# BNZ Weekly Overview

28 February 2013

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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.
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## Unbalanced Growth

New Zealand has embarked upon what will likely be one of the most unbalanced periods of economic growth we have ever seen. It probably won't end well a few years down the track, but until then most householders won't notice that things are astray, outside availability of affordable accommodation, because of happiness generated for most by rising house prices.

The economic forecasts most of us have for the next three years centre around expectations of growth near 3% per annum, sometimes with a slow year or a fast year thrown in based on one's view about what sort of a cycle is in play. The strength we see comes largely from the domestic sector. There is the stimulus of 0.7% per annum to come from the rebuilding of Christchurch, the period of catch-up house construction in Auckland we have long written about, water-tightness remediation work, infrastructure, and earthquake strengthening. Also we see growth from rising wages and incomes in the construction sector, plus a period of cyclical catch-up spending by households.

Businesses will also at some stage engage in a period of catch-up hiring and probably investment as well.

But at the same time these things are going on the export sector will get slammed by the combination of a sustained high NZ dollar set to move higher (in its usual erratic fashion) and fragile conditions in many of our offshore trading partners associated with the post-GFC debt and economic structure reforms.

The most recent economic data we have in hand already show this dichotomy in the economy in play. On the domestic strength side we have the following.

- Retail spending ahead 2.1% in the December quarter and electronic card spending ahead at a 6.5% annualised pace in the three months to January.
- The number of consents issued for the construction of new dwellings ahead 24% over 2012 and houses up an annualised 33% in the three months to January.
- The value of non-residential business building consents ahead by 18% in the last six months compared with a year earlier.

Yet on the exporting side we have this.

- Tourism receipts down by 5.9% during 2012 even with Chinese mainland visitor spending rising from $456mn to $651mn and now accounting for 12% of all visitor spending from 4.5% in 2008.
- Merchandise export receipts fell by 5.1% in the year to January 2013 we learnt yesterday. The annual trade balance is now a deficit (detracts from growth) of $1.3bn from a surplus (adding to growth) of $637mn one year ago and $0.9bn two years ago.

Given my expectation that the NZD will stay high through into 2016 and that many of our trading partners will struggle, medium-term prospects for export growth do not look good. Yet domestic growth is inevitable and when the Reserve Bank looks to suppress the inevitable inflationary pressures to come from the construction sector by raising interest rates probably next year, the NZD will go higher.

The outcome is likely to be a potentially sharp deterioration in New Zealand's current account deficit. This measures the difference between what we make overseas from our exports of goods and services and our offshore investments, and what we import and pay for servicing our borrowing and the investments of foreigners here.

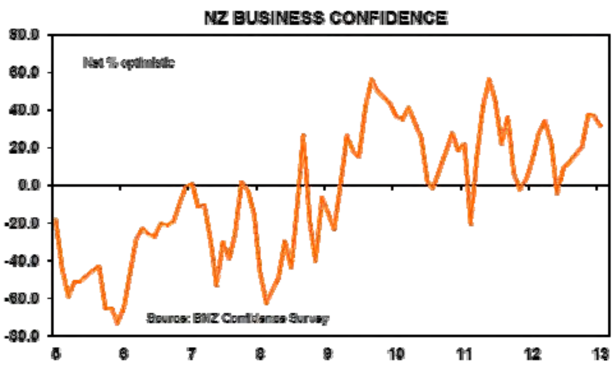
The deficit stood at $9.8bn or 4.7% of GDP in the year to September 2012 and was above 8% of GDP from the end of 2005 to the start of 2009. We may well be headed back to that level. In that case it is quite likely that in 3-4 years' time we will see another cut in the country's credit rating. If and when that happens, will that by itself be enough to push the NZD to a much lower level? Probably not.

Standard and Poors cut New Zealand's credit rating one notch from AA from AA+ at the end of September 2011. That month the NZD averaged 81.3 US cents. The currency did fall to an average of US 77 cents in December, but that was to a large degree due to surging worries about Europe. By February, just five months after the credit rating cut, the NZ was averaging 83.5 cents. There was no sustained impact from the rating cut.

