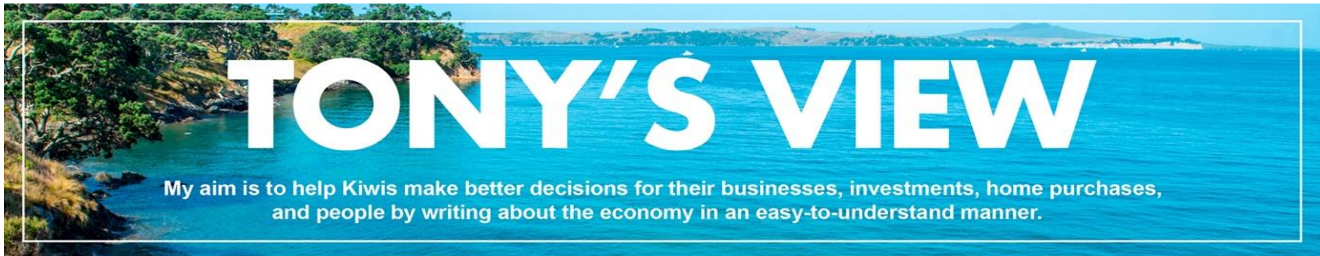

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Recession and business failure

The technical definition of a recession in most countries apart from the United States is two quarters in a row of negative growth. What that means is that one's economy might shrink 0.1% in one quarter and 0.1% in the next and that makes for a recession.

We have all been taught that a recession is a bad thing and that one's government and central bank should do something to either prevent a recession from happening or to make sure it is only shallow and short-lived if at all possible.

But a recession is like a fire allowed to spread through the Australian bush without being extinguished as quickly as possible by overly zealous fire brigades. The more that such events are immediately stamped out the more the quantity of fuel which gets built up for the next event.

The greater the quantity of fuel the higher the temperatures generated and the greater the damage. Parts of Australia have been so protected from fire for so long now that when a fire does make its way through, the gum forests are wiped out never to return. A normal fire doesn't do that. It frees the seeds for new trees to grow amongst the existing ones.

By preventing recessions so assiduously in recent decades central banks and governments have allowed a lot of dead combustible wood to build up in their economies. Low interest rates and the printing of money have allowed businesses to stay in operation well beyond what they would have done without such trigger happy activism by the authorities.

Because capitalism is a process of creative destructionalism the prevention of sufficient destruction has left valuable resources locked up in inefficient activities. This helps explain why productivity growth has been so low for so long, especially since the Global Financial Crisis of 2008-09.

Around the world there is a need for a decent cleaning out of old brush and some of the weakness we are going to see in our economy this year will reflect some of these inefficient enterprises being removed. This is a positive thing for all but the people owning the

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businesses and the employees until they find new employment.

Good time for a recession

That is where this is perhaps the most opportune time to have a recession in decades. Demand for labour is so strong that the people laid off will be able to find new jobs in an extremely short period of time.

This is not an argument for efforts being made to create a recession. But it does mean that if central banks feel they might need to throw their economies into a recession in order to suppress inflation, they will have more than just that inflation suppression available as justification for acting so strongly.

Recession removes a buffer

It is still not certain that our economy will go into recession, and frankly if we do then for most businesses and people it will not mean anything negative. If your economy shrinks by 1% then 99% of previous activity is still occurring. So, why do we worry about recessions?

Because we know some people will be pained and if that happens to be you, then this is the message you perhaps need to hear. For the bulk of businesses which will close down or shrink to bare survival levels in the coming year, it won't be because of something you have necessarily specifically done wrong.

We are living through one of the most uncertain economic environments which any of us have seen. In this climate we are seeing government agencies with large numbers of economists and analysts failing to develop and implement optimal policy settings. If they get it wrong, then you shouldn't feel too bad if you do as well.

The things which have made the current business environment so difficult to predict and navigate through include the following.

Pandemic

We are living through the first global pandemic in modern economic times. Clearly, going by the forecasts we all made in the first half of 2020, none of us had the foggiest idea what impact a pandemic would have on our economies. We did not remotely accurately predict the impact on the pace of economic growth, employment, construction, retail spending, or prices for assets like shares and property.

If you have got your business forecasts wrong in the past couple of years, you are in excellent company with the world's brightest economic and business minds.

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Bad monetary policy

Central banks like our own Reserve Bank have become a source of economic instability and a direct cause of tens of thousands of young people being shut out of the housing market and perhaps now shifting to Australia, and businesses now failing.

By over-stimulating the economy and asset markets people geared up for unrealistically strong levels and rates of growth of business activity and house prices. Now that overly stimulatory monetary policy is being unwound there is a whipping back the other way of our house prices, and the mother of all reality checks now hitting the residential construction sector in particular.

