BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please click here.
http://feedback.bnz.co.nz/forms/Fx-I8ploskSGWgjN_7WOAw
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Offshore in Europe, Watching Their Deterioration

This week I am at the start of a holiday/slash business trip to Europe and have not much to say about the state of the NZ economy – especially as none of the news we have received in the past week alters my outlook. The merchandise trade data show a deterioration in our external accounts is underway and it will get worse as the high NZD depresses exports while the construction boom raises imports and ends up delivering a credit rating cut again probably within five years. The probability of that cut will be raised when our increasingly beleaguered government announces a shift out in the projected timing for its accounts to return to surplus. Before then the NZD is going to stay strong as most other currencies look terrible while interest rates may sit unchanged until 2014 while house prices rise due to a shortage and investors preferring property.

Unlike my usual travelling this journey involves flying not Air New Zealand but Korean Air which offered a very good return deal for the six of us from Wellington to Paris via Auckland and a night in Seoul for just over $13,000. I'm also not travelling alone clearly this time but with my wife who has a conference to attend in Berlin plus 80% of the kids (do the math). I did the booking through Webjet which at the start went okay even though the remoteness of the relationship does engender some uncertainty and I would try to avoid using their services in the future given the communications problems.

In particular, at no stage in the Webjet process was it clear that a hotel would be provided by Korean Air in Seoul for the 17 hour stay. I asked them and they said I needed to make my own arrangements – but that was not true. When we checked in for the flight on Sunday morning we were advised where to go to get the shuttle to the free hotel. So that is a failure for Webjet. Communicating with them via their Chat facility actually worked, but emailing back and forth for getting my return flight changed (just me one week extra in Europe for work) has proved near impossible and a week and a half after making the request they have still processed nothing. So if anyone out there from Webjet reading this wants to try and salvage the company's reputation with me please send me an email because I have not been able to get an emailed response for almost a week now..

Economy Class on Korean Air seems quite good. The legroom in economy is ample but the video selection is tiny so you'd better take a book. For a country which is recognised as one of the most technologically sophisticated in the world this lack of video selection from the Korean airline is simply embarrassing. My son with his 2 terabyte hard disk thing has ten times the video programmes KA has.

Something else weird is that they did not hand out headsets until after the plane was in the air. I asked and they said that the sets were still being sealed in heir bags. So whoever has responsibility for that job needs to work faster back in Auckland and also in Seoul as they also delayed handing them out there for the second leg of our journey. Maybe it is some security thing I am not aware of.

The in-flight crew were good though lacking in good English. When joining the Korean Air Skypass club I went into my account and requested vegetarian meals for all of us but that made no difference on the flight as that request clearly did not reach them.

One other problem for Korean Air is the lack of knowledge by their own air crew about their own facilities at their own base airport. None of the air crew standing in a bunch just on the public side of the arrivals gate at Incheon could tell me where the Korean Air counter is for people spending a night in a KA-assigned hotel on their way to Paris. I found it myself after consulting a map and a helpful person at the Information Desk – but seriously, how much staff training does it take to say “And this is where the foreigners flying through our country go to get details and the shuttle for their one night hotel.” As daughter number 3 would say – Durrrr!

The overnight stay in Seoul was at the Hyatt which is three minutes by shuttle from the Incheon Airport and a truly excellent place to stay. There is a good pool, the rooms are good, and both the breakfast and evening meal are free. The kids loved it and there is a supermarket type general purpose store nearby (Emart) which you wander into to see what Koreans buy. There were many boxes with fancy fruits and some root-looking things in them plus a wonderful heated couch and heated beds on display.

Something not fantastic back in NZ was the check-in for the Air New Zealand flight from Wellington to Auckland on the Saturday night. Using Webjet meant my Airpoints number was not entered therefore when checking in myself and five others the person at the Air NZ counter did not know to upgrade their smile and obsequiousness to Gold Elite level and show pleasure rather than procedure. So although we showed up with only small backpacks they made us weigh every bag. Perhaps one hint here might be that when you don’t travel with checked bags (and I never do) then don’t let your kids grab a trolley for saving their tired backs from carrying small backpacks 30 metres from the taxi to the check-in. The presence of a cart does suggest heavy bags and instant weighing procedure kicks in for the staff. Oh, and the weighing was unnecessary because I’d already taken care to keep the weight down in everyone’s bag, plus the flight was half empty. Go figure.

