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.

A Summary Overview

Here is a quick update on the recent performance of the NZ economy. Growth during the September quarter was a strong 1.1% which meant the official growth rate as commonly quoted was 3% which was unchanged from a year before – but there seems to be an underlying acceleration. Per capita GDP has risen 1.0% in the past year to lie 7.4% ahead of the level five years ago.

Jobs growth was 0.8% in the December quarter from 1.3% in the September quarter or about 4.5% at an annual pace. That is very healthy, as seen in the participation rate sitting at a record 70.5%, and the employment rate also at a record 66.9% from 66.1% just before the GFC.

Retail spending core volumes grew by 0.6% during the December quarter and 4.8% over the full year. Consumers have been out spending up large including on durable goods where spending was 30% higher than three years ago.

Dwelling consent numbers have risen 10% in the year to a near 12 year high of about 30,000. But numbers fell 8.5% during the December quarter with slowing growth evident in many locations, especially Auckland. Non-residential consent values growth has also slowed but the $6bn worth of consents issued over 2016 was well ahead of $4.2bn three years earlier.

Inflation remains low at 1.3% with a 0.4% rise in consumer prices during the December quarter. The current account deficit is just 2.9% of GDP and the government looks like running its third annual fiscal surplus in a row this year.

Looking ahead we have one reading of consumer sentiment at 127 whereas 117 is average – suggesting continued good growth in consumer spending. Business activity expectations are near 37% net positive versus an average 29%, with employment and investment intentions both near a net 23% positive versus averages near 12%.

Migration is continuing at extraordinarily high levels, construction is strong with a near doubling of government infrastructure spending planned over the next five years, dairy prices are 60% up from a year ago, tourism is booming, tax cuts look like being scheduled in the May 25 Budget, and trading partner growth rates are holding up.

Inflation looks like rising further but cash rate rises probably won't start until near the middle of next year and proceed at a gradual, exploratory pace which may take the OCR to 3.5% come the end of 2019 from 1.75% currently.

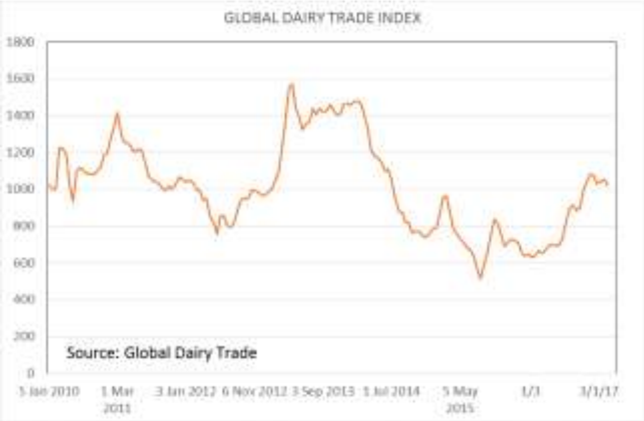
The labour market is currently very tight and looks likely to remain so and employers should anticipate some acceleration in both wages growth and staff churn. Managing margins will remain extremely difficult as consumers push back against price increases with access to plenty of online shopping alternatives and near zero search costs for those other purchasing options.

Macroeconomic Impact of the Dairy Downturn?

International dairy prices started falling early in 2014 and bottomed out late in 2015 with prices declining near two-thirds. Fonterra's payout fell from $8.50 down to $4.30. Did the NZ economy collapse? The opposite in fact happened.

- Jobs growth accelerated from an annual average gain of 1.5% during 2013 to about 4% in 2016.
- The current account deficit declined from 3.3% of GDP to 2.9%.
- GDP growth accelerated from 2.2% to 3%.
- The value of consents issued for non-residential construction rose from $4.1bn to $6bn.
- The number of housing consents issued lifted from 21,300 to 29,790.

- The trade weighted index fell from an average 76.6 over 2013 to 74 over 2015 and 75 last year.
- Net annual migration flows rose from 22,468 to 70,588.



Employment in dairying amounts to 40,000 people or about 1.6% of all NZ jobs. You might on the face of it think that the sector doesn't really matter. However, dairying accounts for over 20% of all NZ export receipts and without it all those cheap holidays we love taking each year would be a lot more expensive with a much lower Kiwi dollar we would suffer if dairying was suddenly wiped out But other export industries would thrive.

Plus dairying offers a brilliant career structure which most Kiwis would have little idea of. Have a go – there is a dairy farmer right now somewhere looking for staff, probably offering accommodation. And one suspects that whatever difficulties they and other employers are experiencing sourcing staff at the moment, those difficulties will get worse after the election with a tightening of entry criteria a very likely outcome of a coalition agreement.

