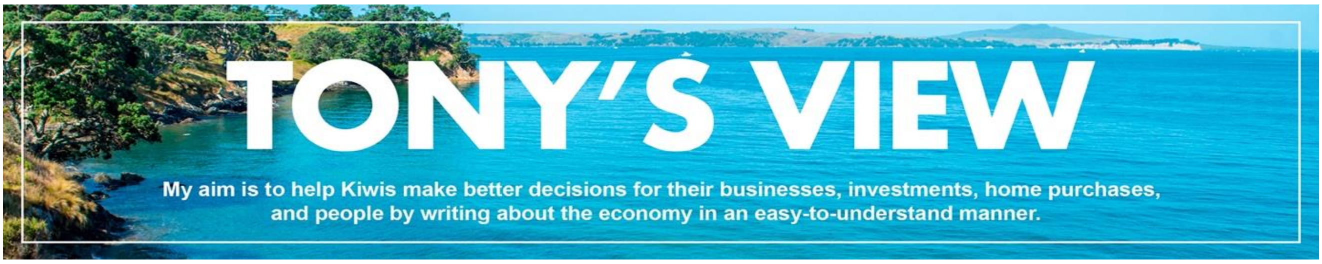

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The four boxes of monetary policy

A key part of the presentations I have been delivering in recent months focusses on the way in which monetary policy works. The description seems to go down well with people according to the feedback I've been receiving. I've covered the issues here in different ways in the past but the structure I use when speaking seems to please people, so I'll run through it here.

Imagine four boxes in front of you. Box number one on your left is interest rates going up. Box number four on your right is inflation going down. We all understand these boxes and know that in order to get inflation down a central bank will raise interest rates.

Now consider the second box on the left. It contains household spending and the aim in raising interest rates is to crunch household spending. The evidence for a long time now is that this is happening in spades. In fact retail spending volumes per capita in the March quarter were 11% down from two years earlier.

Retailers are announcing restructurings, delivering profit warnings, closing down age-old stores, and trying to survive as best they can. People are being pressed by not just high mortgage rates but soaring council rates and insurance premiums plus a loss of job security.

Most people understand this second box. But the thing is this. None of us consumers currently cutting back on our spending set the prices of the 649 items in the basket making up the consumers price index. We can slash our spending as much as we may want but that won't cause prices to fall. For that to happen we need to look at box number 3.

In box 3 we have the price-setting decisions of NZ businesses. The Reserve Bank needs businesses to raise their prices at a lesser pace than has been the case over the past three years. What they are looking for is this.

At their quarterly, half-yearly or annual pricing decisions meeting the accountant will get up and say that costs have gone up by 10% over the past year so the business needs to do what it has successfully done for the past three years and raise its prices by 10%.

But just as everyone is saying that's what needs to be done so just do it, the marketing manager or someone similar stands up and says this. "We can't do that. Customer numbers are already falling, unsold stock is building up in warehouses, people are shopping online. If we pass these cost increases through, we'll permanently damage the brand and collapse our cash flows."

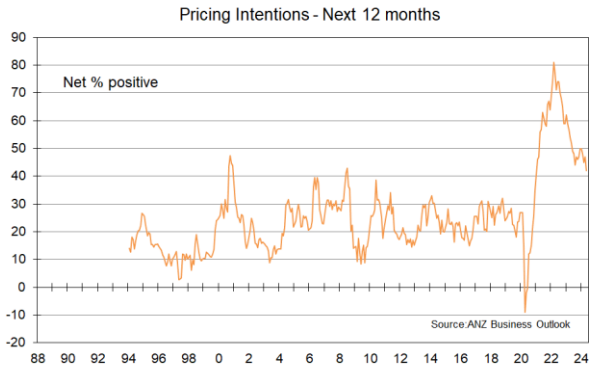
What will businesses then do? They'll have to make tough and ugly decisions to try their best to maintain profitability and get through to the recovery in demand. This might involve no longer producing the least profitable (loss-making) products, no longer operating in low-yielding locations, no longer servicing troublesome low return customers, plus the usual cost-saving things like stopping hiring and so on.

