NZ Observer

April 2015

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.

SUMMARY

- Continuing on with last month's analysis focussing on Auckland's projected high population growth rate, we point out that this growth results substantially from Auckland having the lowest median population age of all regions at 34.8 years. Canterbury is 39.4.
- Many people have recently been making the claim that the small business sector is the engine of employment growth in the NZ economy. The data however say otherwise. Between 2010 and 2013 employment in small firms grew by 2.6%, medium sized firms 5.6%, and large firms 4.8%.
- We look also at internal migration data compiled from the 2013 census. Auckland has lost people to the rest of the country as has Canterbury. But the data need to be treated carefully as for over half the people in the census no information is available on where they were five years before 2013.
- Borrowing costs facing SMEs remain low and with inflation close to 0%, the expected timing for tighter monetary policy in the United States being pushed out, and another interest rate cut highly likely in Australia, borrowers face a benign environment.
- The Kiwi dollar is close to parity against the Aussie dollar but has fallen against the greenback by 13% from a year ago and by 4% on a trade-weighted basis. The good outlook for NZ's economy implies a high NZD for the next couple of years, particularly against the Euro, Japanese Yen, and the Aussie dollar. Greece's exit from the Euro remains a possibility and could cause some volatility in coming months.

Demographic Dividend

Following on from our recent discussion of Auckland's growth, it is important to note that the growth we are projecting for the next few decades results not from a wholesale reallocation of businesses from other parts of the country to Auckland, but largely the simple dynamics of demography with technology/agglomeration/global connectedness effects having a marginal influence. Auckland has in effect become a self-sustaining growth engine.

The demographic part is what we emphasised last month in terms of forecast Auckland population growth of 50% between 2013 and 2043 compared with 30% for Canterbury, 22% Waikato, 20% Bay of Plenty and so on. This extra growth in Auckland largely results from Auckland currently having a younger population than the rest of the country.

The 2013 census shows that the median age in Auckland was 34.8 years which was the youngest for all regions. Next comes Gisborne at 35.8 years, and last comes Marlborough at 44.6 years. Come 2043 Auckland's median age will have risen to 40.5, Marlborough will be 51. Younger populations produce more babies and fewer older people.

	Median age		Population growth	Working age popn growth
	2013	2043	2013-43	2013-43
Northland	41.5	48	11.1%	-6.9%
Auckland	34.8	40.5	49.3	41.2
Waikato	37.1	43	21.9	9.1
Bay of Plenty	40.2	45.5	17.5	3.3
Gisborne	35.8	42	1.3	-9.0
Hawkes Bay	40.2	46.9	3.8	-13.2
Taranaki	39.5	44.7	14.6	0.8
Manawatu-Wanganui	38.7	43.6	1.5	-11.3
Wellington	37	42.1	12.7	0.1
Tasman	44	53.8	10.7	-16.1
Nelson	42.2	50	14.8	-6.1
Marlborough	44.6	51	4.5	-14.2
West Coast	42.6	47.8	0.6	-16.9
Canterbury	39.4	44	29.5	15.3
Otago	38.7	43.1	14.8	0.1
Southland	39.2	44.2	0.8	-11.9
North Island	36.7	42	29.0	18.4
South Island	40	44.9	20.4	5.2
NZ	**37.5**	**42.7**	**26.9**	**15.3**

Onto the population effects of these age projections one adds in trends for internal and external migration to get the population growth projections in the third column, and the working age population projections in column four.

Does this mean businesses have to have a presence in Auckland or Christchurch to be relevant? Definitely not. All the analysis tells us is that the proportion of our country's overall economic activity and employment which takes place in Auckland will grow over time. That is not the same as saying regions shrink. Companies wanting to get a feel for what older populations consumer might usefully undertake market research in the Tasman region.

