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.
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Tying Monetary Policy To The Labour Market

Outside of New Zealand there is a very strong focus by governments and central banks on high unemployment, its debilitating social effects, and how to get it down. History shows that stimulatory government fiscal programmes and industry subsidies are not the answer as they lock resources into dead-end streets, raise the debt and tax burdens, and are no substitute for private sector-driven growth on the basis of free market forces being allowed to do their thing. But in the short-term governments have a responsibility to do what they can to mitigate the worst effects of an economic slump and with budgets heavily constrained overseas by debt built up after years of appalling fiscal mismanagement (Europe, UK, US, Japan), monetary policy is being asked to take the burden.

Central banks have responded to depressionary labour market fears by very diverse combinations of slashing interest rates, boosting money supply, improving liquidity support to banks, and making promises not to raise interest rates until things are much better. This latter tool is increasingly coming into use as central bankers have seen medium to long-term financing costs facing businesses and households rise even without any explicit tightening of monetary policy. The increases have almost entirely been driven by expectations that soon the Federal Reserve in the United States will start its “tapering” exercise involving cutting back on printing $85bn a month.

These expectations have caused US bond yields to go up and through the normal financial channels whereby investors are comparing yields around the world, rates have gone up elsewhere. In response the Bank of England has given “guidance” that it will keep monetary policy loose until the unemployment rate falls from the current 7.7% to 7%. The Federal Reserve have said it won’t raise interest rates until the current 7.3% unemployment rate falls to 6.5%. Neither the ECB or Bank of Japan have given such employment-linked guidance.

Here in New Zealand the unemployment rate is 6.4% having peaked at 7.3% in the September quarter of last year. Hence, to the extent one might want to base monetary policy upon labour market performance the case has already effectively been made in New Zealand for monetary policy to tighten. But what about Australia where the unemployment rate is 5.8%. Is the RBA raising interest rates? No, it has cut the cash rate from 4.75% in September 2011 to 2.5% and another cut may come in February.

Why ease monetary policy when unemployment is so very low by world standards? In a world where one thinks unemployment is the driver of monetary policy the cuts arise because the unemployment rate has risen from 5% in April 2012 and is set to rise further as the resource investment boom winds down and the effects of an earlier very high Aussie dollar flow through the economy. New Zealand’s unemployment rate by contrast has fallen and is widely forecast to decline further.

What is the latest update we have on New Zealand’s labour market? Nothing is showing things taking off as yet, but the trends are in the right direction.

Our BNZ-Nine Rewards Consumer Trends Survey shows that a net 47% of over 500 respondents would like to work longer hours but a net 22% are finding such work less readily available That latter proportion is the lowest in four months and gives a slight signal that things are trending in the right direction.

The ANZ Business Outlook Survey released over a week ago showed that a net 19% of employers plan raising their staff numbers. This is up from 8% six months earlier and an average reading of just 5%.

The Trade Me Jobs data based upon jobs advertised on their website shows that ad numbers in the three months ending September were 9.8% up from a year earlier. In Auckland ads were up 13.5%. Canterbury 10.4%, but Wellington just 3.1%.

The NZIER's Quarterly Survey of Business Opinion released this week showed a net 17% of non-farm employers plan taking on more staff. This reading is up from 9% in the June quarter, is the highest since late-2004, and is well above the ten year average of 7%.

Will demand soon skyrocket? Probably not. The past five years tell us that in a world of major, and as we see overseas, continuing, uncertainty, employers are these days quite cautious in their hiring. There is always the risk that things could turn downward and one will be left with excess staff and a cost blow-out to lay them off. Just this past week the US Treasury Department has said debt default in the United States come October 17 could be "catastrophic". The IMF head Christine Lagarde has said "The government shutdown is bad enough, but failure to raise the debt ceiling would be far worse, and could very seriously damage not only the US economy, but the entire global economy. So it is 'mission-critical' that this be resolved as soon as possible."

Thus, much as we can look at our economy and say that growth could be on the cusp of booming due to positive forces in the construction and dairy sectors, businesses are likely to continue to exercise restraint in their speed of fresh hiring because of (yet again) newly uncertain prospects for global growth. In fact just yesterday we got a sign that even in the retailing sector things are still not yet consistently firing.

