BNZ Weekly Overview

9 May 2019

ISSN 2463-4328

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.

Our Economy

A thought. Many people buy into the argument that there has been a stark widening of wealth inequality over recent years and that this means capitalism has gone too far or that nefarious forces are at play. Actually, all that has happened is that interest rates over the past decade have undergone the biggest structural decline we have ever seen.

From the early 1980s NZ interest rates were high, variable, and at constant risk of being pushed higher by the Reserve Bank because of persistent, high, and variable inflation. Inflation worries and pressures started in the early-1970s with the first oil price crisis. The soaring fuel costs hitting cost-plus economies with strong labour movements produced hikes in wages then hikes in business selling prices then hikes in wages and so on.

The term "wage-price spiral" became commonplace and accurately reflected the situation for a long time. Now no-one uses that terminology. For reasons we cannot fully understand wages growth no longer responds to labour shortages or employment growth as happened in the past. Thus the wages part of wage-price spiral has ceased to properly function. But perhaps more important than that, the price part does not function and to a large degree that is because businesses can no longer use simple cost-plus pricing models – another dead piece of terminology.

In the old days if a business raised prices to its buyers we consumers might moan about it but we would pay up for three reasons. First, the cost of searching for an alternative product, price, or supplier would be very high in terms of petrol, time and stress driving around a city looking for other stores. Second, we would go on strike in the following year in order to gain a wage increase compensating us for the higher living costs. Third, we could just put it down to general inflation.

These days however it is largely public servants who go on strike. But more importantly, the marginal cost to me as a consumer of searching for alternative product suppliers and prices is zero. I just go online and look.

In fact the marginal search cost is probably negative for most people because we humans enjoy looking for bargains and will tend to keep searching until we get a dopamine hit from finding something cheaper. And we can boost that hit after finding something cheaper by clicking "Buy Now", even if making such a purchase entails waiting longer for delivery than purchasing at the higher priced store.

The upshot is this. Inflation, while not dead, is very sickly and not much of a threat to anyone outside citizens of failed states such as Venezuela, Zimbabwe, and Iran for special reasons.

Low inflation and low inflation threats mean central banks have lost reasons for keeping interest rates at high levels and forever threatening to raise them to stamp out wage-price spirals. So over the past ten years we have seen interest rates around the world settle from a structural high inflation environment to a low inflation one.

In the past if we ever thought about big interest rate declines it was always in the context of how this would be great for borrowers. We would think about how wonderful the lives of young home buyers and mortgagers generally would be with interest rates not in double digits.

But what we forgot to give sufficient thought to was what the impact of low interest rates would be on investors. Their returns from simple investments like term deposits and bonds would decline and they would go looking elsewhere. More than that, the prices of assets to a large degree reflect calculations including yields on alternatives. So with lower yields on simple investments the yields on these other assets have also fallen – meaning their prices rise.

What we have seen over the past decade has been a structural shift in the yields and the prices for assets such as shares, houses, farmland, and commercial property to reflect partly reduced borrowing costs for purchasing them but mainly low returns on alternative low risk investments.

Only if we see another big structural decline in interest rates will we see a repeat of their asset valuation hikes. That is extremely unlikely if not physically impossible given the low levels of interest rates overseas for one thing. But in addition, in countries like New Zealand and Australia where official cash rates are still a small distance from zero, there is little point in cutting rates anyway. Even if low inflation easily justifies rate cuts, and even if rate cuts may spur some additional economic growth fuelled by greater borrowing, the feed-through into actual inflation is likely to be very, very small.

Links between changes in official interest rates and changes in inflation have structurally weakened.

The upshot of all this in the context of the opening paragraph is this. Those owning assets before the structural decline in interest rates or who purchased assets early in the period of structural yield/price adjustments have seen their wealth levels rise strongly. Those without such assets have seen their relative wealth decline though their cash flow positions are likely to be better because of lower borrowing costs.

This widening of wealth inequality has nothing to do with developments in capitalism, has nothing to do with flattening of income tax rates, has nothing to do with cutbacks in benefit eligibility etc. It simply reflects a structural shift in yields. And that is why the shift will not unwind. Interest rates are not going to soar and cause a collapse in asset prices which will reduce wealth gaps. And governments are not going to enact big policy changes which shift wealth from those who have it to those who have less because, as we have recently seen, there is not parliamentary support for such changes.

In addition, the other route to flattening wealth dispersion, more heavily taxing those on higher incomes, cannot be pursued to any meaningful manner. Why? Because most people aspire to higher incomes and do not want to feel that they are being heavily punished for daring to boost their incomes through extra education, training, risk-taking etc.

Sensible governments will recognise that the wealth disparities which concern many people reflect a one-off structural shift in interest rates and not a dysfunction of capitalism. And they will recognise that attempts to do anything about it will cause massive pain to many people which in democracies (not dictatorships like Venezuela) will see incumbents pursuing punitive policies thrown out.

There has been a structural, one-off shift in relative wealth levels which will not reverse. The focus for governments needs to be not on penalising those who perhaps through zero action on their part have benefitted from this shift, but on those wishing to acquire and grow assets themselves. Policy attention needs to be directed toward improving education and therefore remuneration levels for people, encouraging a long-term savings and investment focus rather than a short-term focus on the past decade, redistributing income via state assistance rather than new tax measures, and encouraging higher wages whilst removing impediments to businesses handling higher labour costs by investing in new technologies etc.

Housing

Nothing much new this week – another seven days gone so another seven days closer to the government shifting KiwiBuild from trying to change housing affordability to providing social housing.

Will yesterday's cut in the official cash rate to 1.5% restimulate housing markets? No. The cost change is very small and other factors already discussed many times here will dominate.

If I Were A Borrower What Would I Do?

The Reserve Bank has responded to lower than expected inflation recently, slowing world growth, weaker housing markets, and reduced net migration inflows by cutting the official cash rate to another record low. The rate has been cut 0.25% to 1.5% which means it is now a full 1.0% below the level it was taken to early in 2009 when worries about the global financial crisis still persisted.

Like other central banks the RBNZ has been surprised by inflation failing to pick up even with strong jobs growth and capacity pressures. The linkages between growth and inflation have changed and they have clearly taken the view that with inflation looking like staying low they had best take some insurance against price changes consolidating close to 1% by applying some more monetary stimulus.

Will this rate cut and another one sure to come in ensuing months make much of an impact on the country's growth rate? It is likely that some extra demand will be stimulated – but not much. First the lower cash rate is already feeding through to lower deposit rates and this will cut the disposable income available to those with savings. Second, the economy is constrained by a shortage of labour and lower borrowing costs can only stimulate growth in such an environment if businesses choose to boost capacity-enhancing investment.

But with business pessimism very high and investment intentions negative it is not at all clear that a slight lowering of funding costs will encourage much more business capital spending.

There may technically be some stimulatory impact in the housing market – but not much. Mortgage rates have already fallen. But more importantly, in the regions the cycle is simply going through its paces and will wind down as the year progresses while in Auckland few people feel that they need to hurry to secure a place before others buy ahead of them.

Lower mortgage rates are likely simply to help cushion Auckland's easing market while allowing the regions to slow down in a gradual manner. I would not be recommending to real estate agents that they gear themselves up for more business on the basis of this and perhaps another rate cut.

From about two months back I have been writing here that I would be in no hurry to fix my mortgage because falling funding costs suggested banks would soon be cutting their fixed lending rates. I noted also that I would personally be looking at just the two and three year rates, not the longer ones because the jump in cost was too much. Banks did eventually cut those rates yet I retained a view that I would be in no hurry. For the moment I would still take my time before fixing, but not have an expectation that rates will fall appreciably further.

Why? Because much as we have seen some pulling back on hopes regarding the strength of domestic and global economic growth, factors supporting such growth still remain good. And recently we have seen good indicators released for the United States, Eurozone, and China. There are certainly still some weak indicators so it would seem out of touch to talk about last year's widespread expectations of monetary policy tightening offshore returning.

It all adds up to a potentially long-term benign rates environment for borrowers. And perhaps that is why things are now slightly less clear cut for forward thinkers with regard to what fixed rate term to take here in NZ.

Compared with a few weeks back we have seen the five year fixed rate cut from 5.39% at the BNZ to 4.45%. That is a good rate and some borrowers might take it – perhaps investors looking to lock in one of their key costs.

But experience of Kiwis with fixed interest rates since they appeared in the ear;y-1990s tells us that we only tend to fix long when those rates are appreciably below short-term rates – and that is not the case currently. Our two year fixed rate is 3.99% and three year rate 3.95%.

If I were borrowing currently I would be looking to fix for either two or three years. While I might wait a tad longer to see if rates could be cut a bit to reflect falling real estate turnover and writing of new mortgages, I'd not expect something like a 0.25% reduction. Maybe just 0.1% in the near future if that. We have to remember that a lot of the drop in funding costs associated with the OCR cut had already happened before yesterday's RBNZ announcement.

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 here. http://feedback.bnz.co.nz/forms/IFdYSs5FGEq4kAjP95uzTA
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz