BNZ Weekly Overview

17 September 2009

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.

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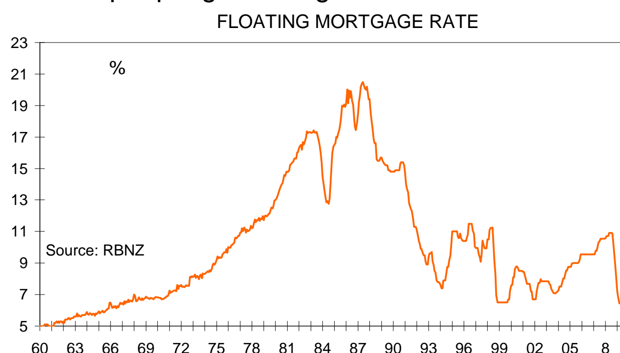
The Weekly Overview is written by Tony Alexander. The views expressed are my own and do not purport to represent the views of the BNZ. To receive the Weekly Overview each Thursday night email me at tony.alexander@bnz.co.nz with 'Subscribe" in the Subject line.

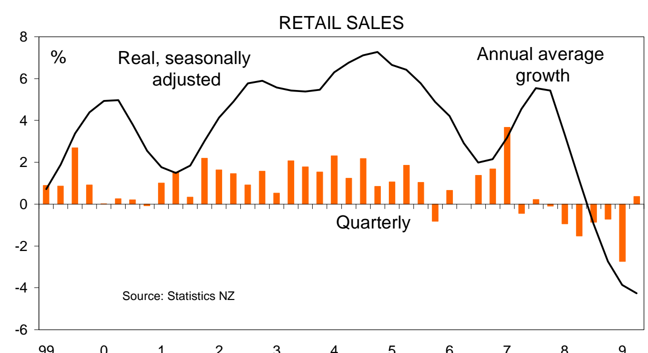
Positives and Negatives

Considerable uncertainty remains about how strong the economic recoveries will be here and overseas over the next two years – and the picture beyond the end of 2012 is almost anyone's guess. But for those who may have strong views one way or the other on relevant matters, here are some of the major pluses and minuses in play for the New Zealand economy.

First, the pluses.

Floating mortgage rates are at their lowest levels in four decades and as a nation of borrowers this has a strongly positive impact on household cash flows. On average maturing fixed rates are rolling off 7.5% so if all these people go floating the rate reduction is well over 1.5%.

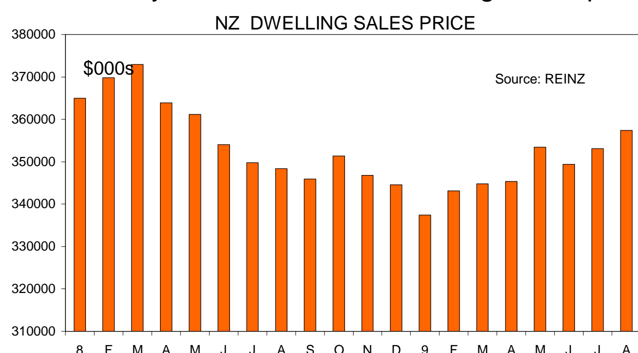


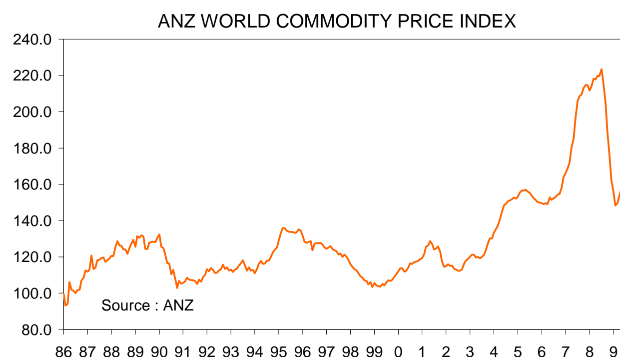


Catch-up retail spending. While we may have taken advantage of hefty retailer discounting to buy new plasma TVs, the cars are wearing out and the furniture is starting to look tatty. Once people feel greater certainty that they will not lose their jobs we may see a period of catch-up spending to replace durable consumer goods.

In particular, buying of furniture, appliances etc. is likely to improve from here on out as house construction picks up. The country needs about 23,000 new houses to be built each year and the number in the year to July was less than 14,000 according to consents data. But there is an upward trend in place and dwelling construction is likely to steadily grow over at least the next two years.

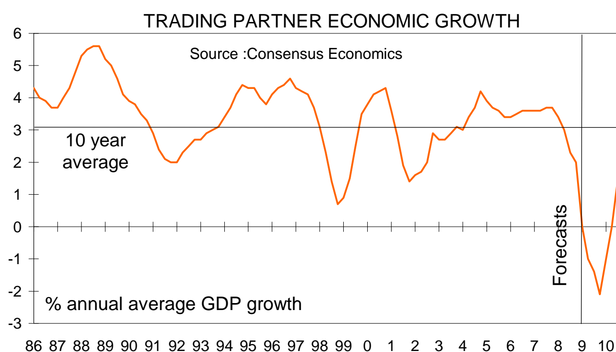
House prices have risen 6% since January and are likely to keep drifting up. This probably won't cause a particularly strong feeling of rising wealth given the recent price shock downward, and spending from perceived higher wealth will likely be quite restrained. But the spending implications of rising house prices are obviously better than those of falling house prices.





Commodity prices on average have risen for the past six months and are up 12%. Further gains are likely and these will go some way toward offsetting the unusually strong NZ dollar.

Forecast growth in our top 14 export destinations has improved to 2.4% next year from 2% expected in May and shrinkage of close to 2% this year.



There will also be support from increased government infrastructure spending and preparations for the Rugby World Cup.

But there are many obvious negatives which should leave one cautious about the strength of growth over the next couple of years.

The NZ dollar has jumped unusually early in its cycle to sit well above average against a generally weak greenback and above average on a trade weighted basis. While the rising NZD will not prevent improved conditions for exporters resulting from rising commodity prices and improving trading partner growth rates, the rise does mean this is not a traditional export-led recovery. That means there is unlikely to be the traditional upward kick in rural land prices and spending spreading from the farms and hitting the cities about 18 months later. In fact farm spending is going to be massively restrained this cycle because of recent land price declines and tighter credit conditions combining to strongly reduce credit availability to the farming sector.