The value of core spending using debit and credit cards fell in seasonally adjusted terms by 1% in September after rising 1.1% in August giving an annualised rate of growth for the September quarter of only 1%. This compares with 5.2% in the June quarter and 5% in the March quarter. There is not a consistent pattern yet of firmly rising household spending.

In this sort of environment, while falling NZ unemployment would justify raising interest rates, our central bank is going to logically do what other central banks are doing and wait to see how things pan out before acting – probably in March next year.

Not that the state of the labour market is the actual driver of monetary policy decisions in New Zealand or the long-term driver overseas. This article was simply written taking as the scenario that such a strong relationship was in place to reach the same conclusion we reach when adopting more traditional analysis looking at inflationary pressures in place and expected, forecast overall growth rates, and capacity availability in general.

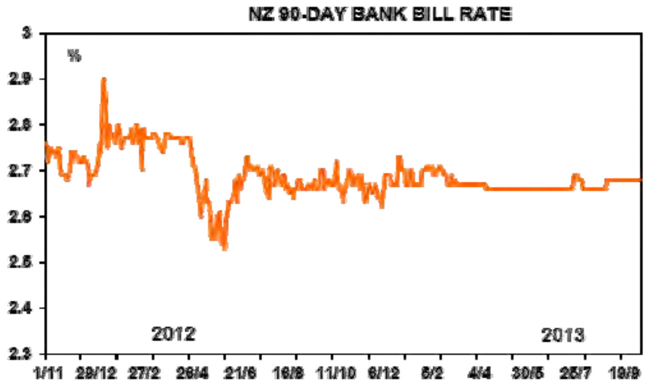
IF I WERE A BORROWER WHAT WOULD I DO?

I would not be sitting there smiling hoping that the US defaults on its debt so the world slips back into a deep recession and interest rates go down. Were that to happen the removal of growth would see unemployment rise and business profits and viability fall so ability to service debt would be severely compromised. Plus asset prices would fall – hardly a good side effect of having something happen which sends interest rates to the floor.

Our expectation is that our central bank will start raising the official cash rate from 2.5% in March next year and take it to 4.5% come 2015. Personally I would run my debt servicing scenario assuming a 3% rise simply to be on the safe side and to recognise the tendency for interest rate rises to be underestimated at the start of each tightening cycle. NZ central bank Governors have shown a tendency to believe that their rate movements and their comments have more influence on people than is truly the case. Maybe the new Governor has already recognised that with his warning that interest rates will need to rise more than they have indicated should LVR rules not have the effect they want.

Note that this week the two main data releases failed to contain much suggesting that inflation risks are rising. The cost and price expectation measures in the NZIER's QSBO actually fell slightly while the Electronic Card Transactions data showed spending much weaker in September and the September quarter than had been expected. You may recall also that last week's consents data hinted at a plateauing of dwelling consent growth. In other words, even though growth in our economy is above trend and picked to speed up, and even though employers are already reporting greater than average difficulties in sourcing both skilled and unskilled labour, inflation risks do not loom large at this stage.

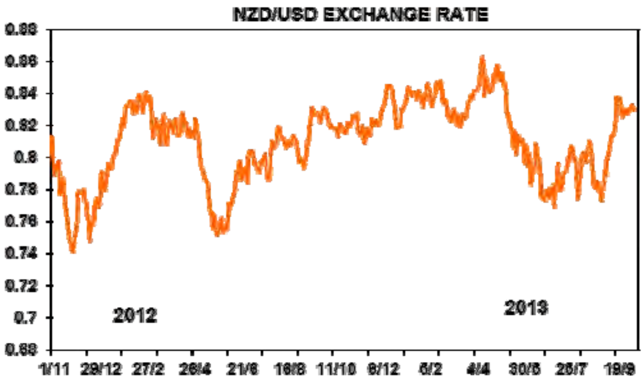
Time remains on the side of the Reserve Bank and with so many home owners sitting on either floating or short-term (and therefore largely meaningless) fixed rates, once the OCR starts rising the impact will be far greater than at the start of the 2004-07 tightening cycle.

