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.

When The Barrel's Empty

The global financial crisis was caused by an over-supply of over-priced houses causing plummeting prices and huge losses for those who financed the excess construction (the builders had a boom!). The situation arose because of an official policy by the US Federal government to boost home ownership in the 1990s encouraging a relaxation of lending standards, blind eyes being turned to such laxity, and the US roller coaster encouraging similar surges overseas.

Home buyers borrowed too much, banks lent too much, investors financed bank lending too willingly, and central banks and rating agencies miscalculated the riskiness of the lending products. Egg on everyone's face in other words from too much credit flying around.

As house prices corrected downward and the falls backwashed into securities backed by house values investors dumped such products, banks recorded huge losses, investors backed away from banks, and for about six weeks over September – October 2008 the world stood on the cusp of a new Depression as the global banking system seized up. Courtesy of hefty injections of cash by central banks, major interest rate reductions, and eventually easier fiscal policies we saw a 1930s repeat avoided and green shoots appearing in March 2009 in the form of economic indicators falling at a slowing pace in the United States.

After that a huge sigh of relief around the world caused sharemarkets to recover, housing markets to rise, confidence levels to soar, and currencies of risky countries such as NZ to jump sharply. We soared from less than US50 cents in early-2009 to over 76 cents by year's-end.

Then things started to falter as the life giving gasps of breath of 2009 as economies surfaced from beneath the waters gave way to laboured breathing as attention turned to high government deficits and debt levels, Greece of course, the unwillingness of businesses and households to borrow and so on. To counter this post-GFC weakness central banks decided the best thing to do to spur things along would be to pump more credit into the world economy through direct money printing and sustained, falling, interest rates. Basically, the central bankers decided to engage in a hair of the dog that bit them exercise of recreating the loose credit conditions of pre-GFC while at the same time working with banking sectors to boost capital bases and lending practices ready for the next crisis.

As monetary policies stayed loose however the economic outcomes failed to reach levels desired by all, yet each time a new bout of the heebie jeebies went through investors the fear and selling quickly turned to buying as central banks eased policies even further. In fact things eventually reached the stage whereby bad economic data would be greeted by rising share prices in anticipation of lower interest rates and more money printing. Money looking for a home and ending up in shares and commodity futures.

But all that cash sloshing around the world had some major deleterious impacts. As investors sought yield in a low interest rate world assets like residential property prices got bid back up again along with commodities – witness our dairy boom. And as investors, finding themselves flush with cash, kept firms afloat which pre-GFC would have been closed down and their parts flogged off, excess quantities of goods appeared – especially in China which engaged in a huge series of stimulatory packages from 2009.

Worries about deflation resulting from excess production and altered consumer, business, and wage earner price-setting behaviour led to more easing of monetary policy, more cash, more over-valued assets, more excess production.

And investors started to act on the new reality of sustained low inflation and central banks not likely to raise interest rates much for a very long period of time. They flooded into low yielding bonds. And as this was happening imbalances in some markets like oil and dairy products brought logical big falls in prices. And at the same time China's economy lost the puff created by the mother of all stimulatory programmes focussed on construction from 2009 at the same time as the period arrived for it to transition from growth driven by exports, manufacturing, and fixed asset investment to services and consumption. Unfortunate timing.

Which brings us to late last year. An environment of the following.

-Worries about the impact of the first US monetary policy tightening since 2006.
-Worries about global growth as China continued to slow.
-Worries about unstable capital flows associated with expectations of a probable big devaluation of the Chinese yuan.
-Worries about major asset and profit write-downs in all businesses associated with the energy sector.

Which brings us to where we are now with the two new big worries driving markets downward. The first is concern about bank profitability as write-offs will have to be undertaken for exposure to the energy sector, slowing economic growth, and tight margins caused by sustained low interest rates.

The second is the killer and it goes right back to one of our main comments/warnings from late-2009. We warned that because of the massive easings of fiscal and monetary policies to fight the GFC, the next time a big hit came along governments and central banks would have very little dry powder to help insulate their economies.

In fact central banks have used the past six years depleting their remaining dry powder reserves trying to stimulate their economies – and they have failed. We wrote that central banks cannot create growth. All they can do is buy time for the private sector to get back on its feet and start investing and growing naturally with the sugar hit of low interest rates and loose liquidity eventually being taken away. But while time has been bought, governments needing to create better conditions for growth have failed to restructure their economies (Japan and Europe), and businesses used to loose monetary conditions have shuddered each time at the thought of the sugar disappearing. And in multiple countries including New Zealand, Australia, Europe, and now the markets speculate perhaps even the US, the sugar bowl has had to be put back on the table with interest rate rises being reversed – twice in our case.

