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/lFdYSs5FGEq4kAjP95uzTA

Could Non-Monetary Policy Measures to Contain House Prices Cause Interest Rates To Rise?

Here is something which might mess with your brain a bit so don't read it if you like to think the world is a straight-forward place. If the government and councils opened up all types of land for unrestrained residential building it could cause interest rates to rise, not fall. Why? Because one would expect lower land prices to lead to a surge in house building. The construction sector is already facing rapidly rising costs which feed into the inflation measure, the Consumers Price Index. But section prices are not included.

Thus higher construction would lift inflation directly and through second round wage effects which could be strong given the loss of tradespeople to Australia and low training in NZ in recent years. The only offset to higher inflation would come if existing house prices were to fall away and constrain consumer spending and there is some evidence that this would happen. Between the four quarters to March 2013 and all of 2009 retail spending in the Auckland region grew by 19% whereas growth in the rest of the country excluding Canterbury was just 9%. Divergent population growth rates including a population shift to Auckland after the Christchurch earthquake would account for some of this difference. But nonetheless one can argue that house price changes do have some retail spending effect.

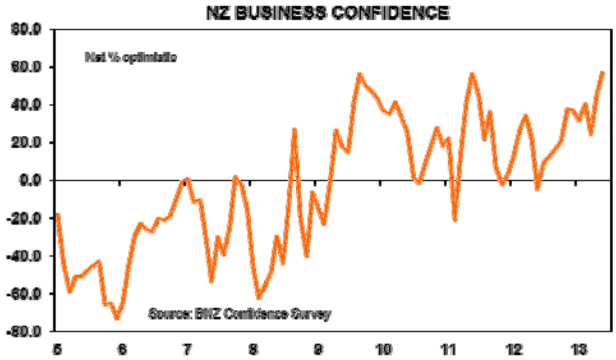
Thus falling house prices would tend to constrain spending and take away some inflation pressure – except there is a problem. Consumer prices nationwide have risen 7.8% over the same period and for Auckland only rises have totalled 7.5%. There is no evidence that if house prices cause divergent spending growth that this causes divergent inflation outcomes.

Thus if your concern is a rising currency caused by rising interest rates caused by rising house prices you had best be careful what policy you lobby for in order to suppress house price inflation. Unless you cap construction (which will simply worsen the shortage problem) then inflation, interest rates and the exchange rate must rise – unless you believe construction can soar without surging inflation.

Houses and China

For your guide, in case you missed it, this Monday I released the results of the latest BNZ Confidence Survey. Sentiment has hit a record net 57% optimistic which bodes well for things like jobs growth, business investment, then later down the track higher cost pressures, inflation, interest rates and NZD. I also introduced some new questions including whether people are happy or unhappy about house prices rising.

29% of people feel unhappy, but 29% are happy and the remaining 42% indifferent. Therefore 71% of people would disagree with the statement that they are unhappy about house prices rising.



I also asked how people feel about New Zealand's growing economic relationship with China and got the result that 22% are concerned, 12% indifferent, and 66% unconcerned. Thus 78% of people would disagree with the statement that they are concerned about our deepening relationship with China.

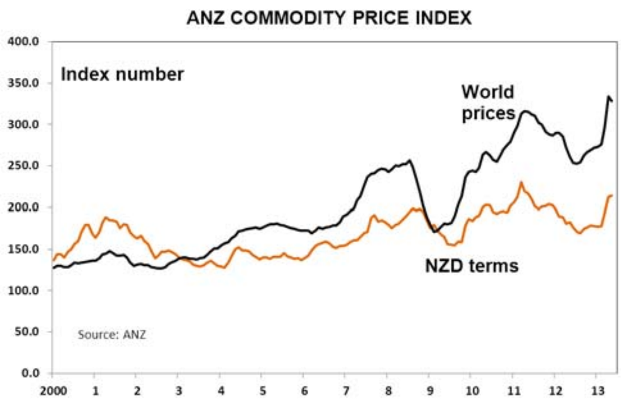
These questions will prove valuable over time as we get a feel for what levels are normal and what are unusually high or low.