None of us necessarily thought our central bank could be this bad. We were wrong.

Russia's invasion of Ukraine

Russia's appalling actions have caused sharp jumps in prices for energy and food. This has added to the current severity of interest rate rises being engineered by central banks and caused a soaring cost of living which is worsening the pullback in household spending already underway.

No-one can be blamed for failing to see these price surges.

China's Covid management failure

China has failed to vaccinate its population with effective vaccines. Their home-grown vaccines use old technology and even as they now shift towards modern products, they risk not being able to keep up with the newer, more highly transmissible variants.

The following of an eradication strategy dropped by the rest of the world has caused new disruptions to supply chains which could easily continue all through 2023.

Climate change

The weather appears to be getting wilder at a hastening pace and the reality of what will happen as global temperatures climb further may only just be settling in.

For many businesses there are changes which have to be made not just to contribute to emissions reductions, but to allow for the heightened inundation risks for many locations. Also, inundation events will interrupt supply chains and further make business planning and operations more difficult.

The need to run higher inventories of vital components and finished stock is an extra business cost which needs to be taken into account.

Labour availability problem

New Zealand's unemployment rate is at a record low of 3.2% and businesses cannot find the skilled and unskilled staff they need, and which customers expect to be in place when they place their orders. This problem has existed in many sectors for some time but has become a critical issue in the travel sector where a surge in demand from people wanting to exercise their freedom to travel has run up against a structural shift of people out of the sector.

In condensed time the airline industry is experiencing what the building industry is still going through. The collapse of house construction around the world during and after the GFC saw many people leave the sector and many others choose not to acquire construction skills.

It might not take as long to train someone up to shift bags as it does to build a house. But the sheer number of people affected by the labour shortage far exceeds any number affected by the shortage of builders.

Frankly, if you are able to delay your foreign travel until next year I would suggest doing so. It's carnage out there.

The main message I have wanted to get across here is that not all business failures this year through 2024 will reflect poor management decisions. It is not necessarily your fault if you have to close down, so keep that in mind as you contemplate your personal wellbeing.

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If I were a borrower, what would I do?

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.

Policy tightening continues

Yesterday the Reserve Bank reviewed their setting for the official cash rate and met market expectations by raising it 0.5% to 2.5%. This rise means that the rate has been boosted 2.25% since October last year. This rise plus anticipation of additional increases has in recent months pushed up the cost to banks of borrowing money in the wholesale markets in order to lend it out at a fixed interest rate.

The big area of interest in yesterday's policy review wasn't any alteration in the anticipated speed of rate rises or the 3.9% predicted peak because those numbers only appear when the Reserve Bank releases a Monetary Policy Statement. The Reserve Bank did in fact specifically mention that no changes have been made in their interest rate plans.

Instead, it was in the general language regarding inflation risks and need for monetary policy firmness.

In that regard the language remained very much focussed on inflation risks and the need for growth in demand to be suppressed to better match growth in supply in the economy.

This is the same sort of message being delivered offshore where last night for instance we saw the

Bank of Canada increase its cash rate by 1.0%. The United States inflation number for June has also just come in higher than expected and that means continued strong interest rate rises are expected there.

However, because it is increasingly looking like some central banks may need to throw their economies into recession in order to suppress inflation, yield curves are flattening out. This reinforces my comment in recent weeks that in New Zealand fixed mortgage rates for two years and beyond are at or very close to their peaks.

This is not the point in the cycle when you lock in a long term rate. It is the point when you take the pain of highish short term rates in order to ride rates down once they start falling – next year probably for monetary policy but probably before the end of this year for fixed rates two years and beyond.

My current expectation for the one-year fixed mortgage rate in July each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current best 2 – 5 year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed averages	
2022	5.19		5.19	1 yr
2023	5.75	5.47	5.39	2 yr
2024	5.00	5.31	5.89	3 yr
2025	4.25	5.05	6.05	4 yr
2026	4.00	4.84	6.19	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 5.47%, three years 5.31%, four years 5.05%, and five years 4.84%.

If I were a borrower, what would I do?

I would probably fix for one year at 5.19% even though the table suggests fixing two years would be better. I have a view that monetary policy will be easing earlier than many people are thinking. But it is a close run thing and for most people fixing two years may be the best option.

To see the interest rates currently charged by major lenders go to www.mortgages.co.nz

Links to publications

Tony's View Spending Plans Survey

Tony's View Business Survey

Tony's Thoughts Vlog

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Oneroof weekly column

Handling high interest rates

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