Speaking about procedure, I knew the story of the woman who was flown by Jetstar to Auckland when near the latter part of her pregnancy but not allowed to fly back because she was over the cut-off number of weeks for their flying rules. What people need to understand is that enforcement of rules by airlines is very strict and quite rightly so. If they ask how many weeks pregnant you are and you give a number over their limit then there is no leeway possible. If they don’t ask then there is no issue. The answer as it were if you are asked seems rather obvious doesn’t it, starting with finding out what their limit is and not grumbling if it differs from Air New Zealand.

On the Saturday night in Auckland we stayed at the new Novotel Airport Hotel which is very good. Its great to be able to get up and stroll just over the road into the International Terminal. For eating with a family on the other side of Customs and Immigration desks head past the first set of shops up the little escalator and settle in near Burger King. The coffee in the café beside BK is as good as you could expect from a place with a captive market (milky, brown, non-threatening, bland), but the cabinet food is quite good and service reasonably quick.

Would I use Korean Airlines again? Most definitely. I now know the procedures, loved the stopover, and love working and reading on airplanes so lack of video selection is no problem. Would I use Webjet again? As noted above, only if I were supremely confident that I would not need to make any changes.

September seems to be a good time to go to Paris. The holidays are over, kids are back at school and the weather is neither very hot nor pneumonia-contributing (February 2009) cold. In fact even the queues for going up the Eiffel Tower are small. But being one who will cut off his own foot rather than queue for anything longer than 15 minutes I simply took the kids on a circular walking tour underneath the tower until one of them pointed to the south pylon and asked why the queue was so short compared with the other two open pylons when there was also a lift going up and down. (Think quickly at this point as to why).

So we mossied on over to the window and saw that the reason for the absence of a queue was because while you got to go down in the elevator you first had to walk up. So being in need of some exercise after watching one's fitness get lost in a whirlwind of talks around NZ since walking the Heaphy Track a couple of months ago I signed us up. And up we went by 700 steps exactly. It was great with a cooling breeze suggesting that you would not really want to take the walking option in the heat of summer. Heck, maybe they don't even offer it to overweight Americans and gung-ho Germans in summer.

You can only walk up to the second level and not the top but the view is still great. The displays around the perimeter showing details (in French) of how the tower was constructed are informative but sort of old and naff – which perhaps explains why they are building a new level dedicated to the engineer Gustave Eiffel.

All the time while walking around we kept an eye out for pickpockets and I'm hoping to encounter one of the ring dropping gypsy tricks for the kids to see before we move on. This involves a man or woman (usually the latter) walking toward you, bending down and appearing to pick up a gold ring and handing it to you saying you dropped it – then as you stand there thinking how lucky you are they start hitting you up for cash.

And so, when D2 (daughter 2) descended from a two storey carousel and showed me two 20 Euro notes which she had found while going up and down on her horse I would like to be able to say I thought immediately that it would be a scam – but it took 60 seconds for that thought to kick in. First I thought we should hand it in to the ride operator – but then thought this is not New Zealand and there is no chance that someone who deals with tourists of all nationalities every day is going to hand it over should someone come back saying they lost it. So we kept it but after a minute as we walked off started looking around to see if we were being followed by someone who might claim that not only was the 40 Euro their's but the other 60 that was with it!

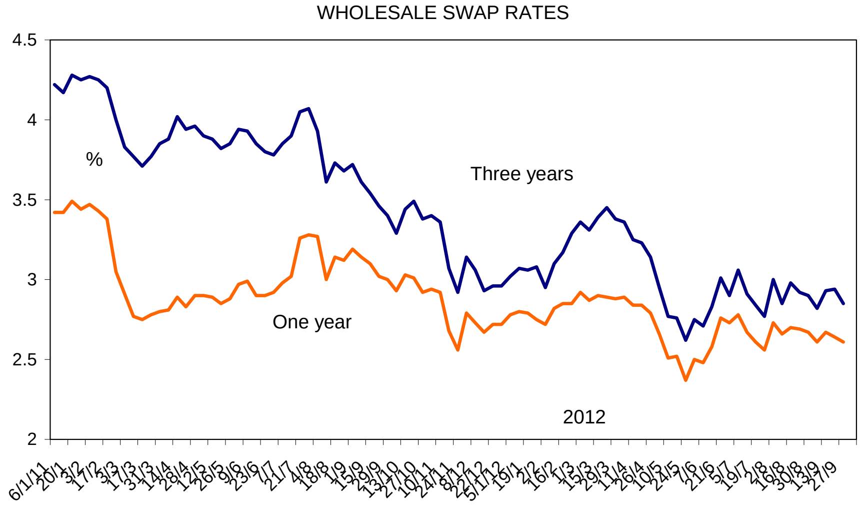
But no-one appeared so that was that. I've started giving the kids some coins to put into the cup of one of the many beggars on the streets. Some have dogs, some don't. None are pushy – maybe there was a crack-down on the organised groups associated with the complete clearing away of the North Africans who had previously been selling small Eiffel Towers from big metal rings. Actually I wrote that yesterday morning and later in the day as we approached the Louvre the tower sellers were there in force.

The Louvre was as crowded as usual and the mosh pit in front of the Mona Lisa as deep as ever with hands raised clenching cameras everywhere. The kids loved the Egyptian stuff. Enough for now, I'm going to check my email to see if the Webjet people have pulled finger yet.

INTEREST RATES

Recent data releases across the ditch show that at the same time as prospects for world growth have deteriorated and some risks have heightened, Australia's growth prospects have worsened. As a result there is a very good chance that the RBA will cut its interest rates a couple of times in the next few months. This therefore becomes a fresh source of downward pressure on NZ interest rates. It is still extremely unlikely that our central bank will ease monetary policy again in the absence of a global growth collapse or the NZD quickly rising to S 90 cents. But upward pressure on swap rates and therefore fixed lending rates is well on hold and the environment remains an unthreatening one for borrowers.

This week wholesale interest rates have fallen to the lower half of their trading ranges in response mainly to the fresh deterioration in sentiment underway in Europe.



FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.70%	2.66	2.68	2.77	2.70	5.7
1 year swap	2.61%	2.64	2.67	2.76	3.02	5.8
3 year swap	2.85%	2.94	2.90	3.01	3.46	6.1
5 year swap	3.14%	3.27	3.22	3.36	3.91	6.3

HOUSING MARKET UPDATE

- **To view the most recent results of our monthly BNZ-REINZ Residential Market Survey click here.** http://tonyalexander.co.nz/bnz-reinz-survey/
- **I also write a monthly column on the residential property market in NZ Property Investor magazine available at your bookshop or newsagent.**

No Fresh Data

Last week I noted the support given to house prices from rising costs and standards. An architect sent in this useful summary of the situation.

“1. House building standards have risen, but mainly as a result of the leaky homes debacle and the need for better insulation.

2. House building is more expensive because
(a) buyers want much bigger houses with more bedrooms, bathrooms and extra living rooms;
(b) subdivision standards are inflexible and grandiose for small developments;
(c) Council fees are staggeringly high, especially when they now try to avoid any responsibility for granting consent;
(d) Many councils now require a resource consent as well as a building consent, even houses that comply with their district scheme - this is an abuse of the RM Act and introduces an unnecessary and exorbitant fee.
3. Building codes have become more prescriptive meaning innovation is discouraged.

4. Council planners are pursuing mad ideological dreams of concentrated housing, restricting land zoned for housing, discouraging building in rural settings, and generally trying to make NZ look as it did before the motorcar was invented.”

If I Were A Borrower What Would I Do?

I would fix for two years at 5.4% with some of my mortgage left at the floating rate of 5.74%. This I would do because the two year fixed rate is nicely below the floating rate and the chances of the floating rate falling near 0.4% in the next few months to reach the current two year rate are fairly slim – unless as noted above the world economy collapses or the NZD shoots soon to US 90 cents.

