BNZ Weekly Overview

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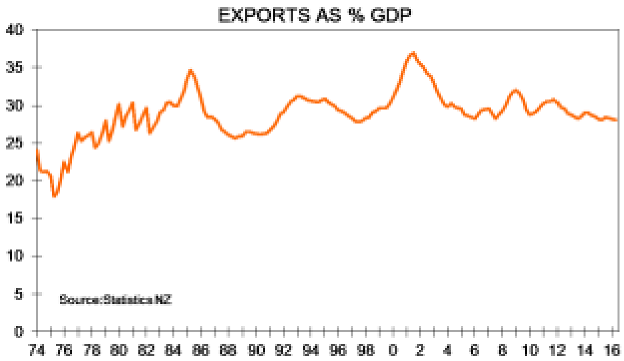
Mission Statement

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

Why NZ Struggles

There has been no growth in exports as a proportion of the NZ economy for nearly four decades. This is a big problem because it is generally in export sectors that economies see the greatest growth in productivity and where the winds of competition and need to invest and innovate are the strongest.



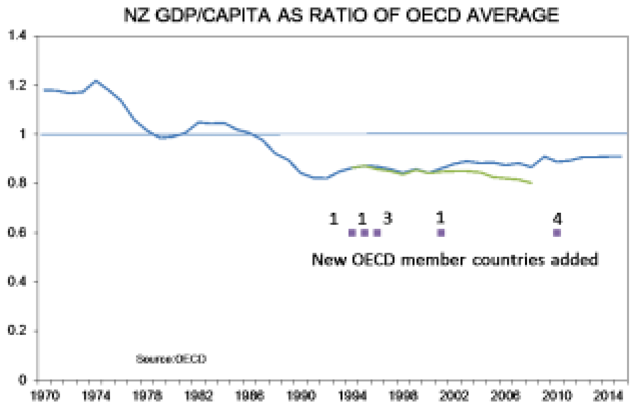
Our failure to grow exports stands in stark contrast to many other small open economies which have seen the importance of exports rise substantially.

	Exports as a % GDP	
	1980	**Latest**
NZ	29	28
Australia	15	20
Belgium	50	84
Denmark	32	53
Finland	31	37
Ireland	44	124
Netherlands	51	83
Sweden	28	45
OECD average	20 (1995)	29

https://data.oecd.org/trade/trade-in-goods-and-services.htm

But many of those other economies have also seen their imports as a proportion of GDP shoot up as well. That is because often what they export has been partly imported. The materials are part processed in their country then shipped elsewhere. This is not really a model of growth for New Zealand because our wage rates are too high to attract bulk assembly or manufacturing businesses generally found in Asia, we are too distant from other markets for transport costs not to be a problem, and no business sees NZ as a good place to locate to gain access to other markets.

But the way our export sector differs from sectors in other countries could explain why incomes per capita in real terms, while growing, are possibly not taking us back up the OECD ladder.

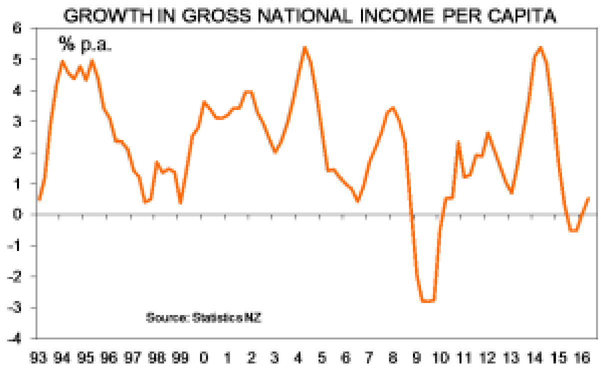


We say possibly because while the official GDP per capita series for NZ starts in 1970 the OECD average data only starts in 1994 when new members were added for the first time since ourselves in 1973.
http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm

This new series shows us improving as a percentage of the OECD average GDP per capita to 91% in 2015 from 86% in 1994. The old series has us declining from 86% to 80% come 2008. So it is hard to know whether we are getting relatively better or worse.

However, as noted above, income per capita in New Zealand has been growing quite well recently and our post-GFC performance has been good compared with many other economies.

