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

Drought affects sentiment, but some like it dry, and the construction boom will carry the economy toward labour shortages astute employers will already be preparing for.

Many thanks to those people who responded to our monthly BNZ Confidence Survey. The results show that confidence about where the NZ economy will be in a year's time has fallen to a six month low courtesy largely of the drought it appears. But that same drought has also boosted sentiment for grain and seed growers, the apple sector, and wine producers. Plus in the construction sector conditions are clearly strengthening assisted by recognition of the worsening housing shortage, although I suspect that sector participants are just as unsure as I am about what the pattern of construction will look like over the next few years.

In Christchurch growth will be massive. But when visiting there three weeks ago it was clear that no-one felt that they had a clear picture of what the construction profile would be – though plenty of planners have scenarios which they are running on. My concern is that for those people and for anyone in fact around the country looking at a project in the next few years, there will be particular labour shortages which risk causing some projects to either grind to a halt or take a lot longer than expected. A repeat of 2005-07 basically. Watch for that if your project is going to be highly dependent upon completion just before a summer tourist season for instance.

That is why companies need to pay a lot of attention to their workforce planning and not fall into the Kiwi-centric trap of thinking that because the unemployment rate is above average in the context of the past decade, that there are plenty of people out there just waiting to be tapped on the shoulder and told they will be starting work on Monday. Many employers are already telling us that they cannot find what they want. Their next step is to adjust the way they think about their people so they give them space to develop and become more productive, and to identify then remove their blind spots to successful hiring and utilisation of the expats and migrants they are soon going to be clamouring for.

Start perhaps by reading Brooke Alexander's book "SuperTalent" (no relation). www.brookealexander.com.au You'll realise that if you don't get on top of shortages when they arrive and press existing staff to do more, the first to leave for better conditions and recognition elsewhere will be your most talented people seeking recognition – something lacking in the poppy-chopping NZ business culture and helping to explain why HR management is a key weakness for NZ businesses.

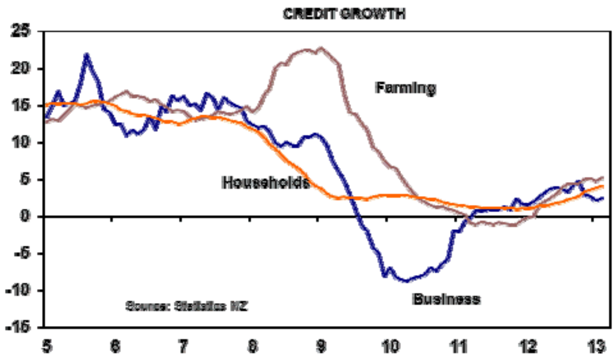
Speaking of people offshore – this week I am in Sydney for a presentation to some private bank clients and general look around as usual, then in three weeks I shall be back in Belgium for some conferences, then London for some presentations and then – Cyprus. I've decided that in the spare few days I have after my week of meetings in London I'll hop across to Cyprus for a few days to view first-hand what happens when a banking sector ceases to function. Of course I'm saying this before actually looking at flights or hotels though imagine the folk there will be very eager for new visitors. With cash. Maybe they'll prefer NZ dollars to spat-upon Euros.

It's ironic that as so many people in the West keep predicting the collapse of China their own economies have proved munted. China's rise and relevance continues apace for all to see in our goods and services export numbers (17% goods receipts, 13.6% tourist spending), inward investment in dairy processing and property (1.4% of all NZ house sales – that will rise), and regional geo-political strategies. After all, if North Korea goes even more nuclear it's the Chinese who will march in to put the regime in order, not the Americans. China's rise is driving an Asian arms race, and America's re-engagement is bringing market-opening opportunities for ourselves. Watch for higher US FDI coming our way. Note also that British engagement here is also rising. Our "relevance" if not particularly great strategic significance to the big players out there is rising.

