BNZ Weekly Overview

29 August 2019

ISSN 2463-4328

Mission Statement

To help Kiwi businesspeople and householders make informed financial decisions by discussing the economy and its implications in a language they can understand.

Our Economy

Call it chooks coming home to roost, the end of the golden weather, the new normal, whatever you like. But big changes are sweeping through the New Zealand economy and chances are that people pay high attention to one particular thing thinking that it is the main cause of their current business profitability problems when in truth there are at least five big pressures in play and a long list of miscellaneous ones. Here is a run-through of most, but not all, of them.

1. A slowdown has already happened
2. Labour force management
3. Pricing power decimated
4. Social licence to operate challenged
5. Offshore weakness and risks

A Slowdown Has Already Happened

Let's call the first factor cyclical, though that description is not exact. Between early-2014 and early-2018 our economy grew on average by 3.5% a year, or some 14% in total. Job numbers rose 14%. This boom was driven by underlying growth in sectors like aged care, healthcare, the digital economy, low interest rates, and high export prices, but mainly three special things. Inward visitor numbers surged 40%, net migration added some 230,000 people, and construction (largely residential) boomed from multi-decade lows in 2011.

Since early last year however growth has slowed to an underlying pace near 2% with jobs growth around 1.5%. Net migration inflows have eased from a peak of 64,000 in the year to mid-2016 to an underlying pace in the past three months near 42,000. Construction sector growth has slowed through lack of resources – staff basically. Tourism growth has slowed to just below 3%. And business pessimism has soared.

Because our slowing in economic growth to near 2% has not been caused by traditional things like collapsing export prices, a soaring NZ dollar, soaring interest rates, global financial shock or global recession, most of us don't really notice it. But the slowing, along with structural shifts in factors driving inflation, helps explain the easing of monetary policy.

And the key importance of this slowing is this. It is taking away a growth buffer which has been insulating a lot of businesses from other big changes. Pain for most sectors lies ahead, and that is where the other four factors and miscellaneous ones mainly fit in.

Labour Force Management

It used to be easy staffing a business in New Zealand because there were so many well motivated and skilled people available following the reforms of the 1980s into the 1990s and generational memories of the pain from the 1970s onward keeping employees quiescent. But now firms are struggling to find people.

A net 43% of businesses say it is hard to get skilled people and a net 34% say unskilled people are hard to find. This relatively high shortage of unskilled people is something new and suggests to us that the pool of people able to be brought in unskilled and trained up has probably largely dried up. That which is left in the pool may not be considered trainable.

The other big problem for businesses however, beyond overall quantity and beyond the new unskilled labour shortage, is the emerging movement of skilled, motivated, long-serving people to other firms.

These people have kept quiet these past ten years, happy to have a job during times when turmoil has dominated offshore. But now they can see that job opportunities are plentiful. They are upset at lowish wages growth in recent years (though real average wages have risen 23% since 2007). They are tired of training up new people, and they're feeling disrespected. So, they are moving to get the respect they seek and remuneration closer to what they think they deserve.

This is depriving businesses of what we call "meta-knowledge". This is knowledge specific to a firm and includes not just insight into how to do things properly, but knowledge of what to look and listen for as early signs of things going wrong. New people do not have this knowledge and as the existing staff leave and new people are asked to replace them things start failing and perhaps outright blowing up.

One of the biggest changes which businesses need to make now that labour is no longer as readily available as before is to stop trying to grow. If you can't get the people and you're unwilling to undertake the labour-saving investment, then every extra contract you sign up to is potentially one step closer to your failure. Already work quality is declining, and job redoes are occurring turning profits into losses for specific projects.

In a capacity-constrained economy, businesses need to first figure out what labour resources they can reasonably expect to command, then figure out what level, type, and location of output that will allow them to pursue. The old way of simply maximising output can't apply now.

Pricing Power Decimated

One might think that businesses should be feeling great because wages growth is so low. But they are instead highly pessimistic and there is more to it than just discontent with a government containing activists who have little idea how to run a business or the pressures which businesses are under – and might not care even if they had awareness.

