

# NZ Observer

ISSN 2422-8672

## Mission Statement

To assist Kiwi SMEs in planning for their likely upcoming operating environment by discussing the economy and its implications in a language they can understand.

Welcome to the first issue of the NZ Observer – a replacement with monthly frequency for the previous Weekly Overview, but with a change in focus. The Weekly Overview was a catch-all document with special emphasis on the housing market, comments on most NZ data releases in the preceding week, and discussion on ups and downs in interest rate and exchange rate markets though with decreasing emphasis on these areas over time. It derived in 1998, like essentially all other economics newsletters out there, from a financial markets perspective with an initial primary audience of large money movers.

The NZO in contrast is aimed squarely at NZ SMEs as input into monthly or quarterly planning sessions regarding the likely operating environment an SME will face over the next 1 – 5 years and how the business might adjust itself to allow for that likely environment. The NZO is not intended for an audience of investors, nor large corporate businesses, nor managed funds, nor traders of financial assets. It is aimed at the near 147,000 SMEs in New Zealand, (there were 150,000 before the GFC) of which some 135,000 are Small with fewer than 20 employees, and 12,000 are Medium with between 20 and 99 employees. Together they account for 53% of NZ employment.

Lets start with what must be the over-riding theme for SMEs thinking that they can develop a strategic or operational plan which will allow them to comfortably profit from the expected operating environment. It can't be done. The reason is that there is no chance that anyone, be they futurist, economist, battle-worn entrepreneur, highest level connected politician, or policy maker, can accurately pick what the world will throw at us in the next five years, three years, one year, or frankly even one month. Think of all the tens if not hundreds of billions of dollars of investment in energy projects now deemed a waste of time because of the unpredicted collapse in oil prices. Think of the near universal forecast at the start of 2014 that accelerating US economic growth would push US bond yields higher. Their ten year government bond yield started the year at 2.8%. It finished at 1.9%.

The list goes on. The future hasn't happened yet. So how can you profess to know what it will be? Does this mean that the very idea of planning for the future is pointless? Definitely not. You may not have the foggiest idea at 16 years of age who you will partner up with. But you primp and preen regardless. You put yourself in a position socially where you maximise your chances of finding someone as a mate (and statistics tell us you'll still fail eventually), you learn techniques and rules to better your chances, and you learn how to recover as you struggle and fail for sometimes many years before finding your true one – or you settle.

The point is, you rearrange yourself, what you do and how you do it to maximise your chances of profit in an uncertain world. That is what strategic planning is about. Flexibility and learning. You have your area of expertise. We will outline the likely environment you will operate in, and will seek to update our outlook as facts and likely facts change. We will attempt to dissuade you from what we think are quite unreasonable expectations for what the future will bring. Success of your business will then depend upon not relying on unreasonable scenarios, gearing toward what will probably happen, and adjusting quickly as facts and expected facts on the ground change.

Let us start then by outlining at the highest level, what we think the economic environment will look like over the next five years. Hopefully next month we will write the same stuff here. Post-GFC history tells us we won't.

## What Lies Ahead?

New Zealand's economy has grown well over the past four years with growth averaging 2.1% and 2.9% growth achieved in the year to September. Better success is seen in the employment statistics with job numbers ahead 221,000 since 2009 and up 3.5% last year with full-time employment ahead 3.8%. Median household incomes have risen on average 2.9% per annum the past five years with growth of 4.7% last year and 4.1% the year before that.

Drivers behind the growth have been the construction sector, a surge in dairy production and investment, ongoing growth in the services sector such as computer systems design, growth in healthcare, early childcare and education, and public administration. Manufacturing has however continued its secular decline, there is no acceleration in the pace of wages growth, and growth has been concentrated in our two biggest cities with the rest of the country not faring so well.

The most recent economic numbers show a lift in the pace of activity since the general election in September. House sales were ahead 11% in the three months to January from a year earlier, with Waikato/Bay of Plenty up 22%, Wellington 16%, Southland 13%, Nelson 14%, and Auckland 11%. The annualised pace of price gains has lifted, most notably to 18% in Auckland but much less elsewhere in most instances.

Consumer confidence has risen along with business sentiment, employment and investment intentions have not lifted but they do remain at well above average levels. Non-residential construction consent issuance has lifted firmly, and tourism inflows have improved.

So what lies ahead from now? First it pays to note that post-GFC a lot of things have changed and these changes have rendered fairly much all economic models unreliable as they are based on how things were before the crisis. In particular, consumers are more price sensitive than before, they feel less job security, everyone is more debt sensitive, businesses outside oligopolistic sectors lack pricing power, interest rates are structurally lower, central banks are becoming more interventionist, inequality of wealth has risen along with concerns about child poverty, income inequality and access to employment (overseas), and so on.

Plus our economy is experiencing at least six shocks, the effects of which we are just taking stabs at. These shocks are

-A near \$7bn fall in dairy incomes this season.

-Drought

+A migration boom

+A 20% shock fall in petrol prices.

+A sharp change in interest rate expectations – downward.

+A renewed surge in Auckland house prices as the shortage we have noted for over half a decade goes further and further to the front minds of people. Plus lots of demographic changes are underway which we will write about somewhere else this issue or in a later one.

Being shocks we can only guess at their duration and what their effects will be. But in some cases such as investors searching for long-term yield they could be profound.

Here are the factors we expect to underpin growth over the next two years at least.

- Catch-up house construction in Auckland
- Catch-up infrastructure investment in Auckland
- Reconstruction in Christchurch
- Leaky building remediation, largely in Auckland
- Earthquake strengthening of buildings around the country
- Strong population growth courtesy of above average net migration inflows

- The structural decline in interest rate expectations boosting investment, durables spending, debt tolerance.
- The probable structural fall in petrol price expectations freeing up spending but curtailing investment in the energy sector – both oil and gas as well as green technologies.
- Investment in farm irrigation schemes
- Continued dairy sector expansion though at a slower pace than before

These factors will act to restrain growth from getting much above 3.5%.

- A near \$7bn fall in dairy incomes this season
- Drought in some parts of the country
- A firm NZ dollar against the currencies of Japan, Australia, and the Eurozone.
- Continued loan to value ration restrictions and a high chance of further restrictions being imposed
- A continuation of the secular decline in the manufacturing sector
- Labour shortages – already apparent in a number of sectors

Bringing together these factors and many others including the world growth environment which we have not discussed this month, we get the following outlook.

### Key Forecasts

Calendar Years	2012	2013	2014	2015	2016
GDP	2.4	2.2	3.2	3.1	1.8
Inflation	0.9	1.6	0.8	0.6	2.3
Employment Growth	0.4	3.0	3.5	2.7	1.3
Unemployment Rate	6.8	6.0	5.7	5.7	6.3
NZD/USD	0.83	0.82	0.78	0.70	0.66
NZD/AUD	0.79	0.92	0.94	0.95	0.88
NZD/GBP	0.52	0.50	0.50	0.49	0.47
NZD/EUR	0.63	0.60	0.63	0.65	0.61
NZD/JPY	69.5	89.1	92.6	86.1	82.5
90-day bank bill rate	2.6	2.7	3.7	3.8	4.5

The main point to note is an anticipated easing in the pace of growth next calendar year as the pace of growth in construction, employment, and household spending eases off. In broad terms we can outline the following implications.

### NZD

The NZD will in general ease away, but the risk is that it will be well supported against the Aussie dollar, Japanese Yen, Euro and to a lesser extent the British Pound by high relative interest rates, a good economic story, and woe in Europe, Japan, and to a lesser extent Australia. We expect the NZD to edge lower against the greenback as the US economy appears to be in improving shape. Exporters and importers should be awake to potential chances for good rates stemming from fluctuations resulting from shock developments regarding the likes of Greece, Russia, and China in particular.