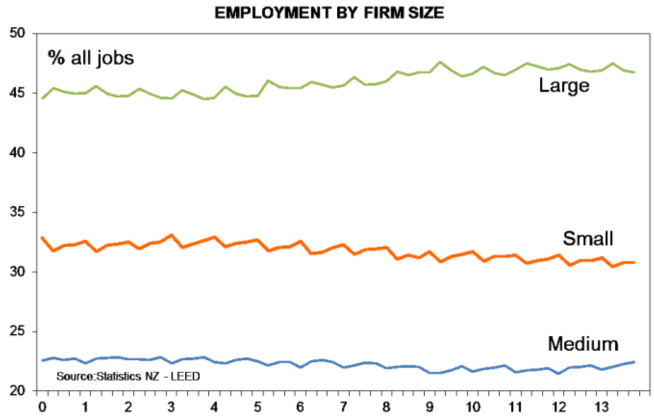
Jobs Growth By Firm Size

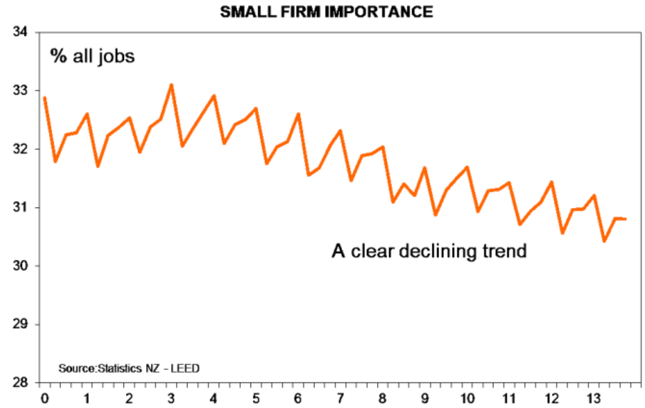
A number of people have been making the claim recently that most jobs growth in New Zealand comes from the small business sector. The only data which we have on this come from the Statistics NZ LEEDS or Linked Employer Employee Dataset. The numbers only run to the December quarter of 2013. We classify Small firms as those with fewer than 20 employees, Medium as 20-99, and Large as 100 and more employees. As at the end of 2013 31% of employees or 581,000 people worked in Small businesses, 22% or 424,000 worked in Medium-sized businesses, and 47% or 882,000 worked in large businesses.

Over calendar 2013 the employment changes were as in the first column below in absolute number terms. The second column shows the percentage annual change. The third and fourth columns take the end of 2010 as our starting point.

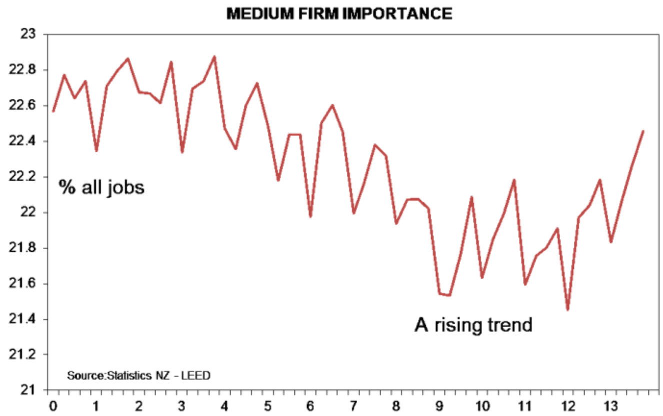
	Growth from 2012 - 2013	% growth	Growth from 2010 - 2013	% growth
Small	10050	1.7	14730	2.6
Medium	14710	3.5	22410	5.6
Large	18190	2.1	40720	4.8
All firms	**42950**	**2.3**	**77860**	**4.3**

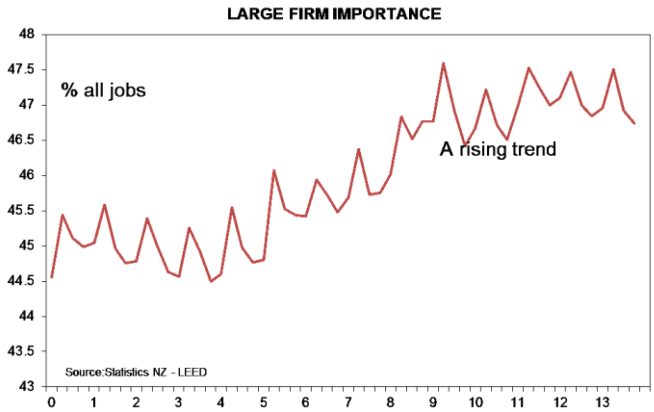
Small firms in fact are not pulling their weight.





There has however recently been good growth from Medium-sized firms. But this comes after some years of decline.





Note that the LEED numbers do not include firms with less than $30,000 turnover and people who do not have tax deducted at source. This helps explain why job numbers at the end of 2013 totalled 1.9 million using LEED data but 2.4 million using the Household Labour Force Survey. The HLFS at the end of 2013 records 103,000 people as employers and 215,000 as self-employed, which almost gives us 2.3 million.