The ability of businesses to offset cost increases from any source by simply raising prices in a cost-plus pricing model, has gone down the drain. Consumers and business buyers can virtually at zero cost go online and access information on alternative products and suppliers. The cost of searching has plummeted because of the technological revolution giving us the internet, the world wide web, search engines, and online retailing.

Businesses raising their prices these days will receive negative customer responses and risk pushing disgruntled people toward suppliers they previously never even knew existed. Price rises are a message to consumers to look elsewhere.

This margin squeeze from technological sources has not been with us for all that many years, and it is possible that only now because very strong growth in the economy has ended, that many businesses are realising they have a major problem. The situation we have seen recently of widespread failures despite very strong customer base growth in the retailing and construction sectors will now spread to virtually every other sector in the economy.

To handle this loss of pricing power, businesses need to rigorously examine where their profits are actually coming from – product line, location, customer type etc. – and focus mainly on the high yielding areas whilst ditching the rest.

But the delivery by new technology of zero search costs to consumers is only one huge hit to businesses from this source. The other is aggravated loss of social licence to operate as concerned people use social media to apply pressure to businesses to act differently. To whit…

Social Licence to Operate Challenged

In the United States recently 180 large firms in the US Business Roundtable said they are changing their primary focus away from simply maximising returns for shareholders. They are now giving equal weighting of that goal to servicing customers, staff, suppliers, and the community. Why?

Society does not like what it is seeing from the corporate sector. The list is long and growing and includes elements like this.

- Bailouts post-GFC yet continuation of payment of bonuses to executives

- Huge executive salaries divorced from reality and with payments even after failures (Fonterra)
- Pollution of waterways
- Emissions of climate change gases
- Low wage rises
- Pushing pills and nicotine
- Mis-selling of financial products
- Violating peoples' privacy with impudence
- Facilitating scams, fake news and voter manipulation
- Use of polluting plastics
- Misleading advertising
- Very high profits
- Exploitation of migrant labour
- Gender wage gaps

And many more. People feel that business sector behaviour has deteriorated and astute businesses are realising that if they are to mitigate the risk of a backlash against capitalism, loss of customers, and giving a free ticket to governments to regulate the bejeebers out of them, they need to get ahead of the "clicktivist" social media activism curve. Millennials are choosing to avoid working for businesses they feel don't behave responsibly, and that will be a growing problem in a labour-constrained economy. Managed funds are divesting from such firms. So, we are entering a phase where returns to shareholders will be sacrificed.

The motivation for making changes will differ from sector to sector and firm to firm. And it is into the context of this widespread change that the pressures on our dairy sector need to be placed. Demands for dairying to change are being driven by pollution concerns and they are highly visible, especially because New Zealand has always been and probably always will be a farming country. To many of us this pressure on dairying is almost existential.

But it is not unique and dairy farmers need to realise they are being caught up in a global shift and are not being especially targeted. As discussed in the Weekly Overview two weeks ago, our dairy sector is going through and will continue for many years to go through a period of big change. Output will probably fall not just as farming practices change, but as eventually consumers and ingredients users switch to the inevitable plant-based dairy proteins currently being developed and into which Fonterra itself has invested. The shift to these proteins will be driven not just by cost but consumer concern about emissions and animal health. Frankly, its going to be a race between dairying getting massively cleaner and keeping loyal customers by being seen as pristine, and development of non-cow low environment-impact alternatives.

For other sectors it is not water and air pollution that is driving social media discussions, activism, calls for boycotts etc., but worries about plastics. Radical changes will have to be made in packaging across virtually all industries. There is a growing slow fashion movement based upon the polluting effects of high polyester and nylon clothing consumption through frequent discarding of used garments and purchase of new ones. That challenge has yet to hit our domestic clothing stores but could provide opportunities for domestic clothing manufacturers of long-lasting garments.

