

# BNZ Weekly Overview

6 July 2017

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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.

## QSBO

**I will be on leave from Monday so there will be no Weekly Overview on July 13. The next issue will appear in a fortnight on July 20.**

Every three months we get a dump of quite valuable data from the NZIER's long-running Quarterly Survey of Business Opinion. (Some of their measures start in 1962.) We pore over it mainly to get gauges of inflationary pressures and capacity constraints in the economy, whereas the ANZ's Business Outlook Survey is better for delivering up to date confidence and investment & employment intentions measures.

In that regard the QSBO told us this week that a net 28% of non-farm businesses expect their costs to go up. This is statistically unchanged from the March quarter reading and the ten year average of a net 30%. But the past two quarters have delivered the highest readings since 2012 so one might think this means higher inflation lies just around the corner.

One strengthens such a view when noting that a net 24% of businesses say they plan raising their selling prices which is just above the 23% ten year average.

But we have two caveats before people feel they need to rush off and fix their mortgage rate for seven years before the Reserve Bank goes ape over inflation pressures.

First, the net 24% of businesses planning price rises is down from 29% in the March quarter. Second, this measure was a net 37% at the start of 2014 and within one year it collapsed to only 6% and the inflation rate had fallen from 1.5% to only 0.3%.

The following graph shows the price rise measure as the orange line measured on the left hand side, and the actual annual inflation rate in blue measured on the right hand side. There is a good correlation with changes in pricing plans tending to precede changes in inflation

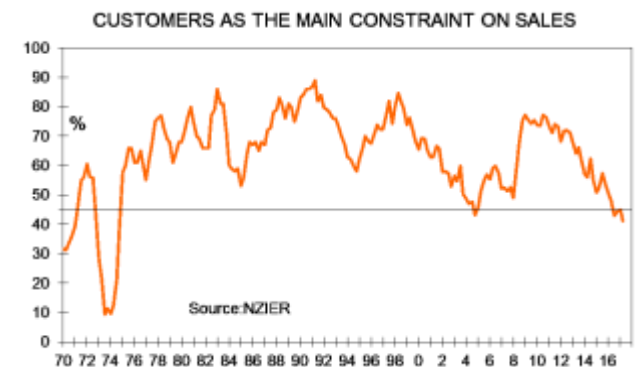
outcomes. But the latest outcomes are not signalling especially high actual inflation (which in fact we forecast falling from the current 2.2% to just over 1% in the coming year) and on that basis the Reserve Bank is highly unlikely to signal any change in its view regarding inflation upside risks for quite some time.



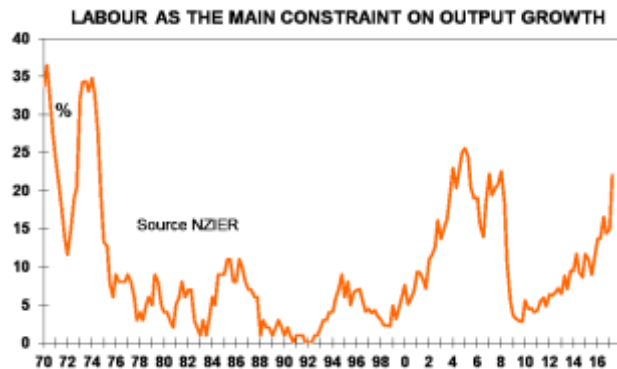
And one more thing making them feel comfortable. The capacity utilisation rate measured in the QSBO fell from a record 93.6% in the March quarter to 92.1% this quarter. This is above the 91.2% ten year average reading, but not by all that much.

But we also have from the NZIER in terms of stuff we can't get monthly from the ANZ survey, measures from respondents regarding what factors they consider are most constraining their ability to grow.

Only 41% say orders/sales which is the lowest reading since 1974. Now that's interesting.



So if businesses are not short of customers, what are they short of? Staff. A gross 22% say lack of people is why they cannot grow more. This is the highest reading 2007.



All analysis based on how the world operated before the GFC would tell us that this means accelerating wages growth and rising inflation to be combated by hikes in interest rates of uncertain magnitude. But post-GFC strong jobs growth does not lead to strong wages growth like it did before – for all countries. There is nothing special about New Zealand. We don't really know why this is.