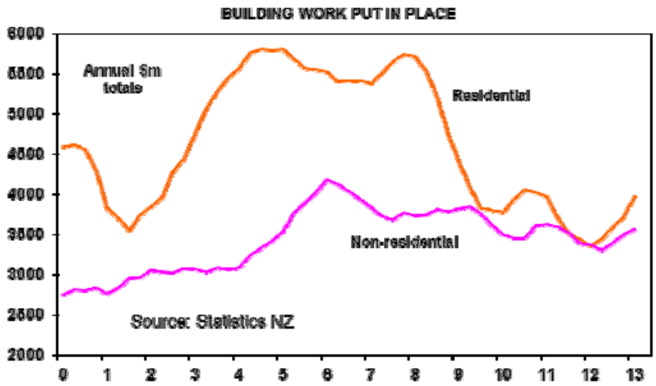
The latest BNZ-Nine Rewards Consumer Trends Survey will be released on Monday 10.

The Week's Economic Data

Strong NZ Export Prices

The ANZ Commodity price Index in world price terms fell by 1.6% in May to lie 26.1% ahead of a year earlier. Converted into NZDs the change from a year ago was a lesser rise of 17.4% but for the month there was a 0.7% improvement. Basically, at a time when some other commodity prices are falling away – iron ore, coal etc., prices for what we ship offshore are holding at strong levels. This is going to help underpin our growth through firm rural incomes plus investment in the farming sector – most notably dairy. But keep an eye on the meat sector where demand from China is rising strongly and there is a deep queue of NZ producers trying to get licences from the Chinese authorities to export into China.





This week we also learnt that the volume of building work undertaken during the March quarter rose by a much stronger than expected 5.8% with residential work ahead 12% and non-residential down 0.9%. Compared with the March quarter of 2012 residential work was up an enormous 30.6% and non-residential 8.5%. This is just the start of what is going to be a very large boom in New Zealand's construction sector and it is inevitable that it will produce cost pressures which will contribute to the Reserve Bank eventually raising the official cash rate and pushing the NZD up – especially as it is very unlikely their new minimum deposit rules will have much impact on house prices and none on house construction.

Interest Rates

Steady Rates This Week

Basically this is what is going to happen with NZ interest rates but we're just guessing at the timing and the levels at which rates end up. Rising NZ inflation coming out of the construction sector plus a fall in the unemployment rate below 5% will combine with the Reserve Bank finding it's minimum deposit rules to be having little measurable impact and cause the official cash rate to rise from some point next year. It will peak at whatever level we Kiwis this cycle find to be painful. Last cycle it was a floating mortgage rate of 10.9%. The cycle before that 11.3%. Best guess this cycle (and it is a guess in this post-GFC world) is a peak of 8.5%. But that forecast will change.

Before the RB starts raising rates and we start ignoring them, fixed interest rates will be marching upward as a recovering US economy produces what some worry could be very sharp rises in US bond yields. They are guessing as to when those yields rise and by how much. That means we can only guess as to the speed and eventual magnitude of fixed rate rises here.

Hopefully you'll have latched on more to the tone of the two above paragraphs rather than any numbers you may have discovered in there and realised that interest rate risk management in this new world means giving hardly any weight to rate forecasts and instead simply hedging to buy time to adjust to rate shocks.

For the record, this week swap rates have moved by little. But be warned. There are weeks ahead this year and next when rates risk moving by large amounts.

