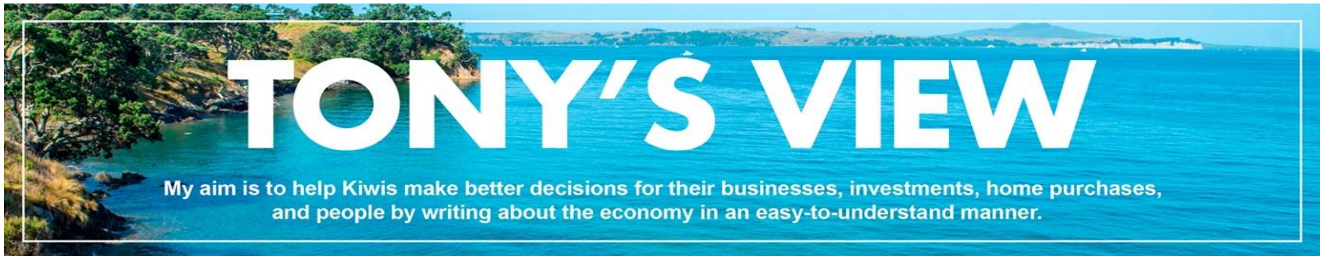

Input to your Strategy for Adapting to Challenges

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ISSN: 2703-2825 24 October 2024
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No fix 'till 26

Exactly two months ago I wrote an article spread over two issues of this publication discussing why the upturn in our economy would not deliver us "rockstar" status and why optimism should be kept in check.

My primary motivation for pointing out the many negative factors in play for the NZ economy was the way people seemed to believe that removal of tight monetary policy would see us bound ahead.

In some regards I can understand why people might believe this. As I have been pointing out in my talks over recent months, we did not enter recession some two years ago because of a soaring NZ dollar.

We also did not begin hard times because of a collapse in export prices, tightening fiscal policy (that is only a very recent development), or population collapse.

Many businesses and households have been doing it hard because of two things – ending of the pandemic spending binge on whatever non-offshore travel thing we could get our hands on and high interest rates.

Now that interest rates are falling this prime cause of our economic weakness won't be in play. So, it is entirely reasonable to expect growth to return. But as I highlighted in my lengthy article there are many factors which will hold us back and I note this again because this past week I have observed some other commentators also trying to curb people's enthusiasm. Analysts have written and warned that 2025 will still be a challenging year and decent growth may not really come until 2026.

Businesses still embrace the idea of "survive to '25". But you won't truly receive a fix until '26. (Catchy – thanks to the bloke at the conference I spoke at last week in Oz.)

Should people get newly depressed again because the time of good growth above 2% in our economy does not lie just around the corner? No, but the message to stay focussed on restructuring to reflect many shifts and shocks in one's operating environment is hopefully reinforced by these subtle changes in others' commentaries.

For the record, here again are some of the things which will restrain the speed of upturn in our

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economy. For good measure I also include some of the longer term stuff as well. Note that despite these factors better times do lie ahead for our economy - just not a boom.

Absence of a large decline in the NZ dollar which is something which has traditionally driven our recovery from recession. This means recovery won't start from the regions.

A continued weak outlook for China. Three years ago China accounted for 33% of our export receipts. That is now down to 27.3% and falling. We have passed peak China. There is little indication that the freeing up of credit flows in China in recent weeks will have much impact beyond some speculative purchasing of shares and feel-good factors for regional governments. If householders are so concerned they do not wish to borrow funds, then loosening credit conditions will make little difference.

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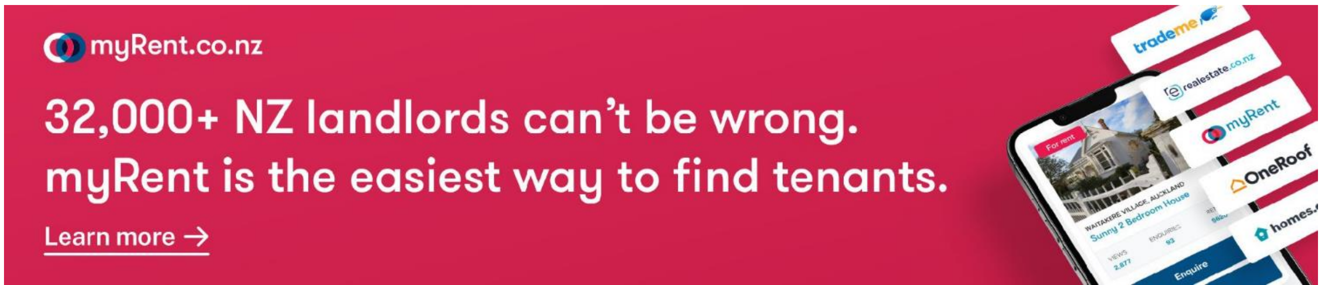
All of our assumptions about **electricity availability** and pricing in New Zealand are having to be reassessed. This can do nothing other than depress business investment and encourage some closures - as we have already seen.