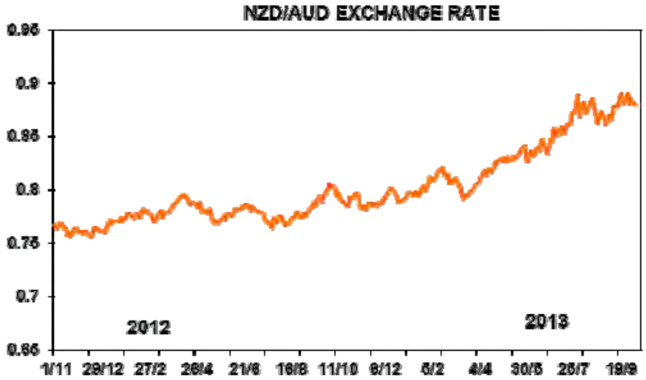


FINANCIAL MARKETS DATA						
	This week	**Week ago**	**4 wks ago**	**3 months ago**	**Yr ago**	**10 yr average**
Official Cash Rate	2.50%	2.50	2.50	2.50	2.50	5.4
90-day bank bill	2.67%	2.67	2.66	2.67	2.76	5.7
1 year swap	3.02%	3.00	3.02	2.91	2.60	5.8
3 year swap	3.95%	3.92	4.00	3.65	2.82	6.1
5 year swap	4.48%	4.43	4.55	4.13	3.11	6.3
7 year swap	4.80%	4.72	4.88	4.44	3.41	

NZD Steady Ahead of Possible US - Initiated Global Storm. Like last time.

The NZ dollar has held up quite well this week in spite of deepening concerns about a potential US debt default which has seen share prices pushed slightly lower in many parts of the world. In more normal times weak share prices would tend to flow through into more generalised selling of high beta assets like the NZD and AUD. But perhaps the continuing run of goodish data for New Zealand is lending our currency some additional support. For instance the NZIER's survey showed a rise in business confidence to a net 32% optimistic from 30% a quarter ago and just 2% a year ago – all seasonally adjusted. And across the ditch the NAB monthly business survey saw confidence rise 8 points to a three and a half year high following the Coalition Federal election victory.





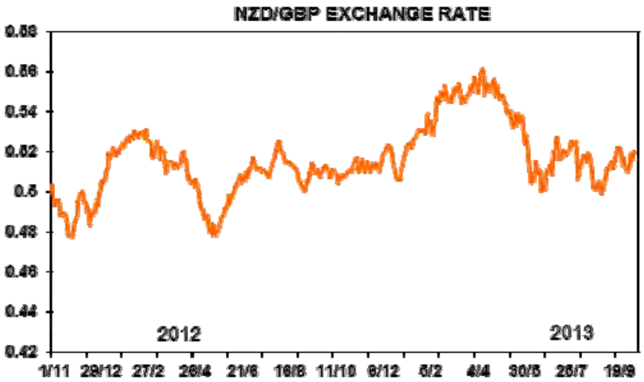
The IMF released updated forecasts for global growth this week and as expected cut them marginally yet again. They cited as the two biggest downside risks facing their forecasts as the US debt crisis then the tapering exercise to be implemented at some stage by the Federal Reserve. Expectations of less loose monetary policy have already led to rises in US wholesale borrowing costs which have flowed through to other parts of the world and led to worries about some sapping of growth in parts of the developed world just starting to show some growth momentum after an extended period of weakness – most notably the UK and EU.

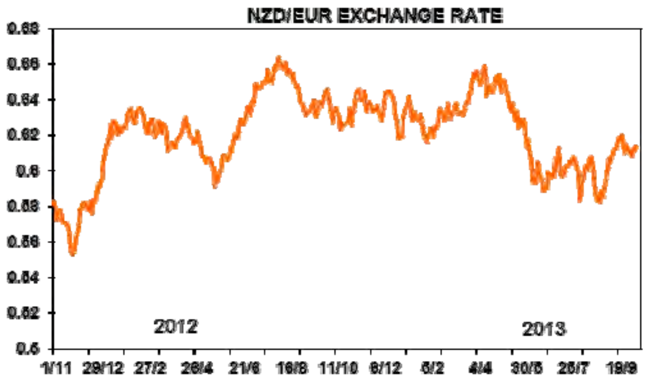
But news that President Obama is going to appoint Janet Yellen as next Fed. Chairman has helped cap rises in global bond yields as she was the main architect of the Fed's stimulus policy recently and is likely to want to see strong signs of self-sustaining US growth before starting to taper the current extraordinary money printing exercise.

The IMF forecast global growth this year of 2.9% from 3.1% previously, and next year of 3.6% from 3.8%. They see the Australian economy growing by 2.5% then 2.8% with the unemployment rate rising above 6%. They forecast NZ growth at 2.5% then 2.9% with an unemployment rate of 5.3% next year.