Credit demand/debt growth is rising, it's no boom, but more will come.

The annual rate of growth in household debt rose above 4% in February (4.1%) for the first time since December 2008 when it was on its way sharply lower from 12% a year earlier. The annual pace has lifted from just 1.1% a year ago so does this mean there is another household borrowing binge underway?

For a number of reasons I'd say no. Firstly, a 3% lift in the growth rate over a 12 month period is not particularly swift. Second, in seasonally adjusted terms debt has been growing at a 0.4% monthly pace largely since August last year with no acceleration evident. Third, 4% growth is not particularly swift in the context of households catching up after three years when debt growth was less than 3% per annum.



For your guide, in spite of the biggest financial crisis since the 1930s, and very poor forecasts back in late-2008 that NZ house prices would fall 40%, New Zealand's ratio of household debt to disposable income has only improved to 143% from a peak of 153.4% in the June quarter of 2009. Whop de doo. The official household savings rate measure has improved in recent years, but only to -0.1% from -8.2% in 2005/6. Australia's rate is near 10%.

The slight lift in the pace of growth in household lending can be seen also in lending to the farming sector which has lifted 5.2% in the past year from flat a year ago, and lending to urban businesses up 2.4% from 1.9% a year ago.

INTEREST RATES

Our central bank may wait virtually until inflation is approaching 3% before raising the cash rate.

I'm in Sydney at the moment so let's start this week's interest rates discussion by looking at the situation here. In Australia increasing talk of interest rates bottoming out has led to a rise in fixed rate borrowing. Up to a quarter of new mortgages are now having their rates locked in rather than floating. Most of this fixing looks to be for one year where rates are below 5% whereas not that many people are locking in for five years near 5.8% or three years near 5.3%. Floating rates are around 5.6%. The Australian fixed rates are about 0.5% less than NZ rates while the floating rates are about the same as ours.

In some regards we are just ahead of Australia in that the recent change in view over there is mainly one of reduced expectations of further interest rate cuts but not yet a solidly formed view on rates rising. In New Zealand hardly anyone expects the RBNZ to cut the official cash rate again, but forecasts of them raising the rate have proved wrong for a long time now and the chances are that the first cyclical rise won't come until well into next year. Or 2015.

The Reserve Bank will eventually react to inflationary pressures coming from the surge in construction sector growth driving costs up in an environment where the sector will quite quickly run out of resources. But the desire of our central bank to raise interest rates is not strong for a variety of reasons. One is that they don't want to repeat the 2010-11 experience of raising rates only to have to suddenly cut them. Another is that history tells us tightening monetary policy pushes the NZD higher and the export sector gets shattered. The NZD is already high, some exporters are in deep pain, and the rate rise cycle has not even started yet.

Third, the RB has to take into account that which is happening offshore, and doing that one finds little incentive to raise rates in the near future. In Europe the economic outlook is deteriorating as opposition to fiscal austerity grows, willingness of creditor nation taxpayers to fund further bailouts diminishes, economic indicators weaken, and the banking sector looks worse as depositors face a huge incentive to move funds out of debtor countries following the Cyprus bailout.

In China growth is above 8% it appears but there is little sign of a switch in the source of growth away from fixed asset investment and exports toward consumption. In Japan the growth outlook is improving as monetary and fiscal policies are set to ease again. But the policy changes are risky and may not work. In the United States growth prospects appear good on the back of falling energy costs and some reshoring through robotic manufacturing and rising Chinese manufacturing costs. But to what extent is the improvement in many indicators simply the result of unsustainable extraordinary monetary policy easing? And what impact will tightening fiscal policy have? In Australia the outlook is for acceptable growth.

Now throw in the risk of escalation of disputes between China and Japan, North Korea and everybody (including China who must be very upset at how their inability to control their protected state makes them look to the rest of the world), fresh deterioration in Egypt, Syria's ongoing collapse and a rising war of words between Iran and Israel (perhaps emboldened to some extent by their recent rapprochement with Turkey). The world looks fairly unsteady.

