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Mission Statement

To assist Kiwi SMEs in planning for their likely upcoming operating environment by discussing the economy and its implications in a language they can understand.

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SUMMARY

- The world is never at peace unfortunately nor economies on stable paths. There are a number of risks SME owners may want to keep an eye on in case they come to fruition. None are expected to, but then generally none of us accurately forecast shocks.
- The outlook for borrowing costs has not altered all that much this past month, though the chances of the Reserve Bank cutting interest rates have risen slightly. For borrowers the outlook remains benign.
- The Kiwi dollar has eased well away from parity against the Australian dollar and that psychologically interesting level now looks like being missed yet again.
- As discussed in our Sporadic 6 – 8 issues, the Auckland housing market has been driven strongly to date by at least eight obvious fundamental forces, not least of which is under-building since the early-2000s which when combined with record net immigration, possibly record well-off migrants, and the lowest borrowing costs anyone taking out a mortgage has ever seen, explains price rises to date. However it is clear that speculative players have been entering the market more and more recently, thus the government and Reserve Bank interventions are timely. But they in no way alter the fundamental forces which perhaps will drive prices higher for two more years.

Budget 2015

The rule of thumb for NZ Budgets since the early-1990s is that they focus on delivering a good set of fiscal numbers, aim toward the long-term, and apart from a few gimmees and spending catch-ups for favoured or growing public sectors do not work to radically alter the path which the NZ economy and society is on. If there are to be big changes however then the first Budget after an election is the one in which to do it. But if the changes are really big and formed part of the winning party's election promises then they will get done as soon as the new government comes to power rather than waiting for the Budget seven or eight months later.

We saw nothing introduced right away by National back in late-September 2014, and the budget released this afternoon contained no major policy changes. By that we mean there was nothing in there which alters our existing outlook for the economy, housing and labour markets, interest and exchange rates over the next few years. The economic and fiscal projections by Treasury look reasonable and show a non-worrying fiscal situation with improving measures. However a surplus next year may not occur given Treasury's projection of GDP growth averaging 2.8% for four years looks too high given the deteriorating dairy sector.
.
The details of Budget changes in Working for Families etc. are well covered elsewhere so we will skip them here.

What Has Changed?

Just briefly, every day we receive new information relevant to where the economy is likely to go, and this month we have decided to do a simple comparison of new information of importance in the past two or three months which will boost growth, against new information which suggests more caution is needed. On the positive side we have these recent changes.

1. Interest rate expectations have fallen. Not many forecasters now believe that the Reserve Bank will again raise interest rates this cycle and the markets are pricing in rate cuts in coming months. A lower interest rates outlook in a debtor country like NZ means improved confidence and improved willingness to spend.
2. Europe's growth has surprised on the positive side recently and although the Eurozone countries have major structural problems and long-term growth prospects do not look good, for now things look a tad better. This could however easily reverse when Greece defaults and probably leaves the Euro.
3. The Kiwi dollar has eased this past month assisted by the change in outlook for NZ interest rates along with lower dairy prices. This is a small positive for exporters.
4. Migration flows continue to surprise on the strong side. More people, more spending, more upward pressure on house prices and Aucklanders' perceived paper wealth.
5. Petrol prices have fallen and help explain why retail spending growth in other areas has been so strong over the December and March quarters.
6. Foreign visitor numbers have been surprising on the high side in recent months.
7. Consumer spending has strongly picked up with core retail sales up nearly 3% in the March quarter.

But on the negative side we have the following, and the first item needs to be monitored very closely.

1. Dairy prices have fallen 26% since the start of March in the Global Dairy Trade Auctions. Hopes of a decent rebound in prices later this year have decreased and forecasts for next season's payout are being reduced. On top of that we have a forecast of El Nino coming back, plus huge uncertainty about how much European dairy production will rise now that production quotas have been removed, how much extra United States production will occur now that feed costs are falling courtesy of lower oil prices reducing demand for biofuel crops, and how much China slows. Russian import bans complicate things further. There is little chance that all these uncertain things move positively for New Zealand.
2. China's recent monthly economic numbers have been coming in weaker than expected and the People's Bank of China have now cut interest rates three times in the past six months. Housing restrictions have also been eased and the central government is making special efforts to assist local authorities resolve their debt issues. The chances are high that China will miss its 7% GDP growth target this year and this will tend to suppress prices for many commodities from iron ore to coal, dairy products, and meat.
3. The Reserve Bank from October 1 will require all investor mortgages in Auckland to have at least 30% deposits and nationwide all non-owner occupied houses sold within two years of purchase will now be assumed to have been bought for capital gain and tax will automatically apply. This is not a new tax but a change in the default assumption made about why a property was bought in the first place. These changes will apply some minor restraint to Auckland house price rises by discouraging the most over-geared inexperienced purchasers who have been starting to feel they need to gear up n Auckland property to avoid feeling embarrassed a year from now should prices rise strongly again and they miss out.
4. In Taranaki there is evidence of the fall in oil prices leading to layoffs in the exploration and extraction sector along with engineering companies.
5. For each of the past three months the number of dwelling consents issued in Canterbury has been lower than a year earlier.

