BNZ Weekly Overview

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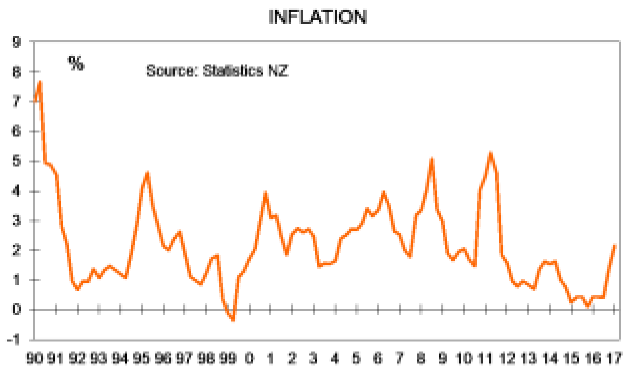
Mission Statement

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

Higher Inflation

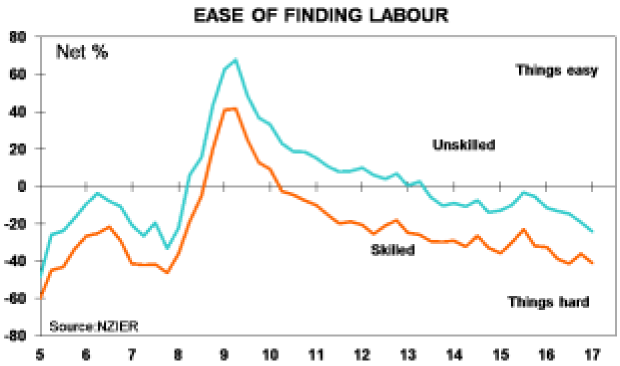
This morning we learnt that New Zealand's inflation rate has lifted from 1.3% to 2.2%. Core inflation measured as non-tradeables inflation has risen to 2.5% and trimming away the top and bottom 10% of items rising and falling gives inflation at 2.2%. Excluding food and energy (a common measure in the US) however gives just 1.6% so it is not a slam dunk case that inflation is getting into highish territory.

Nevertheless, this is the highest rate of inflation since 2011 and various measures which we economists have traditionally looked at when forecasting inflation tell us that this broad measure of change in the cost of living will rise further. That means eventually higher interest rates.



The trouble here is that using such measures has led to near consistent over-forecasting of inflation here and overseas since the end of the global financial crisis (apart from this latest 1% quarterly result which exceeded expectations) and therefore the production of interest rate forecasts which invariably have been too high.

Measures we look at include gauges of labour market tightness. From the NZIER's Quarterly Survey of Business Opinion we see that a net 41% of non-rural employers say that they are finding it hard to get skilled labour. This is above the ten year average of 18% and along with late last year is the highest reading since the end of 2007 when the unemployment rate was 3.3% rather than the current 5.2%.



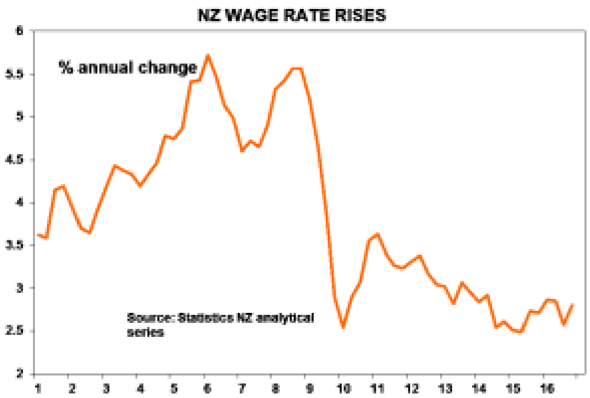
This is interesting as it tells us that even with a lot of people still looking for work employers cannot find the people they are really prepared to have working on their premises. For those people concerned about the 139,000 people officially classified as unemployed in the March quarter the message here is that a stronger pace of growth in the NZ economy is probably not going to deliver jobs for these people. Instead the focus needs to be on improving what they have to offer employers.

The QSBO also tells us that a net 24% of employers are finding it hard to get even unskilled people. The average is 4% finding it easy to do so and the latest gauge is also the highest reading since the end of 2007.

A gross 15% of businesses say that inability to source staff is their main constraint on growth. This is above the 10% average and again along with a reading late last year is the highest since mid-2008.

A tight labour market tells us that wages growth will pick-up. But this has been the case for some time and we have all been incorrect in forecasting sustained higher inflation since 2010 on the basis of this traditional relationship. So will it work now? Will the tight labour market lead to faster wages growth?

All we can say is yes. But don't believe anyone who gives you a number as there is no mathematical basis for validly generating it. Frankly we shall simply have to wait and see and while the traditional incentive for a central bank is to raise interest rates in anticipation of higher inflation that probably won't happen this time around from our Reserve Bank. Why? Because they have taken that approach already two times since 2010 and like the rest of us have been wrong both times. We still anticipate the first monetary policy tightening this time around to come in May next year.



For employers the message worth taking on board however is that eventually you're going to have to bite the bullet and start paying more to your staff. This may be especially so in response to the changes in migration rules just announced. The government has not estimated to what extent the rule tightening will lead to fewer work visas being issued. But we suspect the impact could be limited – meaning noticeable but not making a big enough dent in the recent net migration gain of 71,333 to produce altered forecasts for important things like wages restraint from extra people sloshing around (not relevant as the labour market is tight), pressures on infrastructure, and of course pressures on the housing market.

We economists when forecasting inflation also look at things like recent or expected changes in the exchange rate and commodity prices. We can't forecast either as we have all proven is the case for our most substantial export – dairying – and for the NZD things can be hit and miss. Have either done any big movements which will feed through into inflation?

World inflation has picked up a bit, the trade weighted index hasn't altered much in the past year apart from a small decline, but energy prices have risen. So some temporary boost has arisen for inflation from higher petrol and general business transport costs. But that means these costs eventually fall out of the inflation gauge, just like the current hike in food prices related to flooding will initially boost inflation then lower it a year from now. That is why the core inflation measure which excludes food and energy costs was up only 1.6% in the year to March.

In the absence of any sign of a generalised movement yet in wages growth and without a substantial rise in global inflation, whilst it seems reasonable to expect that inflation is set to spend some time in the middle to upper part of the 1% - 3% target range now, it does not feel reasonable to expect the sort of inflation which will scare our central bank and produce big interest rate hikes.

But the drift in interest rates is upward, even allowing for recent declines in US inflation and monetary policy tightening expectations in response to weaker than expected jobs growth in the US, a comment from President Trump that he now thinks low interest rates are good, not bad as he said on the campaign trail, and that the fiscal stimulus in the US may come later and be smaller than previously expected.

If I were borrowing I'd be factoring in a broad 2% rise in my borrowing costs in a couple of years time. If you want something more specific than that then you still haven't taken on one of the key messages we have been delivering here for some seven years now (one message being upward pressure on house prices, another upside risk to migration flows). Interest rate predictability went out the window with the GFC.

Regarding housing briefly - is it set for a bust? No. Remember the Economics 101 approach we have been taking here for years. Growth in housing demand exceeds growth in housing supply. Still.

If I Were A Borrower What Would I Do?

Done

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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