This exercise is not completely valid, but were we to add Employer and Self-employed to our Small firm employee count we get no alteration in our conclusion regarding Small firms under-performing job-wise. Growth for calendar 2013 comes in at 1.8% versus 1.7% above, and for the three year period 2.6% which is no change.

What if we look only at Micro firms of five or fewer employees? The past year’s growth rate in job numbers for this grouping was 0.9% and from three years ago growth was only 1.7%. Even worse.

Over the past year Small businesses account for just 23% of jobs growth and over the past three years even less at 19%. Large firms account for 42% of jobs growth over 2013 and 52% since 2010. Given that people in Large firms get paid more, churn less often, and are more skilled than people in small to medium-sized firms, this seems like a good thing.

Regional Migration Flows

Every now and then there is a reference to a particular region losing or gaining people from the rest of the country, with perhaps mention of flows with Auckland. We started analysing data from the 2013 Census where people stated where they were five years earlier. It produced results such as Auckland losing a net 4,377 people to the Waikato, and Northland gaining 12 from the West Coast. But then we noticed some rather large numbers in the columns showing “Response Unidentifiable”, ‘Not Born Five Years Ago”, “Not

Stated", and "New Zealand Not Further Defined". So we calculated the proportion of the change in each region's population between 2008 and 2013 for which we could not identify the source region.

For Northland the proportion is 58%, Auckland 54%, Waikato 51%, Bay of Plenty 52% and so on. These proportions are much too large to allow one to safely make the assumption that the Unknowns would be distributed in the same patterns as the Knowns.

Thus in our opinion you should be careful when examining internal migration data and commentary as the data are not accurate enough on a region versus region basis – unfortunately. But for the record, there appears to be a tendency for Auckland to lose people to the rest of the country to the tune of 4,665 in the measurable responses, or maybe near 10,000 aggregated up. These people go largely to Waikato, Bay of Plenty and Northland with net inflows largely from Wellington and Canterbury – though all mention of Canterbury should acknowledge the outflow effect of the February 2011 earthquake. Without the outflow, numbers would presumably look even worse for the other regions.

Regions of the country which shed people to other places include (with numbers all aggregated up and rounded),

Auckland	-10,000
Gisborne	-2,000
Hawkes Bay	-3,000
Taranaki	-500
Manawatu-Wanganui	-4,000
Marlborough	-1,000
West Coast	-500
Canterbury	-9,000
Southland	-3,000

Gaining areas are these.

Northland	1,000
Waikato	13,000
Bay of Plenty	4,000
Wellington	1,000
Tasman	2,000
Nelson	0
Otago	8,000

But remember the bias introduced by the 2011 earthquake. That bias actually implies the situation for non-Canterbury population losers in the first list is actually worse than shown while Wellington and Nelson in particular might not truly be experiencing an internal migration gain at all. Next month we will list data on external migration flows.

Borrowing Costs

The chances of fixed interest rates facing a decent amount of amount pressure before the middle of the year have fallen over the past month. They key driving force in this change has not been any alteration in the outlook for the NZ economy, but instead a pushing out (yet again) of expectations for when the Federal Reserve will start tightening monetary policy in the United States.

Key behind a sharp decline in expectations for the US funds rate rising from the current 0% - 0.25% range has been the much weaker than expected jobs market report for March. Employment had been expected to grow by 245,000 in March but the actual outcome was a rise of only 126,000. Not only that but results for the previous two months were revised down by 69,000. There is probably a slight downward bias to the data caused by slashed spending in the energy sector following the decline in oil prices. But even allowing for this the result says that the sort of capacity pressure which the Federal Reserve has indicated it needs to see before jacking rates up is not looking like appearing anytime soon.

This is of course good news for NZ borrowers, but as we highlighted in the Sporadic issue of April 7, there are also hefty implications for investors of a growing expectation that interest rates here in New Zealand will be long for a very long time. Across the Tasman the RBA might not have cut their 2.25% cash rate to 2% on April 7 as expected, but another reduction is on the cards and this downward trend will simply act to reinforce low rate expectations here in NZ.