### Interest rates

Although the markets are pricing in at least one 0.25% cut in the official cash rate by this time next year we still for the moment expect rises in 2016 on the back of declining capacity availability, an eventual lift in the pace of wages growth, and the Reserve Bank desire to try and stem shifting investment into the housing market. Fixed borrowing costs are expected to drift upward as the year proceeds, pushed partly by higher US yields as the Federal Reserve tightens monetary policy from around mid-year. Firms should look for opportunities to lock in low medium to long-term fixed rates in the first half of 2015.

### **Labour market**

The proportion of the working age population already in work or actively looking for it is already at a record high of almost 70%. This compares with near 63% in the United States and 65% in Australia. For now the migration boom is keeping wages growth suppressed. But eventually labour availability will decline substantially, there will be a wages response, and firms will need to think less about expansion and more about boosting profits through cutting output and raising prices. That is not a story however for this year but more late-2016 through 2017-18. Given their relatively high turnover of staff, below average remuneration, and exposure to loss of key personnel, the tightening labour market will be far more of a problem for SMEs and Small businesses particularly than Large companies with 100 or more staff.

### **Construction**

Very high levels of activity this year through into 2017. Business opportunities will present themselves for many existing and new operators in the widely defined construction and construction servicing sectors. Be wary of new start-ups led by people without experience of the way the sector can and usually does end a boom with a large crash.

### **House prices**

Gains strongly continuing in Auckland and Christchurch and investors searching for yield pushing prices up first in regions near to Auckland then further afield. People who bought regional properties some years back and who have been disappointed with capital gains might look to sell into this movement of investors out of the big cities early next year.

### **Tourism**

Good outlook on the back of the trend rise in outward Chinese travel and catch-up travelling by Europeans and Americans. Inbound visits from Australia are likely to be muted. Be careful of fluctuations around the rising trend in Chinese visitor numbers. The market is immature and can be influenced by official guidance as to where people “should” or “should not” travel.

### **Retail**

Discussed below – good prospects but a sector facing some deep challenges and changes. A rising tide will definitely not lift all boats.

### **Financial services**

Debt aversion by consumers and businesses will slowly ease off, low interest rates and interest rate expectations will boost credit demand, and investors will more actively seek yield with money moving out of term deposits into other areas like residential and commercial property. Bank disappointments at failing to meet sales targets in recent years will drive intense discounting campaigns as is happening increasingly with home mortgages. The tendency to ease lending criteria will attract attention from the Reserve Bank. Watch particularly comments from the RB regarding Auckland housing and lending to the dairy sector which now faces greater volatility in incomes because of high dependence upon the China market.

### **Farming**

Mixed as ever but with hefty restraint in dairying due to the payout decline. Long-term prospects very positive on the back of rising demand for quality food and beverages in emerging economies, and plenty of scope for development in the agritech sector. Employment growth in farming however will be very muted as young people show a preference for city-based service roles and the worsening labour shortage may drive a wave of labour-saving technology through the sector. Researching and developing such input technology good be profitable, just as processing primary products into more sophisticated and offshore respected food and beverage items is a field with huge opportunities.

### **Manufacturing**

Good for construction-related firms, good as usual for the generally undefinable “high-tech” sector, but a continuation of the secular decline for most other areas. As individual firms drop out of the sector this reduces viability for other manufacturers and service providing companies.

## Retailing

- A positive outlook, but first three caveats.

There are a huge number of businesses in the retailing and retail supply and support sectors, so we will make an effort to give some irregular insight into how the broad retail sector is faring. People will want us to write about specific sectors – but be warned. We treat with caution the nationwide data covering all sectors, consider only vaguely accurate the sectoral numbers, place little faith in the regional all-sector data, and would pay no attention to regional data broken down by store type. So that is the first caveat.

The second and more important one is this. The determinant of success for any individual retailer is most definitely not the overall broad trend in retail spending which we macroeconomists write about. It is the ability of the operators on the ground to respond to changes in local competition, consumer tastes, input costs, footpath flows (roadwork effects etc.), weather patterns, and such-like. Consider for instance what is happening in clothing retailing. In 2014 the volume of all non-auto retail spending rose by 4.2% and spending on clothing and footwear rose by 1.8% which is not horribly far below its decade average growth pace of 2.8%. So a tad weak but not devastating. However we have seen quite a number of clothing chains in trouble recently. JK Kids, Postie Plus, Shanton, Pumpkin Patch, plus warnings from Kathmandu and The Warehouse.

If we economists manage to develop models which explain changes in retail spending in aggregate or even by store type, that in no way makes obvious what the likely profitability will be for operators in an individual sector.

The third caveat to note is that post-GFC, as with most other forecasts, those for retail spending have largely been overly optimistic. Sales growth has tended to come in below expectations. Why? Partly because consumers are now more wary of debt than pre-GFC and they wish to reduce debt levels. Additionally, in most economies jobs growth has been weak, but even in countries like NZ and the United States with good growth, wages growth has failed to accelerate. Consumers are not thinking in terms of good rises in incomes in the future against which they feel safe boosting spending now. People are also highly price conscious and increasingly resistant to price rises as they get used to falls for electronic goods and talk of deflation generally.

Retailers therefore in aggregate should be approaching their operating environment with this broad framework. Consumers will be tending to boost their spending. But they will be cautious, won't want to load up on debt, are not encouraged to spend by extremely low interest rates, are wary of future income levels, and are likely to have their spending willingness continually dented by a string of bad news developments.

These latter are discussed elsewhere but include the likes of potential breakup of the Euro and the EU, Islamist terrorist attacks, Ebola and whatever follows it, rising nationalism in Russia, Japan, China, and Asia more generally, rising NZ dependence upon milk, oil price shocks, "what happens when the Christchurch rebuild ends?", and so on.

So now let's run through the most recent measures of retail spending growth then take a look at measures of things which we believe influence what the pace of spending growth will be in the future. By store type retail volumes have risen in the past two years ending December as shown below. The second column shows the extent to which prices for store type goods have fallen in the past two years. We have done this to show that sales have tended to grow strongly for store types cutting prices, and not so much for those raising them. Consumers are price sensitive.

	<b>Two year sales growth</b>	<b>Deflator 2 year change</b>
Electrical & electronic goods	24.6	-16.3
Hardware & garden supplies	19.1	1.9
Motor vehicles & parts	16.3	-2.5
Furniture, floor coverings etc.	14.9	-0.1
Department stores	14.4	-4.3
Non-store & commission retailing	12.6	-1.1
Food & beverage services	11.3	3.2
Recreational goods	10.6	-1.9
Liquor	9.7	-2.6
Specialised foods	7.4	2.2
Accommodation	7.1	3.8
Pharmaceutical	4.3	-0.5
Fuel	3.1	-3.3
Supermarkets & grocers	0.9	2.5
Clothing & footwear	0.2	-1.4

Most recently total retail spending excluding the volatile automotive categories rose by 1.5% which makes five quarters in a row of growth above 1% and 4.2% growth for the year to December 2014 compared with the year to December 2013. Spending growth has averaged 2.5% per annum since 2005 so this is a firm result.

Our first set of data above looked at price changes and sales growth. This next list looks at the change in spending by store type on a per capita basis since 2007 when things were last very strong in retailing in New Zealand. This is one way of getting an indication of longer term consumer spending changes.

	<b>Versus 2007 per capita</b>
Electrical & electronic goods	99.3
Non-store & commission retailing	83.6
Department stores	18.4
Pharmaceutical	13.0
Accommodation	6.9
Core Industries	5.7
Food & beverage services	4.4
Furniture, floor coverings etc.	3.3
All	3.2
Motor vehicles & parts	2.7
Specialised foods	2.4
Clothing & footwear	1.9
Liquor	1.2
Supermarkets & grocers	-0.9
Recreational goods	-4.5
Fuel	-13.6
Hardware & garden supplies	-16.1

Another way might be to look at changes in the number of specialised retailers by sector type. Since 2007 there have appeared a lot more cafes and restaurants, more supermarkets or Grocery Stores and Food Specialists, but fewer Fuel Retailers, Furniture and Clothing stores etc. What does this tell us? Actually nothing too much with regard to consumer spending patterns and perhaps more with regard to some sectors consolidating toward bigger single outlets as for Electrical and Electronic Goods for instance where store numbers are down 17 but spending per capita up 95%. Just because sales are booming DOES NOT mean more of that store type will be opened up.

ANZSIC Code	2007-14 change in Enterprise numbers
H451 Cafes, Restaurants and Takeaway Food Services	1404
G411 Supermarket and Grocery Stores	287
G412 Specialised Food Retailing	196
G431 Non-Store Retailing	85
G392 Motor Vehicle Parts Retailing	61
G432 Retail Commission-Based Buying and/or Selling	7
G426 Department Stores	-2
H453 Clubs (Hospitality)	-15
G422 Electrical and Electronic Goods Retailing	-17
H452 Pubs, Taverns and Bars	-52
H440 Accommodation	-77
G400 Fuel Retailing	-92
G423 Hardware, Building and Garden Supplies Retailing	-129
G421 Furniture, Floor Coverings, Houseware and Textile Goods Retailing	-152
G425 Clothing, Footwear and Personal Accessories Retailing	-196
G424 Recreational Goods Retailing	-201
G391 Motor Vehicle Retailing	-209
G427 Pharmaceutical and Other Store-Based Retailing	-243

Consumer preference for repaying debt rather than spending was revealed a year ago in a MasterCard survey, and this year in a Nielsen survey discussed at the following link.

<http://www.stuff.co.nz/business/money/65488782/kiwis-careful-with-money-despite-growing-confidence-nielsen>

With regard to what spending may do over the coming year we can shed some light by looking at the following influences.

### Consumer Confidence

This is strong and perhaps helped by sharp changes in interest rate and petrol price expectations improved in the most recent ANZ Roy Morgan Survey to a reading of 128.9 in January from 126.5 in December and an average reading of 118.

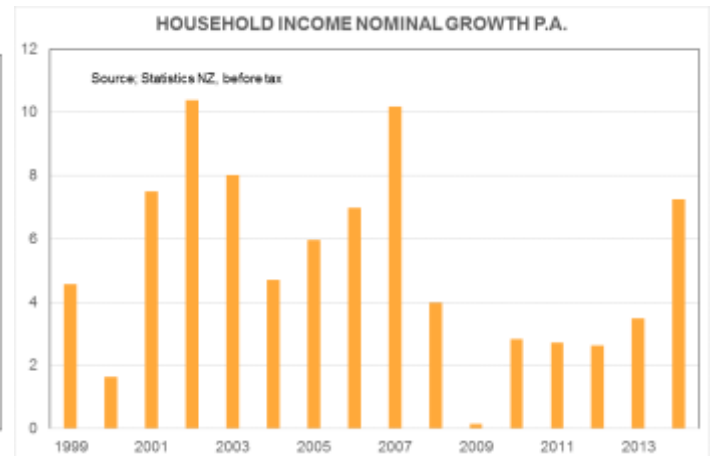
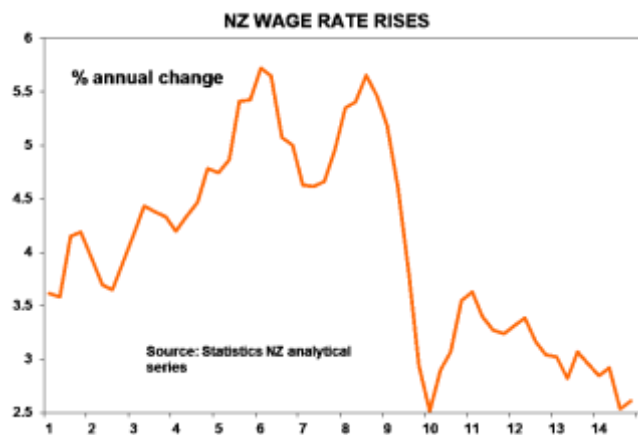


### Employment

Jobs growth is very strong. At the end of last year employment was 3.5% ahead of a year earlier with full-time job numbers up 3.8%. People are so confident of finding work that the participation rate (the proportion of the working age population in work or actively looking for it) rose to a record high of 69.7%. Employer demand for people is also strong with the NZIER's Quarterly Survey of Business Opinion showing a net 21% of non-farm businesses planning to hire more people. The average reading is just 3% and the latest result is the strongest since 2004.

### Household Incomes

There is essentially zero evidence that wages growth is yet accelerating – as shown in the first graph below. However when we take into account the sharp growth in employment we get a rise in total gross household incomes for all NZ in the year to June 2014 of over 7%.



### Interest rates

Borrowing costs rose last year but have since declined for fixed rate loans. More importantly however for our purposes, expectations for where interest rates will go have changed amazingly sharply to the point where this cycle might produce no rises beyond the 1% in total already undertaken. This represents the absence of a negative for retail spending, rather than the presence of a positive as such.

We could also mention the positive effect of rising house prices boosting wealth and therefore perceived spending power. However post-GFC this effect is likely to be very weak so we shall for now not reference it – and it certainly would have little relevance outside of Auckland and Christchurch anyway.

Just about everything is in favour of higher retail spending, though at the local level one needs to factor in the effects of drought and reduced dairy incomes. In the cities however sales growth is likely to be good on average this year. But remember that consumers are price sensitive and perhaps getting more so as headline inflation heads to zero, that debt aversion is high, and that there are some big demographic shifts underway. That is, some places have populations rising strongly, others not so, some with perhaps falling numbers of people. And for those latter places one is likely also to be seeing rapid aging of the average consumer. We will examine updated regional population projections from Statistics New Zealand in a future NZ Observer.

Finally, keep in mind the restraining effect on retail spending, even given all the factors mentioned above, of rising expenditure on services and things which can't easily be avoided. In recent years costs/spending for households have increased firmly in areas like

- electricity supply,
- local authority rates,
- home and contents insurance,
- subscription television,
- telecommunications services,
- childcare,
- house purchase though rents to a much lesser extent on average,
- petrol price levies
- entertainment entry costs (pop stars, Nitro Circus \$540 for a family, stadium sports)
- Overseas travel

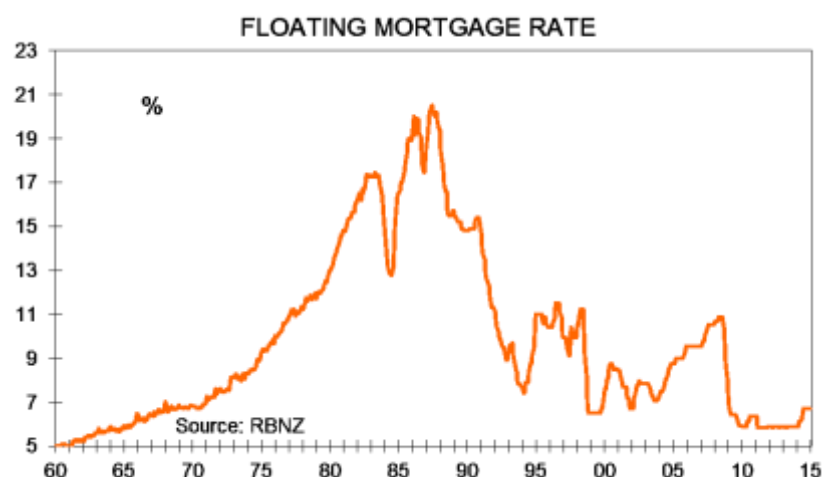


In addition a chunk of spending has been taken out of play through KiwiSaver.