The upshot of all this is that whatever rule our central bank used in the past to determine how long they wait before tightening monetary policy in the face of rising inflation threats, in this current environment they will wait longer – potentially a lot longer before tightening. That ability to wait in fact may be the best it has fortuitously been since the early-1990s given that most borrowers now are sitting on floating rates. The policy tightening when it comes next year or in 2015, or in 2016, will have a swift impact.

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%	2.67	2.66	2.67	2.76	5.7
1 year swap	2.77%	2.79	2.85	2.62	2.89	5.8
3 year swap	3.14%	3.20	3.25	2.84	3.45	6.1
5 year swap	3.48%	3.53	3.59	3.14	3.96	6.3
7 year swap	3.77%	3.83	3.88	3.44	4.35	

HOUSING MARKET UPDATE

The Chinese link with NZ house prices.

Based on last month's BNZ-REINZ Residential Market Survey, the comparability of key results with those from a similar survey by the National Association of Realtors in the United States, and factors related to sample size and outcomes regarding investment, I am prepared to say that nationwide some 4% of house sales are to people offshore who intend staying offshore, with this figure rising to 4.6% in Auckland.

One of the most frequent comments people have offered upon seeing the numbers, whether accepting them or not, is that a key problem is sales of houses to Asians who leave them empty. In the 1990s the main complaint was that houses were being sold to Asians who did occupy them and in doing so produced shops with Chinese lettering in the windows and sections almost entirely covered by the house.

Basically, when it comes to large numbers of Asian buyers the message from non-Asian New Zealanders is that it is a problem – whether they live in the houses or do not!

Speaking of Asia – in China the authorities are taking increasingly strong measures to try and curb house price rises and prevent the situation developing where home ownership is out of the reach of young people. In China you cannot own land, but you can own legal title to a property on the land – such as an apartment or a factory.

The current measure being use to curb price rises is enforcement of an existing tax of 20% on capital gains. The tax had largely been ignored previously with sellers saying they did not know their purchase price and choosing to pay a 2% - 3% tax on the total sale price. But so far house price rises have not slowed down, prices are about 3.5% ahead of a year earlier, and many buyers are concerned that sellers will look to pass the 20% tax onto them.

In a capacity-constrained market the price-lowering effect of a capital gains tax discouraging investors will be offset to some uncertain degree by existing owners (and new ones) potentially raising their selling prices. Thus in New Zealand where capacity is also constrained and changes to LAQCs and depreciation rules have noticeably failed to deter investors, lower prices or boost supply, any new tax on investor returns will likely just lead to higher offer prices – and higher rents.

Auckland's housing problem revolves around supply – not the tax regime. A capital gains tax would actually worsen the supply situation for buyers as sellers will cease trading and hold their existing property which will probably not attract tax (only new ones would probably be hit). They will look to recoup extra returns previously sought through trading to a different property by raising rents, cutting maintenance, turning lounges into bedrooms etc.

Note that I have advised people for some time now to think of this housing cycle in terms of what happened the last time Auckland was in the forefront of the national housing rise, in the 1990s. Back then we saw older people selling up and shifting to nice parts of the country. But we also saw buyers scrambling to buy as soon as they could as much house as they could in order to “get their feet on the ladder”.

But we also saw another thing – people leaving Auckland to work elsewhere in or outside of New Zealand not selling their Auckland property for fear that they “would never be able to get back into the market again”.

This we see that contrary to what economics might normally teach us, rising prices can lead to both rising demand and falling supply – the demand curve shifting out to the right and up in response to a temporal variable, and the supply curve shifting to the left and up. Draw the curves and you’ll see the result is even higher prices.

