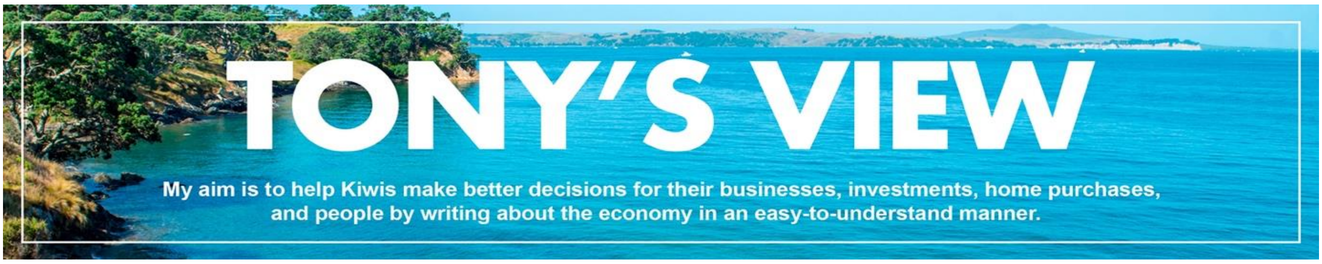

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ISSN: 2703-2825 Thursday 28 July 2022
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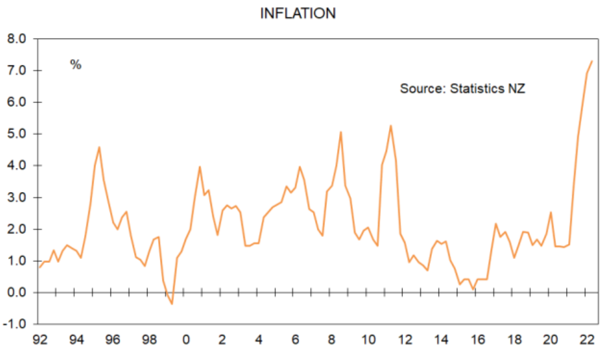
Not a repeat of the 1970s

With the annual inflation rate now at 7.3% and many people discussing their difficulties handling a hike in their cost of living, some have chosen to believe that we will face a repeat of the 1970s. We won't, but first just a dash of perspective.

On average since 1992 the inflation rate in New Zealand has averaged 2.1% per annum. The average up until 2011 was 2.3%. But over the period from 2012 to 2019 inflation averaged only 1.2% a year and our central bank kept interest rates at low levels to try and stimulate faster growth in the economy and wages in order to get inflation back up.



They failed as other central banks did also, but by pursuing the inflation target contributed to much higher house prices and excess pressures on staff availability.

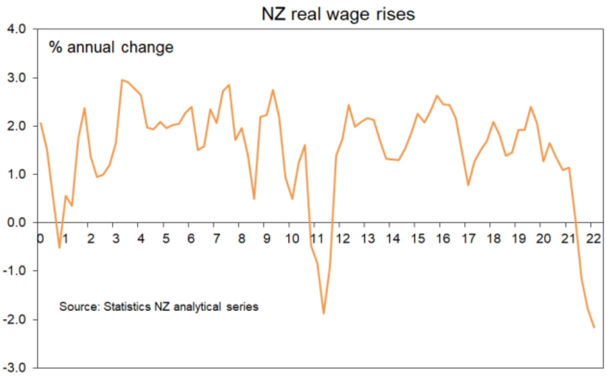
Starting back in 2012, if inflation had averaged the earlier 2.3% rise each year, then the Consumers Price Index in the June quarter of this year would have been at a level of about 1,200. Instead, the reading was 1161.

