

Input to your Strategy for Adapting to Challenges

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Why the long face?

Often people upset about rising interest rates will say that fighting inflation needs to take a back seat to letting the economy develop some good momentum. The problem with this argument is that the biggest issue which people reveal as troubling them is the soaring cost of living and that is the result of inflation accumulating over time. Allowing higher inflation would worsen the cost of living situation, not make things better.

Inflation is measured by Statistics New Zealand as the change in cost quarter to quarter of a basket of 598 things we normally consume every three months, excluding houses and interest rates. This is called the Consumers Price Index.

Interest rates are excluded because raising them to fight inflation would boost inflation if included. Housing is excluded because it is an asset (not the same thing as a car or iPhone) but housing costs are captured in other ways including rent, maintenance etc.

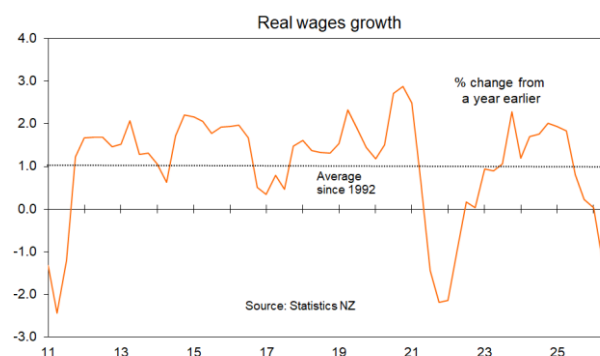
The cost of living as measured by the change in the Consumers Price Index since the end of 2019 has risen by 32%. That is an average rise of 4% a year.

The inflation rate our central bank is charged with achieving is between 1% and 3%. Their failure is why our cost of living has soared 32% rather than the officially desired 15%.

Note, many claim that our high inflation is not our fault and that it is imported. Because of soaring fuel prices our tradeables inflation rate (imported inflation) sits at 4.3%. Our non-tradeables rate is lower at 3.3%. However, since 2019 while

tradeables price rises add up to 25%, for our local non-tradeables inflation the sum is 36%. The cause of inflation averaging 4% rather than 2% is primarily local and not offshore.

What is interesting is that average hourly ordinary time earnings – the wages growth measure most commonly used by NZ economists - have risen by almost 36% since the end of 2019. This equates to real wages growth of almost 1% a year which is the exact average since 1992.



Why then do people feel like the sky is falling and they are failing to keep up? First, because not everyone has been able to achieve this real age increase.

One of the key issues with high inflation the likes of which we have experienced these past few years is that relative real incomes can get stripped apart from each other for different groups. Societal cohesion gets disrupted.

Second, since 1992 we have become used to prices on average rising and generally expect that things will get more expensive over time. But the



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extent of price rises for some key items which we have consumed for decades hits us in the face especially hard.

Butter was the big one a year or so ago. Red meat is now.

Third, there are some things which have risen in price strongly and which we fear will continue to do so, throwing into doubt our projections of whether we can afford to stay in our current house, town, or even New Zealand. (Imagine how many old people would follow their kids and grandkids to Australia if they could take their superannuation with them.)

The two big culprits here are council rates and electricity prices. No matter the traditional efforts one might make to save power, the escalation in prices and switch in burden more towards fixed daily charges means we struggle to see how future bills will be affordable.

Solar is not an option for most people not living in standalone houses, and the economics of solar still don't stack up well – especially since almost all solar houses have to stay on the grid and pay daily fixed supply charges. Plus, after waiting 20 or so years for the theorised breakeven point to arrive the panels will need replacing. By then you'll probably need to pay for their disposal as has become the case with tyres.

With regard to council rates there is some relief coming up with a planned 4% cap. But the split of water functions out of traditional rates means a new fear is created – how to afford to pay for water services in the likes of Wellington projected to rise in cost from \$2,000 a year to \$6,000. We should also expect potentially hefty hikes in council charges, new charges, and reduced services.

Fourth, fuel prices have soared because of the US President's attacks on Iran from February 28. No

easing of petrol or diesel prices appears imminent.

Fifth, while average real wages have grown 1% per annum since the start of 2020, this past year the change has been a fall of 1.2% in the year to June.

Then there are some other new issues occupying people's minds and making us more fearful of undertaken normal activities. Attempts to scam us out of our money have grown, and adoption of AI by the scammers accentuates the risk that any of us can have our hard-earned funds drained away by nefarious actors offshore.

