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.

Lots Happening

This week I take a look at the generally deteriorating situation in foreign economies which implies a continued firm NZD, migration flows here supporting the housing market, and low interest rates for a long time which will encourage investors to seek non-fixed interest assets like property. Falling oil prices are a positive for NZ but with consumers price conscious and debt wary retailers should not anticipate any surge in discretionary spending. Still falling dairy prices and an expected further cut in Fonterra's payout to be announced next week will depress dairying regions to some degree, but long-term focussed developments based upon expected growth in demand from China will likely continue, and the absence of a retail spending splurge by dairy farmers in response to last season's record payout means a massive cutback in retail spending this season is not highly probable.

News offshore reinforces the pattern we have been noting for quite a long time now. In Europe the slide toward what looks like another recession continues with the much-watched monthly PMI index for November revised down to 50.1 from the initial estimate of 50.4. A reading of 50 means no manufacturing growth and below means shrinkage. China's most recent reading was also just as weak with the official measure falling to 50.3 from 50.8 in October and the more SME-focussed unofficial measure at 50.0 from 50.4. In the US in contrast the November result was higher than expected at 58.7, but in Japan the slide continues toward nobody really knows what. Moodys have just cut their credit rating for the country by one notch and now Japan is rated as a higher credit risk than South Korea and China.

Across the ditch in Australia the government has admitted that the budget outlook has become worse courtesy of inability to pass some spending cuts through Parliament but mainly the 50% plunge in iron ore prices which has slashed expected company tax receipts. Further massive discussion of spending cuts will occur in Australia over the coming year or so at the same time as debate deepens about Australia's lack of reforms during the 23 years of no recession. The sense of things not going in the right direction will likely keep the vastly reduced net migration loss from NZ to Australia at a low level through 2015-18. For your guide the net loss has averaged 20,000 the past two decades, was 39,330 two years ago and is now just 5,311.

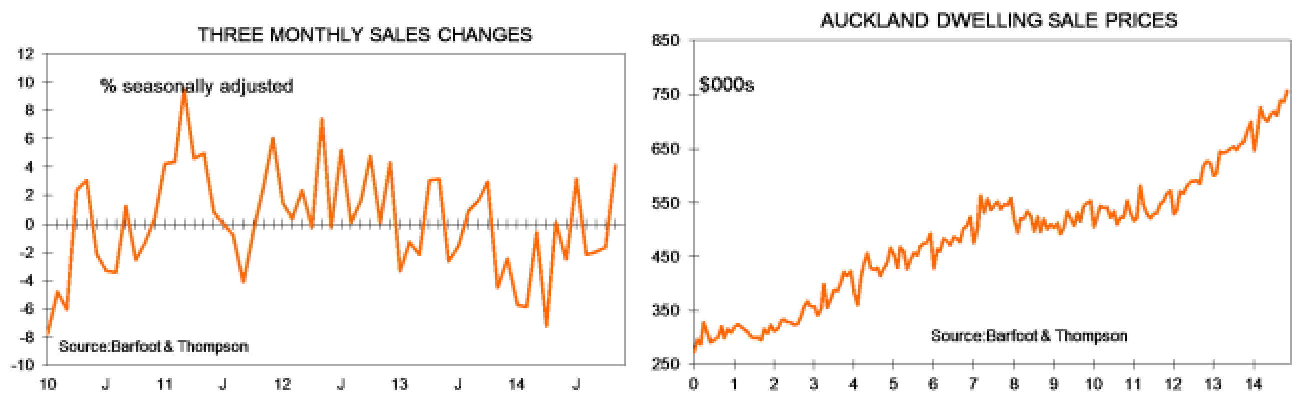
Weakness in gold and iron ore prices has placed extra downward pressure on the Aussie dollar and that means that with our economy in much better shape the NZD/AUD cross rate has risen further during the week, seemingly on its way back to the near 94.5 cent high of March this year. One therefore expects soon people will be once again pondering whether we will reach parity. It is possible but unlikely and would require some decent strength to start appearing in international dairy prices along with an easing of monetary policy in Australia – something which one cannot rule out for the first half of next year. Watch also for some long-term buy NZD against AUD recommendations starting to appear on the basis of divergent long term tracks for Aussie's iron ore and coal export prices versus our tied-into-household income growth food export prices. Accompanying such discussion will likely be some increased noting of Chinese investment in expanding our dairy sector, Fonterra investment in developing China's dairy sector, versus declining investment in development of Australia's minerals sector with more project cancellations.

The Russian rouble meanwhile is in near freefall as the Russian economy gets hit hard by the strong combination of Western sanctions because of President Putin's outrageous annexation of Crimea and invasion of eastern Ukraine, collapsing oil prices, and simple long-term chooks coming home to roost in a country strong on corruption. Like Brazil which is also suffering currently, though they did manage a stronger than expected growth report for the September quarter.