For Japan growth is forecast to slow from 2% this year to 1.2% next year, the US to accelerate from 1.6% to 2.6%. The Eurozone is forecast to contract 0.4% this year and expand 1% next year.

Exchange Rates	**This Week**	**Week ago**	**4 wks ago**	**3 Mths ago**	**Yr ago**	**10 yr average**
NZD/USD	0.825	0.825	0.78	0.775	0.826	0.67
NZD/AUD	0.877	0.881	0.869	0.847	0.805	0.85
NZD/JPY	80.6	81.6	77.5	78	64.5	69.6
NZD/GBP	0.518	0.513	0.502	0.511	0.512	0.388
NZD/EUR	0.611	0.61	0.591	0.597	0.64	0.52
NZDCNY	5.05	5.05	4.77	4.75	5.23	4.99
USD/JPY	97.70	98.91	99.36	100.65	78.09	105.7
GBP/USD	1.59	1.61	1.55	1.52	1.61	1.72
EUR/USD	1.35	1.35	1.32	1.30	1.29	1.28
AUD/USD	0.94	0.94	0.90	0.91	1.03	0.788
USD/RMB	6.1199	6.1195	6.12	6.1335	6.3281	7.56

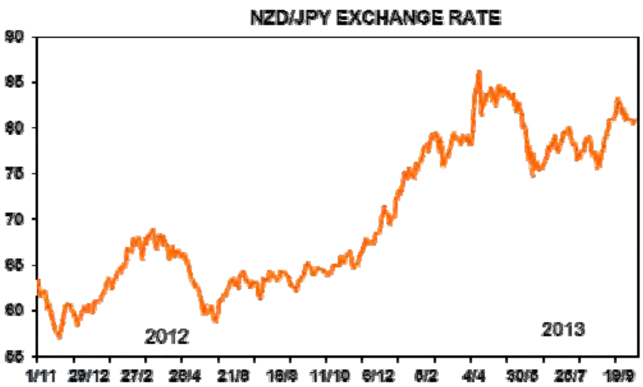


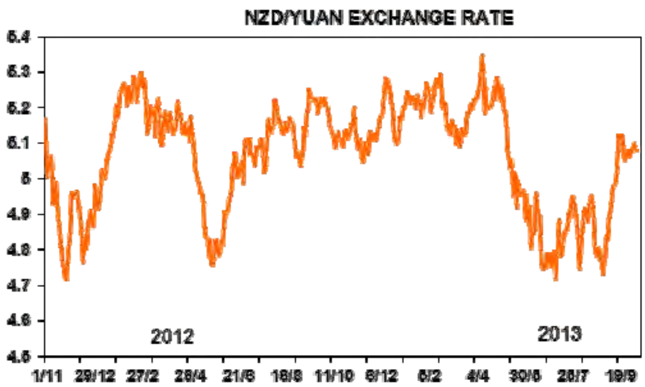


A key thing happening in the UK at the moment is accelerating credit growth which to date has been concentrated in the housing sector as the government encourages people to take on more debt. The Bank of England has been trying the same thing via an extended period of low borrowing costs plus some earlier printing of money. This week evidence emerged that consumers are extending their borrowing from housing into cars.

A record 75% of car purchases in the UK are now apparently being financed with credit. Before the GFC the level was usually 50%. That is quite a big jump and worth reporting here because it calls into question the common assumption that people have been so shocked by the GFC there has been a permanent downshift in the willingness of consumers to buy on tick. These are early days yet in the credit cycle as UK non-credit card debt growth is still just 3.7% versus over 10% in the pre-2008 period.

Finishing off with the NZD. If the US defaults on its debt all bets are off but the probable outcome is a strong decline in the NZD, most notably against the Japanese Yen and Swiss franc, then against the British Pound and Euro, then last of all against the USD which is also likely to be slammed. Failing a default underlying support for our currency looks good and upward drift remains the likely direction.





Housing Market Update

Impossible?

Am I missing something here? The Sunday Star-Times likes to run scary stories on the housing market (remember those from 2008 – 11 about mortgagee sales and forecasts of collapsing house prices which proved incorrect). This week the front page contained this gem in an article about buyers scrambling to get property. “One couple…believe others will find it impossible to go through the property purchase process within the new, reduced time limits.” “…impossible, absolutely impossible.”

