

# BNZ 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.

## Twists and Turns

**This will be the last Weekly Overview for 2014. The next one will appear in late-January. Merry Christmas everyone and have a Happy New Year.**

The biggest piece of news in the field of economics this week was the 321,000 rise in employment in the United States during November. This strong gain was well above expectations of a 220,000 rise and means jobs growth for the whole year could end up being the best in 13 years. There were also signs of good improvement in hours worked and wages and this means it is reasonable to have an outlook for good growth in consumer spending in the coming year and on the back of that enhanced willingness of businesses to undertake investment – and hire even more people.

Contrast this with the still deteriorating situation in Europe and one understands why very early in the days of the Global Financial Crisis we spoke in terms of the US being hit hard but it's brand of capitalism setting the scene for a good rebound as inefficient firms and those on their last legs got weeded out quickly. In contrast in Europe the laggards rule just about everything, some countries ban mass redundancies or laying off of public servants, and each EU member wants the others to adjust their spending and way of thinking to accord better with their own personal way of life and culture. Dysfunctional.

Unsurprisingly the good jobs result pushed the USD upward to over a seven year high against the Japan Yen above 121, and a two year low for the Euro against the dollar under \$1.23. The NZD fell below US77 cents for a while but is now back above 78 cents. Sharemarkets got another boost before weakening on Europe worries, and medium to long-term interest rates moved slightly higher amidst enhanced expectations that the Federal Reserve will look to raise interest rates next year – perhaps in the first half. Then they too fell on Europe worries.

The US is in good shape and the rest are getting worse. European growth forecasts have been revised downward and new data show Japan's economy shrinking at a 1.9% annualised rate in the September quarter rather than the initial estimate of 1.6%. In Greece the Prime Minister has called a snap Presidential election this month and if no-one wins then a general election will be needed and this might see the radical left-wing Syriza Party gain power – in which case all bets regarding Greece's willingness to man up and meet modern economic norms rather than wallow in their bloated public service tax dodging ways are off the table. There is understandably talk again of Greece leaving the Euro which makes a lot of sense as they are not fit to be in it.

Speaking of talk, not many people these days speak in terms of the US dollar losing its top role in the global financial system. Even fewer – of the usually same people – speak about peak oil. Not with the oil price down 40% so far this year and still falling. Y2K anyone? Malthusian starving?

The second very important economic development this week was Fonterra's revision to their forecast payout this season ending in May 2015 to \$4.70 from \$5.30. Last season's payout was \$8.40 per kilogram of milk solids and the five year average is \$6.20. The sharp decline reflects a near 50% fall in wholesale dairy prices driven by a combination of increased NZ production following a drought season, less than expected growth in global demand, a run-down of high inventories in China, and excess product floating around because of sanctions placed on Russia.

The payout decline will take over \$6bn of dairy farm revenue out of a \$230bn economy thus on the face of it represents a near 3% hit to GDP. The actual impact will be a lot less than that. Firstly, the sharp jump in payout last season to \$8.40 from \$6.16 over 2012/13 did not produce a sharp soaring of spending by dairy farmers on everything on offer in retail stores. Farmers instead concentrated on repaying debt. Thus the (extra) reversal of that jump will not cause a collapse in rural retail spending though there will definitely be an impact.

In addition, a positive long-term outlook for rising demand in China remains so it is highly likely that investment focussed on boosting and processing milk production will continue, including conversions, bigger dairy factories, irrigation schemes, R&D etc. Also, financing costs are currently low.

The third event of significance this week was this morning's regular review of the official cash rate by the Reserve Bank. As was near universally expected they left the rate at the 3.5% it was taken to back in July having been 2.5% at the start of March. But they maintained a tightening bias which surprised a few optimists and that pushed the NZD up 1.5 cents against the greenback and to 94 Aussie cents.

Since they started raising the cash rate things have changed quite substantially on the inflation risk front. Global commodity prices have fallen away, most notably oil, so our petrol prices are now down 10% to under \$2 a litre for 91 octane. Deflation is (the latest) concern in Europe with the inflation rate only 0.3% and well away from the ECB's 2% target. The Kiwi dollar has held up very well – as we expected on the basis of much of the rest of the world except the United States looking like rubbish. There remains zero statistical evidence of any acceleration in the pace of wages growth in New Zealand and instead some evidence of a slowing. Inflation measures in the various surveys remain well under control with some easing recently.

