RODNEY'S RAVINGS take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports, that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can signup to the **RAVINGS** and for notification about forthcoming **Property Insights** and **Property Research** reports on our website – http://www.sra.co.nz/lists/.

RODNEY'S RAVINGS

Putting the cut in Fonterra's payout in perspective

EXECUTIVE SUMMARY

Having been in Hamilton when Fonterra announced the cut in the dairy payout, which was reported in the paper as meaning a $400m loss in income for the Waikato region, it is no wonder some people asked me how much this might dent the recovery underway in the local housing market. My response, based on past research, was that the negative impact would be limited compared to the stimulus in the pipeline from super-low interest rates and rising net migration. But the "urban legend" that the diary industry is the heart of the Waikato economy runs deep in some quarters so to better answer this question his brief Raving looks at the relationship between dairy commodity export prices, which are used as a proxy for the dairy payout, and housing market activity in the Waikato.

It may come as a surprise to people brought up with the idea that the dairy industry is the heart of the Waikato region but the data confirm my earlier research on the topic. Cycles in dairy product prices have limited impact on local housing market activity and there are even noticeable examples of falling dairy product prices being associated with rising housing market activity and vice-versa. As our regular pay-to-view reports on the housing market show, interest rates and net migration are the primary drivers of housing demand so the "green shoots" appearing in the Waikato housing market should blossom and bear fruit despite the slashing of the diary payout.

More generally my past research has also shown that it is an urban myth the economic upturns start in the agricultural/export sector and filter through to "Queen Street", which may be an appropriate topic for a future Raving given that I suspect many people still believe in this rule of thumb.

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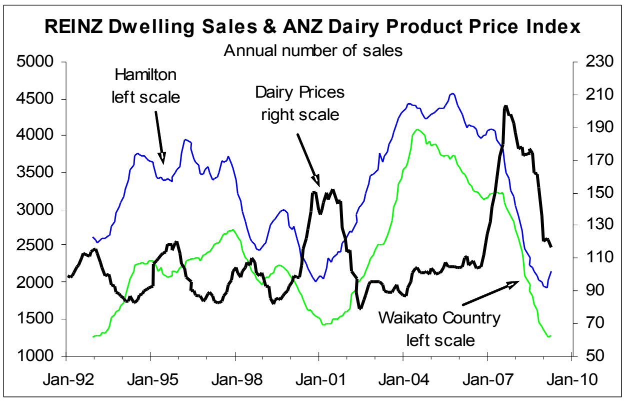
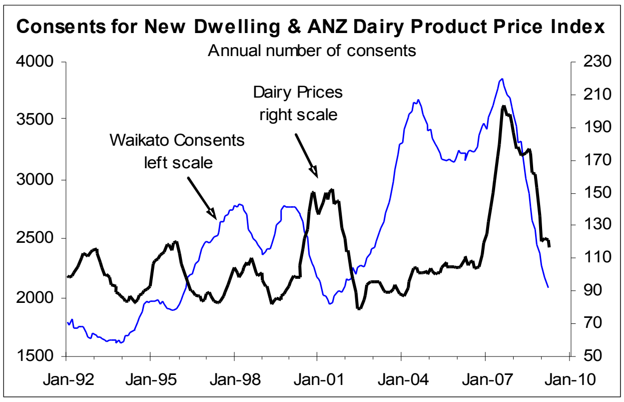
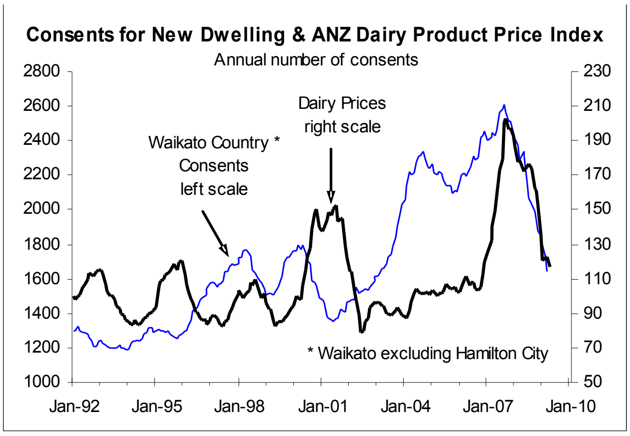
When in doubt look at the facts

Many moons ago I was briefly a member of the Monetary Policy Committee (MPC) at the Reserve Bank. To my dismay the discussion around the table at the MPC was a series of “I think this” and “I think that” (i.e. opinions based on preconceptions and/or rules of thumb). The quality of the analysis of economic prospects at the RBNZ has improved materially since those dark ages although when I critique the RBNZ’s forecasts, as covered by our **Monetary Policy Briefing** reports (http://www.sra.co.nz/monetary.html), I find that at times preconceptions and wishful thinking still overrides quality analysis. Over the years I have focused on searching out the facts and using them as a basis of argument rather than blindly adhering to rules of thumb. Often the rules of thumb are intuitive appealing, like the idea that what happens to the dairy payout will have a material impact on the Waikato housing market. But as often as not I find that these rules of thumb are not supported by the data and this is a case in point.

The left chart shows the relationship, or lack thereof, between the ANZ NZD Diary Product Price Index, which is used as a proxy for the dairy payout, and the annual number of REINZ dwelling sales in Hamilton City and the rest of the Waikato region (labelled Waikato Country in the chart). Even a cursory inspection of the chart reveals that cycles in dairy product prices have had little impact on house sales although at times the relationship has been inverse or perverse. Rising diary product prices corresponded with falling house sales in 1997-98, 2000-01 and 2007-08, while falling dairy product prices were associated with rising house sales in 1993-94, 2001-02 and is about to happen again.







The story is the same when we look at the relationship between diary product prices and the annual number of consents for building new dwellings in the Waikato as is shown in the right chart above. Even when we look at the relationship between dairy product prices and the annual number of consents in Waikato Country, where there is reason to expect a closer relationship, the data point to dairy product prices having had little impact on consents (see the adjacent chart). The fall in the payout will have some impact but the charts, which reflect how the world actually works, offer little reason to expect the $400m hit to the Waikato region to derail in the blossoming housing recovery.

We can explain prospects for national and Waikato house sales and residential building consents with a high degree of accuracy based on assessing the impact of interest rates and net migration/population growth, aided by some consideration for what economists call Tobin’s Q for assessing prospects for new house building (i.e. the relationship between existing house prices and the cost of house and land packages). This analysis is presented in our **Housing Prospects** (http://www.sra.co.nz/housing.html) and **Building Barometer** (http://www.sra.co.nz/building.html) reports. The outlook for the housing market and the domestic economy more generally are driven much, much more by interest rates and net migration than by export prices but this hasn’t brought an end to the urban legend that the agricultural/export sector is the heart of the NZ economy. Like any sector it is important and it has some impact on housing demand, but this impact is dwarfed by the impact of interest rates and net migration. So here’s a big thumbs up to the unfolding Waikato housing market upturn and to the Chiefs!