This refers to banks cutting the time during which pre-approval of a loan is valid for loans above 80% of the value of the property. Here are two hints for those young people looking to buy a house.

1. Save a bigger deposit.
2. Make your property offer conditional upon bank finance.

You should already know near exactly what the bank will lend you when you put in an offer on a house because of the debt servicing criteria which you will have discussed with your bank. What is the counter argument to this? It is a seller’s market therefore sellers can simply not accept conditional offers if they choose. Preference may be shown to offers which are not conditional on finance. Given that investors will tend to have better access (older, more existing assets to use as security) than young people, there is validity to the argument that the LVR changes will bias NZ house ownership toward investors. Thus one suspects there will be quite a strong level of support for Labour’s just announced policy to exempt first home buyers from the Reserve Bank’s new LVR rules. But as the Governor has rightly pointed out, given the dominance of first home buyers in purchases with low deposits this would render the rules of not much use and result in interest rates rising higher than would otherwise be the case. What a mess.

These are still very early days for the rule changes and it will take some time until we see the sustained strength of any negative impact in the housing market but as noted many times before, the impact is unlikely to be large in aggregate because of the strong factors contributing to house prices rising. These include a shortage in Auckland and Christchurch with the former getting worse every day, an aging population which naturally lifts housing demand as bedrooms sit empty of sleepers, rising construction costs, a coming shortage of builders, booming migration flows, and catch-up spending by all those investors and first home buyers who from 2008-2011 bought into the scary stories of house prices collapsing. I bet they wish they had not paid so much attention to the sensationalist media.

What about the idea that young buyers should forgo home ownership and instead plan to rent and place their money into a diversified range of assets? I would be lying if I say I ever gave such a strategy one second of thought when I was making my first home purchase in 1987. I came back to New Zealand in mid-1987 specifically to own a piece of Godzone and I’ve made more profit from property than I have ever made from financial investments (lost everything on a forestry investment).

For the record what was my most profitable investment? Ignoring currying favour with the popular kids and cliques at primary school, high school, and university and instead concentrating hard on lessons and doing extra reading around my preferred topics. Attending all but three lectures during my five years at varsity. Not shooting off to the UK as soon as I graduated to bum around Europe on a career-stalling rite-of-passage OE. Then when at work focussing on developing to the max the areas in which I have natural ability and determination rather than addressing the deficiencies in areas unimportant to me which others felt were important to them. In other words, the way I self-educated then pursued my career yielded my best return and not what I purchased and when.

Back to the desire to own property, I actually started writing the second section of this article after reading a piece in the Weekend Financial Times out of London on what a woman who won Lotto there in 2005 did with her money. Among the many things she said were these comments “The way to go is definitely property.”

And the lottery people said with regard to what big winners do “The vast majority are very sensible and want to get their children on the property ladder.”

The cultural desire which we have to own property is strong. That is a key reason why the LVR rules will probably fail when it comes to part of their goal which is to limit house price rises. On a final note readers should understand that the primary factor behind the RB’s decision to impose the rules is to limit vulnerability of banks to an economic shock which lowers house prices. The rules are not intended as a substitute for official cash rate changes, but when they fail to stem house price rises and the RB raises the cash rate more than people may be expecting, the failure of people to abide by the spirit of the rules will be used by the RB as a scapegoat.

Good luck young people. Look outside of Auckland and if you gravitate toward an apartment in Auckland as activity there enters a new golden period, take care with regard to buying off the plan and ensure the developer has strong finances. Expect also to face competition for off the plan purchases from Chinese buyers who are big and getting more dominant in this area in Sydney and Melbourne. The Chinese buyers tend to purchase but not always bother renting out the apartments. Make sure they keep the water out also!

Key Forecasts

Dec. year		**2011**	**2012**	**2013**	**2014**	**2015**
GDP	annual average chg	1.4	2.7%	2.5 – 3.0	3.0 – 3.5	2.0 – 3.0
CPI	on year ago	1.8	0.9	0.5 – 1.5	1.5 – 2.0	2.5 – 3.0
Official Cash rate	end year	2.5	2.5	2.5	3.5 – 4.25	3.5 – 4.5
Employment	on year ago	1.6	-1.3	2.5 – 3.5	2.0 – 2.5	1.0 – 2.0
Unemployment Rate	end year	6.3	6.8	5.5 – 6.5	5.0 – 6.0	5.0 – 6.0

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