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	2.66%	2.66	2.66	2.67	2.76	5.7
1 year swap	2.78%	2.80	2.72	2.85	2.50	5.8
3 year swap	3.23%	3.29	3.03	3.25	2.75	6.1
5 year swap	3.57%	3.64	3.22	3.59	3.16	6.3
7 year swap	3.85%	3.92	3.57	3.88	3.54	

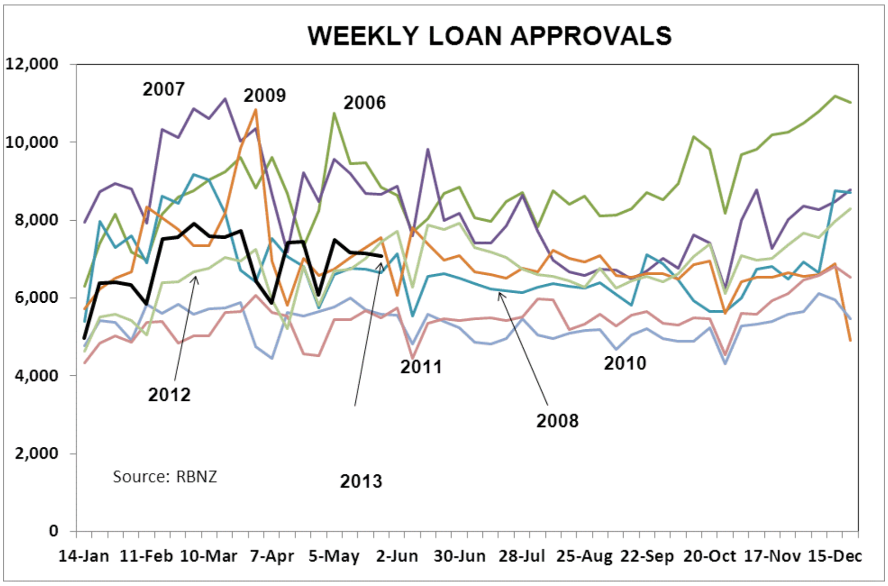
Housing Market Update

House Price Expectations Rising

On Monday we will release the results from our latest monthly BNZ-Nine Rewards Consumer Trends Survey. One of the results which we can note here from analysis already done is that the average expectation for the extent of nationwide house price rises over the coming year has lifted from 4.3% to 4.6%. The Auckland expectation has lifted from 5% to 5.6%. In other words, there is disagreement that Reserve Bank's efforts to make the cost of housing finance more expensive for highly geared borrowers including first home buyers will cause reduced house price inflation – let alone price declines.

Lending Surge Not Occurring - Yet

This graph is a bit messy but I've so far found it the best way to present these data in a useful format. Each line represents one year and the data shown are the number of loan approvals each week for the same weeks (almost) each year. What you need to look for is the solid black 2013 line which finishes in late-May. Loan approvals are running above rates in 2008, 2010, and 2011, but below 2009 and importantly 2012.

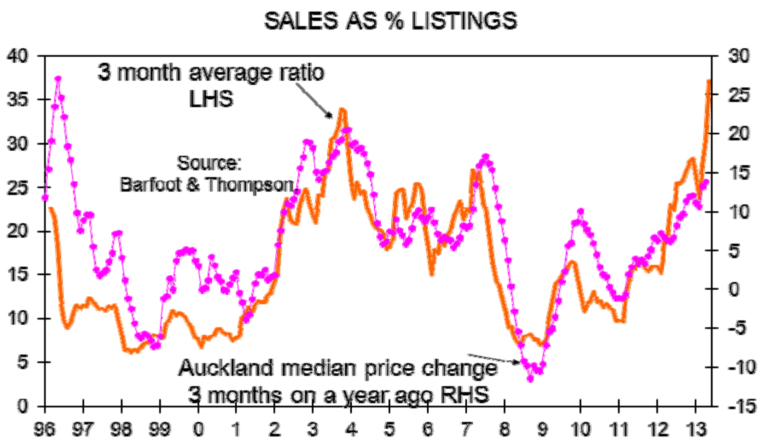


I include the graph to bolster the argument that so far debt growth has not been a key driving force behind the rise in the housing market. What that means is that when the Reserve Bank implements policies aimed at restraining debt growth the effect on the housing market will be minimal if felt at all – because they will be targeting the wrong thing – unless you believe the problem they are targeting is not housing affordability or the inflation which will inevitably come as construction rises, but bank risks associated with high loan to value lending. And I would suggest that is in fact all they are targeting.

In fact this is probably an opportune point to put a bit more structure around the housing issue than has appeared anywhere so far in order to help you better understand what is happening. There are actually four housing problems – affordability, bank exposures to price falls, inflation forcing higher interest and exchange rates, and accommodation availability for low income earners. I was going to include an article here on all four things but the WO is already long enough so will run it next week.

Record Level of Sales Versus Listings

Barfoot and Thompson this morning reported that in Auckland in May they sold 1,284 dwellings. This was a 10.2% rise from a year earlier and near zero monthly change. So sales activity growth has plateaued. The average selling price has also flattened out for now at about $645,000, a 10.8% rise from a year ago. With regard to all important inventory, during May 1,315 new listings were received. This was 7.5% fewer than in May 2012. That means that at the end of May total listings stock stood at 3.034 which was a 433 decline from April, and a 30.3% fall from May last year. Put together with sales this means the ratio of sales to listings hit 42.3% in May which is a record level. The graph says it all with regard to where this means prices will be going – up, up, up.



If I Were A Borrower What Would I Do?

I guess I'd be asking myself the same question as the two real estate agents sitting at the table near mine in Ruby Café in Plimmerton on Tuesday afternoon – when are interest rates likely to start going up? Our current best guess is next year but uncertainty surrounding interest rate predictions is huge and quite rightly too as no-one has got their interest rate predictions right for four or so years now. But for modelling purposes I would assume the official cash rate starts rising in the middle of 2014 and is 3% higher come the middle of 2015. That would broadly mean floating and short-term fixed interest rates rising about 3% as well. Longer term rates will also rise but their movements will be more and more influenced by what happens with rates overseas – principally in the United States. In that regard it is hard to over-estimate the massive uncertainty regarding what US rates do in the next few years.

How do you get house prices down in an area? Have a decent landslip – again according to the agents I am eavesdropping on who have just broken out in laughter about selling houses in Berhamphore. That seems to be in bad taste considering the poor people concerned.

Offshore

Generally weaker than expected data this week and a reality check on Japan's excess optimism.

In Australia the week ended better than hoped for last Thursday when quarterly estimates of private sector capital spending plans came in better than expected – and the improvement occurred before much thought would have been given to the recent decline in the AUD. That means the next numbers could be better again and so people are now speaking in terms of the mining investment boom more hitting a plateau than plummeting away. Mining industry spending plans for 2013-14 were 10% lower than a year ago for 1012-13 but 2.7% ahead of this year's expectations made three months ago. Even manufacturing investment plans were 5.7% better than three months ago. Perhaps the data plus some good housing indicators such as strong auction clearance rates in Sydney and Melbourne in recent weekends helped influence the RBA's decision this week to leave its cash rate unchanged at the 2.75% it was cut to just a month ago. The RBA will probably want to see where the AUD may be settling and how firm the housing upturn may get before it gives the economy an extra nudge through lower rates as many still expect they will do.

As to the extent of the extra nudge needed, it is probably not much given that DP still grew by 0.6% during the March quarter to deliver a good 3.1% growth rate for the year to March from a year earlier. The result was slightly less than expected but still reasonable.

One of **China's** challenges is that its population is aging rapidly as a result of the one child policy introduced in the late-1970s and that means that in contrast to Western countries experiencing the aging of the Baby Boomers it will get old before it gets rich. China is still a developing economy with low income per capita and will not be able to deliver modern health and care for its aging population as will be the case in other countries including Japan. This is problematic not just because of the high elderly poverty which is locked in but because it sends a signal to younger people that they need to save aggressively where possible for their retirement. That makes the task of switching China's source of growth from exports and fixed investment to consumption even more difficult.