True radical change may one day come the way of the tourism sector. It is not just a feeling by NZ society that tourism operators from airlines to airports, car rental firms and hotel chains have ignored their concerns and pumped as many people as possible into New Zealand regardless of impact. They've acted like US banks pumping credit to anyone breathing pre-GFC. The biggest threat to our largest export earner is an event causing people to holiday close to home rather than injecting tonnes of CO2 into the atmosphere to come all the way down to New Zealand. Our tourism sector is highly vulnerable to societally common activism over climate change.

The burning of the Amazon forest does not appear to be a trigger, nor wandering polar bears, nor shrinking Greenland glaciers. But note the European threats to Brazil not to ratify a trade agreement if the burning continues. And the decision by some royals to fly economy to Aberdeen last week rather than go by executive jet. There is also a growing flight-shaming movement in Europe. For aviation, as for dairying, there are few technological solutions available beyond reductions in activity for curbing emissions. Some cite biofuel. But producing enough biofuel to replace all of today's aviation fuel consumption would require feedstock equal to all of the planet's food consumption by humans. The world is filled with millions of kids who would love to be the next (non-flying) Greta Thunberg.

Electric planes? Maybe one day for short-haul flights. But potentially decades away for the long-haul flying our tourism sector is dependent on. I'd

keep this tourism threat in mind in the context of considering prospects for our regional economies and their housing markets medium to long-term.

The world's business sector is on notice to clean up its act in many ways. If I were running a strategic planning session for a business, I would be seeking discussion of how customers, staff, suppliers, and society might negatively perceive and be willing to act upon things which my firm is currently doing.

Offshore Weakness and Risks

Growth in China's economy is slowing down as a natural result of four decades of extraordinary growth from a low base simply not being sustainable. Other economies have historically done through the same pattern. But China has extra downward pressure on growth coming from the increasing role of the state and state-owned enterprises in recent years under the current president for life. Debt levels are high, corruption is rife, 20% of the housing stock sits empty, and there are worries about the quality of much infrastructure which has been built.

But on top of these pressures is massive disturbance to supply chains as United States firms slowly try to extricate their production and inputs from a country now seen by both sides of the US Congress as an exploitative player intent on challenging key Western values.

And on top of that extraction and supply chain disturbance comes falling exports to the United States due to still rising tariff levels as President Trump applies pressure to try and extract a generous trade agreement between the US and China.

China is our largest export destination and industries in NZ such as dairying have become dependent on it. Slowing growth in China will eventually affect prices for more commodities than just logs, and volume flows may decline. This direct impact on our economy from slowing Chinese growth will be reinforced by weakness in Australia which would come in the event of a large decline in China's demand for minerals such as coal and iron ore.

The unrest in Hong Kong could be the trigger for a Western economic backlash against China if people start dying on the streets.

The weakness in China factor is already in play with potentially a lot worse to come. Already in play also is a tiny impact on ourselves from recessions which might already be present in Italy and Germany. Brexit looms and while we can reasonably anticipate a fiscal stimulus package in the United Kingdom, slower UK growth is in the offing with duration of such a slowdown impossible to predict.

Then there are things which could easily go bad and disturb global confidence such as conflict in Kashmir, potential flaring into the open of military engagement between Israel and Iran, Russian activism in eastern Ukraine and so on.

Miscellaneous

Slower Population Growth

The net annual migration inflow peaked at 64,000 three years ago in mid-2016 and now sits at 50,000. This has been a gradual, non-threatening pullback. But seasonally adjusted data suggest the annual net inflow is currently running just above 42,000, courtesy of a lift in the number of people leaving. The net gain is still above the 20-year average of near 29,000 so a stimulus to growth is still occurring. But its strength is waning.

Credit Availability

A banking supercycle ended with the global financial crisis of 2008-09. In the ten years leading into 2008 household debt in New Zealand grew by 195%. In the past decade it has grown 60%. In the ten years to the GFC business and agricultural sector debt grew by 167%. In the past decade growth has been just 36%.