On balance the drift of risks appears to be toward the weaker side mainly because of slowing growth in China and the easing off of confidence about next season's incomes in the dairy sector. Hence the easing NZ dollar and decline in interest rate expectations.

Sources Of Risk

Are there things which you as a small or medium-sized business owner should be aware of because they could take an unexpected turn for the worse and generate a shock to your profitability? We say “unexpected” because as a rule we generally do not expect something to go drastically wrong. This reflects the fact that it is either impossible to forecast something going very wrong, or impossible to forecast when it will happen. Plus, put simply, those who forecast shocks are almost always wrong.

For instance, in markets for things ranging from tulip bulbs and houses to financial derivatives and shares one may conclude that fundamentals have gone out the window and people are buying simply because other people are buying and they expect to sell to some other person who will buy because they believe even more people will buy. This environment of irrational exuberance as former Federal Reserve Chairman Alan Greenspan called it in 1996 can extend for many years before something causes a reality check and big price declines. In this case Mr Greenspan’s concerns expressed about US share prices came when the Dow Jones Industrials Index of shares was near 9,600. It did not peak then start falling until three years later above 16,000.

Here are some things which have potential to cause shocks to confidence, but for which the prevalent view is essentially “the worst will be avoided”. Plan for them if you like but we do not expect any to come to fruition. One’s focus should instead be on flexibility and resilience if and when one of them does in fact come along.

Greece defaulting and exiting the Eurozone.
The chances of default in the next few weeks are high, and as that means inability to pay the likes of Greek pensions and public service salaries the expectation is that Greece will first create a de facto separate currency through IOUs, then eventually formally leave or be chucked out. The assumption that this can occur without major economic disruption is based upon the fact that very little Greek public debt is now held in private hands. In addition some other European economies for which major worries of contagion existed have been performing better recently, including Ireland, Spain, Italy and Portugal. So default when it probably comes will exercise the minds of many people and cause some market disturbance, but it is unlikely to generate a new European or global downturn.

China and Japan “engaging” each other in China seas
The potential for disruption if war broke out is massive, probably in the trillions of dollars. With almost two-thirds of our exports going to Asia and Australia the impact on our economy of disrupted trade flows would be massive. Conflict is considered extremely unlikely even though mutual enmity is deep, from China’s side for historical reasons, from Japan’s side for current and future regional influence reasons. Militarily China is not ready for a naval war and may never be given US presence. Both Japan and China are focussing on alternative routes to garner regional support and influence.

China’s economic growth slowing precipitously
Concerns about China’s economy have deepened in recent months, as evidenced by previous policies aimed at restraining the housing market being removed in order to try and stimulate buying and prices which have fallen about 5%. Monetary policy has been eased three times via interest rate cuts in the past six months and bank reserve requirements have been eased. The hefty loan burden of local governments is being alleviated through allowing them to issue new debt which banks can use as security with the central bank for further lending, and there is no doubt that Beijing would recapitalise any banks experiencing any major difficulties. China is settling into a slower growth track but with 10-15 million people still moving into the cities each year, rising household incomes, a high 30% household savings rate and generally lowly leveraged houses, a major slump in the overall pace of economic growth is unlikely.

Dairy
Fonterra recently cut their payout for 2014/15 even further from the $8.40 of last season to just $4.50. With the breakeven payout for most farmers being between $5.40 and $6.50 according to two agri research groups, this means rising indebtedness for farmers – particularly those who have expanded recently, and

those who have embraced systems of supplement feeding of their animals. Recent research suggests that apart from the top operators this supplementary feeding has failed to boost returns. http://www.stuff.co.nz/business/farming/dairy/68144618/Rising-feed-costs-eroding-NZ-dairyings-competitive-advantage

The risks of weaker generalised economic growth throughout New Zealand stemming from reduced dairy sector incomes and spending have increased following a string of disappointing results at the fortnightly Global Dairy Trade auction. Average prices are 38% down from a year ago, 54% off the April 2013 peak, and have decreased 24% since the start of March. Our expectation is that prices will move up later this year.

However there is almost complete uncertainty regarding milk volumes likely to come out of the European Union now that production caps have just been removed, and out of the United States where massive scope exists for production to rise and hit global markets – especially if feed costs decline as they are doing. This decline in feed costs partly reflects reduced demand for biofuels following the sharp decline in oil prices. Additionally the Russian ban on dairy imports from the West has added product to the global market, and predictability of demand from China is very low and the risk is downside risks to economic growth cap dairy product demand in the short-term. Downside risks to the NZ economy from a “correction” in the dairy sector are growing and worth monitoring.

Auckland housing market

As outlined in our Sporadic 8 there are simply too many very strong fundamental factors in play to reasonably expect that issues of affordability and rapid price rises will be “solved” in Auckland in the immediate future. http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-8-May-12-2015.pdf
Prices will rise further and the issue now is whether a true debt-fuelled bubble will develop and bring potentially destabilising price declines when events conspire to cause a sharp turndown in investor sentiment. Our view is that the only serious candidate for a period of price declines is an NZ recession being aggravated by a sizeable downturn in trading partner growth. This is not something we expect to see happen within the next two years. Note that the new Reserve Bank rule that lending to non-owner occupiers in Auckland will require a minimum 30% deposit from October is unlikely to have much impact as only 2.5% of all current lending to investors occurs where deposits are below 20% of valuation. In fact only 0.9% of all mortgage lending is to investors with less than 20% deposit. The new application of a capital gain tax on all non-owner occupied housing sold within two years of purchase plus requirement for all buyers to have an IRD number is equally unlikely to make any noticeable dent in the Auckland housing market for the two years which might remain in this period of “repricing” of Auckland’s housing stock.

Middle East

Tensions have increased markedly in the Middle East in recent months with the long-lasting conflict between Shite and Sunni countries breaking out into the open more obviously. War rages in Iraq, Syria, Libya and Yemen in particular with no sign of things simmering down. In fact the potential June 30 agreement to allow nuclear technology development and uranium processing to continue in Iran as sanctions are removed risks deepening the divide between key players including the United States and Israel whilst initiating a Middle East nuclear arms race. It is impossible to know how the situation will develop and potential for disruption to oil flows is likely to remain for decades rather than necessarily come to fruition in the near future.

Ukraine

After invading and seizing the Crimean Peninsula from Ukraine and throwing the entire post-WW2 European security framework into disarray, Russia has been supporting rebels in eastern provinces of Ukraine aiming to secede from the country. Russia’s aim is to push back against Western Europe’s encroachment upon territory which Russia has traditionally considered to lie within its sphere of influence, and to shore up home support for President Putin in an economic weak environment by stirring traditionally strong nationalistic and authoritarian sentiment of the Russian people. Tensions are likely to continue for some time. But provided no additional country within Russia’s traditional “sphere” makes moves to align much more closely with the West, a spreading of the conflict to those other countries is very unlikely. Like China, Russia carries a burden of feeling some humiliation from the West, focussed on insufficient attention being given to the dominant role Russia played in defeating Nazi Germany – with the assistance and much lower death toll of Western Europe and the United States. http://en.wikipedia.org/wiki/World_War_II_casualties

Bond market selloff
Currently NZ interest rates are at their lowest levels since the 1960s – something completely unimaginable pre-GFC. Since interest rates were cut radically around the world over 2008-09 there have been concerns of a sharp rebound in interest rates associated with either

- money printing causing high inflation (has not happened),
- the ending of money printing causing a rush of funds into other assets (has also not happened, in fact rates have moved lower), and more recently,
- increasing economic growth.

Given the first two candidates for higher rates have not come to fruition we focus on the last. In the United States in spite of the economy recording essentially no growth during the first three months of the year, yields on the benchmark ten year government bond have risen to near 2.3% from lows around 1.7% in January. However expectations for tighter US monetary policy have been pushed out and it is unlikely that a sizeable lift in US and therefore medium to long-term NZ interest rates is underway. Given the growing chances that there is no further increase in New Zealand's official cash rate from the current 3.5%, we assess the probability of a growth-sapping surge in bond yields as happened in 1994 to be relatively low.

However, it is difficult to overstate the uncertainty around ongoing effects of massive liquidity injections in recent years. Easy money has encouraged sharp increases in investor risk taking in assets such as shares and property (including Auckland housing), wealth inequality globally has ballooned, and as already highly valued assets rise further in price as easy money conditions continue, risks to financial systems and economic activity in the event of a correction grow stronger.

This then, outside of the deteriorating outlook for dairying in the short-term, is probably the greatest risk facing NZ SMEs – and it is impossible to forecast how things will develop. But it is worth noting the strong expressions of concern by the likes of our own Reserve Bank in their May 14 Financial Stability Report, and the European Central Bank Governor recently as well. http://www.ft.com/intl/cms/s/0/f5d530c4-fa54-11e4-aa42-00144feab7de.html#axzz3a9eZ7g8T

Training In The Small Business Sector

In last month's NZO we wrote …

"Over the past year Small businesses account for just 23% of jobs growth and over the past three years even less at 19%. Large firms account for 42% of jobs growth over 2013 and 52% since 2010. Given that people in Large firms get paid more, churn less often, and are more skilled than people in small to medium-sized firms, this seems like a good thing. "

No-one has disputed the first two claims, but some people challenged the claim that people working in large firms are more skilled than people in small firms, though no-one has been able to produce evidence to counter the claim. The comment should have been more accurately written as follows – "…and because small firms undertake less staff training than large firms it is likely that skill levels of small firm staff are lower than staff in large firms."

The support for this comes from many sources. From the business.govt.nz website.

