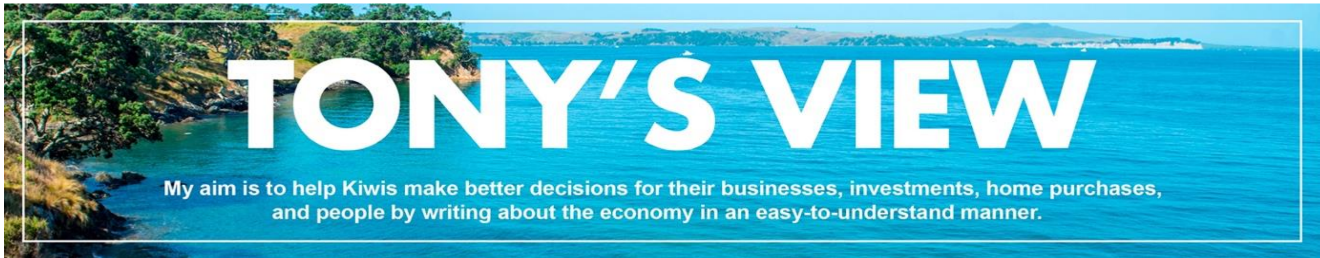

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Rock Star Economy? I Don't Think So

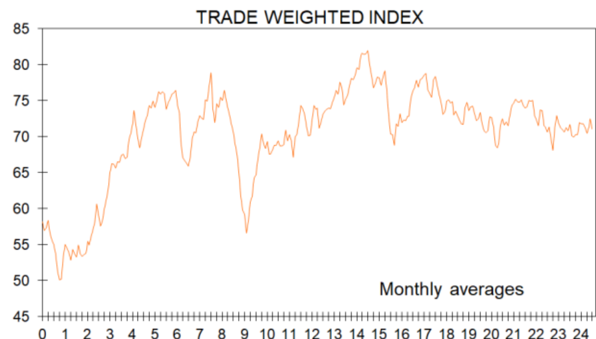
During the week there was an article in the media giving a view that the description given to NZ by a foreign economist in 2014 that we were akin to a rock star economy would be appropriate once again. The view is strongly based on falling interest rates solving the bulk of our problems and everything turning up roses again.

I have written a lengthy article discussing this issue. Here is half of it and the rest will appear next week.

Just because the intense interest rate pain created by the Reserve Bank to fight the inflation they helped create is now starting to ease does not mean it's rose smelling time. The big question to be answered is this. Will falling interest rates be enough to restore a positive outlook for the New Zealand economy, hold Kiwis here, and attract lots of productivity-enhancing foreign investment? No.

On the face of it the answer should be yes. As I have pointed out here in the past year, our economy has not been thrown into its now third recession since the end of the pandemic because the NZ dollar has soared to painful heights.

The trade weighted index measure of our currency sits near 70 from 74 three years ago. The NZD has gone down during our period of tight monetary policy and not up as has been the case in the past. This has spared the export sector and farmers and the regions in particular from the usual pain they uniquely suffer when inflation is being fought.



Our economy has not been in recession because of a collapse in our terms of trade. This measures the size of a basket of imports which we can buy with an unchanging basket of exports. The measure is down only some 8% from where it was three years ago.

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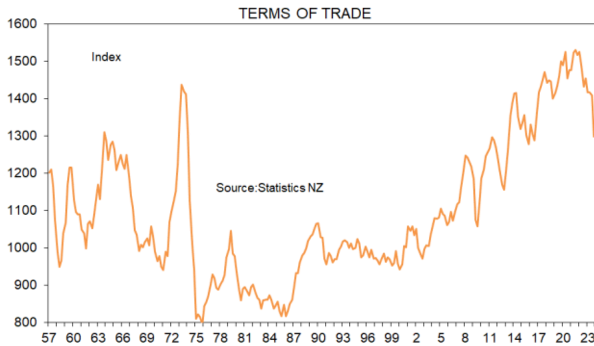

There has been a decline, so this has made a contribution to our economic weakness. But it is still not the primary cause of our decline.

Our dire performance bringing a 6% shrinkage in GDP per capita has not arisen because of tight fiscal policy. Instead we have less than a year ago seen the ousting of a fiscally irresponsible government which boosted debt over 80% in six years for no benefit to our society or economy. Throwing money around does not guarantee positive outcomes. The left need to get over their obsession with money.

Fiscal restraint has only just started.

A shock loss of people from our country is not the cause of our economic shrinkage. The opposite has happened. Over the past three years our population has grown by 4.3%.

We have not had this string of recessions because of a fresh global financial shock as was the case during the Global Financial Crisis. Our weakness is also not attributable to a particularly strong drought as has happened in the past.

Our economy has been crushed by two things of deep strength. First, the absence of the pandemic spending binge. During the pandemic we took the extra cash irresponsibly thrown our way by the government and Reserve Bank and splurged on spas, cars, fridges, kayaks – basically whatever we could get our hands on.

This gave a good boost to our economy over 2020-22 in two ways. First the higher retailing activity and local consumer goods manufacturing activity. Second, the quick return of strength in our top export destination of China because that is where much of the stuff we purchase as consumers is made.

The second cause of our dire economic weakness has been high interest rates imposed by the Reserve Bank to belatedly attack the inflation they helped create.

The recovery

Now interest rates are falling and the feeling of relief on the part of millions of Kiwis is so great

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that some are embracing a scenario that all will now be great. No it won't. There are deep and deepening underlying problems facing the New Zealand economy which won't prevent improvement through 2025 but will limit its strength as well as our long term average pace of economic growth.

For your guide, since 1992 growth has averaged near 2.7% a year for our economy with population growth averaging 1.3% a year, and inflation 2.3%. Going forward I would expect the same inflation outcome, and similar population growth (dying Baby Boomers and lower birth rate versus higher net migration). But lack of productivity growth means the average rate of growth in GDP will probably be closer to 2% than 2.7%.

With respect to the coming recovery in our economy next year, here are some of the many factors which mean use of the term "rock star economy" is woefully misplaced and mere eyeball bait.

No NZ dollar collapse

Normally the tightening phase of monetary policy in New Zealand produces a soaring NZD which crunches the export sector and regions in particular. That did not happen this time around because of soaring interest rates offshore. Now as our borrowing costs decline so too are falls starting and expected to continue elsewhere. The upshot will be the absence of the likes of the 33% decline in the NZD/USD exchange rate over 2008/09.

This means the farming sector and regions will not lead this recovery. It will have to come from consumer spending.

Fiscal restraint

The New Zealand government books are not in bad shape compared with accounts in other countries. But we are heavily dependent on the savings of foreigners to finance our daily lifestyles based on debt (happiness about interest rates falling remember). We are also vulnerable to earthquakes and trade barriers and need a good fiscal buffer to handle the next shocks – which are inevitable, not just possible. We just cannot know when.

The new coalition government will tend to tighten fiscal policy though by the looks of it their main focus is on stripping the fat from the public sector rather than rapidly turning the accounts around.

These necessary actions will place downward pressure on our pace of economic growth though I suspect the magnitude will be small.

As regards the longer term outlook for business and personal taxes, the costs of financing the

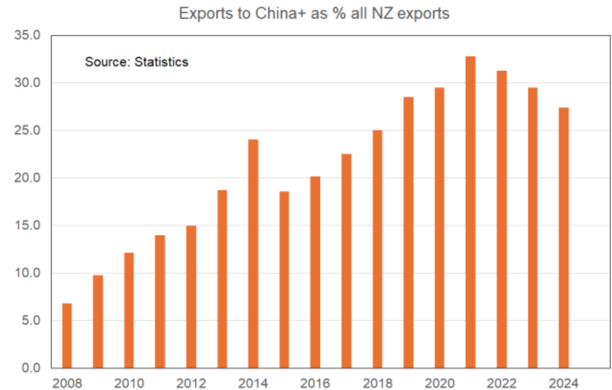
health and pension needs of an aging population imply upside risks.

No global upturn

The IMF three months ago were predicting that the pace of growth in the world economy next year will be about the same as this year. On that basis it would seem unreasonable to expect much upward movement in prices for our commodity exports.

China's slowdown

The value of NZ exports to China fell 12.1% in the year to June while the decline for all countries was 5.4%. This is the third year in a row when our China market has under-performed and means that whereas in 2021 China including Hong Kong Special Administrative Region generated 32.8% of our export receipts, that number now is 27.4% and falling.



Our economy has been greatly boosted by our free trade agreement with China which came into effect in 2008 when China generated just 6.8% of our foreign receipts. Now, the outlook for China's economy is increasingly poor and this will act to heavily constrain incomes and growth in the NZ sectors which have gained most from our exposure to China – primary industries.

China is struggling under hefty levels of regional government debt with regional receipts now heavily reduced because of still falling property development.

Dwelling prices are declining, and people feel they have lost the wealth they placed into property. This is constraining consumption at a time when the Beijing authorities have been attempting to shift the country's growth away from a

dependence on infrastructure, property, and exports towards household consumption.

China is finding it harder to access foreign markets, whichever candidate wins the US election it looks like access to the US market will worsen. The population is aging rapidly and now shrinking, and deflation has set in with the GDP deflator - the widest prices measure available – falling near 0.8% in the past year.

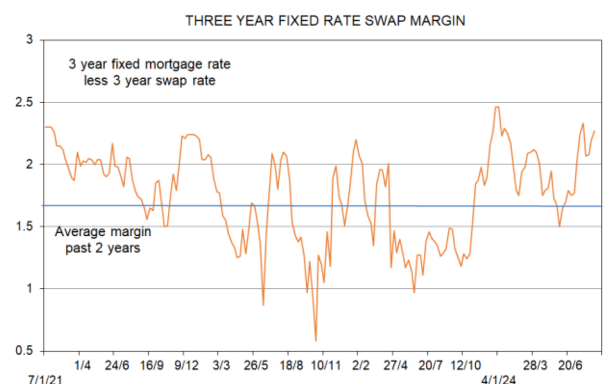
No-one now talks of China becoming the world's largest economy and in Australia rapidly falling iron ore prices because of falls in Chinese steel production are exercising the minds of public servants as state and Federal budgets come under strain from reduced royalties.

Add in China rapidly developing its own dairy sector and other areas of food production and New Zealand is now on the lookout for the next big thing. It seems overly optimistic to think that will be India anytime soon.

That was the first half of my article. The next half will appear next week.

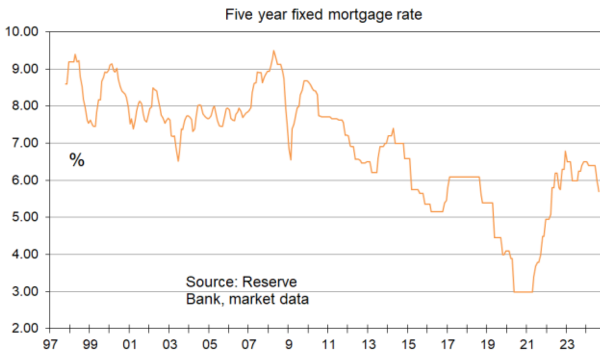
If I were a borrower, what would I do?

I've nothing much new to say on interest rates this week. They've fallen a bit more in the wholesale markets and banks are slowly cutting their mortgage rates. The graph here shows how the margin between what it costs banks to borrow money in the wholesale markets and what they charge us has blown out.

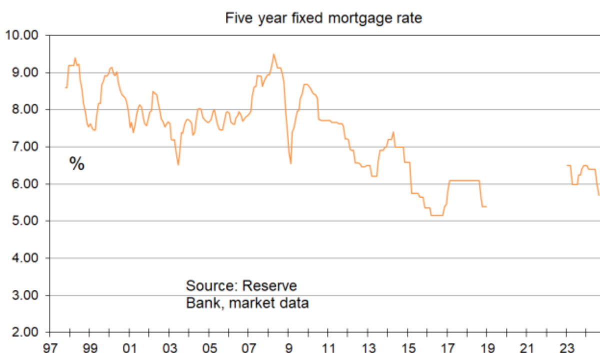


Scope exists for further cuts in fixed mortgage rates and if I were borrowing at the moment and thinking about what term to fix, I would not yet touch one of the long rates.

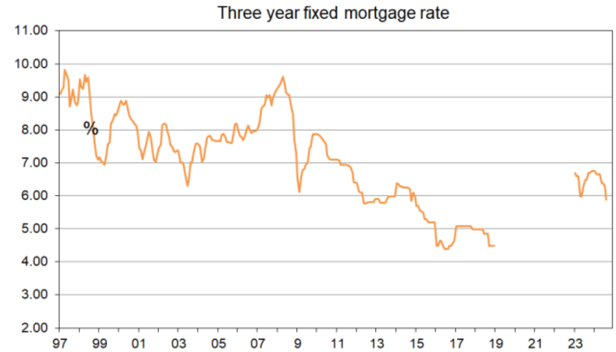
Fixing five years at as low as 5.69% at the moment is certainly a lot better than 6.49% at the start of the year. But I feel the rate has capacity to go lower even excluding the 2019-22 period when rate levels were uniquely impacted by deflation worries and then the pandemic. You should completely ignore interest rate levels from 2019-22 when considering what level of rate looks good to you.



In fact, here is the above graph with 2019-22 data stripped out.



Here is the same thing for the three year rate.



If I were borrowing at the moment, I'd just fix six months and anticipate if I do that again in six months there is a good chance I will break the rate in order to lock in five years. But there are too many unknowns in play to seriously take a stab at when the five year rate will be at its cyclical low point.

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.

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