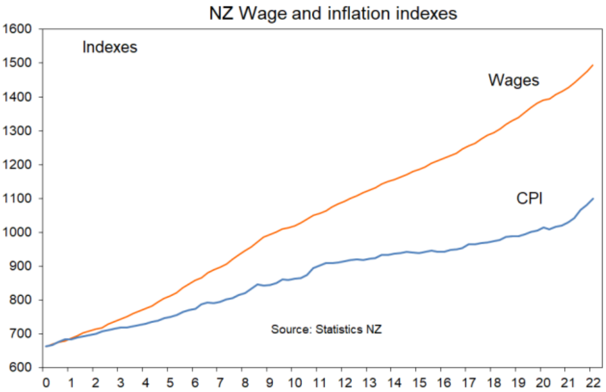
Over the past decade, even taking into account the recent surge in the cost of living, inflation has averaged 1.8% a year which is 0.5% less than over the previous two decades.

If you view the latest inflation rate of 7.3% as a catch-up after years of inflation being too low (which would be a bit weird) then things are not so bad. It becomes a question of what you choose to focus on – the current sharp cost of living change or the average change for the past decade which has been in your favour.

Now, some of you will have leapt ahead here and developed the thought that if people had put aside their extra wage gain against the unusually low inflation rate from 2012 to 2019 then they would have no trouble paying for their goods and services at the moment despite the 7.3% cost of living surge.

However, growth in wages adjusted for inflation was not at unusually high levels from 2012 to 2019, as seen in the following graph showing annual real wages growth.





So, why are we not facing a repeat of the 1970s when inflation averaged 11.5% a year?

Weak oil price shock

The oil price shock back then involved a quadrupling of prices over 1973/74 then a doubling late in the decade. Nothing remotely approaching that has happened this time.

The world economy is less dependent on oil per unit of output now than was the case back then. Therefore, any percentage increase in oil prices these days has far less impact on consumer prices than in the 1970s.

Independent central banks

Central banks these days are independent with low inflation targets. Back then most of them did what politicians of the day told them, and the past few years have shown us just how useless politicians in New Zealand at least really are.

Operating monetary policy in accordance with the election cycle and the absence of any formalised target of low inflation meant efforts to get inflation down in the 1970s were minor compared with the past four decades.

Central banks will act to suppress inflation and the intensity of their determination to (belatedly) get inflation under control is reflected in the speed with which cash rates here and overseas are being raised, and the explicit noting by our Reserve Bank that they are prepared to run the risk now of tightening too much rather than too little.

None of us can have any doubt that our central bank and most others will do whatever is necessary to ensure inflation does not get cemented in at a level above our target range of 1% - 3%. For this they should be congratulated. Pity they didn't recognise things were too loose last year.

Low unionism

The role of unions in our economy these days is far smaller than back then. The frequent calling of strikes during the 1970s led businesses and government to acquiesce to wage demands then pass the extra cost on immediately in higher selling prices which consumers were prepared to pay because they could get higher wages. A wage-price spiral developed.

Alternative routes to higher income

Nowadays industrial action is far less a part of wage negotiations. Also, people see routes to higher incomes through changing employer to a greater degree than back then when there was more of a "job or career for life" way of thinking.

Reduced credit availability

The recent surge of inflation and jump in interest rates has been accompanied by a once in a generation structural change in household credit availability. In the short term this partly reflects the tighter LVR lending rules but the 10% limit on bank new lending at low deposit will eventually be changed back to the previous 20%.

Mainly though the structural credit availability change reflects the government's changes to the Credit Contracts and Consumer Finance Act. Banks feel they have far less leeway to accept what people say at face value with regard to their expenses and income.

Reduced credit flows will help contain pressure on the inflation rate.

Reduced business pricing power

Businesses do not have the same repricing power now as they did back then. Competition from offshore is more intense, there is a far greater acceptance of entrepreneurialism in our society, and social media can produce pressure against business price rises and produce a faster change in spending patterns than back then.

There are other variations between now and then, but the main one of relevance here is the independent role of central banks and their low inflation instructions. We are not facing a repeat of the 1970s and in fact one of the key themes I am running currently is that before the end of this year the degree of concern about high inflation and high interest rates will be falling away potentially quite rapidly.

That is because we already have downward pressure on the inflation rate emerging from things like the absence of new rises in international prices for energy, minerals and food, falls in prices for these things now occurring, and a lower inflation rate to be reported come the middle of October.