"Staff training and development is fundamental to business growth. It can help sales, save staff hours, create more efficient production methods, improve technical systems and more. Unfortunately it's also something that's often ignored by many small business owners because it is seen as too time consuming or expensive."
http://www.business.govt.nz/staff-and-hr/employee-and-team-performance/training-and-development

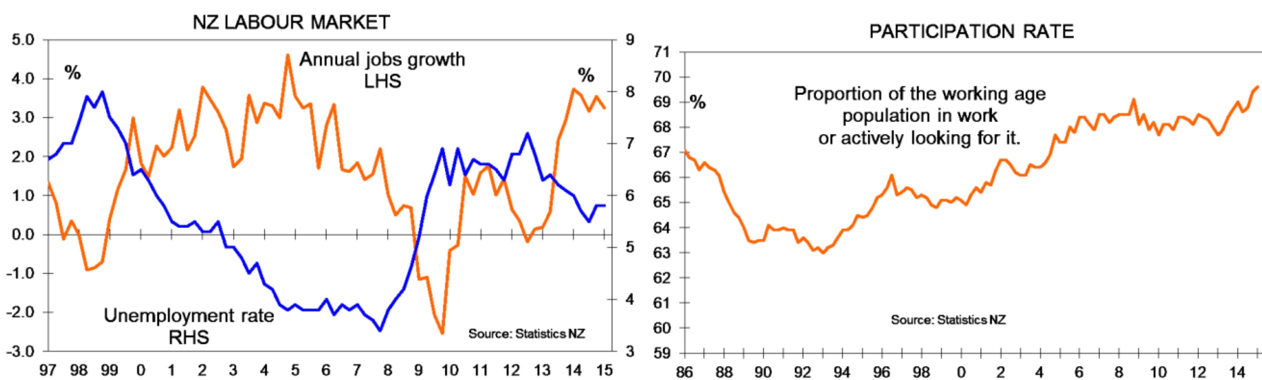
From a 2012 OECD paper.
"…on various measures of the activity, the smaller the firm the less likely it is to be engaged in training, and a sizeable proportion of small firms undertake no training at all. The recent LEED programme studies,

conducted in regions of Belgium, Canada, New Zealand, UK and Turkey, found that around a third of firms have not participated in training in the past year – a figure that largely reflects lack of engagement by small firms."
http://www.oecd.org/cfe/leed/Skills%20Workshop%20Background%20report_Stone.pdf

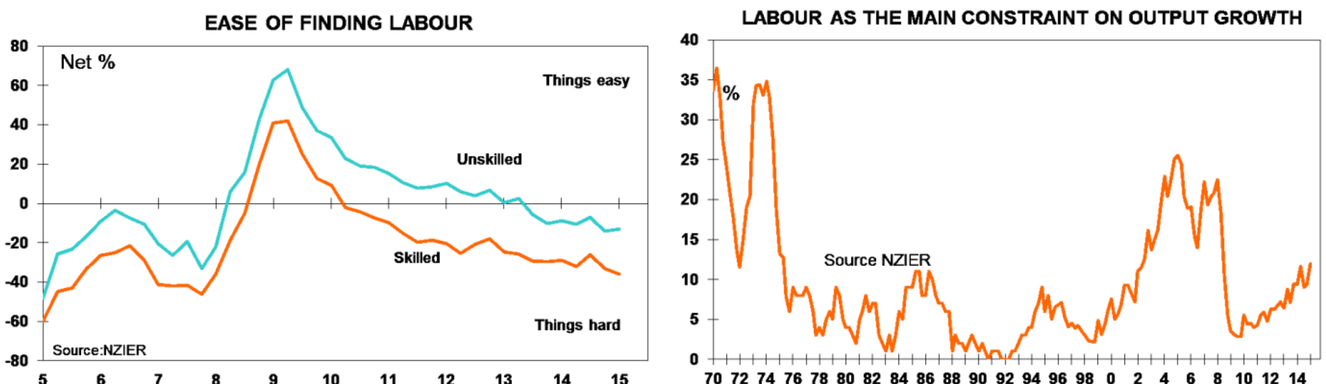
SME owners train their staff less than people running large firms. One reason commonly cited by SME owners for this is concern that trained staff will take their better skills and earn more elsewhere. The answer would appear to be to pay them more as skill levels improve so they have less monetary incentive to leave. This training is very important, because as cited in the OECD study just referenced,

"Smaller firms been (sic) a much more dynamic element than large in most economies over recent decades and those that train their workers are significantly more likely to grow (and less likely to close) than those that do not (Collier et al., 2007). The increasing pace of technological change makes skills become obsolete more quickly, while older workers have to remain in the labour market longer for reasons to do with demographic change and pensions requirements."