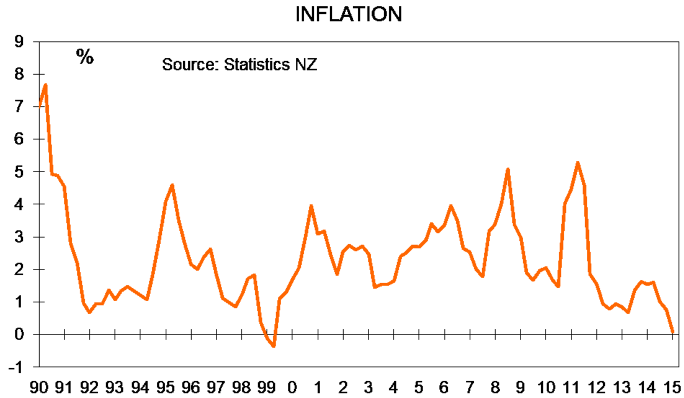
Their likely cut next month will reflect deepening concerns about the state of the Australian economy in light of a worsening fiscal outlook causing worries among businesses as to what policy changes may be needed down the track to get the fiscal track sufficiently in the right direction to avoid a credit downgrading. In addition the iron ore price keeps falling and with BHP representatives saying they intend boosting output, China saying it intends cutting steel production, and China's growth outlook still easing off such that housing policies and monetary policy are being eased, the chances are that iron ore prices will fall further.

The upshot of these developments in China, the United States, and Australia is that NZ interest rate prospects still look very benign from a borrower's point of view and as frustrating as ever from an investor's point of view.

This applies even though traditional analysis would have one forecasting immediate rate rises. NZ economic growth is strong as is jobs growth. In the NZIER's Quarterly Survey of Business Opinion released on April 14 a net 36% of business respondents reported skilled labour as difficult to find. This was a rise from a net 33% in the December quarter survey and the tightest result since the end of 2007. Only a net 13% reported unskilled labour as hard to find, though this was much harder than the net 5% on average who report unskilled labour as easy to find.

Eventually a tightening labour market will produce accelerating wages growth. In addition, with the QSBO showing the capacity utilisation rate rising to the highest level since 2008 at 92.3% from 92% in the December quarter and an average reading of 90.4%, one would expect firms to be raising prices soon.

However the QSBO also shows why a rate move from the RBNZ is not imminent. Only a tiny net 6% of businesses say they plan to raise their selling prices. This was down from 11% in the December quarter, 37% a year ago, and is well below the 22% long-term average. As we have highlighted here, businesses lack pricing power post-GFC and there is no sign at all that this is changing. In fact the annual inflation rate has now fallen to only 0.1% from 0.8% over calendar 2014 with falling petrol prices making a major contribution to this outcome.

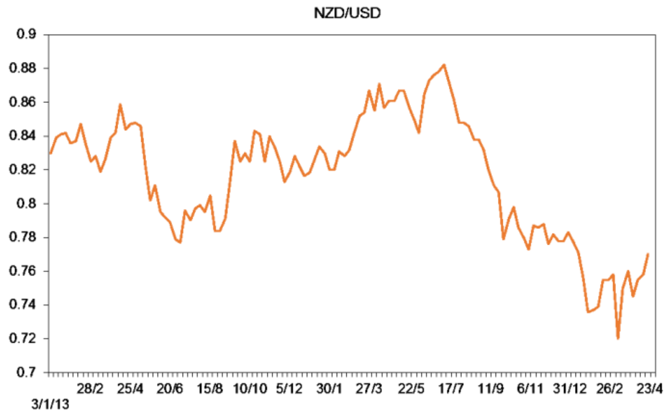


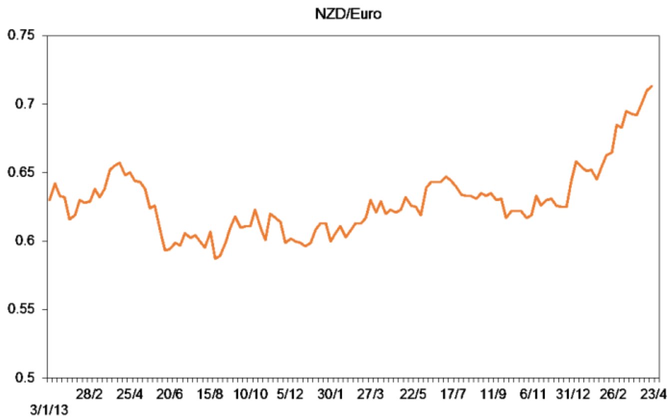
If I Were A Mortgage Borrower What Would I Do?

