Insights

Topical commentary on the Auckland economy

June 2019

Let's connect: How New Zealand's global role affects household buying decisions

- The New Zealand economy is increasingly connected to the global economy.
- This is evident through financial markets (interest rates and exchange rates), trade (exports and imports) and migration/labour (geopolitics and uncertainty).
- The global economy, including global interest rates, are becoming more important for decision-making by the Reserve Bank of New Zealand (RBNZ), the guardians of our financial system.
- As a result, the rest of the world increasingly affects what and how much we buy, from houses to mobile phones.

A stronger connection

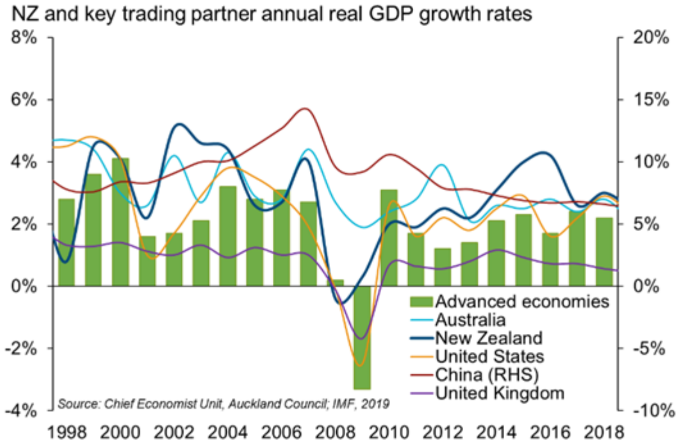
The RBNZ in its May 2019 monetary policy statement and recent bulletin discusses the increasing links between the New Zealand economy and our trading partners, stating that "[our] economic growth has become increasingly synchronised with that of advanced economy trading partners". The fact that we are connected to the world is not news.

But the continued strengthening of our connection to the rest of the world in terms of trade, financial markets and migration impacts us greatly.

Being more connected is both good and bad. Global connection has allowed our economy to continue to expand and has given Aucklanders access to products and services we might not otherwise have had.

But globalisation also means we are increasingly sensitive to troubling international events, such as the Global Financial Crisis (GFC), even though we had very little direct exposure to its causes. During this time New Zealand's GDP growth sunk in line with the world's advanced economies (US, Australia and Advanced Economies).

NZ and key trading partner annual real GDP growth rates



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There are at least three channels that transmit the effects of global economies to New Zealand – trade, migration and financial markets. We now consider these three channels.

International trade

We trade because it gives us access to more products and services at better prices. Issues affecting our trade partners (led by China, Australia and the US) are risks to the demand for and supply of products and services. This has economy-wide effects from weaker business investment and hiring through to higher prices for products and services. Auckland, as New Zealand's trade hub, is considerably exposed to these ups and downs.

So the recent rise of trade protectionism poses real risks. Freer trade has led to mass dissatisfaction in affected sectors, and to political support for trade protectionism, as seen in the US-China trade war. Economies on the periphery are collateral damage.

For example, as Chinese manufacturers feel the pinch, they buy fewer commodities from our second largest trading partner, Australia. The Reserve Bank of Australia (RBA) has identified increased risks for a slowing Chinese economy that can dampen demand for Australian goods and services. In turn, the health of the Australian economy has a direct impact on us.

Migration

It is not just the financial markets and trade that open New Zealand up to global developments. New Zealand's (and Auckland's) ongoing rapid net immigration in recent years further intensifies our connection to the global economy. It also has implications for economic activity via housing and infrastructure demand, consumption, and the reputation of our city and country.

Financial Markets

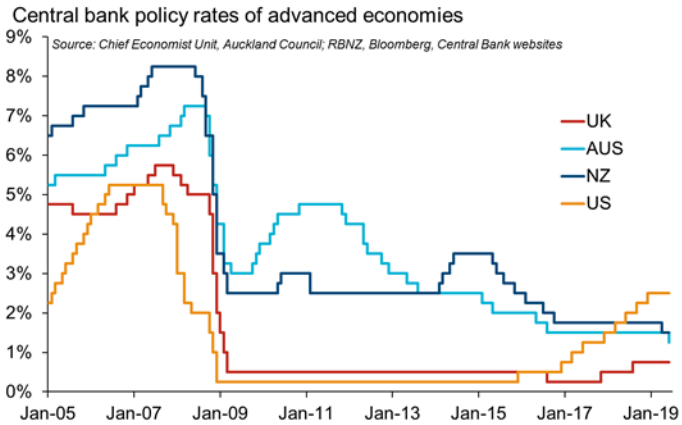
Financial markets move over $3 trillion across borders each day, or 10 times New Zealand's annual GDP. Two financial market mechanisms that influence the wider economy are interest rates and exchange rates. While interest rates represent the cost of borrowing, exchange rates reflect the relative value of one unit of currency and provide a snapshot of the "per dollar" value of an economy.

Although the domestic economy plays a bigger role in the overall health and outlook of the economy, in a small open economy like New Zealand, RBNZ decisions increasingly consider global conditions.

As a result, the Official Cash Rate (OCR) is set by the RBNZ with the domestic and the global outlook in mind, specifically with regard to how they affect inflation and unemployment. The OCR plays a key role in how banks set mortgage rates.

But long-term interest rates (typically the 10-year government bond yield) tend to reflect the economy's long-term health. Long-term rates also tend to be higher than short-term rates. Usually.

However, recently we have seen an inversion in this relationship especially in the US, and risk of inversion in Australia, both of which have considerable flow on effects for us. Higher short-term rates relative to long-term rates make banks nervous about funding their loan book, affecting access to new credit (lending), and they reflect uncertainty about the future health of the economy.



A weakening global economy?

The recent interest rate inversion in the US economy is in contrast to the rise in US interest rates over the past couple of years. But now, the monetary policy outlook for many advanced economies is toward lower interest rates.

As a result, recent decisions by the RBNZ and RBA to lower rates have been accompanied by comments highlighting global risks more than in the past. The RBNZ points out that "since mid-2018 global growth has slowed, and this has affected…activity, employment, and inflation in New Zealand".

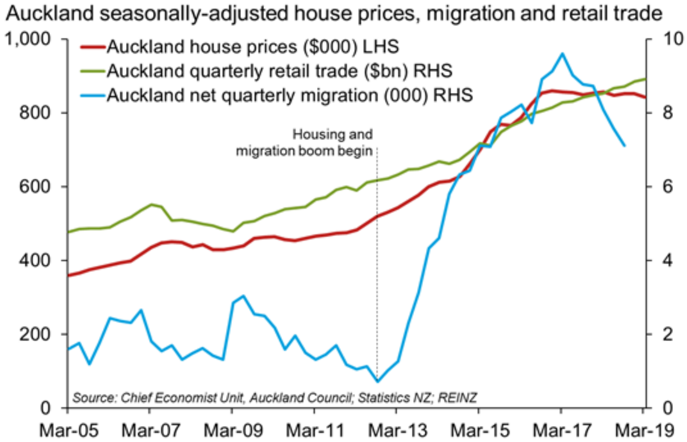
This weaker global picture and the fact that inflation has been low for so long in New Zealand, with little indication of an imminent reason for a surge, mean interest rates in New Zealand are likely to stay low for a long time.

What does this mean for Auckland house prices?

Economists rarely tend to agree on much, but there is a consensus that lower interest rates facilitate up-swings in house prices and other investment. When the cost of borrowing falls, people can borrow more to [bid up prices in times of housing shortage.]()

Another outcome is that people borrow to invest in businesses. In the meantime, this means that as Auckland tackles its housing shortage, with mortgage rates now lower there could be a possible lift in prices as the gavel holds out for the next highest bid. At the very least, the recent nervousness brought about by the capital gains tax risk and foreign buyer ban seems to have been arrested with the former off the table, the latter baked into prices already, and lower interest rates.

Auckland seasonally-adjusted house prices, migration and retail trade



What does this mean for what you buy?

During times of house price growth, people perceive themselves to be wealthier – the *wealth effect*. We saw this during the last house price boom in Auckland. Nominal retail trade in Auckland grew 10.8% in the year to June 2016, for example, as house prices surged.

When they feel richer, people opt to increase the quality or quantity of the products and services they purchase. Lower interest rates also mean that people aren't earning as much for their savings, so the temptation to consume that little bit more rises, or to instead invest in another asset, like a house. People also have more money left over to spend on other things after servicing debt because of low interest rates.

On the other hand, renters don't get the benefit of a wealth effect and face the additional challenge of house prices rising further in times of low interest rates and housing shortage. This can increasingly keep renters off the property ladder.

What does this mean for Auckland ratepayers?

Auckland Council does some of its borrowing oversaes. Overseas markets give better access to greater volumes of trade, allowing diversification and more competition for our borrowing, which is good for the ratepayer. At the same time, because a lot of Auckland's borrowing is for infrastructure and other long-term investments, good risk management requires the council to lock in fixed rates on most borrowing. This means the immediate benefit of lower interest rates takes some time to flow through, but also protects council borrowing against interest rate uncertainty.

Putting this all together, there is no doubt that New Zealand has become increasingly connected to the global economic web. With it comes a bigger market to play in, but also considerations that must be accounted for when making decisions around consumption and investment, and an even bigger responsibility for the guardians of our financial system. In the medium term, we expect that those guardians will continue to keep interest rates low as they watch weak international economic conditions.

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