So maybe we are creeping back up the ladder at a very slow pace. Or not.

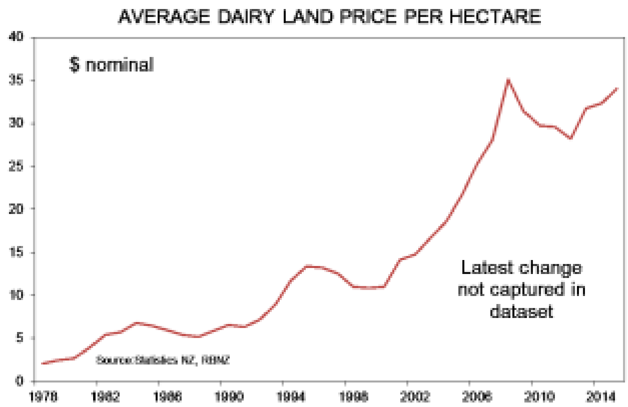


Our export sector is dominated by primary products such as dairy, wood, and fish, and the growing sector of tourism is generally a low yielding one for staff with major assets often owned offshore. This delivers profit gains outside the hands of New Zealanders. Hospitality sector jobs are generally low skilled and not high paying.

A key problem with our primary sector export dependence is that the focus of growth and development is completely different from other economies which form part of the global supply chain. In those economies there is an ever present risk that whole industries will up sticks and go to a different location offering cheaper wages and better transport infrastructure – logistics. Fear of becoming uncompetitive drives businesses to continually innovate, to seek new products to process, and to pressure policy makers for better infrastructure. Business and government work very closely together because government knows loss of competitiveness will see loss of industries and quickly rising unemployment. We are different.

No farmer or politician fears the loss of their dairy, meat, wool, wood, or fish production offshore. The industries can shift around a bit from one output to another, but they will essentially always be there. "They're not making any more of it" we tell ourselves with regard to land, implying its simple existence under our feet will always be our saviour.

In the minds of operators is not the fear of becoming uncompetitive but worries about prices not being high enough to cover costs, cash losses occurring, and land values falling. The attention of operators is on handling price volatility, not product innovation. It is on building wealth through higher farm values, not developing new products and slashing costs.



Their expectation is that if losses are being made the currency will fall and save them with an eventual good cyclical upturn – and this happens every time. And the focus they want policy makers to undertake is not on helping develop new products and constructing better and better infrastructure, but on signing new trade deals opening up new markets for the same old products, or securing better access into existing markets for these old products – meat and dried milk.

Can this situation change? Not unless farmers see more value from producing less output and investing in downstream activities and products, than in investing simply to produce more product. Sheep with higher lambing percentages and faster growth from fewer inputs. Cows which produce more milk.

Whole industries of tens of thousands of people exist to boost output, but possibly not a single person fears that dairy, sheepmeat, beef production etc. could completely disappear. (NZ milk production has doubled since 1997 – feel wealthier?) And without that threat and with the history of strong wealth gains simply from sitting on land and waiting, there is no high chance that our export base will become a strong source of economy-wide productivity/income growth.

Or, put another way, just as the journalists in "All The President's Men" were told to follow the money, so we economists tell people to look at the incentives. What is the incentive for our major exporters? Invest downstream in a string of 10,000 Kiwi-branded and owned shops throughout China and ASEAN nations selling our primary products processed into high priced nutraceuticals like infant formula etc.? Or focus on cost control, boosting output, lobbying politicians to open new markets for old products, and holding land while it rises in price, facilitating the latter with more and more debt?

The challenge is how to change the incentive for where farmers and outsiders invest their capital and policy lobbying – away from more cows and new markets, toward pooling capital to cut production and invest in offshore presence and high valued-added products. There seems little chance of this happening. Instead what will happen over the coming century is that the proportion of NZ primary sector output processed into high value added products will surely rise, but ownership of the value chain will be by non-farmers who allocate their capital without the blinkers of a simple maximum production focus. Maybe Kiwis, more probably people offshore knowing consumer demand and its changes and able to raise and allocate capital needed for maximising returns.

The best we can hope for is probably that we take part ownership in the foreign-controlled businesses which will process our raw materials. The question then is where will the processing occur? In a country with its expertise in bulk production of raw materials, or one skilled in participation in global supply and value-added chains, highly responsive to market changes, relocatable, and highly focussed on logistics. The latter possibly. Once a cheap method of shipping milk without any degradation is developed its all over for the milk processing industry in New Zealand.

Our traditional economic base is not going to deliver sufficient income gains to address societal concerns we see developing and to meet the aspirations of our school-leavers. So while the current migration burst makes us feel good we should not kid ourselves that we are headed to the top of the class. We are nosing in front of a race filled with competitors held back for a few years more by post-GFC woes or woes revealed by the GFC. We are riding the unsophisticated first stages of an income surge through Asia. Eventually moribund economies will throw off their shackles and surge forward some years from now. We won't with our traditional economic base and the risk is the migration numbers a decade from now take a structural decline once more.

How to stop this given that things will not change in agriculture and therefore in the regions where economies are dominated by agriculture and low yielding but high employing tourism? Maybe one part of the solution is to focus on Auckland and its wider economic community, rapidly deepen Auckland's infrastructure, and link Auckland (plus Hamilton, Wellington and Christchurch) into centres of growth and innovation offshore. After all, in a world where wealth accrues from participation in global supply chains of products, people, and expertise, there is a price to being an island of bucolic isolation. NZ's future lies in our big cities, especially Auckland, or its back to underperformance and migration outflows.

Housing

I gave a talk to a large group of people interested in the property market last week and one of the many questions put to me at the end was this. When is it a good time to buy property?

I initially answered that it is unwise to try and pick peaks and troughs in asset markets and history shows that simply staying in a market over the long-term tends strongly to deliver good gains. This is what any advisor in the equity markets will tell you. It is what farmers rely upon as they generally run low cash surplus operations yet grow wealth strongly over the years as their land prices rise.

But I elaborated on the answer by noting that staying in a market for a long period of time means not being forced out by circumstances when the inevitable and invariably unpredicted shock comes along. **The best time to invest in the property market is when you are in a position to handle an unexpected decline in prices and rental income at the same time as you potentially suffer loss of income from another source.**

It is unwise to buy with very high levels of debt (low equity boosts the chances that your lender will sell your asset from under you). It is unwise to buy if you don't have spare cash to undertake property maintenance, or if you are servicing the debt with your wages – yet you are vulnerable to being laid off.

Being able to see yourself through the guaranteed bad times which come along needs to be a key factor in all investment decisions. It should also have some influence on your work and personal decisions.

Only buy when you can handle the next unpredicted recession and your own unemployment.

Looking out over an audience for a housing market session one notices a very wide range of people of all ages dressed in all range of largely non-business outfits.

For some people property investment is a business choice which they made years ago. They have bought properties for the yield they offer and the long-term capital gain. They devote a good portion of their time to managing them and have developed skills in doing so. They are what we have traditionally called landlords and have always provided a vital housing product for people not able or willing to buy a house to live in. Many of these people will not be buying currently because the cycle is past its peak in terms of the pace of price rises and the quality of people making purchases. They are probably selling off their rubbish properties to over-optimistic inexperienced buyers.

For other people property is bought as a retirement asset and they are happy to have it managed by the rapidly growing property management sector. They do not think of themselves as landlords. This is the group I have written about for some time as including Baby Boomers seeking assets giving higher total yields over an extended retirement period than conservative assets like bank term deposits and bonds which now yield very little.

Then there is the group of people who started jumping into the market last year. They are driven by panic and FOMO (fear of missing out) having ignored everything written here since 2009 and believed those people who have been incorrectly predicting price collapse. They feel like they have missed out on easy money and are scrambling to try and buy any meth-infused tinny joint to take away the stress of not riding the bandwagon.

These are likely to primarily be the people which the Reserve Bank is burning off with its tightening credit controls. They have low deposits, don't know how to act as responsible landlords, often have jobs highly vulnerable to a recession and will look to sell their properties at the first sign that a pullback in prices may be happening because fear is their primary motivator.

In the absence of a supply surge (lots of houses being built) they are the main causes of busts. We assume that many if not most of these people have successfully been blocked from entering the investment market by the new deposit rules. If so good. If not then a lift in the investor minimum deposit to 50%+ is guaranteed.

