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.

Fieldays 2017

This week I am in the middle of the usual three days at National Farm Fieldays at Mystery Creek beside Hamilton Airport. As multiple media have already reported the mood of farmers is very good, buoyed by firm prices for most primary sector outputs, and particularly the rise in the projected Fonterra payout from $3.90 to $6.15 – for which we think there lies considerable upside risk.

Questions I've been receiving during six hours each day spent chatting with farmers revolve around the outlook for the NZ dollar (with no expressions of concern as yet about its current level), the direction of the housing market, cryptocurrencies, migration policy, and availability of bank credit.

Many farmers have noted that getting credit from banks has suddenly become harder and that in fact is what I have spent 90% of my 15 minute speaking slots at 11.00am and 2.00pm talking about. (Same again tomorrow, Friday.)

New Zealand has a unique vulnerability to offshore financing of the banking sector. Ahead of the GFC that dependency peaked at 45% and it has now fallen to 31%. That is not only still too high to safely allow the sector to comfortably get through the next global economic crisis without aggressively restricting credit, but it has been rising recently.

The dependency has been rising because while we face high demand for credit by businesses entering and expanding across a huge range of sectors, we need to fund that lending as best we can from domestic sources. But Kiwis don't like to save, and those with the funds are usually over 55 years old and remember much higher interest rates in the past. They are taking money from term deposits and shifting it into managed funds, shares, commercial and industrial property, and miscellaneous equity schemes.

We simply cannot finance the quantity of domestic credit demand with domestic borrowing. That is why residential property developers are struggling to get funds – the new ones at least. That is why property investors are also struggling and when they get funds they are on far tighter terms than before. And across all other sectors loan requirements have increased and money is no longer flowing out from banks at the same ease as before.

This is not a temporary change – more credit rationing is coming. Not least because the chances of our central bank raising interest rates much over the next two years have always been low and have taken a fresh step back in light of scaled back expectations for growth in the United States, the recent firming of the NZ dollar, the recent decline in oil prices, the flattening of our main housing market, the complete absence of evidence of any decent acceleration in the pace of average wages growth, the plateauing of residential construction growth, and the relatively weak 0.4% and 0.5% GDP growth rates of the past two quarters.

Chances are that savers will not find themselves being offered rates which they consider attractive, taking into account what they saw in the past, for a great number of years.

What this means for borrowers is that reliance upon debt needs to be reduced. Speed of growth in one's business needs to be slowed – to reflect the worsening labour constraint as well. New equity sources will need to be found including reduced personal drawings and higher retained earnings.

Oh, and next year it is highly likely that the Reserve Bank will require banks to hold more capital. That will also constrain lending growth. Welcome to the new post-GFC world of reduced credit flowing from banks around the world.

Debt to Income Restrictions

Last week the Reserve Bank issued a consultation paper, inviting feedback by August 18 on their proposal to ask the Minister of Finance to alter the Memorandum of Understanding so they can introduce DTIs.
http://www.rbnz.govt.nz/news/2017/06/debt-to-income-limit-consultation

How does a DTI work?

Banks would be restricted to lending at most a pre-set multiple of the household income of the borrower. In Ireland the limit is 3.25. In the United Kingdom 4.5. The Reserve Bank have suggested 5 for New Zealand. Within the definition of debt would be not just the mortgage which someone is seeking but any other debt they have with any other party.

The RB have suggested that they would apply the same exemptions as currently exist for LVRs such as new builds. Banks might be restricted to having at most 20% of their mortgage lending at DTIs above 5 compared with about 45% currently.

In the three months to January of this year, based on data coming in from the five major banks, the RB estimates that in Auckland 60% of new loans have been more than five times the borrower's income, and in the rest of the country 30%.

Their central scenario sees 10,400 people prevented from getting a mortgage of which 8,800 would be investors, 700 existing owner occupiers, and 1,600 first home buyers. The RB estimate that abut one-third of first home buyer borrowing exceeds five times income and about 50% of investor borrowing does so. The RB scenario would also see some 14,000 of 160,000 top up loans being constrained each year.

They estimate that because of reduced demand prices would rise 2% - 5% less than otherwise. But the central benefit upon which they base their case is a 0.1% boost to GDP per annum above what it would otherwise be. Sounds great! But it's not what you might think, as we shall discuss further on.