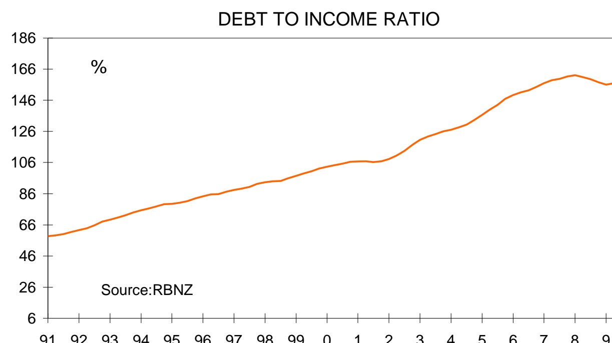
While the dairy sector in particular is lagging the economic cycle this time around so too is tourism courtesy of the massive economic decline offshore. Improved revenue overall for the tourism sector may not come until late-2010.

The commercial property sector is also lagging the economic cycle with vacancy rates rising around the country and businesses giving more serious thought to their true accommodation requirements.

Credit availability has not only tightened for farmers but for practically all borrowers as a result of the global financial crisis revealing inadequate risk assessment by lenders to banks, inadequate prudential supervision

in some countries, and in NZ the severe erosion of the finance company sector. Reduced credit availability is likely to strongly limit growth in areas which have traditionally relied upon high risk lenders – such as property development.

Every commentary for at least the past decade can have had this final factor on the minus side – high household debt. The common assumption is that because Kiwi's have a far higher ratio of debt to income now than in the past when credit was essentially rationed by banks who were heavily regulated by the central bank, debt levels are unsustainable. This has not proved to be the case and it is an article of faith or deep desire which leads people to currently conclude high debt this time will surely restrict new household credit demand and spending. It seems reasonable to make this assumption, and one of the best things which could happen in NZ is we all save a lot more, but it will be interesting to see if it holds in practice.



On top of these negative factors we think it is still valid to explicitly include as a negative the continuing high level of uncertainty regarding world growth, NZ growth etc. Consider businesses for instance who may plan capital expenditure but are wary of how much credit they will be able to access. This uncertainty will tend to delay actual expenditure.

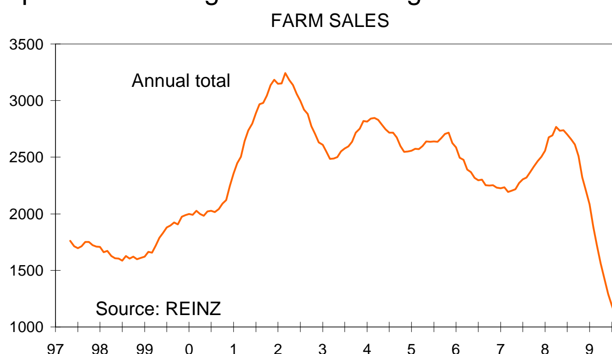
Overall we are of the view currently that over 2010 the NZ economy will grow close to 2.3% then 3.3% over 2011. The unemployment rate will peak just over 7% from 6% mid-2009 and fall over 2011 at the latest.

NZ ECONOMIC DEVELOPMENTS

Monday 14

Farm Real Estate Very Weak

In August there were only a paltry 51 farms sold around New Zealand. This was a 65% fall from a year earlier taking the three month total down 64% from a year ago and the 12 months to August result down 59% from a year earlier. In rough seasonally adjusted terms sales have fallen 7% in the three months to August so severe angst continues to grip rural real estate – probably due partly to clearly tighter credit conditions, the strong rise in the NZD against the greenback, and warnings from the Reserve Bank regarding the level of farm debt, their intentions to make banks put aside more capital when lending to farms, and advice to banks to provision for higher farm lending losses.

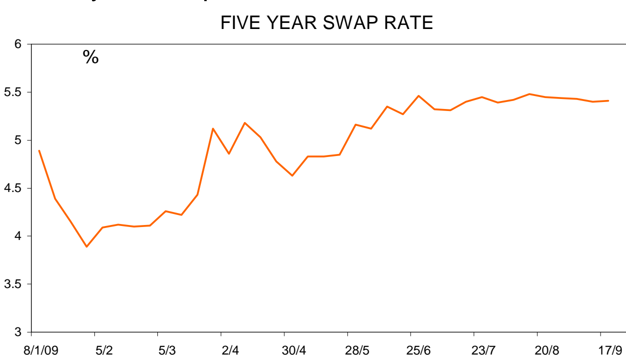


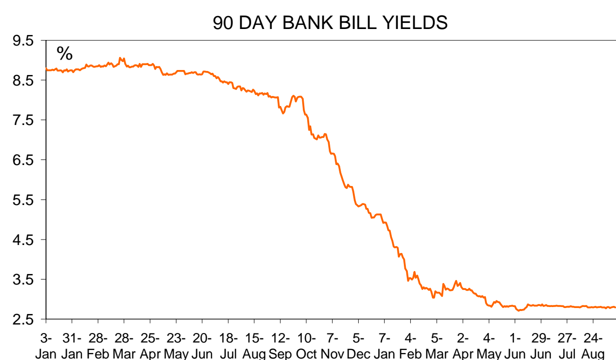
INTEREST RATES

The Reserve Bank remain of the view that they will be able to keep the official cash rate at the current record low of 2.5% until "…the latter part of 2010." Of course back in 2004 they were also of the view that taking the cash rate from 5% to 6.5% would be enough to contain inflation. They were mistaken and took it then to 7.25% over 2005-6 then 8.25% during 2007. So one needs to be careful – and the markets are near universally of the view that the RB will have to move earlier with the common pick being March 2010.

We think the first tightening will come in July with a risk that the tightening will happen before then. This risk arises because economic data continue to largely come out on the positive side – especially in the housing market yet again this week. But one cannot ignore the unfortunate restraint which the early cyclical rise in the NZ dollar will have on the export sector and therefore the overall economy, and of course not all of the data releases are strong. We learnt this week for example that retail spending weakened in July.