Increasingly we need to base our decisions of where to place our funds on the ability of institutions to keep not just our funds safe but to save ourselves from ourselves and our own natural psychological behaviour which the scammers exploit. Our culture makes us lambs to the slaughter for scammers.

Plus, there are the worries about AI bringing down websites and computer systems around the world. More than that, there are plenty of experts embedded in companies developing these threatening AI systems issuing warnings of a threat to humanity from their creations.

Let's add in also the warnings associated with the long-predicted aging of our population and rising costs for superannuation and healthcare. Fiscal deficits are expected to grow substantially and either taxes will need to be raised or cost savings made.

Nothing about the current focus on the sustainability of superannuation is new. The articles in media today look the same as all the others written since the 1980s. Action taken to do something about this expected bulge amounts to very little and that includes the introduction of KiwiSaver and coming imposition of a compulsory

element to the savings system. (The NZ Super Fund will help a little bit.)

Higher savings in KiwiSaver accounts make no difference to the future fiscal burden unless an abatement regime is introduced. Given the reluctance of people in retirement or approaching it to vote for reduced entitlement since the 1980s, the voting against an abatement regime is likely to be just as entrenched.

By the time something potentially is done about the situation the burden is likely to be easing as the post-WW2 generation dies off.

I could add high unemployment to this list. But having lived through the likes of 11.1% unemployment in 1992 and 6.7% in 2012, the current 5.6% rate seems not scary.



However, in the social sciences field everything is relative and because people have become used to unemployment sitting at relatively low rates for a decade, a 5.6% rate is a legitimate cause of concern for many people.

I could also add in falling house prices in parts of the country excluding the likes of Southland, Canterbury, and Queenstown Lakes. There is little to no positive wealth effect in play this cycle and instead a negative wealth effect exists.

This is reinforced by the media focussing on those who have suffered equity loss since purchasing at the 2021 peak, rather than how affordable housing now is for young people relative to the past decade or so.

The absence of strongly rising house prices is a great development for our society.

Climate change extreme impact predictions are also likely contributing to pervading feelings of helplessness and fears for the future.

Our long faces also may reflect sadness about the impact on our society and feelings of togetherness cause by the covid pandemic and government policies in reaction to it. The presence of many people living on the streets of our city and town centres also says to us that something is wrong.

Then there is the role played by social media where a primary function of the algorithms seems to be analysing our behaviour and finding something to make us feel angry, then alienated, and then suicidal or vengeful.

Let's add in also the key problem for many businesses of crunched margins because they have not been able to raise selling prices enough in recent years to offset cost increases. They fear swift loss of customers especially in very competitive sectors such as hospitality.

Plus, a key problem is that New Zealand's level of productivity has fallen by 4% in the four years to mid-2025 (latest data). We are producing less with the same resources.

The current state of our economy and where it is headed no longer can act as a safe guide as to how people generally feel now and will feel in the future. A split has developed which means something quite important in the social sciences field. A well performing economy may be necessary to have a good society. But it is no longer sufficient.

If you think the answer to this problem lies in the outcome of this election, you're probably being a tad optimistic regarding the performance of people entering or keeping the highest paying job most of them will ever have.

If I were a borrower, what would I do?

The highlight for most of us this week was yesterday's view of monetary policy settings by the Reserve Bank. As was not at all universally expected they decided to leave the cash rate unchanged at the stimulatory level of 2.75%.

It appears that they are increasingly worried about where the world economy is heading. But they are also choosing to assume that businesses will not take advantage of an improving economy to rebuild margins by raising their selling prices.

They also appear to have adopted an assumption with little basis of support that the neutral level of interest rates in New Zealand has just shifted lower.

The upshot is that they are acting consistent with the pattern of behaviour for our central bankers which I have repeatedly highlighted over recent years. They loosen too late then loosen too much, then they tighten too late and tighten too much.

Given the overly relaxed attitude which our central bank has shown to New Zealand's inflation risks the risk of extra and accelerated tightening towards late-2027 and through 2028 has grown. That means at a minimum if I were borrowing at the moment, I would fix my mortgage rate for two years but also opt for three years if I could get a rate slightly better than the 5.59% rate currently on offer from the main lenders.

Good luck to those of you who have fixed rates maturing come the turning of 2027 into 2028.

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