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.

Bits and Pieces

At the start of one of the talks I gave last week attendees were asked what they would like to hear discussed. Here are some of the things they listed.

Income inequality

This reflects a debate coming from two sources. First there is the lack of wages growth in a number of countries leading to a proliferation of articles about people feeling left behind, being worse off than their parents, and voting for politicians who they feel may be able to do something about it.

In New Zealand the data do not support the stagnant wages story as since 2007 the average wage measure I follow has risen 32% while inflation has totalled 17%. So real wages on average have risen quite well – note the minimum wage has risen about 31% over this period of time.

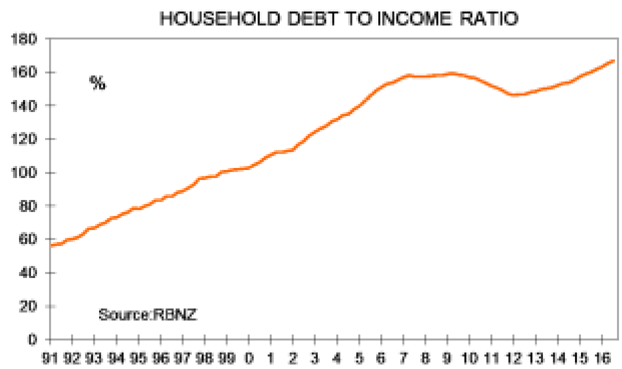
Of issue in NZ is more the second source of the debate about inequality – the big decline in housing affordability. The structural shift in housing affordability caused by structural shifts in mortgage interest rates, term deposit rates, net migration flows, planning rules, materials costs etc. concerns most people in New Zealand.

Young people will on average buy houses later than previous generations and there is nothing any reasonable government policy initiative can do to change that. Hence an electoral impact from this inequality source is unlikely but social impacts will accumulate over time. Note that a lowering home ownership rate for young people increases labour market and overall economic flexibility and efficiency because it is easier for the young workforce to shift location as labour demand alters.

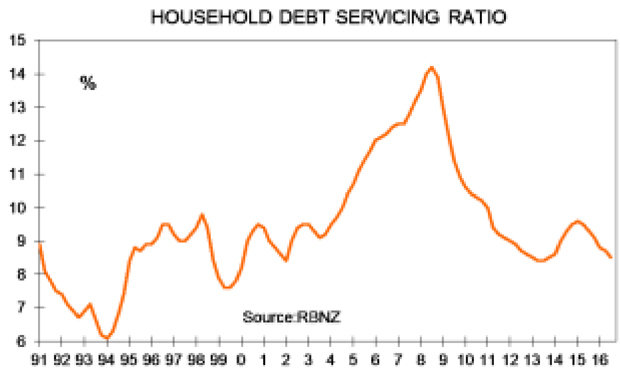
Having said that, related to the house price problem is the home availability issue which has been getting worse for many years. Inevitably the tightening housing market is depriving more and more low income people of housing security. The general discussion suggests that this issue will generate greater voter focus on political choice because more viable options exist to address the social housing availability situation to some degree than the wider housing affordability problem.

Household Debt

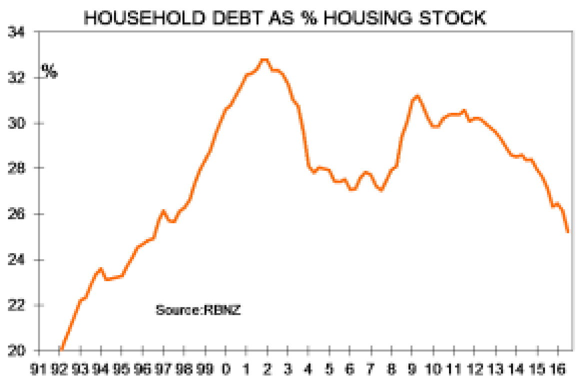
There has been a focus on household debt and worries about the level of it and its impact on economic growth and stability in all 30 years since I came back from Sydney in 1987. So far there is no evidence that it has caused any sizeable economic disruptions or housing market corrections. Maybe one decade this will happen.



The household debt to income ratio now sits at 167% from 146% in 2012, 159% in 2009, and 86% two decades ago. But the debt servicing ratio is only near 8.5% from 14.2% in 2008 and 9.5% two decades back. Plus the debt/housing stock value ratio sits at 25.2% from 30.6% in 2011 and 25% two decades back.



The debt vulnerability then is to a hike in interest rates or collapse in house prices. We expect house prices to hold up because of the structural issues we have highlighted here for seven years. We expect the cyclical rise in mortgage rates to be limited because of lower NZ and global inflation on average, lower global interest rates on average, and the simple fact that the Reserve Bank won't need to raise the official cash rate much to get the cash flow impact it will eventually want.



In fact the existence of LVRs will help limit interest rate rises because the RB can also use that weapon to slow things down and probably will do so if their concerns about a strong NZD down the track become great enough. But that is some time away from now.

The key point is this. None of the dire predictions related to household debt or house prices which some people have made over the past three decades have come true.

Taxing Water Exports

This seems to be a complete no-brainer. The Saudi's don't charge foreign companies just $2,000 per annum to extract as much oil as they want. We don't give away fish in our waters for free. Charging for water exports makes perfect sense – not least because it will place greater emphasis on the need to make sure NZ water quality is not allowed to deteriorate further through expansion of irrigation and dairying. Pressure in fact will increase to scale back these activities. Pricing water can help drive positive environmental outcomes.

Cows

The NZ dairy industry has expanded rapidly over the past couple of decades. This has boosted export receipts but generated few extra jobs (only 40,000 or so people are employed on farms and in milk processing), negatively affected the environment, and been a sub-optimal use of capital. No extra milk has been needed to boost value-added output. Additional milk has been dehydrated and put in big bags.

In the absence of inclusion of pastoral farming in NZ's emissions pricing regime, marginal pricing of negative externalities (pollution), and removal of the requirement that our biggest cooperative take all milk farmers offer it, this situation is likely to continue. Note – from 2018/19, under changes to the Dairy Industry Restructuring Act Fonterra will not be obligated to accept milk from new dairy conversions. Additionally, note that the requirement for all new suppliers to purchase additional shares helps fund costs of collection and processing of the milk, but is still not the optimal use of capital in the overall sector.

Dairy farming provides a great career structure and like other areas of primary production offers a wonderful challenge to those wanting to test themselves in the hinterland and raise a family in a different environment than a city. But the sector is at risk of not moving fast enough to mitigate rising environmental impact concerns and if one day a government prioritising the environment forms the sector will face a pricing and (greater) regulatory shock.
http://www.oecd.org/newzealand/oecd-environmental-performance-reviews-new-zealand-2017-9789264268203-en.htm

Synthetic milk is another risk. Same for lab-grown meat.

US Fiscal Impact on New Zealand

A loosening of US fiscal policy is highly likely under President Trump as taxes eventually get cut and spending boosted. This will boost the pace of US growth and NZ will benefit via scope for higher export sales including to other countries feeling the effects of faster US growth.

However there will be an offset through interest rates sitting higher than would otherwise be the case. In addition, as discussed in the interest rates section below, it is increasingly looking like the fiscal stimulus will be less than initially thought.

Housing

Attendees at the talk also requested discussion of housing but there is no need to address that much here as there is nothing new to add to what we have written in recent weeks.

Nevertheless, as is the case in most state capitals in Australian, and London, plus myriad other cities around the world, in Auckland there is a shortage of housing as economic activity coalesces in already large centres rather than staying more geographically distributed. The shortage will disappear in the same year London's does. The growth in population expected in the next few years will almost certainly exceed housing supply growth so the shortage will worsen. This will underpin Auckland prices with an upside bias. This will underpin prices in nearby locations even as they flatten out this year following the traditional rush to the regions.

As with many other things in their lives, first home buyers will increasingly shift their first home purchase date into their 30s rather than their 20s. This reflects the need to raise a larger deposit than before, higher house prices compared with incomes, and the higher opportunity cost of settling down in one's 20s in a world with many more opportunities for advancement and adventure outside one's home town than was the case in the past. Realisation of this higher opportunity cost will start to pop more to the fore over the next couple of years as FOMO eases away.

Here are a couple of links which might be useful for home seekers.

http://www.stuff.co.nz/life-style/home-property/90810160/firsthome-buyers-there-is-no-magic-bullet-just-hard-work

http://www.stuff.co.nz/business/property/90964583/New-owners-of-decontaminated-P-house-plan-quick-do-up

If I Were A Borrower What Would I Do?

Prepare for higher interest rates but not get pessimistic about the speed or magnitude of rises. This past week has brought two reasons for not expecting quick rate rises. The failure of the US President to get his health bill through Congress has raised doubts over his administration's ability to deliver the fiscal stimulus which markets have priced in since November last year. That is, the infrastructure spending surge may not amount to much and the tax cuts could be minor while both could be delayed.

This change in the outlook for US growth has decreased expectations of the Federal Reserve having to move more quickly than they have indicated (note that the Fed. have not factored in a fiscal stimulus). Thus the US ten year government bond yield has retreated to around 2.35% from 2.55% early in March.

The other factor causing wholesale interest rates globally to fall slightly has been evidence of some OPEC members failing to cut production as they had agreed. This has helped push oil prices lower. This means that not only will the boost to inflation in countries around the world from the rises in oil/petrol prices in recent months fail to repeat, but some of the price rises will likely be reversed.

It all adds up to a pullback in some of the stronger concerns about rising world inflation and upside risk to interest rates. But the track for rates still remains upward in our estimation but with NZ monetary policy as represented by changes in the official cash rate probably still not being tightened until near the middle of next year.

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. **This edition has been solely moderated by Tony Alexander**. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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