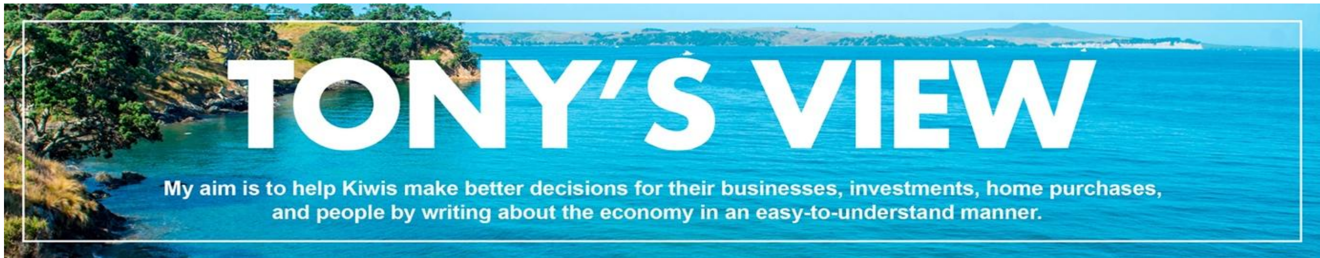

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ISSN: 2703-2825 16 January 2025
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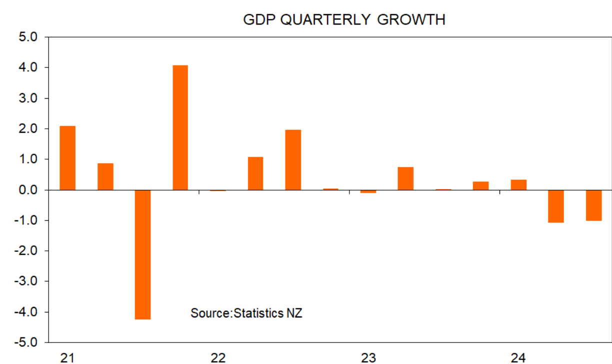
Beware interest rates optimism

Welcome to 2025 everyone and another year of trying to interpret what is happening in our economy and attempting to pick where some key things may be headed. Late last year we saw three important pieces of information appear on the same day. One favours a lower interest rates outlook (sort of), the other two higher. That leaves me still warning borrowers not to get optimistic about big rate falls this year, and still expecting a 0.5% cut at 2025's first cash rate review on February 19. 0.25% is also quite possible but 0.75% highly unlikely.

On December 19 the September quarter Gross Domestic Product data for NZ were released. Our economy shrank 1% whereas the Reserve Bank had been expecting a 0.2% decline and private sector expectations were for a 0.4% fall. The June quarter fall previously reported as 0.2% was revised to 1.1%.



These are very weak numbers and excluding the pandemic onset period represent the weakest six months period for our economy since 1991. On the face of it you would think extra easing of monetary policy is justified.

However, each year at this time Statistics NZ revise their data and the revisions this year actually show our economy currently to be 0.6% larger than the Reserve Bank had estimated. How can that be when the last two quarters were so weak? Earlier periods got revised upward and in fact the data now show we were never in recession in 2021, 2022, or 2023.

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This actually slots in well with the point I'd been noting through 2024 that it takes 18-24 months for a tightening of monetary policy to have its biggest impact and that the tightening only really started in November 2022 with the 0.75% cash rate rise and warning of recession.

A second caveat is that more up to date data show the economy to be improving so there is no need for extra policy easing to turn things around.

Third, if data can be revised heavily up they can also be revised heavily down further along the track – probably in December this year. Given the poor quality of economic data in New Zealand it is no wonder our central bank and Treasury struggle to get both their forecasts and their policy actions optimally placed.

All up, the data were weaker than expected for sure. But the numbers are out of date, subject to big revisions, and superseded by more recent data showing improvement is underway.

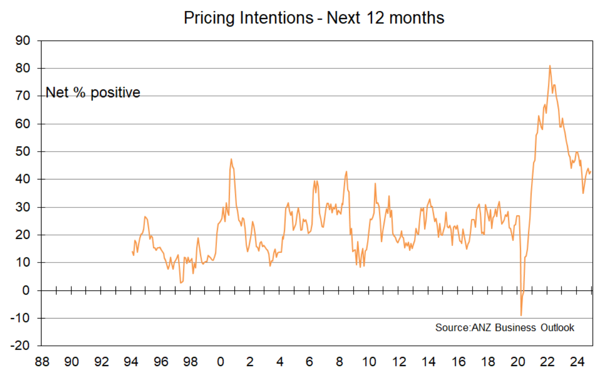
The second thing of note which happened on December 19 our time and 18 US time is that the Federal Reserve cut the US cash rate target by 0.25%. That was expected. What was not expected was that they changed their prediction for 2025 from four cuts to only two and indicated the economy was in better shape that previously allowed for.