I would not fix at the three year rate of 5.9%, not because that is above the floating rate but because the premium to pay over fixing two years is simply too great.

What about something tricky like buying into a scenario that the RB eases and floating now then fixing right after they do? Or fixing one year then fixing three years in a year's time just before an improving outlook perhaps pushes all fixed rates upward? Or fixing two years but breaking the rate to move into three years or longer if there are signs of rates shooting up?

Someone is going to have the optimal hedging strategy for the next five years for sure. But it is impossible given the huge uncertainties in normal times to be confident that any variant on one of the three strategies just mentioned will be optimal – let alone in these massively uncertain times. As noted for about two years now, you are a fool if you base your interest rate risk management decisions on a particular set of interest rate forecasts. Whatever the forecast is now it won't be the same in six months time and one cannot even be confident about what the direction of change will be. That is because you need to take views on things such as
-how high the NZD goes and whether it looks like going higher
-whether the Euro holds together
-whether the American Republicans and Democrats can politely agree on a means of avoiding the programmed in 4% of GDP tightening of US fiscal policy at the start of next year
-whether China's growth is comfortably slowing to just 7% then naturally kicking back upward or whether this is a large structural change which by holding off from a big stimulus the authorities miss and growth plunges to 5%,
-whether you and I go crazy on stories of housing shortages, sustained low interest rates and rising house prices and start mortgaging to the hilt to taste that beautiful tax-free capital gain. (Not that imposing a CGT would make much difference anyway given the very low returns available on alternative investments and the fact that any such tax would simply worsen the shortage and after an initial small dip contribute to pushing prices even higher).

So putting together all these uncertain factors and so many which we can't even conceive a probability for at the moment (impact on oil prices of Middle East tensions, impact on oil prices of soaring gas availability and rising oil supplies from new extraction techniques) we are left with simply chasing a low cost borrowing option delivering mild but not high insurance against interest rate movements for the next few years.

MAJOR OFFSHORE ISSUES

Just for your guide, the ECB and Bank of England have done it, the Fed. are doing it again, and the Japanese have jumped in boots and all as well – printing money. Having decided that the hair of the dog that bit them is the best cure the world's major central banks have embarked upon a money supply boosting exercise not seen since the 2000s when the world became awash with money. The difference this time around is that whereas the central banks turned a blind eye to the 2000s surge and said "she'll be right", this time around they are the ones pushing the drugs. So does this mean we should all be extremely scared?

In one respect the answer is most definitely yes because if the world was a good place then such outrageous measures would not be necessary. So it is right to be scared and one should give strong thought to how much risk it is wise to take on in a world in such bad shape that central banks are doing this.

But outright panic is not yet justified because although the central banks are forcing money onto banks, the banks don't want to lend it, people don't want to borrow and spend it, so much of it ends up right back with the central bank. In the case of the United States that means banks having some $1.5tn on deposit with the Fed. when they would normally have maybe $4bn.

The problem comes if and when desire to lend and borrow/spend does rise. Will central banks catch the movement in time and take money back out of the system at exactly the right pace to prevent a surge in inflation or a collapse back into recession? The example provided by the People's Bank of China is that opening the monetary spigots when people want to spend and buy assets can lead to over-construction and inflation. So caution is required and there is virtually no chance that when the money withdrawals by central banks start they will be smooth. That means we should all anticipate a continuation of the extremely uncertain interest rate environment which frankly we have been living with in New Zealand initially on the upside and then the downside since 2006.

Speaking of uncertainty – while world trade growth is slowing the incidence of trade disputes is rising – from President Obama telling Ohio car workers of the US taking a case against imported Chinese motor vehicles to the EU investigating dumping of solar panels, other emerging economies taking China to task over other items being dumped, and China itself complaining to the WTO on a number of matters. Were the world a happy growing place not only would the ridiculous route of money printing not be in action but trade protectionism would not be growing as it appears to be.

Europe

Spain started having a good week with some €4.8bn in ten year government bonds sold at 5.67% which was 1% less than the yield at the last such auction in August. But the good feeling about this development did not last long with Spain's most powerful economic region Catalonia set to vote on whether to split from the rest of the country – something which can only make investors more scared about stability of Spain's tax base and the ability of the government to exercise fiscal restraint and economy-modernising reforms.

It is interesting watching the actions of those opposed to fiscal austerity. There appears to be an inability to understand that they are living off someone else's money and the investors and rest of the world do not owe them a living. No wonder the Germans are scared. They see people with limited grasp of basic economics calling out for someone else to pay for their way of life and if the investors won't keep lending them more and more then they want the central bank to simply print money.

This crisis still appears to be getting worse at its roots when looks beyond the most recent patch-ups and considers the underlying recalcitrance of the debtor states. The future for Europe looms quite dim compared with a modernising Asia and a United States which with its embrace of creative destructionalism will almost certainly bound back strongly.

United States

No time to comment.

China

You can find my China page on Facebook at http://www.facebook.com/TonyAlexanderNZ I have set up this page specifically for discussing the NZ-China relationship and as a tool for disseminating information and furthering my own still inadequate knowledge.

Every few days I have been adding three points at a time to the list of reasons why the West is apprehensive about China. You can find the updated list here. http://tonyalexander.co.nz/wp-content/uploads/2012/09/Sources-of-Western-Apprehension3.pdf

Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.827	0.828	0.811	0.787	0.776	0.67
NZD/AUD	0.794	0.792	0.778	0.786	0.794	0.85
NZD/JPY	64.200	64.700	63.800	62.700	59.5	69.6
NZD/GBP	0.510	0.510	0.512	0.505	0.502	0.388
NZD/EUR	0.641	0.635	0.648	0.629	0.576	0.52
NZDCNY	5.215	5.225	5.155	5.009	4.957	4.99
USD/JPY	77.630	78.140	78.668	79.670	76.675	105.7
USD/GBP	1.622	1.624	1.584	1.558	1.546	1.72
USD/EUR	1.290	1.304	1.252	1.251	1.347	1.28
AUD/USD	1.04	1.05	1.04	1.00	0.98	0.788
USD/CNY	6.3059	6.3108	6.3558	6.3644	6.3883	7.56

The Stupidity of Targeting Higher Inflation

Over the past ten years inflation in New Zealand has averaged 2.7% compared with 2.1% in the previous ten years. The outgoing Reserve Bank Governor Alan Bollard has used almost all the wiggle room provided by the official 1-3% target range to let inflation creep up. What that means is that he has overseen a period when your cost of living rose on average by 2.7% a year rather than 2.1%. Your costs have risen in total by 30.1% whereas they rose just 23% in the decade ending mid-2002.

There are those who propose Kiwi householders should have their costs rise by even more than 30% in the coming decade – perhaps by 34% if inflation is allowed to average 3%, or 48% if it is allowed to average 4%. One struggles to see how society will be better off under such circumstances.

Nevertheless, is there a case to be made for tolerating higher inflation in order that the NZD can come down? First lets consider what it would mean for interest rates. If you are a saver and you expect inflation will average 4% rather than 2.7% will you want more or less compensation from your bank for saving your money? You will want more – and keeping in mind that your total and not real (inflation-adjusted) return is taxed you will need more than an average 1.3% to be paid to you. If you cannot get that because the Reserve Bank is keeping interest rates down what will you do?

One thing you will do is take your money out of New Zealand to earn a better return elsewhere. That process will cause weakness in the NZD which is what exporters want. It will also mean a reduced pool of money available in New Zealand for people to borrow or invest. Our already dysfunctional capital markets will become more dysfunctional and entrepreneurs looking to raise capital will have an increased incentive to take their ideas overseas.

With banks unable to raise as many funds domestically as before they will need to source more funding overseas. That means that instead of our banking system being dependent upon savers overseas for about 38% of total lending in new Zealand it will become more dependent upon the attitudes of foreigners. That means we will be more violently shaken in terms of funding availability and capacity to lend when the next global financial shock comes along. Also, as a result of increased borrowing offshore more income will flow out of New Zealand.

In New Zealand the lower average level of interest rates will encourage people to borrow more. Perhaps the rate of growth in household debt will move back closer to the 10% per annum on average which prevailed before the global financial crisis. The household debt to income ratio will start climbing again from its current 143%.

