

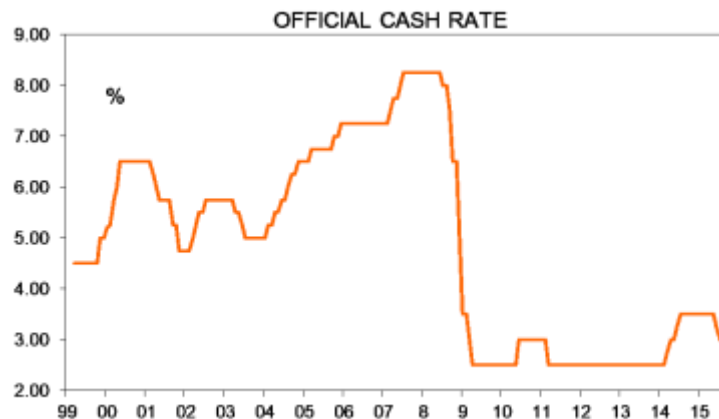
Sporadic

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RBNZ Almost Back To Square One

Sporadic 19

The Reserve Bank this morning cut its official cash rate by 0.25% so it now sits at 2.75%. Cuts since June now amount to 0.75% and come October 29 when we expect a further 0.25% cut the rate will be right back at the 2.5% level it was taken to in 2009 as the economy was slammed by our own recession then the global financial crisis.



This is the second time that the Reserve Bank has had to unwind a bout of monetary policy tightening. The first was in 2011 when they cut the rate back to 2.5% from the 3% they had raised it to during 2010 as the economy showed good signs of growth. Last year between March and July the rate was raised from 2.5% to 3.5% in anticipation of higher inflationary pressures expected to arise as a result of accelerating economic growth lifting the pace of wage rises and boosting business pricing ability.

But instead of going up inflation has fallen. For instance, in March last year the Reserve Bank predicted that our inflation rate in the year to March this year would be 1.9%. It was in fact only 0.3%.

Repeatedly here in NZ and offshore things have not turned out as all of us forecasters have been expecting. It is not just that our growth predictions have been too high, and that on the basis of that our employment forecasts have been too optimistic. It is that even with good jobs growth wages growth has failed to accelerate. And businesses have tended not to use stronger sales growth to boost selling prices.

The world has radically changed post-GFC and old relationships between key economic variables are no longer what they were. The trouble is we don't yet know what they newly are – and it is a problem not just here but overseas as well.

As previously noted our central bank is not alone in having to cut interest rates after raising them in anticipation of things happening which ended up not happening. The European Central Bank took their cash rate from 1.75% to 2.25% in 2011. It now sits at 0.3%. The Reserve Bank of Australia took their rate from 3% to 4.75% in 2009-10. It now sits at 2%. The Swedish central bank, the Riksbank, took their repo rate from 0.25% in 2009 to 2% in 2011. It is now -0.35%.

Interest rate forecasting accuracy has gone out the window. Apart from getting the 1% rise in the RBNZ cash rate correct last year you will struggle to find any other accurate interest rate predictions in New Zealand – or elsewhere – since early-2007.

Why are forecasts proving wrong? There are many reasons and the first and most obvious one is that the period leading up to the GFC of 2008-09 proved we do not at all well understand the linkages between financial flows, the finance sector, and real economic activity. Finance globally moves far more quickly into various assets these days than before, and using asset prices as a gauge for what market participants consider to be the true worth of something is not valid in many cases.

Second, our behaviour as economic individuals has changed post-GFC. We are more sensitive to price changes than before and will more willingly back out of a purchase if prices rise, looking for the same or a similar good or service online, offshore, or via price comparison apps. Businesses do not have the same pricing power as in the past and have to think twice before putting up a price.

Third, as employees we have changed. Our willingness to ask for a wage rise has declined as we see continuing news about high unemployment overseas, economic shocks and turbulence. We are unwilling to have the boss call our bluff and be forced to leave to risk being last-on, first-off elsewhere in the event of an economic downturn.

Four, we are more sensitive to our debt levels than before and this not only reduces our willingness to borrow at low interest rates, it also makes us less willing to run the risk of periods of no wage income – thus feeding back into the point just above.

Five, and this is a key problem in the United States and more so in Europe, businesses are far less willing to undertake capital expenditure than before. This has the very bad effect of reducing long term productivity growth and is a key factor behind reductions in assumptions about where economic growth rates will average in the future. But it also means less short-term growth and again more so offshore than here, less willingness to boost payroll numbers.