Competition between banks for mortgage business remains very sharp, though cash back offers have almost disappeared from the marketplace. The easing off in expectations of tighter monetary policy anytime soon in the United States, anticipation of easier monetary policy in Australia, and weakish economic data out of China have combined to push fixed borrowing costs slightly lower. Were I borrowing at the moment I would look for a nice discounted three year rate for the bulk of my debt though could be talked into a five year rate if it was a little bit further below current average published levels. I would not have much debt sitting at a floating rate given the difference with medium-term fixed interest rates for home purchases.

NZ Dollar

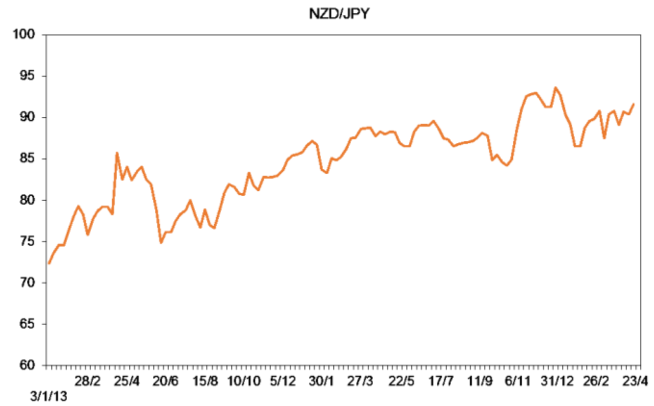
One month ago the NZ dollar was buying 76 US cents and now it sits slightly higher near 77 cents having traded only as low as 74.5 cents during the month. The NZD remains as well supported as ever by a good view offshore of the state of and immediate prospects for the NZ economy, and benefit of the doubt being given to key export commodity prices not falling much further from current levels. The relative level of interest rates is giving some currency support also and in that context the pushing out of the expected timing for tighter policy in the United States accounts strongly for the NZD’s one cent appreciation this month.

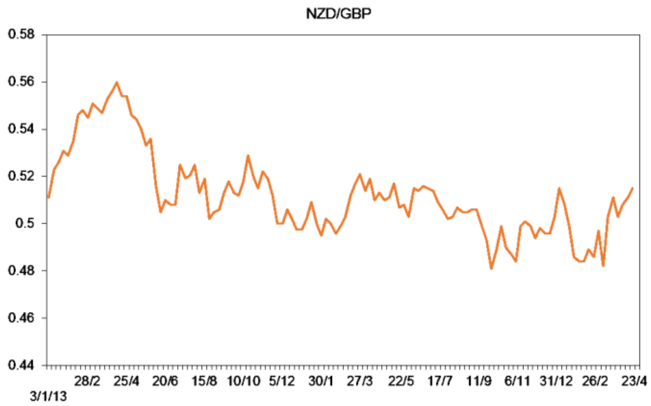




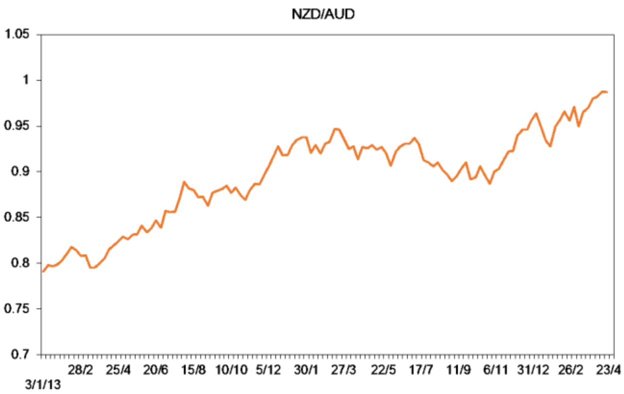
Against the Euro the Kiwi dollar has hit a record high during the month with the Euro depressed by the printing of money by the European Central Bank and worries about Greece defaulting and leaving the Euro outweighing. These factored have outweighed the positive impact on the Euro of some slight improvement in expectations for Eurozone growth this year as the economy benefits from low interest rates, falling fuel prices, and money printing.