Therefore, even though a cut in 3 – 4 years' time will add to the cost of borrowing in New Zealand, it is extremely, unlikely to be the trigger for a deeper sustained fall in the NZD to reflect our rising net indebtedness to the rest of the world. That will happen in one of the other decades lying ahead of us. Until then exporters will be severely challenged.

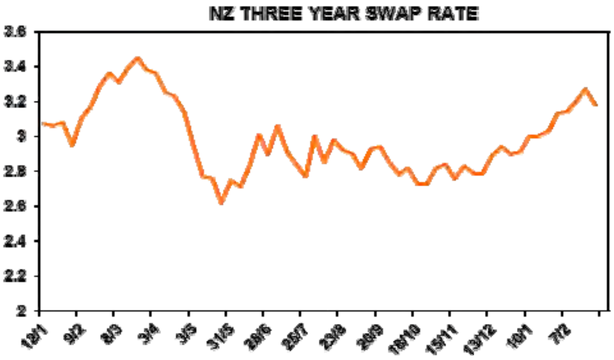
Can we soften the conclusions regarding a deficit blowout by saying that a decent chunk of it will reflect higher imports of capital goods as businesses look to boost capacity and hopefully productivity – which they will need to do when the labour market gets a lot tighter? Not yet is the answer. In the three months to January in seasonally adjusted terms the value of imports of plant, machinery and equipment fell 0.1% and was only 1.7% up from a year earlier.

But maybe such imports will be rising soon. Our BNZ Confidence Survey shows sentiment running at a firm level well above average.



# INTEREST RATES

Wholesale interest rates have fallen slightly over the past week largely in response to falls in fixed interest rates offshore due to worries about politics in Europe. But the declines may not last given the increasing frequency of positive data releases in the United States and our own domestic data showing growth accelerating. For now though, with drought deepening in the North Island and the currency already very high, there is little chance of the Reserve Bank tightening monetary policy. 2014 still remains my pick for when they move.




| 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 | 2.67% | 2.70 | 2.66 | 2.67 | 2.76 | 5.7 |
| 1 year swap | 2.81% | 2.84 | 2.81 | 2.69 | 2.92 | 5.8 |
| 3 year swap | 3.18% | 3.27 | 3.13 | 2.79 | 3.36 | 6.1 |
| 5 year swap | 3.52% | 3.64 | 3.43 | 3.11 | 3.82 | 6.3 |
| 7 year swap | 3.76% | 3.93 | 3.74 | 3.43 | 4.19 | |

# HOUSING MARKET UPDATE

## Prices in Auckland Ahead 27%

The upturn in the housing cycle underway in New Zealand has only just started and it will probably run for another three years. It bears greatest resemblance to the 1990s cycle which was also led by Auckland, rather than the 2000s cycle which came out of the regions. The 1980s cycle was a mish-mash of everything with massive structural changes in the economy meaning one needs to be careful about extrapolating anything out of that decade.

One of the phenomena of the 1990s cycle was that it spread out of Auckland to the rest of the country. Commentary over the past three weeks has started to revolve around that theme. So just to reinforce it, using the stratified price data produced by the REINZ the table below takes the average dwelling sales price over the three months to January and compares it with the low-point in 2009 and the previous peak in late-2007 (except sections when the peak was early-2008).

What we see is that Auckland house prices are up 27%,Christchurch 23% and Wellington just 11%. Compared with the 2007 peaks Auckland prices have now advanced by 12%, Wellington is the same, Christchurch is ahead 9%.

| | Since 2009 Low-point | Since 2007 peak |
|---|---|---|
| Auckland | 27% | 12 |
| Wellington | 11 | 0 |
| Christchurch | 23 | 9 |
| All NZ | 16 | 5 |
| Sections | 11 | -11 |

These data suggest that Wellington is due for a decent catch-up. You can have fun doing the same analysis for yourself by downloading data from the REINZ website. Go to this link https://www.reinz.co.nz/reinz/public/reinz-statistics/reinz-statistics_home.cfm
Scroll down to the Housing Price Index heading and click on the last item “REINZ HPI – January 2013” to open an Excel file and go for it.

## Offshore Buyer Anecdote

There are literally hundreds of anecdotes flying around regarding Chinese buying residential property in Auckland. In 2 – 3 weeks we will have some solid data on the presence of offshore buyers generally in the NZ market. For now here is one of the emails on the issue received this week.

“We build housing in Auckland both for developer clients and for our own developments. We recently put in a tender for a development plot. Spent many days working numbers and taking advice from various consultants and put in what we considered was a price at the higher end of what it was worth as a viable development. There were numerous tenders received that far exceeded our tender price and from what I am told they were all from Asian investors. Every developer we talk to is complaining of being consistently outbid by Asian investors on development land.

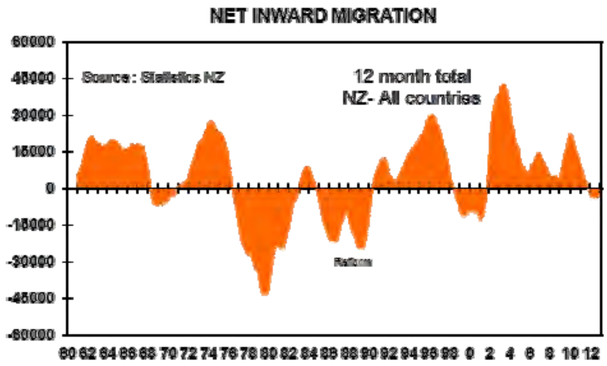
Fair competition perhaps? There is a lot of speculation that these investors are using the purchase of development land to gain entry to the country under the investment route somehow (either directly or through an already established development business), and if that was the case it would not only be unfair competition (they are paying a premium for the land to purchase residency), but also has implications to the housing market and surely won’t be helping affordability?”

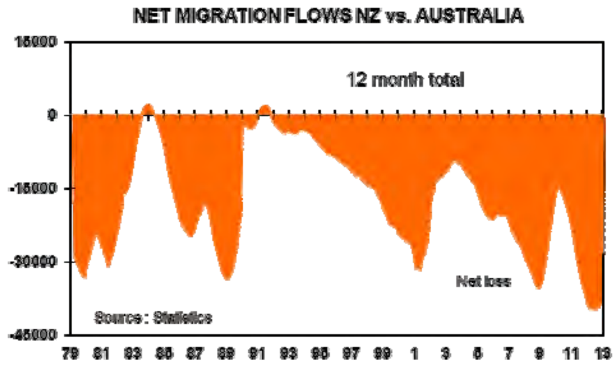
## Migration Flows Now Positive

And so now we enter into the upward swing of the migration cycle – something which traditionally has a multiplier-like impact on the housing market as the simple population effect is boosted by people looking to invest more in property in expectation of migrants driving capital gains.

In the month of January in seasonally adjusted terms there was a net gain to our population from permanent and long term migration flows of 350 people. That followed a loss of 80 in December and a gain of 550 in December. The annualised pace of gain in the past three months has been 3,280 compared with 1,200 three months earlier and 240 three months before that. So things are moving but not at a huge speed.

The annual net migration gain using unadjusted data now stands at +12. This compares with a loss of 1,165 people in the year to December, 3,134 a year earlier, and a peak loss of 4,118 in August last year.




If we take the year to August as our basis for comparison, where has the 4,130 annual improvement to achieve +12 come from? The net loss to Australia has eased from an evil 39,956 to a disturbing 37,936. That 2,020 movement accounts for about half the improvement. The net population gain from the UK has improved a small 297 to reach 5,666, the net gain from China including Hong Kong has improved 351 to reach 5,925, and those are the only changes of substance.