Data show housing supply slowly rising, but listings shortage worsening

The supply of new dwellings continues to rise and in February in seasonally adjusted terms the number of consents issued for the construction of new dwellings rose by 1.9%. This is a relatively small increase following a 0.2% fall in January. However in the three months to February consents rose 5.7% seasonally adjusted which is a good underlying pace of growth.

The 12 month total number of consents issued for new houses now stands at 17,432 from a multi-decade low of 13,269 in July 2011. This is below the ten year average of 22,200 and means that still as each month goes by the housing shortage in New Zealand gets worse rather than better. At some stage before the end of this year annual consents will rise above 22,000 but even annualising the last three months seasonally adjusted does not get us there (18,900).

The upshot is that there is a long long way to go before the supply shortage begins to be seriously addressed and in Auckland in particular the situation is going to get a lot worse for many people. Last week I did an extended interview on the Auckland housing situation and you can find it here.
http://www.interest.co.nz/property/63758/bnz-chief-economist-tony-alexander-says-numbers-offshore-based-home-buyers-will-incre

Speaking of Auckland, data from Barfoot and Thompson show us that they sold 1,430 dwellings there in March which was a 15% gain from a year earlier and near 10% seasonally adjusted rise for the month. But the stock of listings at the end of the month fell to 3,721 from 3,988 at the end of February to sit 22% down from a year ago. That meant that the ratio of sales to listings in the month hit 38% which is the highest on our records which go back to 1996.

In a nutshell activity is strong, listings are becoming scarcer – therefore it is no surprise that house prices are soaring. The average sales price jumped to $646,000 in March from $604,000 in February, but this sort of jump is normal for this time of year. The price is nonetheless 13% ahead of a year ago.

If I Were A Borrower What Would I Do?

I would stay floating or maybe lock in a nice low one year fixed rate for half my mortgage, then for the other half I would stay floating looking for a heavily discounted 3 – 5 year rate close to what I would pay floating and lock into that in order to reduce my interest rate risk.

OFFSHORE

In Spain the situation remains poor with the economy now expected by the Bank of Spain to contract by 1.5% this year rather than the near 0.5% predicted by the Spanish government late last year. The budget deficit is declining but at a projected 6% of GDP from 6.7% last year is still going to be well above the target of 4.5% - a level which will only stabilise the debt to GDP ratio if GDP stops shrinking. More than that, with the unemployment rate already at an eye-watering 26% and some deficit-reducing measures set to expire next year, without fresh budgetary measures the deficit will rise again next year to over 7% of GDP.

One piece of data showing Spain's woe this week was the PMI falling to 44.2 in March from 46.8 in February.

Spain therefore is a long way away from being out of the woods with regard to its budgetary problems, and because solving such problems brings economic weakness that means social problems associated with high and rising unemployment are going to worsen. Yet backing away from fiscal austerity is going to be very difficult as higher deficits will push interest rates (debt servicing costs) back up and willingness of northern European countries to fund further debt in Spain is not high.

That latter point is what the Cyprus bailout was about – the sending of a signal to the large economies in the Euro-Zone which really matter (Cyprus accounts for just 0.2% of Euro-Zone GDP), that the bailout coffers are no longer replete and harsh conditions will in future be imposed.

That scary message aimed at the likes of Spain, Italy and Greece is a key reason why weakness in the Euro is likely to continue and the NZD/EUR exchange rate push onward toward perhaps eventually 0.70.

For the record, France is also failing to meet its deficit targets. The budget deficit in 2012 came in at 4.8% of GDP rather than the aimed for 4.5%, and this year the 3% target is unlikely to be met and a result above 3.4% is likely instead. France's debt to GDP ratio now stands at 90.2% from 85.8% in 2011. This is the problem with failing to meet debt targets in a low inflation low growth environment – the relative debt burden grows and the vulnerability of the government to a spike in interest rates rises sharply.

In Italy a government has still not been formed following the percentage victory for a comedian. In Germany economic data are coming in weaker than expected with the March PMI at 49.

This week brought more indicators showing a reasonable though not rapid upturn underway in the United States housing market. The market is rising – in price terms at least – because of weak construction in recent years, investors converting homes into rental properties, low interest rates, a growing economy, and rising demand from investors not wanting to miss by much the lows in the house price cycle. Analysts in the United States are starting to predict average house price gains this year near 10%.

The manufacturing sector however is still struggling to grow at a good pace. The much-watched PMI measure came in lower than expected in March with a reading of 51.3 from 54.2 in February. The level is above 50 and thus growth is occurring in manufacturing output. However the failure to maintain February's good reading is a reminder of why the Federal Reserve intends keeping the cash spigots open as long as possible. They are not yet convinced that the US economy has developed good upward momentum so do not feel the time is yet close to begin withdrawing the artificial props. While this means low interest rates for a long period of time, it also means a greater inflation risk once growth does emerge, and lessening chance that monetary stimulus withdrawal will occur in an orderly manner.

This Friday night the all-important non-farm payrolls report will be released and analysts are anticipating jobs growth just below 200,000 in March following a strong 256,000 rise in February.

Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.842	0.839	0.823	0.829	0.82	0.67
NZD/AUD	0.805	0.8	0.806	0.791	0.791	0.85
NZD/JPY	78.3	79.2	77	72.2	67.3	69.6
NZD/GBP	0.556	0.553	0.547	0.514	0.513	0.388
NZD/EUR	0.655	0.652	0.632	0.634	0.618	0.52
NZDCNY	5.22	5.21	5.12	5.17	5.16	4.99
USD/JPY	92.99	94.40	93.56	87.09	82.07	105.7
GBP/USD	1.51	1.52	1.50	1.61	1.60	1.72
EUR/USD	1.29	1.29	1.30	1.31	1.33	1.28
AUD/USD	1.05	1.05	1.02	1.05	1.04	0.788
USD/RMB	6.2014	6.2118	6.223	6.2325	6.297	7.56

Kiwi dollar blips higher after a pullback – this is the story since mid-2009 and will remain so for perhaps another 3 - 4 years.

Short of war breaking out on the Korean Peninsula, attacks between Israel and Iran, foot and mouth breaking out in NZ, the Euro breaking up (though hard to figure that impact) or the Chinese and Japanese going at each other over their disputed islands, the NZD is going to go up. This week the NZD climbed against all currencies bar the Yen on the back of a range of factors.

First global sharemarkets have been recovering after being hit last week partly by worries about Cyprus. Second, if you have money in a bank in one of the indebted European countries best by recession, fiscal austerity and political ineffectiveness just how attractive do you think the NZD, AUD, and USD are now compared with the steaming pile called the Euro? In the Wall Street Journal Asia this Tuesday one finds the following quote “New Zealand, with a small agricultural and tourist-based economy, has a reputation as a haven from global financial turmoil.”

Third, the Kiwi dollar is a commodity currency and at the Global Dairy Trade auction this week average prices rose by double digits for the third auction in a row taking prices to levels double what they were at their lows of May last year. Dairy is our largest export and although only 10% of annual production remains to come out of our lactating mooers ahead of Winter, rising prices will mute some of the impact of the drought on the economy.

The NZD’s path is upward and all exporters can do is look for the occasional pullback to get some extra hedging in place. History tells us that the NZD goes up when our monetary policy tightens and that tightening has not yet started and may not start until well into 2014 or even 2015 given the way the world looks. Exporters could easily still be facing a painful exchange rate through to 2017.

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/
- monthly Brain Gain NZ publication http://www.braingainnz.co.nz
- monthly BNZ Confidence Survey, http://tonyalexander.co.nz/topics/surveys/bnz-confidence-survey/
- monthly BNZ-REINZ Residential Market Survey. http://tonyalexander.co.nz/topics/surveys/bnz-reinz-survey/
- 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

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