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

This week we are running our monthly BNZ Confidence Survey, so if you have not already done so in the email used for sending the Weekly Overview out please click on the link here and let us know how you see the economy and your own sector.

https://feedback.bnz.co.nz/surveys/Fi8Go-yFGEu0bwjPu5Waww

This Week's Learnings

Here is some stuff we have learnt over the past week, none of which changes our view that growth prospects are strong in New Zealand - but first a reminder. Even during booms some businesses will fail, and even during recessions some businesses will soar. That is because what ultimately determines the fate of companies is not whether the economy grows 1% or shrinks 1%, but the quality of management and their ability to anticipate and handle changing conditions be they for their markets, their inputs or their processes. Thus if you do an MBA the lecturer will not tell you that your success depends upon the economy, but teaches you that what you do will determine your company's outcomes.

For example, some timber companies are currently going under partly as a result of high log prices. Not all of them are. Some dairy farms went under in recent years, most didn't.

A quarterly global survey of 45 countries by Grant Thornton found that a net 88% of surveyed NZ businesses are optimistic about where the economy will be in a year, up from a net 74% last quarter. In other words, no evidence of a negative impact from anticipated or actual interest rate rises or a high Kiwi dollar. The global average reading was a net 44% optimistic from 27% last quarter. We stand out as being in a very optimistic frame of mind which bodes well for employment and wages growth, though the survey may not have captured many responses after the first cash rate rise in mid-March. Perhaps the ANZ Business Outlook does. It shows firms' own activity expectations easing to a still very high net 53% positive last month from 58% two months ago. But it also has employment expectations at a high net 30% positive, the same for investment intentions all good stuff basically.

Interestingly, an MYOB survey of 107 hospitality sector businesses found that only 27% plan raising their wages in the coming year. The article reporting this and other results took an optimistic line. Frankly that is an appallingly low percentage considering the strong jobs growth underway, rapidly falling unemployment rate, strong employment intentions, and inflation heading towards 3%. What I take from the survey is that most businesses have not budgeted for higher labour costs. They are probably in for a shock.

The number of consents issued for the construction of new dwellings rose by a seasonally adjusted 8.3% in March meaning that consents have risen by 28% in total over the past year. That places numbers just 6% above their ten year average so although growth in construction is strong we are not at boom levels. Worryingly for those hoping for a grand surge in house supply in Auckland the pace of growth is slowing down and at just under 6,500 the 12 month number of consents is still below the ten year average of 7,500.

Household debt grew by 0.4% seasonally adjusted in March to give an annual pace of growth of 5.6% compared with 4.4% a year earlier. In the six months before the LVR rules came into play household debt grew on average by 0.48% a month. Since then it has grown on average by 0.43% a month. So while there has been a huge reduction in the proportion of mortgage lending done with small deposits, from at times 25% to now near 5% of mortgage lending, total lending has been largely unaffected. So too have house prices. Using the REINZ house price index which adjusts for changes in the mix of houses sold from one month to another we see that in the six months before October house prices on average around New Zealand rose by 4% and in the six months since they have risen by 5%. Therefore while the Reserve Bank have achieved their goal of reducing bank vulnerability to a house price shock, they have failed to slow house price inflation.

Labour's Monetary Policy Proposal

This week the Labour Party Finance spokesman David Parker announced some proposed changes to monetary policy should Labour help form the next government. For your guide, various changes have been made since 1989 but they all add up to about zero when it comes to altering monetary policy behaviour and the extent of interest rate movements over their cycle. A far bigger determinant of how monetary policy implementation changes over time than the little changes made since 1989 and those now proposed is the preference of the Governor. The previous Governor explicitly targeted inflation just below 3% and in doing so ensured interest rates went a lot higher in 2007 and 2008 than if the current Governor had been in the job. Mr Wheeler explicitly aims for 2% therefore will move earlier and perhaps more forcefully initially in the cycle than Mr Bollard did.

Keeping that in mind then let us consider Labour's policy. Labour would broaden the target of monetary policy to include trying to get the external accounts in balance over the economic cycle. That is fairly meaningless and can be ignored just as previous additions of words such as "avoiding unnecessary volatility in interest rates, the exchange rate and output..." had basically no impact on policy implementation.