We have only just entered this territory for the bulk of businesses and the worst thing the Reserve Bank could do at the moment would be to take their foot off the economy's throat and give businesses a reason to take the easy route ahead and simply pass on their cost increases. That would lock inflation in at a rate well above 2% and set the scene for a new recession to have to be imposed 18 months down the track.

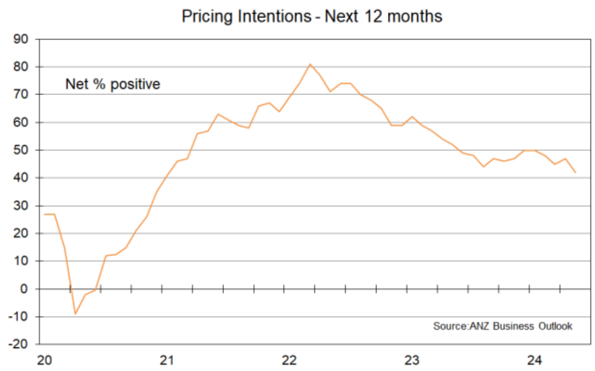
Can we get a gauge of how far through this business restructuring process we are? Not explicitly, but we can attempt a proxy beyond the many media articles about some big decisions being made by looking at the pricing series which I have highlighted here all this year so far.

I am referring to the pricing intentions measure contained in the ANZ's monthly Business Outlook Survey. It is not the be all and end all by any means when it comes to monetary policy decisions. But it gives some insight into the third box process and progress.

On average over the past three decades when the inflation rate has averaged 2.3% a year a net 25% of businesses have said that they intend raising their selling prices over the coming year. This measure peaked at a horrible 81% in March 2022.



Since then it has fallen but got stuck either side of 50% from May last year until April. The latest reading is a net 42%.



The trend is looking better. But the level is still much too high. This is why I say that we should anticipate weak economic conditions, pessimism feeding upon itself, and no easing of monetary policy through winter and spring.

Come summer with any luck this measure will be below 25% and the Reserve Bank will be getting concerned enough about the new weaker state of the economy to cut the official cash rate in their November monetary policy review. I think they will as do Treasury according to their Budget documents.

If you are in business and having read this, you say that you still have to pass on your cost increases into selling prices then you will be the one ensuring this recession extends into 2025. That applies whether you are a small trader in a competitive market, or one of the larger firms in an oligopolistic position (maybe 2-5 operators only).

Until businesses radically refocus their means of handling cost increases, interest rates will not fall.

In case you missed it

This week I released the results of my monthly survey of residential property investors undertaken with sponsorship from Crockers Property Management. The key things I found if interest were these.

- Landlords report that it is becoming harder to find good tenants.
- There has been a sizeable drop in the average rent rise which landlords will aim to achieve in the coming year.
- Investors overall still intend being net sellers of property in the near future.

[Investor Insight with Tony Alexander | Crockers]

I also released results of my monthly Business Survey sponsored by Mint Design. The key insights included these things.

- Concerns about customer demand and cash flows are high and some areas of desired spending are having to take a back seat. These things include climate change mitigation and unfortunately spending on workplace culture.
- Fewer businesses plan raising their selling prices but as yet a killer blow against inflation necessary for the Reserve Bank to cut interest rates is not at hand.
- Labour market conditions continue to ease.

Mint-Business-Insights_June24.pdf (mintdesign.co.nz)

If I were a borrower, what would I do?

Wholesale interest rates have edged up about 0.05% this week in the absence of any significant news on the state of our economy or inflation outlook. Expectations are slowly shifting towards monetary policy easing earlier than forecasters were picking a few weeks ago but it still looks like just myself and Treasury picking November this year as when the first cut in the OCR from 5.5% will be made.

If I were borrowing at the moment, I would take a mix of 6 and 12 month fixed rates and expect to make a similar decision in 6-12 months time.

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.