A lot of the slowdown in the debt growth we can put down to demand naturally falling away following the shock of the GFC and the desire to get debt levels down. Some we can put down to banks tightening up their lending criteria worldwide following the GFC. In NZ there has been tightening associated with banks pulling back from funding domestic lending with offshore borrowing – a key vulnerability for NZ.

Going forward there is likely to be more tightening up of lending stemming from the RBNZ's determination to make NZ banks hold higher levels of capital. The constraint will come not just

through a higher cost of funds, but rule changes just announced in Australia which will limit the ability and willingness of Australian owners of banks operating in NZ to advance required capital.

The slow structural decline in credit availability in NZ will not be too challenging for the household sector where loan to value rule changes can be more important, and where competition between banks is strong and likely to intensify. However, businesses and agricultural sector operators will be challenged not just by tightening up of lending criteria to come in future years, but the cultural unwillingness of Kiwi businesses generally to expand through attracting new capital rather than raising debt.

Already poor business capital expenditure in recent years will likely weaken further in the coming decade due to this tightening of credit supply and poor capital inflows. Low productivity growth will ensue and this will further retard business profitability whilst contributing to a slowing of per capita income growth in New Zealand.

Infrastructure Pipeline Delays

The Labour-led government have put many infrastructure projects on hold and this is making it difficult for firms in the sector to make forward plans. This could however be just a temporary situation with the recent appointment of an infrastructure Tsar who will presumably look to improve timing of flows and ensure resources to conduct projects remain in New Zealand.

Left-Leaning Politicians

The business sector has little faith in the current government which is driven more by social, environmental, and equity concerns than economic growth and business profitability. Fine, and necessary now and then. But recognition of the pressures on business in the current climate and that which may come is probably going to be difficult for many government MPs to achieve and this will likely retard official measures of assistance should things turn bad. Ignorance of business pressures because few government politicians (especially at the highest levels) have ever had a real job let alone set up and run a business, means further burdens from regulations and compliance are guaranteed.

Disruption, Speed of Change

There is nothing to suggest that the recent wave of disruptors across many sectors will either fade away or not be joined by new and innovative operators in many other areas. In fact, some speeding up of such competition is possible because very low interest rates will make investors offshore willing to back ongoing loss-making but market-capturing ventures in the hope they may one day turn a profit.

Retiree Incomes

Low interest rates will not stimulate business investment according to global research over the past three decades. They will provide some strength to the housing market while boosting asset prices. However, there will be a greater offset than may have been the case in the past from low term deposit rates, bond yields and dividends reducing the incomes of retirees and those planning to retire soon. So, the net stimulus from monetary policy easing these days is likely to be substantially less than was the case previously.

Highly-Priced Equities

Share prices globally have been boosted strongly over the past decade by falling interest rates. A lot of the boost to share prices, as for house prices and commercial property prices, will be structural and sustained. But continuing market strength in the face of a fraught and deteriorating global economy suggests share prices could have moved beyond sustainable levels. A hefty correction could easily occur in the event of a shock, perhaps associated with the US-China trade war or deaths in Hong Kong.

China Communist Party Interference

The CCP has cemented itself in place as dynastic rulers of China through delivering good economic growth, regaining global mana, securing (some) territory traditionally seen as part of China, and controlling scope for criticism of and discontent about its regime within China. They have been extremely effective.

But the drive toward an authoritarian police state is manifesting itself in other countries with the CCP attempting to influence attitudes toward China outside of their mainland. Western pushback against this interference via politicians, media, disinformation campaigns, universities is

now growing. More is sure to come as the CCP is certain to further use the economic dependence of other countries on China as a weapon.

That is, when wishing to express discontent, put a country in its place, and change behaviour, they will deliver a backhander through suppressing visitor flows, stalling goods on wharves, discouraging studying in that country, placing tariffs, and so on. Withdrawing investment won't much be used because many locals would probably welcome such withdrawal.