And now here we sit with analysts concluding that central banks have failed to stimulate growth, forgetting that such is not their job on a sustained basis. But the conclusion these analysts reach is nonetheless the same as if they did have better understanding of the role of central banks. There is nothing left that central banks can do of any great magnitude to boost growth any longer. The realisation that central banks have become near impotent as a buffering factor for weak economies is sweeping the markets reinforced by the sheer desperation shown by the Bank of Japan in introducing a negative interest rate. The Japanese economy recorded no growth in 2014 and only 0.4% in 2015.

So what is going to happen now? Commercial banks will be able to finance themselves so a credit crunch scenario as happened awhile over 2008-09 is extremely unlikely. But funding costs may rise briefly until losses have been revealed by large lenders to sectors such as energy. Little interest rate rises will get lost in the wash of central banks still easing and introducing negative rates so businesses and households won't back away from borrowing because of debt servicing costs.

Growth forecasts for this year and next will get revised down slightly, inflation will stay low and deflation worries persist, and businesses will look to boost productivity to cut margins facing downward pressure from easing retail prices in some countries.

But here is the key thing which means that even though central banks have become toothless tigers, the world economy will do alright. The world is awash with cash. The cash is looking for a home. Some of that cash will be eagerly used to purchase the assets of distressed businesses more than would have happened in the past because return on investment hurdles are lower than pre-GFC.

Thus underneath what for the next few years will be a series of bouts of market turmoil and negative headlines, capitalists will be buying and restructuring companies which can't hack it, new technologies will continue to be developed and implemented, and countries with specific driving factors such as we have will enjoy strong currencies and migration inflows as they will look so much better than other places.

But in areas where these economic forces are not free to function – much of Europe and Japan – the aversion to pain will produce more useless policy easing, rising government debt, and eventually long-term capital flight to other parts of the world – America, Asia, and Australasia. Not Eastern Europe because of the deteriorating situation between economically failing Russia and economically stagnant Europe. Not the Middle East because of the munted energy sector and war. Not Africa because as the sugar of huge Chinese investment passes without political, social, institutional, and legislative structures being reformed, old under-performance will return.

Dairy

Speaking of under-performance – dairy. For a number of years now it has been as politically incorrect to say anything negative about the dairying sector as it is to say cats should be killed. (I was jumped on by many 10-15 years ago for predicting a sub-$3 payout.) But thankfully we have been able to slip in a few reality checks along two themes. The first has been an observation from practising economics since the mid-1980s that while we can all generally make some good reasoned predictions about where demand for a commodity will go, we are all completely hopeless at forecasting supply growth – be that for oil, iron ore, coal, LNG, beef, wool, or of course milk. And if you can't accurately forecast both supply and demand changes then you have no hope of predicting prices.

Currently the Europeans in our media are being "blamed" for producing too much milk and depressing prices. But here in New Zealand we have invested in high cost feeding out regimes, pushed into more marginal land, and focussed capital on more and more milk production – rather than avoiding what has been our second theme – not going up the value added chain.

We have failed to radically boost the proportion of our milk going offshore as highly processed high margin items. The usual example is infant formula. To boost value added capital needs to be invested in such things. But that means lower payouts to farmers in the short to medium term. Yet farmers have raised substantial debt to boost production by buying increasingly expensive land and animals so they have made it clear that maximising the payout is everything and capital cannot be retained in any great magnitude to take dairy cooperatives up the value chain. And this will never happen in New Zealand. In dairy all we will ever be primarily is a bulk producer of milk which we dry out and bag for someone else to reliquify or process further.

Why? Because dairy farmers enter the industry taking on the daily challenge of working the land, working with their animals, handling the weather, the pests, the diseases, the regulations, the sheer unpredictability of so many things around them with the aim of extracting maximum milk from the land available to them. (Same as sheep and beef farmers for meat.) And the industry has a great career structure for doing this. Few aim to make enough capital as quickly as possible so they can get their organic infant formula from named animals into Asia. Some do. The vast majority don't. Dairy re-investment occurs almost always back in the land by the farmers, not up the chain.