More significantly Labour propose giving the Reserve Bank a new tool, specifically the ability to alter contributions to Kiwisaver accounts as a means of influencing the pace of household spending growth, therefore economic growth and therefore inflation. They hope that use of this tool would mean less reliance upon interest rates and therefore less upward pressure on the exchange rate and perhaps even a small structural decline on the theory that a higher average level of contributions to Kiwisaver would lead to a reduced average level of interest rates.

There are many implications of Labour's policy.

- Long tern Kiwisaver returns will be reduced as savers are forced to buy more shares when prices are high and fewer when they are low.
- Volatility in the sharemarket will rise.
- Investors will have extra incentive to purchase residential property, thus pushing house prices higher.
- Overseas debt will tend to be boosted.
- Bank profits will rise.

In more detail......

First, it is completely experimental. We have no information on how consumer borrowing and spending or business pricing behaviour will change in response to a change in Kiwisaver contributions. Therefore the Reserve Bank would not be able to place much reliance on this policy in the early stages. However one can counter this criticism by noting that the loan to value rules are experimental as well and yet they have been implemented by the RB with a view that they will supplant 0.5% worth of interest rate rises. In addition we have long described this entire post-GFC monetary policy period as a huge experiment here and overseas because we do not know how behaviour has changed in response to interest rate changes since the GFC.

Second, whereas higher interest rates act as a tax on borrowers and take away funds which they will never get back, that would not be the case with an increase in one's Kiwisaver contribution. You will eventually get the money back when you reach 65. Knowing that, there is a risk that tightening monetary policy by altering contributions could have very little impact on willingness to spend. In fact as you see yourself saving more you might simply pay off the mortgage at a slower pace, or if you are already an investor you may simply save less in other areas.

In fact the policy as proposed would probably act as an incentive to raise one's debt level thus boosting New Zealand's external debt rather than lowering it as Labour would like. Why? Because the explicit reduction in the heights to which interest rates would go over the monetary policy cycle means the income shock from that tightening would be less. Borrowing money would become safer as interest rate variability would be reduced and the incentive to fix one's mortgage interest rate reduced.

Thus while some of the commentary from Labour and others has been negative toward banks, their proposed monetary policy would actually boost bank profits because more people would stay on floating rates than going fixed and bank margins are greater on the former than the latter. In addition because people would borrow more money bank business and profits will be boosted. Plus earnings from managing the larger Kiwisaver accounts would be greater.

Now look at this from a portfolio investment point of view. The policy would boost Kiwisaver contributions when the economy was booming and presumably asset prices like shares rising firmly and at high levels. The tightening of monetary policy would lead to more asset buying out of the contributions and this would amplify the equity price cycle while forcing people to buy more when equity prices are high. Then when the economy is weak and Kiwisaver contributions get cut people would be buying fewer shares thus amplifying the falls in share prices while seeing people buy fewer long term assets when their prices were low. Thus Labour's policy would achieve exactly the opposite of what is recommended for long term savers with regard to purchasing equities, namely steady monetary value purchases through the economic cycle or even boosting purchases when prices are cyclically low rather than running with the herd and contributing to boom then bust asset price cycles.

The policy would also tend to boost house prices because the risk of having a large mortgage posed by the potential for high interest rates would be reduced. Additionally, because of lower average borrowing costs and because of reduced returns on the likes of term deposits plus the increased volatility in share prices we would expect to see more investors divert toward residential property. This would again tend to boost house prices, reduce home affordability, and again bias the housing market against young buyers.

In my conversations about this policy with the media on Tuesday efforts were made to get me to say that it was bad because if would have a particularly negative impact on low income earners. If one buys into that then it becomes an argument for excluding them from Kiwisaver in the first place which makes little sense.

The policy as proposed by Labour is a valiant attempt to mitigate the impact on exporters of the monetary policy tightening cycle and they should not be criticised for trying to make a positive contribution to our economic growth in this way. But the policy is not backed by any research as to how it would work and how effective it would be, and if Labour were to defy the polls and hold power after September 20's general election, implementation would likely be a long way off. The bastardisation of the generally popular Kiwisaver scheme also does not seem an optimal route to take.

Unfortunately one must make the same comment regarding another aspect of Labour's inflation control policy which is to consider reducing migration when house prices are rising strongly. This sounds like a good idea, but this is why we economists spend years at university. We learn that if you base policy on one obvious relationship between two variables you will probably make your macroeconomy worse because you are missing all the other linkages. To whit.... if you cut immigration when your economy is strong you risk boosting inflation overall because you will reduce labour supply and push wages higher. Reduced house construction in particular will push house prices higher and work to offset the price effect of decelerated population growth.