## Borrowing Costs

Before you read any commentary on developments in interest rate markets and where someone thinks rates will go you should remember this. Not a single person on the planet has had their interest rate forecasts prove accurate since the start of 2008. Invariably interest rate forecasts have been too high. One day they will be too low, but there is no way of knowing when. Thus, as we have been explicitly writing in our publications for five years now we repeat our central warning. No-one should base their interest rate risk management decisions on a particular set of interest rate forecasts proving accurate. That would be foolish.

And so to what has been happening recently. Let us interpret recently in this context as the past half a century. Back in February 1965 the average home floating mortgage rate was 5.8%. It is now 6.7% but was 5.87% a year ago. In the 1960s and 1970s rising inflation pushed interest rates up. In the 1980s the fight against inflation pushed them higher. In the 1990s and 2000s interest rates were lower but at times high on the back of fighting cyclical inflation, and low when bad times came around. Now interest rates are only just above 1960s levels courtesy of borrowers not being so hungry for debt. If they were then these current low rates would already have generated a truly massive surge in borrowing. Imagine how many houses each of us would have bought in the 1980s, 90s or 2000s had we been able to access funds below 6%. Interest rates are low now largely because credit demand is weak.



When credit demand is no longer weak interest rates will go higher else a huge borrowing binge will occur with inflationary consequences. Are we close to this point and should you be highly fearful of borrowing costs jumping sharply? Not at all. The chances are your borrowing costs will remain low well into 2016 though our official view is fixed rates edging up by midyear and floating rates rising next year.

Instead of inflation and surging credit growth occupying the minds of central bankers and ourselves it is deflation which has become of concern. This is the situation where consumer prices on average are falling. Why is it dangerous and why therefore is there a lower band to the Reserve Bank's inflation target as well as an upper band – 1% to 3%? There are three main reasons.

1. If consumers believe prices will fall their incentive is to delay spending until this occurs. The risk is they keep delaying in order to gain extra discounts and the plunge in spending causes closures of factories, unemployment, loss of spending power, and a depression or at least protracted recessionary conditions as experienced by Japan the past couple of decades.
2. Low inflation/deflation means low interest rates which means only a limited interest rate buffer available to a central bank in cases of negative economic shocks. When the GFC struck in 2008 our central bank was able to greatly assist the NZ economy by cutting the official cash rate almost 6% from 8.25% to 2.5%. Were a new GFC to occur the rate cut would be just a maximum 3.5%.

3. Low inflation means low nominal growth in output therefore government and corporate debt burdens relative to income do not get reduced as fast as when inflation is average or high. Debt weighs more as a constraint on business sector growth and government ability to prepare for future shocks by reducing debt ratios.

Around the world already low inflation rates have been pushed lower by the over 50% collapse in oil prices causing consumer petrol prices to plunge. Here in New Zealand we expect the annual rate of inflation to fall to near 0% in the March quarter. Does this mean the Reserve Bank should immediately cut the official cash rate to stimulate inflationary pressures? No. Our inflation rate rose above 5% in mid-2008 yet the Reserve Bank slashed interest rates. What is driving the inflation/deflation is important and in that case it was the temporary effect of a plunging NZ dollar with very bad economic times in prospect due to the global financial crisis. This time it is the effect (partly) of an oil price shock downward, and our economic prospects look very good.

Thus we do not expect our central bank to continue the 1% rise they made in the official cash rate between March and July of last year until – well there be the rub. Our initial view was October 2014 for the cash rate to rise above the current 3.5%. Then we shifted to December. Then the middle of this year. Then the end of this year. At this point in time we think the first half of 2016.

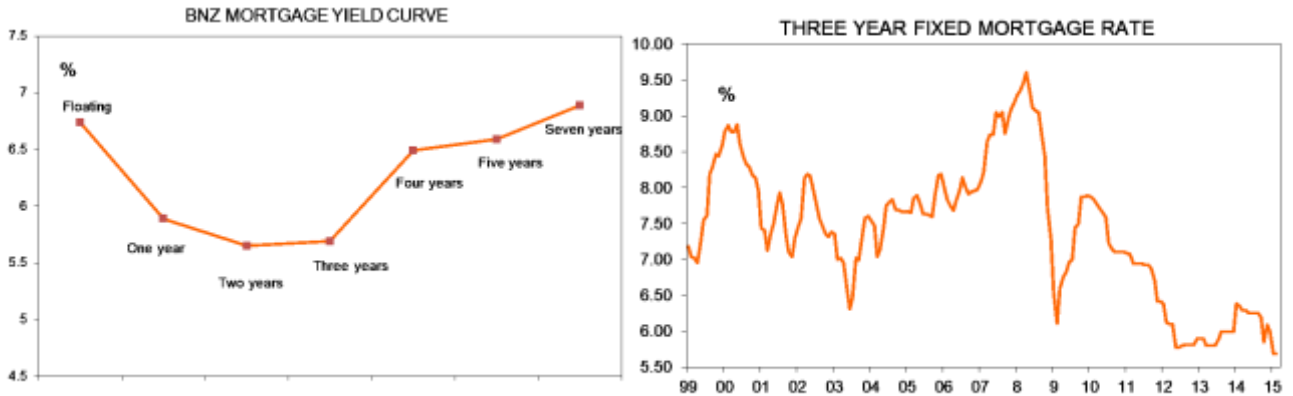
In no way can you as a borrower reasonably develop a hedging policy based upon forecasts for when floating rate borrowing costs will rise. Instead you must consider how damaged your bottom line would be were interest rates to suddenly jump by 1%. If the answer is not at all then one may as well stay floating. If a lot then look at fixing the interest rate on part of your debt, perhaps with some fixed for a year, some for three years. Just get a spread is the main message.

Speaking of fixed interest rates – they have fallen in recent months which is 100% the opposite of what we all expected would happen. Take the three year fixed housing rate for instance as a gauge. It was 6.35% this time last year. It was 5.99% at the start of 2015 and is now 5.59%. Why the decline? Because bank borrowing costs have fallen in response to reductions in world growth forecasts and worries about global deflation. The benchmark United States ten year government bond yield for instance has fallen to near 2% from 2.85% a year ago and 2% at the end of last year. A couple of weeks ago the rate was below 1.7% but since then strong data on employment in particular have boosted expectations of US monetary policy tightening from the middle of this year.

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

At some point, probably in the first half of this year, fixed borrowing costs will be as low as they are going to get. Post-2008 experience tells us that we will not be able to pick this point in advance. Therefore, given our expectation that eventually fixed rates will be pushed upward by economic developments principally here and in the United States this year, each borrower will have to make their own call regarding when they feel rates are low enough for them personally to lock in.

Currently the drift in rates is downward, assisted strongly by banks trying to boost market share. Were I borrowing at the moment I would hold off for another round of cuts in fixed rates. If someone offered me a four or five year rate at 5.5% I would take it today. A three year rate at 5% would win my business right away also.