The importance for us here is that scope for falls in fixed borrowing costs in New Zealand for periods of three years and longer looks now to be very limited.

The third thing to happen on December 19 was ANZ releasing their Business Outlook Survey. Throughout 2024 I wrote a lot about this survey and the way it showed business pricing plans not to be falling to levels consistent with near 2% inflation in New Zealand.

In particular I have focussed on the measure showing the net proportion of businesses planning to raise their selling prices a year down the track. This peaked at 81% early in 2022, started 2024 at 50%, fell to 35% in June then rose from there.

In December the reading was 43% from 42% in November.



Businesses are strongly saying that when the time is right they will raise their prices.

Of note also from the survey was a rise in year ahead average inflation expectations to 2.63% from 2.53% in November. Also, the net proportion of businesses saying that they expect their costs to go up in the next three months rose to a strong 70% in December from 63% in November.

These measures are moving in the wrong direction.

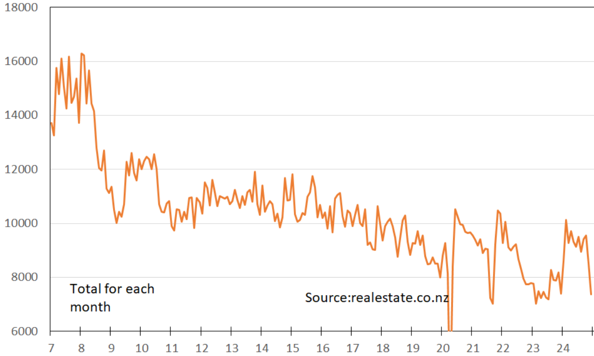
Looking ahead to 2025, the year is likely to see some mediocre growth in the economy on the

back of lower interest rates, higher dairy sector incomes, higher infrastructure spending, improving standalone house construction (but falling multi-unit building), positive net migration flows, some recovery in household spending and business investment, some recent weakness in the NZ dollar, (haven't written that for a long time) and ending before the year's end of the lagged response of employment levels to shrinkage in economic output recorded last year.

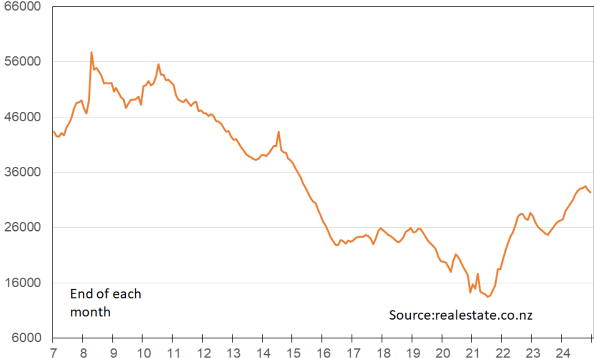
The key word to note in the above sentence/paragraph is "mediocre". New Zealand is no longer on a strong growth path, and we have proven that just because one deregulates one's economy as happened from 1984-92 does not mean sustained strong outcomes ensue. We are increasingly reliant on migrants to boost economic output but without evidence of a per capita income growth improvement.

Property listings easing slightly

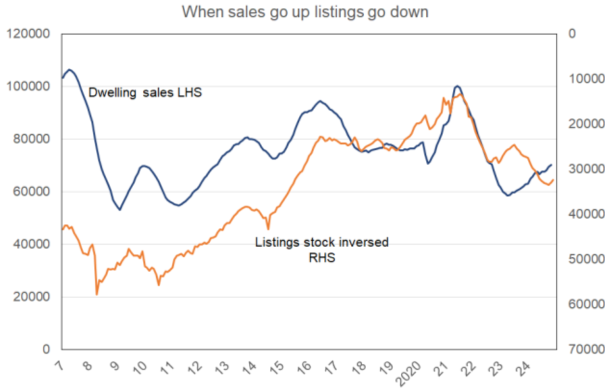
Data from realestate.co.nz tell us that during the month of December the number of properties freshly listed for sale fell in seasonally adjusted terms by 13% after falling 11% in November. These are quite firm declines over a two month period and what I will be looking for from here is evidence in my monthly surveys that the strong rise in vendor numbers following growth in buyer numbers may be petering out.



