BNZ Weekly Overview

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Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

The Changing Christchurch CBD

I spent a couple of days in Christchurch this week delivering four talks and was impressed by the change in the CBD from about a year ago when I think I last took a look at what the centre was like. There are many four to six story buildings going up including the BNZ building in Cashel Street into which we will be moving hundreds of staff just over a year from now. Other banks have buildings on the go, the new police station is going up, buildings are being erected along the old "strip" area beside the Avon River and so on.

There are still not that many functioning shops in the centre beyond the Restart Mall and Ballantynes though bit by bit more are showing up. The challenge for operators will be not so much to get Christchurch people visiting in a couple of years as I am sure everyone will want to see what the new centre eventually looks like. Instead the challenge will be getting them to visit the many malls less often and instead come into town for shopping and a broader inner city urban experience which malls never offer – strolling in parks, along the river, discovering non-chain shops, eating in non-chain cafes and restaurants, giving their children and grand-children a unique experience of connectivity with the city (e.g. Charlies Ice Cream) that a mall can never deliver.

To achieve those repeat visits will take a great city layout which appears to be underway. But the experience as such may be more than two years down the track although the tram is apparently very popular. Parking will be critical and if the approach of charging people as much as possible is implemented, perhaps by handing building contracts over to private sector operators, then the city will only end up back where it was before 2011 – a place most people visited just occasionally when they found themselves not in the handy vicinity of a mall.

Overall I was impressed by the development underway but there is still a lot of questioning in business circles over the time being taken to get the convention centre back up and running and uncertainty regarding whether or not a new stadium will appear. There are some tourists in the city including at the Novotel where I stayed. But walking around the Cashel Mall area Tuesday morning and afternoon I felt there were fewer people around than one, two, and three years ago and wonder if the planners have given thought to whether that is really the case or not.

The CBD currently is and for the next year at least by the looks of it will be essentially a building site. But two years down the track something truly fantastic will be taking shape and I look forward to spending more time there then.

Housing

A number of people are saying that the biggest threat to New Zealand's economy is the Auckland housing market. This is not correct. A threat has to be assessed based on the probability of its occurrence and the apocalyptic scenario people postulate of prices falling over 40% is very unlikely to occur unless we get a combination of foot and mouth, Mount Rangitoto bubbling, and a technological discovery allowing houses to be built for half their current cost. (Imagine the vested interest lobbying to prevent such innovations ever being implemented.)

This common expression of fear about Auckland is probably driven by three things. One, failure of the market to stop rising and fall back as 99% of people have predicted since 2008. The desire to one day be right and the inability to understand why they have been wrong leads people to assume unsustainable unpredicted forces have been at work and eventually the truth will come out and past wrongs will be righted.

Second, an expression of not so much impotence but impatience on the part of the central bank which feels it has taken its eyes off the ball by letting an asset market surge in a manner all central bankers decided post-GFC would not be allowed to happen again. They are struggling to develop and implement new weapons to influence the housing market now that changes in the official cash rate are off the table because of entrenched low consumer goods and services inflation.

Third, concern about the deteriorating housing affordability for young people leading to a misplaced leap of logic that because young people are supposed to be our most valuable asset and because there is a thing happening which makes them unhappy that thing will eventually be removed one way or the other – don't know how but worldly or other-worldly forces will eventually gallop over the brow of the hill and save the day.

Fourth, a desire by many frustrated buyers for a price correction so they can purchase and make a future capital gain. You may recall that in one of the three surveys I used to run I would ask respondents to indicate whether they were happy or sad that house prices were rising. A majority were happy. Remember that as you lobby politicians to implement measures which will lower house prices and cause voters to opt for the other party. Note how Labour have dropped their logical policy of raising the retirement age from 65 (it makes huge sense as our life expectancy is rising. Affordability of superannuation for taxpayers is a completely separate issue.) Labour have also dropped their capital gains tax proposal. However I consider it highly likely that under a future government different from the current one we will see the two year bright line test for capital gains tax imposition to be extended to five years, then seven years, and one day ten years.

Speaking of extending things. Watch for the Reserve Bank extending the 30% minimum deposit requirement for mortgages taken out to buy investment properties from Auckland to other regions if not all the country if the non-Auckland market produces price rises which start to scare them. This is an example in fact of the way in which the RB is outright experimenting with non-OCR tools to influence bank housing risk. They will be wondering how messy the 30% tool will become if they need to extend it to other regions. Will they stick with 30%? What about 15% in some, 45% in others? It could become a Muldoonist nightmare.

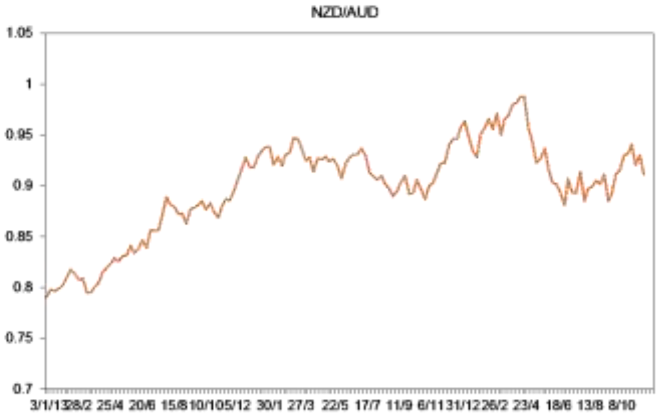
Oh, and be ready for Auckland's 30% to be boosted to 50% if that market reignites in the New Year. Trigger? When the Chinese economy stabilises, growth lifts, and the Beijing government relaxes rules on private capital outflows in order to achieve their goal of making the Yuan a truly global currency like the US dollar. They will have no choice in relaxing the capital outflow rules if global acceptance is what they want. Timing of such a thing is however anyone's guess.