Under the cooperative structure where someone will buy everything you produce once you are in we cannot rely upon dairy to lead our economy to higher wealth. Or any other commodity which we minimally process. But why then has our economy grown so long on the back of some animal? Because for a long time we were a low cost producer of high quality products. Now we are not so cheap, and other countries are getting in on the game as they try to boost their domestic food security. China has barely started on milk.

But this is not an argument against our primary sector in the end – only a reminder that our farmers survive as a driving force behind our economy because of what drove them to the land in the first place – acceptance of a challenge, willingness to learn as much as possible on the job and proudly teach it to others, and to change land use when the numbers demanded it.

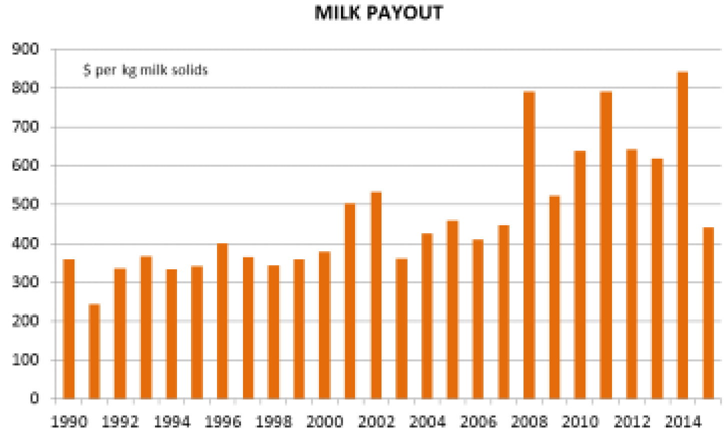
That is the crux of it and the best current illustration is the land being given over to growing manuka bush for bees to feed on to produce high value manuka honey. Exports of honey from New Zealand are now worth $300mn. In same dollar terms that is where the wine industry was in 2002. Wine exports are now worth $1.5bn. Some farmers are also converting to milking goats.

As long as land use can freely change in New Zealand then farming will always be a key part of our economic base, though it won't take us up the OECD ladder and that is why we need the Auckland agglomeration and the talented people developing and implementing new technologies. Only if a government were to ever try and retard that land use change process with artificial support mechanisms would we sink – like in the 1970s up until the painful removal of SMPs. Google it young ones.

And why have I written this? Because for the first time in over two decades whilst speaking at a conference last week of people involved in the animal industry, someone asked if it might be a good idea for the government to help dairy producers with a price support mechanism. Then it happened again at a different session this morning in Matamata.

It would never work because farmers would not give up payout in good times, because no-one knows what average level payout can be accurately assumed for the next decade, because the taxpayer has in the past bailed out farmers who in the 1970s and 80s benefitted from price equalisation schemes set with prices too high, and because it is necessary in all sectors that when hard times come the most indebted and highest cost units get weeded out. Same as happens in every other sector.

If price stabilisation is important then each farmer could have done it for themselves with a special bank account. The old hands probably did by keeping debt down. They will be the ones buying some of the assets which will come on the market in the next two years. Like they did in 2009, 2003, and 1991.



Housing

What things cause house prices to fall and are any of these things likely in the near future?

Soaring interest rates.
-Nope. Our central bank is under pressure to cut rates further following last year's 1% reduction in the official cash rate, central banks overseas are either easing or delaying planned rises, and one of the factors causing recent sharemarket weakness has been worries about deflation. In NZ inflation is just 0.1% and the RBNZ has found itself unable to get headline inflation back into the target range of 1% - 3%.

Soaring house supply.
-Nope. Courtesy of massive net migration flows NZ population growth is picking up. NZ's average population growth rate is 1.1% per annum. Growth last year was 1.9% following 1.5% in 2014. Since 2006 the population has risen by 411,100 people. At an average nationwide house occupancy rate of 2.7 people that

means a need for 152,000 houses. Since 2006 consents have been issued nationwide for 204,000 houses. With some 80% of consents estimated as adding to the housing stock this means 163,000 extra houses. Take off about 12,000 houses in Christchurch removed from the available stock by the earthquakes five years ago and things are about in balance until you allow for an aging population bringing more households of just one or two people. So no over-supply BUT.