House construction is falling away with architects reporting very little new business coming through. I do however remain confident that the decline in activity will be limited, and growth will return come early-2026. The construction correction underway is not a repeat of the late-1970s or post-GFC.

Growth in inbound tourist flows has slowed down and even cruise ship visits are now surprising on the low side. This high volume and usually low value part of our economy does not look like being much of an economic driver in the near future now that the post-pandemic effect may have passed through the system already.

The budgets of homeowners and property investors are being challenged by **soaring costs of insurance and council rates** with potentially a lot more of the latter imposts to come. This will suppress the strength of consumer spending and increasingly make aspirational young people thinking about a house purchase look towards Australia instead.

DAVID REID
HOMES



The **red meat sector is shrinking** as land gets placed into bio-diversity destroying pine trees and this is decimating the very sector which has accounted for so much of New Zealand's economic growth and development since the 1800s.

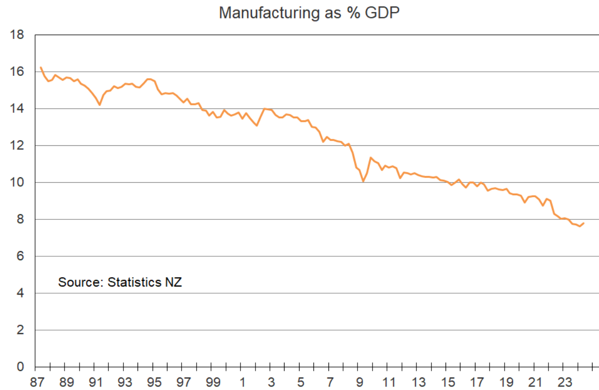
Business cash flows will remain under pressure for some time as **IRD chase up overdue tax bills**.

The government is going to have to keep **tightening fiscal policy** in order to get Crown accounts onto a solid improving track before one day a change in government brings a fresh structural deterioration as repeatedly seen in recent decades.

Net migration flows are falling away reasonably quickly, and the annual gross outflow of Kiwis has reached a record 81,000. Given the weak state of NZ's labour market compared with continuing strong jobs growth in Australia it seems reasonable to anticipate this outflow hitting 100,000.

If **Mr Trump wins the November 5 US Presidential election,** we can anticipate reduced global trade flows as tariff barriers are erected.

The proportion of NZ GDP accounted for by the **manufacturing sector** has been falling since the GFC and there is no sign of this trend ending as yet.



Our economy is replete with oligopolies, and this suggests not just productivity-retarding business practices but also higher average inflation and therefore interest rates than would otherwise be the case.

Climate change costs will sap productivity and add to inflation and interest rates.

As many young Kiwis with get up and go do exactly that the growing proportion of the population who have self-selected to stay will increasingly determine policies. Those policies won't be focussed on striving for lofty economic goals but increasingly on **redistributing income**. Hence, Labour are not pushing a growth agenda for when they get re-elected but new taxes to address issues of envy.

Reflecting this, delivered of high corporate positions from which commentary about options for New Zealand going forward could be made, **our top people are not presenting ideas for greater economic freedoms and growth policies**. Instead they are pushing taxes. That is where New Zealand's economic debate is at. More taxation.

Also we need to add in the other factor beyond talk of a "rockstar" economy which encouraged me to deliver my growth restraint warning two months ago – **Fonterra throwing in the towel on branded consumer product businesses**. The talk of becoming another Nestle died some years ago and is on the cusp of being buried well deep.

Do these things mean New Zealand is stuffed? No. We are what we have always been – a nation of immigrants and immigrant descendants exporting minimally-processed commodities, creating good businesses for people offshore to buy and relocate, and focussed not on strong income growth but income redistribution and issues of egalitarianism.

