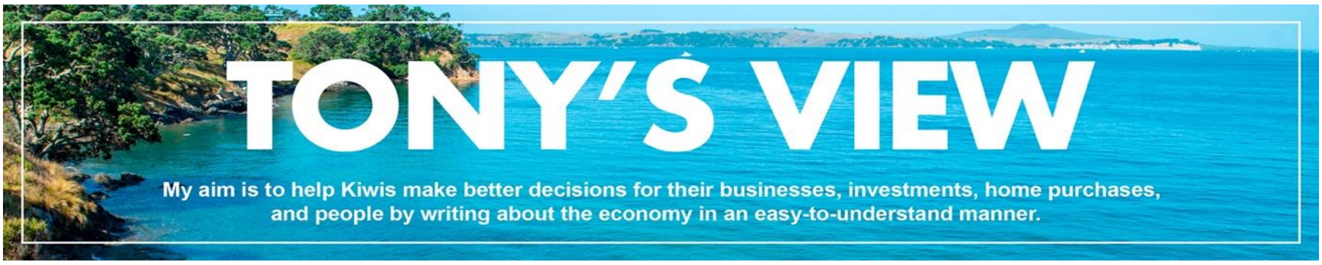


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# Economic boom. I don't think so

In my weekly issue of August 22 2024 I wrote the headline "Rockstar economy. I don't think so". It was in reference to the wave of euphoria suddenly running through the household and business sectors as a result of the Reserve Bank signalling in July that they would soon cut interest rates and confirmation of a cut (0.25%) on 14 August.

This euphoria was seen in the ANZ's Business Confidence Survey rising from just a net 6% of businesses expecting a stronger economy in July to a peak of a net 66% in October. My Spending Plans survey went from a net 42% of consumers planning to cut spending to a net 10% planning to do more come December.

The headline however was specifically prompted by a journalist becoming so ecstatic about the cuts in interest rates that they figured we would experience a massive boom. That was rubbish and over a two week period I published a list of reasons why we would not experience a boom in 2025 and businesses would still need to embrace efforts to cut costs and boost productivity. I should have been slightly more pessimistic as it turns out.

Now, again, there is a new air of optimism afoot following last week's more dovish than expected news from the Reserve Bank. That news was not the universally expected cut to the official cash rate of 0.25% but the reduction in the projected rate low-point from 2.9% to 2.5% and the fact that two of the committee members setting the rate had voted to cut it by 0.5% immediately.

Hopes have been expressed that things are now going to well improve. The Post in Wellington led with a headline regarding a "Spring bounce" in various parts of the economy ahead of Christmas. The assessment in the NZ Herald has so far been much more reasoned.

No-one this time around is talking about a rockstar economy or a boom coming along. Once bitten, twice shy. But there is something important to note.

A lot of attention has been getting paid recently to the level of debt in New Zealand. The message being delivered and lapped up by most is that our debt levels are too high and something needs to be done about it.

What effect does one traditionally get from cutting interest rates? Apart from anticipation of some household cash flow savings for the one-third of families with mortgages, there is an expectation that lower borrowing costs will lead to a stronger housing market and more consumer spending because people will take on even more debt.

New Zealand has a debt problem which eventually will deliver a credit rating downgrade from the rating agencies, probably when we next get a change in government and spending restraints are once again removed.

If lower interest rates are seen as the answer to the economic problem, then there is little understanding about exactly what that economic problem is. Lower borrowing costs can only provide a short-lived then ultimately inflationary sugar rush for one's economy and when it is over and rates have to rise again to fight inflation, the path forward will only have been sustainably improved if the good times were used to address the real factors holding our income per capita growth back.

Given that the economic growth debate in New Zealand mainly centres around which taxes to increase and what new ones to bring in there can be little hope that our productivity growth path will much improve in the next few years. Fonterra's throwing in the towel on branded foods adds to that poor outlook. Dairy farmers will get a sugar hit of over $3bn which will assist the rural recovery and boost the cities next year. But our long-term income per capita growth prospects have been diminished.

Prospects for an acceleration in our economy through 2026 have been improved because of the extra monetary policy easing signalled by the Reserve Bank. Debt growth will be accelerated. But our long-term prospects are unchanged and if the rate cuts take pressure off politicians to support measures which will change our culture and boost productivity, then we will ultimately end up worse off ten years from now looking back in time.



## Assume nice things

You would think that when setting monetary policy the Reserve Bank does so on the basis of a robust set of economic forecasts. After all they have a great number of economists devoted to picking where the economy is headed.

However, if you look at the 59 page Monetary Policy Statement released last week you will find just over four pages only are devoted to their Economic Projections. There is one page summarising their outlook. Then there are just over three pages running through their assumptions. Assumptions are not forecasts.

They assume things like the following.

