20 March 2014

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.

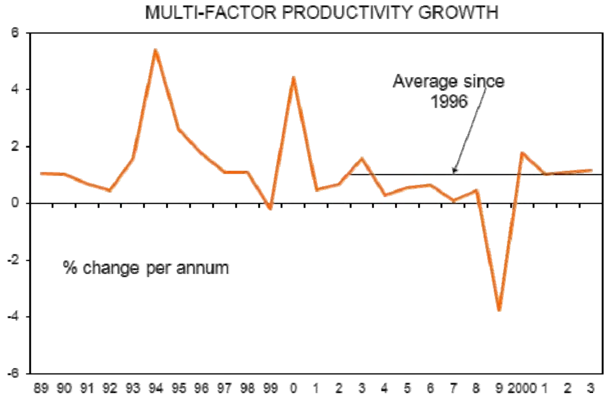
To receive the Weekly Overview each Thursday night please click here.
http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA

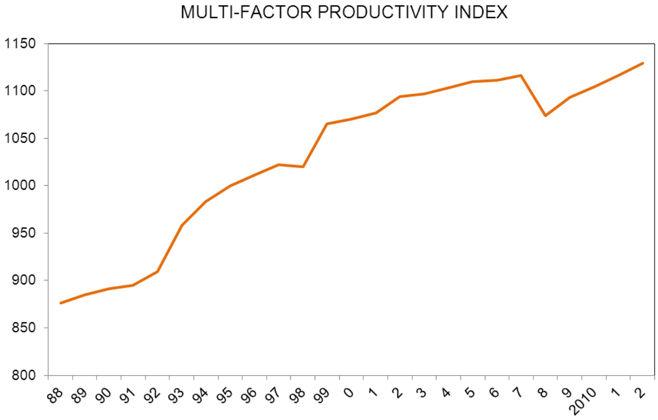
2014 Themes

- Interest rates will rise
- The NZD will remain highish
- The labour market will tighten, pushing employment costs up
- House prices will rise with gains spreading out of ChCh and Auckland
- Construction will boom
- World growth will improve with unprecedented uncertainty regarding monetary policies
- Business capital spending will grow
- Household spending growth will accelerate

Are We More Productive?

This week Statistics New Zealand released 2013 March year productivity data and at first glance the numbers make for good reading. Combining labour and capital one sees that productivity growth was 1.2% in 2013 from 1.1% in 2012, 1% in 2011, and 1.7% in 2010. Given that growth has averaged 0.8% since 1996 this above average performance might lead one to conclude that NZ has embarked upon a good growth period with inflation-suppressing help from rising productivity. But such is not really the case.

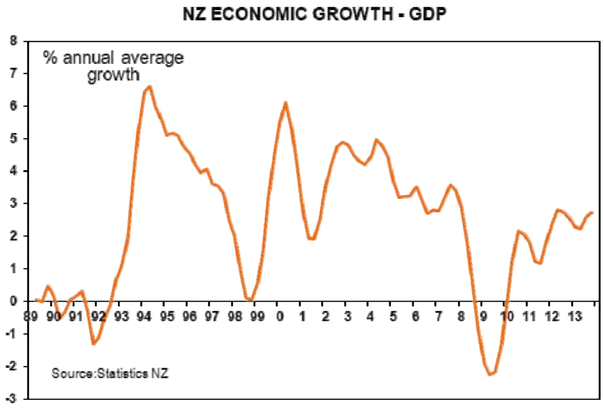


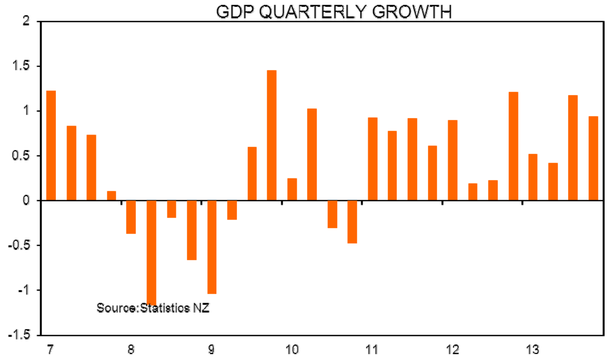


Mainly it seems what has been happening recently is a simple whip back the other way following a 2.8% decline in productivity in 2009 associated with the global financial crisis. If one averages the period from 2008 to 2013 then productivity growth has been only 0.3% per annum. The second graph shows no obvious extra steepness in the productivity index line in recent years compared with what has been happening since 1988.

