

BNZ Weekly Overview

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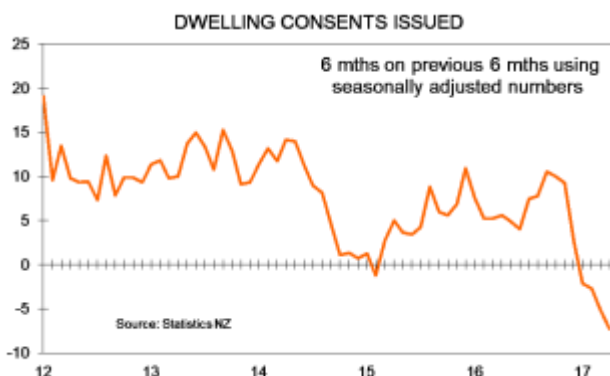
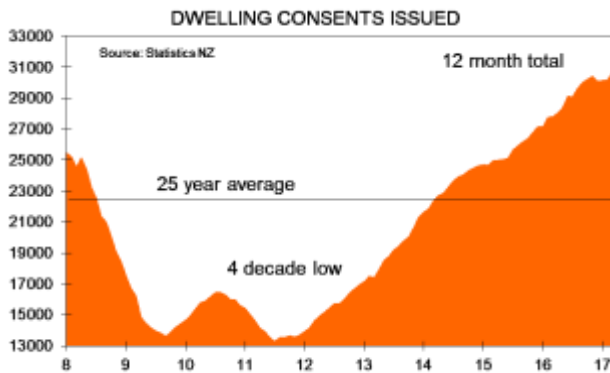
Mission Statement

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

House Building Stalls

In April the number of consents issued around New Zealand for the construction of new dwellings totalled 2,428 in seasonally adjusted terms. This was a 7.6% fall from March and for the three months to April growth of 11.3% s.a. does not offset the fall of 11.9% s.a. in the three months to January. Nationwide consent growth has plateaued.

What sticks out in this breakdown therefore is the flattening of issuance in Auckland. Yet this is the location where the shortage of houses is greatest, where the focus on the need to boost construction is greatest, and where the greatest efforts are being made to allow a construction boom to occur. Auckland consent issuance has plateaued at 35% above the 25 year average. Why?



There is no longer a lack of subdividable land courtesy of the Unitary Plan. But there is a lack of builders and a growing deficiency of finance which is set to get worse. Banks are cutting back on lending to property developers for three broad reasons.

First there is the need to fund domestic lending with domestic deposits. Funding can be done offshore easily enough, but there is deep concern that bank lending is still dependent for 31% of its funding from offshore (down from a 45% peak pre-GFC). This is a key vulnerability for the NZ economy and the only way to address it is to switch off new offshore funding and match domestic lending with domestic funding, cutting back on the traditionally riskiest parts of lending.

Second, around the world banks have been under pressure since the GFC to rein in lending to the property sector and to raise capital. The recent surge in demand for property development financing has newly run into this wall of a new paradigm.

Third, new developments are often bought by investors and offshore buyers. Lending to both groups has been clamped down on over the past three years and more restrictions are being applied. Investor demand for property has declined. The risk of non-settlement by buyers has gone up. Bank requirements for pre-selling of units before funds will be advanced to developers have gone up. So reduced debt funding for end buyers means reduced debt funding for the developers.

Some of this we can explain by the ending of the Christchurch post-earthquake boom. Canterbury consents were still 43% above the 25 year average in the year to April. But at 5,446 the annual total was down from 6,054 in November.

Interestingly, this 608 decline over five months almost exactly matches the 587 rise for all NZ excluding Canterbury and Auckland. That means that the Auckland annual total of 10,130 in April was seven fewer than 10,137 in November.

More restrictions will come. Some new financing will come in from offshore managed funds, hedge funds etc. Some projects will be (are being) completely financed by the offshore builders (Chinese largely). But the offset will not be enough.

Auckland's housing shortage will continue to get worse – our key message since late-2011. The price implications over the medium to long-term are fairly clear. In the short-term however there is some clearing out to happen. Already real estate agents are commenting on the switch in FOMO from buyers to vendors.

For young buyers (and professional investors) this switch in the group most affected by fear of missing out will provide some good purchase opportunities. How long will this window last? Maybe a year but that is just a guess. How far will prices decline in areas which have been driven upward largely by investors? Impossible to say. For other areas largely driven by either first home buyers or existing owners switching homes, little changes.