Over the past week wholesale interest rates have held steady with 90-day bank bill yields still at 2.8% and the five year swap rate at about 5.40%.





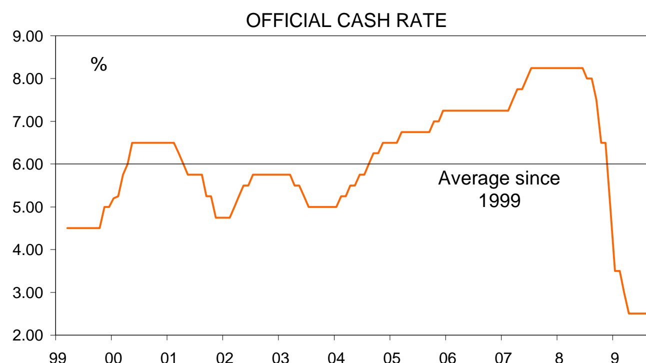
Key Forecasts

- No more monetary policy easing this cycle.
- Medium to long term housing rates have seen their multi-year lows – stop-start rises now lie ahead. Speed unclear.

FINANCIAL MARKETS DATA	This week	Week ago	4 wks ago	3 months ago	Yr ago	10 yr average
Official Cash Rate	2.50%	2.50	2.50	2.50	8.00	6.2
90-day bank bill	2.81%	2.78	2.83	2.84	7.70	6.5
10 year govt. bond	5.65%	5.58	5.88	5.92	5.76	6.2
1 year swap	3.17%	3.15	3.16	3.01	7.30	6.7
5 year swap	5.41%	5.40	5.45	5.27	6.84	7.0

If I Were a Borrower What Would I Do?

More and more people are thinking about where interest rates are going to be a couple of years from now, given that the RB forecast rate rises further out and the likes of ourselves and other forecasters are predicting the cash rate near 6% come late-2011. We think forecasting where the cash rate will be by then is not really all that hard. That is because we are only thinking in terms of removing the current excessively stimulatory level of the cash rate and returning it to a more neutral or normal level near 6%.



You may have noticed that we rarely speak about what happens after early 2012. That is because by then, for rate movements above 6%, we are thinking in terms of the degree of restraint on economic growth and inflation which the RB will need to be imposing. And this far out from that time as we exit the most uncertain economic conditions we have seen around the planet in decades, it is impossible to reasonably pick what monetary policy will need to be doing over 2012-14.

And that creates a big forecasting problem – not so much for the cash rate over 2012 etc, but for fixed rates over 2011. This is because fixed rates tend to reflect expectations of where floating rates will sit over the relevant period of time for the fixed rate. (Note though that cash availability at different terms also determines fixed rates.). But if we can't even seriously guess how much the cash rate will rise over 2012-14 then we cannot really generate a believable forecast for where fixed interest rates will be.

Therefore, if you are planning some canny interest rate risk management policy based on floating for a while perhaps, fixing to late 2011, then fixing again, please realise that you cannot reasonably pick what your refixing rate will be then. That lack of forecasting insight will dissipate over 2010 as we get closer to late-2011 and learn more about the true strength of economic recoveries here and overseas and the speed with which spare resources get used up.

And if one had to take a punt on where fixed rates will be come late-2011 what would one personally pick? Higher than they are now by at least 1% for terms of three years and beyond – but without any serious analysis able to back up that expectation.

And a final thought for those people enjoying the lovely low floating rates at the moment. Over the past ten years the floating mortgage rate in New Zealand has averaged 8.5% and over the past five years 9.3%. hence our warning that come late-2011 when the official cash rate is returned to somewhere near a normal 6%, floating rates will also go back to something close to a normal 8.5%. More than that?

Upside risk to floating rates further out comes from tighter credit conditions delivering higher average funding costs to banks therefore presumably higher average lending rates. But the Reserve Bank sets the official cash rate aiming for a certain degree of influence over bank lending rates. If the tightening of credit means bank borrowing costs are higher for any given level of the cash rate then they will not need to take it so high to get the restraint they need. Maybe that implies a 5.5% cash rate average going forward – though with floating mortgage rates still averaging 8.5%.

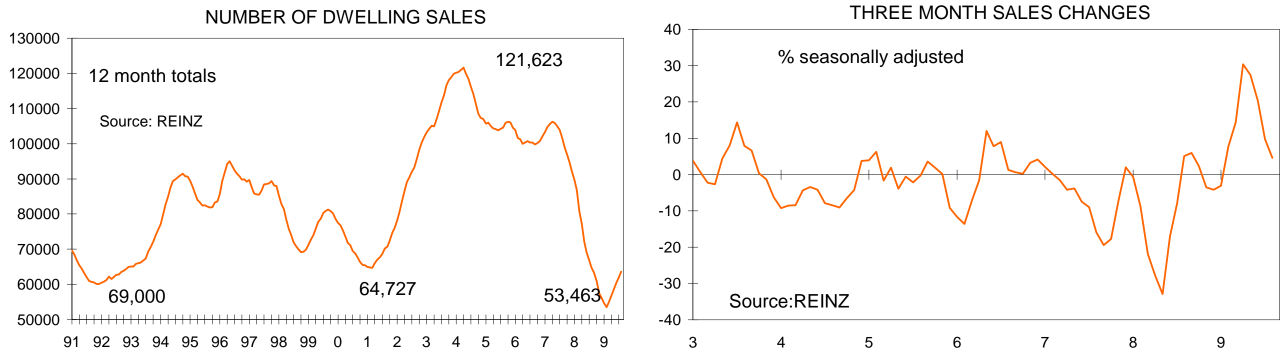
Downside risk to rates further out however comes from the shock to people's finances recently which may curb debt enthusiasm, the already high level of house prices compared with incomes, and the high level of debt compared with household incomes.

In other words we again repeat our warning that developing a canny interest rate risk management strategy based on forecasts of where interest rates will be a couple of years from now is a highly uncertain exercise. And that is why if I were borrowing at the moment I would still personally want to have a portion of my debt fixed. I would also use the period of low floating rates to keep monthly payments up and get my debt burden down.