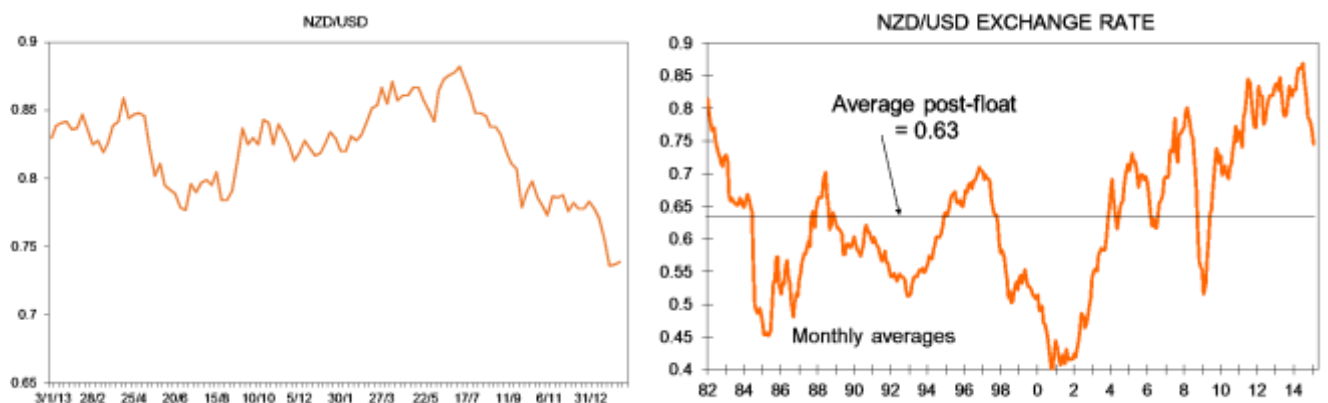
The biggest threat to my being able to achieve such low rates and therefore the thing I will want to keep a close eye on in the news would be the US economy. Any string of data showing growth taking off could trigger a bond market selloff. Frankly however, there is for now a greater risk of shocks pushing yields lower rather than higher, including the risk of a Western war with Russia, Greece leaving the Euro (that seems inevitable and EU departure could follow), and bad economic developments in Japan and Europe.

### NZ Dollar

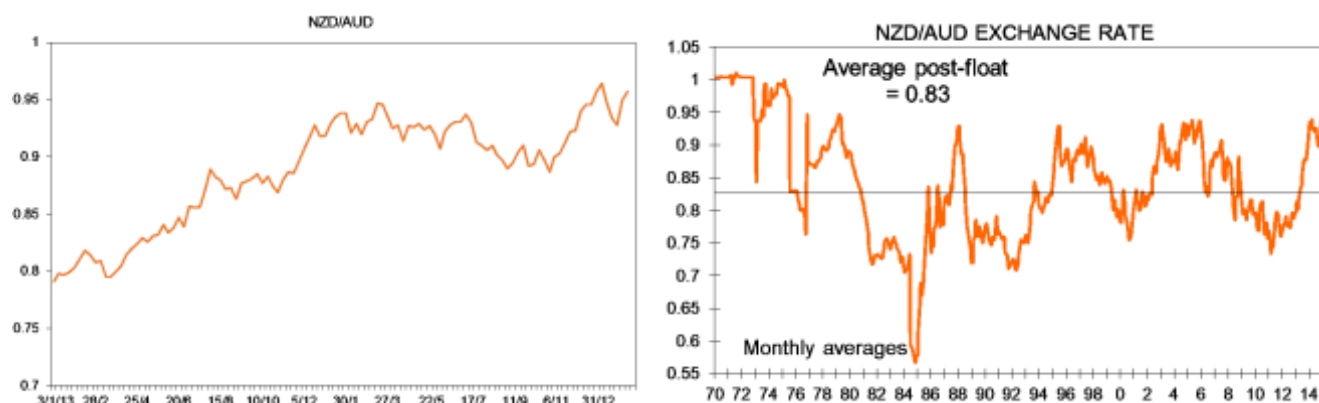
There is no proof that anyone before the GFC had the ability to reasonably accurately forecast exchange rates, and post-GFC whatever ability existed has become worse because of changes in relationships between economic variables. Therefore no exporter or importer should develop a currency hedging strategy which places more than a minor reliance upon a particular set of forecasts for where the NZ dollar will go over the next week, month, year or five years. That said, everyone wants a set of numbers which they can refer to in the future to say that at the time they made their hedging decision which eventually turned to custard it seemed reasonable to think that the NZD would tend to go up/go down/hold steady or so on.

In that regard we start this section by first of all looking at where the NZD has gone and why, and then we postulate what at this short-lived moment in time seems like a reasonable possible scenario for where the NZD will go. Next month if not next week a completely different scenario may well look reasonable.

Against the US dollar the NZD is currently near 74.5 cents from a peak of 88 cents in July last year. The decline these past few months has been driven by good data out of the United States and a now complete erasure of expectations in market pricing that there will be any further tightening of NZ monetary policy this cycle. Falling export prices have also contributed to NZD weakness. Our expectation is that good data will continue for the US, they will tighten monetary policy near mid-year, and that this will see mild NZD easing against the greenback over the next couple of years and perhaps into 2018 if the NZ economy's growth rate slows sharply as Christchurch construction falls away. At this stage little suggests a move below 60 cents in the next five years given limited downside risk for NZ interest rates from an official cash rate level of 3.5%.



Against the Australian dollar the NZD is currently near its highest level since July 1975 close to 96 cents. Just four cents away from one dollar one cannot rule out the possibility if parity being achieved. Why the surge since 2012?

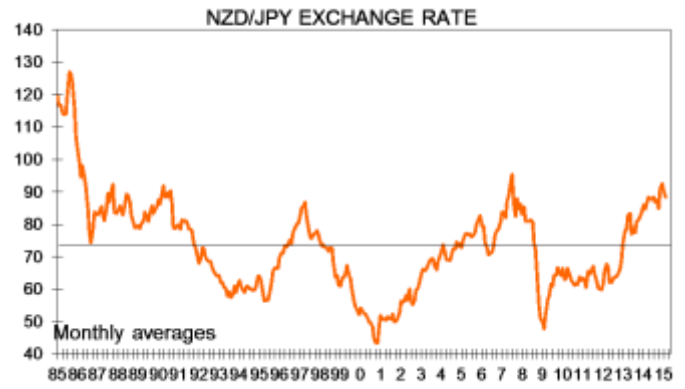
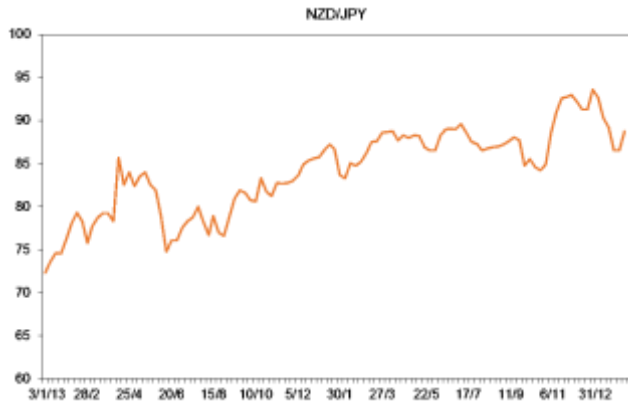


Mainly it reflects weakness in the Aussie dollar which is currently near 77.5 cents from 90 cents a year ago and US\$1.05 over two years ago. The Australian economy has grown by 2.7% in the past year with jobs growth of 1.6% so it is not in recession. But many chooks have come home to roost including

- the car vehicle assembly sector shutting down
- manufacturing generally suffering from the previously high AUD and poor labour competitiveness,
- 23 years of no recession building up inefficiencies and over-optimistic attitudes through many sectors including government,
- a deteriorating Federal budget deficit track and political dysfunction slamming business expectations of both reforming policies and deficit control,
- retailing struggling to adjust to online competition,
- collapsed prices for iron ore and coal exports
- deepening worries about the pace of growth in China – which takes 37% of Australia's exports.