Growth at 2.7%

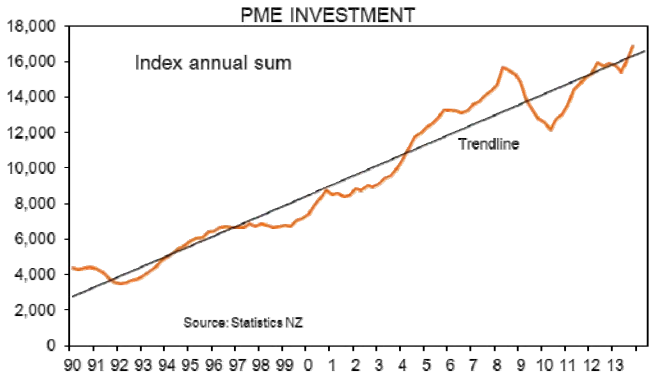
This morning we learnt that the NZ economy grew by 0.9% during the final quarter of 2013 which is a good outcome following the 1.2% rise during the September quarter. Full calendar year growth was 2.7% from 2.6% during 2012, 1.9% during 2011, and 2.1% during 2010. Thus the NZ economy has been growing at a reasonable pace for four years and now embarks upon an acceleration in growth to probably above 4% this year and close to that over 2015.





Key sectors contributing to the growth last year Mining +4.8%, Construction +12.6%, and Retail Trade +4.2%. Agriculture and forestry actually declined 2.9%. On an expenditure basis private consumption rose by a firm 3.4% last year and gross national expenditure gained 3.9%. Exports rose only 0.9% while imports soared 6.2%.

The result was near market expectations so elicited little reaction in the financial markets. One important piece of news however was a 7.5% rise in spending on plant, machinery and equipment which followed an 11.6% rise in the September quarter and 3.2% rise in the June quarter. The strong result means we can move beyond discounting earlier PME strength as possibly simply normal volatility to say that there is a good lift occurring in investment, with growth of 6% recorded for the full year from just 2% in the year to September.



Key offshore debates

United States – Growth lifting to 2.8% from 1.9% in 2013 but could interest rates jump as tapering proceeds?
China – Impact of non-performing loans following the 2009+ credit boom, ability to switch from export and fixed asset investment as growth-driving forces toward consumption, impact of loosening controls on outward capital flows.
Australia – ability of strengthening retailing and housing to offset the resource sector investment decline plus vulnerability to China shocks.
United Kingdom – Construction is picking up along with manufacturing, but worries exist regarding the 2017 referendum on EU membership, and the risk of premature policy tightening by the BOE.
Japan – Tension with China is growing as Japan breaks away from its post WW2 accepted pacifist shackles to confront its traditional regional competitor. Conflict appears probable with potentially severe economic consequences.
Eurozone – growth is picking up but will it be strong enough over the cycle to seriously dent entrenched unemployment, especially of youth? If not will the resulting social deterioration foster more radicalism?

Industrial production in the **United States** rose by a stronger than expected 0.6% in February to be 2.8% ahead of a year earlier. This is clearly not a particular rapid pace of growth but the direction is positive. The data adds to other pieces of information showing growth proceeding at an acceptable pace which should not lead to any change in the common expectation that the Federal Reserve will keep cutting money printing by $10bn at each meeting in the next few months. They did so last night so the monthly target is now $55bn. These actions will tend to deliver some support to the greenback while marginally capping strength in equities and placing upward pressure on bond yields.