The CCP is also introducing a system of social credit scores for individuals and businesses with ratings dependent upon a wide range of factors. It is not hard to imagine that once the system is cemented in place for foreign firms operating in and trading with China that continuation of operating and trading will become dependent upon ratings – with ratings influenced by the degree to which obedience to then promotion of the CCP dynasty is shown. (Episode 7, Season 1 of "The Orville" contains a credit score system for people but ratings are determined by individuals, not the state. The Majority Rule concept also could not be further from China's CCP rule regime.)

China is unfortunately going down an Orwellian track completely at odds with Western liberalism and respect for basic human values. Businesses dealing with China need to consider that eventually that engagement will be restricted to terms imposed by the CCP and that one cost of such ongoing engagement will be the loss of respect and societal support back home. China presents as a huge money-making market. But it's a honey trap with the price being eventually one's Western values and soul. Disengage over the next few years if you're not prepared to sacrifice your key values.

Given the thuggish behaviour of CCP representatives we are even very close to it being no longer politically incorrect to make negative comments once again about China and even its mainlanders. And there are spreading indications that standing up to China's bullying may pay off electorally for leaders around the world. Conflict based on basic human values lies ahead and those most affected economically will be countries, sectors, and companies with the highest exposure to the Chinese market. Good luck if this is your business.

Lack of Monetary Policy Buffers

There is no great evidence to suggest negative interest rates act as a good boost to growth and inflation, or that quantitative easing does anything other than leave money sloshing around in inefficient businesses which retard productivity growth and in fact contribute to deflation. Japan has fought ineffectively against deflation and weak economic growth with zero interest rates and money printing for three decades. Worries about Japanification stalk the world's central banks. But we are close to far more widespread use of tools by central bankers who, like scorpions on foxes crossing rivers, can do only what it is in their nature to do. That is to try and keep inflation near 2% and try to prevent and minimise economic downturns. Our central bank said as much in a comment from it's Governor yesterday, with a plea at the end that you and I "understand". A plea reprinted in full in this morning's "The Australian" newspaper.

The truth is, we don't really know how things will play out when NZ interest rates get cut further and get close to zero. And that uncertainty has to be something we will all keep in mind as we consider our future hiring, spending, and investing decisions.

So, Are We Munted?

We are challenged and about to become even more so. Many businesses are going to close down over the next three years across most sectors as margins evaporate. Most will need to rejig how they work one way or the other, just as people dependent upon investment income will need to rejig their spending levels for their new reality. Some of these people will invest in commercial property and lose their money because they know nothing about the sector and its special risks. Others will look at bloodstock – and hope their syndicated horse does not break a leg. Alpaca farming shares? Lets just go the whole hog and offer shares in angora rabbit and goat farming – again. Or a share in a beachside house up until rising seas swamp it.

Business opportunities will arise in the field of assisting businesses to review their operations and make change.

But as yet there is little justification for a view that we are headed for recession. That would require

some big deterioration offshore. Locally we have good support for reasonable, but not stellar, growth from a range of sources.

- Underlying growth in sectors like aged care, healthcare, digital, communications.
- Low borrowing costs
- A slightly weaker NZ dollar
- Likely fiscal stimulus
- Good prices for most of our primary exports
- Infrastructure and construction catch-up generally
- Net migration still at above average levels for the next couple of years
- Good job security
- Events in Auckland over 2021

Risks however lie on the downside, and businesses might want to use this document as a prompter for discussion at their next strategy session.

If the stuff about China confuses you, maybe take a read through this paper I wrote back in 2013. I've just reread it and it all still looks valid, apart from the Yuan not actually being deliberately undervalued at all, and China now actively interfering in other countries – mainly ones where "their" people live and study. http://tonyalexander.co.nz/wp-content/uploads/2013/02/Sources-of-Western-Apprehension.pdf

Housing

Will interest rate reductions spark a lift in the Auckland housing market two years earlier than I have been thinking would occur? The uplift story sounds good.

