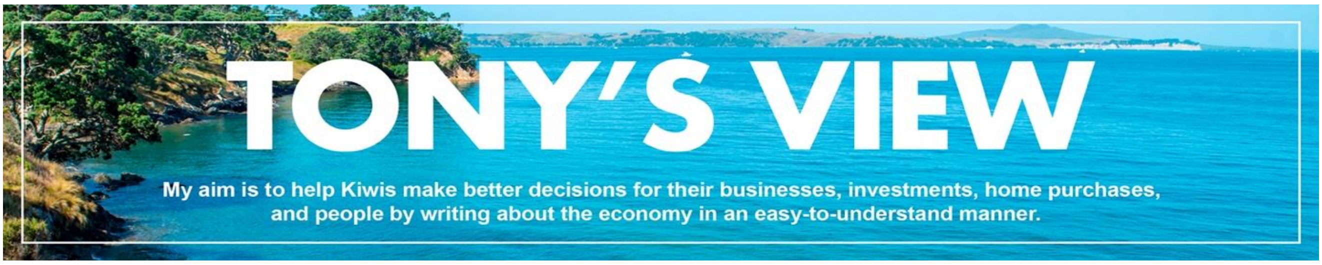

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Monetary policy tightening risks

I did a radio interview this week regarding the ANZ economists' decision to lift their predicted peak for the official cash rate cycle this time to 3.5% from 3.0%. The change is understandable considering the large number of factors pointing to upside risk for inflation and interest rate predictions over 2027 and 2028 in particular.

A good starting point is to realise that the Reserve Bank made a mistake last year when they cut the cash rate 0.75% down to 2.25% over the October – November period last year when the economy was already experiencing accelerating growth.

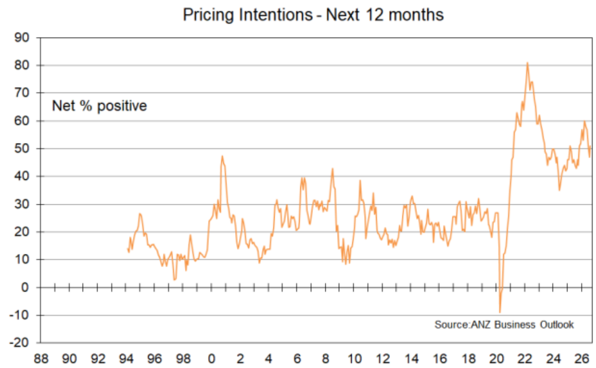
GDP rose by 0.9% during the September quarter than another 0.5% in the December quarter and 0.9% again in the March quarter.

They misread the state of the economy on the upside just as they had misread it on the downside in the first half of 2024 when they warned about raising the cash rate above 5.5% as the economy was shrinking almost 2%.

What this means is that with only 0.5% worth of cash rate rises so far this cycle they have not fully unwound their mistake of last year. That is, removing easy monetary policy has not ended, and tightening of policy into growth-restraint territory has yet to start.

A second key point I have been highlighting for over two years now is the way in which a well above average net proportion of businesses are saying they plan raising their selling prices – with the unspoken bit here being "when customer flows are stronger".

We can see this in the ANZ's monthly Business Outlook survey. Since inflation fell to average 2.4% from 1992 the net proportion of businesses planning price rises has been 27%. The low in recent years was 35% mid-2024. The latest reading is 51%.



Adding to the promise of higher prices which businesses are delivering (driven by a need to rebuild margins) is the illogic revealed in the Reserve Bank's forecasts for the economy.

They are predicting that the annual average rate of growth in our economy will lift from 0.9% in the year to March 2026 to 1.9% then 2.6% then 3.0% for year ending March 2029. They also predict the unemployment rate will fall from the current 5.6% to 4.6% come March 2029.

As a result of this acceleration in growth and reduction in unemployment they predict the inflation rate will fall from 4.1% (let's say 3% without the Middle East War effect) to 2.1% come the end of next year then 2% after that. This does not add up.

Then there are the many things for which upside pricing risks exist, including but not limited to the following.

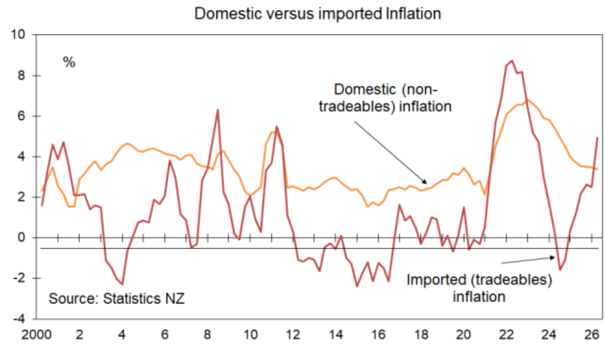
El Nino causing reduced agricultural production here and overseas pushing up food prices.

The AI boom causing computer chip prices to soar. As most electronic goods these days contain chips this means upward pressure on prices for these things directly to us consumers and via higher business costs.

Also, a key source of downward pressure on our inflation for the past two decades has been falling prices for these things. Take that away and our underlying average domestic inflation rate of 3.5% is revealed.

The terminology in the following graph is not completely correct but broadly, the orange line shows our own internally produced domestic inflation and the red line is imported inflation (plus items influenced by export prices). Since 2000 our non-tradeables inflation rate has averaged 3.5% versus just 1.4% for tradeables (imported).