The first problem is unlikely to be addressed and many elderly will spend their end days in difficult, lonely conditions. Solving the second problem however will require development of a better retirement income system, better health system, and better social connectivity (legislation forces offspring to visit their elderly parents). Current pension levels and health insurance payouts are very small and leave people hugely exposed to large health bills – hence the high savings rate for China which some estimate to be around 40%. The NZ household rate is about zero.
Sources of Western Apprehension About China

Regarding the problems getting meat off Chinese wharves – while it is a certainty that normal international friction down the track will lead at times to such things happening (though that does not appear to have been the cause this time), NZ generally is going to enjoy good access to China. That is not just because of the 2008 FTA but because by and large our overwhelmingly primary sector exports to China are not competing against products from state-owned firms in China. Western companies often find that the extent of impediments to entering and operating effectively in China depend upon whether or not one is competing against state companies. But if China were to buy meat, seafood and dairy producers in other countries of greater strategic interest that may well change for us.

Following the weaker than expected preliminary PMI from HSBC there was a sigh of relief this weekend when the official measure improved slightly to a May reading of 50.8 from 50.6 in April. This is only just in growth territory however and progress in the manufacturing sector is being challenged by the Yuan's sharp rise against a depreciated Japanese Yen, rising input costs, and weakness in the European market.

The common forecast for growth in the **United Kingdom** economy this year is 0.6% but the British Chambers of Commerce has just lifted its pick to 0.9% - the first such upward forecast revision in five years. The improvement flows through to 2014 with growth of 1.9% picked from 1.7% earlier with 2015 growth of 2.5% forecast from 2.2% before. The change largely comes in response to some better than expected data on consumer spending – perhaps as people react to news of rising house prices. Frankly however research from the pre-GFC period shows that the wealth effect of rising house prices was more often than not over-estimated around the world.

But not just consumer spending is edging up a tad. The monthly Markit CIPS PMI came in better than expected in May with a reading of 51.3 from an expected 50.3 and 50.2 in April.

For the next four years expect to see a lot of discussion about UK membership of the EU. A bill is making its way through Parliament aimed at cementing in place the PM's promise to hold a referendum on membership in 2017 should his party win the 2015 general election. The chances seem high that the UK will leave with one key motivator for a departure vote being increasing societal concern over an influx of migrants and the burden which they are perceived place on the UK's welfare, health and education systems. The European Commission has in fact just decided to take the EU to court to overturn special rules applied by the UK authorities to limit migrant access to welfare benefits and housing. This action is sure to raise anger about migrants, especially with Romanians and Bulgarians from January 1 becoming eligible to work (or not work and draw benefits) wherever they want.

For **Japan** it's all about 'Was that it?" The Nikkei Share Index soared 78% from early-November last year to mid-May but since then has shed around 18% on the back of a reality check on peoples' expectations for his ability and even willingness to implement necessary economic reforms.

In the **Eurozone** the big question is about whether countries have the ability to reform their economies and bring their adaptability to change and resilience to shocks up to world (read German) standards. The French President has already all but flipped the bird at those critical of French resistance to change by saying "It's not for the Commission to dictate what we have to do." In one sentence he has all but wiped out the relevance of the movement toward a union-wide fiscal pact and said thanks for giving us an extra two years to get the deficit to 3% of GDP but we'll do nothing in exchange for such leeway unless we want to.

That just reinforces the risk (and my expectation) that in 2 – 3 year's time Europe could be in a deeper problem than it is now as interest rates will be higher because of firmer US growth but debt levels will also be higher – thus debt servicing burdens will be greater, the willingness of investors to advance funds will be lower, the ability of countries to tolerate renewed austerity will be weaker, and default of some Eurozone members will again be back on the table.