As an aside, borrowers outside property should be asking themselves what the shift in credit availability means for them. It will tend to reinforce a focus on debt repayment in the recovering dairy sector and not facilitate a fresh round of dairy farm conversions. It will necessitate across all SMEs that growth is funded more by retained earnings and outside capital. That will mean a slower pace of business formation and growth than would otherwise be the case.

Businesses will need to prioritise finance discussions with their banker before committing to expansion plans.

Retailing

Around the world the retailing sector is undergoing substantial change which is leading to an increasing number of operators closing down – bankruptcy and sometimes voluntary liquidation. Recently we have seen a string of closures in New Zealand and Australia and the Wall Street Journal this Monday included a good article discussing the rising trend in the United States. Retailer bankruptcies there have hit their highest levels since the GFC.

Blame is usually laid at the door of growing online retailers such as Amazon which is set to open in Australia before the end of next year. That will likely increase the range of products which Kiwis can buy as shipping across the Tasman will be easy compared with shipping from the United States.

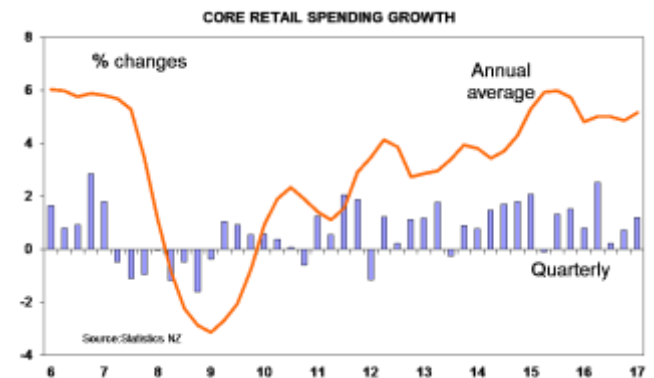
But there are other things in play as well as any experienced retailer would be able to attest. One factor is upward pressure on rents (often locked in for long periods and non-negotiable downward) as retailers in recent years have sought prime positions. As the sector undergoes a multiyear cleanout of unprofitable operators this may call into question the income projections of property owners. That is one relevant implication from this short discussion.

Another factor in play is expansion. There seems to be a correlation between stores expanding and then closing down. Expansion is costly and if even a minor new competitor comes along things can turn bad very quickly.

Another factor is margin management. This has become structurally (permanently) harder because consumers can easily find alternatives to products who's prices they become unhappy with – at essentially zero search cost. Compare that with the era before smartphones when searching meant driving around a city.

Some retailers simply lose their way and end up squeezed by larger operators – think Dick Smith.

And all of this is happening when the data we economists have focussed on in our discussions for years are very, very strong. Core retail spending which excludes cars and fuel rose by a strong 4.8% in volume terms in the year to March after rising 3.6% the year before and 7.3% the year before that.



Consumer confidence is tracking at well above average levels.



Imagine what will happen to many NZ retailers when the pace of retail spending growth slows down (house prices flatten, interest rates go up, migration growth eases), and our newspapers start talking about Amazon as is happening across the Tasman.

So we get the second implication of this discussion. As a consumer, be very careful about purchases of vouchers for future purchases, and be careful about payments before delivery of goods.

(As an aside, be very careful when paying a deposit to get a house built. Builders are facing rapid cost changes, problems keeping to schedule because of inconsistent materials availability, and shortages of tradespeople. Make sure whoever you sign with has a completion insurance scheme in place to cover you if they go under. Builders fail all the time all around the world.)

The third implication is the most obvious one and is directed to retailers. Pay minimal attention if any to what we economists write about potential growth in consumer spending. It is not the pace of that growth which will be the main determinant of your profitability. Farmers know this approach. They know that it is not the pace of growth in the NZ or world economies which will be the main determinant of their output prices and their profits. Such forecasts can give insight into potential changes in funding costs and sometimes exchange rates – but not much else.

And one more thing which is bad news for retailers. There is a glaring item missing from this period of strong growth in the economy and the Prime Minister highlighted it post-Budget. There is

no acceleration in the pace of wages growth outside of the broadly defined construction sector. It has to come as pressures on staff availability are only going to get more intense as labour demand remains strong but numbers coming in on work visas fall back. Post-election negotiations to form a coalition government are highly likely to produce further tightening of visa rules.