Remember how so many people ascribed foreign Chinese as main players in soaring house prices? I have yet to have a single person say to me that the sharp lift in dwelling sales outside Auckland and upward pressure on prices is being driven by foreign buyers let alone a Chinese hoard.

NZ Dollar

Our currency was pressed downward slightly against the USD this week toward 64.5 cents from 65.5 cents by two factors. First the terrorist attacks in Paris which naturally prompted a wave a risk aversion amongst investors which usually means cutting back positions in far flung currencies like the NZ dollar. Second, the further 7.9% fall in average dairy prices at Tuesday night's Global Dairy Trade auction.

Dairy prices on the auction have now declined by 17% since early-October and sit 56% down from the early-2013 peak. Back in August after prices had fallen 50% from March levels things were off 67% from early-2013. There is a sizeable but not substantial difference between 56% and 67% declines therefore we should expect to see continued expenditure restraint in the dairy and dairy support sectors which will be one of the factors capping growth in the NZ economy over the coming year or two.



However there are plenty of other factors which will underpin GDP growth near 2% such as construction, migration, low borrowing costs, non-dairy exports, and services sector growth. Thus it still seems unreasonable to expect that the Kiwi dollar will undergo further substantial decline from current levels. Exporters and people with funds offshore which they wish to convert into NZDs might be advised to take advantage of these occasional downward spurts in our currency to purchase some Kiwi dollars. Importers and those with timing flexibility wanting to shift funds offshore might be advised to simply wait for the next inevitable blip up.

Note that it is highly likely we will see increased currency volatility over the coming year. United States monetary policy is set to be tightened for the first time since 2006 and not only is a nine year gap a long period of time over which links between key variables can have altered, all such links have been blown asunder by the GFC. No-one has any strong idea of what will happen with the US housing market, business investment, employment, confidence, share prices, retail spending, and currency as US monetary policy tightens. Debate regarding the impact of rising US rates will be huge, fluctuations in interest rate expectations may be highly frequent, and this will cause gyrations in the USD's relationship with other currencies and flip-flops in market risk tolerance levels.

One key factor helped the NZD from falling further this week – the stronger than expected retail trade numbers released on Monday showing core spending in real seasonally adjusted terms up by a healthy 1% in the September quarter. Note also the strong rebound in consumer confidence reported last week which suggests continued good consumer spending growth in the next six to nine months.

Against the Australian dollar the NZD has declined over the week courtesy of a much stronger than expected jobs growth number across the ditch for October. While Australia's economy is being negatively affected by the end of the commodity super cycle and slowing growth in China, there is good strength in the services sector, residential construction (though it varies a lot from state to state), tourism, and retail spending recently. The Reserve Bank of Australia has recently made comments indicating they see the economy slowly transitioning toward growth driven by the non-mining sector and the probability that the cash rate will be cut below the 2% level it was taken to in May are fairly low.

Against the Euro the NZD is down only marginally from a week ago with the Euro understandably weaker over the week in response to the terrorist attacks in Paris boosting expectations of continued low business investment growth as confidence takes a hot, and a higher chance of the ECB continuing money printing beyond September 2016.

If I Were A Borrower What Would I Do?

Nothing in this past week has jumped up in front of me to make me believe that the outlook for NZ interest rates has altered. The currency is doing the usual toing and froing. The economic data still suggest reasonable but not stellar growth ahead, dairy prices paint the same weak picture for the sector in the short term that they have been doing since March, world growth prospects still contain downside risks, Australia's growth is holding up with highly mixed performances between sectors, NZ consumer and business sentiment measures are reasonable, and the key problem facing our central bank has not changed.

That problem is that they would like higher interest rates to help curb what they perceive to be rising risks facing the financial sector as a result of strongly rising house prices. But with inflation at 0.4% and a high risk that their forecasts of inflation rising to 2% predicated on a strong pass-through of the weaker NZD are wrong yet again (and most of us have been wrong in this area) they cannot raise rates as they may lock in deflation.

The RB are likely to cut the cash rate a final 0.25% come December 10 with the probability of a cut enhanced recently by the terrorist attacks offshore and weak dairy prices, but reduced by our recent strong consumer sentiment and retail spending numbers and accelerating regional housing markets. A rate cut below 2.5% is not a highly probable scenario and borrowers should note that with US monetary policy to tighten soon the chances are very high (surely this time around) that we have seen the lows for medium to long-term fixed borrowing costs.

Were I borrowing at the moment I would have a strong bias toward locking in a two year fixed rate.

For Noting

You may recall a couple of weeks ago that we got data showing employment falling by 0.4% during the September quarter. We noted that the labour market tends to be a lagging indicator of the state of the economy rather than a leading indicator of what lies ahead. Here is a way of backing that up. Although employment fell in the quarter, on Monday we learnt that the value of retail sales rose by 1.4% or by 1.6% if we focus on volumes. That strong result was partly driven by a 5% surge in motor vehicle sales, and such spending on long lasting (durable) items is not what occurs if people are concerned about their future income levels.

Core retail spending which excludes fuel and vehicles rose by a healthy 1% after being flat in the June quarter (cautious consumers wondering what falling dairy prices meant), and having soared 2.2% in the March quarter and 1.9% in the last quarter of 2014. Retailers have basically enjoyed a strong lift in sales over the past year with the growth in the entire year to September versus the year before a healthy 6% compared with long-term average annual volume growth of only 2.5%.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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