Last Thursday in **Australia** the employment data showed the labour market to be in far better shape than thought. Job numbers were expected to have risen by 18,000 in February but in fact they soared by 47,000 (far outstripping job losses expected from the unsustainable car manufacturing industry and bloated Qantas). Full-time employment jumped by 81,000 and the unemployment rate held steady at 6%. The data are a useful reminder that the easing in growth in Australia is not sending the economy into recession, that some firm growth drivers exist, and that the strong easing of the net loss of Kiwis across the ditch is only a cyclical and therefore temporary phenomena.

In **China** over the past week data releases have been most definitely on the weaker than expected side and this has ignited a fresh round of concerns about whether GDP growth will reach the 7.5% target this year. Some minerals commodity prices have fallen and sharemarkets generally have taken a step back. Retail sales in China over the January – February period were 11.8% ahead of a year earlier compared with 13.6% growth in December. This is the slowest pace of annual growth since before at least 2006. Industrial production grew 8.6% from a year ago versus 9.7% in December – the slowest pace since early-2009.

These numbers come at a time when concern is growing about high corporate debt levels and what might be a string of defaults.

The PBOC during the weekend announced a widening of the Yuan's trading band from +-1% to +-2%.

In the **Eurozone** the rate of inflation has dropped even further away from the official 2% target to just 0.7% in February, leading to more debate about what the ECB might do to try and stimulate growth and smash talk of a period of deflation. Their cash rate already sits at just 0.25% and a further cut might achieve little. Options include an outright monetary injection via bond purchases, lines of cheap liquidity provided to banks, or a negative interest rate on bank deposits with the ECB.

However the ECB are forecasting that inflation will rise to 1% this year and .5% next year so the chances seem low of some further stimulus which might cause a decent decline in the Euro.

IF I WERE A BORROWER WHAT WOULD I DO?

Let's imagine you are in your late-twenties and at some time in the past four years you have bought yourself a house with a mortgage that you find frightening because you have never borrowed so much before in your life. You have worked a bit extra and maybe sacrificed a few things to get the principal down a tad but you haven't put in a major effort to do so because interest rates are low and when you calculated the savings you would make by accelerating the loan repayments they did not amount to much. (Compare that with doing the exercise when rates were a lot higher and you'll see why people haven't gone all out recently to pay down debt.)

You have been sitting on a floating mortgage rate near 5.7%, or you took advantage recently of one of the low 6 – 24 month fixed rates. Now you have been reading that the Reserve Bank has raised its official cash rate by 0.25% to 2.75%, you hear people on the left complaining about interest rates rising, you hear some manufacturers complaining about upward pressure on the exchange rate, and both groups advocating less focus on inflation and raising interest rates and switching to efforts to control the exchange rate and other lovely Muldoonist things about which you know nothing because you are very young and you don't even know what a Muldoon is supposed to be.

Here is the start of your education into what the real world is like instead of the situation you have been in recently. First, the interest rate which you have been paying for your mortgage is the lowest it has been since the 1960s and your parents never got such a low rate and possibly your grandparents have only a vague recollection of interest rates back then for those who were rationed some bank money. Your mortgage rate has been – and still is – so low because in 2008 the world looked like it might enter into a new Great Depression – a time when half of Americas banks collapsed, unemployment soared in much of the Western world, and we eventually got some wonderful literary works as The Sugarbag Years by Tony Simpson and his father.

To prevent a depression from happening central banks radically lowered their interest rates, set up emergency lines of credit for private banks and each other, and printed money in some cases. The depression was avoided but the period of recovery was dominated by the sub-prime crisis in the United States morphing into a debt crisis for European governments and the ongoing series of shocks has left businesses unwilling to invest and hire and consumers unwilling to spend.