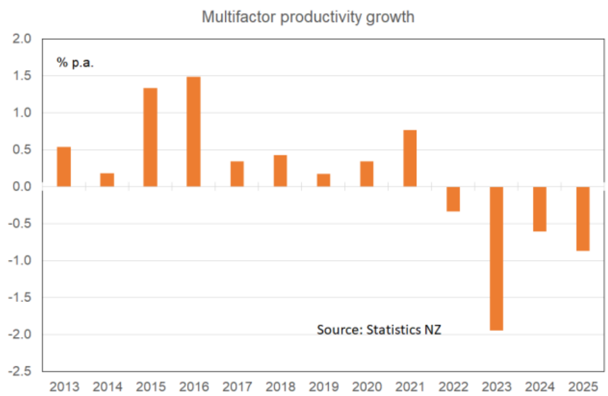
The only reason our inflation has averaged 2.4% or so this past quarter century is because of falling imported goods prices with a lot of those decreases being for electronic goods like cell phones and computers.



Construction of data centres will tend to place upward pressure on electricity prices along with resources used in the construction sector.

The NZ dollar is running at lower levels than the Reserve Bank and the rest of us expected. That means higher input prices but also better returns to exporters bringing upside potential for our pace of economic growth.

New Zealand is going through a period of falling productivity. In the four years to March 2025 our level of productivity fell by 4%. That means with the same quantity of inputs we can now only produce 96% of the widgets we did four years earlier.



The Reserve Bank estimate that our potential growth rate is only 1.5% per annum. So, with GDP growth in the year to June of an annual average 1.8% we are already in resource-depletion territory.

Councils have two years to boost their rates as much as possible before rate caps come in from 2029.

Newly created water entities do not face such restraint and not only are large cost increases predicted for these bodies, if I were working at a council I'd be trying to figure out clever ways to shift council costs into the relevant new body entity.

Now that the Ukrainians are attacking Russian oil and grain distribution facilities there is extra upward pressure on prices for both internationally. Higher grain prices are relevant in that a lot of beef production offshore is grain-fed. Output will reduce and that means higher red meat prices which is good for our farmers but bad for the CPI.

Around the world increased resources are being allocated to the production and running of defence systems. That means fewer resources available for other uses and hence upward pressure on global inflation at the margin.

We should also add in the global reassessment by investors of risk pricing for government bonds. Concerns are deepening about government debt levels and inability of most to rein in their deficits – with the US increasingly becoming a focus of this concern.

This means higher average interest rates than would otherwise be the case.

Note also the change happening in Japan. Their cash rate has just been lifted to an over three decade high of 1.25% with more increases looking likely. The period we have lived through of cheap Japanese money is coming to an end and the result may be some extra upward pressure on interest rates elsewhere as Japanese investors increasingly divest from offshore assets to earn better than expected fixed interest returns at home.

Plus we should note the recent more hawkish than expected comments about potential monetary policy changes in the likes of Canada, Australia, and the Eurozone.

Tuesday also saw own one central bank Governor warn of inflation in the short-term coming in higher than expected because of the persistence of high energy prices.

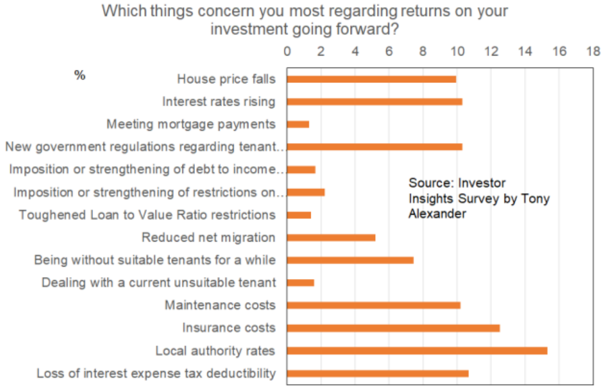
Overall, we should expect the coming 1-2 years to be a period of upward revisions to inflation and interest rates. I pick an OCR peak of 4% - 4.5%, not the common view of 3.5%. Oh, and watch for this red herring.

One economist with a challenged record of predicting house prices changes has opined that current weakness in the housing market with regard to turnover and prices means that monetary policy is already a lot tighter than people think and the need for higher interest rates is minor.

What he and others are missing is that the housing market weakness we are seeing results primarily from structural changes in the housing market discussed in length here over recent years. Basically less investor demand, more construction and supply.

What about Labour's backtracking in their view on the worthiness of retaining interest expense deductibility for investors in residential property? They now promise no removal of this deduction if they help form a government. The change does remove a key source of concern for current and prospective property investors. But there are plenty of other thigs which investors are worried about.

This graph from the survey of investors which I run with sponsorship from the Property Consortium people shows that while 11% are worried about loss of interest expense deductibility, more are worried about insurance costs and council rates and about just as many concerned about house prices falling, interest rates rising, and costs of maintenance.



If I were a borrower, what would I do?

I reckon I've said enough about the upside risk to NZ interest rates above. Suffice to say last night there was a fresh selloff in fixed interest markets offshore in response to some stronger than expected economic data, oil price worries, and a bout of shivers about government debt levels.

The result is that the US ten year government bond yield now sits near 5.11% from 4.66% a month ago.

The NZ one year swap rate at which banks borrow fixed one year to lend to you and I fixed for one year has risen to near 3.71% from 3.64% last week and 3.37% a month ago. The three year rate is now near 4.25% from 4.18% last week and 3.79% a month ago.

As warned, banks have started lifting their fixed rates but the weakness in dwelling sales and strong preference of people for fixing two years has actually seen rates for that term cut slightly. Long live market competition – but it won't live long will it.

The direction for interest rates is upward, and it is just a matter of making compete guesses as to the speed, when the peak comes, and how high rates will go. I see the official cash rate peaking between 4% and 4.5% come 2028. Good luck.

If I were borrowing atm I'd prefer fixing three years to get away from the mess coming up.

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

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.