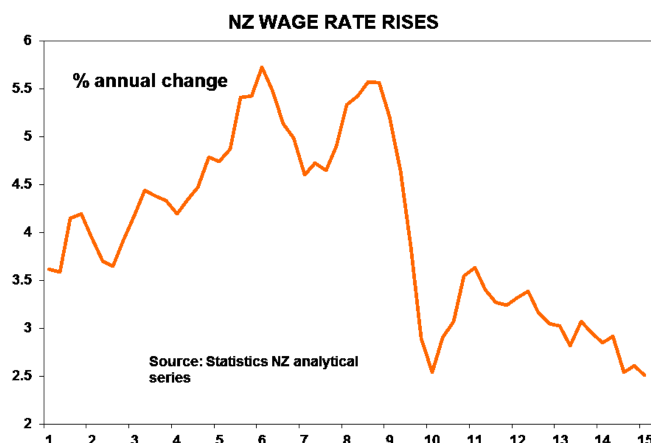
That very last point is important for SME owners to note. The workforce is aging and with the unemployment rate still highish at 5.8% despite 3.2% jobs growth this past year you are already finding it hard to get staff. This is easy to understand when one considers that the participation rate is at a record high of 69.6%. This measures the proportion of the working age population which is either in work or actively looking at it. The high level implies not many other people may be able to come forward and enter the labour market.



According to the Quarterly Survey of Business Opinion released in April a net 36% of businesses (big and small) are finding it hard to get skilled labour compared with a ten year average of 17%. This is the greatest level of difficulty since the end of 2007 when the unemployment rate was much lower at 3.5%. That is something quite important to note. Imagine how big your problems will be when the unemployment rate slips below 5% yet you won't be able to easily recoup extra costs of training your highly churning and wage demanding staff by easily raising selling prices in a post-GFC world where consumer sensitivity to price rises is the highest since probably the 1960s.



For your guide, as yet there still remains zero statistical evidence that the pace of average wages growth throughout New Zealand is accelerating. The measure we follow eased in fact to show an annual rise of 2.5% in the March quarter from 2.6% the quarter before and 2.8% a year ago.



Other reasons cited in the OECD study for why small firms don't invest much in staff training include the following.

- "Small employers commonly cite lack of information on what training is available to them, as well as evidence of the benefits of training to set against perceived and real barriers to training activity..
- Small firms tend to be more oriented to immediate goals, notably survival, and operate to shorter horizons than larger ones…
- Lack of access to economies of scale in training raise training costs for smaller employers, who, compared to large firms, pay typically three times more per member of staff undergoing formal training.
- From surveys, a principal reason for small firms not providing training is the managers" belief that the workforce is already proficient… Owner-managers consider that undergoing training themselves will not enhance their ability to operate the firm, although fear of exposing deficiencies in their knowledge is sometimes behind their reluctance to participate.
- Larger firms often pay higher wage rates, so formal qualifications are perceived by many small employers as more valuable to employees than the business itself. Thus, it is frequently argued, many provide only in-house firm-specific training, which produces skills that are less transferable in the open market.

If you accept the argument from small business lobbyists that your firms are the key driver of employment growth in the economy and your staff are not less skilled than staff in large businesses, then you risk being slammed when the labour market gets tighter. The large firms will bid your staff away. That is probably what happened to you from 2005-07. Also, if your staff are as skilled as those in large firms, why are they being paid less? Either staff are less skilled, or they are being underpaid.

You are already finding it hard to get skilled people and according to the ANZ Business Micro Scope Survey released in April you continue to rate lack of skilled staff as your top concern, ahead of regulations.
http://www.anz.co.nz/about-us/economic-markets-research/business-micro-scope/

The key issue therefore becomes this. How to retain and acquire the skilled staff you need? One answer is the approach you use for customers – focus strongly on retention. In this case it means boosting staff training, boosting staff productivity, thus boosting wages and reducing the incentive staff face to shift to larger firms. Overcoming the many obstacles and more mentioned above however requires focussing your lobbying of politicians and public servants away from the emphasis on cutting regulations and red tape which everyone targets, and instead discussing how those people can assist with staff training and retraining.

Personally, were I a lobbyist on the issue, I would have one angle being the aging workforce and the growing societal need for retraining of older people. I'd emphasise that especially with the Labour Party's Finance Spokesperson Grant Robertson as he runs Labour's two year Future of Work Commission.

Borrowing Costs

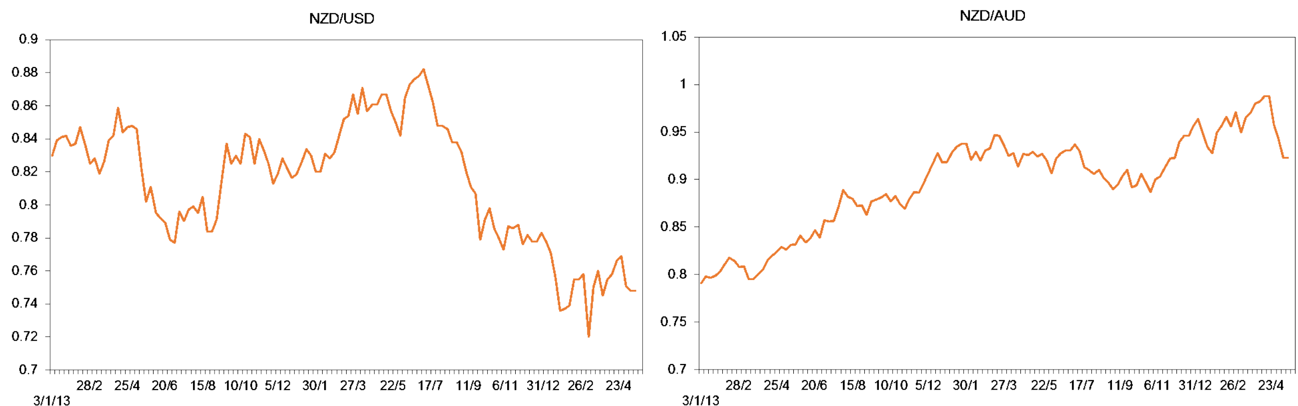
The chances have increased that the Reserve Bank will cut the official cash rate before the end of the year. Influencing factors include the change in the RB's monetary policy bias away a tad from neutral toward noting conditions under which they would ease, evidence of a deceleration in the pace of average wages growth, low inflation confirmed at just 0.1% mid-April, and some easing in dwelling consent growth.

However, our view remains that a cut is not going to happen, especially in light of booming retail spending growth during the March quarter, and the RB admitting that the restraining effect of the LVR rules appears to have ended in the Auckland housing market.

The financial markets are however pricing for rate cuts and borrowers may want to take advantage of this by locking in some fixed rate borrowing near the three year term.

NZ Dollar

Thank goodness one of the key things we have emphasised regarding currency markets over the years is that exchange rates are for all intents and purposes unforecastable. They are the door through which every piece of information regarding a country goes including expectations for how everything related to that country and therefore currency will develop in the mainly short to medium terms.



This past month the Kiwi dollar has moved well away from parity against the Australian dollar. It is currently sitting near 93 cents compared with a peak of just above 99.5 cents during the day on Tuesday 7 April, right after Easter. Why the decline? Largely it reflects heightened expectations that the Reserve Bank of New Zealand will cut the official cash rate before the end of this year. Expectations have lifted in response to further declines in international dairy prices at the fortnightly Global Dairy Trade auction, along with weaker than expected wages data released on May 6. Those latter data suggested some easing in the pace of wages growth in New Zealand, raising the chances that with the official inflation rate now at just 0.1%, there will be even further slowing as inflation expectations move lower.

Strong net migration inflows in an environment where employees still appear somewhat shell-shocked following the 2008-09 Global Financial Crisis is contributing to hefty wages restraint – something which the Labour Spokesperson on Finance Grant Robertson noted when discussing the potential for Labour to introduce regional economic development strategies including a regionally-biased immigration policy. Note that already there are extra points awarded to potential migrants saying they would be prepared to locate themselves outside of Auckland. However, given that it is to Auckland and Christchurch that migrants need

to go if best agglomeration benefits are to be gained from their entry into New Zealand, it should be understood that a regional economic development strategy would retard New Zealand's growth prospects rather than enhance them. And pushing migrants into the regions when jobs are not there is a no-goer for reasons that locals already there will likely resent them, they may potentially resent also the branding of their region as undeveloped, and the skilled motivated migrants which we want may simply choose to bypass New Zealand if they cannot live where they want.

Back to the exchange rate, monetary policy tightening expectations were also lowered on April 30 when the Reserve Bank released its review of the official cash rate. The rate was left unchanged at the 3.5% it was taken to in July last year. But in the text accompanying the decisions the RB said

"The Bank expects to keep monetary policy stimulatory, and is not currently considering any increase in interest rates. … It would be appropriate to lower the OCR if demand weakens, and wage and price-setting outcomes settle at levels lower than is consistent with the inflation target."

We still think a rate cut is a low probability, especially as the RB now consider the restraining effect of the October 2013 LVR rules in Auckland is now minimal.

"…in the Bank's view, the LVR speed limit is now playing a much weaker role in dampening house price growth in Auckland." Page 12, Financial Stability Report.

Previously they estimated the rules were the equivalent of a 0.35% rise in the official cash rate. But the odds of an OCR cut happening have certainly increased – hence the lower NZD. Thus it is certainly possible that the Kiwi dollar has peaked and that the drift from here will be generally downward. But history tells us we cannot forecast the speed of a currency decline. In fact research we used to publish once a year proved that we economists on average could not even accurately forecast the direction in which the NZD/USD exchange rate would move in the ensuing year any better than someone tossing a coin. In fact for much of the time we were worse.

For exporters and importers out there trying to make sense of recent NZD moves and contemplate future cash flows, your first port of call needs to be a currency risk specialist who can help you determine your risk tolerance and then develop the appropriate strategy. Don't base any such strategy in the first place on what we economists are forecasting.

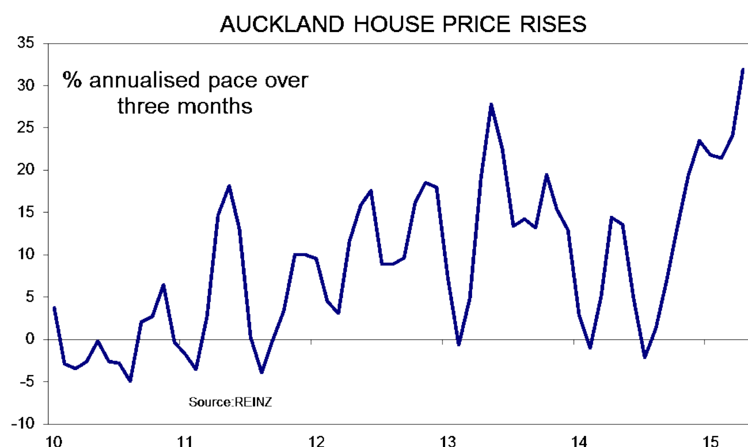
For the record, our view is of mild generalised depreciation in the NZD over the next couple of years. Good luck.

Housing

I have written about driving forces in the Auckland housing market in three recent issues of Sporadic recently and those who missed those brief publications may wish to catch up here.

Sporadic 8. Eight Records Driving Auckland House Prices. http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-8-May-12-2015.pdf
Sporadic 7. Auckland Housing Shortage Again
http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-7-May-5-2015.pdf
Sporadic 6. Auckland Housing Shortage is how big?
http://tonyalexander.co.nz/wp-content/uploads/2015/04/Sporadic-6-April-29-2015.pdf

My central argument is that Auckland house prices to date have not been driven upward by speculative forces, but instead by a repricing of the housing stock to reflect Auckland's emergence as an international city, under-building since 2002 which is ongoing, a population surge, and other factors mainly covered in Sporadic 8. However, in recent months the nature of the price surge has started to shift from being driven by fundamentals to frenzy factors coming into play, as evidence perhaps by the annualised pace of increase in prices accelerating to 32% in the three months to April from 22% in the three months to January, 13% three months before that, and -2% in fact in the three months to July last year.



This acceleration in the pace of price rises almost certainly explains why the Reserve Bank and government have decided to be seen to be doing something. Their moves are likely to cool the heels of the most frenzied, under-capitalised desperate gain-seekers, but have little impact on true investors. Thus what is likely to happen is that the annualised pace of growth is likely to slip back toward the 10% - 15% range rather than cease entirely.

Realistically, where will this all end?

The numbers are in dispute but there is under-building of houses in Auckland and the missing stock of houses is still rising. See the two graphs below. The simple interaction of supply and demand tells us prices will rise. There will be further upward pressure from baby boomers seeking retirement assets, savers and investors adjusting to lower interest rates by seeking rental property yields in Auckland and outside of it, strong migration flows for an undefined prolonged period, buying by foreigners seeking investments outside their increasingly developed and wealthy home countries, planners and existing Auckland residents not wanting to build up, build out, or fill in existing open/recreational spaces, and so on. But when will an equilibrium be reached at which demand and supply are in balance?

Looking at rental yields gives no guide as all models based upon rental yields have given bad house price forecasts in Auckland and the rest of New Zealand for two to three decades now and lie behind the incorrect forecasts made by some very frustrated analysts in the media recently. Even trying one's best to forecast fundamental influencing factors like interest rates, population growth, and house construction will not work because of the role being played by pure animal spirits. What does that mean?

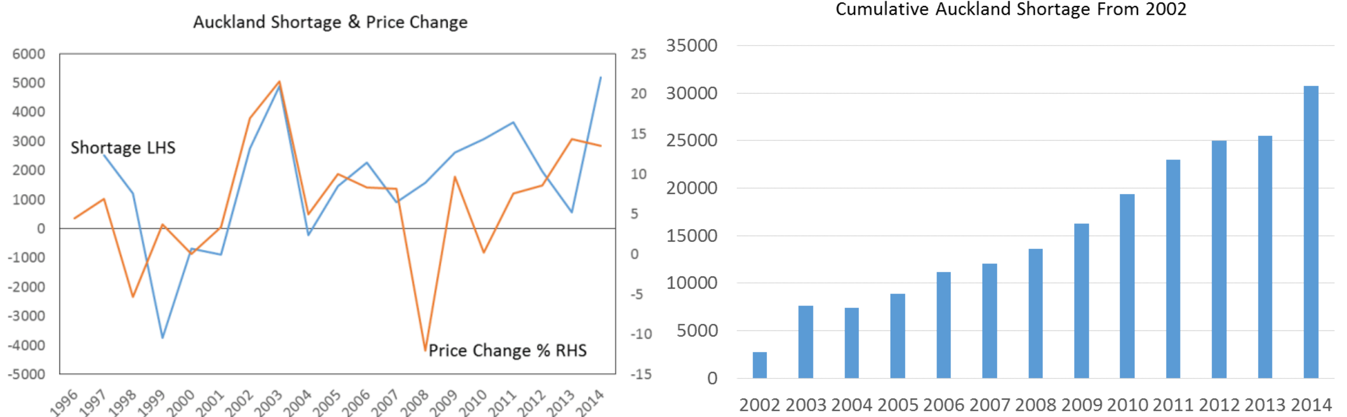
It means that as with all periods of rapidly rising prices in all asset markets there are people buying simply because others are buying and they want to buy first – just as on the way down there are always people selling because they want to get in before other people sell. **It is not possible to forecast animal spirits.**

No-one really wants to admit it because we all like to think that there are people who know what is going to happen and that there is good unemotive logic which determines what happens. But we cannot forecast

- when the Auckland housing market will peak,
- how much higher prices will rise between now and then,
- how quickly prices will fall on the other side,
- how much they fall on the way down.