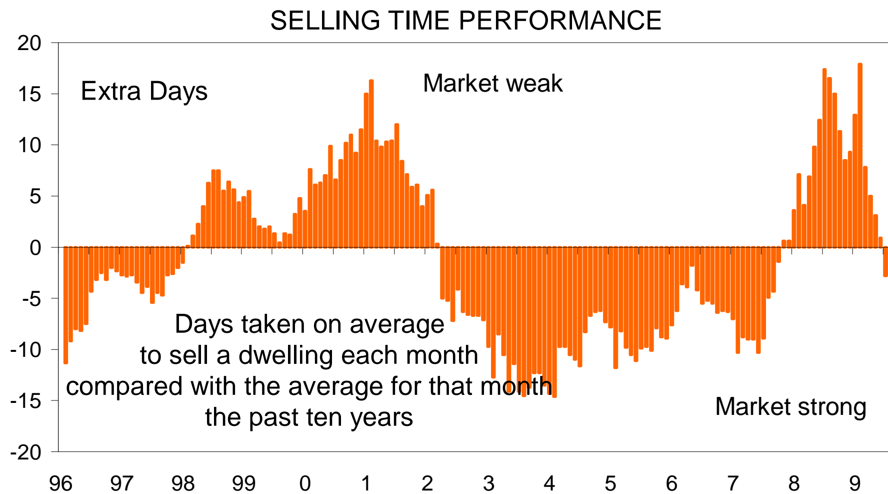
HOUSING MARKET UPDATE

Housing Market Rising As Expected

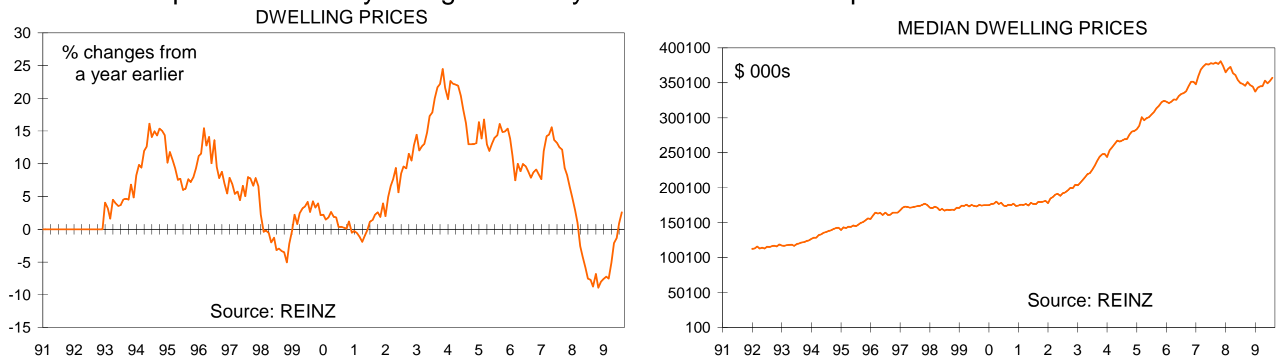
The highlight of the week as far as housing activity goes was the monthly REINZ report released on Monday. It showed that in rough seasonally adjusted terms sales of dwellings fell by about 5% in August but at 5,878 were ahead a still strong 39% from a year ago. One can easily put the small easing in sales activity down to the frequently reported shortages of listings – and because listings are in short supply it is no surprise that the average number of days taken to sell a dwelling fell even further in August.



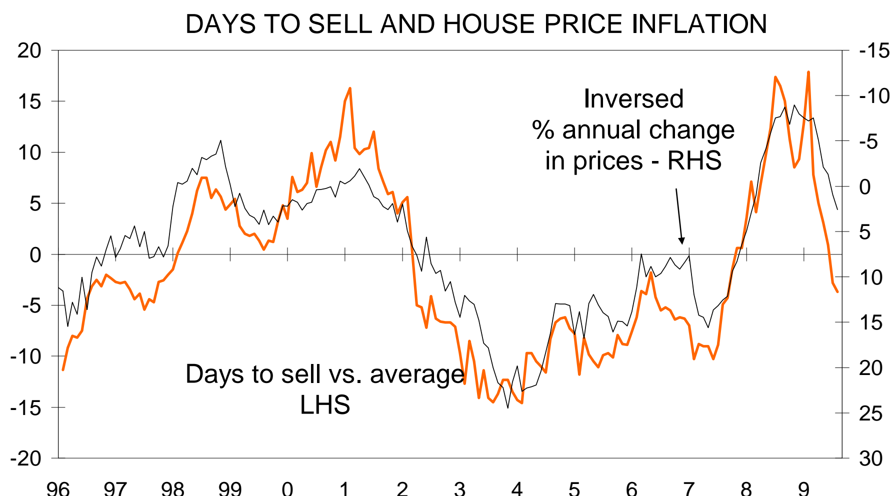
This measure now sits at 34 days from 37 in July and 55 a year earlier. This puts the speed of sales back practically at the 33 of August 2007 and the August result is 3.7 days faster than average for the month. In July the days to sell measure was 2.8 days below average while June was above average by 0.9 days.



And so, with sales constrained by a vendor shortage, it is no surprise that prices continue to go up. The stratified measure put together by the Reserve Bank shows that on average prices in August were up 1.2% after rising 1.0% in July. Prices have now on average recovered 5.9% from their low point back in January and sit 2.6% up from levels a year ago and only 6.2% down from the peak reached in November 2007.



So where are prices going from here? Simply look at the graph below and the answer is as obvious now as it has been for all but the most biased for some time.



An editorial in a newspaper this week noted that were the government to introduce a capital gains tax on residential investment property it might be able to eliminate the "...biggest structural flaw in the economy." Putting aside the issue that there is actually a far greater structural flaw – the sheer unwillingness of Kiwis to save – consider for a moment what the impact of a CGT might be.