- That the output gap (the distance between what will be produced and what can be produced) will remain very large for the rest of this year.
- That lower interest rates and higher export prices will support higher growth going forward.

- US tariff policy will lower world growth and be disinflationary for NZ.
- That import prices will fall as will export prices.
- That interest rates offshore fall faster than previously expected, and this boosts the NZ dollar.
- That uncertainty about the world economy suppresses growth in NZ as Kiwi businesses and consumers exercise caution.
- That recent lower than expected house prices cut household spending.
- That house prices in future grow in line with wages.
- That business investment falls in the near future but that the Budget Boost policy will promote investment growth.
- That house building grows in 2026.
- That the track for government spending doesn't change from that contained in the Budget.

And so on for another page.

The point here is not to slam the Reserve Bank. No economic models can be accurate these days, and we are all just grasping at straws, trying to sound intelligent, and shaking in our boots about every prediction we make.

The point is to reinforce that the Reserve Bank's projected cash rate track will be altered again many times in the future and at some stage those alterations will be upward. The markets will be surprised, wholesale and then retail interest rates will be surprisingly increased.

Do not look for certainty about where the economy and interest rates are headed when you consider your plans and think about your interest rate risk management. If you have a plan which is heavily reliant on the economy or interest rates following a particular path, then you'd best invest strongly in real-time indicators of change so you can make adjustments to what you do quickly when the operating environment shifts. Our assumptions too often prove wrong even though at the time of making them they seem very reasonable.



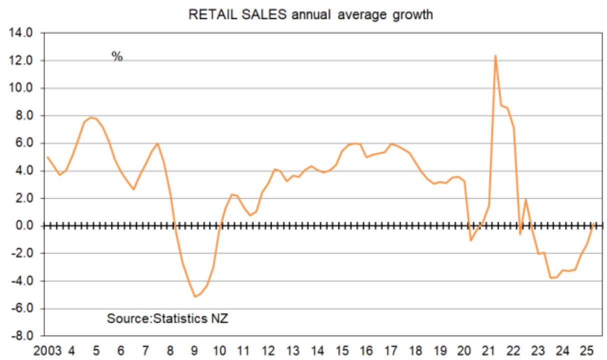
## Retail spending grows

On Monday Statistics NZ revealed that in seasonally adjusted terms the volume of retail spending in New Zealand during the June quarter grew by 0.5% from the March quarter. Core spending which excludes the volatile automotives categories grew by 0.7%.

These growth rates were stronger than expected and the popular view had been that the volume of retail spending shrank during the June quarter.

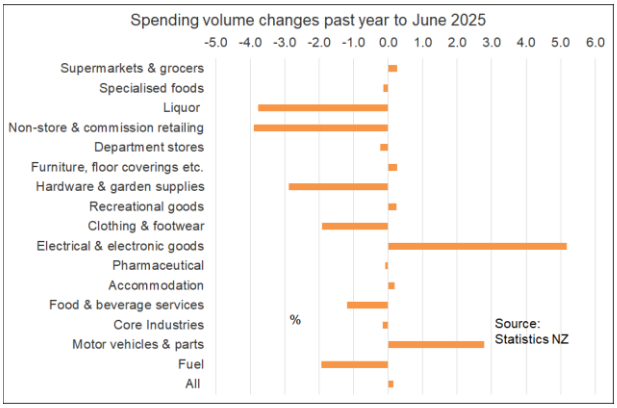
Spending on durable goods grew by an unusually firm 2.1% following a decline of 0.9% in the March quarter.

We can see that a recovery is underway in the underlying trend for retail spending, shown as the annual average change measure in the following graph moving upward. Growth for the full year to June 2025 versus the year to June 2024 was a small 0.2% - the best since 1.9% in the year to September 2022.




This 0.2% annual average growth rate is well away from average growth for the past 20 years of 2.4% and tells us that retailers have been through a very torrid time – for three years in fact.

This graph shows annual average growth by category for the past year. The only area with good growth has been Electrical and Electronic Goods. Some categories have done very poorly including garden centres, food and beverage services (eating out), and clothing and footwear.




Looking ahead we start by extrapolating the most recent trend towards improvement and allow for the lagged effects of lower interest rates and higher farm incomes. For retailers next year is likely to be considerably stronger than this year. But before we get there it is highly likely that we will still see more rationalisation in the retail sector.



Just for your guide, the 0.5% reported growth in real seasonally adjusted retail spending during the June quarter again calls into question the usefulness of the monthly Electronic Card Transactions release undertaken by Statistics NZ.

This is one of the high frequency indicators which the Reserve Bank relied upon to justify its recent dovish stance on monetary policy. However the ECT data produced an estimate of a 0.6% fall in nominal retail sales over the June quarter and that led to the common expectation that when the official retail data appeared for the quarter it would show a 0.3% or so fall – not +0.5%.

