Sporadic

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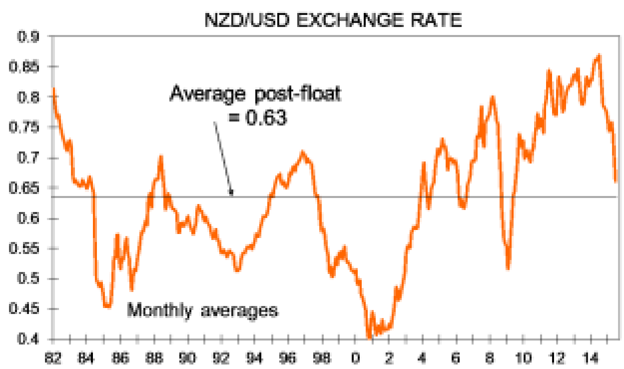
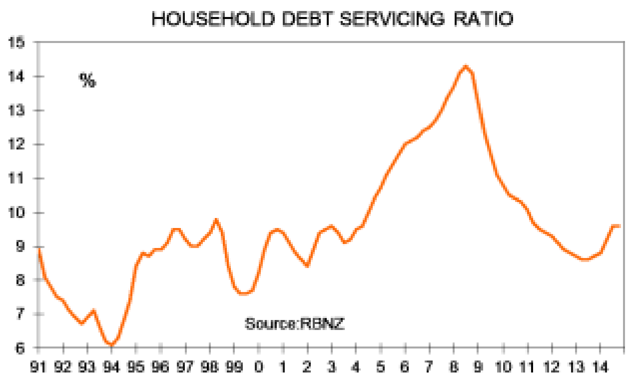
Insulating Factors Helping – Unlike 1997/98 and 2008/09 Sporadic 16

Lets have a look at what the Kiwi dollar has been up to recently. This is an important thing to do because with dairy prices falling 64% from their peak two years ago with a 41% decline since March, warnings of El Nino appearing, Christchurch's rebuild perhaps plateauing and not adding to existing levels of activity, Greece entering a new extended recession, China's economy slowing and sharemarket bubble bursting, one might slip into automatically thinking that we are heading for recession.

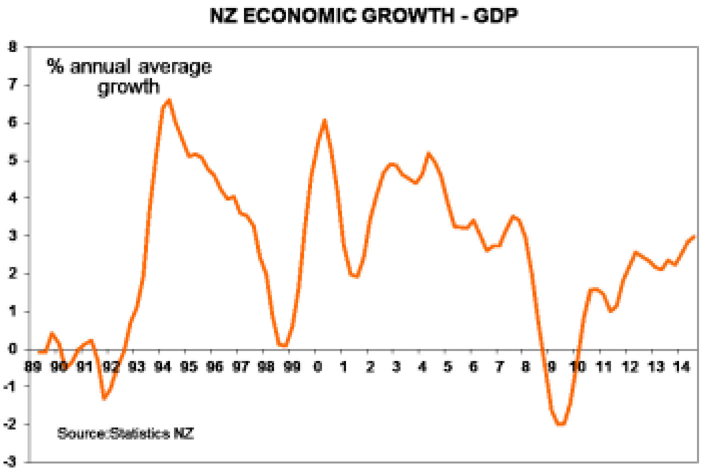
Strong growth insulating factors are already in play this time around

The last time we did that in 2008 however we had seen the NZ dollar rising from US 55 cents in 2003 to US77 cents at the end of 2007. We also saw floating mortgage rates rising over the same period from 7% to 10.5%. Exporters across the board were being badly affected and borrowers were facing huge pressures with the household debt servicing ratio rising from 9% to eventually over 14% of disposable income.





But this time around as we watch dairy incomes fall the Kiwi dollar has already declined 22 cents from its 88 cent peak against the greenback while debt servicing costs are below 10% of household income from over 14% in 2008.