Then there are some other types of buyers. There are the Chinese simply looking for any reasonable asset to park their money off the mainland away from the CCP (in your dreams). There are people who have inherited property, and those who bought their second and better house but had enough money to keep their first property so did so. There are those who are rentvestors – buying a property which they rent out whilst renting themselves of living off ma and pa. There are people who have bought properties occupied by family members in order to help them out in a rough patch.

It is incorrect to claim that people owning and buying investment properties are all speculators, just as it is incorrect to claim that they are all responsible landlords interested in the well-being of their tenants.

Another person after the function bemoaned the difficulties for young people buying houses. I agreed and pointed out that structurally things have become permanently more difficult for young people these days compared with past generations. They cannot get a foot on the ladder with a low spec house any longer. It must meet high and expensive standards for toilet facilities, insulation, energy efficiency, earthquake resistance and so on with all of that applying also to the materials which go into the house. So the materials are more expensive as is the design. Planning regulations are more intense and expensive as are developer contributions to councils.

Land is less readily available than before with lack of transport infrastructure limiting development of new subdivisions further from work locations. Infrastructure has to be structurally more able to handle higher traffic flows than before the 1980s because there are far more cars on the road per capita (females in the workforce, cheap imported cars) and because these days we undertake more travel for recreation, socialising, shopping and schools. Few kids walk or cycle to school now. We drive them. Infrastructure to handle these lifestyle changes is expensive. That limits urban spread.

As already discussed some weeks back, there is a generation of Baby Boomers passing through looking for assets to help finance the retirement which for three decades they have been told will be wretched. And as luck would have it just as they hit retirement interest rates structurally plummet so they need assets other than deposits and bonds.

Migration flows and therefore the pace of population growth appear to have structurally shifted with New Zealand a far different place than before this decade. The need to leave is far less. The attractiveness of returning from offshore has grown.

China's economic rise is bringing a wave of foreign buyers not there before. The rise in the divorce rate these past four decades means more split families occupying two houses rather than one.

The best job opportunities come in large centres filled with many businesses and people whereas in the past NZ was a big farm with servicing towns of various sizes. The ability to achieve good income and wealth accumulation and feelings of societal achievement have changed at the expense of the regions and to the "benefit" of our cities.

And, on top of other factors which I am sure exist but have not made it to this list we have the fact that fewer young people actually want to buy a house as early as previous generations anyway. They will live longer than you and I. They have more time to undertake life's major steps of entering into a partnership, having kids, and buying a house.

Young people are in a structurally more difficult position for buying a house than in the past, and their situation is only partly because of the hike in prices these past few years. Had prices not jumped up they would still struggle to find a house because of the under-building in Auckland since the mid-2000s. Same for people affected by homelessness. And Indian migrants and students would still be (willingly) sharing bedrooms. There was a great article on this phenomenon here.
http://www.stuff.co.nz/business/money/84664975/auckland-house-prices-not-only-the-bane-of-buyers--renters-suffer-too

NZ Dollar

The Kiwi dollar has lost some ground this week ending near US 72.8 from 73.5 last week – which puts it back where it was a fortnight ago. There is no direction to the NZD's movements currently.

Personally, were I looking to shift funds into a foreign currency by the end of the year my inclination would be to wait a while. The NZ economy is in good shape, dairy prices have recovered a bit, and things offshore still look wobbly, and a cut in the official cash rate from 2% to 1.75% on November 10 is factored into market pricing.

If I Were A Borrower What Would I Do?

Realistically there is not much downside left in fixed rates even if the cash rate is cut another 0.5%. But equally the chances of the OCR rising in the next two years are fairly slim. The main risk facing borrowers comes from offshore in the shape of any rapid tightening of US monetary policy and/or expectations of stronger US growth and inflation raising expectations of the funds rate reaching over 2.5%.

Were I borrowing at the moment I would have one-third floating because of the early repayment flexibility. Then I would probably have one third fixed two years at 4.29% and the remaining third fixed three years at 4.49%. I feel my concern about rising rates further out is not strong enough that I would fix four years at 4.99% or five years at 5.15%.

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
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