The criticism of a CGT absence is that it encourages over-investment in housing hence fuelling inflation etc. etc. The inflation link comes about because we bid up the prices of each others' houses just as farmers bid up the prices of each others' land. As we feel wealthier we take on more debt and buy more consumer goods.

Now – two things to consider. First, if we invest less in houses because of a CGT, will this lead to the widely presumed movement of billions of dollars into productive business investments? Definitely not. Why? Because most of the money which gets "invested" in housing is borrowed from foreigners and not part of a big pool of funds we have here in New Zealand ready to go into some investment. If we don't buy each other's houses we will not shift our $350,000 instead into a business. Maybe a 10% deposit of $35,000 will become available but that's about it.

Second, consider what happens when there is speculative over-investment in something. Suppliers provide more of it and one ends up with excess supply at market prices once one takes away the speculative fervour. Think for instance in terms of angora bunnies. But there is no evidence that the tax attractiveness of housing has led to massive excess construction except in the apartment markets of Auckland and (temporarily) Queenstown. The supply of new houses is constrained by the regulatory environment.

And so we get to a point we have made here before and which ultimately rules out introduction of a CGT in New Zealand. We have a housing shortage which is getting worse because of the four decade low level of new house construction at a time of above average net migration inflows. Regulatory restraints have been enough to restrict a large construction response to rising house prices, but there are clearly housing developments which get marketed as provided tax free gains to investors. If a CGT was introduced these sometimes large scale developments would presumably not occur or be far smaller in magnitude.

The result therefore would be a further restriction in housing availability. This would tend to place upward pressure on house prices over the long term and suggest that if introduction of a CGT was followed by a period of price decreases that period would provide a good environment to increase one's property exposure.

Oh, and here are two other points to consider. First, the presence of CGT in other countries has not stopped their housing markets experiencing periods of speculative price gains. One would expect therefore a CGT here to fail to prevent such periods of strong price rises also.

Second, in a way over the next few years we are going to see the equivalent of a CGT-induced restriction of new housing construction anyway. This will arise because of the low availability of funds from finance companies to allow a lot of the sort of subdivision development which occurred in the past.

In other words – one may as well introduce a CGT now and bank the short term suppression of the house price cycle in order to help extend the current period of low short term interest rates and perhaps have a small downward currency impact as well. And what are the chances of CGT in the near future? Zero.

Are You Seeing Something We Are Not?

If so, email us at tony.alexander@bnz.co.nz with Housing Comment in the Subject line and let us know.

Key Forecasts

- Dwelling consent numbers to recover now with potentially good activity from late-2010..
- Real estate sales continuing to increase but the rise limited by listings shortages.
- House prices edging higher.

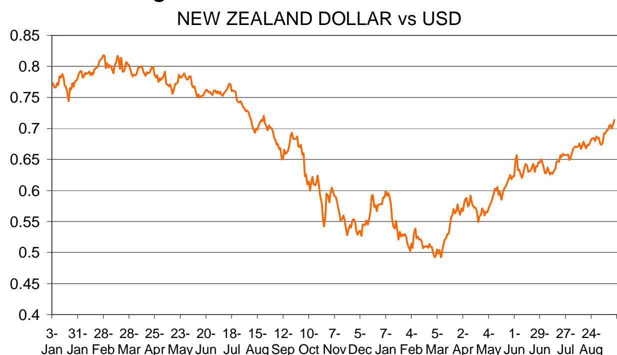
Exchange Rates & Foreign Economies

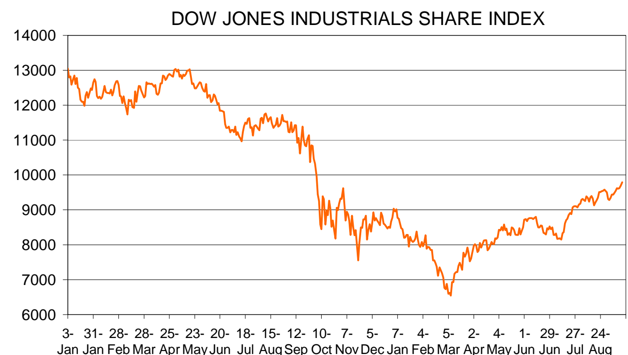
EXCHANGE RATES

	This week	Week ago	4 wks ago	3 months ago	Yr ago	Consensus* Frcst Yr Ago	10 yr average
NZD/USD	0.696	0.674	0.671	0.627	0.668	0.651	.592
NZD/AUD	0.809	0.808	0.804	0.782	0.832	0.796	.856
NZD/JPY	64.3	62.2	65.5	61.1	71.4	70.9	66.8
NZD/GBP	0.422	0.414	0.402	0.384	0.38	0.373	.345
NZD/EUR	0.479	0.472	0.474	0.445	0.473	0.47	.51
USD/JPY	92.1	92.3	97.6	97.5	106.9	108.9	113.9
USD/GBP	1.654	1.628	1.669	1.63	1.76	1.74	1.709
USD/EUR	1.457	1.428	1.417	1.41	1.41	1.387	1.156
AUD/USD	0.863	0.834	0.834	0.80	0.80	0.818	0.69

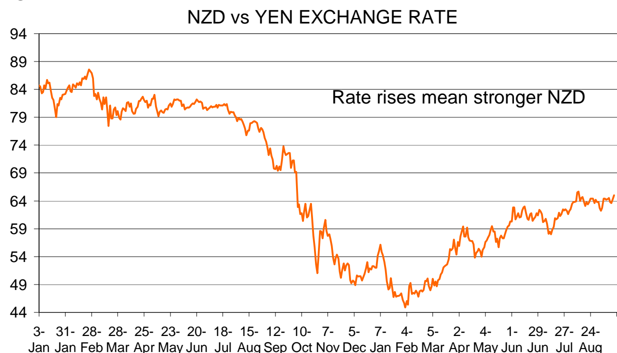
Same Story – NZD Rises

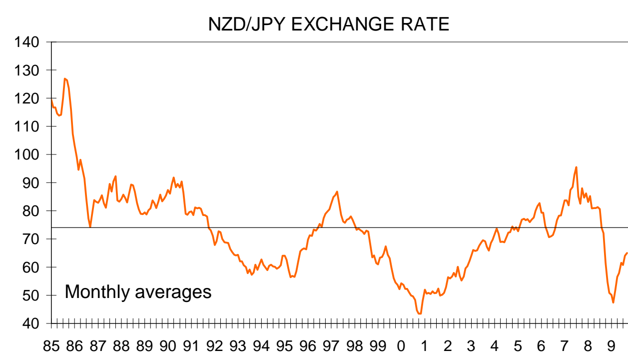
The Kiwi dollar has soared higher this week with trading late this afternoon near US 71.5 cents from 69.6 cents last week. Repeating what we have been writing here for a number of months now – the only way in which the NZD is going to head strongly back down again is if something akin to a depression scenario gets put back on the table and that has looked very unlikely since early-March's green shoots. The rise in the NZD is being caused by investors moving into growth and risky assets and the NZD's rise is well correlated with rises in global sharemarkets.