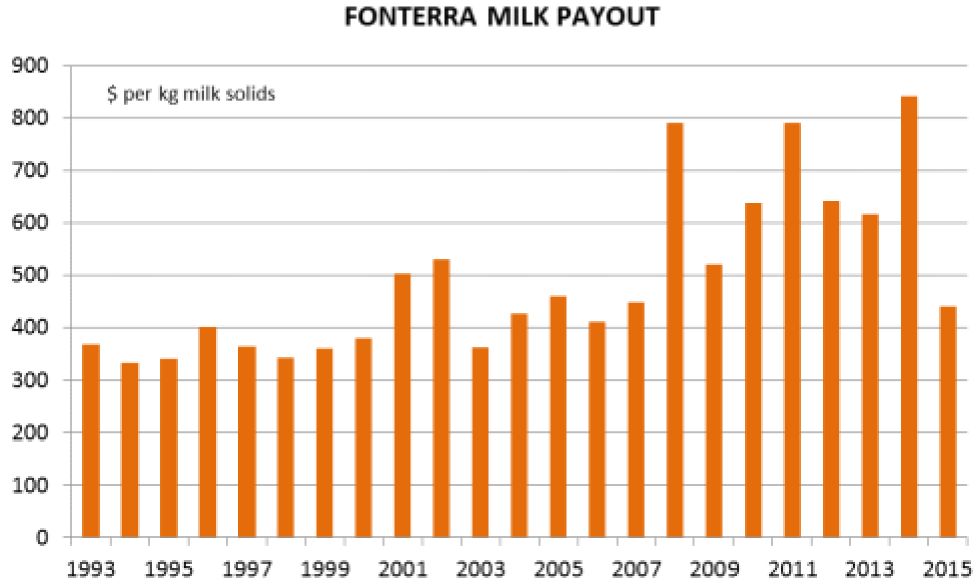


What about ahead of the 1997/98 recession? Ahead of that the NZD had risen from 52 cents in 1993 to 70 cents in 1997. Floating mortgage rates had risen from 7.4% in 1994 to 10.4% in 1997 then 11.25% in 1998. Note that for both this recession and the 2008 one interest rates were not cut by the Reserve Bank until after the economy had started shrinking. Tardy monetary policy easing is a factor which has tended to make our recessions worse than could otherwise have been the case. Household debt servicing costs rose from 6% of disposable income in 1994 to a peak of almost 10% in mid-1998. The ratio is currently near 9.5%.

To repeat, this time around even before our economy has started shrinking the RB has embarked upon a phase of monetary policy easing and the NZD is trending downward. This latter development is very important because of the strength we have previously noted in many non-dairy export sectors such as pipfruit, Kiwifruit, wine, education exports and tourism.

Thus some of the forecast flying around regarding the Kiwi dollar plummeting a lot further and the Reserve Bank slashing interest rates a long way are probably reflecting too pessimistic a view of where our economic growth will go over the next couple of years. Especially in light of the numbers out yesterday from the Building and Housing Ministry showing projected construction spending of $200bn over the next five years.

And to look at this from another angle, does a decline in dairy incomes tend to lead to recession in New Zealand? No. Notice in the following graph the large payout decline in 2003 – after which our economy grew by 4.4% in 2003 then 4.6% in 2004. The 2009 decline was somewhat different as a lot of other things revolving around the GFC were in play and the economy shrank by 1.4% in 2009 then grew 1.6% in 2010.



If I Were A Borrower What Would I Do?

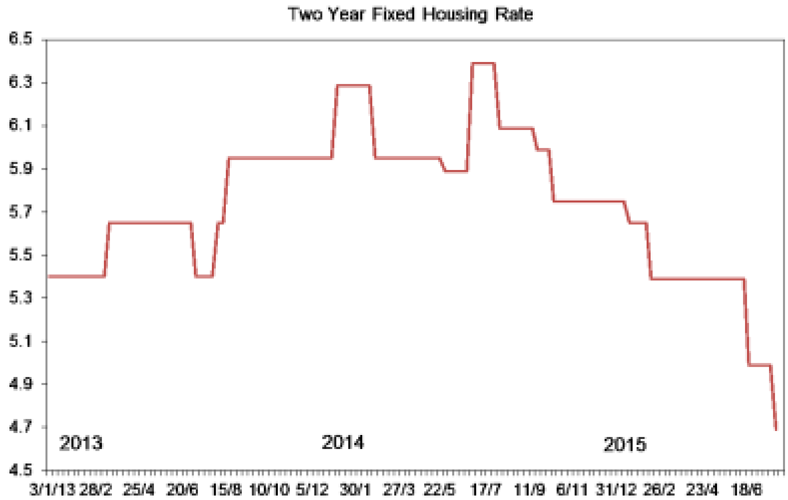
I am still hoping that the focus of bank mortgage competition will shift from the one to two year fixed rates to the three to five year area and deliver the 5% three year and 5.5% five year rates I have been targeting since February. But there is of course a level of rates for shorter terms which I would accept rather than take the punt of waiting. When our two year rate was specialled down to 5.39% earlier this year I remained committed to waiting. And the recent rate of 4.99% also left me prepared to wait. But now we have a two year fixed rate of 4.69%.

If the alternative to that is a three year rate of 4.99% then by fixing two years the rate I pay for the missing third year will need to be higher than 5.59% to make me worse off. So do I think it highly likely that in August 2017 the one year fixed rate will be above 5.59%? It is currently 5.19% reflecting an official cash rate of 3.0%

which is expected to go down another 0.5% by the end of the year. Will the Reserve Bank be tightening monetary policy in 2017?

Our view is they will and that the cash rate will be 3.5% in two years time. The chances are high that in two years the one year fixed rate will be at or above 5.59%. So, if I think our forecasts prove accurate I would opt for a three year rate at 4.99% rather than a two year rate at 4.69%.

However, the three year rate is currently 5.29%. The other main banks are at 5.59%, 5.75%, 5.69% and 5.49%. Frankly, the chances that I get the lovely rate I have been waiting for are not all that high. In addition, essentially all interest rate forecasts since 2008 have been too high so the risk is interest rates are not rising over 2017 as we currently forecast.



Thus my incentive, and perhaps yours as well, is to fix two years at 4.69%, rather than hang on hoping that Greece goes completely pear-shaped, China's economy tumbles anew, or the NZD shoots up 5 – 8 cents and encourages extra rate reductions by our central bank. None of these scenarios can be ruled out. But whereas the 5.39% rate earlier this year and recent 4.99% were not good enough for me, the new 4.69% is a good enough rate to get my business.

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Sporadic 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. Please sign up at www.tonyalexander.co.nz
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