REFERRER NEWS

with Bernard Hickey

Rates cut and KiwiBuild stripped

The omens on both the supply and demand sides are looking better for house prices as the spring open home season arrives.

The Reserve Bank surprised almost everyone by cutting the Official Cash Rate by a full 50 basis points to a record-low 1.0 percent at its last full Monetary Policy Statement decision. Governor Adrian Orr then started talking about using 'unconventional' policy such as negative interest rates and Quantitative Easing (QE or money printing) to buy bonds, including mortgage bonds and Government bonds, to try to pump up inflation.

Other central banks have printed US$15.5 trillion of money to buy Government bonds and stocks over the last decade to try to stimulate the global economy. All it did was lower long term interest rates and push up the value of existing assets such as stocks, bonds and property. It was effectively money printing to make already rich people even richer. New Zealand has been a partial beneficiary. Our stock market is at record highs and our housing market has risen in value by NZ$512 billion or 83 percent since 2008, even without money printing here.

Money printing by the Reserve Bank to buy Government bonds and mortgage bonds would give banks and fund managers more cash to lend out or invest at lower interest rates. Banks are likely to focus their lending on housing, because it requires relatively less capital, and is less risky than lending to businesses or farms. The Reserve Bank's plans to increase capital requirements for banks later this year is also forcing the banks to focus on the least risky lending that generates the highest profits, which means mortgages.

The Reserve Bank hasn't decided yet what type of unconventional policy it would adopt if it cuts the Official Cash Rate to zero percent. Adrian Orr told me last month he preferred negative interest rates to money printing to buy bonds, saying he still believed rate cuts would boost economic growth and inflation, even at these very low levels.

There is a debate on the effectiveness of negative interest rates and whether the Reserve Bank is just 'flogging a dead horse' by cutting any more at these levels, given the banks can't pass on much more of the cuts. That's because Reserve Bank rules stop them from funding new mortgages by using virtually free and short term 'hot' money from London and New York, like they did before

2008. Now banks here have to raise their money from local term deposits from very reluctant local savers.

The experience with negative or zero interest rates overseas is that regular savers won't accept very low interest rates of one percent or lower. They certainly won't accept negative rates, which would mean paying the bank money to look after their money. Banks in Germany, Sweden, Switzerland and Japan have not cut their term deposit rates below zero percent for regular savers, which means they are making a loss on that money. The perverse irony of this policy is that it has made banks less profitable and more risk averse, so they are less likely to lend out the low interest rate money in the way that might stimulate the economy.

In my view, the Reserve Bank should not do either conventional 'QE for the rich' or negative interest rates. It should either just print money and directly buy bonds off the Government, known as 'going direct' in central banking circles, or it should print the money and simply give it in a one-off grant to each resident in equal amounts, which is known as helicopter money. The even better option would be for the Government to step up and become a better monetary policy mate and borrow conventionally from international and local investors to invest in infrastructure and spend in the economy.

Both forms of money printing would be politically controversial and is no doubt one reason why the nominally independent Governor currently prefers negative interest rates. This will soon become a political debate. My view is the OCR will be cut to zero by this time next year. ANZ Economist Sharon Zollner forecast this month that the OCR would be cut to 0.25 percent by the middle of 2020.

Either way, interest rates will keep falling and the most conventional type of unconventional policy, money printing to buy mortgage bonds, would further boost house prices, particularly if there is not much of a supply response to the higher prices.

The Government is not doing much to boost new housing supply or help the Reserve Bank with a fiscal policy stimulus. Treasury forecast its May Budget would actually subtract from the economy by a total of 1.2 percent of GDP over the next three years because the Government has delayed its capital spending plans for road and rail. New motorway building has virtually stopped because the Government wants to build railways, but the railways have also been delayed, because the Government does not want to breach its self-imposed debt limits and councils also won't borrow more.

The Government also announced this month it was dropping its KiwiBuild target of 100,000 homes over the next 10 years, saying it was too ambitious and the early homes were built in the wrong places. It lowered the deposit requirement for KiwiBuild buyers and allowed more than two people to use their KiwiSaver money for a deposit for a first home. Both measures will increase the amount of demand for existing homes.

The Government also refuses to borrow to pay for the necessary housing and transport infrastructure in the big cities to ramp up the production of more affordable medium density homes that potential KiwiBuild buyers could afford. It promised not to borrow much before the 2017 election and doesn't want to break that promise. Councils are also refusing to pay for the infrastructure needed for such a building effort, given ratepayers who vote won't accept the higher rates needed to fund the infrastructure.

The end result is there are plenty of supply and demand drivers to support house prices, including that net migration is rising again because the Government has increased the number of temporary work visas on issue and working holiday makers continue to pour into the country. Over 340,000 new work and student visas were issued last year.

Most economists now expect Orr to cut the OCR to as low as 0.5 percent or lower by this time next year because of a slowdown in economic growth globally and here, which would add to deflationary pressures.

Inflation has not sustainably reached the central bank's 2.0 percent mid-point target for nearly eight years and unemployment is now rising. The bank also now has an extra responsibility to help create full employment. Some have asked why all the money printing and rate cutting globally over the last decade has not 'caught fire' and generated inflation.

There are two reasons. Firstly, the money printed was given to already rich people, who simply recycled it into savings or bought already existing assets such as land or stocks, rather than spending it or investing it in new businesses. Secondly, the advent of the smart phone in 2007, rapidly rolled out to billions of consumers and producers, is globalizing once-inflationary areas of local economies in services, which include financial, medical, educational, media and professional sectors.

These disinflationary pressures are endemic and are forcing central banks to try extreme measures. Orr said he was trying to get ahead of the curve with the rate cut and has said he is very focused on avoiding a drop in inflationary expectations. The latest business confidence figures showed 'own activity' measures at their lowest levels since 2009. The own activity measures are not nearly as politically biased as the wider economy measures.

The tailwinds for house prices are most evident beyond the two biggest cities and the Waikato and Bay of Plenty, which are also slowing in Auckland's wake. Housing markets in Hawkes Bay, Wellington, Nelson and Dunedin are still busy and rising as they play catchup with Auckland's big rise from 2012 to 2016 and their populations grow.

Key things to know:

- House price inflation was broadly flat in August in Auckland because prices are beyond affordable levels for first home buyers, the Reserve Bank is limiting landlords and banks from using their equity to the full to buy many more properties, and foreign buyers have been banned.
- Christchurch prices are edging lower because housing supply was responsive there because the RMA was suspended, and the Government suspended its own debt limits in the wake of the earthquakes to help build housing infrastructure.
- Wellington prices were up 8.3 percent from a year ago, while prices in Hamilton and Tauranga were up 5 percent. Dunedin, Invercargill and Nelson are still rising 12-16 percent from a year ago. These cities are still catching up with Auckland's 2014-17 surge and also face the same RMA and debt limit constraints that everyone but Christchurch faced.
- The Reserve Bank is expected to cut the OCR by another 25 basis points at its mid-November Monetary Policy Statement, possibly followed by one or two more in February and May next year.
- Banks have dragged their best advertised fixed mortgage rates down to 3.5 percent and could drop them towards 2.99 percent by this time next year if capital controls aren't too tough and the OCR is cut towards 0.0 percent, as I expect.
- The key variables to watch in 2019 are Adrian Orr's views on unconventional monetary policy, global interest rates, Europe's political and economic dramas, the Chinese economy and Donald Trump's twitter account, in that order.

By Bernard Hickey