And is it migration which has been pushing Auckland house prices in particular higher? Not at all. Auckland house prices rose by 38% between January 2009 and July last year. It was in July that the net annual migration flow for NZ rose above the ten year average of 10,000 people on its way to the latest reading near 32,000. Thus prices soared during a period of below average migration gains.

What Auckland needs is more houses and for that it needs more of lots of things including land and builders. Restricting immigration may have the opposite effect to what Labour intend. So again, good on them for showing a willingness to look for solutions to their identified problems. But just as subsuming Kiwisaver's focus on building retirement savings over the long term to the dictates of monetary policy under the control of the Reserve Bank is a bad idea, so too is making migration policy a slave to the monetary policy cycle.

Also, if one were a spokesman on matters economic then it would probably not be a good idea to suggest one has low understanding of how monetary policy works by saying low inflation in the most recent quarter means no need for any change in interest rates. Monetary policy looks forward and cannot affect what has already happened - though with a time machine as proposed by Mr Wells one might give it a go. Monetary policy changes now affect inflation a year and a half down the track. Full marks for seeking solutions, but deep research into policy effectiveness is required.

I figured out how to keep my tables in place using Pages. Now if only Numbers were a lot more user friendly. I have thought about Office 365 but do not have decent broadband where I work (from home) and don't want to commit to ongoing payments for access.

IF I WERE A BORROWER WHAT WOULD I DO?

How long might it take before we get some good insight into the impact which rising interest rates are having? Certainly not yet I theorise because many new borrowers and probably quite a few of the older ones with short memories have not yet been presented with anything particularly worrying. That is, half a percent more on one's floating mortgage rate is not really here nor there. But add 1% and then more importantly get people starting to wonder where rates may go to and then we may start to see some decent changes in spending and borrowing behaviour.

This is why the Reserve Bank will almost certainly, though not definitely, raise the official cash rate by another 0.25% again in June and then July. Then they are likely to pause, but given the high probability that the exchange rate is still above levels which they have assumed in their economic and inflation forecasts, many forecasters could easily be pulling back on their forecasts of where rates go to.

So the risk is that we don't really see any decent impact on economic activity until very late this year. After the general election on September 20. Heading into that election the unemployment rate will be falling, wages growth will be picking up, house prices will be higher with rises in Auckland and Christchurch spreading out to other parts of the country. The currency will likely still be high meaning people will continue to find holidaying overseas to be relatively cheap

It all adds up to an environment in which although borrowing costs will be rising lots of positive things will be happening.

	OCR	90 day bb	1 year swap	2 year	3 year	4 year	5 year	7 year
This week	3.00	3.37	3.68	4.03	4.28	4.44	4.55	4.74
Last week	3.00	3.33	3.7	4.08	4.33	4.5	4.63	4.82
4 weeks ago	2.75	3.13	3.72	4.16	4.44	4.61	4.74	4.96
3 months ago	2.50	2.94	3.52	3.91	4.21	4.42	4.61	4.88
1 year ago	2.50	2.66	2.75	2.89	3.05	3.19	3.33	3.59

NZD Holds Strong

The NZD initially eased slightly this past week, not really in response to anything happening locally, but more in a general backing off from risky assets around the world in response to concern about the situation in Ukraine. However the extent of the easing was mitigated by better than expected monthly trade data released on Tuesday reminding everyone that NZ's export performance remains strong. Then last night there was a general movement away from the USD following data showing annualised GDP growth during the March quarter of only 0.1% and not the 1.2% which had been expected - with the low expectations attributable to the effects of a particularly harsh winter.

The NZD remains very well supported by the strong NZ economy and is going to remain strong for a long period of time.

	NZD vs. USD	AUD	JPY	GBP	EUR
This week	0.861	0.926	88	0.51	0.621
Last week	0.861	0.927	88.3	0.513	0.623
4 weeks ago	0.867	0.935	89.5	0.52	0.629
3 months ago	0.808	0.924	82.7	0.492	0.599
1 year ago	0.848	0.829	82.4	0.546	0.644

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

A Reminder

Back in the Weekly Overview of November 1 2012 I published a list of 19 reasons why house prices in Auckland would keep rising. Since then average prices have increased by 16%. For your guide here is the list.