Thus there is unlikely to be a rate rise from the RBNZ for a long time. Will they cut the cash rate soon? Even though the usual exporter groupings want this to happen (have they ever lobbied for rate rises to suppress inflationary pressures?) it is unlikely. As repeatedly noted there is a housing shortage in our two biggest cities and price pressure remains upward with assistance from still-rising net inward migration plus a sharp reduction in worries about borrowing costs and investors newly seeking better yielding assets. The pace of economic growth is also above average and theory plus experience tells us this eventually raises the rate of inflation. How long that will take however is anyone's guess in a post-GFC world where lags between economic events appear to be a lot more stretched out than before.

Note also the slight increase in discussion recently about Chinese buying of NZ houses. My point there remains the same as it has been for the past couple of years. The current level of Chinese buying of NZ houses is undoubtedly quite low and not a key driver of house prices. But demand will rise over time and eventually become a major source of discontent which will then elicit a policy response which the government now does not wish to undertake. When that happens our export dependence upon China will be probably closer to Australia's current 35% than our current 23% and we risk a backlash from China for this insult. Faced with this apparent bullying we will opt for tighter buying controls just as we went nuclear-free and suffered the American response, and the economy will undergo a period of suffering. I have no idea when this will happen. It is positive however that the government has let slip that officials are at last looking at whether a register of who owns what in New Zealand can be set up.

Of course there a lot of other important things happening out there rather than just these few items. The biggest one is the collapse in oil prices by what could add up soon to near 50%, with West Texas Intermediate pricing now widely expected to settle near US\$60 in response to burgeoning shale supply and the OPEC decision not to cut output. Lower oil prices will benefit our economy as we are a net energy importer. Other economies such as Venezuela and Nigeria may be brought to their knees while Russia and Iran will have their deepening suffering aggravated.

There is a growing view that the oil price change will last for quite some time and have potentially major geo-political and economic implications, not to mention aggravating global warming contribution from greenhouse gases as burning fuel becomes relatively less expensive.

The other major thing happening out there is a strengthening US dollar which will hit emerging countries as companies with debts denominated in USDs face a blowout in their servicing costs and import costs soar, stoking inflation.

2015 is lining up as a year of huge uncertainties with weakening strength of the global financial system due to the shocks which will hit a huge variety of system participants. Be prepared for high volatility.

### Auckland, London Again

During the week I received an email from a person who said they wanted to run an exercise of what things would look like if Auckland were a separate country. I am not going to do that as it is a waste of time along the lines of the old “cut the cable” campaigns in Christchurch back in the ‘70s. They wrote “I was thinking a passing thought, Auckland looking like a net drain on NZ.” And so on. That comment shows why I am calling Auckland our London. People still think Auckland is just a bigger version of Wanganui and as such suffers from having to have a lot of infrastructure invested in it and therefore things would be better if people just shifted to a smaller place to use the existing infrastructure.

But Auckland (London) is New Zealand’s agglomeration. It is where the highest number of nodes exists therefore the best neural network is in place for generating and following through on ideas. Engineers mingle with capitalists, administrators, scientists and so on. This type of dynamic works best with more nodes – people. This is why all effort needs to be made to boost the number of people and businesses associated also with a key node in our South Island London – Christchurch, the EPIC Innovation Centre.

Auckland is generally where returning Kiwis with their deep knowledge bases and connections move back to, and where we have the best chance of retaining them given that returning to anywhere in New Zealand from London in particular involves working for less pay with sharp reductions in cultural activities and sometimes miniscule awareness by workmates of what is happening internationally and what it means. Repats often shoot back “where they came from” after 18 months or hop across to Australia or maybe increasingly vibrant Asia.

The idea that Auckland is a great sinking weight on the rest of New Zealand reflects a failure by people to grasp how modern economies work, the speed with which they need to work in the technology area, the high need for strong connectivity with overseas nodes (people, technology and research centres etc.), and the idea that Auckland is simply a big typical Kiwi rural town.

Outside of Auckland planners need to quit thinking negatively about Auckland and the way one-third of Kiwis want to live there and instead work on linking their region into Auckland’s growth perhaps by locating a key connecting-type person in Auckland to represent their region and its businesses.

### If I Were A Borrower What Would I Do?

Same comment as for over four years now. I would not develop an interest rate risk hedging strategy based upon a particular set of interest rate forecasts proving correct. Not a single soul can stick their hand up and say that they have got it right picking interest rate movements for not just the past year, or four years, but since 2007. I would try to spread my risk by seeking a mix of floating and fixed rates but would opt currently for a good weighting toward the three to five year area on the basis that bank funding costs have recently fallen, their disappointment about continued low lending growth has spurred extra competition, and that competition has shifted this year from the short end of the mortgage yield curve to the mid and longer sections.

