe, D. W. L. (2004b). *Efficiency in integrated banking markets – Australia and New Zealand*. Paper presented at Reserve Bank of New Zealand workshop on 27 April. Available at <http://www.rbnz.govt.nz/research/workshops/27apr2004/0149272.html>
- Tripe, D. W. L. (2009). The global financial crisis and its impact on the agricultural sector. *Journal of Primary Industry Management*. 13 (1). 13-14.
- Tripe, D. W. L.; McIntyre, M. L. & Wood, J. (2009). How do retail depositors perceive foreign-owned bank risk: Evidence from New Zealand. *Risk Management*. 11 (2). 135-153.
- Woolford, I.; Reddell, M. & Comber, S. (2001, December). International capital flows, external debt, and New Zealand financial stability. *Reserve Bank of New Zealand Bulletin*. 64 (4). 4-18.