With regard to the actual stock of listings at the end of December the total of 32,300 was down slightly from 32,900 at the end of November (data seasonally adjusted) and the peak of 33,500 at the end of October.



Is this the start of a downward trend? In the past when sales have improved listing stocks have tended to fall and maybe that process is now commencing.



Business sentiment improves

We already know from the ANZ Business Outlook Survey undertaken each month plus my own Business Survey with Mint Design that sentiment in the business sector has been improving in recent times since the interest rate direction shifted.

So there is not really any surprise in the NZIER's Quarterly Survey of Business Opinion showing that a net 9% of businesses expect the economy to improve compared with a net 4% in the September quarter expecting a deterioration. In the June quarter a net 40% expected things to get worse in the next six months.

This improvement in sentiment has been accompanied by small improvements in hiring and investing intentions though the latter two remain slightly negative.

The QSBO is most useful for the insight we can gain into inflationary pressures down the track - or at least in the next three months. Back in the September quarter survey a net 41% of the non-farm businesses surveyed said they expect their costs to rise. That has now eased to 35% which is still above the 29% three decade average.

The net proportion of firms planning to raise their prices has lifted to 15% from 7% where the average is 21%. These developments are okay but not supportive of any acceleration in the pace of monetary policy easing.

In fact, the capacity utilisation rate has climbed to 91.3% (roughly speaking) from 89.1% in the September quarter. But with 67% of businesses saying lack of customers is the main restraint on their output compared with 64% last quarter and an average of 59%, some justification for further slight easing of monetary policy remains.

If I were a borrower, what would I do?

Not be optimistic that interest rates will fall much this year.

People are highly confident that the economy will be stronger this year than last year and 2026 will be even better. As a rule inflationary pressures are stronger the faster the rate of growth in one's economy unless that growth is driven by a surge in productivity – which hasn't happened in New Zealand for a long time and doesn't look likely in the near future.

This means that the natural tendency of inflation will be to start cyclically rising at some point in the next two years and as I noted from probably late in the September quarter last year that is where my focus now is – not the short-term inflation outlook.

This matters because monetary policy aims at influencing inflation 18-24 months down the track and by then from now the unemployment rate looks like it will comfortably be falling again, and businesses will before the end of this year likely have regained pricing power.

This is an especially important consideration because pricing plans have held at well above average levels over the past year even as the economy shrank by 1.1% in the September quarter and 1.0% in the December quarter.

Over the past few months confidence about the speed and extent of monetary policy easings in the United States and Australia has declined. Most notably just this past week the expectations for the US have changed in light of a far stronger pace of jobs growth in December than had been expected. Employment rose 256,000 versus an expected 155,000 and average rise of just above 180,000 a month throughout 2024.

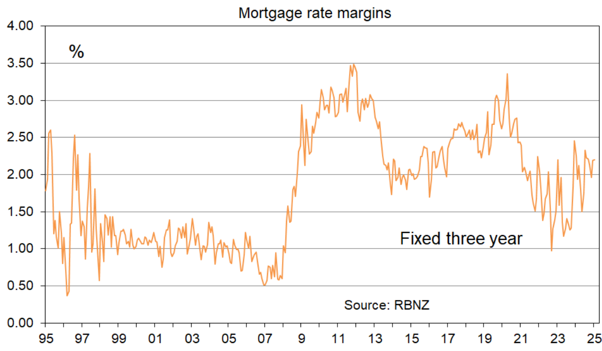
The US economy is in reasonable health and the labour market remains relatively strong with the unemployment rate at just 4.1%. Throw in the risk of higher consumer prices because of likely tariff increases by the incoming President and markets now generally only see scope for two more cuts in the Fed. Funds rate this year. One or two forecasters are picking no further cuts at all.

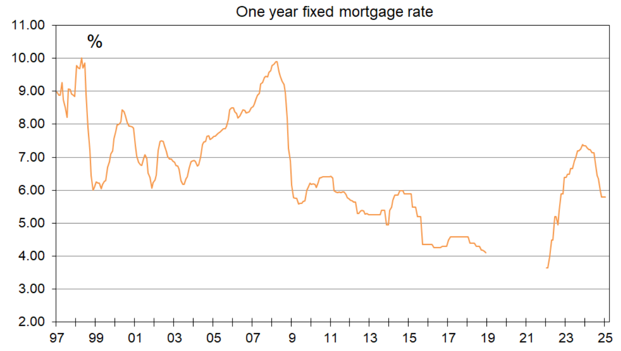
The changes in policy expectations in the two economies of greatest relevance to ourselves have helped cause increases in NZ medium to long-term bank borrowing costs. Another factor bringing caution here is the declining NZ dollar.

