

## 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.

## Explanations

This week, for something different, I thought it would be useful to take a look at some of the key points and explanations of things which we have been making not just this year but for a number of years post-GFC.

### **Baby boomers are not selling houses as expected, they are buying more.**

BBs have saved for 3 – 4 decades planning to have a conservative portfolio of bonds and term deposits when they approach retirement and during it. But expectations of returns near 8% have been shattered by low interest rates and expectations that those rates will stay low. So, still wary of shares since the 1987 crash, many have been investing in property for the yield it offers, for the long-term gains they have seen from their own houses, for the low maintenance worries given their home handyman and self-reliance skills built up over decades, and because they want an asset delivering a yield for a retirement period which may stretch to 30 rather than just 15 years.

Their buying has helped boost house prices in a manner exactly the opposite of what so many pessimistic house price forecasters have expected.

### **Baby Boomers won't shift to the regions**

A few will. But most have their children and grandchildren living in Auckland as well. The nanas and granddads provide child minding services during school holidays given that both parents (or the single parent) will be likely working full-time. The oldies can help out and if they retain their older large house rather than downsizing they can easily have the grandchildren stay in the holidays. And when they do downsize, selling their largish house to free up capital, they can move to a new apartment just a few hundred metres from where they have been living for decades as most apartments being built in Auckland are going up in the suburbs, not the CBD.

### **Young people probably don't want space for three chainsaws.**

They have grown up amusing themselves indoors with technology and its progression rather than seeking open spaces and adventures outdoors which physically and spatially challenge them. They have looked down their noses at outside work and hut building and seem to want an adult life quite different from what earlier generations aspired to. Older people bemoan the lack of new houses with big sections. Young people and probably most immigrants instead want something low maintenance and handy to transport routes. If that means small then so be it. Creation of lots of tightly packed small houses/townhouses does not imply the societal dystopia many older people fear. Get with the times.

### **Asians helped drive the housing surge by realising and acting upon the implications of rapid population growth.**

Many migrants have come from countries which have experienced not just rapid growth in their economies and personal incomes but also intensive urbanisation. They have seen people who bought property-related assets before millions of people appeared do very well for themselves.

Coming to New Zealand they have listened to locals moan about how horrible Auckland will be with an extra one million people cramming in goodness knows where. But instead of joining in the tut-tutting they have bought property knowing full well what population pressures will do to house prices. They acted. Locals just grizzled.

### **The Unitary Plan won't radically boost house supply**

It is ironic that at exactly the same time as the Unitary Plan for Auckland is on the cusp of coming into force (subject to legal challenges), and freeing up a lot of land new roadblocks have appeared.

One is a shortage of builders which is unlikely to disappear anytime soon given the lack of training in the past two decades and low probability that migration rules will be relaxed to let more builders in. Another constraint is a worsening shortage of building materials – remembering that New Zealand's building materials sector is an oligopoly.

Third, finance is getting harder and harder to find. Banks have reached their risk tolerance limits on financing developers, whilst the Reserve Bank has imposed restrictions on the people which banks can lend to. Plus banks operating in New Zealand need to reduce their dependence upon the savings of foreigners. Some banks also need to restrain lending so they can send capital back to their parent companies in Australia. Lending in NZ now needs to be matched as near as possible by borrowing in NZ, and that is hard with the ongoing low level of interest rates discouraging people from saving and encouraging them to gear up on what they have and borrow more to find yield.

For your guide, after some years of official-speak optimism regarding quickly boosting Auckland housing supply and the problem being solved, now that the Plan is almost in place subject to legal challenges it has become acceptable to state explicitly that it won't alter the fundamentals. Check it out here.

<http://www.stuff.co.nz/business/property/8635006/2/increasing-land-supply-isnt-enough-to-solve-aucklands-housing-crisis>

### **NZ does not need more cows, more farms, more minimally processed primary products.**

Farming is not a large driver of jobs growth. According to one measure the proportion of people employed in NZ working in the agricultural sector fell from 10.5% in the early-1990s to 6.6% come 2009 when apparently this particular measure was last calculated.