Nonetheless, it is readings like this, plus adding the expected stimulus to NZ growth from higher government spending and the highest terms of trade since 1973, which makes us convinced that the next change in NZ monetary policy is a tightening – probably in May next year.

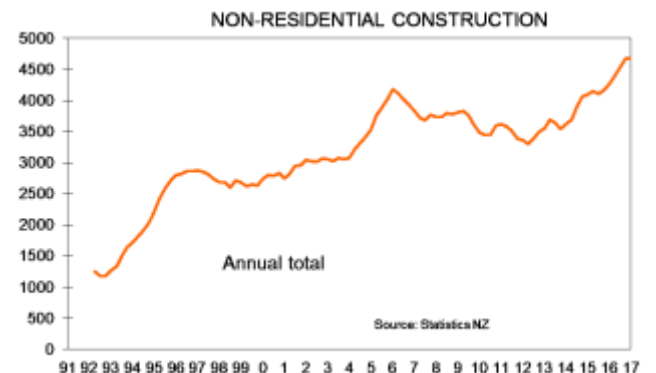
But picking the timing of policy changes has become a nightmare around the world because central banks have no better access to information than us in the private sector, central banks have repeatedly tightened too soon since 2010 and been forced to ease and flood their economies with liquidity, and the world has changed in ways we all do not yet understand and cannot model.

One might excuse central banks for thinking that having been burned once, twice or more with tightening since 2010, next time they may wait to see a lot more than the whites of the eyes of inflation before they pull their trigger – especially as there is already restraint coming from new quantitative weapons like LVRs.

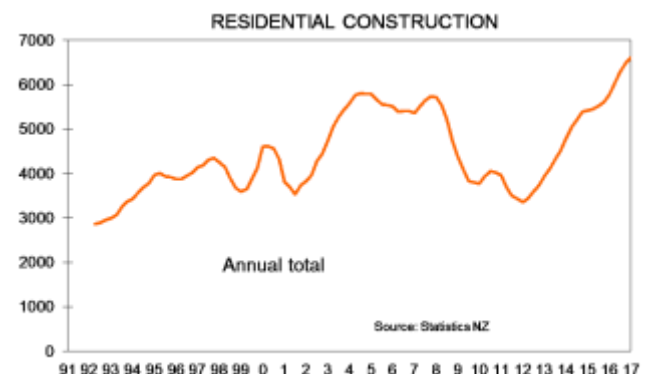
## Construction

There's nothing quite like a building boom. It provides employment for lots of people in usually lots of places across a wide range of areas and levels of expertise, with plenty of opportunities in particular for unskilled people to get themselves on a good employment path. Banks love it because there are many lending opportunities. Governments like it because all the extra spending boosts employment, generates more revenue, makes people happy, and therefore boosts election chances. Manufacturers love it because of the demand for materials – and so on.

So are we having a boom? When it comes to non-residential construction the answer is probably yes. The inflation-adjusted (volume) of non-residential building work was up 9% in the year to March. This followed a rise in the previous year of only 4%, the year before 13%, and the year before that 2%. Activity is 29% ahead of three years ago. The graph shows things trending up over time with a decent surge since 2012.



What about house building? Yes also because the volume of residential construction in the year to March was ahead 38% from three years ago.



Does it look like recent strong building growth rates will continue? To answer that we like to look at consents data. Doing so we see that the value of consents issued for the construction of non-residential buildings was up 11% in the year to May after growing 9% the year before, 22% the year before that, and 9% one year earlier. Sounds good.

But measured by floor area consents have declined by 13% in the past year. Have things peaked then? Maybe. But it is hard to say because over 2008-2010 consented floor area fell over 40% but actual work done barely changed.



So perversely, a measure seemingly closer to activity levels than values does not really give the greatest of insight. Chances are that non-residential construction will grow a bit further, but not by all that much – not least because of a shortage of builders and finance.

For your guide, in the NZIER’s QSBO a gross 11% of builders said finance was their main constraint compared with only 3% of manufacturers, 1% of merchants, and 5% of service sector respondents. On average over the past 20 years the reading for builders has been just 5%. Note that this survey covers builders, not property developers for whom inability to get finance means they essentially never exist – like cabbages which have never existed because no seeds were ever planted.

And a gross 29% of builders (17% average) rate labour as their main constraint. Manufacturers 15% (7% average), merchants 6% (5% average), and service companies 26% (14%).

Regarding residential dwelling consents the annual number stands at 30,645 which is a rise of 8% from a year earlier and 34% from three years ago. Growth is continuing but over the past six months things have somewhat plateaued after

reaching an annual total of 30,399 units in November.

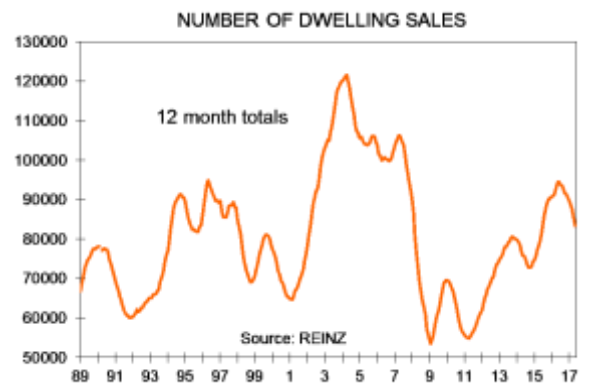
We may well have seen the peak level of construction activity this cycle occur without the usual cause of such a peak – hikes in borrowing costs from a central bank fighting inflation. That means what happens now will be vastly different from what has happened in the past – widespread business collapses and redundancies. Activity levels are close to plateauing because of finance and staffing capacity constraints, not financing costs pushing end-buyers away and destroying margins.

Our expectation is that construction levels will actually remain at these current highish levels for an uncertain number of years.

Note that the NZIER’s QSBO revealed a drop in builder confidence about the general economic situation to a net 18% positive in the June quarter from 31% in the March quarter and 24% a year ago.

**Residential Real Estate Jobs**

The annual number of dwelling sales all around New Zealand tends to bottom out about every ten years. 60,000 in 1991, 64,000 in 2001, 55,000 in 2011 (ignoring the unique GFC-induced 53,000 of 2009). On that basis it seems reasonable to expect that dwelling sales will continue their decline from the 94,000 peak last year to 83,000 now down to near 65,000 come 2021. This means the pressures which real estate agents are already under to maintain revenue will become more intense and we will see the usual wave of people leaving the sector soon.



The decline in dwelling sales also has implications for mortgage brokers who will be getting less busy now.

Whilst on the topic of falling sales, Barfoot and Thompson this week revealed that in Auckland in June they sold 27% fewer houses than a year ago and the average sales price was up only 0.6% from June 2016. Over the past three months average prices have eased by 1.9% whereas in the June quarter of 2016 prices rose 6.2%, June quarter 2015 7.5%, and June quarter 2014 3.6%.

The data are in line with numbers from other sources showing the Auckland market flattening out in terms of prices with sales falling. General media are now increasingly picking up on one of our main points for some time now – selling by investors who are worried about price declines and looking to either take their profit and run, or minimise what will be losses for some. Auckland has an over-supply of subdividable land and a dearth of fresh investors because of the 40% deposit requirement. This cycle has well and truly ended its upward leg and now we will see stories of some big declines of particular properties in areas which have been targeted mainly by investors.

For first home buyers the situation is now better in terms of range of properties to choose from, reduced chances of having to attend multiple auctions and being outbid by investors, and even some better chance of grabbing something reasonably priced from an investor just wanting quit of their now depreciating asset.

For Mum and Dad investors times are now getting tougher because of the psychological hit from no longer seeing their paper wealth rising through no effort on their part. For professional investors the time for selling off crappy stock to over-optimistic new investors ended last year and this year we will move into the part of the cycle where they start to pick up low-priced bargains from panicked sellers.

The challenge for those interested in residential property is to continue to make sure they do not get lost in the woods from focussing too much on the individual trees of price shocks. The underlying picture for Auckland is the same now as it was a year ago, five years ago, even ten years ago.

Demand growth is exceeding supply growth. Long-term price prospects remain strong.

### Driverless Cars – Some Thoughts

Driverless cars in a fully networked transport system. Why will driving yourself eventually be frowned on and taxed out of existence? Because 90% of road accidents are caused by human error and such accidents are the greatest source of woe for thousands of people every year. Just one look down the list of items on Google News this Tuesday morning shows it.

“Two dead in serious crash near Taupo.”

“Killer drink driver is jailed again.”

“Several injured after taxi hits crowd at Boston Airport.”

“Police confirm 18 dead in German bus crash.”

Peer pressure not to drive and put the lives of oneself, one's loved ones, and other people at risk is why eventually a driverless car system will replace the way we currently drive ourselves – maybe in 20+ years time.

In similar vein, those of us who love meat and will eat anything bar a rat, cat or dog, will eventually switch from eating carved off parts of a dead animal to genetically identical meat with the same texture, goodness and taste grown in a factory. Such meat grown without involvement of bones, offal and a brain will mean no early death for billions of animals every year (being no longer in demand they will no longer ever live at all for the most part). Water demand will decline along with greenhouse gas emissions – partly offset however by the resource demands and emissions associated with factory-grown meat.

Same for milk. Milk production involves the deaths of many thousands of bobby (male) calves every year, sometimes hefty pollution of waterways, use of water, and of course greenhouse gas emissions. Presented with a genetically identical alternative with the same properties (probably lactose-free) many if not most consumers will opt for the factory produced milk on moral grounds.

Why will these things happen? Because moral grounds producing peer pressure explain the movement of managed funds away from investing in things like weapons production, tobacco production, coal mining etc. Moral and peer pressure via advertising campaigns lies behind our movement in the seventies away from dropping litter whenever we felt like it. The same

more recently for drink driving. Legislated punishments only go so far in changing behaviour.

Does this mean our pastoral farming sector is munted? In current form maybe. But the secret to business continuation (as in personal lives) is the ability to adapt as circumstances change. One adaptation may be movement away from production of beef which ends up mainly in US hamburgers toward premium cuts from animals which are shown to have lived fruitful enjoyable lives. Some categories of consumers will pay a premium to consume them – most won't as they already live on takeaways and are losing the ability to cook for themselves. The same for milk. Maybe we do what large businesses try to do but usually fail at – initiate our own disruption and become world leaders in production of synthetic meat and milk. At the same time diversification into other primary outputs would seem like a wise idea for investment at the margin.

As for a fully networked driverless car system (which could render a light rail system from Auckland CBD to the airport redundant), all we can do is hope we each don't get killed or injured by the other drivers on the road or ourselves before that system comes along. Good luck out there today. The data tell us one week from now about eight of us will no longer be here because of our wild west transport system.

Speaking of wild west, our bad driving means lots of people, myself included, no longer cycle on the road because of the risks involved. Cometh driverless cars that risk will greatly diminish and cycling is likely to enjoy quite a rejuvenation – especially as e-bikes become even better.

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

In Australia the ratio of household debt to income has hit almost 190% compared with 165% in New Zealand, 167% in Canada, UK 143%. So much for the debt benefits of compulsory saving which people in the managed funds industry salivate about achieving. Beyond the issue of allowing people to make their own choice is the fact that as people's assets in the form of retirement savings in Australia have grown they have chosen to also boost their liabilities. So while household balance sheets are in net wealth terms superior in Australia to what they are in New Zealand, the gains are not enough to assuage concerns about excessive investment in the housing market and vulnerability of the banking system and economy

in the event of a shock which hits household incomes or house prices. In fact worries about such destabilisation are far greater in Australia with its compulsory saving than here in New Zealand with our simple voluntary system and even simpler superannuation structure.

For your guide, research recently released shows that because of abatements to pension payments for assets and incomes, someone who has saved just \$400,000 for retirement will have a higher total income in retirement including the Aussie pension than someone who has saved \$1 million.

The incentive for people is that unless they feel they can save more than \$1 million there is zero point in aiming to save more than \$400,000. In fact given the higher utility of spending now rather than later, the incentive is to minimise savings and enjoy higher spending unless savings are seen as likely to exceed maybe \$1.5mn or so. In a compulsory savings system the only way to achieve optimal lifetime utility is offset savings above an expected \$400,000 by deliberately boosting debt and spending and paying off that debt when the lump sum becomes available at 65 years of old.

