THE WORLD IN TEN MINUTES

MONTHLY ECONOMIC ROUNDUP

July 2018

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Our View

There is little doubt that the NZ economy has hit a soft patch. But this does not mean that things will get worse. Business confidence about the general outlook is a poor indicator of future activity, and companies in New Zealand and abroad continue to enjoy strong profit growth. A global trade war is a concern, but hopefully the awareness that no one wins will keep politicians in check. New Zealand households have taken on very high levels of personal debt, mostly to buy into very expensive housing. The worm looks like it has finally turned on our housing market as discussed in our June feature, and in our view this presents a more material risk for our economy.

JULY FEATURE

Pricing at the Margin

Alfred Marshall was a very influential English economist in the late-19th Century who was first to develop the standard demand and supply graphs now taught at high schools throughout the world. The basic idea is simple – the "equilibrium" or market-clearing price of a good or service is found when demand matches its supply. But there is an implication of Marshall's work on prices that is often forgotten, and which matters enormously for a debate that has raged in New Zealand since at least the mid-1990s - the impact of foreigners on the price of housing.

Data from Statistics New Zealand suggests that foreign buyers may have counted for around 20% of house sales in Auckland, 10% in Queenstown, and around 3% nationally, over the past year. For real estate agents and other parties incentivised to keep the ball rolling (such as developers and some local body politicians) these figures are seen as too low to matter, and hence measures to restrict foreign buyers in our market are decried as unnecessary and damaging for New Zealand's international reputation. This view largely swayed National when in power, who was even loathe to support a collection of data on foreign buyers (though they did tighten up on the sale of 'sensitive' land to offshore purchasers). The current Labour-led coalition government, in contrast, has ploughed ahead with their pre-election promise to limit the ability of foreigners to purchase residential housing. Associate Finance Minister David Parker suggested that the fact foreign activity was higher in the more expensive parts of New Zealand vindicated the move to ban foreign buyers.

So, who is right? Marshall's analysis from over a century ago would suggest that the portion of foreign vs. domestic buyers is a red herring. Instead, what matters is the marginal price setter or buyer who is willing to pay just that bit more than anyone else. This buyer will obviously be the successful house purchaser. But more than that, such a buyer can establish a new "reference point" for real estate agents' to market other listings at; which in turn can impact prices for a street, and then a neighbourhood, and then a suburb, and so on.

In other terms, if a foreign buyer thinks our market is cheap compared to what they perceive the value of housing to be, the buyer may well-be the marginal price setter. And not just for a market in which foreign buyers are active in. If some NZ residents are unwilling to pay a new reference price in, say, Auckland, and move to other parts of New Zealand to grab what they perceive to be a bargain, this can set up a dynamic of prices ratcheting up in regional New Zealand too. The media has called this the "halo effect". In the economics jargon it is an example of marginal price setting.

The argument above suggests that even with small numbers foreign buyers may have had an outsized influence on the dizzy levels that house prices are today. Alternatively, have foreign buyers been passive actors in this story, buying at prices set by Kiwis who found they could afford higher and higher prices as interest rates fell to very low levels? Reserve Bank of New Zealand evidence on the matter suggests that net migration is a very important driver of house prices, which tend to suggest that foreign buyers (and returning kiwis) have been key marginal price setters. Net migration has peaked and house price growth is slowing (see figures over page). With this and restrictions coming on foreign buyers, as well as the ring-fencing of tax losses, has the worm finally turned?

KEY FACTS

Events

- The Trump Administration proceeded with its tariffs on steel, aluminium and other products. China, the EU, Canada and many other nations affected have responded with tariffs on the US, and launched a case with the World Trade Organisation to protest the legality of the US moves.
- Markets so far have largely shrugged off the tariff moves and the risk of the trade war intensifying. The exception is the Chinese equity market, which is down over 20% so far this year.
- The NZ economy is growing, but at a weaker pace than has been experienced over the past few years. NZ business confidence about the outlook has turned quite pessimistic, although most businesses still expect their own conditions to improve.

