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.

Interest Rates Still Falling

As had been widely expected the Reserve Bank this morning cut its official cash rate by 0.25% to 2.0% and indicated further cuts lie ahead. To whit...
"Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range. We will continue to watch closely the emerging economic data."

They have published a set of rate forecasts implying one more rate cut than they planned back in June and this is because of the NZ dollar being "significantly higher" than they assumed, uncertain prospects for global growth with heightened political risks, and cuts to their inflation forecasts.

Yet while noting the reduced inflation track which has prompted their action they also note that ":House price inflation remains excessive.." and "The Bank is consulting on stronger macro-prudential measures that should help to mitigate financial system risks arising from the rapid escalation in house prices."

In other words almost certainly the establishment of a regime of limiting mortgage size banks can offer to a multiple of household income.

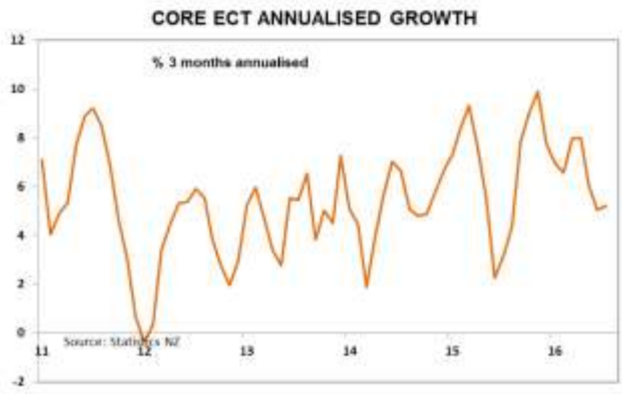
Outside of their twin problems of low inflation (which hardly anyone else considers to be much of a problem and not really something which lower interest rates will solve), and rapidly rising house prices (again, not a problem for the majority of Kiwis though a terrible issue for young buyers), they paint a good economic outlook.

Our economy has good support from construction, tourism, and migration though it looks like the RB have not repeated their call of a few weeks back for the government to consider migration changes to reduce housing market pressures. In fact yesterday the Prime Minister got in before any potential new comment from the RB by noting that no changes are planned.

With borrowing costs still falling we can expect good growth in the economy to continue, but like most other analysts doubt that the low rates will generate much extra inflation. Price growth is being held back by the complete absence of any sign that the pace of wages growth is accelerating, and other factors we can only guess at.

My personal pick is that because the cost to consumers of searching for alternatives to products rising in price is nowadays near zero because of smart phones, retailers struggle to raise prices. This is causing margin management problems for many companies and as we have long warned means that retailers can fall over even when retail spending growth is strong – which it is now.

We get a reasonably up to date gauge of whether consumers are opening their wallets much or not from the monthly Electronic Card Transactions data released by Statistics NZ. The July data released on Tuesday told us that in that month seasonally adjusted core spending rose by 0.7% after rising 1% in June. That means growth was an annualised 5.2% during the three months to July which is just below the average pace of growth since 2004 of 5.7%.



However, with inflation only 0.4% compared with an average 2.2% since 2004 we can conclude that in volume terms spending is growing perhaps around 1.5% stronger than average. This stands in contrast to the situation in many other countries where consumer spending growth is weak.

Offshore people may be worried about their economies with those worries in some instances looking like they have been deepened by central banks getting so desperate that they have introduced negative interest rates. The countries with the most negative rates are tending to have the highest household savings rates.

Why Worry About Low Inflation?

During the week an emailer asked why it is desired by our central bank that the rate of inflation goes higher. Apart from the fact that they have been set an official goal of 1% - 3% the argument in favour of inflation in that range rather than tracking just above deflation at 0.4% where it currently is runs as follows.

If inflation stays below 1% then the risk of deflation when the next downturn comes along are high. The problem with deflation is it tells consumers to spend later not now in order to achieve lower prices, especially for durable goods. So the economy weakens even further in a downturn bringing more unemployment, greater financial losses and risks of bank failure.

Second, with prices falling but debt not business ratios of debt to sales, equity etc. get even worse during a downturn so more firms will go under and the recession is deepened.

Third, sustained extremely low inflation means sustained low interest rates and that means when the next downturn occurs scope to cushion the blow with reduced cash outflows to service debt is reduced. Again, the downturn is worsened.

Fourth, as with companies, falling prices make government debt ratios worse as tax returns are affected but debt levels stay high. Scope to mitigate a downturn with temporarily stimulatory fiscal policy is weakened.