<http://www.tradingeconomics.com/new-zealand/employment-in-agriculture-percent-of-total-employment-wb-data.html>

According to Federated Farmers all employment in agriculture, forestry and fishing amounts to 150,000 people, which is about 6% of total NZ employment.

<http://www.fedfarm.org.nz/about-us/Farm-Facts/>

According to the Statistics New Zealand NZ.Stat site the employee count in Agriculture, Forestry and Fishing in 2015 was 115,240 from 107,860 in

2010, 109,250 in 2005, and 100,160 in 2000. As a proportion of all employees the results are as follow.

2000	100,160	1,596,310	6.3%
2005	109,250	1,856,980	5.9%
2010	107,860	1,902,170	5.7%
2015	115,240	2,045,610	5.6%

These numbers partly reflect increasing forestry sector employment associated with the growing volume of timber being harvested.

As we can see the data are not very good. But suffice to say, another trade deal giving NZ access to another market for bulk produce will be of little benefit to our labour market. What is needed is redirection of capital into value-added products and market positioning for those products.

### **We do not ride on the cow's back.**

Between the 2013/14 and 2015/16 seasons Fonterra's dairy payout fell from \$8.40 to \$3.90. Export earnings from dairy products fell from \$17bn to \$12bn. The rate of growth in New Zealand's GDP net of inventory changes went from 1.6% to 3.7%. Jobs growth went from 3.6% to around 5.5%.

### **Major uncertainties have surrounded us since 2008. Ignoring them has been a good tactic to handle them.**

You don't need to listen to talkback radio, apocalyptic preachers, or echo-chambered social media to find reasons for crawling into a corner fearful of a collapse in the global economy. We economists can deliver you some truly horrible scenarios. But 99% of us don't and people who paid attention to our analysis and commentaries rather than the massively sensationalised stories out there would have done well since 2009.

Apart from one economist wrong for three decades now on the housing market the rest of us restrained our downside price forecasts over 2008-09 placing faith in the cushioning effects of massive interest rate declines, absence of a housing oversupply, and strong Kiwi cultural (and legal) aversion to losing one's house.

Not many of us prophesied the collapse of European civilisation in response to the three bailouts so far of Greece (one more to come probably), or the collapse of the US economy in

response to burgeoning debt and the shutdown of Federal employee payments, or the collapse of China in response to (insert your choice of a proxy for one party rule here) a debt blowout, over-building of apartments, corruption, etc. or the collapse of Australia because of lower minerals prices, or the collapse of Japan because of an old shrinking population plus deflation and zero growth, or the collapse of the UK because of Brexit, or the collapse of Christchurch's economy because of the 2011 earthquake....

The point is, there is always something in the economic/financial sphere sitting out there around which one can build a very, very bad scenario. Anyone who did so was wrong. Anyone who believed it and held back investing, hiring staff, or buying a house has made a mistake as our economy is now around 16% bigger than back in 2007.

Take note of the risks by all means – but keep calm and carry on.

**We've gone back to the 1970s where credit growth is constrained by supply restrictions and not the cost of debt.**

Our central bank largely has two jobs – keep inflation between 1% and 3% on average, and make sure bank lending does not leave the sector and therefore the entire economy vulnerable to a major decline in the event of a shock.

Before the GFC both risks would move together and could be fought with one weapon. Strong economic growth would drive inflation and risky lending. Both problems could be eased by raising interest rates.

Now however inflation is structurally weak in spite of GDP growth above 3% and a very tight labour market, and the Reserve Bank has been cutting interest rates to try and boost inflation. They cut rates to encourage borrowing and buying. But strong economic growth is helping drive risky lending which low interest rates boost even further. Yet this rising risk cannot be fought with interest rates any longer.