Economics

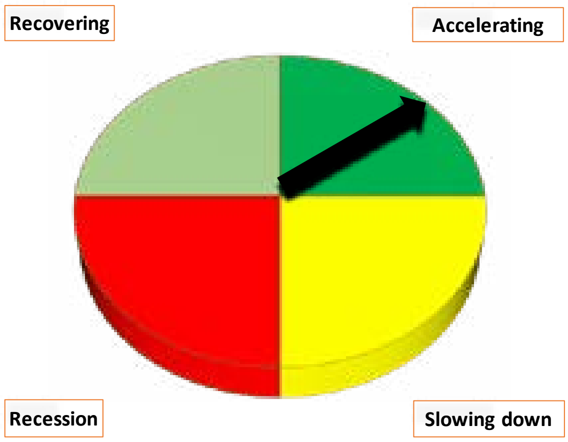
- All 24 economies that are members of the MSCI developed equity markets index are currently growing, as are the 26 economies that make up the MSCI emerging market index.
- Global real GDP growth is currently running at around 3.8%, well above the 2.5% level experienced on average over the past decade. The most recent data outturns suggest this pace may be moderating, although more so in Europe than the US where conditions remain very strong.
- The Reserve Bank of New Zealand left the OCR on hold at 1.75% in its 28 June update. It noted that the weaker-than-expected GDP outturn for March means its assessment of inflationary pressures are also weaker.

Markets

- Developed equity markets were flat for the month of June, whilst Emerging Markets were down around 4.5%. In contrast the Australian and NZ share markets increased around 3.5%.
- The NZ dollar fell against major currencies, declining around 3.5% against the USD, 2.5% against the Euro and around 1.5% against the Yen and British Pound.
- Prediction markets for the FIFA World Cup have been horribly wrong. Favourites like Germany and Brazil have been knocked-out. Bucking decades of disappointment of its fans, England has advanced to the semi-finals.

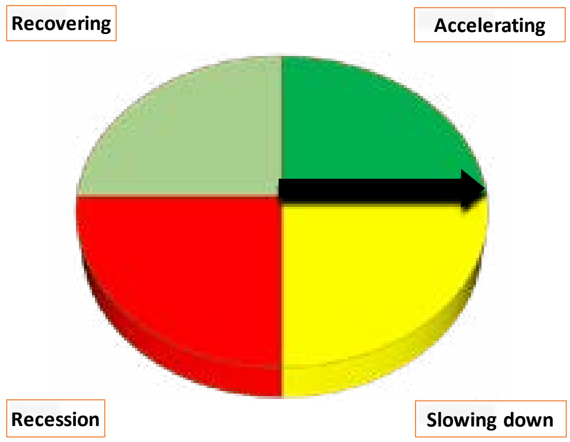
KEY FIGURES

Figure 1: Global growth is accelerating



Source: MyFiduciary, OECD

Figure 2: NZ growth is around trend

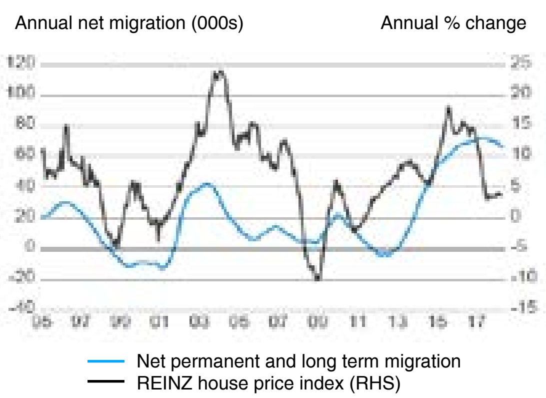


Source: MyFiduciary, Statistics New Zealand

Figure 3: Risk to growth and markets are moderate but event risk is material

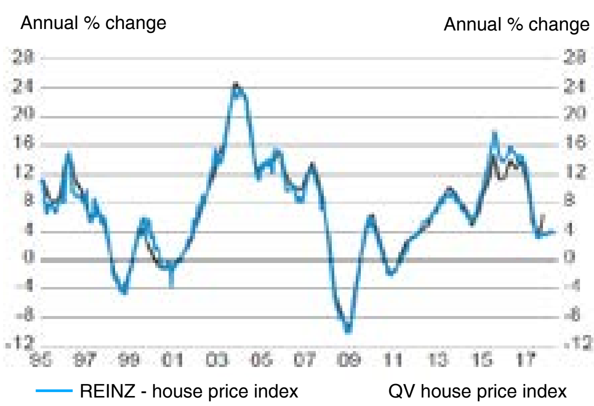
Source: MyFiduciary, BlackRock Market Risk Monitor

Figure 4: Net migration matters for NZ house prices



Source: Statistics New Zealand, REINZ

Figure 5: Has the worm turned



Source: REINZ, QV