Why seek DTIs?

In the event of borrowers getting into trouble because of an economic downturn there is a risk that falling house prices make a downturn worse than would otherwise be the case. This is because as house prices fall people feel less wealthy and cut back their spending. House construction also tends to fall sharply in such a scenario.

The LVRs which were introduced in October 2013 then strengthened in 2015 and 2016 are aimed at containing the fallout from **falling house prices** by limiting the potential number of people who may be caught with negative equity. But a DTI regime is aimed at containing the fallout in the event not so much of house prices going down, but people losing their jobs and/or interest rates soaring, producing widespread inability of borrowers to **service** their mortgages. This is not the same as net worth risk. It is a cash flow effect.

Previously this effect could be grossly mitigated with substantial cuts in interest rates, such as happened during the GFC when the RB official cash rate was quickly and effectively slashed from 8.25% to 2.5%. Cash flow relief quickly appeared for borrowers. But if next time around the cash rate is only 4% from 1.75% currently, scope for reductions is much much less.

If people cannot meet their mortgage payments houses will be sold thus generating extra downward pressure on prices. In attempting to meet payments people will massively crimp spending elsewhere which will exacerbate the existing economic downturn.

The Reserve Bank have gone through the literature with particular reference to economies most affected by housing downturns during the Global Financial Crisis. Those economies with high ratios of debt to income of borrowers suffered very large downturns and as we can see the effects of massive economic weakness can stretch for years.

The Reserve Bank have run a cost benefit analysis and estimate that in the first year of a DTI regime the economy would grow 0.1% - 0.5% less than would otherwise be the case and that growth would also be less than otherwise in following years. But this would be offset by a reduced negative economic shock stemming from a housing correction in the event of a large economic downturn. Offsetting the lower GDP years against the reduced shock they estimate a net gain of 0.1% per annum.

And this is where the chances of a government introducing a DTI in New Zealand turn to the weak side. The rules were introduced in the UK and Ireland after the housing markets had collapsed and when people (voters) could easily see the value of restricting future lending so such an event could be prevented from happening again.

But in New Zealand we had no collapse – just an average 11% nationwide fall in prices roughly from extreme peak to extreme trough. Our economy reasonably quickly recovered from 3.5% shrinkage and the unemployment rate only reached 7.5%.

Any government contemplating selling a DTI regime to the public will have to offset the expected gains of reduced economic collapse one day and house prices averaging lower than otherwise, against growth perhaps 0.1% or so less than otherwise during the years in which the DTI is in place and the crisis has not yet arrived. That would be a big sell. That is probably why the RB appear at pains to emphasise that if they had ability to use DTIs at the moment they would not be doing so, and why the government is all but silent on the issue.

But the regime could be successfully sold to a public concerned about deteriorating home affordability by focussing on the RB expectation that some 85% of the borrowers who would no longer qualify for a mortgage would be investors.

It is likely that a DTI regime will eventually be introduced in New Zealand and that it will be one outcome of the bigger review of the macroprudential environment planned by the Reserve Bank for next year. It is likely the limit will be set at 5 with exemptions for new builds and banks able to have 20% of their lending above 5. Perhaps the RB will get DTI authority in 2019. When they would actually implement it however is impossible to say.

All we can say is this. Once again, in anticipation of lending restrictions, the signal to potential buyers of property is to act sooner rather than later – but only at the margin. Anticipation of a possible DTI regime with unknown timing of introduction is unlikely to show up in any meaningful way in housing market behaviour over the next couple of years except for perhaps a few investors.

And note this key feature of both the LVR rules and the proposed DTI rules. They encourage buyers to target lower priced dwellings. They shift investors down the price scale into the market traditionally occupied by first home buyers. Having said that, investors generally have not traditionally gone after properties priced above an area's average, and much of their shift into young buyer territory has probably already occurred.

For your guide, in their recent duo of reports on New Zealand the IMF last month recommended the RB adopt a DTI regime and that it be kicked into life should housing markets reignite. Their view is that the LVR regime has reached as far as it can go and further raising the 40% deposit requirement could have unintended consequences – which they do not specify. Page 12.
http://www.imf.org/~/media/Files/Publications/CR/2017/cr17111.ashx

Labour's New Migration Policy

Since the events of Brexit and Mr Trump's victory we have expressed the opinion that there would be more tightening of migration policy in New Zealand and we have seen two bouts from the current government in the past year or so. We've expressed the view that it would seem reasonable to expect that if either major party negotiates with NZ First to form a coalition or minority government that one outcome would likely be a further rule tightening for migrants.

Around the world the tide has been turning against minimally restricted migrant flows for some time, but usually for different reasons than here in NZ. Islamism, high unemployment, terrorism feature strongly. Here in NZ the key driver behind often only quietly discussed concern has been pressure on the Auckland housing market. There has also been some concern that migrants may be one cause of the absence of near any sign that wages growth has accelerated as yet post-GFC in New Zealand.

Plus there has been growing concern that the influx of students, often undertaking fairly low level types of studies, has pushed low skilled Kiwis out of entry level jobs. And there has been growing concern about fraud, especially out of India which has produced a surge in student numbers here the past three to four years (though falling now).

Regarding the wages impact, there is no evidence of a depressing effect of the influx of low skilled migrants, and this is not just a phenomena in New Zealand. The Economist magazine this week noted the ongoing debate surrounding two major studies of the impact on low skilled wages in Miami following the Mariel Boatlift of 1980. Cuba's President Fidel Castro allowed 125,000 Cubans to flee Cuba that year, boosting Miami's labour supply by 55,000. A paper written in 1990 by David Card found no wages impact from the influx. An updated study in 2015 by George Borjas found wages did fall.

The debate is not settled. Other work finds that when wages are depressed it tends to be just for previous generations of the same migrants, not the natives.

Labour have responded to numerous concerns with a new migration policy. They are aiming to cut immigration by 20,000 to 30,000 per annum, almost exclusively of low skilled people doing low skill courses then staying on as long as possible afterward working toward residency.

Labour would halt student visas for "low level" courses – which means little impact on universities and polytechnics but potentially a 70% cut in business for small providers of these courses.

They would also restrict the ability of students doing non-low level courses to undertake part-time work. Businesses would also have to undertake a stricter test to prove they had sought staff within NZ before recruiting offshore. A new visa would be created for those with Exceptional Skills, and regions would be able to draw up their own lists of skills shortages with successful migrants having to stay in the relevant region for an extended period.

If implemented, what will be the impact? Less supply of lowly skilled people will mean extra upward pressure on wages for such positions, thus closures of some businesses which have grown reliant upon such foreign staff. In theory the change would mean more opportunities for low skilled Kiwis. But feedback from employers suggests the issue is not foreigners snapping up such jobs, but Kiwis not having the attributes which they are seeking. If this is true – and the evidence is mixed – higher wages will help overcome the problem by providing greater incentive to people to upskill and get clean.

There would likely be less demand for inner city accommodation in Auckland than would otherwise be the case. But going by the anecdotal evidence of high density living that means in some cases a reduction in the number of foreign students per bedroom. The boom in student numbers probably accounts for most of the rise in Auckland's inner city population from around 25,000 to now 45,000 since 2012. Impact on the wider housing market will be very little in the short to medium term as it takes many years for a migrant working in a low wage job to become a house purchaser.

Inner city eateries would suffer, but retailing broadly would be little affected as student migrants tend not to buy durable items like cars and household appliances.

If National win the election as polls currently suggest (like they did for Remain, Clinton, and the Conservatives?) would that mean low skilled migrants can breathe a sigh of relief? Not necessarily, despite the Government heavily criticising Labour's seemingly well thought out policy. The writing has been on the wall for this growing group of people for quite some time. Chances are that under a National-led government we would also see some rule changes and that is where NZ First would come in.

In contrast to the very heated, often racist migration policy debates and actions offshore, Labour's policy appears well thought out and world's away from their previous effort to highlight migration housing pressures by counting up "Chinese sounding" names of house buyers. Recent data from Land Information New Zealand suggest only 2% of dwellings are in fact sold to foreigners.
http://www.linz.govt.nz/news/2017-06/linz-releases-latest-property-data

Ignoring the Data

In the most recent Economist magazine there is a great line which helps explain why most of us don't engage in debate with people who hold strong views – be those views on religion, politics, immigration, sports teams or whatever. To whit...
"Studies confirm what is obvious from experience: people frequently disregard information that conflicts with their view of the world."