To reduce lending risks the Reserve Bank is reinstating more and more stringent controls on credit supply. So far view loan to valuation rules by and large. But they want permission from the Minister of Finance to impose limits on bank mortgage lending as multiples of household income – a debt to income regime. That desire

was reiterated this week in the release of the six monthly Financial Stability Report.

<http://www.rbnz.govt.nz/news/2016/11/financial-system-continues-to-face-housing-and-dairy-risks>

Thus the problem for borrowers now is not the cost of finance (in the old days floating rates would peak above 11%) but being able to get a mortgage in the first place – welcome to the 1970s, 60s, 50s etc.

**Our economic models no longer work. Look to what for guidance?**

As a result of the GFC the degree to which economic agents react to changes in things has altered. With jobs growth of over 5% in the past year wages growth would be rapidly accelerating if this was 2006. But there is no statistical evidence of this. With the economy growing at above a 3% pace inflation would be threatening 3% were this 2006. But it is only 0.4%.

Many things have changed and this has meant virtually all interest rate forecasts anywhere since 2008 have been wrong. Reasons for inflation failing to appear include excess manufacturing capacity offshore, internationalisation of labour and service markets, debt aversion, disruptive technologies, fear of job loss, smartphones making price and product searching largely costless and so on.

But what do you do for guidance if economic growth forecasts are very important to your business? You still use them because they can still land in the general ballpark. But you go back to the techniques used by investors, individuals, governments and businesses before we had economic data and forecasts. You look at demographics including where populations are growing fastest, where they seem to be changing in nature the most. You look to where major transport routes and infrastructure are going. And you get there before everyone else or become a rapid follower when the trends are clear.

You also pay greater attention to what your competitors are doing and in particular the shifting preferences and purchasing levels of your current and potential customers – perhaps using big data techniques requiring the employment of data specialists and not just market researchers.

### **There is a large structural element to the change in migration flows.**

In the ten years ending in 1986 the average net migration flow for New Zealand was a loss of 17,000 people. In the ten years to 1996 it was a gain of 3,000. In the ten years to 2006 it was a gain of 11,000. In the ten years to 2016 it has been a gain of 21,500. The trend is clear. Not only are we more and more attractive to outright foreigners, there are 4.7 million of us here less inclined to leave, and one million Kiwis offshore more inclined to come back. Why?

Partly the weakness in foreign economies. But that would not explain the long-term trend. Mainly it is the movement away from New Zealand simply being a collection of farms and farm-servicing towns. Auckland in particular is no longer just a much bigger version of Invercargill. It is a sophisticated city with a widening diversity of people and sectors with increasing depth in those sectors. This is important because it sends a signal to Kiwis offshore that if they come back to NZ they can remain fully engaged in their sector and do not lose out on re-entering their field offshore should they one day decide to do so. Coming back to NZ is still hugely challenging for repats, but less a matter of stepping off the ladder and going bush that it used to be.

Kiwis already here know they can stay and develop their skills in New Zealand and be able to stay fully up to date with developments in their sector. This is the way in which technology is allowing distance working – not through telecommuting by tens of thousands of Aucklanders upping sticks to Kerikeri and Nelson, but through rapid information transfer between centres of excellence in every field.

### **Income inequality in NZ is not worsening.**

The ratio of income of a high income household to income of a low income household was 2.6 in 2015. It was 2.52 in 1995 and 2.7 in 2005. The trend has been essentially flat since the mid-1990s.

[http://www.stats.govt.nz/browse\\_for\\_stats/snapshots-of-nz/nz-progress-indicators/home/social/income-inequality.aspx](http://www.stats.govt.nz/browse_for_stats/snapshots-of-nz/nz-progress-indicators/home/social/income-inequality.aspx)

What is worsening is housing affordability and this trend will continue. Why? There is more in play than just restrictions on land use, building costs etc. Technology developments are shifting us to a world where consumerism as we traditionally have defined it since the 1950s is changing. We used to

focus our savings and financial arrangements on acquiring washing machines, toasters, televisions, cars etc. Keeping up with the Joneses. These things remain important – but they are tending to get cheaper and cheaper and eventually will plummet in price as robotic 3d printing using more than just basic plastics and resins becomes feasible. (Think in terms of Star Trek's replicators.) Income will increasingly be freed up for spending on other things – services and housing. More devotion of income to housing means higher house prices. More money for services means lots more tourism.

### **Artificial intelligence is a long way from the HAL 9000**

Over the coming year you will hear more and more about large companies employing artificial intelligence. The gut response of most people will be to think in terms of individual entities with personalities along the lines of the HAL 9000 from 2001:A Space Odyssey, the T1000 from Terminator 2, or Fritz Lang's Maria.

But at this stage AI is only computers which are really, really fast at analysing millions of pieces of data and identifying patterns. To paraphrase something someone else wrote recently, even if you radically lifted up the speed with which a dog thinks, it still won't be able to bake you a cake or discuss what the Warriors need to do to win the NRL.

### **Housing**

Enough already written this week. But note these comments from the Reserve Bank's Financial Stability Report released Wednesday morning.

"House price inflation in Auckland has softened in recent months but it is uncertain whether this will be sustained. ... There is a significant risk of further upward pressure on house prices so long as the imbalance between housing demand and supply remains."

We have received more information showing the housing market slowing down. But it is not yet certain that this slowing will be sustained in the context of continued low interest rates, rising incomes, strong population growth and insufficient construction.

Watch for market activity come February. And try to get your head around this very important point. You don't need any trade happening for the price



of something to go up. Consider for instance if during a weekend shipping gets disrupted in the Persian Gulf. Come Monday when the markets open the price of oil will be much higher in the first transaction than in the last on Friday. Instant price change.

We mention this because it is relevant with regard to Auckland housing. Finance is harder to get for people buying properties. That means less demand. That means less upward pressure on prices and less turnover.

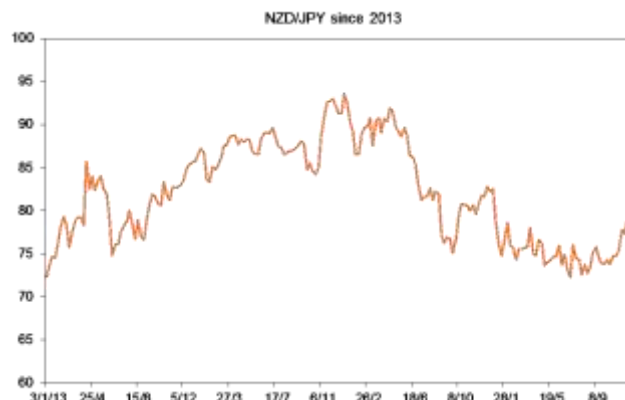
But, finance is getting harder for people building houses. That means less supply. That means more upward pressure on prices and less turnover.

In a market where there is a recognised shortage the simultaneous withdrawal of both some buyers and some sellers is more likely to lead to sustained upward pressure on prices than downward. Low turnover – yet prices still rising.

### NZ Dollar

Nothing new this week. Much world attention is on trying to figure out where US economic policy is heading and how numerous elections in coming months in Europe will affect the Eurozone and EU. Uncertainty is high yet with strong growth continuing in the NZ economy the NZD is likely to remain firm.

This week we have ended against the USD near one cent higher than last Thursday near 71 cents. A large jump was made against the Japanese Yen to 81 from 79 last week with this being the highest cross rate against the Yen in a year.



### If I Were A Borrower What Would I Do?

Nothing new. I'd look to fix three years for most of my debt as it looks like fixed rates have bottomed out now but jumping to four or five years is a bit expensive.

Floating	5.64%
1 Year	4.29%
2 Year	4.45%
3 Year	4.65%
4 Year	5.29%
5 Year	5.45%
7 Year	5.99%

Note that this week our best two year fixed rate has increased from 4.39% to 4.45%.

### 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](http://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](mailto:Tony.alexander@bnz.co.nz)

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