Six, governments are aware of their high debt levels and the need to rebuild the fiscal buffer for when the next national and/or global economic crisis comes along – and one always does at least once a decade. Thus as growth strengthens in an economy businesses know the pace will not lift all that much above the norm because fiscal policy will be tightened (and interest rates will be raised).

Seven, inflationary pressures are naturally being suppressed by a lot of excess capacity which has built up in many sectors across many countries, most notably the emerging economies and China in particular. To whatever extent a commodity super-cycle existed from 2008 it has now well and truly ended and there is a structural shift down in energy costs underway along with prices for most commodities stretching from coal, iron ore, aluminium, to milk.

Eight, technological developments and their application appear to be becoming more dominant influences in economies, usually with downward pressure on prices for goods and services produced by existing long-standing providers.

Nine, the GFC has revealed deep structural problems in many economies – notably in southern Europe – and every now and then the implications of those problems and the reluctance of the population to fix them butts up against the willingness of people to lend more money down the gurgler and a crisis erupts – usually involving Greece.

Ten, chickens are coming home to roost and sapping growth in a number of emerging economies which previously boomed on the back of either high oil prices or unsustainable fixed asset investment growth. Brazil, Russia, China. India has been no more or less corrupt than normal in recent years and it alone among the BRIC economies is escaping a big adjustment.

Eleven, for many years we have noted one of New Zealand's special characteristics which is that average gross emigration and immigration flows as a proportion of the population are perhaps the highest of all countries. On average each year we lose about 1.7% of the NZ population overseas and gain 2.0%. These flows can change quickly resulting in big fluctuations in the rate of growth in the NZ population, labour force, and housing requirements. Currently the record net migration gain of 60,000 people resulting from a 2.6% of

population inflow and just 1.3% outflow is boosting housing demand while suppressing wages growth and generalised inflation pressures through boosting the size of the workforce. At some stage we will receive a shock from these flows reversing. Don't know when.

Twelve, related to the first point, it is not just that we do not understand linkages between the financial sector and real economic activity. Worse is that the world is awash with liquidity looking for a home courtesy of hefty money printing in the United States (now ended) and continuing printing in the Eurozone and Japan with no end date on the latter and probable extension beyond September 2016 of the former.

Thirteen, as long predicted we have now entered a period when Baby Boomers are retiring. The passage of this cohort of hundreds of millions from working life into retirement will have profound impacts upon consumer and asset markets, but in ways which are difficult to predict. For instance do retirees sell investment property to free up cash, or buy more to fund a longer retirement than earlier anticipated, especially with bank deposit returns now so low?

Fourteen, increasing globalisation of markets for goods, services, capital and labour mean shocks in individual economies are more quickly transmitted with greater impact to other economies than in the past.

This list does not capture all the factors explaining why predictability of economic variables has fallen off a cliff. But hopefully it helps reinforce our long-running warning not to place high reliance upon a particular scenario playing out when you make personal and business financial decisions. Build flexibility into what you do, and focus on constructing resilience to shocks we have no hope of predicting. Bird flu, El Nino, terrorism...

Speaking of which, next week is going to be interesting. There is a strong though not universal expectation in the financial markets that the Federal Reserve in the United States will raise interest rates for the first time since 2006. The common view is that rates may track up in a slow stop-start fashion for perhaps three years. But there is not only much debate about the starting time and the pace of rises, but also how the US economy will react, how emerging economies will be affected, how sharemarkets will change and so on.

In other words, the Federal Reserve is about to put itself either this month or maybe before the end of the year into the same position as our Reserve Bank, the RBA, ECB, and Riksbank at various stages since 2010. What few in the markets seem to have discussed is the chance that the US monetary authority in a year's time cuts interest rates. So be careful regarding forecasts for NZ interest rates over the next two years which reference the impact of assumed rises in US rates for the next couple of years. They could easily be as much in error as all other forecasts of sustained fixed borrowing cost increases since 2007.

If I Were A Borrower What Would I Do?

As predicted since early this year the intensity of competition between lenders has picked up and borrowers can pick up some very good deals. However I haven't been so accurate with regard to predicting that lenders would shift the focus of their competition to longer fixed rate terms. The opposite is happening with best discounting for the one and two year terms.

Given the low chance that national and global conditions are going to require a tightening of monetary policy by our central bank for quite a long time, the risk of fixing short and being caught by rates being on the rise when one's fixed term ends seems quite low. So my borrowing preference for the moment is fixing two years with a decent chunk floating to allow for early repayments without penalty. Many people will however be quite comfortable with fixing one year. I consider six month fixing just opportunistic and not really a risk management strategy.

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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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