We are not stuffed, just like Fiji is not stuffed, nor Albania, nor Uzbekistan. But having blown the potential economic benefits of the reforms from 1984-92 our frame of reference has to be more those types of countries and not the old ones people used to think about emulating – Singapore, Ireland, Switzerland, and Sweden.

At least the bush is beautiful, and we provide a good route of upward economic mobility for tens of thousands of people from poorer countries every year. Like we always have done. Maybe ultimately that is the purpose of New Zealand – being a stepping stone.

If I were a borrower, what would I do?

Apart from speculation about whether the Reserve Bank cuts 0.5% or 0.75% on November 27 (I am firmly in the 0.5% camp), the other item of interest regarding monetary policy is where rates bottom out.

The popular pick is about 3% which sounds right. Some favour as low as the 2.5% reached during the GFC. But given the absence of another global financial crisis that feels like a bold call. It's a call which ignores the improved economic conditions already widely expected by the business sector. But it also reflects a potential blindspot regarding one specific thing.

How long will it take for the cyclical rise in inflationary pressures to reappear? They always come back, and my suspicion is this will happen sooner than the general assumption encapsulated for instance in the Reserve Bank's forecasts of never.

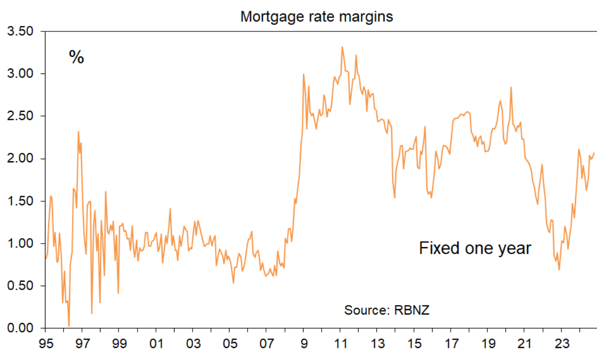
That is, the RB forecast (probably they assume) inflation of 2.3% come the end of this year and 2025, then 2% over 2026 and 2% over 2027. That won't happen. There will be (is) initial downward pressure on their forecasts from the period of strength and therefore enhanced demand for resources in our economy not really coming in 2025 but more appearing in 2026.

But there will be upward pressure from factors such as climate change costs, higher electricity prices, higher maintenance costs for the country's infrastructure, higher wages growth because of the loss of many skilled and motivated young and middle aged people to Australia from here on out, and so on.

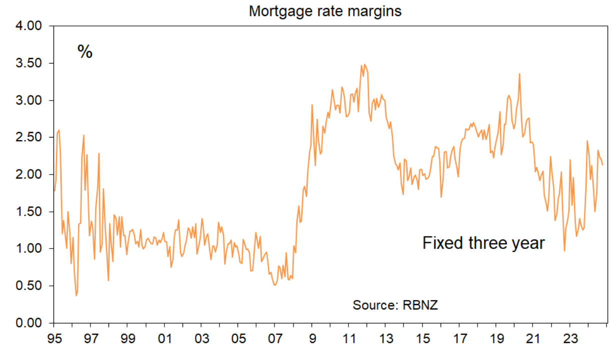
It's impossible to accurately predict what inflation is going to do. If it were possible then we wouldn't pay any attention when the number comes out every three months. But my suspicion is that the underlying base level of inflation is going to be higher now than was the case in the post-GFC period and that this will manifest itself in medium to long-term NZ fixed interest rates ending their cyclical decline at higher levels than people may be anticipating as they think in terms of an extra 1.75% or so coming off the OCR from the current 4.75%.

We're not there yet. Historically all rates tend to edge down together as the official cash rate is cut. But given the speed with which we may be headed towards the 3% OCR low (or thereabouts, possibly 3.25%) the lows for 3-5 year fixed mortgage rates may be reached before the middle of next year – unless bank competition for business picks up which is something also impossible to predict and very unwise to assume.

Banks are probably trying to prevent a return of lending margins on fixed rate lending to the low levels seen over the period from 2021-23. This graph shows the simple calculated difference between the best one year fixed rate on offer by the top four lenders and the one year swap rate. It makes no allowance for increases in other lending costs such as meeting increasingly intrusive regulatory requirements, higher capital levels and so on.



Here is the same graph for the three year fixed rate.