So it is best to view extraordinarily low inflation in the same light as high levels of interest only borrowing, lots of low deposit borrowing. Everything will be fine while growth is okay. But when a recession comes along – and they always do eventually – the impact will be much more severe risking extreme financial instability (a polite way of saying bank bankruptcies) and a far deeper downturn. So trying to keep inflation close to 2% is all about risk management rather than any association on average of a particular lowish inflation rate with a particular rate of economic growth.

Don’t link inflation with growth whether real or nominal. Think instead in terms of providing scope for reducing the risk that the next recession turns into a depression.

Housing

The REINZ reported this week that in July there were 7,299 dwellings sold around New Zealand. This was down 10% from a year earlier which makes for the first annual decline since October 2014 when sales were for a while knocked back by the imposition of new lending rules from late-2013 and the Reserve Bank raised interest rates 1% between March and July 2014.

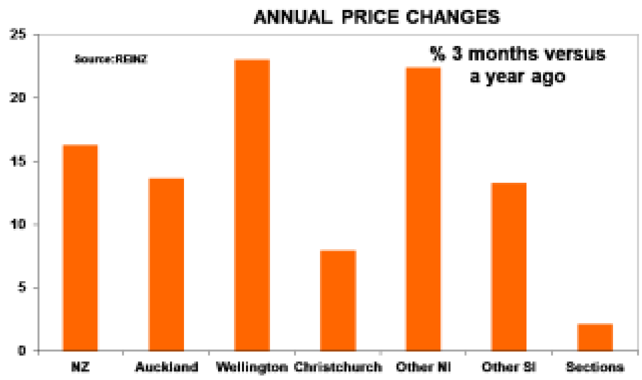
Does this new decline mean the market is stalling? No. Why? Because the key factor causing falling sales appears not to be buyers withdrawing from the market as happened from late-2013 but sellers not placing their properties on the market.

On average in July the time taken to sell a dwelling was 8.5 days faster than average at 30 days. June was 7.8 days faster than average, May 7.6 days and both April and March 4.8 days.

Unsurprisingly then because of the supply shortage prices have risen. The average price when adjusted for changes in the types of houses sold each month rose by 2.2% nationwide in July after rising 0.8% in June, 2.1% in May, a.5% in April, and 3.4% in March. The February rise was 3.9%.

The annualised pace of average nationwide price rises in the three months to July was 22.5% from 22.3% three months back, and a 4.5% fall in the three months to January which was when the Auckland market was hit by the 30% minimum deposit requirement imposed on investors and need for buyers to have an IRD number and NZ bank account.

The following graph shows price changes between the three months to July and the same period a year ago.



Speaking with a gathering of real estate agents in Wellington this week it is clear that their major problem is a shortage of listings which when set against an abundance of buyers has fairly obvious price implications.

NZ Dollar

The Kiwi dollar has risen against the USD this week assisted this morning by the Reserve Bank publishing a forecast interest rates track implying just one more cut whereas the markets had largely factored in two more. This evening we sit against the greenback near 73 cents from near 71.5 last week. So here is our reminder about the NZD yet again .... it is well supported by economic fundamentals far stronger than in many other economies. The risk is the NZD stays strong and heads to 75 cents. And if the next dairy auction produces another price rise above 5% we could be there next week.

Against the British Pound the NZD remains well supported with some upward movement this week to 56 pence following the bigger than expected easing of monetary policy by the Bank of England last Thursday night. The BOE cut their cash rate to its lowest level in the 322 history of the organisation to 0.25% from 0.5%. This cut was expected. But it came alongside the announcement of plans to supply banks with ultra cheap four year funding if they wanted it, plus buying of £60bn worth of government and a few corporate bonds. This return to printing money is aimed at blunting the downturn forecast to come following the Brexit vote and the BOE cut their UK growth forecast for next year to just 0.8% from the previous 2.3%.

In the United States meantime the chances of monetary policy being tightened this year, following the single 0.25% rate rise late last year, have increased following the stronger than expected employment data released on Friday night. But that has not stopped the NZD rising against the firm USD, hence we have risen against the Yen to near 74 from 72.5, and against the Euro to near 65 from near 64 centimes.

Against the Aussie dollar the NZDS is unchanged from last week near 94.5 cents with the AUD well supported in spite of the RBA last week cutting its cash rate 0.25% to 1.5%. Further cuts are likely, perhaps taking the rate to just 1%.

If I Were A Borrower What Would I Do?

We see a good chance that interest rates will be cut two more times this year. But scope for fixed interest rates to fall much below current levels is limited by the risk of tightening US monetary policy with that risk heightened by strong jobs growth in July and June.

Were I borrowing currently I would be inclined to have about a quarter of my mortgage at a floating rate and the rest fixed two or three years.

If I Were An Investor ...I'd see a BNZ Private Banker

The text at this link explains why I do not include a section discussing what I would do if I were an investor.
http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/

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
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz