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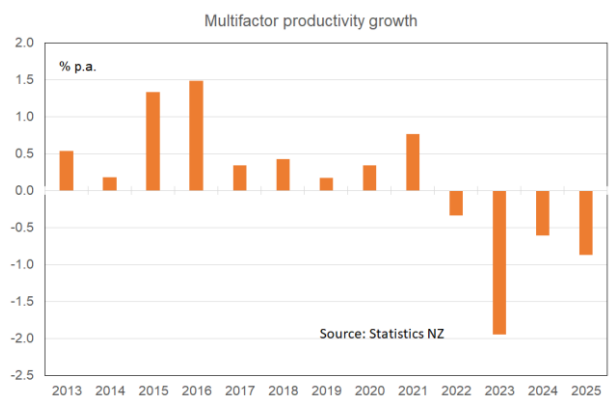
Increasing interest rate risks

For borrowers there is little hope for relief in the near future unless the economy badly tanks and businesses lose almost all of their pricing power while wage earners face escalating unemployment.

It is not just the fact that inflation is running almost 0.8% higher than the Reserve Bank predicted six months ago, with just 0.1% of their error attributable to the Iran War. There is also the unfortunate productivity path for the NZ economy revealed this week in data from Statistics NZ.

Their numbers show that productivity in our economy fell for the fourth year in a row in the Year to March 2025. That is not saying that the rate of growth in our productivity slowed down but that the quantity of widgets which we can produce with unchanging quantities of inputs like labour and capital is falling.


The decline was 0.3% in the year to March 2022, then 1.9%, 0.6%, and now 0.9% in the year to March 2025.



This is problematic on a number of fronts. First, we are getting poorer. Second, for any given rate of growth in demand in the economy there will be more inflationary pressure than would otherwise be the case.

As to the issue of why our productivity is falling - I'll leave that to others to figure out. The issue has consumed economists and policy makers for some centuries and will continue to do so.


Another piece of bad news for borrowers came from Moodys Credit Rating Agency who have downgraded their outlook for the country's credit rating. In theory this means investors will demand




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a higher risk premium for taking exposure to the NZ economy.

In practice there was no impact on wholesale interest rates from the change, partly because a downgraded outlook had already been announced by another of the big three agencies a few weeks ago. Also, it is more the fact of a credit rating change which matters rather than a shift in the outlook – unless that shift is accompanied by some fairly fierce and worrying language which was not the case on this occasion.

Another inflationary factor I may as well throw in the mix here is the extra upward pressure on our electricity prices to come from diversion of generation to AI-powering data centres. Also we should add in extra pressure on council rates as the effects of climate change become more prevalent in affecting infrastructure.

What is the track likely to look like then for Kiwi borrowing costs as we advance through this year? The oscillations will be upward, but it is impossible to pick the periods both when the wholesale markets ratchet up and when the Reserve Bank either signals rate rises coming or actually moves its cash rate up.

This reinforces the value of having a good portion of one's mortgage at a medium to long-term fixed period. You get some hedge against the huge uncertainties we face in normal times, let alone the environment we are moving through now.

At some stage the Reserve Bank will start to first unwind their error of cutting the cash rate an extra 0.75% late last year. They will also at some stage begin to address the risks of higher inflation becoming entrenched in place from the current Middle East shock.

They will be able to do both under the cover of extra inflation appearing because of that shock – which unfortunately is where some of the extra upside risk for inflation arises from the business sector.

Since August 2024 initially but then more forcefully over the second half of last year I have been highlighting the risk of businesses rebuilding crunched margins once more customers appear. The inflation shock from the war provides a good excuse/reason to push through price increases. But the absence of nicely increased customer flows in most sectors will newly restrain this tendency.

How these key pricing drivers balance out is anyone's guess and all we can do is try and read the entrails from the various surveys at our disposal. In that regard the recently released Quarterly Survey of Business Opinion from NZIER is useful to analyse – but not suggestive of inflation restraint.

Looking beyond the obvious headline of a sharp decline in business sentiment, we have employment indicators. A net 9% of businesses said they cut staff numbers during the March quarter and a net 5% said they plan further cuts. This latter reading was a healthy net 22% planning more hiring in the same survey three months earlier.

So, the labour market measures have worsened and that should mean slower wages growth which will help suppress the second round effects of the surge in inflation about to hit us.

However, there was an increase in the net proportion of businesses saying that they are

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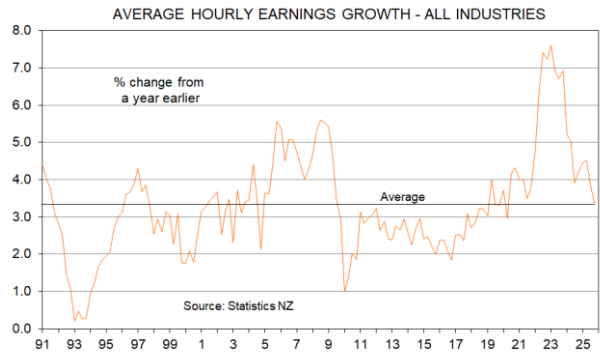
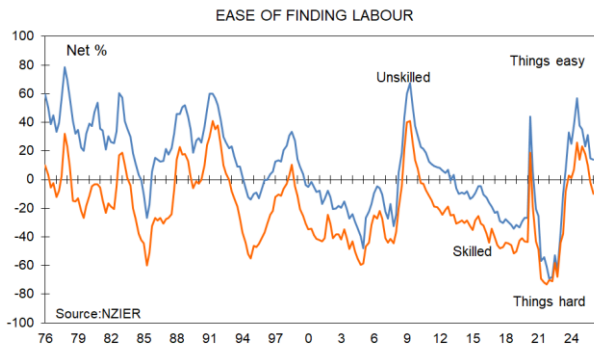


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finding it hard to source skilled labour - to 10% from 2% the previous quarter. This is shown as the orange line in the following graph stretching further downward below the horizontal axis.



The result does not bespeak of a wage surge risk as such. But it does highlight the risk that the labour market is not in fact as loose as the headline unemployment rate of 5.4% would suggest. The Reserve Bank are relying heavily on above average unemployment suppressing growth in wages and therefore inflation.

But with a strong net loss of Kiwis both skilled and unskilled offshore, there remains a risk that wages growth tracks at a still relatively high level.

For your guide, the average increase in ordinary time average hourly earnings since inflation fell to 2% in 1992 has been 3.3%. One would have thought that after pressure from high interest rates and a rise in the unemployment rate from 3.2% that we would currently be experiencing a low rate of wages growth.

But growth over calendar 2025 was 3.3%.

The chances are that this annual rate will dip below 3% in the short-term as the measure tends to lag overall changes in the economy. But it is unlikely that the pace of wages growth will slow down to where things were in the post-GFC period.

Also from the NZIER QSBO we can look at what businesses plan to do with their selling prices. The news is not good. There was a rise in the net proportion planning to jack their prices up to 43% in the March quarter from 25% in the December quarter. The average since 1992 has been 21%.

The data tell us that businesses are planning to cover their shrinking margins by raising their prices and that reinforces the outlook of rising inflation with upside risks.

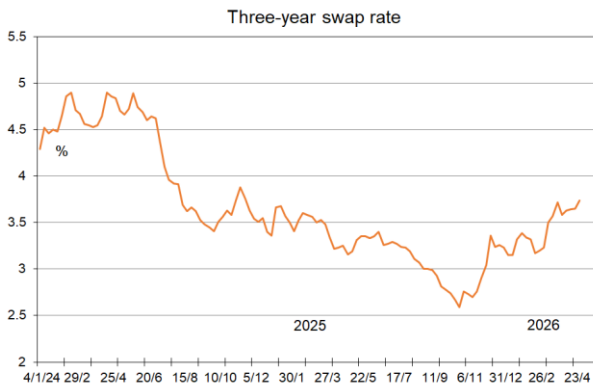
There is more that one could discuss. But the risks are clear. Unless the economy heads back into a decent recession, interest rates risk rising to a firm degree in unpredictable fits and starts over the coming 1-2 years.

History tells us that it is not possible to accurately predict where borrowing costs will peak and when. But if you fix for a medium to long-term period (3-5 years) then that doesn't really matter.

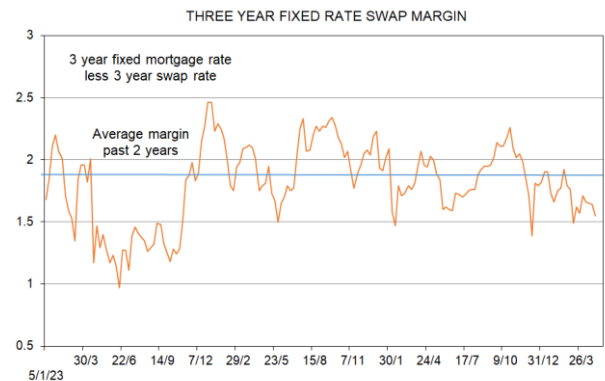
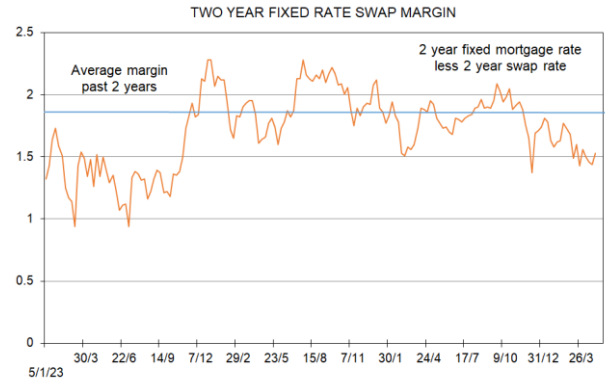
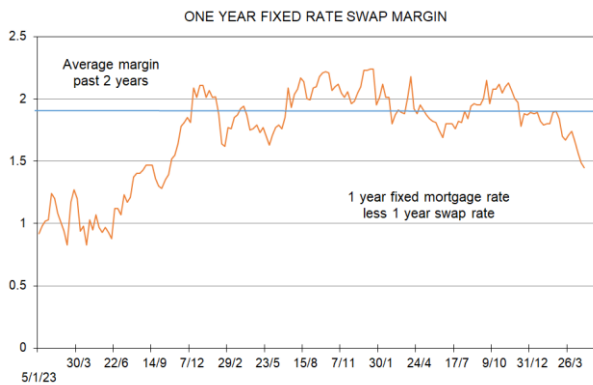
Most borrowers won't. They will continue to focus on the cheaper 1-2 year fixed rates and again be cannon fodder for the messy inflation fight to come. Good luck. Again. And good luck to the Reserve Bank trying to set policy through all these uncertainties.

If I were a borrower, what would I do?

Wholesale interest rates have gone higher this past week with a decent rise last night as the markets factored in a growing risk that the Hormuz Strait blockage lasts for months. The likes of the NZ three year swap rate at which banks borrow to lend to you, and I fixed for three years has risen to near 3.74% from 3.65% last week.



Relevant to floating mortgage rates the 90-day bank bill yield has lifted to near 2.69% from 2.62%. This reflects growing market expectations of a rise in the Reserve Bank’s official cash rate earlier rather than later. Note that margins for fixed rate lending are below average and additional rises loom.



If I were borrowing at the moment, I personally would still favour fixing three years.

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

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