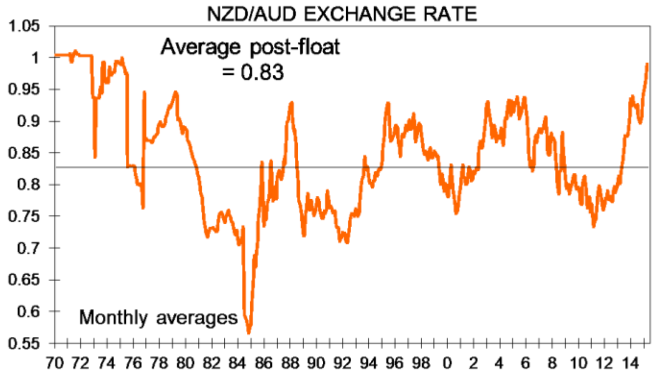
Against the Japanese Yen the NZD is little changed from a month ago even though optimism about Japanese growth has decreased even further, along with hopes for inflation getting close to 2%. Against the British Pound the NZD has bounced up to near 51 pence assisted by the Pound being weighed down in association with the Euro, and ahead of a UK general election on May 7 which may produce a fairly divided Parliament.





Finally, against the Australian dollar the NZD came very close to parity on April 7 but retreated from a peak near 99.7 cents back toward 98 cents after the Reserve Bank of Australia left its cash rate unchanged at 2.25% rather than cutting it as had been widely expected. Will the NZD nonetheless still reach parity? The chances are very high given that a cut in the RBA's cash rate to 2% is likely next month, Australia's iron ore prices continue to decline, and these developments along with talking down of the AUD by the RBA will likely cause renewed Aussie dollar depreciation soon.





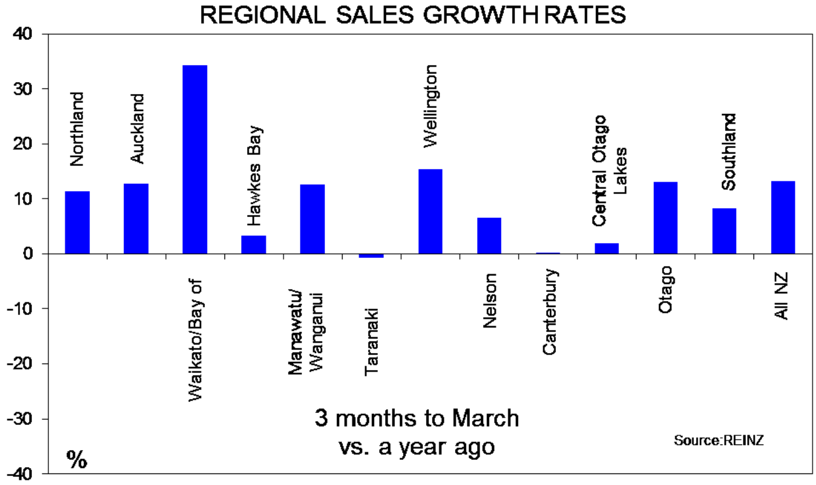
Housing

Housing Turnover Accelerating

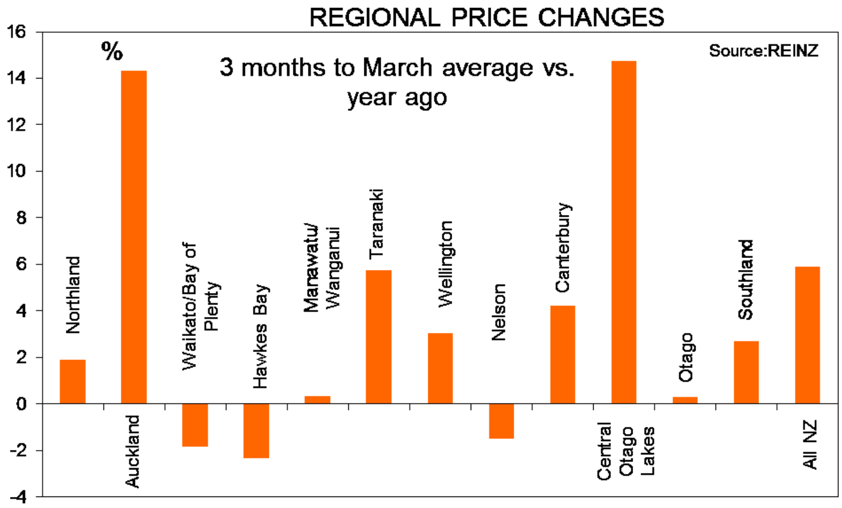
Data from REINZ released on April 14 show that dwelling sales in March around New Zealand were 20.3% higher than a year earlier, and 13% higher in the March quarter from a year ago, whereas for the full year ending in March the change from a year before was -2.1%. Housing turnover has lifted substantially. This is not what the Reserve Bank would have expected to see happen in response to a 1% increase in the official cash rate between March and July of last year.