The Blame Game

When something happens which people cannot understand they invariably blame someone or a group of people for the situation – illegal migrants in the United States undermining wages and decreasing blue collar job opportunities, Muslims in the UK destroying community fabrics, Chinese buying houses, Baby Boomers being greedy, witches casting spells, God being angry at the LGBTIQ community.

Most of the time the arguments are plain ridiculous, but they serve to reduce the stress of some people because failing to know why a thing is happening is stressful and our brains are hard-wired to try and get stress levels down one way or the other – even if that means in extremis diving into alcohol, drugs, gambling or pornography.

I've yet to hear anyone blaming lust for the high levels of house prices in New Zealand. But the way some people have switched from blaming the Chinese to dumping on Baby Boomers as the cause says we may not be far off.

Sometimes house prices in a location will soar because of something very specific like an energy boom – think of Western Australia and North Dakota. Then they collapse when the boom ends – see Western Australia. But this is not the case for New Zealand. Instead we have some very long terms trends underway. And the thing about long-term trends is that they can happen so slowly people fail to recognise that they are happening.

Specifically what do we mean?

1. Not A Big Farm

First, a few decades back New Zealand was essentially just a big farm with lots of medium-sized towns highly dependent upon servicing the rural sector. There wasn't a huge perceived difference between pursuing one's career or business interests in Auckland versus New Plymouth or Ashburton. People tended to be quite happy being almost anywhere around New Zealand with location of choice influenced by family and cultural ties and historical business interests – even father/son footstep following.

Land was readily available in all parts of the country (still largely is outside Auckland and Central Otago Lakes), red tape to develop and build was minimal, and the hardest part was getting a mortgage rather than finding a home.

This wide distribution of people throughout the country was assisted by the manufacturing sector spreading regionally over the decades beyond the 1930s and the nature of that manufacturing. Basically it involved components being made locally or brought in at a leisurely pace, things assembled, and plenty of time spent all around shifting stuff from one stockpile to another. The concept of just-in-time production barely existed. Transport links did not need to be mega-efficient, and location next to such links mainly meant being near a railway siding.

But our world has changed. Farming is the main contributor to our exports, but only accounts now for some 6% of our economy. Note the figures for our dairy sector which has boomed over the past decade or so through conversions of land from alternative uses. But only 1.6% of our workforce works on farms and processing milk.

Farming is not a large generator of new jobs. Manufacturing is a shrinking sector here and in practically all Western countries. Since the late-1970s manufacturing has shifted to a global supply chain basis with final products constructed from numerous inputs sourced from and processed in a variety of countries with ever changing cost dynamics. The transport infrastructure and transport costs and timeliness have become of huge importance. Just-in-time manufacturing reigns supreme and the ability to quickly retool in response to consumer and competitor changes is of high paramountcy.

Manufacturing has become a very very fast changing sector which is now becoming robotised. Closure of no longer efficient manufacturing businesses has decimated employment throughout the NZ regions for three decades now and as seen by the announcement of the planned closure of the Cadbury factory in Dunedin is still happening and affecting our regions.

And as any town which has experienced the closure of a manufacturer these past few decades knows, unless you have an employer of equal size ready to start up as soon as the old one closes, you lose people and capital to where staff perceive job opportunities to lie – the cities.

The global process of reduced relative size of farming sectors and shift of manufacturing to an ever changing global production base has hit global regional employment and boosted the cities – thus creating over at least a three decade period extra housing pressure in our cities.

For your guide, don't read this as saying people should abandon the regions. In my talks I recommend anyone tired of their current job to move to the regions and set up a business servicing the growing number of tourists who are getting off the main routes and seeking experiences more real – hugging a sheep, feeding pretty ducks, kayaking in clean water.

2. The Technological Revolution

Second, we have entered the technological revolution. People undertake their work on computers, are ideas focussed, work collaboratively in ever-changing teams, and few people nowadays have relatively well defined career structures. Flexibility in one's skills application, openness to continual learning have become of great importance to employers. Businesses compete to develop new goods and services, new marketing methods, and speed of change and recognition of the need to change rank very highly.

A generation has grown up being told that they will have seven careers (or something as equally glib). They assign low probability to only being in one role and even one firm for a short time. Therefore proximity to other employment opportunities is very important – and the best locations for maximising chances of acquiring a new position exist in the cities. It is costly and disruptive for one's family to shift from one town to another following jobs.

The world is increasingly urbanising, existing cities are getting bigger, and if anything this process will accelerate rather than slow simply because broadband technology theoretically permits telecommuting. Few people seem to willingly choose that option. Tried it – went gaga.

3. Relative Return On and Cost of Property

Third, a substantial jump has occurred in the return which investment property can deliver – relative to simple alternatives like term deposits and bonds. Interest rates now average much less than during the 1980s, 1990s, and 2000s. The cost of borrowing to purchase a property has plummeted and because of this structural jump in demand for property prices have lifted. Those Baby Boomers people are dumping on paid mortgage rates in the late-1980s around 20%. This link will take you to the Auckland Council Chief Economists quarterly report which on page 3 has a good graph showing the impact of lower interest rates on housing affordability (between 2002 and 2016).
http://www.aucklandcouncil.govt.nz/EN/AboutCouncil/businessandeconomy/Documents/akleconomicquarterlyfeb2017.pdf

4. Retiree Loss Aversion

Fourth, a generation of people (Baby Boomers) is entering retirement having been bombarded by official campaigns for near three decades warning them of destitution in retirement and disappearing pensions if they did not save to provide for themselves. So they have built up savings with a jaundiced eye toward shares because of what they saw and experienced during the 1987 sharemarket crash, an aversion toward finance companies because of the money they lost to them a decade ago, and awareness of how house prices have increased since the 1970s.

They have been presented with data showing how shares have fared quite well for a long time now. But as we age we lose ability to recover from financial/wealth shocks and avoidance of wealth diminution in retirement becomes a matter of moment which personally in my discussions with young investment advisors I find they have little ability to understand.

Loss avoidance preference grows as you age and because houses are not repriced every day, because they have risen so much in price over time, and because the costs of property ownership seem always to get brushed over, many Baby Boomers naturally have a preference for property.

5. Rent Demand Forecast To Be Strong

Fifth, the property preference is enhanced because all investors hear in the media is that a whole generation of young people expect to rent for decades – guaranteeing occupancy and rental income. And meth contamination? That will always be assumed to happen to someone else. Further enhancement comes from the flows the Baby Boomers see into neighbourhoods they have observed for decades of unfamiliar faces. Migrants, more people seeking accommodation, strong population growth. Which gives us...

6. Population Growth

Sixth, accelerated NZ population growth. Because we are no longer just a big farm, because we have a stable democracy, and because working from New Zealand is no longer a barrier to keeping up to date with rapid technology developments, you and I are staying here. One million Kiwis offshore are increasingly returning. Foreigners want to be here.

As noted many times now, there has been a trend change in NZ net migration flows. We suffered a net loss averaging 17,000 per annum in the decade up to 1986. That switched to a net gain of 3,000 through to 1996, then 11,000 through to 2006, and now 22,000 through to 2016. There is no longer a brain drain. There is no longer talk of the last one out turning off the light.

Migrants go where migrants have gone and where they see job opportunities exist – the cities. You and I are staying in the cities. Kiwis returning here are invariably coming from large metropolises and they are a tad apprehensive about the pace of life (and their acquired spouse in particular is) so they hedge bets by going to the cities. And they keep an eye on the jobs markets in Sydney, Melbourne and Brisbane.

7. Double Income Households

Seventh, the proportion of households with both partners working has risen strongly since the 1970s as women have entered the workforce. House prices have altered to reflect the increased purchasing power of two income households over the old single income bloke-only working model.

To say that high house prices are caused by Chinese buying is wrong. To say that Baby Boomers are greedy and they are the cause is wrong. To blame it all on women working would also be wrong.

And we haven't even discussed long-term trend changes in construction costs, materials standards and costs, consenting costs and lags, builder shortages and the new factor many people have still not cottoned on to. We have gone back to 1984, the period before the banking system was opened up and credit (mortgages) flowed like the gutters in a milking shed. The growing problem for people seeking to borrow funds has shifted from the cost of credit to getting it in the first place.

This lack of credit so far caused by the loan to valuation rules (LVRs) has had the effect of stymying demand and the 40% investor deposit requirement in particular seems to have hit the sweet spot which the Reserve Bank was seeking – well done.

But the lack of credit is also slowing down new property development and many projects are being shelved. What will be interesting is the extent of market reaction to this unsatisfied demand. We can expect Chinese banks already operating in New Zealand to soon expand their operations. Their focus will be property development rather than property purchasing by individuals. We can also expect foreign hedge funds to soon seek to fund developments. But unless the gates are opened to an influx of migrant builders (little chance of that happening) then what will happen is that building costs will get pushed even higher while building standards decline – as happens every building cycle.