With economic conditions very fragile central banks were not in any position to start taking away emergency-level borrowing costs. But things have been improving since late-2012 and in response in the United States the Federal Reserve has started reducing its monthly money printing operation from $85bn a month to $55bn so far. In other countries though things still look wobbly so central banks are at pains to tell everyone that they do not plan taking away their depression-fighting sugar for a long, long time.

Here in New Zealand our central bank responded to the crisis by slashing its official cash rate from 8.25% to just 2.5%. They raised it to 3% in 2010 when things looked to be improving. But when fresh rot set in they cut the rate with the Christchurch earthquake of February 2011 providing a convenient point in time for doing so.

Now here in NZ things are barrelling along very strongly. Consumer confidence is at a nine year high, business confidence an 18 year high, export growth strong, construction booming, the dairy sector going gangbusters, and employment growth rocketing with job numbers up 67,000 last year and the unemployment rate falling from 7.2% to 6%. Growth is accelerating and is highly likely to exceed 4% this year.

In New Zealand the need for depression-fighting interest rates no longer exists. So our central bank has started the process of taking away extremely low interest rates. In doing so they aim to achieve two things.

1. Provide an interest rates buffer in case the world falls over again.
2. Contain the lift in inflation which is coming.

The latter factor is the most important one and here is your economics lesson. Inflation is another word for change in your cost of living – the thing you worry about each time you open your power bill, pay insurance, go to the supermarket and so on. The inflation rate is currently 1.6% which means that on average the cost of living for NZ families has gone up by 1.6% in the past year. Those manufacturers and others wanting higher inflation to be tolerated are saying that they want your cost of living to increase at a more rapid pace so instead of your power bill going up 8% maybe it rises 10%.

You might think that this is not important as long as your income rises more than the cost of living. True, but not everyone has good power to get remuneration increases. How have you done the past six years? Plus as the cost of living pace rises businesses see their costs rising and start to spend more time figuring out how to raise their selling prices than developing new products and markets. Investors shift funds toward assets which tend to give good insulation against rising inflation – such as property.

Overall, as inflation goes up the pace of growth in efficiency in the economy tends to decline – and that ultimately is where our income growth comes from.

All good so far. But why does the Reserve Bank fight inflation? The answer is that they are required to by the Reserve Bank Act with the specific target laid out in the Policy Targets Agreement. That agreement says that the RB should aim for inflation between 1% and 3% on average over the business cycle. The previous Reserve Bank Governor was a bit slack and proved tardy at getting ahead of inflation and aimed for outcomes only just below 3%. The current one is well on the ball and aiming for 2%. That 2% target is fairly much what most other central banks aim for offshore.

The Reserve Bank aims for 1% - 3% inflation by influencing the pace of growth in the economy. When growth is very fast we use up resources quite quickly. That can be seen in terms of the unemployment rate falling, capacity utilisation rate rising. As resources get in shorter supply businesses bid for them by raising wages and prices for things like building materials – with the materials suppliers of course likely to get ahead of such buyer auction behaviour by raising their selling prices anyway. After all, if you are struggling to get people to work in your factory and have lots of orders you cannot easily satisfy, the best thing to do is raise your selling prices to boost profits.

So how does the Reserve Bank slow down the pace of economic growth? In common with central banks overseas they have very few tools. One new one was introduced last year in the form of minimum deposit requirements for home loans. But the primary target of those rules is not inflation but riskiness of bank lending portfolios. The rules have certainly severely dented demand in the housing market from first home buyers, but the impact on inflation will be barely measurable. That is because what drives inflation is not much the pace of growth in prices for existing houses, but the cost of building new ones and that cost will keep going up because demand for houses to be built is huge – think of the shortages in Christchurch and Auckland.

The Reserve Bank cannot slow growth by introducing new taxes and levies. They do not have that power. All they can really do is change the cost of borrowing and the return to saving – interest rates. They have only one true means of doing this beyond altering bank capital requirements (to which banks cannot respond in a timely manner), and that is using the official cash rate. Think of this as the cost to a bank of having to borrow overnight from the Reserve Bank with which they all hold accounts.