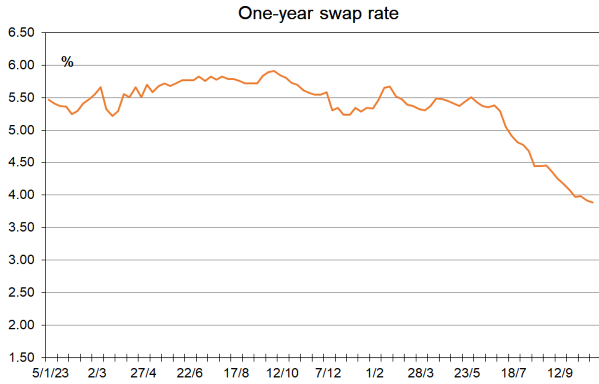


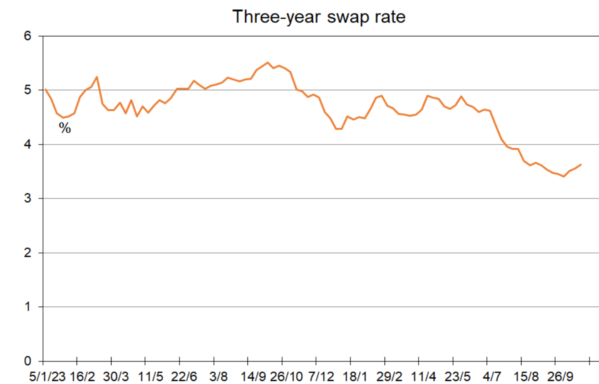
Note the change in the banking world resulting from the GFC. That shock to everyone caused banks to pull back from their aggressive low margin fixed rate lending.

The graphs show us that at the moment margins are on the high side. But that doesn't mean we will see fixed rate cuts outside of changes to the OCR. It all depends on what the banks want to do.

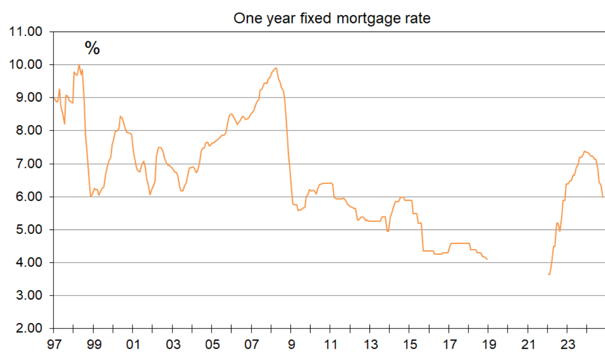
For the record, this week wholesale bank borrowing costs have generally risen in NZ in response to higher rates in the US. The markets there are pulling back on their optimism regarding the speed with which the Fed. will cut rates in coming months in light of some stronger than expected economic data. The same thing is happening in Australia where the labour market in particular has proved to be very strong and the World Bank has just lifted its prediction for Australia's inflation rate over 2025 to 3.6% from 2.8%. Rate cuts there might not come before the Federal election which is due before the end of May.

The NZ one year swap rate has edged down to 3.89% from 3.92% last week but the three year rate has risen to near 3.63% from 3.56% and the five year rate to 3.79% from 3.67%.

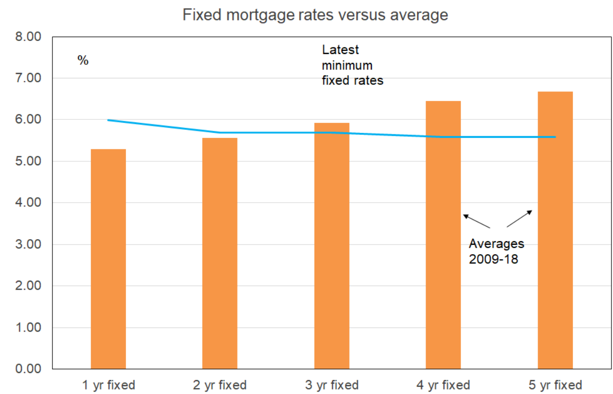




These three graphs show levels of the one, three, and five year fixed mortgage rates over the past few years excluding the 2019-21 period when rates were absurdly low because of worries about deflation and then the effects of the pandemic.



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



If I were borrowing at the moment, I would be fixing for either 6, 12, or 18 months looking to eventually fix for 3-5 years perhaps in 2026, perhaps 2027. It is impossible to say at this stage.

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

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