If I were a borrower, what would I do?

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.

Recession worries dominating

In response to weaker than expected data coming out in the United States and Europe, plus anticipation of a large hit to European growth from restricted gas supplies, the markets this week have focussed strongly back on the potential for recession. The implication being drawn is that the greater the chances of recession the less work central banks will need to do of raising interest rates to control inflation through potentially generating…a recession.

The ten-year US government bond yield has fallen to around 2.8%% from 3.02% last week and markets are not only thinking about interest rates not going as high as previously thought. They are also picking the ending of the tightening cycle coming forward in time and monetary policy being eased earlier than previously thought.

This feeds into the general theme I have putting across since early this year that the need for our central bank to aggressively raise interest rates to high levels is less strong than people think because the economy is already being pressed downward.

This is most clear from my monthly Spending Plan Survey which now shows a net 26% of people planning to cut back their spending in the next 3-6 months compared with a net 17% planning to grow it in December's survey and an average 25% positive for the year and a half leading into the end of last year.

It is clear also in the near record low levels of both consumer and business confidence in other surveys, plus the below average business intentions of hiring more people and boosting capital expenditure.

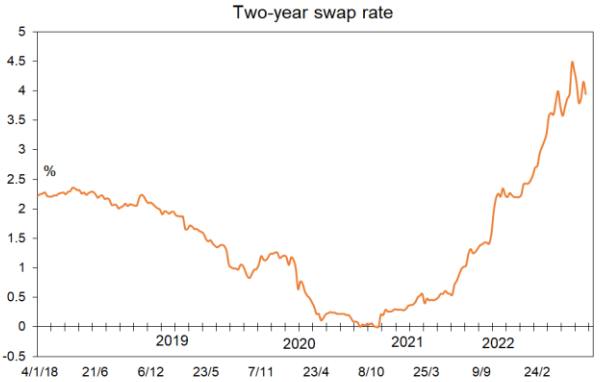
Then we need to throw in the point I am currently making that in a few months' time the general discussion about NZ inflation will shift. It will move from how terrible 7.3% is and how worrying that is towards how quickly inflation is falling in response to falling prices for oil etc. plus the weakening economy.

Come the next review of monetary policy in New Zealand on August 17 we will still be in an environment of high inflation worries. So, the Reserve Bank will raise the official cash rate from 2.5% to 3.0%. That is the level I previously thought we would peak at. But since the higher than expected inflation gauges of a few weeks back I've been picking 3.5% and anticipate sticking with that.

It is much too soon for the Reserve Bank or any of us to make any strong statement regarding high inflation not feeding into high wages growth. That is why the tightening will continue and 3.5% will probably be reached.

But I see only a low chance that the cash rate will be pushed to 4.0%.

Assisted by the falls in interest rates offshore this past week we have seen the NZ two year rate at which banks borrow to lend to you and me at a fixed rate for two years fall to 3.95% from 4.15% last week. The five year bank borrowing rate has fallen to 3.7% from 4.0%.



My current expectation for the one-year fixed mortgage rate in July each year is shown in the first column of the table below. I focus on that rate because there are many people who have fixed one-year repeatedly since 2009 and the strategy has worked very well.

The second column shows what the one-year rate will average over the next 2-, 3-, 4-, and 5-year periods. The last column shows the current best 2 – 5 year fixed rates charged by the lenders I track.

	Forecast 1 year rate	Rolling average rates	Current fixed averages	
2022	5.19		5.19	1 yr
2023	5.75	5.47	5.39	2 yr
2024	5.00	5.31	5.89	3 yr
2025	4.25	5.05	6.05	4 yr
2026	4.00	4.84	6.19	5 yr

If these forecasts prove correct (I'd give that a 10% probability), rolling one-year fixed will deliver an average rate for the next two years of 5.47%, three years 5.31%, four years 5.05%, and five years 4.84%.

If I were a borrower, what would I do?

I'd probably just fix one year largely with a small amount only fixed for two years. Banks now have scope to start cutting their fixed rates for three years and beyond.

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

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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