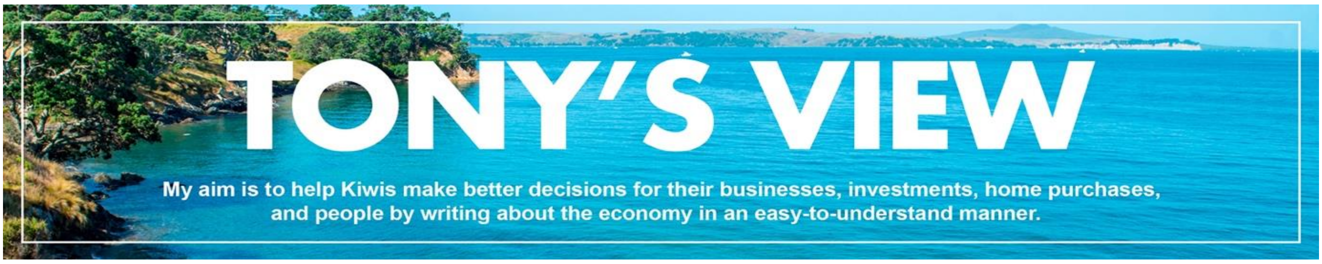

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A recession session

What does it mean if our economy goes into recession? Three things. First, the level of output will shrink. Second, most people will notice nothing at all. Third, many people will be better off.

A recession is not what you think it is. You've been brought up to view recession as a terrible disaster – like a wildfire. But as those with historical knowledge on their side will tell you, in ecosystems where fires occur, they are a natural and necessary part of preserving the system over the long-term.

In a recession your economy will decline in size. In simple terms that means instead of 100 widgets being produced only 95 are, or 99.9. The size of the downturn matters at the time, but it is irrelevant to the definition of recession.

Let's say our economy shrinks by 1% from its level of activity in the September quarter last year. Given that activity rose 2% that quarter this would take things back to where they were halfway through the quarter, or in the month of August.

What if the economy shrinks by 3% as it did during the GFC? That would take us back to late-2021.

If you look at just the Gross Domestic Product numbers to try and understand why a recession can matter you're not going to get anywhere. Having your factory or café output go back to where it was a few months earlier is hardly of consequence because such things happen all the time for virtually all businesses.

So, why does a recession matter? There are a number of reasons. As Grandmaster Flash sang "Don't push me 'cause I'm close to the edge". Many businesses and households live on the cash flow of one week to pay the debts of the previous week. Take one of those weeks away or half of a week's earnings and you and your kids will go hungry, you might not be able to order more stock for your store or factory, and you may in fact lose your business.

There are always businesses in precarious positions, and some are always getting weeded out as their sales take a step back even when the overall economy is growing strongly. In a recession the number in such a position can become highly increased. They have to take drastic action to remain solvent. The answer, as any student of government actions in the Great Depression knows, is to cut spending.

So, firms in need of a cash flow boost will lay off staff, delay payments for inputs received, cut orders for future inputs, and put investment plans on the back burner. Now we are into second round effects of a recession.

Some firms not being paid on time will themselves engage in cost-saving measures. Some firms expecting orders for goods and services will cut back on their spending.

Thus, one aspect of a recession is that it can have a snowballing effect. This effect will be severe if banks are scared about what lies ahead and cut provision of credit when firms most need it. They take away the umbrella as soon as it starts raining. This is why these days when economic shocks come along central banks quickly make sure banks do not panic for fear of making losses or not being able to fund themselves from depositors concerned about the quality of their lending to date.

The central banks will make special lines of funding temporarily available to banks and make sure everyone knows the funding is there to stop a new snowballing effect of firms drawing down their credit lines as quickly as possible just in case they need the money – thus making banks even more nervous.

At the same time as cautious firms are begetting cautious firms who beget more cautious firms, worries in the public grow about the number of people who will be laid off by the business sector. These worries about loss of income will make consumers do exactly what the firms have been doing. They will cut their spending, delay planned large purchases, and maybe even try to find some extra work, thus placing downward pressure on incomes of others if they accept lower than standard wages for doing so.

People cut back in particular on buying what we call "durable" goods. These are couches, cars etc. Sales of these things fall and retailers cut orders to manufacturers who then lay off staff. In addition, the retailers will cut inventories to save stock-financing costs. This process can become deflationary as discounts are introduced to get inventories down. This is one way in which inflation falls away. But it can also cause extra weakness in spending as people expect lower prices so cut planned spending and sit waiting for lower then lower prices to come along.

People also cut orders for new houses, so the construction sector weakens, and layoffs occur with some over-stretched businesses failing – as in the first round effects of a recession getting underway.

A recession is all about these second round effects and not whatever caused it to start. We economists try to gauge the intensity of these effects by looking at measures of business and consumer sentiment to see how depressed they really are. We then try to guess the extent to which they will cut back on staffing, capital expenditure, and purchasing consumer goods and services and houses.

Which all raises this obvious question. How does this process ever stop?

There is the problem. As people see weakness beget weakness they envision gloom continuing on and on and feel encouraged to cut their spending even more. The whole thing just naturally spirals down towards everyone growing their own veges and eating roadkill.