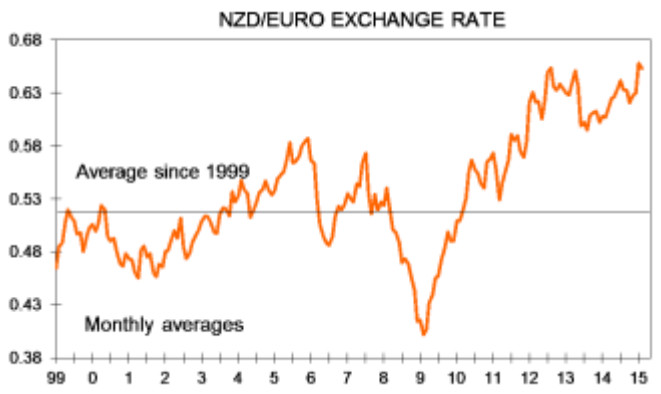
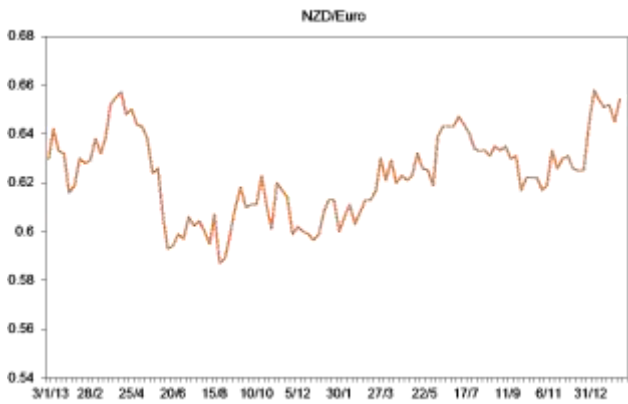
Growth of 2%+ is generally predicted for the Australian economy over the next couple of years. But just recently deepening worries about the short-term growth track have caused the Reserve Bank of Australia to cut the cash rate from 2.5% to 2.25%, and we expect another two 0.25% cuts this year. Given that prospect there looks to be a 50% chance that in the next few months the NZD will hit parity against the AUD. However this will not represent a new paradigm for the NZD. Our economy for this period is simply being artificially boosted by an extended one-off phase of dairy sector expansion which cannot continue indefinitely, rebuilding of Christchurch which will fade away, catch-up construction in Auckland which will however take a lot longer to ease off, and a migration boom which history tells us never keeps going. Picking when we are back at 75 cents however is honestly anyone's guess. But we will see it.

In brief, against the Japanese Yen we expect the NZD to generally remain strong because policies there so far aimed at sustainably boosting growth and inflation are failing. Although unemployment has fallen to 3.4% wages growth has yet to accelerate. Without that happening, in a world of spreading deflation inflation is likely to edge back down and already with core price rises of only 0.5% the goal of 2% sustained inflation looks like a pipe-dream. The Japanese economy has in fact just exited another recession partly caused by a consumption tax increase from 5% to 8% last April.

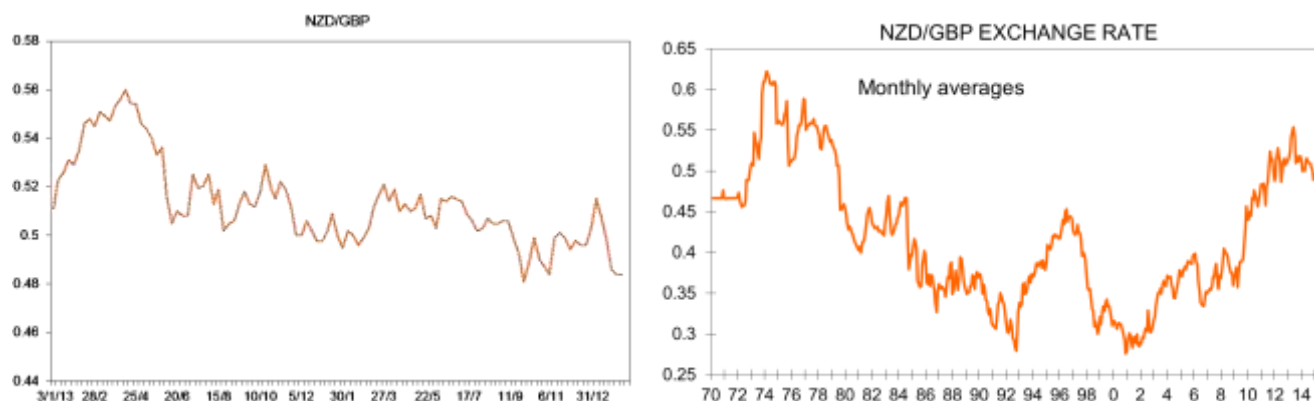


Against the Euro we also expect the NZD to stay well supported as things there, frankly, spiral downward. Although efforts have been made to improve functioning of the European Union’s banking and financial systems since the GFC, there is widespread reluctance among politicians and voters to undertake reforms necessary to make many mid and southern EU members competitive on the world stage – especially against a resurgent United States and growing, modernising and integrating Asian economies.

Europe is losing its economic standing and with a socialist government elected in Greece it matters not whether agreement is shortly reached to avoid debt default – their policies of boosting the size of government, stopping privatisations, and essentially demodernising their economy will eventually crush their growth yet for now find support in other recalcitrant EU members and send debate on a path toward splitting up. Russian aggression against which the Europeans display Chamberlain-like staunchness just reinforce the ineffectiveness of the EU construct. Add in a UK referendum on EU membership in 2017 should the Conservative Party win the UK general election in May and investors are likely to ease further back from the Euro in coming years, weighting instead toward US and Asian investments.



And against the British Pound? It is hard to expect much weakness given that as debate grows about UK divorce from the EU uncertainty about the economic impact – which is not at all clear – will likely generate some selling of Sterling. No clear NZD/GBP view emerges.



## Don't Borrow Offshore Unhedged

As a small business owner you probably have debt and would like the interest rate you pay to be lower. You will eventually notice that interest rates tend to be lower overseas and ask yourself whether you might be better off borrowing in a foreign currency. You will convince yourself that you are missing out on something obvious by believing that banks are borrowing in these foreign currencies then lending the money to you at much higher interest rates. You will get indignant, your view of banks will worsen, and this grumbling will affect your business first because your discontent will take intellectual and emotional time away from actually managing your business, and because you will waste time investigating how to borrow offshore. Don't even think about it as you will be putting your business' future at risk. Here is why.

Exchange rates cannot be predicted. You are a fool if you think they can. When banks borrow in a foreign currency and pay a low interest rate they convert the funds into higher interest earning NZ dollars, but they remove the risk that the NZD falls against the other currency by hedging away the risk. The key point to note is this. The cost of hedging away the risk of a bad currency movement is the difference in interest rates between the two currencies. Hedging basically removes the interest rate advantage.

If you borrow in Swiss francs for instance and use the funds to pay NZ bills but do not hedge the principal and interest repayments risk, you run the risk of a sharp jump in your liabilities should the Swiss franc rise sharply against the NZ dollar – which is exactly what happened on January 15. The exchange rate between our currencies went from near NZD1.26 to buy one franc to near \$1.50 overnight. Had you borrowed initially the NZD equivalent in Swiss francs of \$500,000 your debt would have ballooned to almost \$600,000.

The jump happened because the Swiss central bank stopped trying to prevent the franc from rising against the Euro – just days after saying they had zero intention of altering their currency policy.

In the world of foreign currencies completely unpredictable things happen and currencies move for reasons which after the fact we economists can talk about in an intelligent manner and sound like we know lots of things, but which before the event we fail to pick. Bankers know that borrowing in foreign currencies is dangerous so do not promote foreign currency borrowing though such products are available. Note that while ultimately the reason such products are not promoted is that the borrower generally lacks the intellectual ability to understand the risks involved, the product does suit businesses which have receipts in foreign currency. If this is you however ask yourself these two things. How would you be left if you had to shift markets quickly and receive a different foreign currency? And, how would your balance sheet (liabilities versus assets in NZDs) look if the NZD were to fall sharply? You might be in breach of banking covenants were a sharp NZD depreciation to occur, and you could be put into receivership.

No Victoria, there is no offshore funding Father Christmas.