For ourselves, falling petrol prices, assisted by OPEC trying to burn off high cost US producers by failing to cut output and thus guaranteeing low prices which are now down near 35% since early this year, are a good thing and our expectation for inflation slipping below 1% will keep our central bank unwilling to raise the official cash rate again for a potentially very long period of time. Borrowers face good times – especially as bank lending behaviour is changing in the face of continuing low credit demand. Woe offshore will also boost our population growth rate through migration flows, more and more of which could represent a long-term structural shift in our relative attractiveness rather than simply a strong cyclical blip.

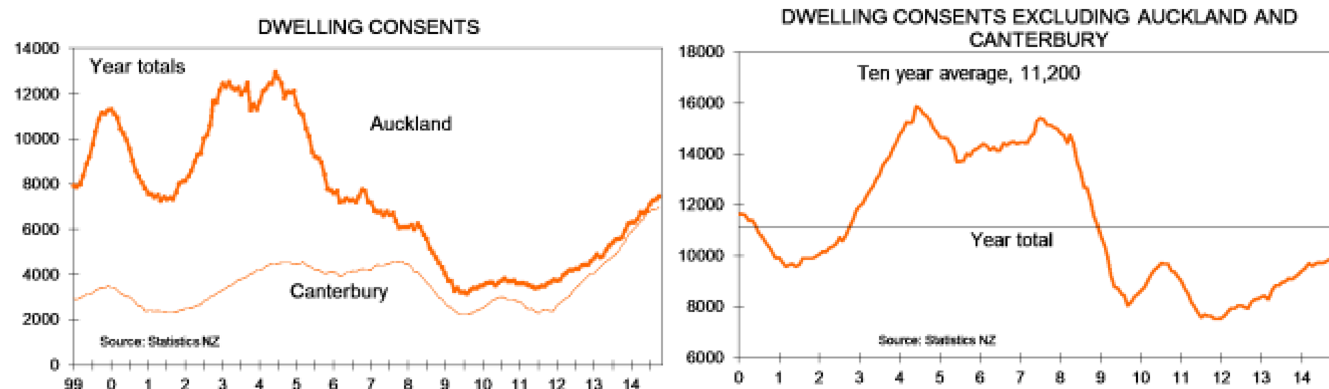
So the housing view I have remains basically as robust as ever for our two Londons at least (Auckland and Christchurch for those of you not up to speed). Strong net inward migration with many investors yet to factor a lengthening period for such into their purchase and holding decisions, a growing backlog of young buyers wanting to buy and just waiting until they have big enough deposits, and continuing low borrowing costs making investors seek better yields than on term deposits. Note that the attraction of term deposits has waned with recent rate cuts and banks giving notice that here and in Australia one will need to give 32 days notice of any desire to break a term early. Makes sense. If you need to break your term deposit but the bank won't let you then consider a loan using the maturing deposit as security. Given the reduced flexibility of term deposits now we will likely see a lift in medium to long term rates versus short term rates over time to reflect the reduced attraction to investors of term deposits. But we will also see greater shifting of funds into other assets – like, you guessed it, property. Though that hardly offers greater flexibility!

On the housing front this week we learnt a couple of things. For Auckland the Barfoot and Thompson data showed a near 10% seasonally adjusted rise in sales during November, a 10.7% lift in the average sales price from a year earlier (ahead $21,000 from October to $757,000), and total inventory down 9.2% from a year earlier. The data are strong and in line with our belief that the Auckland market is solidly supported. But outside of Auckland and Christchurch that is not the case and with Fonterra's payout not inconceivably ending up this season at half last year's it is simply not reasonable to expect much sales and prices strength in regional housing markets. So if you have a nationwide business with staff located in the regions you had best not have sales targets remotely approaching those which you have in our two biggest cities.



We also learnt of a firm 8.8% jump in the issuance of consents for new dwellings to be built in October though this still leaves a seasonally adjusted decline for the three months to October of 5.7% - both including and excluding apartments.

For your guide, over the past year consents for Auckland have risen 32%, Canterbury 31%, and the rest of New Zealand 9%.



Wages pressure on employers is likely to still be light this coming year due to the increased pace of labour force growth, very low inflation breaching the bottom of the RB's target zone, and general employee caution because of the woe they will read about all next year in Russia, Japan, Europe and Australia – plus Brazil, Venezuela, Sierra Leone, Iraq, Syria, Israel, and so on. Plus talk will start up about the likely 2017 referendum in the UK on leaving the EU – something which would be massively disruptive in that part of the world. Disruptive also would be the breaking up of the Euro – something which is still not completely off the table as zone economies struggle and political opposition parties rail against their lack of independent monetary policy, enforced budgetary cuts from Brussels, and floods of immigrants. Elderly and haggard Europe is going in the wrong direction and goodness knows what will happen with Russia biting on the edges.

And in China further slowing in growth is likely though with some 10-15 million people each year still moving to the cities (latest urbanisation rate is near 54%) and wages rising near 15% per annum, outside observers should beware of getting too pessimistic. China merely has some digestion problems following a period of massive credit growth and excess apartment building construction, plus a dose of salts is going through government ranks as the President strongly pursues an ever-deepening attack on entrenched corruption.

This is a necessary attack which since early this year has greatly weakened sales of luxury goods in China including Hong Kong (SAR), as well as casino revenue in not just Macau but Las Vegas.