But there are things which get set in motion as soon as a recession comes along or looks like it is going to come along.

First, the bad outlook will tend to discourage people from investing in one's country. This causes the exchange rate to decline. This decline starts to improve the bottom line for exporters and in our context is very important.

Unlike most other countries, virtually everything exported from New Zealand is made in New Zealand. The imported component is much smaller than in other countries where manufactured goods form far larger proportions of export receipts. Inputs to those manufactures are often imported.

Initially the falling currency does nothing positive. In fact, it makes people depressed as they look at how much more an offshore holiday will cost. We become more pessimistic and cut our household spending further. Petrol gets more expensive and that hits all of us.

But eventually, as the currency crawls lower and lower exporters will take their rising incomes and expand production, hiring more people. This can take a while – maybe 18 months. This lag is a key input in models of any economy.

Second the bad outlook for one's economy will lead to expectations that businesses will cut their selling prices to move stock, as noted above. Expectations will grow that businesses will push back harder against claims for higher wages. We also know that it is during times of adversity that businesses will rationalise their operations and cut out the flab from earlier years of good growth which easily covered up extra expenses being built into processes. Productivity can rise though this is not guaranteed, especially this time around. Memories of labour shortages will this cycle make firms very reluctant to layoff staff.

Basically, a recession will cause the rate of inflation to fall away. This does not happen right away, but it does happen – and that is the space we economists are living in right now. We see weakness in our economy through 2023 and we know this weakness will bring the inflation rate down – eventually. We just don't have accurate models any longer to tell us how long this will take. Neither does the Reserve Bank.

Interest rates eventually fall away and that does interesting things. People with funds in the bank will see low returns and some will decide they may as well spend some of their cash rather than watch it grow less valuable.

Remember right at the start where I wrote about some firms living on the edge? Most firms are not in that position. They are well run, well capitalised, have good cash flow management, and have learned something important over the years.

When bad times come along for some, and you are in a good position – shut up. Let the chooks talk themselves into a downturn. You will suffer weakness in your sales. But you will also be able to pick up businesses and the assets of businesses which are failing at cheap prices. You will get good deals for new premises and machinery and boost your outlook for the coming 1-2 decades. Low interest rates will make the decision to fund such purchases through debt relatively easy to make.

You will also find an increased availability of good, motivated staff. That is a key dynamic at the moment. Plenty of firms in our country are doing very well. For them any recession will be meaningless. But they know it will present an opportunity to address their biggest recent problem – staff shortages.

They will either say nothing publicly about their being okay, or will actively talk down the economy because they will benefit from the woe perceived by others.

Low interest rates and a lower exchange are two key reasons why downturns do not continue forever. They boost exports and import-competing businesses, and can cause an eventual lift in capital spending levels.

Low interest rates will also cause an eventual recovery in consumer purchasing of goods and services as long as they are not financed with credit cards. Those rates essentially never come down.

Low interest rates also eventually bring the house buyers out of the woodwork. House prices may start to edge higher and deliver a positive household wealth effect. This is not a biggie however. Housing is interesting much later in the cycle when things are cranking along again.

The simple passage of time will also bring higher consumer spending on durable goods. The couches and cars become even more worn out and decrepit and people begin asking themselves if things are really so horrible that they have to continue living like they are.

There may be other things in play. For instance, the thing which cased the recession in the first place may be ending or reversing. Inflation, as discussed above, may be falling away. Export prices may be improving as offshore economies pick up.

A recession, by its very nature, sets the scene for recovery. Central banks try to limit the depth of a recession by cutting interest rates and ensuring banking system liquidity is assured and good. Governments may try to limit weakness by increasing their own spending. But history repeatedly shows us that unless this comes via direct handouts to households the impact is limited and can eventually be inflationary on the way out of the recession.

Where we sit now in NZ is this. Recession may happen. As we increasingly believe it will happen forecasts for inflation will fall and interest rates will go down. The labour market will ease up in favour of businesses. The scene will become set for eventually stronger growth.

Wise firms will sit back and let this thing play itself out, looking to pick up people and cheap assets.

If I were a borrower, what would I do?

The significance of yesterday's on-expectations 7.2% inflation number was that it was not a surprise like the October 18 release. That means the market focus will increasingly go on the shocking sentiment readings and what we know these will do for the pace of economic growth and then inflation. Seeing these things in motion the chances of the Reserve Bank taking the cash rate from the current 4.25% to 5.5% on April 6 have declined.

That means wholesale borrowing costs for banks have declined a bit further this week and I retain my 90% confidence that we have seen the peaks for fixed rates of two years and longer.

One bank now has an inverse mortgage curve where long rates are lower than short rates. It makes little sense to fix for five years near 6.5% when the inflation outlook is improving and the range for the past eight years for this tern has been 2.99% to about 7%.

I would not touch the five year rate with a bargepole and suggest people be careful in this environment. At bank pricing committee meetings members will be saying they can lock people into 3-5 year rates then work on selling them other products if they reflect the shift in whole rates and price long rates lower than short rates. It's a trap.

If one can it is probably best to accept the pain of fixing short then riding the rates down when falls for the one year rate eventually come along. But don't get overly optimistic with regard to when such cuts come along.

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.