Note that we can look at the data to see what portion of the 4,130 is accounted for by an increase in gross numbers of Kiwis returning from offshore. Only 1,202 of this change is accounted for by expats returning, though another 716 is accounted for by fewer Kiwis leaving.

Just to finish with, look back up to the graph showing the net loss to Australia. There is a clear trend for those losses to get bigger each cycle.

## Maximum LVRs

In a speech this week the Finance Minister Bill English noted that mid-year the RB will be given powers to alter bank capital rules and impose maximum loan to value ratios for use in influencing the credit cycle. The media commentaries following his announcement have noted that while the strength in the housing market will be suppressed any LVR change will likely disadvantage first home buyers because they will struggle to raise a deposit. One expert noted how banks will be able to get around any rule by lending on an unsecured basis. Second mortgages might make a comeback from lenders working in conjunction with a primary lender.

This is what I wrote on the issue last week.

Will the Reserve Bank try to stem the rise in the housing market by forcing banks to impose maximum loan to value ratios (LVRs) = minimum % deposits? No.

- Housing conditions including affordability and availability vary across the country and measures put in place to combat Auckland's price squeeze would be quite wrong for a lot of the rest of New Zealand.
- Young buyers would be near completely shut out of the market as few have a deposit of, say, 30%.
- Investors would down-shift to buying lower priced properties in order to meet a lower LVR, thus increasing competition in the price range first home buyers are looking.
- Many offshore buyers (detail coming in next month's BNZ-REINZ Residential Market Survey) tend to buy with cash. They would not be affected.

Thus the impact of maximum LVRs would basically be to prevent young NZ-domiciled Kiwis from buying property and opening up greater opportunities for offshore cashed up buyers. Now who on earth is going to vote for that?

One emailer noted the following this week.

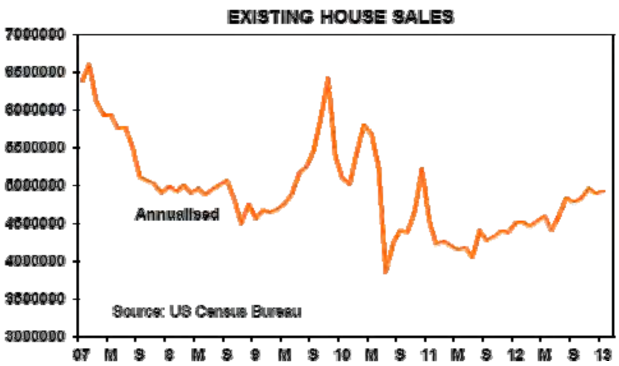
"I really enjoy reading through this each week, and the understanding I'm gaining from it is incredibly valuable. My husband and I have recently purchased our first house, and your comments on maximum LVR are so very true. We were fortunate enough to have a substantial amount of money in Kiwisaver that helped us onto the property ladder much sooner than we would have managed otherwise, and like you say a 30% deposit for young first home buyers would have shut us out for a number of years. Feedback from friends buying on the North Shore is that auctions are depressing as the houses go for tens of thousands (at least, in some cases 100k+) more than expected. We purchased in a nice area of Papakura, South Auckland for a reasonable price, but were in a multi offer situation as demand for nice houses in the area has shot up – one house that we viewed had an offer two days after going on the market in what has been a slower paced Papakura market."

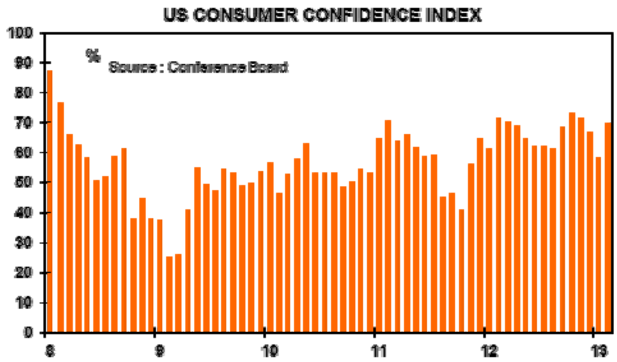
## If I Were A Borrower What Would I Do?

In case you had not noticed there is the sniff of a fixed rate discounting war in the air. I'd be keeping an eye out for a nice low long term fixed rate and locking half of my mortgage into it while placing the other half in a mixture of floating and fixed rates out to two years. I'd not be doing this with the goal of minimising my interest rate cost because doing that requires faith in interest rate forecasts which have all been wrong for about five years. Instead I'd look at it from a near pure risk management perspective of giving myself time to adjust should interest rate surprise on the upside.

# OFFSHORE

In the United States one of the key things happening at the moment is what appears to be a sustained improvement in the US housing market in recent months after a number of false starts since 2009. In January the number of existing dwellings sold was ahead 0.4% seasonally adjusted from December but more importantly 9.1% from a year earlier. The stack of unsold houses is now equivalent to just 4.2 months of sales compared with 6.2 months a year ago and 7.7 months two years ago. The peak was 12 months in the middle of 2010. The median sales price is now 12% ahead of a year ago. These developments are important because they will make the Federal Reserve feel that its massive monetary policy is easing and that they can start to think in terms of when to end then remove the stimulus. They also mean that employers will feel more confident of rising consumer spending and therefore may become more willing to hire people and invest in new technology, plant and premises.




There was also a good rise in consumer confidence recorded in the monthly Conference Board survey. Their measure rose to 69.6 in February from a lowly 58.4 in January.

This week the Federal Reserve Board Governor Mr Bernanke noted that he reads recent increases in some interest rates as a sign that the economy is improving. The data above show that and so do some other numbers released last night. Orders for durable goods – a measure of business investment – excluding defence and aircraft orders rose by a strong 6.3% in January after falling 0.3% in December. Orders seasonally adjusted have now risen by 7.2% in the past three months.

In the United Kingdom this week all attention was on the downgrade by Moodys of their UK credit rating to Aa1 from Aaa. This places the UK one notch below NZ and the change was driven principally by concern that the many structural reforms and fiscal retrenchment being applied in the UK would lock in low growth for an extended period of time. The UK economy shrank by 0.3% in the December quarter and grew 0.2% for all of 2012, and given the high probability of shrinkage underway this quarter means the UK is almost certainly back into its third recession since 2008. The British gross government debt to GDP ratio is just below 100% compared with an EU average of 88% and NZ's ratio just under 40%.

In Europe things have taken a turn for the worse. To start with data released last week show that the Euro-zone shrank by 0.9% during the December quarter and 0.5% for all of 2012. The European Commission is forecasting further shrinkage of 0.3% this year with the unemployment rate rising to 27% in Greece and Spain, 17% in Portugal, and an average of 12.2% for all zone members for the full year. Fiscal austerity by necessity continues and just when the markets were thinking that the worst period with regard to doubts about any country defaulting and the Euro falling apart had disappeared – along comes Mr Berlusconi with a large spoiling role in Italy's upper house.

The current PM's party (Mr Monti) garnered just 10% of the vote in this week's general election whereas Mr Berlusconi's party got around 29.1% of votes for the lower house and the poll leader Mr Bersani 29.6%. That gives Mr Bersani control of the lower house via some bonus seats, but the problem is in the upper house where Mr Berlusconi could rule if he joined with the comedian Mr Grillo who's party gained 25% of the popular vote. Mr Grillo however has said he will join with no-one.

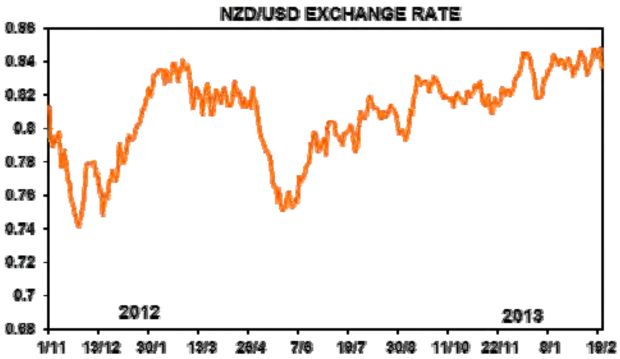
It's a mess – hence rises in Italian bond yields and weakness in the Euro. The UK PM's talk of the UK leaving the EU probably just received some extra support.

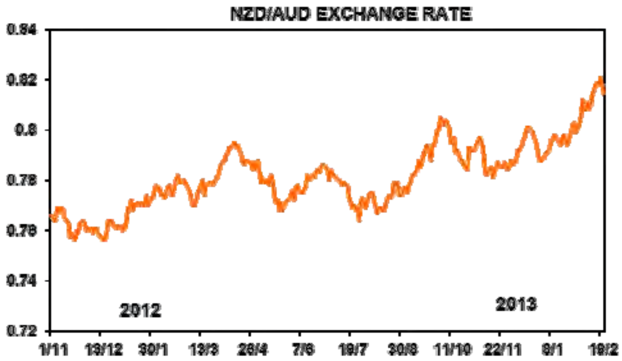
# Exchange Rates

| Exchange Rates | This Week | Week ago | 4 wks ago | 3 Mths ago | Yr ago | 10 yr average |
|---|---|---|---|---|---|---|
| NZD/USD | 0.825 | 0.836 | 0.837 | 0.82 | 0.836 | 0.67 |
| NZD/AUD | 0.808 | 0.814 | 0.803 | 0.784 | 0.778 | 0.85 |
| NZD/JPY | 75.8 | 78.3 | 76.1 | 67.4 | 67.2 | 69.6 |
| NZD/GBP | 0.545 | 0.548 | 0.53 | 0.512 | 0.526 | 0.388 |
| NZD/EUR | 0.629 | 0.628 | 0.622 | 0.634 | 0.621 | 0.52 |
| NZDCNY | 5.14 | 5.21 | 5.21 | 5.11 | 5.27 | 4.99 |
| USD/JPY | 91.88 | 93.66 | 90.92 | 82.20 | 80.38 | 105.7 |
| GBP/USD | 1.51 | 1.53 | 1.58 | 1.60 | 1.59 | 1.72 |
| EUR/USD | 1.31 | 1.33 | 1.35 | 1.29 | 1.35 | 1.28 |
| AUD/USD | 1.02 | 1.03 | 1.04 | 1.05 | 1.07 | 0.788 |
| USD/RMB | 6.227 | 6.2379 | 6.2224 | 6.2268 | 6.3003 | 7.56 |