If the OCR goes up then the cost of being in debt to the Reserve Bank (which can only be a temporary thing, they do not fund banks) goes up. To reduce the chances that one will pay this rising rate banks will attempt to borrow more money from depositors and each other. That leads to rises in term and current deposit rates, and increases in bank bill rates.

Thus, even though we don't fund ourselves from the RB and don't actually pay much in terms of an OCR debit, changes in the OCR do influence bank borrowing costs.

The RB's intention when they raise the OCR is that bank cost of funding goes up and banks pass the higher costs onto borrowers. If because of a market share fight banks do not raise their lending rates then the OCR rise will have achieved nothing. There will have been no tightening of monetary policy. To get what it wants in terms of higher mortgage and business lending rates the RB will simply have to raise the OCR again.

As interest rates go up the cost to people of bringing their spending forward in time goes up. Some people choose to delay their spending. That is, you will put off buying a car, couch, TV, houses, trip etc. because the cost of doing so early has gone up. You will save up some extra money to fund your purchase. Thus, because interest rates represent the cost of shifting purchases through time, higher interest rates slow down the current and imminent rate of economic growth. As the pace of growth slows down the inflationary pressures become less intense than if growth had remained strong.

Ultimately, what the RB does now will influence inflation outcomes in about a year and a half's time.

Where will it end? Well, if people do what they did in the 2004-07 period and ignore rising interest rates for a long time then rates have to go very high to find the pain point. In 2007-08 that was a cash rate of 8.25% with floating mortgage rates almost at 11%. Why so high? One reason is that people avoided rising floating rates by hopping into longer and longer term fixed interest rates which were tending to stay low because they are influenced quite a bit by rate movements overseas rather than in New Zealand.

Another reason is that the RB Governor back then kept implying that interest rates would not go very high and might not stay high for very long. He was explicitly inviting people to not worry too much about their financing costs – so they didn't. In this way in the past tightening leg of the monetary policy cycle the Governor failed to use what is often a very powerful tool – influencing expectations. This time around the Governor has been warning for some time that rates will need to rise. He released a set of forecasts last week that not only imply at least another 2% going on the official cash rate and therefore floating mortgage rates from current levels, but failed to pencil in a picture of when rates will start falling. That is very sensible because there are so many uncertain factors one can find little justification for saying the peak will be in 2016 rather than 2017 or 2018.

So, young inexperienced borrower, this is what is going to happen to you over the next three years. You will first of all not pay too much attention to interest rates going up and will think that if rates keep going higher you will simply flick into a fixed interest rate. Yes you will, but you won't for the moment realise that by the time you do that the fixed interest rates will also be higher than they are now, and you'll still not have taken on board the lesson that fixed interest rates always rise well before floating rates do.

As interest rates rise, let's say when they have gone up by 1%, your concerns will be greater and you will start to pay attention to forecasts of how high they will go. You will start to cast around for understanding as to why rates are rising (and usually fail to intellectually grasp the reasons), and you'll start to pester people like me with your pet theory on what the RB could do differently. You will propose assisting manufacturers getting hit by rising interest rates and a rising currency with direct currency control. You will propose some sort of tax system rather than interest rate rises. You will blame the banks for lending too much, failing to look at the data showing lending growth to in fact be quite low. You probably won't get an email response.

Mainly though you will get increasingly indignant and fail to accept that the Reserve Bank will raise rates much further simply because you will already be feeling some pain and unable to understand what further rate rises will achieve. The lesson of history however is that the Reserve Bank will take interest rates to whatever level is necessary to keep inflation in check and if that means mortgage rates once again at 11% then so be it. That level is extremely unlikely this cycle but you should budget for 8.5%.

As pointed out for some time now, some of the factors driving growth and inflationary pressures this cycle are different from past cycles. Specifically, the pace of rebuilding of Christchurch will not be slowed down by rising financing costs. One suspects near the same for the period of house building catch-up in Auckland, near the same also for much of the growth in the dairy sector, same for the infrastructure drive, same for the migration surge.