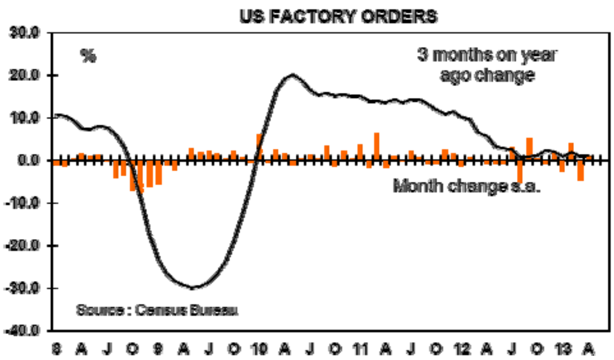
The Eurozone unemployment rate continued its march upward in April reaching a record 12.2%. Germany's rate is 5.4%, Portugal's 18%, and Spain's over 25%. Car sales in France during May were 10.3% lower than a year earlier.

In the **United States** the big questions revolve around whether the economy is really picking up or if it is simply a housing bubble spurred by unsustainably cheap credit, whether rising bond yields signal expectations of improving growth or worries about the Fed. tapering money printing, and whether in fact tapering will start soon. Concern about the Federal deficit has faded into the background now that it is sitting around 4% of GDP. This Friday night's monthly employment numbers are therefore very important. If they show strong jobs growth above 200,000 we can expect surging expectations of tapering soon as the Fed. have stipulated that they are aiming for 6.5% unemployment. That and rising economic growth implied by strong jobs growth will drive bond yields up along with the US dollar and probably push the sharemarket down.

If however the report is weak the USD and bond yields will fall, but the sharemarket will head higher as money printing for longer means more cash seeking assets.

This week the May Purchasing Managers Index came in weaker than expected at a recessionary reading of 49 from 50.7 in April. This is the weakest reading since June 2009 and adds a note of caution to forecasts of improving US growth. Following the result the USD fell and the sharemarket rose. The first move makes sense, the second shows money printing is a key supporter of US equities – which is exactly what the Fed. said it wanted from money printing.

Last night the US sharemarket fell away by over 200 points in response to weaker than expected data – thus telling us something interesting. Previously the release of weak data caused higher share prices on expectations of money printing continuing. Now weak data is leading to market weakness as the cash supply angle is pushed aside for now and the focus is going instead on implications for corporate profitability. Orders placed with US factories rose by just 1% in April after falling 4.7% in March and were just 0.9% ahead of a year ago for the three months ending in April. Plus the ADP jobs measure was weaker than expected thus leading to worries of a weak non-farm payrolls report this Friday night.



Exchange Rates

Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr average
NZD/USD	0.795	0.811	0.853	0.83	0.756	0.67
NZD/AUD	0.834	0.841	0.828	0.811	0.776	0.85
NZD/JPY	78.9	81.9	84.6	77.5	59.6	69.6
NZD/GBP	0.516	0.536	0.548	0.549	0.492	0.388
NZD/EUR	0.608	0.626	0.65	0.637	0.608	0.52
NZDCNY	4.87	4.97	5.26	5.16	4.81	4.99
USD/JPY	99.25	100.99	99.18	93.37	78.84	105.7
GBP/USD	1.54	1.51	1.56	1.51	1.54	1.72
EUR/USD	1.31	1.30	1.31	1.30	1.24	1.28
AUD/USD	0.95	0.96	1.03	1.02	0.97	0.788
USD/RMB	6.1275	6.1239	6.1677	6.2211	6.3684	7.56

NZD Lower – But Fundamentals Argue Higher Maybe Later This Year

Predictability of exchange rates is bad during even stable times. But currently predictability is exceedingly poor and if you are considering where the NZD may be in the coming weeks, months or years you need to pay close attention and avoid locking in place a strategy with heavy reliance upon a particular set of currency forecasts proving correct.

The world's economy and financial markets have been hit by a large number of shocks in recent years from terrorist attacks to share market and housing market collapses, bank collapses, government debt restructurings, diseases, wars and so on. There is no reason for believing that the shocks of the past few years will decrease in number and plenty of reason for believing that there could in fact be more shocks in store for the next few years.