Why the lift in turnover? Partly we believe it is because of the change in interest rate expectations regarding the cost of servicing a mortgage over the long-term. Partly it will be the lift in net migration inflows and heightened awareness of the lift with forecasts of high numbers continuing due to woe across the Tasman. Additionally there is greater awareness of the shortage of housing in Auckland clearly not being addressed. There will also be the slow entry into the real estate market of young buyers who have saved up required deposits whereas they did not have enough cash on hand previously. House construction is also stronger and that means more sales.

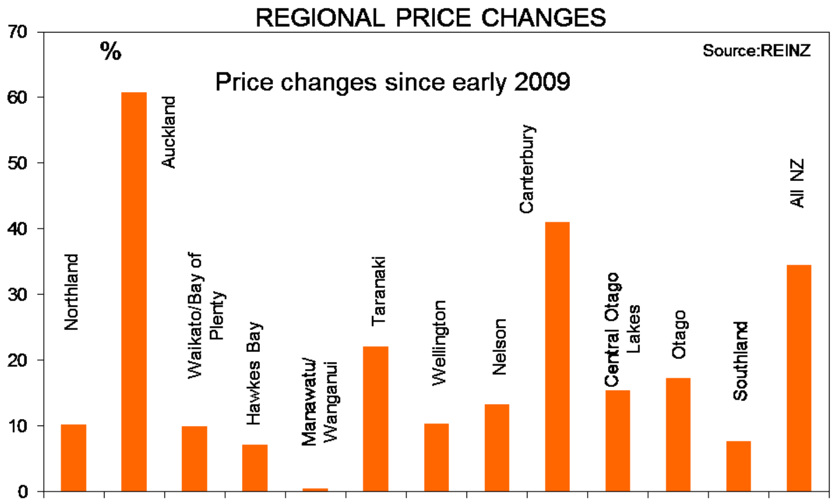
Is the lift in turnover evenly spread around the country? Definitely not though it is not concentrated in Auckland and Canterbury. The graph below compares sales in the March quarter with a year earlier.



What about price changes? Nationwide sales prices on average in the March quarter were ahead 7.7% from a year ago. Three months ago this pace of change was 5.3%, three months before 4.9%, and in the March quarter a year ago versus March quarter 2013 the change was 8.4%. There has been not so much an acceleration in price growth but a continuation of firm rises. And are these rises spread remotely evenly around the country? Of course not. To measure this we use prices not adjusted for quality changes as the adjustment is not done by REINZ for all parts of the country. These numbers are shown in the graph below. Auckland prices have risen by 14.3% from a year ago, Central Otago Lakes 14.7%.



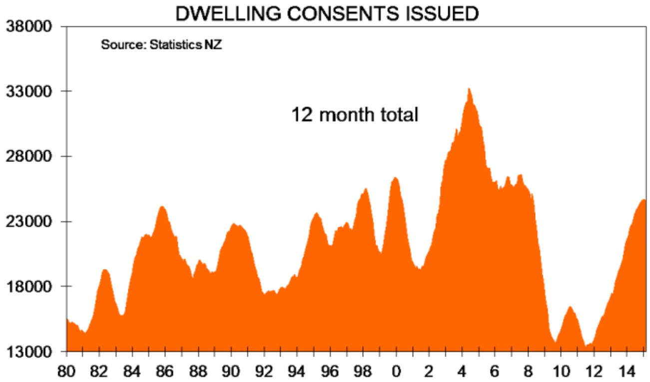
Turnover may be rising firmly in Waikato/Bay of Plenty but prices are still falling. This next graph shows changes in prices since 2009.



Where to now? The shortage in Auckland is worsening. Prices will rise at a continuing firm pace. The shortage in Canterbury will reverse to over-supply sometime in the next 12 – 18 months. Prices will stabilise and probably ease back a tad. There is some spreading of investors and young buyers out of Auckland so prices growth will likely improve in Waikato/Bay of Plenty. Nelson is due a catch-up in price. Central Otago Lakes will keep going firmly with rising incomes and erosion of the previous shortage boosting prices.

New House Supply Falling?

Last month we wrote about the relatively low level of building consent issuance this cycle with numbers looking to peak near 25,000 compared with the previous peak of 33,000 in 2004. In fact that 2004 outcome was an outlier and peaks usually are in a range from 23,000 to 26,000.