At the same time the Chinese authorities have lifted efforts to meet another key concern of people – pollution - with the recently signed carbon emissions target with the US President, plus enhanced efforts to clean up air pollution around Beijing. Reducing steel production should take care of a lot of that but outright switch to nuclear generation of electricity is needed to do much about pollution from the coal-fired plants which produce about 85% of China's electricity.

Last week I noted that there are some trends which people (businesses I suppose, truth be told) should keep an eye on. These included growing wealth inequality and employers exploiting staff. Perhaps this latter thread is one of the motivating factors behind the new Leader of the Opposition's announcement that he will set up a two year "Future of Work Commission". The intention is that this project will examine changes in the way people work via numerous workshops and extensive contact with various groups. The risk is that it ends up being a grumpy free for all for all and sundry so the first task of the work which Grant Robertson will lead is to tightly define what they wish specifically to focus on and go from there.

Good luck to them because one outcome of the GFC is an altered relationship between employers and employees. But more than that whole new industries and jobs have appeared, there is more casualisation and contracting, and a generation of people have come through the education system and entered the workforce with minimal awareness of what unions can offer them. And that union movement suffers greatly from being associated with exactly that – a politically motivated always Labour-supporting "movement" rather than true representation of employee concerns.

These are early days for the re-elected National government and early days for the latest Labour Party leader, so the thrust of changes in the employee-employer relationship for the next three years is still likely to be in the direction of further empowering the former. But employers should keep an eye on the building undercurrent of discontent among the working poor in particular, what the Aussies call the “battlers”, and where possible seek input into the new Commission.

As promised last week, here are a few comments based upon learnings from the many papers on innovation presented at the conference I attended in Sydney last week.

- Strong economies tend to have a high ratio of intangible to tangible patents.
- Big business presence in a country is good for economic growth but can boost income inequality as big firms tend to be more capital-intensive equipment-wise than SMEs and hire skilled people (and encourage acquisition of such skills) compared with SMEs. As big firms expand overseas this can reduce income inequality but best growth outcomes come when they take their domestic SME suppliers and business partners with them to offshore expansion sites.
- Financial crises have very long-lasting impacts on economies. Singapore was well on it’s way to surpassing US income per capita but got knocked back almost one and a half decades by the Asian Financial Crisis of 1997/98. It now exceeds US income per capita.
- Bigger and fewer grants to researchers tend to produce better payoffs than lots of smaller grants to many people.
- Firms which collaborate with universities tend to have higher research productivity.
- Sending one’s researchers abroad boosts productivity as this positive “brain drain” improves linkages not just with probable end users of one’s products but also ensures one stays solidly within research and development networks being set-up overseas and which over time will incorporate higher and higher levels of expertise – highly relevant to China and the development of not just it’s consumption sector but its own researchers and research centres.
- Australia’s manufacturing sector needs to boost its level of integration into global supply chains and the sector suffers from poor collaboration between government and the private sector. This is not the case for the mining and agriculture sectors.
- One needs to be careful to avoid thinking that manufacturing means merely the production of physical items. Increasingly manufacturing is morphing into the services sector.
- Around the world the basis of competition is shifting from efficiency to innovation. Being efficient is no longer enough to produce good productivity and income growth, and relying on exchange rate or wage competitiveness is a route only toward the locked in production of low value goods.

The conference was held in the University of Technology Sydney Faculty of Engineering and Information Technology. The building was opened earlier this year And as someone who went through university from 1980 to 1984, pre-internet, pre-cell phones, pre-personal computers, pre-flat screen TVs it is something amazing to see. The gaps between rows of installed tables are generous, there are large projectors, technology to boot for the lecturers, power sockets for students under the tables, a high speed free wireless system of course, lots of places to sit outside lecture rooms, nice bright lighting, and goodness knows what green technology at work. Actually just over the road there is a building with plants growing all over it.

Beyond the main lecture rooms there are “collaboration” rooms with tables against the walls, each with its own display panel for presenting material called up by the host who stands at their own display in the middle of the room.

I envy students today for having such user-friendly environments to operate in. But then I guess when the University of Canterbury was constructed and people moved out there from the old campus in central Christchurch (the Arts Centre), people were similarly impressed by the advances.

If I Were A Borrower What Would I Do?

Nothing new here. We do not expect the next cash rate increase to happen until December 2016 at the earliest if it happens at all. I would look for a good rate to fix for between three and five years and leave very little floating.

	This week	**Week ago**	**4 wks ago**	**3 mths ago**	**Year ago**
Official Cash Rate	3.50	3.50	3.50	3.50	2.50
90-day bank bill	3.69	3.70	3.72	3.73	2.72
1 year swap	3.78	3.78	3.81	3.93	3.26
2 year swap	3.91	3.93	3.93	4.15	3.81
3 year swap	4.00	4.03	4.04	4.29	4.15
4 year swap	4.07	4.11	4.13	4.39	4.41
5 year swap	4.15	4.18	4.21	4.47	4.64
7 year swap	4.25	4.30	4.34	4.59	4.97
10 year swap	4.37	4.43	4.46	4.67	5.24

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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