People will borrow more money in order to buy more imports so our current account deficit will face certain upward pressure from the interest rate cut, but uncertain downward pressure from whatever enhancement exporting may receive from a lower exchange rate on average.

With inflation expectations lifted people choosing to leave their funds in NZ dollars will more strongly seek compensation for that higher inflation. They will therefore move toward a preference for property over business investment. This will drive house prices higher and push home ownership even further out of the hands of the young and those on low incomes – to the benefit of those who already own property. New Zealand will experience a property and not an entrepreneurial boom.

Businesses will also find that their cost base is increasing at a faster average pace given that for most firms the bulk of their costs are domestic – and even if they are from offshore those costs will rise also because of the fall in the NZ dollar. Therefore whatever advantage accrues to exporters in the short term from a lower exchange rate will be eroded over time by increasing cost inflation.

Businesses generally will find it necessary to devote more of their time to working out how to beat rising cost inflation rather than developing and marketing new products. Perhaps seeing that the lobbying of exporters for higher inflation proved “successful” they will hire lobbyists to try and get some special economic policy changes which will assist them. Productivity growth in the economy therefore will slow as efforts move from pure business management toward handling inflation and managing politicians.

But there is more to it even than this. Most of our exports come from the capacity-constrained primary sector. A lower currency will have little impact on production volumes. It will simply generate higher profits for primary producers. What about the incentive for manufacturers? This has long been a declining sector in New Zealand and most other parts of the Western world and the question is not one of an optimal exchange rate for them but the extent to which they are embracing or will embrace new production techniques increasing focussed on robotic technology and the likes of 3D printing. Seriously though, these are expensive and not applicable to the bulk of manufacturing one suspects so what we will be left with is a shrinking manufacturing sector as the idea that continually reducing our exchange rate to help manufacturers get wage costs comparable internationally with those in China is ridiculous.

What if the RB did abandon low inflation targeting and instead tried to lower the currency by cutting interest rates and printing money? Ask me in the afternoon. In the morning I’ll be occupied breaking my term deposits, taking half of my money out of the country and putting the other half into properties geared to the max at as long a fixed rate as I can get to protect my borrowing costs against the inevitable eventual interest rates surge upward.

This week the NZD is largely where it was a week ago against most currencies apart from the Euro where it is a tad higher as pessimism regarding Europe creeps back in again, and quite rightly so too.

Key Forecasts

Dec. year		**2011**	**2012**	**2013**	**2014**
GDP	annual average chg	1.4	2.0-3.0%	2.0 – 2.5	1.0 – 2.0
CPI	on year ago	1.8	1.8	2.2 - 2.9	2.5 – 3.5
Official Cash rate	end year	2.5	2.5	2.5 – 2.75	2.75 – 425
Employment	on year ago	1.6	1.0 – 1.5	1.0 – 2.0	0.5 – 1.5
Unemployment Rate	end year	6.4	6.0 – 6.5	5.5 – 6.0	5.0 – 5.6

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 27,000 subscribers each week and is one of a stable of regular releases which include the

- monthly Growing With China publication, http://tonyalexander.co.nz/topics/china/
- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/ and the
- monthly BNZ-REINZ Residential Market Survey. http://tonyalexander.co.nz/topics/surveys/bnz-reinz-survey/ This latter survey provides information from a survey of over 10,000 licensed real estate agents on the current state of the residential property market in New Zealand.

- He has also written a weekly newspaper column since 1998, search www.stuff.co.nz
- produces a monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.co.nz/ and
- writes a monthly column for the NZ China Trade Association. http://www.nzcta.co.nz/
- Most of these publications plus research into impediments to NZ's economic growth are available on his website. www.tonyalexander.co.nz
- Discussion of New Zealand's relationship with China can be found here. www.facebook.com/TonyAlexanderNZ

Tony Alexander has been Chief Economist at the BNZ since 1994 and apart from publications and advising management spends considerable time on the road around New Zealand making presentations and speaking with the media. He travels to the UK and Europe twice a year to assess economic conditions and present at numerous functions, has five children, tramps, and his partner Dr Sarah Farquhar runs the early childhood education network www.childforum.com

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