Auckland has a big and worsening shortage. Many other parts of the country will have an over-supply. So if you are an Auckland investor jumping boots and all into the regions buying what you consider to be cheap properties with good yields be very, very careful. Those locals giggling outside the dairy may not be laughing at the latest headlines regarding some celebrity, but at you. Watch for investors whipping back toward Auckland once this run of regional growth peters out perhaps early next year.

Migration outflows.
-Nope. The net gain last year was 65,000 people, our economy is in good shape compared with others, we are distant from worsening geo-political situations offshore, and the commodities boom has been and gone in Australia. Annual flows will likely peak this year but the easing off is likely to be very gradual and occur over many years.

NZ Dollar

The NZD has weakened over the past week despite dairy prices falling much less than expected in the fortnightly auction (but they still fell 2.8%) and retail spending rising more than expected, mainly in response to low inflation expectations recorded in a quarterly Reserve Bank survey. This survey rarely receives any attention but has taken on increased importance because of low 0.1% inflation in New Zealand, the Reserve Bank's displayed failure to forecast inflation accurately any longer (they are in good company), their displayed failure to boost inflation (again not alone there), and the way monetary policies elsewhere are being eased anew as inflation readings track lower and lower.

Basically the expectation is building that the RB will have to follow the offshore trend and ease monetary policy – which in itself gives us an answer to the question of whether an easing or two this year will much depress the NZD. It won't because policies are also being eased elsewhere. Maybe more than that however, policies are being eased offshore in economies with low inflation and weak growth. We also have low inflation but good economic growth.

For exporters the message here remains the same. Now and then the NZD will have a decent run downward but it probably won't stay low for long given our economic state relative to other economies. It might be a good idea to boost hedging whenever we approach US 60 cents and AUD 90 cents.

You will find current spot rates here. http://www.xe.com/currency/nzd-new-zealand-dollar

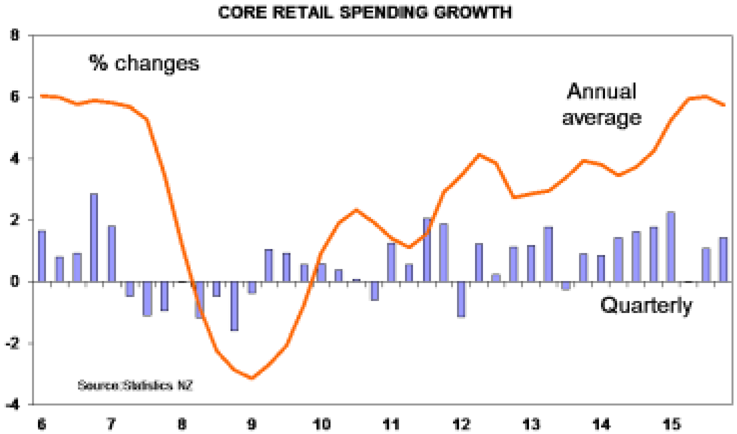
If I Were A Borrower What Would I Do?

Personally I would fix three years at 4.49%. It is true that rates may go lower if the Reserve Bank eases monetary policy again. But there is some upward pressure on bank funding costs offshore currently because of worries about European banks. Plus the NZ economy does not need a boost from even lower interest rates, as evidenced by the strong growth in retail spending discussed just below. The only argument in favour of lower interest rates comes from inflation persistently under-shooting the target range. But the RB will not feel the need to lower rates to try and boost inflation if it believes doing so will not in fact boost inflation. Offshore the easiest monetary policy settings ever seen are not lifting inflation and wages growth is slowing in the UK, Japan and Europe therefore there seems little reason for believing lower rates here would suddenly alter pricing behaviour.

In addition there is no evidence that people are worried enough about deflation to put off buying durable and discretionary items. That is a key argument against letting deflation development – that people will stop buying to wait for lower prices and the longer they wait the weaker their spending, the deeper the recession, the further the price falls and so on in a Depression spiral. We are not in recession so that deflation link is completely different from the environment we all think of and fear when saying deflation must be avoided, the 1930s Great Depression.

For Noting

We consumers have been doing a lot of spending recently with strength assisted by falls in petrol prices, a tourism boom, strong population growth, reasonable jobs growth, and low interest rates. In seasonally and price adjusted terms core retail spending (no cars or petrol) grew by 1.4% during the December quarter after rising 1.1% in the September quarter. Full year growth was a very strong 5.8%.Spending growth on durable goods was even stronger at 3.6% for the quarter and 10.6% for all the year.



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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