TONY'S VIEW

My aim is to help Kiwis make better decisions for their businesses, investments, home purchases, and people by writing about the economy in an easy-to-understand manner.

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Monetary policy takes time

There are benefits to having been around a while and seen a number of cycles for interest rates, inflation, the housing market, the economy overall, the world economy, commodity prices, and so on. One learns that a very clear tendency which many people display when we are at one end or the other of a cycle is over-extrapolation of whatever has just happened and expectations that the current situation will continue for a long period of time.

For instance, I've had two or three emails recently from people saying they expect high inflation around current rates will persist for a number of decades. They usually throw in something about high oil prices and then a comment on the particular sector which interests them most. But they'll be wrong.

The key to understanding monetary policy is to realise that when a central bank is fighting inflation they will always win. They will always get inflation back to the target range they are aiming for.

It's really just a matter of how high interest rates need to go in order to suppress inflation. Interest rates have to go high enough that consumer spending becomes so crunched businesses realise they cannot pass on recent cost increases into their selling prices without decimating their sales.

If the evidence in hand is that pricing behaviour is not changing then that simply means interest rates need to go higher and that is the thinking at the moment.

There is also something else experience teaches us with regard to these monetary policy cycles. It takes about a year and a half for rising interest rates to start having a decent impact on underlying inflation. The official cash rate in New Zealand was only taken up from the record low of 0.25% just over a year ago. So, we should not expect that underlying inflation when we strip away some of the special ups and downs in things will be showing much of a reaction as yet.

But we were of course all hopeful that there would be some decline appearing in the underlying inflation measures which were announced last week. Our hopes have been dashed and frankly that's really all they were and now we're back into

the traditional reality of waiting to see the true impact of monetary policy tightening.

This period might last from 6 to 9 months and while it is ongoing we can expect to see some fairly extreme volatility in the financial markets as has been the case over the past few weeks. Here and there we will get indicators suggesting or outright showing us that monetary policy is having a negative impact. But then at the same time we will have other indicators in hand telling us that the impact might be relatively weak or not appearing at all.

Frankly it could be quite some time before we can definitively say that monetary policy has definitely got traction and we can be reasonably confident about inflation heading back comfortably below 3%.

So, we should all expect that over the next few months we will continue to see ups and downs in bank wholesale borrowing costs, our sharemarket and sharemarkets overseas, and the exchange rate as well. The exchange rate movements will reflect different timings of changes in monetary policy views between countries as has been the case for New Zealand versus Australia most recently.

In Australia the central bank is saying that there are further increases in interest rates to come but that they are taking a rest just for the moment to see what the data are telling them. In contrast, in New Zealand even though we don't have some fresh strong statements from our central bank we have the strong view in the financial markets that there is a lot more work which needs to be done.

This has caused the New Zealand currency to rise about two cents against the Australian dollar and an expectation is building that there will be further appreciation.

But again, this is where having a bit of experience can prove useful. Financial markets tend to overshoot. Because they are always forward-looking and driven by what participants believe other participants believe you can quickly get changes in sentiment which feed upon themselves and there's probably a large element of that going on at the moment.

In the absence of any comments from our central bank regarding how they feel about the recently announced 7.2% inflation rate the markets have decided the outlook is universally bad for inflation and so we have seen some very strong increases in wholesale interest rates.

The risk is that the markets now are pricing in too much tightening of monetary policy in New Zealand. That is, they are overshooting on the high side with regard to interest rates. Then again maybe they aren't. It's not as if anybody has an accurate economic model these days and in fact,

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as noted many times in the past, economic models have failed since about 2007.

They didn't pick the global financial crisis, they didn't pick that printing money would lead to disinflation around the world rather than inflation let alone hyperinflation. They certainly didn't pick that the onset of a global pandemic would lead to house prices soaring 45% and sales of spas, kayaks, luxury vehicles, and home renovation products going through the roof.

So, you need to be very careful not to get fixated on any particular set of forecasts of where the economy is heading. Every single one of us economists operating in New Zealand has had to lift our predictions for interest rates over the past few months in a repeating fashion. Have we finished yet? Don't know. Maybe, maybe not. We'll just have to wait and see. Heck, at some stage we're going to be chasing our tails downward with falling interest rate predictions. We've been there before.

From my own point of view, having seen these things in action before, I would be very hesitant to radically alter my outlook for our economy, inflation, interest rates, housing market, share prices et cetera for an extended period simply on the basis of monetary policy tightening rapidly recently and the impact of that tightening yet to show through.

In other words, don't panic. We've been here before and we know that many people do panic. For instance one of the emails I've received in the past week was from some people noting that late last year they shifted some of their money out of term deposits because of the low interest rates and into managed funds. Now that their managed funds market valuations have appreciably declined, they are thinking about crystallising their losses and going back into term deposits.

You're probably laughing to yourself at the moment having just read that but unless you've been in that situation it's hard to understand that for the people concerned this is a legitimate question. When the price of something you have invested in goes down you become gripped by a desire to avoid further losses. And unfortunately, that desire becomes so strong you subconsciously believe you have developed an ability to predict share prices now which obviously you did not have before.

You think you've developed an ability allowing you to predict that the falls over the past few months will repeat themselves. You want to avoid further losses, so you move your funds into a conservative asset and lock in your losses.

But no miracle has occurred. You are no better at predicting share prices now than when you put your money into a managed funds portfolio many months ago. Share prices go up, share prices go

down, which brings us to what is likely to be the next interesting phase in the share market here and overseas at some stage in probably the next 12 months.

One day a collective view will be formed that inflation is under control and that it is heading down. When that happens, all attention will shift towards how quickly interest rates will decline and when the declines from central banks will start. When that happens there will be intense discussion of the risk that one's central bank has raised interest rates by too much.

This will lead to a view that the decline in interest rates will be particularly rapid when it happens. That will then jump very quickly to an expectation that investors will seek higher yield and that as long as one is prepared to look beyond the temporary period of economic weakness depressing profits then this shift of funds will boost share prices.

The markets will factor that view in straight away and at some point we will probably see share markets rally by 10%, 15%, maybe 20% or so. To repeat there is absolutely no way of knowing when this is going to occur. But that is the way markets move.

Therefore, if I had money in managed funds with a strong equity exposure and had seen the value of my funds decline maybe 15% or so in the past year, I'd personally be leaving the money in there expecting that at some stage prices will recover even though I've got no idea when that recovery will come along. Watch out you don't panic when we go through these very uncertain periods replete with shocks adding to the traditional monetary policy cycle uncertainty as we wait to see the impact of higher interest rates.

Last week, we were too optimistic in our thinking that the impact would be showing through already from the fastest jump in mortgage interest rates in over three decades.

If I were a borrower, what would I do?

I'd fix 1-2 years personally.

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