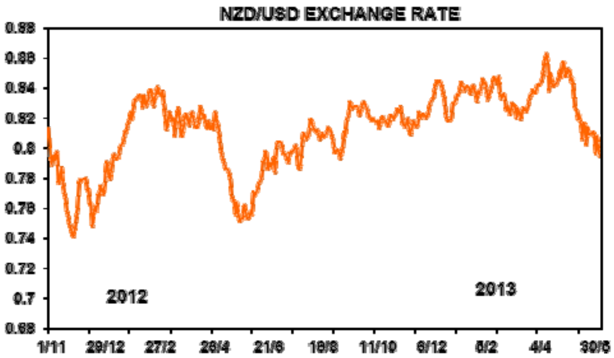
One shock in particular which is already generating volatility and about which some strong expressions of concern have been made is the effects of first aggressive central bank monetary policy easing via sustained low interest rates and money printing, and the effects of interest rate rises back to normal levels and cessation then reversal of quantitative easings.

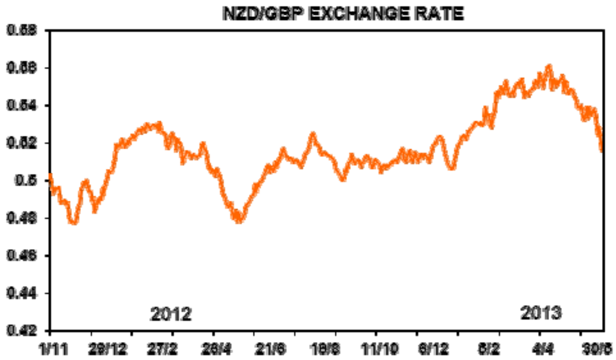
Just this week the central bankers bank – the Bank for International Settlements – expressed its worries about cheap money causing excessive rises in asset prices. Higher asset prices are an explicit goal of central banks like the Federal Reserve which is easing policy aggressively, and the Bank of Japan which plans doubling money supply. The Bank of Japan's beggar-thy-neighbour currency decline is causing high angst in economies against which it's sophisticated manufactures compete such as Taiwan and South Korea and it is not inconceivable that those countries take measures to depreciate their own currencies.

The US dollar has been initially weakened by Fed. money printing efforts and now is experiencing bouts of strength on market expectations that money printing will ease off. Such expectations fluctuate in line with the strength or weakness of US economic data and given that data flows have been particularly unpredictable in recent years that means currency and equity market movements are also unpredictable.

For an export-dependent economy such as New Zealand what this means is that we analysts struggle to come up with a view on where exchange rates will average over particular periods of time and therefore whether an exchange rate bounce up or down is a good opportunity to boost hedging or not. For the moment we have generally bought into the view that the average for the NZD/USD rate has moved from maybe 85 to maybe 80. For the NZD/AUD rate we are thinking maybe the average is now 84 or so rather than the previous 80. For the NZD/JPY we all seem to struggle for any view given the huge role being played by the Bank of Japan.

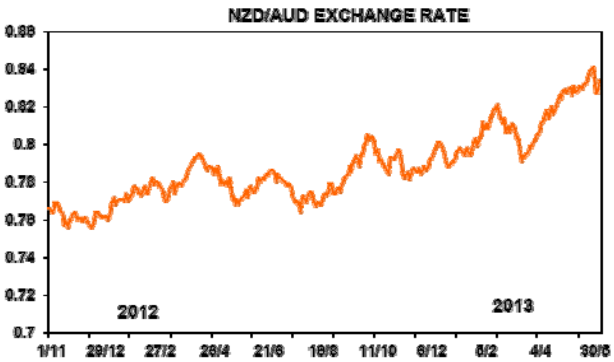
This week the NZD has fallen across the board to reach a ten month low against the greenback near 79.5 cents and five month low against the British pound near 51.6 pence. This rate is quite some distance from the 55 – 60 pence range we were on the verge of settling into a month and a half ago and the decline can be attributed to some rerating downward of commodity currencies (basically NZD dragged lower by an eight cent fall in the AUD), and a mild lift in optimism about the UK economy.