I got an example of that in response to last week's Overview where we made rough calculations of regional housing shortages or over-supplies using 2006 as a starting point and examining changes in population and issuing of dwelling consents. The data suggest a continuing over-supply of dwellings in a number of districts. For one, Manawatu-Wanganui, a businessman who traditionally has favoured interventionist policies upon seeing the data emailed "Could it be lies, damn lies, and statistics?"

In other words, ignore the data and go with what you want to believe is or will be the reality. That might be a useful approach heading into an election and ignoring the polls showing you will suffer a landslide loss (Jeremy Corban's UK Labour Party). But in the real world it is a good idea to pay attention to what the data are telling you and adjust your view if necessary.

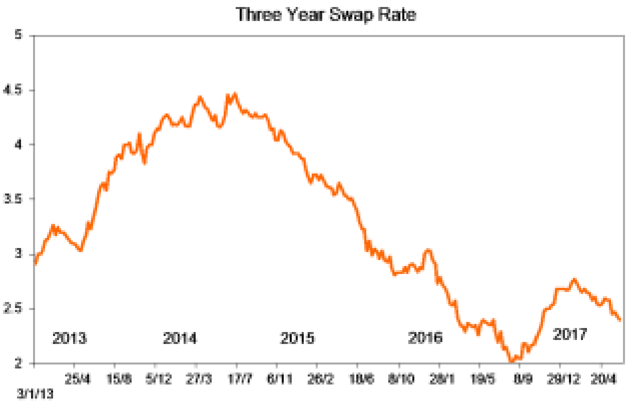
In economics the trick is not to change view just because one data point or series challenges it. It is best to consider data and information from a range of sources before concluding that the ground has shifted or that one's long held view simply has no chance of proving correct.

If I Were A Borrower What Would I Do?

It has been a very long time since we discussed movements in swap rates here. That is because the insight their movements provide us into possible movements in mortgage lending rates is not what it used to be. Banks are facing rising costs and rising cost of funds from things like having to boost retail deposit rates and to raise more capital (more capital is likely to be demanded by the Reserve Bank next year following a fresh review).

But it could be useful this week to point out that swap rates have fallen quite a bit in recent months in response to reduced expectations of rapid monetary policy tightening in the United States, and a pullback in NZ tightening expectations also.

The following graph shows the three year swap rate which peaked at 2.8% early in February but is now 2.4%.Our three year home mortgage rate went from 4.65% in December when the swap rate was 2.68% to 5.09% when the rate hit almost 2.8%.



Does the 0.4% decline in four months mean the fixed rate is about to be cut 0.4%? No. We are now in a world of credit rationing either via LVRs or direct bank cutbacks because of difficulties raising enough funding within New Zealand to finance lending here. Competition between banks to lend to people has naturally declined in an environment where there are more customers wanting service than can in fact be served.

However, don't be surprised if in the near future there are some small fixed rate reductions. It is often the case that a bank will find itself having too much of one type of lending and not enough of another. They might cut their rates to get a better mix. That is why it pays to shop around.

Just for your guide here is a graph sourced from data gathered by the RBNZ from registered banks. It shows the industry's net interest rate margin. In the March quarter it sat at 2.02%, down from 2.19% a year ago, 2.32% two years ago, and 2.33% three years back. The ten year average is 2.18%.

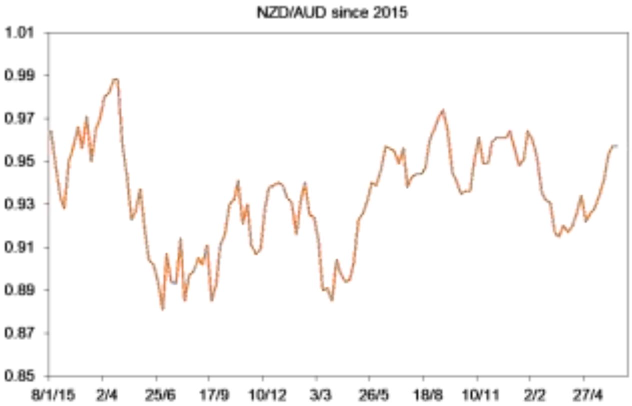
http://www.rbnz.govt.nz/statistics/s20

With regard to wholesale interest rate market movements this week we have seen few changes but a lot of attention on the United States where the funds rate was raised 0.25% as expected to 1.0% and the Fed indicated more rate rises lie ahead. But at the same time data emerged showing weakness in actual inflation and that coupled with only slim chances that President Trump will be able to produce a decent fiscal stimulus anytime soon has caused the benchmark 10 year US government bond yield to fall to 2.13% from 2.2% last week and 2.5% in March. The rate is now at its lowest level since just before the US Presidential election but still well above the 1.5% of August last year.