## BNZ WEEKLY OVERVIEW

	<b>This week</b>	<b>Week ago</b>	<b>4 wks ago</b>	<b>3 mths ago</b>	<b>Year ago</b>
Official Cash Rate	3.50	3.50	3.50	3.50	2.50
90-day bank bill	3.69	3.69	3.72	3.74	2.73
1 year swap	3.79	3.78	3.84	3.90	3.27
2 year swap	3.90	3.91	3.99	4.10	3.75
3 year swap	3.98	4.00	4.13	4.25	4.14
4 year swap	4.03	4.07	4.21	4.37	4.41
5 year swap	4.13	4.15	4.29	4.46	4.65
7 year swap	4.24	4.25	4.40	4.59	4.98
10 year swap	4.33	4.37	4.55	4.72	5.26

Just briefly on the state of the housing market. My view has long been one of rising prices driven by shortages in Auckland and Christchurch, strong net immigration, investors seeking yield, and more recently borrowers facing low financing costs. Plus now and then I have tossed in growing awareness of shortages driving more investors to buy, plus a rising tide of young frustrated buyers building deposits and eager also to buy once they fit around LVR restrictions.

Data out this week from the REINZ give me no reason for changing that view – and no the fall in the dairy payout does not worsen the house price outlook. As I pointed out a few months ago, the worse dairying looks the lower the inflation and interest rate outlook, hence the better the housing markets in Auckland and Christchurch at least. Not so much maybe in more rural locations.

In November the average house sales price adjusted for quality changes rose by 3.3% after rising 1.4% in October. The three month nationwide change has accelerated to a pace of 2.7% from -1.2% three months ago. The three month change for Auckland is 4.2% from 1.4%, Christchurch 1.8% from 0.7%, Wellington 4% from -4.7%, the rest of the North Island 1% from -0.1%, and the rest of the South Island 1% from 0.3%.

Sales were ahead 6.5% in November from a year ago and in rough seasonally adjusted terms were up 1% after gaining near 10% in October.

The numbers will not please the Reserve Bank and as previously noted, the chances of any decent relaxation to the LVR rules happening in the coming year are very, very low. In fact watch for further rules to appear, targeted at investors.

And finally, here is a run-through of some key themes and things to keep in mind for 2015 and beyond. The list is not exhaustive.

- The pace of growth in NZ's economy will remain firm with falling unemployment, a slight eventual lift in wages growth, but still low inflation as falling dairy incomes and potential El Nino hit are offset by strong construction, rising wealth in house prices, and strong net immigration.
- The Kiwi dollar will fall against the greenback but stay strong against everything else and potentially rise against the Aussie dollar as economies overseas look in risky shape, apart from the US, UK not too bad either.
- Japan and Europe will increasingly be written about in terms of going down global economic ladders with dysfunction in the latter leading to rising talk of Euro breakup and members leaving the EU, and rising militarism in the former with talk of a debt market collapse as credit ratings get cut further.
- China's growth will slow and there is a risk of financial disturbance.
- There is a high risk of global shocks from sources such as potential new default in Greece, the difficulty Chinese authorities will have offsetting slowing growth against financial problems, changed long-term views and market positioning on Japan and Europe.
- Whatever interest rate forecasts you are reading at the moment will be changed. The chances are that although the next move in NZ interest rates will still be upward, that move may not happen for a long, long, long time – if at all.

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- House prices will continue to rise in Auckland and Christchurch due to the simple economics of shortages existing, strong immigration, low borrowing costs, low alternative returns, and changing view on the nature of our two cities.
- The Reserve Bank won't much change LVRs if at all.
- On the policy front there will be more debate about the growing divide between our two Londons and the regions, the existing and worsening housing crisis in Auckland and the effects it will have on social divisions.
- More disruptive technologies like Uber will appear, and someone will find and market something like Smiley Cat and it will make income exceeding Grumpy Cat's US\$130mn.
- Oil prices will probably stay low (not that anyone forecast the recent sharp decline) as Saudi Arabia keeps production up to pressure Iran and US shale oil producers. Yes, OPEC is still relevant to oil prices.
- There will probably be some new global health threat like Ebola, Bird Flu, SARs.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. 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 sign up at [www.tonyalexander.co.nz](http://www.tonyalexander.co.nz) To change your address or unsubscribe please click the link at the bottom of your email. [Tony.alexander@bnz.co.nz](mailto:Tony.alexander@bnz.co.nz)

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