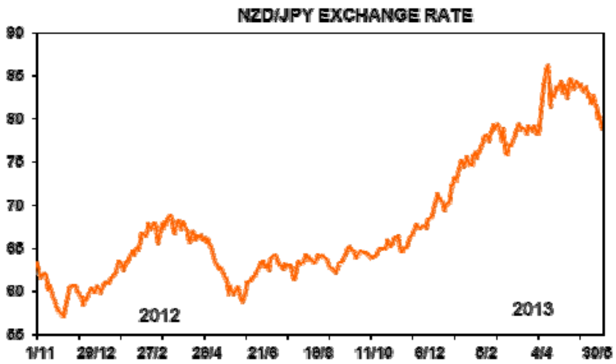


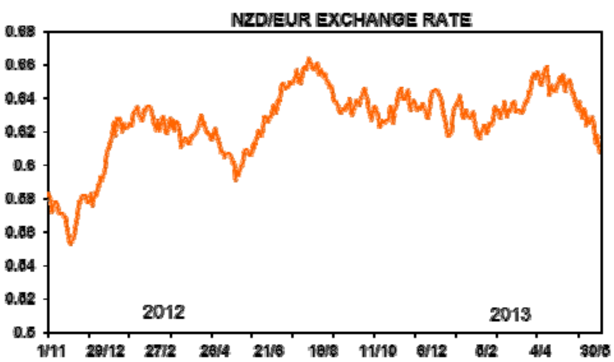


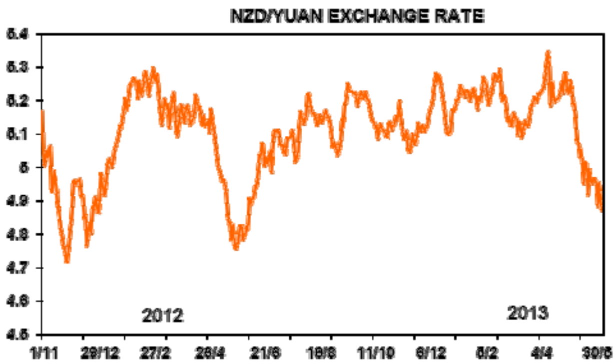
Will the NZD decline further? Anything is possible in the FX markets especially now that a new wave of risk aversion is sweeping through on the back of some weaker than expected numbers in Europe and the United States in particular. But while those numbers sap risk tolerance such sapping tends to be only temporary and when it fades we expect to see a lot of attention paid to the way in which growth in the NZ economy is accelerating while it is still weak in other countries. That will tend to place upward pressure on the NZD especially as speculation of tightening NZ monetary policy rises.

Thus this period of weakness in the NZD is probably a good opportunity for exporters to get extra hedging on board out to a couple of years and a good time for expats to repatriate some of their GBPs into Kiwi dollars ahead of coming back to help build houses in Auckland or Christchurch, construct irrigation schemes and milking shed in Canterbury and Hawkes Bay, or strengthen commercial buildings all around the country up to 67% of the earthquake code.









Key Forecasts

Dec. year		2011	2012	2013	2014
GDP	annual average chg	1.4	2.5%	2.5 – 3.0	3.5 – 4.0
CPI	on year ago	1.8	0.9	0.5 – 1.5	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	n/a	2.0 – 3.0	2.0 – 2.5
Unemployment Rate	end year	6.3	6.8	5.0 – 6.0	5.0 – 5.5

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The publication is sent to 28,000 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 Brain Gain NZ publication http://tonyalexander.co.nz/topics/brain-gain-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 BNZ-Nine Rewards Consumer Trends Survey http://tonyalexander.co.nz/topics/surveys/bnz-nine-rewards-consumer-trends-survey/
- Monthly column for the NZ Property Investor magazine, http://www.propertyinvestor.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

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It's a Hard Life

Nothing this week.