The NZD's appreciation is of course also due to some weakness in the greenback and quite recently a rise in the carry trade involving borrowing in USDs at low interest rates and investing in higher yielding currencies. The frightening thing about this is that this trade traditionally involves the Japanese Yen and when that activity gets cranking again one can see easy NZD upside considering how low we still are against the Japanese Yen.

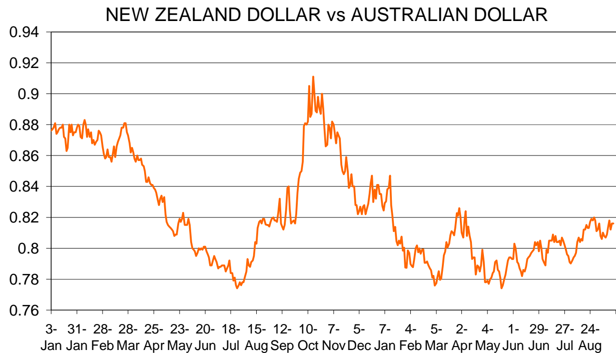


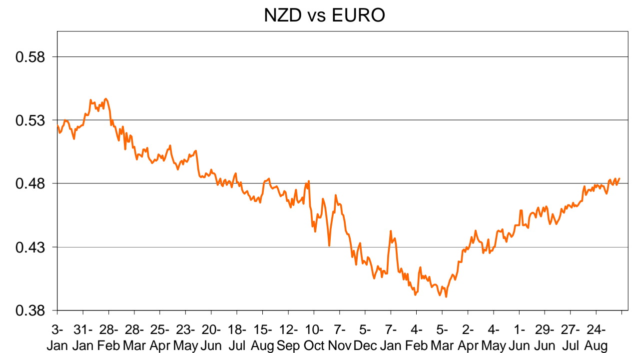


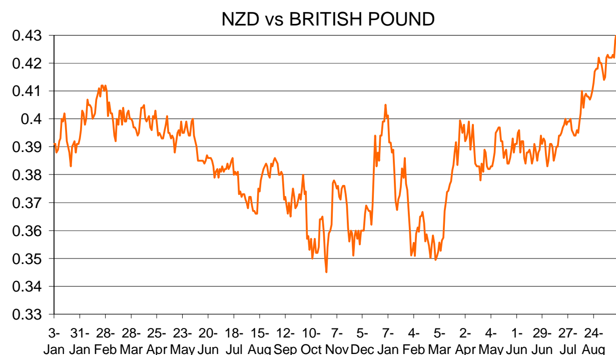
The chances are the NZD is going to keep rising over coming months – though note that the more carry trades which get put on against the greenback the greater the potential for a decent decline in the NZD from higher levels when expectations grow of monetary policy tightening in the US. Given that our tightening cycle

is likely to start before theirs such a pullback may not occur before the second half of next year – which means the NZD could reach US 80 cents mid-2010. That is a frightening prospect for exporters and a key reason for caution about the strength of the current economic upturn.

On the crosses the NZD has also firmed slightly over the week as detailed in the table above.



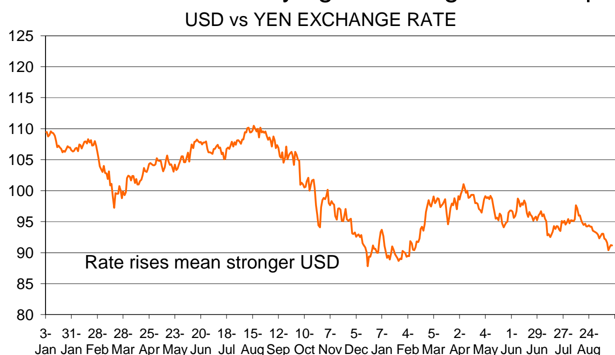


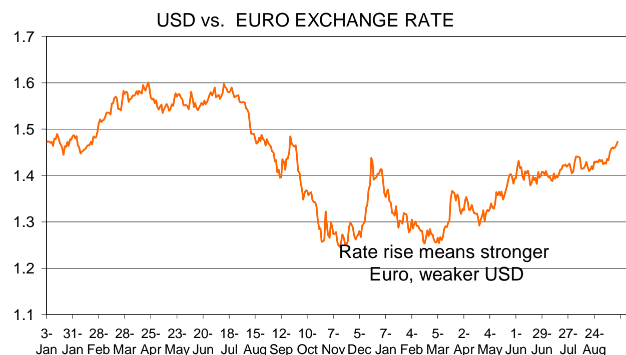


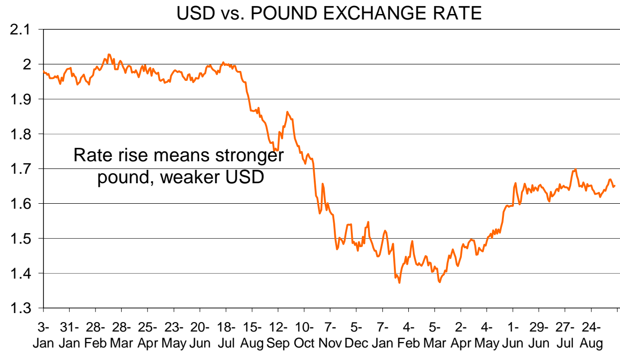
Helping the NZD up this week was some slight weakness in the USD against the Yen, but little change against the Euro and Pound. Data out of the US has largely fallen on the better than expected side – hence the increasing demand for risky assets like shares and the NZD.