Auckland House Prices Will Keep Rising

Regular readers of the Weekly Overview will know that I have had a vastly less negative view on the NZ housing market than most other commentators over the past few years with one of my key points being that shortage of supply would limit price declines over 2008-09. Now here is a list of 19 reasons why prices in Auckland in particular are going to keep rising. Enjoy, or despair, depending upon whether you own or wish to own Auckland property. And ask yourself – where does the greater number of votes lie? With those wanting to get their foot on the ladder, or with those who already own property? Hence no big legislative changes. As the Americans say, turkeys don't vote for an early Thanksgiving.

1. Auckland did not enter the 2008 recession then late-2008 into 2009 global financial crisis with an over-supply of property. Shortages of personnel constrained house construction from 2004 through 2008.

2. The shortage has become worse in the past four years and last year annual consent numbers were at a four decade low. (**Latest data show annual consent numbers of 6,477 still below the two decade average of 7,500.)**

3. The government is explicitly aiming to grow Auckland's population as a means of achieving "agglomeration" benefits for economic growth which accrue from high interaction amongst economic players.

4. Despite the biggest global financial crisis since the 1930s NZ house prices only fell 11% at their worst and now sit on average above 2007 levels.

5. Removing the ability to use LAQCs to offset housing investment losses against other income has produced no flood of properties onto the market.

6. Removing the ability for property investors to deduct depreciation expense has not produced any flood of property onto the market.

7. Over the past four years young people have put off their normal household formation (leaving home, buying their own house) because of worries about mortgage availability, falling house prices, employment, and ability to raise a deposit. Now those four years worth of people are entering the market and looking to "catch-up" on their purchase. (**But this effect has been reversed by the LVR rules)**

8. Construction standards in New Zealand are always rising (watertightness, earthquake strength, energy efficiency) and this boosts construction costs.

9. A big fall in apprentice numbers in the past five years coupled with the loss of skilled people to Australia and older tradespeople leaving the sector rather than get licensed means labour-related construction costs will rise and labour will not be available to build houses even were more land available.

10. Banks are not going to step back into the property development sector left bereft of funds from the closure of finance companies.

11. Poor growth prospects in the next few years for Western economies mean their and our interest rates will remain at low levels for many years. This means low borrowing costs for home buyers. (**But these costs are steadily rising now)**

12. Low returns on bank deposits mean older savers in particular will be seeking extra yield through investment in residential property either directly or through a yet to appear wave of property investment vehicles. (Be in no doubt. They will come.)

13. The migration cycle appears to be on the cusp of turning and if the housing market has performed so well with net outflows over 3,000 in the past year the implications of positive gains are clear. (**Called that one big time and the net migration gain is soaring so far to 32,000 for the year and maybe headed now for 40,000)**

14. The nature of net inward migration is changing toward greater numbers of people coming from Asia and with Asia's middle class booming in size potential inflows of wealthier people are large. (**No, the boom is of Kiwis not leaving for Australia and lots coming back from there, but there is a steadily rising trend up in numbers coming from the likes of China)**

15. The NZ unemployment rate of 6.8% is likely to fall quite quickly over 2013 as the construction sector booms on the back of the rebuilding of Christchurch. (**The rate is now 6% and still looking like it will fall fairly quickly.)**

16. The aging population will produce a decrease in the average house occupancy rate and therefore a need for more houses for any given population size. People will retain their old homes with many bedrooms to allow visits by grandchildren, gyms, home offices, home cinemas etc.

17. The government has announced its efforts to improve housing affordability (lower prices) and they are minor and unlikely to have a noticeable impact if any for many years.

18. Any credibility people may have assigned to those who have been predicting big price declines simply because prices have risen a long way and now fallen sharply in some other countries has gone out the window. Few people will now listen to their price decline views.

19. Members of the Opposition believe monetary fairies can make the exchange rate settle permanently lower by forcing interest rate cuts and printing money while letting inflation therefore go up. Given the non-zero possibility that such economically ignorant policies get introduced it is worth getting inflation protection by investing more in property – not less.

So compared with when this list was produced we have two new negatives of rising interest rates and the LVR rules, but a migration boom. That implies a slower pace of house price gains but certainly not a reversal or even a plateauing.

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