To repeat then a point I have made here many times before. Monthly data in our small economy can be highly volatile and we need to smooth things over a three month period to gain good insight into what is happening. But even then we can still end up with quite inaccurate measures such as just produced by the ECT series. And keeping that in mind you can't really place any reliance on regional economic data in our country for periods less than one full year averages.

What are the chances that the Reserve Bank have taken too dour a view of the NZ economy? Maybe high. After all, it took them a long time to realise the weakness in the first half of last year.

I still fall back on this simple dynamic as a warning to borrowers not to get optimistic about rate declines from here on out. After our economy has just shrunk by 1%, inflation in NZ is still bumping near the top of the 1-3% target band at 2.7%. Consumer inflation expectations have risen recently to 5.1%, and businesses have well above average plans for raising their selling prices once the customers return. Add in the lagged effects to come from easier monetary policy, higher farm incomes (with Fonterra's asset sale boost to come also), and we get upside inflation risk for 2027 and interest rate risks from the second half of next year.

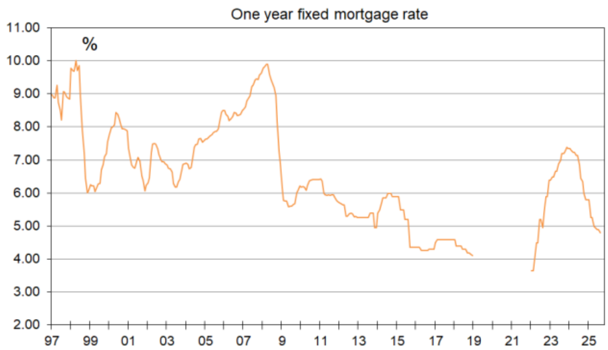
## If I were a borrower, what would I do?

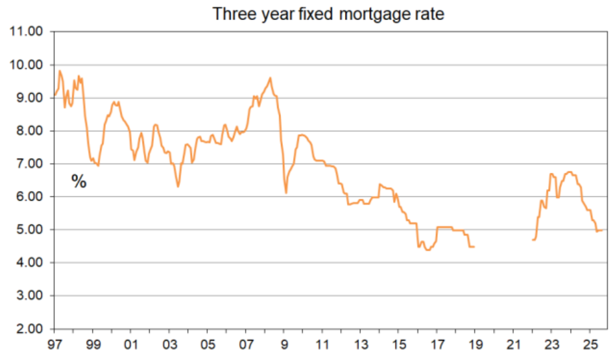
Wholesale interest rates have declined slightly this week, but no fresh news has appeared to alter the underlying dynamics. Those dynamics are potential for another 0.25% - 0.5% to come off retail floating rate borrowing costs but only minimal scope for further reductions of fixed rates from current levels as extra easing is already factored in.

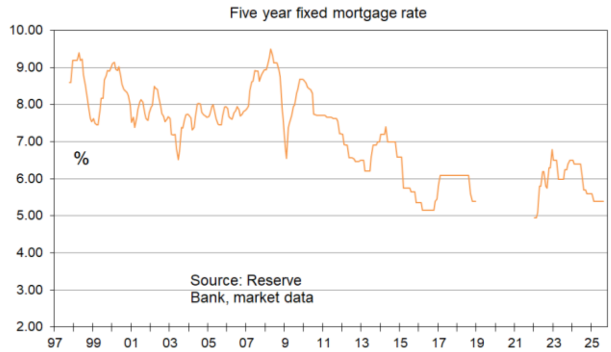


If I were borrowing at the moment, I'd be happy to fix three years but have no issue with anyone opting for a shorter term. Splitting across a couple of terms is often a good idea in order to smooth the impact of rate changes down the track.

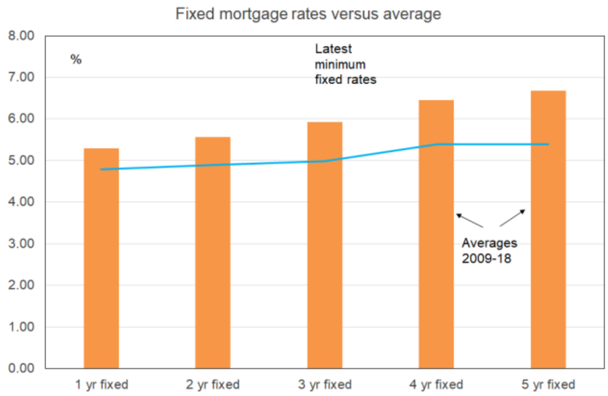
These three graphs show mortgage rates since 1997 excluding the period of deflation worries (2019) and the pandemic.




This graph shows how current rates compare with averages from 2009-18.




To see the interest rates currently charged by major lenders go to [www.mortgages.co.nz](http://www.mortgages.co.nz)

**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.**