In February the seasonally adjusted number of dwelling consents issued was down by 6.3% after falling 4.6% in January and 2.5% in December. This makes for a change in the three months to February versus the three months to November of +1.9% following a 3.9% fall three months earlier. Even excluding the volatile apartments sector we get a change in the past three months of +0.2% from -4.2%. Consents have flattened out.

Compared with a year ago the three month nationwide total was up only 4% from 20.5% six months ago. For Auckland these rates are 2.4% and 36.1%, for Canterbury 5.2% and 31.7%, and for all the rest of New Zealand they are 4.2% and 3.1%. Thus we see that the slowdown is driven by Auckland and Canterbury looking like topping out while very slow growth continues in the rest of the country. Why are numbers flattening out in Canterbury? Simple. Lots of houses needed to be built to replace those taken out of use by the earthquakes, and now people can see a risk of supply exceeding short-term demand.

Are consents falling in Auckland? Not quite yet. Whereas January and February numbers for Canterbury were lower than a year earlier, Auckland was still ahead though the pace of rise as noted above has slowed tremendously. Now if those numbers start falling expect to see a huge debate regarding whether anything serious has actually been done to improve supply in Auckland. Politicians at the local level will come under a lot of pressure.

New Credit Controls For Investors

A thought occurred late-March when discussing the high probability that the Reserve Bank will introduce a credit control on lending for housing investment purposes – it will make the situation even worse for many young people. How does that work?

On the face of it one would think investors will cut house buying thus reducing upward pressure on prices. True. But some of those investors are young people buying lower priced properties which they rent out planning to accrue tax free capital gain which when they sell they will use as their over 20% deposit to get a house which they themselves will live in. These first time investment property first time buyers may be weeded out anew.

Relative Interest Rates

Many SME owners bemoan the lower interest rates which home buyers pay than business owners. There are many reasons for this including

- the greater ease of registering and, in extremis, realising security for a housing loan versus a business loan,
- the greater ease of estimating worth of housing as loan security than business assets or cash flows,
- lower cost of drawing up and processing a home loan than a business loan,
- greater capital requirements imposed by the RBNZ for business than home loans, and
- the low default rate on home loans versus business loans.

To illustrate this latter point consider data from the RBNZ Financial Stability Report of November last year. In the year to September 2014 non-performing home loans amounted to just 0.4% of the total. For rural loans 1%, Commercial Property 1.4%, SMEs 1.6%, and Corporate 1.8%. In 2010 when the effects of the GFC were washing through these ratios were as shown in the second column below.

NPLS as % all

	2014	**2010**
Housing	0.4	1.2
Rural	1.0	3.9
Commercial Property	1.4	4.0
SMEs	1.6	2.7
Corporate	1.8	1.6

The outlier in this is not housing, but rural where strong competition for lending businesses produces rates which don't really seem commensurate with the risk – and maybe even more so going forward as rising dependence upon sales to China generates extra volatility in rural incomes because of China's often violent inventory cycles.

Who Borrows?

Since only August of last year the Reserve Bank has been collecting data from banks showing a breakdown of home loans by the type of borrower. We see that in February 10% of the value of loans went to first home buyers, 31% to investors, 58% to people changing house, and just over 1% for "Business Purposes". The 31% for investors is in line with Australia where about one-third of lending is taken up by investors.

An interesting thing however is found when we look at high lending to value ratios – or loans with less than 20% deposit. One might think that investors accounted for most of such lending and that first home buyers were being left out. This is not the case.

In February 33% of high LVR lending went to first home buyers – well above their 10% share of all lending. Just 12% of such high LVR lending went to investors and 55% to existing home owners. About one-third of high LVR lending is to first home buyers so they are not missing out. Most goes to people presumably shifting up to a bigger house.

Key Forecasts

Calendar Years	**2013**	**2014**	**2015**	**2016**	**2017**
GDP % an. av cng	2.2	3.2	2.8	1.8	1.6
Inflation Qtr on yr ago %	1.6	0.8	0.4	2.3	2.3
Employment Growth " "	3.0	3.5	2.7	1.3	0.8
Unemployment Rate Year end	6.0	5.7	5.7	6.3	6.7
NZD/USD	0.82	0.78	0.70	0.66	0.66
NZD/AUD	0.92	0.94	0.95	0.88	0.84
NZD/GBP	0.50	0.50	0.51	0.47	0.46
NZD/EUR	0.60	0.63	0.69	0.62	0.60
NZD/JPY	89.1	92.6	86.1	82.5	79.9
90-day bank bill rate	2.7	3.7	3.7	4.2	4.15

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