This is set to be one of the most interesting tightening legs we economists have ever seen – and that is just here in New Zealand. Eventually in 2015 and 2016 as central banks overseas get their tightenings underway there will be equal fascination at how things go – though without the obvious stimulatory factors which we have.

What should you be doing about this coming period of rising rates, rising frustration, increasing clamouring for radical solutions which have no hope of being adopted let alone being effective, even were there a change in government? Get your debt down. Cut your spending on cafes, technology, travel etc. Hedge your risk with some debt floating, some fixed at potentially a range of terms. Nothing you do will stop your interest cost going up short of getting rid of the debt. If you fix now for five years at 7.2% you take the rate rise now. Note that floating rates will be at about that level in a year's time in all probability.

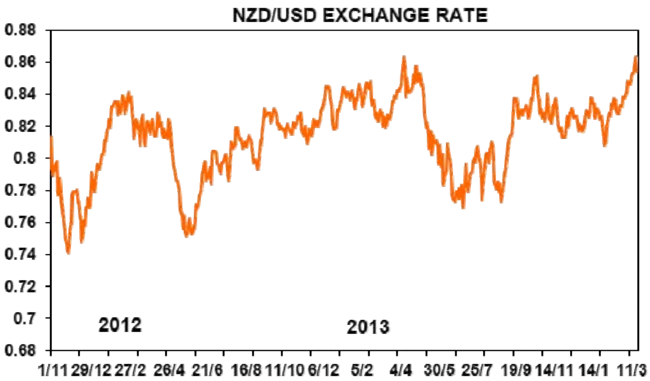
Good luck. You've recently had the benefit of a level of interest rates those of us who paid 18.5% for their floating rate mortgage when getting it in 1987 then 15.5% for a one year fixed rate only ever dreamed of. Plenty of people were paying over 20% for a while. Of course back then average houses prices were just over three times average household incomes versus over seven times now. Swings and roundabouts.

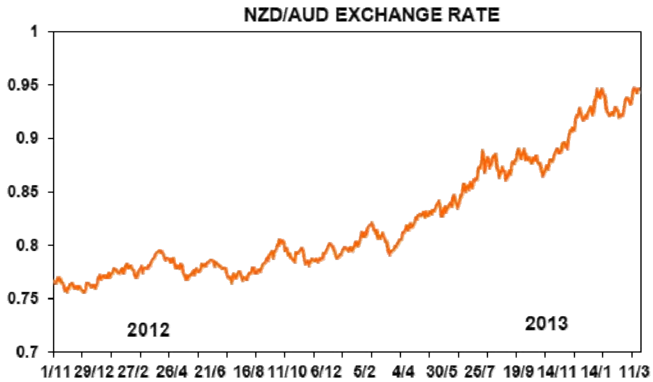
Were I borrowing currently I would fix three years at least.

FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.75%	2.75	2.50	2.50	2.50	4.9
90-day bank bill	3.06%	3.06	2.89	2.70	2.70	5.2
1 year swap	3.64%	3.57	3.53	3.36	2.80	5.3
3 year swap	4.37%	4.28	4.18	4.22	3.20	5.5
5 year swap	4.66%	4.63	4.59	4.73	3.56	5.7
7 year swap	4.86%	4.89	4.88	5.06	3.88	5.8