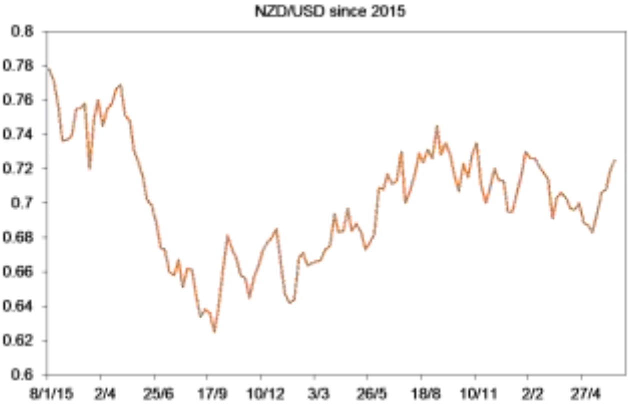
NZ Dollar

Our view on the Kiwi dollar for a long time now has been that it is fundamentally very well supported by the firm state of the NZ economy offset against a wide range of illnesses afflicting economies, politics, and societies elsewhere. We see nothing to alter that key fundamental view and the rule for exporters now remains the same as it has been for a long time – hedge the Kiwi when the inevitable dips come along.

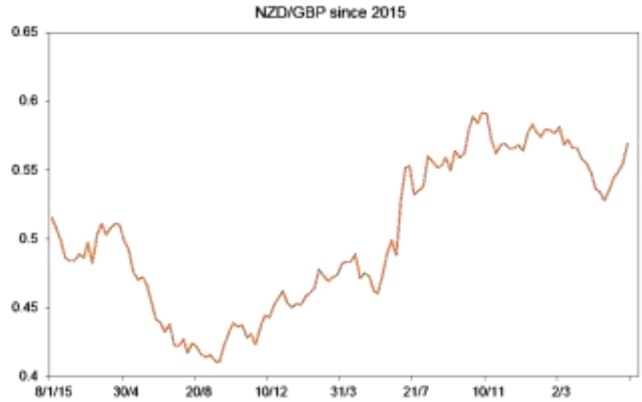
We have recently seen a couple of those dips in the form of the NZD falling to 91.5 Aussie cents in March from 96.5 cents in January. Now we are back at 96 cents with the AUD hit by Moodys cutting China's credit rating and a sharp pullback in coal and iron ore prices following an earlier unusual rally.



Against the USD we fell to 68 cents early in May from 73 cents in January. Now we are back near 72 cents.



The NZD has also of course gone back up against a British Pound hit by the debacle created by PM Theresa May – call an election three years before one needs to and lose an outright majority. We bottomed out against Sterling near 52.5 pence in May from 58 in March. Now we are back at almost 57 pence.



So what happens now? That is impossible to say, and instead the approach I take is to adopt an underlying long-term view (Kiwi strong) and assess unpredictable short to medium term movements against that view to ask whether where the Kiwi has got itself to seems reasonable or unreasonable. There is no point dealing in exact specifics like 54 pence versus 55 pence, or 72 versus 71 cents.

NZ Treasury in fact produced a good Treasury Staff Insights paper on May 2 this year illustrating the uncertainty which surrounds their forecasts of key economic variables like GDP growth, the unemployment rate and interest rates. They note with regard to the NZD the following. "Forecast errors for the exchange rate are relatively large compared with other key macro variables, highlighting that our ability to forecast the exchange rate is not as good as it is for other

economic variables (for which there is still considerable uncertainty)."
http://www.treasury.govt.nz/publications/research-policy/staff-insights/mei-forecasting-uncertainty

