# BNZ Weekly Overview

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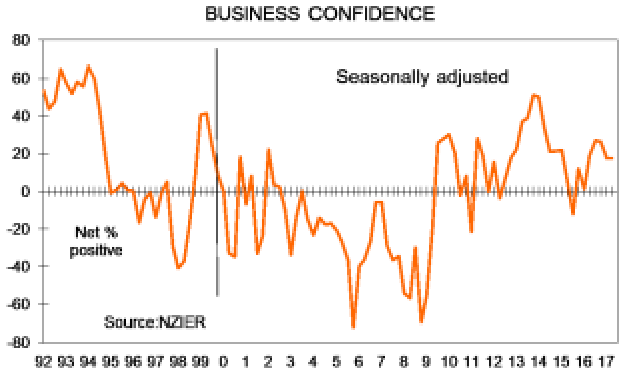
## Mission Statement

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

## September 23

The opinion polls following the appointment of Jacinda Ardern as Labour's leader show an increased chance of a government after September 23 led by Labour, though the polls also still favour return of a National-led coalition. If Labour do govern then this will be the first time Labour have come to power after an extended period of a National government since 18 years ago in 1999. What happened back then?

The 1999 general election was held on November 24 that year. Business confidence as measured by the NZIER's Quarterly Survey of Business Opinion declined from a seasonally adjusted net 25% positive in the September quarter of 1999 and 9% in the December quarter to -33% in the June quarter of 2000 and -35% in the September quarter. This collapse in business sector sentiment was known as the "winter of discontent".




Consumer confidence fell from positive territory readings of 115 and 121 late in 1999 to 104 and 98 respectively in the June and September quarters of 2000. Sentiment did not fall as much as for businesses and barely turned net pessimistic.

The annual pace of jobs growth accelerated from 1.7% in the September quarter of 1999 to 2.3% a year later. Firms were unhappy – but they kept hiring. Why the collapse in business sentiment?

Probably three reasons. First, the Reserve Bank was tightening monetary policy at the time, taking the official cash rate from 4.5% just ahead of the election to 6.5% come May 2000. Second, Labour replaced the Employment Contracts Act with the more union-friendly Employment Relations Act, a 39% top personal income tax rate was introduced even though fiscal projections showed no deficit hole needing to be filled, and businesses accustomed to easy conversations with the previous National government found doors less open with the new Labour-Alliance coalition.

In other words, the business sector got the pip because they felt they were not being listened to and worried about what further reforms might lie down the track. Consumers in contrast got the government they wanted.

Eventually the business sector learnt to live with the change in policy orientation, and the new government learnt to slow down the pace of reform. But before then the third factor came along to crush business sentiment – the Dotcom crash from March 2000.

Come the end of 2000 business confidence was back at a net 18% positive. GDP growth was 4.5% over 1999, 4.3% over 2000, and 2.5% over 2001. 1999 into 2000 growth was assisted by the bounceback following the Asian Crisis of 1997/98.

Is it likely that we could see a similar collapse of business sentiment if a Labour etc. government is formed as a result of September's general election? The probability does not seem high.

- The electorate currently does not appear to be suffering fatigue after an extended period of on-off reforms, so implied if not explicit support for anti-business policies does not appear as strong as back then.
- The Reserve Bank do not expect to be raising interest rates until the end of 2019.

- The economy has good momentum from big sectors like primary activities, tourism, construction, and an ongoing migration boom.
- Labour are planning a fiscal boost above current government projections of about $7bn over four years, and this will add further to the pace of economic (business) growth. But it will also place slightly greater upward pressure on inflation and interest rates at the margin.
- Labour's policies regarding the labour market are less radical than in 1999, though considerable uncertainty surrounds the depth and spread of changes which could result from the planned Fair Pay Agreements stretching across industries.

Nonetheless, if there is a change in governing party it would be unusual for business confidence not to fall to some degree because a new mix of people, policies, and ideologies will be in charge after nine years of National.

Some momentous things in the political sphere have happened in recent weeks and we cannot know to what extent current polls are merely capturing unsustainable shifts in sentiment. We also have the examples of Brexit and Mr Trump to remind us that outcomes can defy what popular polls show. And it pays to remember the comment by Prime Minister Jim Bolger on election night in 1993 when things did not turn out quite as nicely for National as the polls had been suggesting – "Bugger the pollsters."

As he told Mediawatch in 2004.

"I stepped back to the polls and expressed "bugger the pollsters" because in that '93 election the polls had all moved consistently in favour of the National Party and all the last polls had us eight to ten points ahead, including the one that was released on the night of the election, taken on the day before on the Friday, it wasn't allowed to be released, which showed us eight or ten points ahead. In the event of course, on the night we got about half a percent ahead of Labour – if that."

## Nuclear War

What will happen if there is a nuclear war involving North Korea?

That was the question asked of myself at a recent presentation. My response? We have to ask ourselves what usually happens with financial markets, housing markets, economies overall when we have a nuclear war. There has never been a dual exchange nuclear war – just two nuclear attacks in 1945 at a time from which no lessons can be gleaned for modern economies and financial markets given the effects of the preceding global conflict. (WW2)

It would depend upon whether the weapons generated air bursts or ground bursts. It would depend upon which way winds were blowing at the time of detonations. It would depend upon which countries specifically were involved in the exchanges and which might be seen as potentially joining in. It would depend upon which trade routes were affected, which production locations and their role in global manufacturing supply chains, which centres of consumer spending power, which financial centres.

In other words – not able to be easily modelled, especially as current models can't even generate accurate wages growth, inflation, and interest rate forecasts currently.

Best guess then? It seems like it would be a negative thing which would cause a collapse in business and consumer confidence therefore a decline in levels of business hiring and investment, bank lending, and consumer spending. Economies would probably go into recession depending upon conflict duration in particular.

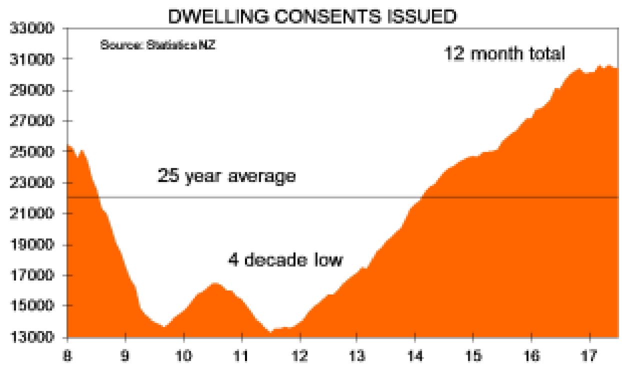
Interest rates would fall. Currencies of attacked countries would probably fall. Currencies of peripheral commodity-dependent countries like New Zealand would probably fall. Interest rates would decline with central banks cutting official cash rates and providing liquidity to institutions affected by a drying up of funding sources – New Zealand banks in particular given dependence upon foreigners for some 31% of the lending which occurs in New Zealand. Gold prices would rise along with the Swiss franc and the Euro plus the British Pound.

Sharemarkets would decline sharply, house prices would almost certainly fall across the board. But again, it all depends massively upon conflict duration, spread, how initial attacks would metastasise into conventional warfare, and after-effects like radioactive ground zeros and fallout zones. Duck and cover. And never look at the blast. If there are sufficient ground bursts the resulting dust thrown into the atmosphere could produce the Nuclear Winter effect much analysed in the 1980s and that would cool the planet thus offsetting global warming to some extent!

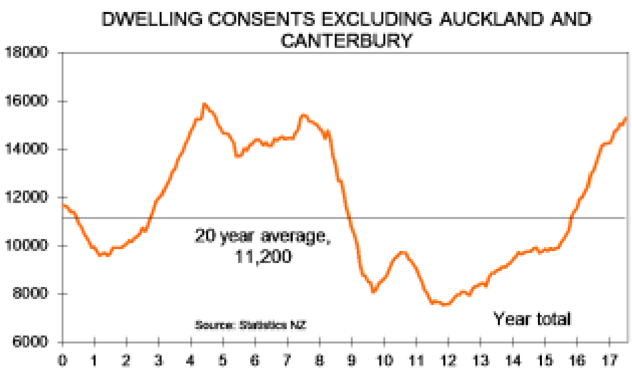
## Housing

The number of consents issued for the construction of new dwellings fell in seasonally adjusted terms by a tiny 0.7% in July after falling 1.3% in June. In the three months to July numbers fell 1.6% from the previous three months which recorded a rise of 11.8%.

Things are a bit volatile but the best picture is perhaps provided in this instance by the 12 month total. This sits at 30,404 which while ahead 4.5% from a year ago has basically been flat since October. Nationwide issuance has stopped growing. Where?




In Canterbury over the past year consent numbers have fallen by 19% and the trend has been firmly down since late-2015. In Auckland annual numbers sit at 9,955 from 10,268 in June and 9,960 in September last year. In the rest of New Zealand annual numbers sit at 15,269 from 13,769 in September with a firm upward trend in place still.




Thus Canterbury is falling, Auckland has no growth, the rest of New Zealand is still going up. In Auckland a shortage exists. Strong population growth is expected. Supply growth is inadequate. The price implications are obvious outside of some areas likely to fall in the coming year as over-extended investors sell down.

In the regions supply growth has been rapid but population growth is unlikely to meet the expectations many people have in some places. So price risks exist in the regions.

## LVRs

Yesterday in his final speech as Reserve Bank Governor Graeme Wheeler reiterated points already made by the RB recently with regard to the conditions under which LVR rules will be loosened.

The conditions set by the RB for LVR removal are
-Signs that financial stability risks have eased.
-A degree of confidence that these conditions won't worsen again when LVRs are removed.

The RB feel that financial risks have eased. "**However, the underlying drivers of housing demand (population growth, low interest rates) remain strong with housing demand still outstripping supply. There is a risk of a housing market resurgence (and a sharp lift in high LVR lending) if LVRs were removed at this time. The Bank will continue to review developments, bearing in mind that removal could be made in stages as a safeguard to a resurgent market.**"

In other words, the RB wants to be fairly sure that the housing market will not take off again. But like the Federal Reserve contemplating reversing money printing they will eventually have to bite the bullet, make a change, and see what happens. When might they be willing to undertake the first LVR easing?

The stock of home lending at an LVR greater than 80% has fallen from 21% at the time of their introduction in October 2013 to 8% now. Because banks have prioritised lending to first home buyers their share of real estate buyers has remained close to 21%.

Given that growth in house supply in Auckland has stalled while net migration flows continue to surprise on the high side, and it was Auckland's

boom which drove the TB to introduce LVRs, a change in LVR rules does not look imminent. The chances are that when it happens it will take us by surprise – maybe late next year if Auckland prices stay flat. And if thoughts of that get you and your friends excited about house prices rising at a strong pace again, then you'd best not let the RB see your communications because if they sniff such excited anticipation they will leave the rules in place.
https://www.rbnz.govt.nz/research-and-publications/speeches/2017/speech-2017-08-30

## If I Were A Borrower What Would I Do?

Increasing tensions on the Korean peninsula, the economic hit from Hurricane Harvey in the United States, and reducing expectations of a decent tax cut package in the United States have pushed US bond yields to their lowest levels since November last year. The US ten year government bond yield is near 2.13% from around 2.3% a month ago.

Where yields go from here (and therefore broad pressure on NZ medium to long term borrowing costs) depends not just on these developments, but also next month's comments from the Fed. regarding unwinding money printing. That is, with a balance sheet of some $4.5tn the Fed wants to start reducing it and withdrawing funds injected into circulation post-GFC through their buying of government bonds. Their buying injected money into the US economy because they bought bonds to finance the US federal deficit private investors would otherwise have purchased. Those investors were left with cash in their bank accounts which they looked to invest somewhere else. The flood of spare money seeking a home has pushed up asset prices such as for shares and property.

Presumably then, as the Fed. takes cash from Treasury when the bonds they hold mature the replacement bonds which Treasury will sell to the public will withdraw money from circulation. This will both deliver some unknown upward pressure on US interest rates whilst producing a withdrawal of some funds from other assets.

It is anyone's guess as to how much US interest rates will subsequently rise and how much other asset prices will weaken. This uncertainty in the context of a US economy having a long but not strong post-GFC recovery has left the Fed. wary of so far announcing money withdrawal. And the uncertainty means that when they do announce timing for withdrawal the actual programme followed could be a stop-start affair at the whim of fluctuations in the US economy and market sentiment.

This Friday night the monthly employment numbers will be released and if they are strong the Fed. will feel that they will be on safe ground soon announcing money withdrawal. When and if they do we will get the first indications of what the impact might be in US financial markets.

Locally this past week or so we have seen no large changes in wholesale interest rates or expectations for New Zealand's monetary policy track.

Were I borrowing at the moment I would personally be inclined to have a bit floating (perhaps 20%) to allow for cost-free early repayment or loan offset through the Total Money facility. The rest I would fix for one, two and three year terms at 4.59%, 4.79%, and 5.09% rates respectively.

## NZ Dollar

Yesterday in his speech the Reserve Bank governor made the common comment that "a lower NZ dollar is needed." It is perhaps time for this politically correct way of talking about the NZD to end. The NZD is not trending down as we all assumed and expected from the 1980s, it is possibly trending up although short to medium term fluctuations will be all over the place.

Why an upward rather than downward trend? Tomorrow the terms of trade data for the June quarter will be released. We expect to see that our terms of trade will have hit a record level – higher therefore than the previous peak in 1973 which occurred just before everything really turned to custard courtesy of the first oil price crisis, the UK entering the ECC, and subsequent very bad policy decisions in New Zealand.

The common way of thinking for a long time has been that New Zealand produces the wrong mix of exports, we need to shift toward manufacturing, we need to reduce our dependence upon imported energy, we will continue to lose our young and skilled people to better paying and more interesting jobs offshore, and we will not be able to attract capital from the rest of the world.

But consider our export mix. It is true that exports as a proportion of GDP have not grown in decades. They may even be declining whereas in most other countries the trend has been upward. But there is something very important to note here. Almost everything which we export from New Zealand is produced almost entirely in New Zealand – milk, meat, wood, tourist experiences, etc. In contrast other countries tend largely to export manufactured goods and the components for these exports have invariably to a large extent been imported from somewhere else. Their export numbers are boosted because of churn from imports. So comparing lack of growth in NZ's exports to GDP ratio compared with other countries since the 1970s is not valid.

Second, consider our import mix – manufactures and energy. Oil prices have taken a structural shift downward and no-one these days talks about Peak Oil. Instead we talk of Peak Demand for oil – the time soon when global consumption of oil will start to decline. And for manufactured goods, this is where competition between producers is immense. All the time companies must be looking for the next source of cheap labour, the next cost-saving innovation, the adoption of robotic production techniques.

Third, consider demand growth for our exports. Rising incomes throughout Asia are delivering strong demand for our outputs.

Now add in the structural shift in our long-term migration flows from net losses and everyone asking the last one out to turn off the light, to strong net gains increasingly expected to be sustained at high levels for many, many years. Political parties are competing with each other this election to come up with policies to stem the flood.

Now add in the good reputation of New Zealand in global capital markets – deregulated economy, stable government, educated workforce, strong trade agreements and so on.

It all adds up to massive erosion of the long-standing popular view of the NZD – that it is destined to decline because we run current account deficits, we export farm products, and everyone is leaving.

And the final kicker is this. The comments regarding the need for a lower NZ dollar are completely at odds with the deafening silence from the export sector regarding the level of the currency. No-one seems to be complaining about it except the old dinosaurs still dreaming of a Muldoon resurrection.

It is time to change the old mantra regarding our currency needing to go down because our exporters are inefficient and cannot stay in business without ongoing depreciation. Thinking and analysis needs to reflect the true state of New Zealand these days and not memories of the horrors of the 1970s and 1980s.

The long-term trend for the NZD is likely to be upward – but remember that there will be large fluctuations along the way and at the moment the NZD is going through a little weak patch.

**If I Were An Investor ...I'd see a BNZ Private Banker**

The text at this link explains why I do not include a section discussing what I would do if I were an investor.
http://tonyalexander.co.nz/regular-publications/bnz-weekly-overview/if-i-were-an-investor/

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 at www.tonyalexander.co.nz
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