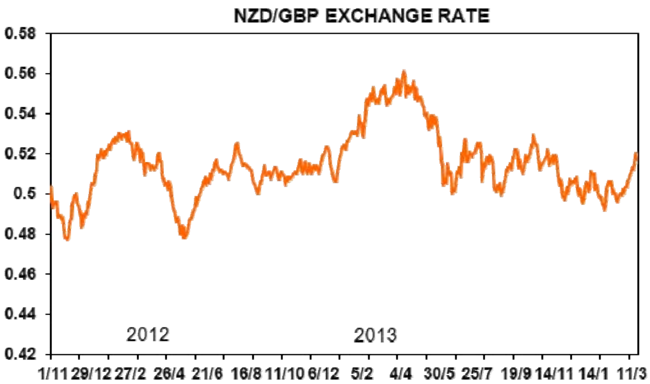
NZD Strong

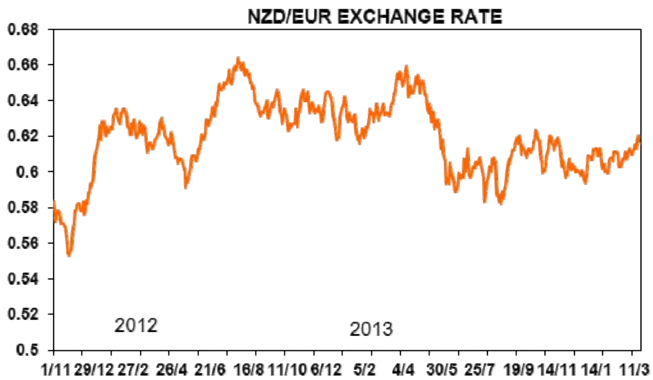
The NZD has ended today close to where it was a week ago. The Kiwi dollar has held up this week in spite of a 5.2% fall in average prices at the fortnightly dairy auction. Upward pressure on the NZD has come from a generalised lift in awareness of the monetary policy tightening cycle getting underway in NZ, a reduction in risk aversion following President Putin's statement that no further territory is to be claimed from Ukraine, and perhaps the announcement of direct trading commencing between the NZD and Chinese Yuan.



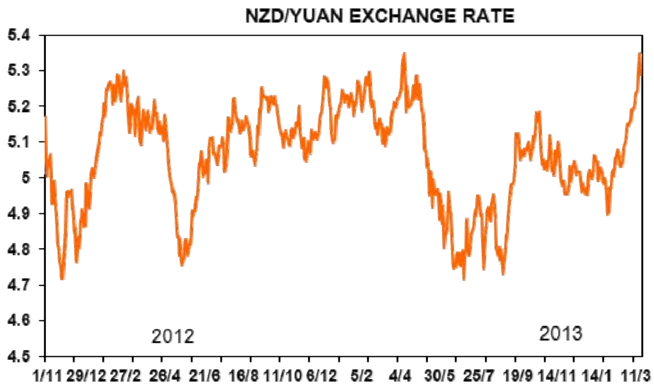


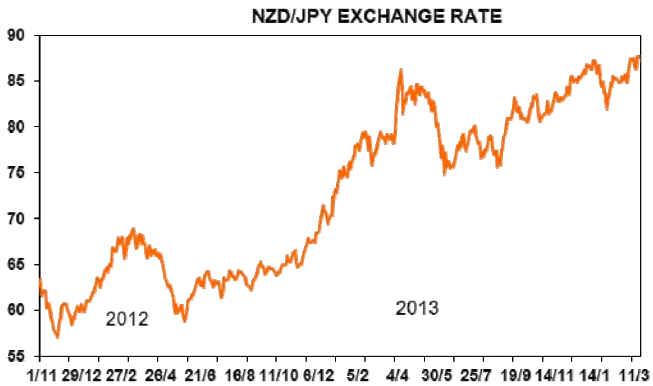
The greenback found strength last night after the regular Federal Open Market Committee released a set of forecasts showing expectations that the funds rate will rise from 0.25% currently to 1% at the end of 2015 and 2.25% at the end of 2016. In December these expectations were lower at 0.75% and 1.75% respectively. Expectations of monetary policy tightening in the US will add to greenback strength more and more over time and that is why the NZD looks unlikely to reach 90 cents, could be a good sell at levels near 88, and why we will probably drift lower against it over the second half of this year even as our interest rates rise further.