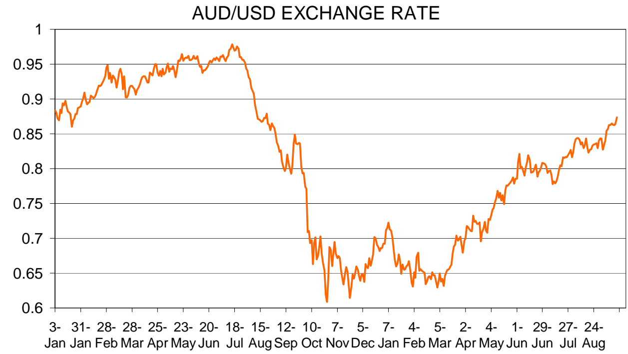
US retail sales firmed by a far greater than expected 2.7% in August further providing evidence that the US economy has come out of recession. The Federal Reserve Chairman in fact again noted this week that the US economy is probably now out of recession, but understandably warned that it will "…still feel like a very weak economy for some." We also learnt last night that industrial production in 0.8% in August after gaining 1.0% in July – thus indicating some solidity to the manufacturing sector upturn.

With global sentiment still slowly improving – with occasional wobbles along the way – sharemarkets are generally firming and the increasing risk appetite means ongoing support for risky assets like the ever-volatile NZ dollar. Even Warren Buffet has now bought into the positive sentiment by noting at a conference this week that he is "buying stocks right as we speak".









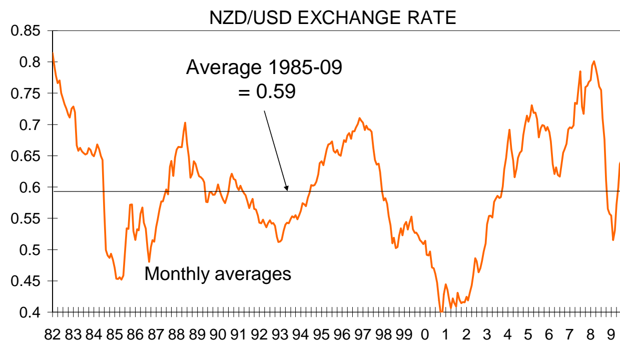
Like the NZD the AUD has also risen over the week to sit this afternoon near US 87.4 cents from 86.3 cents last week. For the Aussie dollar upward pressure continues from generally (though not universally) good economic data plus heightening expectations that the RBA will start raising its 3% cash rate easily before the end of the year. In fact this week the minutes of the last RBA Board meeting earlier this month revealed rate increase is under active consideration.

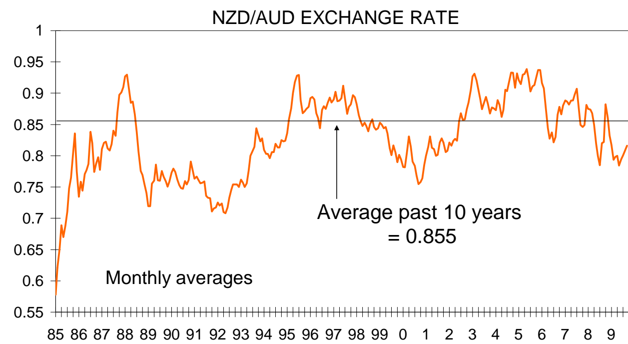
“At the (August) meeting, members had agreed that if the economy continued to evolve as in the latest forecasts, the Bank would in due course need to adopt a less expansionary policy stance. The information at this meeting suggested that economic conditions were indeed evolving broadly in that way. Nonetheless, some uncertainty remained about the outlook both abroad and at home.”

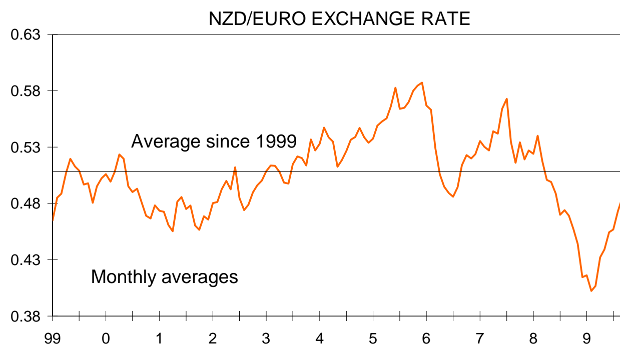
The expectation of our NAB economists in Australia is that the RBA will undertake its first rate rise in November.

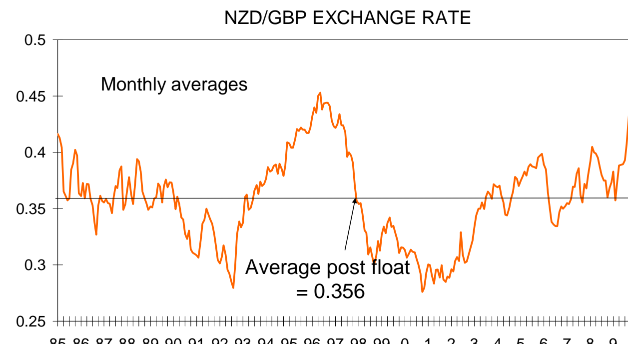
If I Were An FX Receiver What Would I Do?

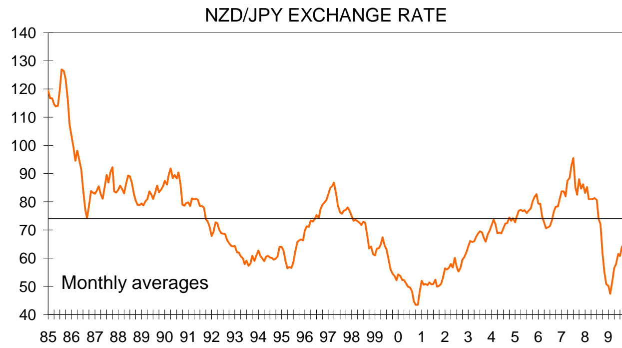
Still hedge – same old message we have been giving for months.