## Auckland – Its Different

Since 1996 New Zealand's population has grown by 21%, Auckland accounts for 53% of that growth with a rise of 411,100 or 37%. In 1996 Auckland accounted for 30% of NZ's population. In 2013 the percentage was 34%. Come 2031 this percentage is projected to be 38%. The latest population projections (soon to be updated) show a central expectation of New Zealand's population growing between 2011 and 2031 by 18%. Auckland is picked to grow 33%, Canterbury 16%, Bay of Plenty and Waikato near 14%, Wellington, Nelson, Tasman, Marlborough near 11%, all the rest of NZ 6%. Some regions will show no or not worth speaking about population growth including Southland, West Coast, ManawatuWanganui, Taranaki, Hawkes Bay and Gisborne.

For your housing investment, business location etc. plans these projections should be your starting point. Why the extra Auckland population growth? The planet is increasingly urbanising and whereas technology may theoretically allow us to operate remotely with virtual presence, in practice it is bringing people physically closer together.

Increasingly business growth is coming not from minimising costs of production but from innovations, ability to respond on the ground to operating environment changes (agility), and ability to inculcate entrepreneurial attitudes amongst one's staff. Ideas, their promotion, their development, their execution, their monitoring, their altering are the strengthening source of success in a digitising world and the environment which best produces cross-fertilisation of ideas and technologies between businesses, and businesses and research organisations is an economically dense one – provided it has infrastructure which allows it to function well.

Research tells us that agglomerations (people, businesses) can produce 6% - 27% boosts in productivity for every doubling of population. Agglomerations tend to attract young aspirants looking to maximise income, advancement chances, and education and training. They attract businesses looking for economies of scale and closeness of a range of suppliers and diverse customer groupings which they can closely interact with to gauge how products and services are being received and need to be changed.

Auckland is New Zealand's only chance of an agglomeration which can deliver us these benefits in terms of job opportunities, income growth, and vital connectiveness with the rest of the world. Christchurch falls into this camp as well though to a smaller extent. For other cities and towns the global links are more likely to be firm or sector-specific rather than generalised. That generalised comment applied to Auckland might help explain why

- 50% of migrants to NZ go to Auckland,
- 39% of Aucklanders were born overseas versus 18% for the rest of NZ,
- 35% of Aucklanders speak more than one language compared with 20% for the rest of the country,
- 40% of people in NZ with degrees live in Auckland though the city accounts for just 34% of the NZ population,
- Auckland receives on average 44% of the people visiting New Zealand for business,
- Auckland accounts for 78% of intellectual property applications yet makes up 62% of the population of our five biggest cities (Statistics NZ special five city study)
- People cram into Auckland so the average number of residents per household stands at 3 compared with an average 2.5% in the rest of the country.

In the regions people have self-selected not to be in Auckland. Therefore their ability to understand the underpinnings of Auckland's growth and attractiveness to Aucklanders are likely to be low. That represents then a blindspot for councils and business organisations outside of Auckland thinking about how they can link into Auckland (and Christchurch's) growth – and that blindness may stop them seeking answers to the linking question in the first place and instead send them down a path of lobbying to force migrants out to the regions which Kiwis are voluntarily leaving. Without companies expanding in the regions and screaming out for employees such forced locating cannot work.

Auckland accounts for about 35% of NZ GDP and about 34% of our population. Both percentages will rise in coming decades as Auckland continues to attract migrants and returning Kiwis plus young people from elsewhere in NZ, though it will shed some aging people looking to free up cash for retirement elsewhere. For businesses generally around the country special attention may need to be given to developing a specific Auckland strategy in terms of branding, marketing, distribution system, and of course business location. Auckland's demographics are different from the rest of the country and will become increasingly so – more Asian, more Maori people, more Pacifica people, younger.

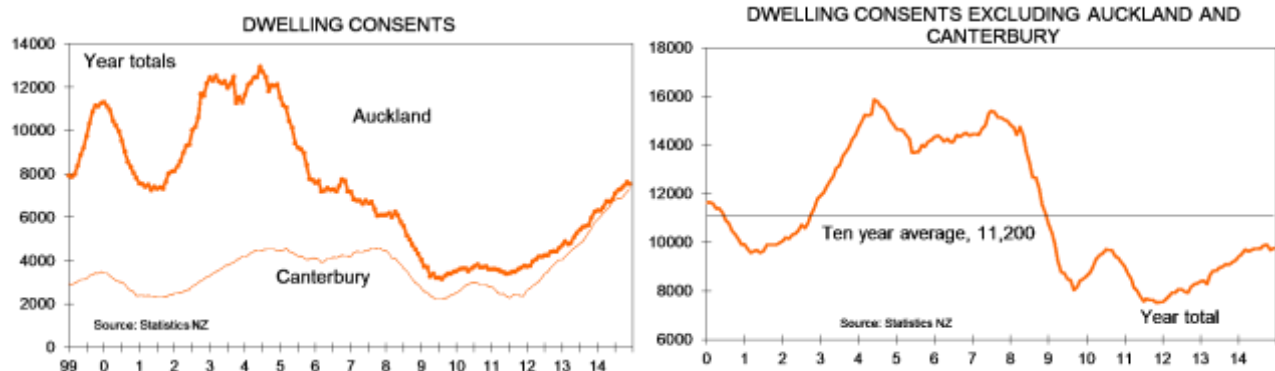
Of special interest is the Auckland housing market from this perspective. Housing sales in Auckland accounted for 35% of the NZ total in the past ten years, so are in line with population size. Nothing interesting there. However Auckland house prices are about twice the average outside of Auckland. Do the maths and that means that about 55% of the value of house sales activity in New Zealand occurs in Auckland. From a lenders point of view Auckland housing is however more important than that and perhaps around 60% of total nationwide lending. Why? Because the no mortgage home ownership rate in Auckland is 23% but outside of Auckland it is 29%. More properties in Auckland relative to the population have mortgages. Were property prices in Auckland and the rest of the country all of a sudden to be the same on average, Auckland mortgage market business would still exceed Auckland's population share of 35%.

Therefore if you are a lender, if you are not getting your market share in Auckland you have got a problem.

## Housing

### Construction

Construction is on the way up with nationwide consent numbers in calendar 2014 ahead 16% from 2013, 10% above the 20 year average and well ahead of a five decade low near 13,500 in mid-2011. Auckland consents have risen by 21% in the past year from 37% growth in 2013 but sit only right on their 20 year average of 7,500. Canterbury consents in contrast are twice their 3,500 20 year average at 7,300 with numbers ahead 27% last year and 43% in 2013. As for the rest of the country consent issuance is below the 20 year 11,200 average at 9,700 with growth of only 5% last year and 12% in 2013. Outside of our two biggest cities residential construction is below par and the pace of improvement has slowed not just over 2014 but in recent months as well.

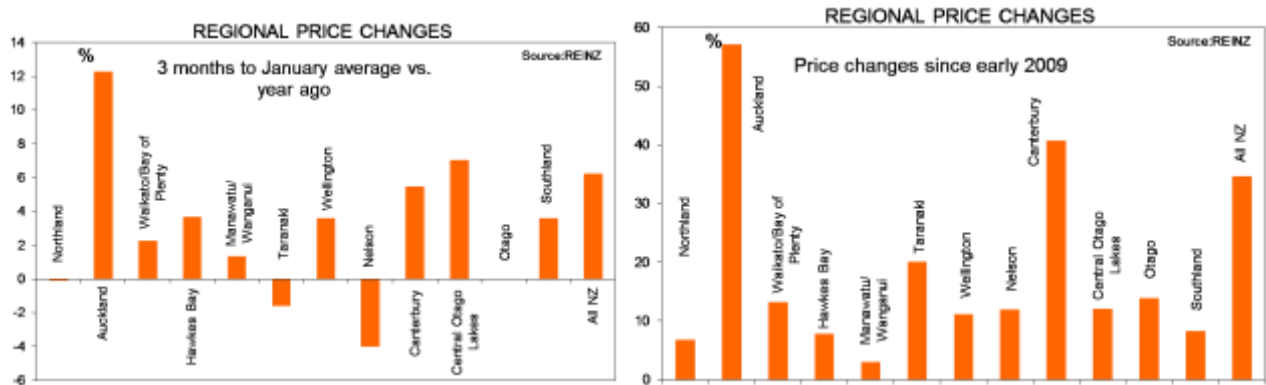


For businesses involved in the residential construction sector activity levels are likely to be good over the next three years because of the obvious factor driving Christchurch activity, and the fact that it will take a generation perhaps for construction to “catch-up” in Auckland. But as the receivership of one building company this month shows us, just because you are growing, just because you have a good orders list does not mean you have a viable financial business model. Christchurch has produced many business failures despite the building surge because of poor ability to manage cash flows and lack of capital. Too many firms appear to confuse bank lending with capital. They are not the same and from a bank's point of view with knowledge that building booms usually turn to bust rather than gently taper off, job orders are a future not reached yet and not guaranteed profits against which they can take security for an extra loan right now.



**House Prices**

We start this final section of the NZO with two graphs. The first shows average house sales price changes in the three months to January compared with a year earlier. Auckland leads at 12% followed by Central Otago Lakes (Queenstown, Wanaka...) at 7%, with falls of 4% for Nelson and 2% for Taranaki. The second graph shows house price changes since the broad low-point in the GFC-induced cycle of early-2009. Auckland prices have risen by 57%, Canterbury 41%, then outside our two NZ agglomerations there is a very different picture. All regions have recorded rises but for Manawatu-Wanganui the six year gain is just 3% (estimated 1.4% population growth since 2009), Northland 7% with 5% population growth (interesting dynamic of minimal growth yet population rising), Southland 8% with 2.8% population growth and Wellington and Nelson at 11% and 12% respectively and population changes of 3.3% and 7.6%. Auckland's population change has been 7.4%.



Personally speaking, were I a person who actively invested in residential property, I would be getting interested in regions which have had minimal price growth since 2009 yet enjoyed reasonable population growth, and for which population projections from Statistics NZ look reasonable. In fact lets make this exercise easy for all you people thinking about seeking higher yield with capital gain potential outside Auckland. The following table shows regional population growth since 2009 and population growth projections (soon to be updated however by Statistics NZ). Have fun and good luck.

	Population growth since 2009	Projected population growth 2011-2031
Northland	4.9%	9.6%
Auckland	7.4	32.5
Waikato	6.0	13.7
Bay of Plenty	3.5	14.5
Gisborne	1.7	1.5
Hawkes Bay	2.8	3.8
Taranaki	5.0	1.5
Manawatu-Wanganui	1.4	3.2
Wellington	3.3	10.6
Tasman	4.7	12.3
Nelson	7.6	10.6
Marlborough	0.9	8.5
West Coast	0.3	1.2
Canterbury	2.4	15.8
Otago	4.1	11.2
Southland	2.8	-0.3
North Island	5.4	19.7
South Island	3.0	12.2
<b>NZ</b>	<b>4.8</b>	<b>17.9</b>

We all know that affordability of housing in Auckland is very poor and mid-January brought the 11<sup>th</sup> Demographia International Affordability report ranking Auckland as ninth least affordable city out of 378 around the world. <http://www.demographia.com/>

There is nothing new in the report and it merely confirms what we have been pointing out since at least 2008 when we warned that the GFC would not cause a collapse in NZ house prices. In Auckland there is a housing shortage and it is getting worse every day, especially with the recent surge in population growth. We have long concluded that the imbalance between supply and demand at current prices would cause prices to rise and that is exactly what is happening. Because the imbalance is still worsening prices will keep rising and from an investor's point of view with young buyers forced to rent longer by the loan to value rules, strong immigration, plus very low borrowing costs the attraction of investing in the Auckland market has long been obvious. It remains so.

We don't know by how much Auckland house prices will rise this year. We have never seen anyone produce a model which allows accurate predictions to be made. But something akin to last year's near 14% rise seems a reasonable expectation.

What about the rest of the country? A shortage continues in Christchurch so prices will continue to rise there. Shortages do not exist in most other parts of the country except maybe the Central Otago Lakes district which is enjoying good population growth. So outside the two agglomerations price growth will be much muted. But try to get a feel for how people will react to falling yields in Auckland, and falling expectations for simple interest rate returns on term deposits. People approaching retirement or in it will be thinking more and more about finding yield away from banks and this will spur increased demand for investment property – especially as group investment vehicles are likely to become more prevalent.

In addition lets leave you with one thought which applies not just to housing investment but businesses across a wide spectrum. Although there is a wave of obesity-related diseases to hit the health system and curtail life expectancy for those affected, for the rest expectations of longevity are rising. As people expect to live longer in retirement and be more active how will that affect the things which they do and buy? At a minimum it suggests better demand for investment property. But it also implies higher demand for voluntary medical procedures, house redesign and modification, and so on as people anticipate being able to reap the benefits of such things over a longer period of time than before. As people say less and less that there is "no point it doing that as I'll be dead soon" there could be radical changes in demand for business goods and services. Food for thought.

### **Resources**

Business Mentors NZ

Well respected mentoring service for NZ SMEs.

<http://www.businessmentors.org.nz>

The Icehouse

Provider of business growth workshops and programmes

<https://www.theicehouse.co.nz/>

NZ Business Demography Statistics

Detailed annual data on NZ businesses by industry, employment etc.

[http://www.stats.govt.nz/browse\\_for\\_stats/businesses/business\\_characteristics/BusinessDemographyStatistics\\_HOTPFeb14.aspx](http://www.stats.govt.nz/browse_for_stats/businesses/business_characteristics/BusinessDemographyStatistics_HOTPFeb14.aspx)

The Small Business Sector Report 2014

Detailed analysis of firms with fewer than 20 employees, so doesn't really capture medium-sized enterprises of up to 100 employees.

[www.mbie.govt.nz/.../the-small-business-sector-report-2014.pdf](http://www.mbie.govt.nz/.../the-small-business-sector-report-2014.pdf)

#### NZ SME Business Network

“The goal is provide support to SME Business owners and give them a voice to influence national policies that directly impact them.”

<https://www.facebook.com/pages/New-Zealand-SME-Business-Network/193512437408817>

<https://www.linkedin.com/groups/New-Zealand-SME-Business-Network-4202444/about>

#### Small Enterprise Association of Australia & New Zealand

Academic research group operational since 1987.

<http://www.seanz.org>

#### MYOB Business Monitor

“It’s a nationwide survey of over a thousand business owners of sole trading, micro, small and medium sized businesses from across all industry groups.”

<http://myob.co.nz/myob/backing-kiwi-business/myob-business-monitor-1257829565839>

#### Asia-Pacific Small Business Survey

Run annually by CPA Australia, latest from November 2014.

<http://www.cpaaustralia.com.au/professional-resources/business-management/small-business/asia-pacific-small-business-survey>

#### Small Business Voice

“The Small Business Voice is an incorporated Charitable Trust set up to support and represent SMEs throughout New Zealand, formerly the Independent Business Foundation.”

<http://www.smallbusinessvoice.co.nz/>

#### SME Research Hub

Nothing here for business operators as such, instead a still very undeveloped website for researchers into SMEs.

<https://www.gen.org.nz/tiki-index.php?page=Welcome+to+the+SME+Research+Hub>

#### Growing New Zealand Businesses

“Growing New Zealand Businesses (GNZB) is an ambitious research programme that seeks to systematically explore growth and innovation issues in New Zealand small and medium enterprises (SMEs).”

University of Auckland Business School

<http://www.business.auckland.ac.nz/en/about/our-research/bs-research-groups/growing-new-zealand-businesses-gnzb/our-research-group-3.html>

The NZ Observer 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 NZ Observer 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)

This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. To the extent that any information or recommendations in this publication constitute financial advice, they do not take into account any person’s particular financial situation or goals. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.