- Confirmation of no capital gains tax.
- Record low interest rates and frustrated older investors looking for something else to do with their money.
- Existing property investors holding off from selling because returns on cash are low and set to go lower.
- Supply growth failing still to keep up with demand growth.
- Stories of many people enquiring after rental properties.
- The attraction to young renters and buyers of shifting out of Auckland declining due to rent and price rises in other major centres.
- The Reserve Bank is highly likely to ease LVR rules again come their November Financial Stability Report.
- New buyers from Hong Kong.

But consider these other developments.

- Ring-fencing applies from this year and with 40% of rentals running at a loss with averaging ring-fencing tax advantage of $2,000, cash outflows might start to look a tad large for some investors.
- The annual net migration inflow to NZ has only very slowly declined from 64,000 in mid-2016 to 50,000 now. But the underlying net gain is running at 42,000 and falling. That is still strong and population growth continues to exceed supply growth. But the speed at which the shortage is growing is slowing.
- Banks are continuing to apply a test rate above 7% so mortgage eligibility to many is nowhere near as good as sub-4% mortgage rates would imply.
- Consumer confidence has shifted to below average levels.
- Global and domestic growth risks are increasing.
- Jobs growth has slowed down to a pace near 1.0% than the 3.5% average from 2014-18.
- The flattening of the housing market in Auckland from 2016 has not been severe, has not produced widespread bargains, has not sent mortgagee sales skyward, and has not caused a fresh queuing up of young buyers unable to act because of job worries.
- If China's growth slows appreciably, Chinese student numbers in NZ (Auckland largely) will decline, and investors may sell housing stock to repatriate funds back into China.

There is no slam dunk case for prices easily continuing to fall at the recent annual pace of 3.5% in Auckland. But equally it is difficult to see that investors are about to flood back in given the increasing switch in power away from landlords toward tenants.

For myself the recent developments strongly support flattening in prices. But it still feels a tad too soon to reasonably be expecting price gains to return again to a range of 5% - 10% per annum. Especially in light of the worrying risks offshore. But regardless, nothing happening currently changes my view that if I were looking to buy in Auckland, I would be actively out there sorting the wheat from the chaff whilst not too many other buyers are out there attending open homes and auctions. The immediate upturn scenario is really only relevant to quick traders, and for them the prospect of a couple of years with price rises near 7% will not be all that exciting frankly.

If I Were A Borrower What Would I Do?

Nothing new here. Given growing downside risks to the pace of international growth, the slowdown already underway in our own economy with special pressures noted above, and the structural weakening of how capacity pressures cause prices to rise, lower interest rates are highly probable. The next easing of NZ monetary policy is likely in November, but before then further easing offshore may push wholesale fixed borrowing costs even lower in New Zealand.

This factor, coupled with the approach of spring and the inevitable spring mortgage campaigns from lenders, suggests further falls in mortgage lending rates lie ahead.

If I were borrowing at the moment rather than wistfully remembering the good-old days when I could get 3.5% on a short-dated term deposit, I would probably fix one year. I would anticipate being able to lock in a lower rate in a year's time.

And if I were an investor? One's starting point has to be acknowledgement that returns in the past from low risk assets have disappeared forever. Spending and wealth growth plans need to be scaled back, just as borrowers had to do the same in the past when interest rates settled at high levels. The second thing is to be aware that the shysters are going to come out of the woodwork to offer you investments in things promising high returns but about which you will know very, very little. If you know they're coming for you, then you can be ready to switch back off the part of your brain which will grasp at their promised financial nirvana – built around pictures of happy older couples romping without care in the outdoors.

Basically, speak with a qualified financial advisor. Chances are the bloke you just spoke with who has a great recommendation is not qualified, even though he might be good at throwing darts, hitting a golf ball, downing beer, slagging off millennials, and frankly chatting you up as a good mate whose approval you want.

The Weekly Overview is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. **This edition has been solely moderated by Tony Alexander**. To receive the Weekly Overview each Thursday night please sign up here. http://feedback.bnz.co.nz/forms/lFdYSs5FGEq4kAjP95uzTA
To change your address or unsubscribe please click the link at the bottom of your email. Tony.alexander@bnz.co.nz