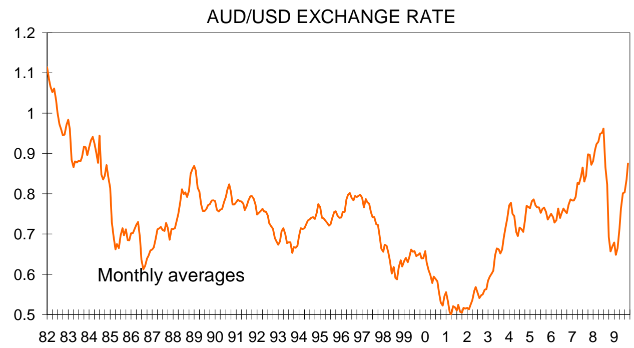












*Sourced from Consensus Economics. http://www.consensuseconomics.com/

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ECONOMIC DATA

All %		Latest qtr only	Previous qtr only	Latest year	Year ago	2 Yrs ago
Inflation	RBNZ target is 1% - 3% on average	0.6%	0.3	1.9	4.0	2.0
GDP growth	Average past 10 years = 3.0%	-1.0	-1.0	-1.0	3.1	1.8
Unemployment rate	Average past 10 years = 5.3%	6.0	5.0	......	4.0	3.7
Jobs growth	Average past 10 years = 1.9%	-0.5	-1.4	-0.9	0.8	1.5
Current a/c deficit	Average past 10 years = 5.5% of GDP	8.5	9.0	......	8.0	8.5
Terms of Trade		-3.0	-1.0	-5.2	11.6	4.5
Wages Growth	Stats NZ analytical series	0.6	0.8	4.6	5.6	4.6
Retail Sales ex-auto	Average past 9 years = 3.8%.	-1.2	-0.0	-0.8	3.2	4.9
House Prices	Rise > inflation since 1992 = 5% p.a. QVNZ	-2.0	-2.1	-8.9	8.0	9.7
Net migration gain	Av. gain past 10 years = 10,400	+12,515	7,482yr	......	4,735	10,080
Tourism – an. av grth	10 year average growth = 5.0%. Stats NZ	-2.8	-3.9	-2.8	0.9	3.4
		Latest year rate	Prev mth year rate	6 mths ago	Year ago	2 yrs ago
Consumer conf.	10 year average = 2%. Colmar survey	38	3	-9	6	-8
Business activity exps	10 year average = 26%. NBNZ	26.0	12.6	-20.1	4.7	16.7
Household debt	10 year average growth = 11.3%. RBNZ	2.4	2.6	4.2	8.5	13.7
Dwelling sales	10 year average growth = 3.5%. REINZ	34.0	40.3	-28.5	-32.6	-14.3
Floating Mort. Rate	(Total Money) 10 year average = 7.6%*	5.85	5.99	6.99	10.49	9.99
3 yr fixed hsg rate	10 year average = 7.9%	7.45	6.99	5.99	9.09	9.10

ECONOMIC FORECASTS

Forecasts at Aug. 20 2009	**March Years**					**December Years**				
	2008	2009	2010	2011	2012	2007	2008	2009	2010	2011
GDP - annual average % change										
Private Consumption	3.3	-0.7	-0.5	1.8	2	4.1	0	-1.3	1.7	2
Government Consumption	4.3	3.4	3	2.8	1.9	3.9	3.9	2.9	2.9	2.2
Investment	4.3	-8.9	-16.2	5.9	8.9	5	-5.1	-17.7	1.1	9.6
GNE	4.2	-2	-4	3.4	3.4	4.5	0	-5.4	2.6	3.6
Exports	2.9	-3.4	-3.5	0.9	4.9	3.8	-1.6	-4.2	-0.7	4.6
Imports	9.6	-4.4	-14	2.3	5.9	8.6	2	-17.1	0.4	5.6
GDP	3.1	-1	-1.2	3	3.1	3.2	0.2	-2.1	2.3	3.3
Inflation – Consumers Price Index	3.4	3	2.5	0.7	1.8	3.2	3.4	2.5	0.8	1.5
Employment	-0.3	0.8	-1.6	2.6	3.2	2.3	1	-2.9	1.7	3.4
Unemployment Rate %	3.8	5	7.3	7.2	6.1	3.5	4.7	6.9	7.3	6.3
Wages	4.4	5.1	2.4	1.5	3.8	4	5.1	3.1	1.3	3.3
EXCHANGE RATE ASSUMPTIONS										
NZD/USD	0.8	0.53	0.7	0.72	0.68	0.77	0.56	0.69	0.71	0.69
USD/JPY	101	98	102	108	110	112	91	100	108	110
EUR/USD	1.55	1.31	1.44	1.41	1.31	1.46	1.34	1.43	1.42	1.35
NZD/AUD	0.87	0.8	0.8	0.82	0.83	0.88	0.83	0.8	0.8	0.82
NZD/GBP	0.4	0.37	0.39	0.41	0.4	0.38	0.37	0.39	0.4	0.4
NZD/EUR	0.52	0.41	0.48	0.51	0.52	0.53	0.41	0.48	0.5	0.51
NZD/YEN	81.1	51.8	70.9	77.8	75.3	86.3	50.9	69	76.7	76.4
TWI	71.6	53.8	64.7	68.2	67.1	71.6	55.1	64.3	67	67.3
Official Cash Rate	8.25	3	2.5	4.25	6.25	8.25	5	2.5	3.75	5.75
90 Day Bank Bill Rate	8.91	3.24	2.7	4.62	6.62	8.9	5.23	2.75	4.12	6.12
10 year Govt. Bond	6.36	4.77	5.75	6.4	7	6.4	4.88	5.7	6	6.8

All actual data excluding interest & exchange rates sourced from Statistics NZ.

The BNZ Weekly Overview is prepared by Tony Alexander, Chief Economist at the Bank of New Zealand. Ph 04 474-6744.

*extrapolated back in time as Total Money started in 2007