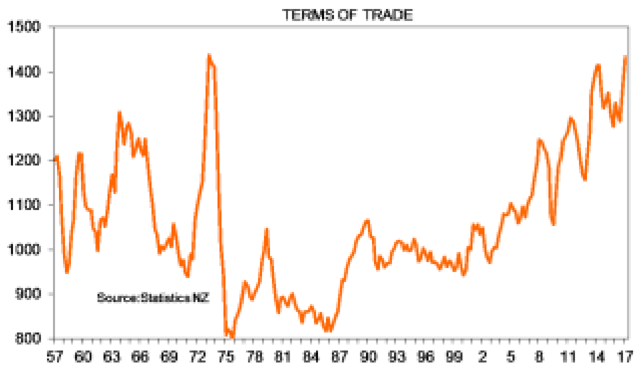
Where the NZD sits now looks reasonable – meaning that when some inevitable unpredictable shock comes along and we dip back down, I'd boost my hedging if I were an exporter. And what could such shocks be? Military confrontation in the seas off China. A new dimension to military confrontation in the Middle East. Mr Trump doing something.

Regarding the NZD's underlying support we have the following non-exhaustive list of factors.

Terms of trade up over 5% in the past year to the highest level since 1973.

Just as importantly, complete erasure of the argument we markets-derived economists used for near two decades for NZ needing to abandon farming and embrace something else. The late David Lange when PM said "Farming is a sunset industry and manufacturing and tourism will take its place" He wasn't even right on tourism as it sits alongside farming and has not replaced it as our main generator of foreign earnings.

The trend in our terms of trade since the start of the millennium has been upward. Key factors include structural declines in oil prices recently due to shale extraction, strong growth in manufacturing sector capacity and efficiency pushing down imported goods prices, strong sustained growth in China boosting demand for our primary products. China has 18% of the world's population but only 7% of its arable land – and much of that (as much as 19%) is heavily polluted so Chinese-grown produce can be poisonous if consumed long-term.

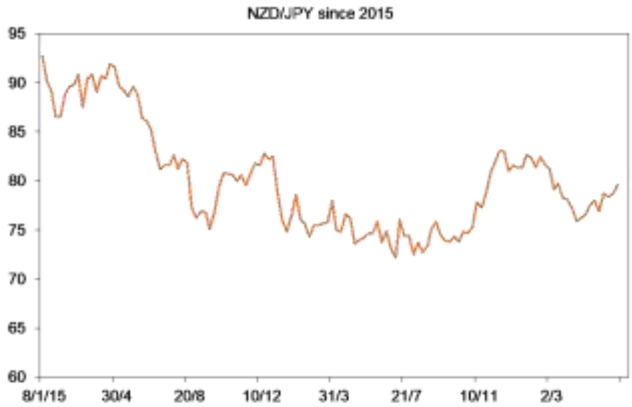


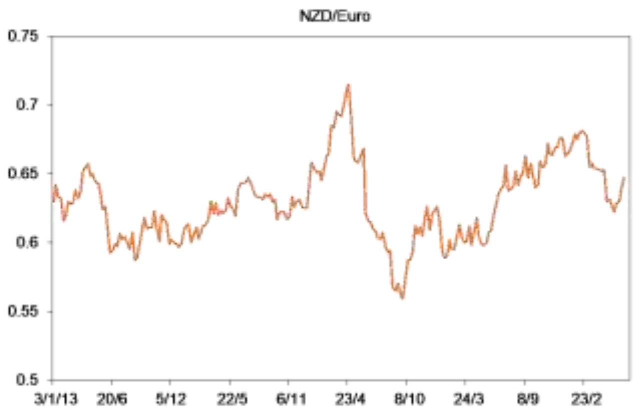
Strong growth outlook

NZ Treasury forecast GDP growth of 3.5% in the year to June 2018, then 3.8% in the following year. The consensus view garnered from the regular survey of forecasters undertaken by NZIER is 3.1% then 3.3%. Strong growth is supportive of a firm currency.

Tightening monetary policy

Forecasters of a falling NZD place extreme reliance upon the USD rising strongly as the Federal Reserve tightens monetary policy. They have raised their cash rate 1% so far this cycle (including a 0.25% rise this morning). Yet many US growth and inflation indicators are not advancing as had been hoped and soon the chances are that the markets will be talking about an extended pause in the tightening cycle. In contrast the NZ tightening cycle may commence before the middle of next year though major uncertainty surrounds this timing. Chances are NZ rates rises from the RB are still a long way out.





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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