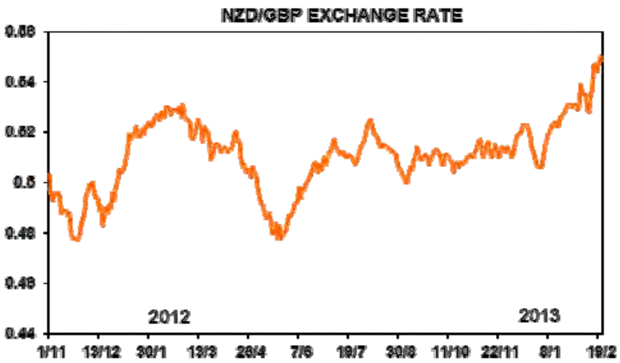
## NZD Takes A Rest

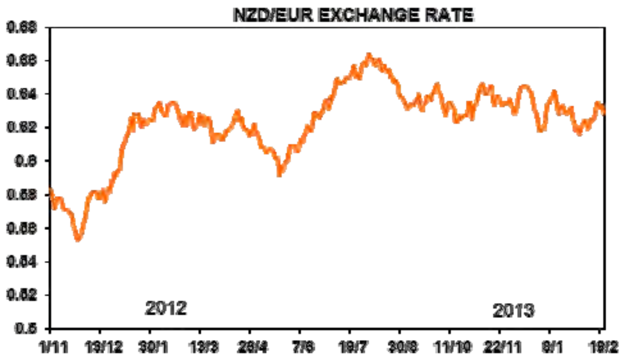
The Kiwi dollar has weakened against all currencies we monitor in the above table except the Euro. The weakness largely reflects a lift in global risk aversion associated with new concerns about Europe following the election outcome in Italy which calls into question the continuation of economic reforms and fiscal restraint in Italy. A monthly manufacturing gauge in China also came in weaker than expected. Those concerns depressed the Euro and hence while we have decreased one cent against the greenback the NZD is up 0.1 centime of the Euro.



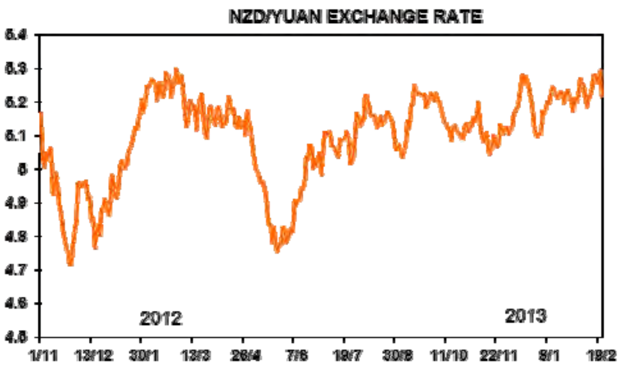



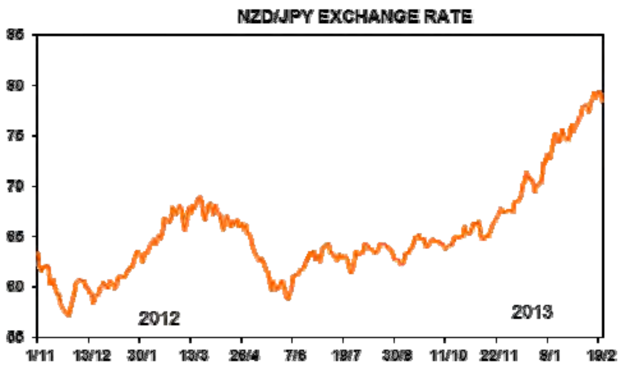

Against the British Pound the NZD shot above 55 pence for a while in response to Moodys cutting their UK credit rating one notch to Aa1. That places it one notch below New Zealand and comes about in response to Moodys expecting mediocre growth for an extended period of time. But courtesy of the Italian election (and maybe some selling on the back of drought conditions in the North Island and poor export data for January) the NZD has finished just back below 55 pence at a still very high level.




The NZD's fall against the Yen was tempered by the Japanese Prime Minister indicating that his favoured pick for the new Bank of Japan Governor is someone who has heavily criticised BOJ policies in the past. Presumably he will be more amenable to money printing and currency weakness in order to get inflation up in Japan.




## Key Forecasts

| **Dec. year** | | **2011** | **2012** | **2013** | **2014** |
|---|---|---|---|---|---|
| GDP | annual average chg | 1.5 | 2.0-3.0% | 2.5 – 3.0 | 3.0 – 3.5 |
| CPI | on year ago | 1.8 | 0.9 | 1.0 - 2.0 | 2.0 – 2.5 |
| Official Cash rate | end year | 2.5 | 2.5 | 2.5 – 2.75 | 2.75 – 4.25 |
| Employment | on year ago | 1.6 | 1.0 | 1.0 – 2.0 | 1.5 – 2.0 |
| Unemployment Rate | end year | 6.4 | 6.5 – 7.0 | 6.0 – 7.0 | 5.5 – 6.0 |

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 27,500 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/
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- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/
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- Monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.co.nz/
- 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

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

Tony.alexander@bnz.co.nz Ph. 00644 474-6744