The current state of the New Zealand economy,

by Keith Rankin, 13 April 2007

At 10:45am on Black Friday (13 April), the New Zealand dollar shot up from it's already excessive highs, even against the buoyant Australian dollar. Market interest rates for periods from 90 days to 10 years also jumped sharply. The markets were responding to the news that, in February, there was an unexpectedly large increase in retail sales, especially in supermarkets, appliance stores, and restaurants.

We are still conditioned to believe that an increase in the value of the Kiwi dollar is a vote of confidence in the New Zealand economy. Indeed this rise came two days after the government trumpeted a record low number of people receiving unemployment benefits (29,000) as proof that the New Zealand economy is performing better than it has for decades.

Let's take a reality check. Why did the Kiwi dollar really increase? It increased because the surge in consumption spending is very bad news; so bad that the Reserve Bank will feel even more compelled to raise interest rates.

In other words, the world's financial markets are taking a one-way bet on us. As a result of this news, the chance of a cut in interest rates sometime soon is now seen as zero. The chance that interest rates will be raised this month has increased. And, most importantly, the tone of the Official Cash Rate announcement on 26 April is almost certainly going to be more pessimistic than it would otherwise have been.

Overseas investors love it when our Reserve Bank is pessimistic. It means we pay them higher interest rates. So they bring even more of their money into the country. Much of this money is borrowed at much lower interest rates overseas. This pure speculation is called the "carry trade".

This carry trade money either flows in or it flows out. There's no middle ground.

What happens when it flows in? The exchange rate surges as the borrowed overseas money is used to purchase Kiwi dollars. Our banks, even more flush with funds, desperately seek even more borrowers, whose spending on imports prevents the exchange rate from rising even more.

With the exception of the globally buoyant dairy industry, New Zealand banks don't want to lend to businesses that compete with foreign producers. The high New Zealand dollar has rendered uncompetitive New Zealand's manufacturing, tradable services and non-dairy farming. These crippled industries are required to be our country's breadwinners of the twenty-first century.

So who will the banks increase their lending to? You and me, is the answer. They lend more to households, especially lending secured by mortgage or consumer durables. They also lend more to the "non-tradable" sector, meaning construction, utilities, retail and financial services.

The carry trades have made the New Zealand economy excessively liquid. That liquidity of course drives the high retail figures, while also employing more people in the non-tradable service sectors. The national accounts show that gross national expenditure has increased much faster than gross national income.

Intelligent readers will see that this process is a vicious "upward" spiral. Higher retail spending increases the likelihood that the Reserve Bank will increase interest rates. And rising interest rates in New Zealand further stimulate the carry trade, which both makes the New Zealand economy more liquid (meaning even more retail and housing expenditure) and pushes up the exchange rate, further ruining our tradable sector businesses.

What will happen when the carry trade reverses? Large sums of hot money briefly flowed out early in March - following a minor panic in the Shanghai stock exchange - before flowing back into New Zealand in double strength. Was this now-almost-forgotten event a warning shock before a major financial quake?

We have to be prepared for a more sustained reversal of the carry trades which have pushed both our dollar and our housing markets to grossly unsustainable levels. Tough talk by the Reserve Bank may not be enough, and is at best a short-term fix.

Our government, basking in the glory of its data on unemployment benefits, is quite unprepared.

What, by the way, is the true picture of unemployment? The most recent official unemployment figure (actual, not seasonally adjusted) is 79,000. Actual unemployment always rises in the March quarter, so the next official release will show in excess of 80,000 actually unemployed.

The same data source shows 162,000 people were jobless ("those without a job and wanting a job") at the end of 2006. In fact the number of jobless people increased by 17,000 between the end of 2005 and the end of 2006. Given seasonal factors, the March 2007 data will show a further rise in joblessness.

The New Zealand economy is not performing well. Further, it is balanced on a knife edge, and the knife is getting sharper. The foreign "carry trade investors" who prop us up at present do not actually care about us. They care only for their own profits.

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