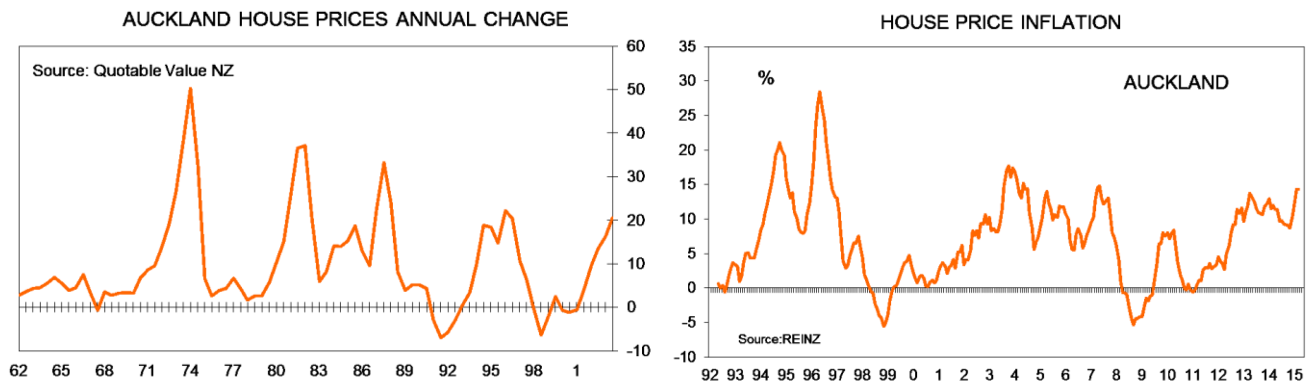
But everyone wants a view from us economists so here is mine, already outlined in the Sporadic 7 issue of May 5. http://tonyalexander.co.nz/wp-content/uploads/2015/05/Sporadic-7-May-5-2015.pdf

"And what is the third thing one can take from the shortage vs. price change graph? Look at the two periods when Auckland house prices were falling – 1998-2000 and 2008. What was happening then? The Asian Financial Crisis, then the Global Financial Crisis. Thus it seems quite reasonable to write the following.



When will Auckland house prices fall? When the world economy next has a meltdown. How much will they fall by? No-one can forecast that, but it will be interesting when that inevitably happens to see the interaction between the heights of prices versus incomes, debt servicing versus incomes (the interest rates effect), the extent and longevity of the global or regional economic decline, and the magnitude of the housing shortage by then. Best guess on timing? 2018. By then the no-brainer stimulus to our economy from rebuilding Christchurch, expanding dairy production, adjusting to structurally lower interest rate expectations and petrol prices, and the migration boom will have passed. What will drive our growth then given the re-emergence of long term trends such as lack of export diversification, absence of a rising exports to GDP ratio, baby boomers leaving the work force, manufacturing's secular decline, the shift of employment to low paying tourism sector jobs, and a cultural aversion to growing firms to big size? "

Just for your guide, many people talk about a seven year cycle in the Auckland housing market. We have old data on Auckland house prices from QVNZ running from 1961 to 2003. The first graph shows the annual change in this measure. The second graph uses REINZ data and starts in 1992. You may or may not see some cyclical regularity. Good luck.



Regarding the rest of New Zealand. Christchurch's housing market appears to be peaking with a lot of supply appearing. Tourist flows, an aging population, and foreign buying are likely to continue to drive Central Otago Lakes. Shifting of investors out of Auckland seeking yield will give some momentum to the likes of Waikato, Bay of Plenty, and near-to-Auckland Northland. But with the dairy sector taking a step back, the currency staying reasonably high, and increasing talk about regional economic development more likely to scare businesses into shifting to Auckland and Christchurch rather than remain in regions official considered on the way down, housing markets outside of Auckland and Central Otago lakes are likely to remain relatively subdued.

Key Forecasts

Calendar Years	2013	2014	2015	2016	2017
GDP % an. av cng	2.3	3.3	2.8	2.0	2.0
Inflation Qtr on yr ago %	1.6	0.8	0.5	2.3	2.3
Employment Growth " "	2.9	3.5	2.6	1.5	0.9
Unemployment Rate Year end	6.1	5.8	5.8	6.2	6.5
NZD/USD	0.82	0.78	0.70	0.66	0.66
NZD/AUD	0.92	0.94	0.95	0.88	0.84
NZD/GBP	0.50	0.50	0.53	0.48	0.46
NZD/EUR	0.60	0.63	0.69	0.62	0.60
NZD/JPY	89.1	92.6	87.5	83.8	81.2
90-day bank bill rate	2.7	3.7	3.7	4.2	4.15

The NZ Observer 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 NZ Observer each month please sign up at www.tonyalexander.co.nz
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