Measured by the Trade Weighted Index average gauge of our currency's level the NZD currently sits about 5% down from where it was six months ago and 6% down from a year ago. It is 3% below the level assumed by the Reserve Bank in November which implies slightly more imported inflation than they would have expected – but not all that much.

So, given my caution how long will I keep saying I'd just fix six months and when would I likely flick to fixing at least some (half+) of my debt at a fixed rate for at least five years? That is impossible to say but my gut tells me I'll make the switch before the middle of this year.

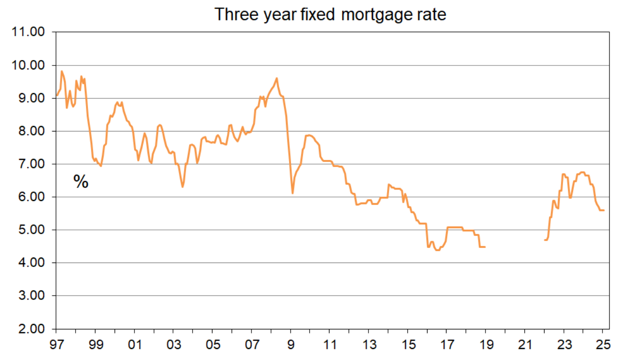
At the moment I could fix for three years at around 5.6%. I feel that with the margin for this rate looking a bit high I'd like to wait for a rise in bank competition to drive a round of cuts before fixing at about three years, or maybe two though that rate currently is only 0.1% less than fixing for three years.

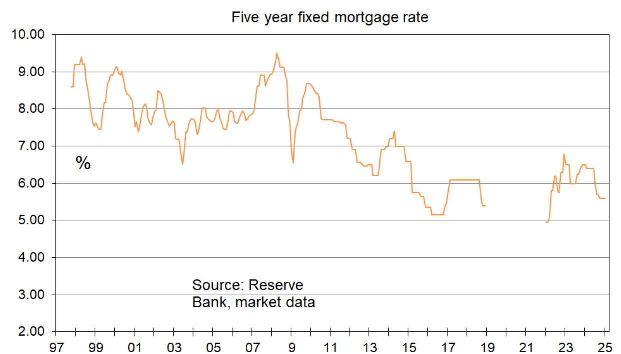


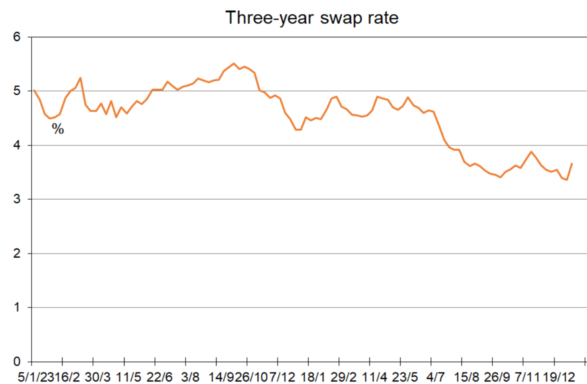


The main thing which borrowers contemplating a decision like this need to take on board is this. Scope for mortgage rates for terms of two years and beyond to fall much from current levels is quite limited.

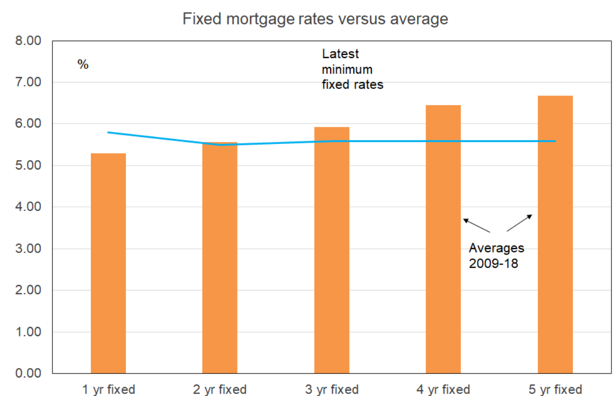
The cost to NZ banks of borrowing money at a fixed rate for one year in the wholesale markets currently sits near 3.55% from 3.57% three weeks ago. The three year cost is near 3.66% from 3.55% and the five year rate near 3.84% from 3.66%.







This graph shows how current rates compare with averages from 2009-19.



These three graphs show levels of the one, three, and five year fixed mortgage rates over the past few years excluding the 2019-21 period when rates were absurdly low because of worries about deflation and then the effects of the pandemic.

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

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