If you are a young person seeking first home ownership what do you do? Take courses in basic building and home maintenance skills, find a dunger or even a meth house to strip, and do it up. Basically be prepared to do what the Boomers did in many instances – after all, the way credit availability has tightened up here and is tightening up across the Tasman (e.g. http://www.afr.com/personal-finance/cba-and-other-lenders-cut-discounts-raise-fees-and-rates-20170226-gultrd)
you'll soon be experiencing the same rationing of credit as they did back in the day. Start out in a desolate new suburb of clay soil far from work, do up a piece of shite, or build and live in what will become your garage whilst building the rest of the house around you in the following few years.

And how to finance it? Go to cafes and spend as much on lattes, muffins, frappes, wraps, etc. as often as the Baby Boomers did. Get takeaway as often as they did (Thursday night, payday, on the way home from the weekly supermarket run in the single family car) and consume as much food beyond daily calorific requirements as they did.

Mend clothes instead of buying replacements like they did. Take as many overseas holidays as they did. Upgrade your electronics as often as the Boomers did. Change your car as often as them. Subscribe to the same number of TV channels as they received. Change your telephone as often as they did. Drink the same limited range of domestically produced non-boutique beer and wine as they did, at home, at the local motor lodge or working men's club. Hmm, Claytons, Cold Duck. Pretend you pay the same tax rates as they did and put the difference from your actual rate into a savings account (About 65% top marginal rate for almost all of the 1960s – 1987.)
http://www.treasury.govt.nz/publications/research-policy/wp/2012/12-04

Aim for a house with as many toilets as they had (one). Hire as many gardeners, landscape designers, decoration consultants, plumbers, feng shui consultants, window washers, dog walkers dog washers, cat whisperers and general handymen as they did.

And hope to hell that when you come to retire you don't sit looking at your bank statement shaking your head because when you had a mortgage the bank charged you 20% but now that you have term deposits you're only getting 3.5%, all whilst listening to people saying you and your profligate ways are the problem. Oh, and whilst being pressured to give money to the generation below you don't forget to look after your elderly technology-averse parents as the current sandwich generation is doing.

But don't spend as much as the Baby Boomers did on fags and for goodness sake don't use the language they did or the versions of nursery rhymes they learnt in the school yard. Oy vey! And free education? Check out the tax rates mentioned above.

And one final thing noted already above but probably not made explicit enough as you will have skim read right past it. Sometimes when the ground shifts under your feet it can take a very long time to realise it. The big ground shift underway now and set to hit you in the next two years more than it already has is credit availability. Getting a mortgage. As a young buyer you think LVRs are the constraint on your borrowing ability, but that you have special exceptions. Not so fast.

The banking world in NZ changed radically over 1984/85, then again after the sharemarket crash late in 1987 (ask a Boomer what that was, they'll never forget it.) It is changing again courtesy of the Global Financial Crisis, the lesson of which to central banks was don't follow the Alan Greenspan philosophy of letting bubbles grow to splendid maturity then burst by themselves, but stop the bubbles before they grow.
"He said kill it before it grow
He said kill them before they grow
And so ..."

New Zealand's banking sector vulnerability, our Achilles Heel, is reliance upon the savings of people overseas. Ahead of the GFC we funded between 40% and 45% of every loan in NZ from offshore. That fell to just under 30% come 2014. But since then progress at reducing this vulnerability to the sentiment of folk elsewhere has stalled.

And recently the dependency has started growing again. This is not what our central bank wants. We banks have to fund more of our domestic lending from domestic borrowing. But that is hard when Kiwis traditionally do not save and those who do are averse to leaving their money in the bank earning just 3.5%.

So, what does a bank do when it has to fund locally but cannot? It cuts back on lending. That is where we are going with the impact so far almost exclusively being felt by property developers – mainly the newer ones without track records. Next will likely be large corporates who traditionally fund from a number of banks and can issue bonds in their own name. What does this mean for young people wanting to get a mortgage offering far less security than people who already own property? Ask the Baby Boomers. They are the ones who lived through an environment of credit rationing. They had to save for a number of years with one organisation before being considered eligible to go into the pool for consideration for a home loan.

That may be an exaggeration because young home buyers are likely to be specifically given priority. But the message we aim to deliver is this. Question your assumption that when you are ready for a mortgage you will be able to get one as quickly as everyone has been used to over the past quarter of a century. And question your ability to finance expansion of your business at the pace you would like. The ground is shifting.

If I Were A Borrower What Would I Do?

Nothing new to offer here. I would look to lock in much of my mortgage for three years.

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. To receive the Weekly Overview each Thursday night please sign up at www.tonyalexander.co.nz
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