Businesses, including retailers, are going to have to alter their current plans for investment to accelerate incorporation of labour-saving technologies. But such things as robot bartenders, computer system upgrades, and use of AI/facial recognition/targeted advertising etc. don't always come cheaply. For some the jump to alter their ratio of capital to labour to use old phraseology will be too costly – and that then will become another reason for businesses closing down.

Agglomerations

For your guide, Monday's Wall Street Journal also included a good article discussing one of our main themes for the past three years – the world is urbanising/agglomeration. Technological developments in theory allow people to live remotely. That sounds good for the countryside/regions. But it hasn't happened. People are living more and more in cities, and more and more in already big cities.

Most commentators on the Auckland housing market have missed this extra driving force behind the rises in Auckland house prices. People are choosing congestion, choosing to be where living costs are high, because they choose involvement as close as possible to the coalface of the technological knowledge-based age we are living through. Remote living is feasible. But few choose it and in the case of IBM, the multi-decade working from home program for employees has been scrapped. Productivity gains never materialised as expected.

In addition, a recent research project looking at how expected robotisation will affect the US economy concluded that it is the small to medium-sized locations which will fare the worst because they have a smaller proportion of their jobs which are difficult to mechanise. Big cities will get bigger as people shift for employment opportunities – eventually.

In the NZ context this reinforces our key point of warning regarding the regional housing markets.

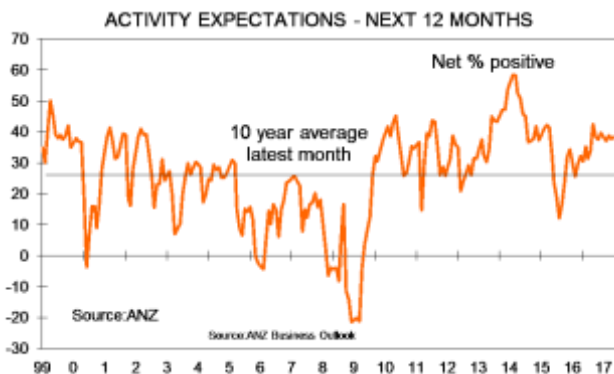
The population outflow many investors are anticipating from Auckland to the likes of Taranaki and Hawkes Bay will not happen. At the margin some people will shift. But the bulk of shifters will be looking toward our other two (mini) agglomerations of Christchurch and Wellington.

Keep an eye on such flows in 3-5 years time toward Christchurch.

Businesses Confident

This Wednesday the ANZ Business Outlook survey was released and it showed a rise in the proportion of NZ businesses feeling confident about the economy in the coming year to a net 15% positive in early-May from 11% in April. This is below the 20% average. But what really matters is what businesses expect for themselves. In that regard things are firmer.

A net 38% expect to be busy which is unchanged from April but above the 30% average. Unsurprisingly, because businesses anticipate being busy they plan hiring people and investing. A net 24% plan extra hiring which is up from 22% in April and well above the ten year average of 11%. A net 24% also plan boosting capital spending. This was unchanged from April but above the 14% average.



These two indicators are important as they tell us it is reasonable to expect recent firm employment growth to continue and that this will tend to underpin demand for housing and retail goods and services.



For interest rate implications we look at inflation gauges. A net 30% of businesses plan to raise their selling prices. This is the highest reading since early-2014 and above the net 25% ten year average. Does this mean we need to worry about interest rates jumping up? It is reasonable to expect that borrowing costs will go higher, but not reasonable to think rate rises will be rapid or large.

One reason for this is that post-GFC inflation rates around the world have settled at structurally lower levels. One influence is that strong jobs growth is not producing anywhere near as much upward movement in wages as tended to happen ahead of the GFC.

Another is that business plans to raise selling prices often end in tears as customers quickly turn away to find cheaper products online using smartphone technology. Business assumptions about their ability to easily raise prices are one of the areas which we think have become a blindspot for retailers in particular and a partial cause of retail operator profitability problems.

If I Were A Borrower What Would I Do?

Nothing new – though the recent pullback in expectations of the pace of monetary policy tightening in the United States has taken some upward pressure off fixed borrowing costs for now.

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/>

BNZ WEEKLY OVERVIEW

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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