<http://www.theaustralian.com.au/business/wealth/retirees-punished-for-saving-more/news-story/14edfb8b8f26ffa304f8e8800f80bf9>

Regarding all the hundreds of articles we are bombarded with each year telling us to save more for retirement and boost contributions to Kiwisaver – the truth is people have made their choices. Half of Kiwisaver members have chosen not to make regular contributions. (Some will however be kids signed up when the government start-up subsidy was still in place.)

Over time people will increasingly in NZ match their Kiwisaver asset with a larger mortgage or delayed mortgage repayments. Their intention will be to cash up Kiwisaver at the age of 65 and repay the mortgage then.

This is not to argue against the high value of the Kiwisaver scheme to which everyone should consider joining and using as a long term savings vehicle and deposit account for building up a deposit on a first home. For those planning to eventually own a home you'd be silly not to join.

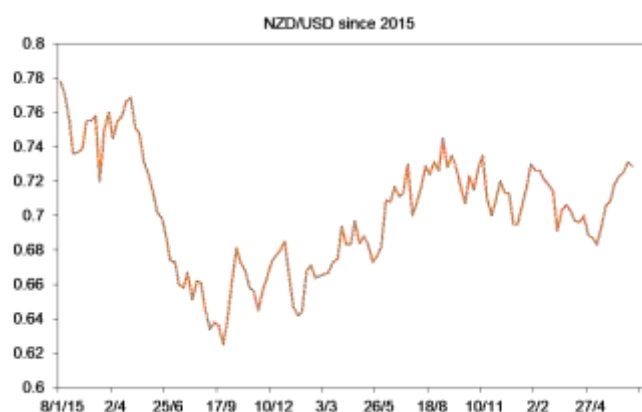
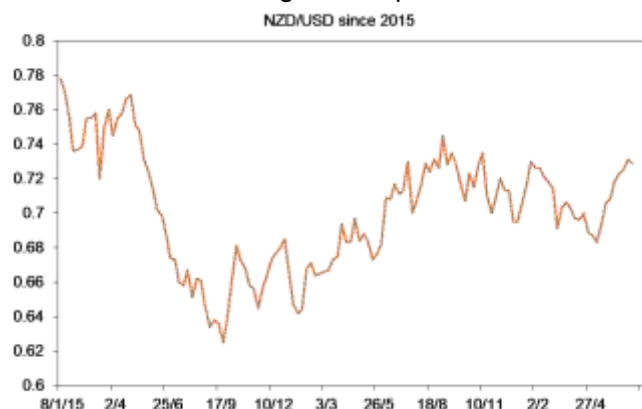
For the record, there's nothing much new to write this week regarding where interest rates seem to be headed in the near future. One or two banks

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have discounted some of their fixed housing rates as we expected, but no major changes seem to have been undertaken as yet. The probability of any decent cuts has declined slightly these past two weeks with global bond yields rising slightly following comments by central bank officials offshore suggesting they would like to tighten their monetary policies soon.

### NZ Dollar

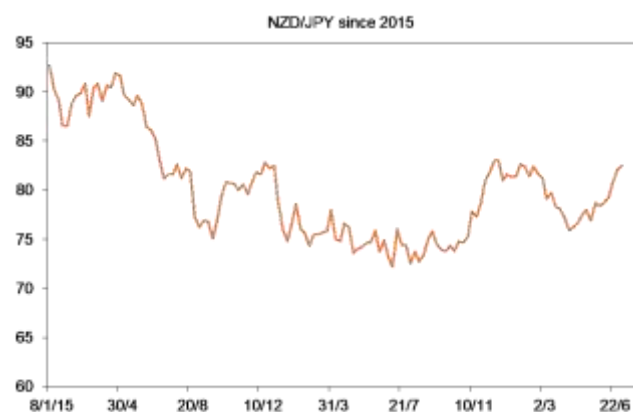
Nothing at all interesting happened regarding the NZ dollar this week. This afternoon it was sitting near US 72.9 cents from 73.1 cents last week. Against the Aussie dollar we sit near 95.9 cents from 95.6 with the AUD slightly weaker after the Reserve Bank of Australia indicated on Tuesday that it sees little need for raising interest rates with comments about Australia's growth prospects which were less strong than hoped for.



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](http://www.tonyalexander.co.nz)

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### 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/>