It's actually a bit hard to paint a picture of much large movement in the NZD/USD exchange rate given the competing factors in play. Against the British Pound additional upside beyond this week's run-up to 52 pence looks not highly likely given improving economic activity in the UK. Upside looks more possible against the Euro and definitely against the Yen while against the Aussie dollar a move to parity is unlikely given near complete erasure of market expectations that monetary policy will again be eased by the RBA.





Exchange Rates	This Week	Week ago	4 wks ago	3 Mths ago	Yr ago	10 yr Average
NZD/USD	0.854	0.852	0.828	0.817	0.824	0.726
NZD/AUD	0.946	0.947	0.92	0.923	0.795	0.839
NZD/JPY	87.6	87.5	84.8	85.2	78.2	72
NZD/GBP	0.517	0.512	0.496	0.499	0.545	0.423
NZD/EUR	0.617	0.613	0.603	0.598	0.639	0.545
NZDCNY	5.29	5.24	5.03	4.96	5.12	5.1
USD/JPY	102.58	102.70	102.42	104.28	94.90	99.3
GBP/USD	1.65	1.66	1.67	1.64	1.51	1.72
EUR/USD	1.38	1.39	1.37	1.37	1.29	1.33
AUD/USD	0.90	0.90	0.90	0.89	1.04	0.87
USD/RMB	6.1943	6.1456	6.0764	6.0713	6.2158	7.15

For more detailed FX analysis including the ‘BNZ Markets Outlook”, “BNZ Strategist” “BNZ Commodities Wrap” and lots more go here. https://research.bnz.co.nz/Research/NewZealand/Pages/NZpublications.aspx

Housing Market Update

Additional analysis and commentary are available fortnightly in the NZ Property Press and monthly in the NZ Property Investor magazine.

Not Much New

Apart from our BNZ-REINZ Residential Market Survey there has been little fresh information on the state of the housing market released this past week. All eight of our measures of market strength eased in March compared with February but still a net 31% of agents feel that prices are rising and a net 15% are seeing more investors in the market. But a net 44% say that they are seeing fewer first home buyers. On balance it is neither a seller’s nor a buyer’s market. The full report is here.
http://tonyalexander.co.nz/wp-content/uploads/2014/03/BNZ-REINZ-Survey-March-2014B.pdf

Things are starting to get a little more active in the field of worries about Chinese buying NZ houses. First it pays to note that across the ditch concerns have reached the point where the Federal Treasurer Joe Hockey has requested that the House of Representatives Economics Committee hold an investigation into whether Chinese buyers are pricing first home buyers out of home ownership.
http://www.dailytelegraph.com.au/news/nsw/fears-chinese-investors-are-pricing-firsthome-buyers-out-of-the-market-will-be-investigated-by-parliament/story-fni0cx12-1226855755918

A report by Credit Suisse estimates that 18% of new dwellings in Sydney, 14% in Melbourne and 7% in Brisbane are being bought by Chinese. The Quarterly Australian Residential Property Survey from National

Australia Bank shows that 6.5% of all sales of established houses nationwide in Australia are to foreigners while 11% of all new property sales go offshore. Given that almost all houses are established rather than new the Australian 6.5% is statistically the same as our 6.4%.
http://business.nab.com.au/quarterly-australian-residential-property-survey-q4-2013-5762/

That 6.4% is derived from the results of our March BNZ-REINZ Residential Market Survey released Monday this week. We again asked agents what proportion of their sales go to people located offshore. But this time we chopped the lowest percentage category of "Less Than 10%" down into
Zero %
0-5%
5-10%

This far better degree of disaggregation has given us a more accurate result. Gathering all three responses back into the Less Than 10% category would yield the result of 9.3% of dwelling sales to people offshore from 7.8% last May and 9.2% last March. From this we conclude that there is no upward, or downward, trend apparent in foreign buying of NZ property. However the proportion of properties sold offshore going to Chinese appears to have risen from 15% - 20% to 25%.

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