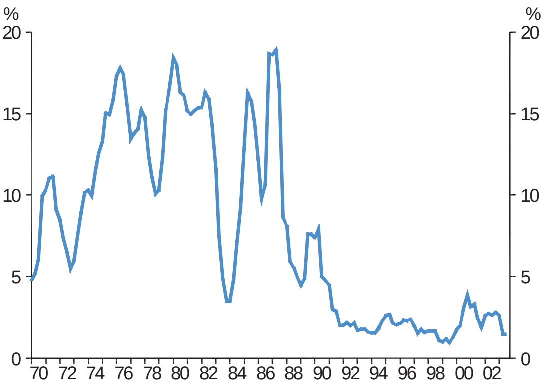
Investing in a low inflation world

An address by Dr Alan Bollard, Governor, Reserve Bank of New Zealand, to the Auckland Club and the MBA Business Meeting, Auckland.

14 October 2003

The theme of my speech today is "investing in a world of low inflation". New Zealand has succeeded in achieving a low inflation rate and keeping it stable for more than a decade now. The average CPI inflation rate since 1992 has been just 2 per cent per annum, as against an average of 12 per cent per annum in the 1970s and 1980s.

Figure 1
CPI inflation



Sources: SNZ, RBNZ.

I have chosen my topic because I fear that, currently, too many New Zealanders are taking higher risks than they realise in their investment and borrowing strategies, because they don't understand that investing in a low inflation environment may be quite different from investing in the high inflation environment of earlier decades.

Some of these risks arise due to the mix of assets New Zealanders are investing in. I suspect that too many households may be over-exposed to real estate investment, and that too many are becoming increasingly exposed to relatively high risk financial investments, without fully appreciating the risks involved. Also, there are some risks relating to the extent of borrowing being undertaken by households, which has left many households with very high levels of debt.

Before getting into these issues, let me briefly say why I think this topic is important, and why the Reserve Bank takes a close interest in the issue of saving and investment.

Households making well-informed saving and investment decisions not only make themselves better off, but also contribute to the stability of the financial system and growth across the economy.

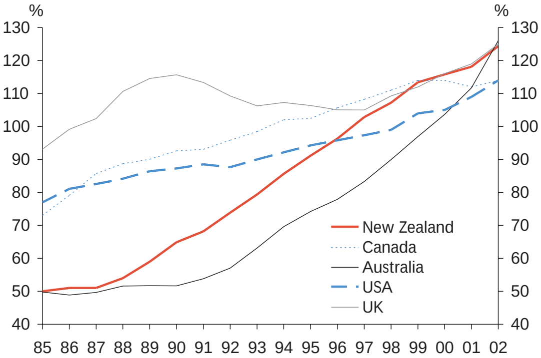
Of course, at any point in time, not all New Zealand households are in a position to save and invest, and not all savers can afford anything other than a house as their investment. Currently, about one third of households own their house mortgage-free, putting them in a good financial position to consider a range of investments. A further third live in a house they own, but with a mortgage, and for these households a strategy of reducing the mortgage as quickly as possible may make a lot of sense. The remaining third live in rented accommodation, and some of these households may have a strategy of saving to buy their own home.

However, for households in any of these categories, if their financial position and scope to invest in a range of assets improves, important decisions about investment strategy arise. Those strategies often involve investing greater proportions of funds in financial investments, as opposed to housing, increasing the need to be well-informed about the risks involved.

Clearly, unsound investment and borrowing decisions can have severe consequences for individuals and families. Households with high levels of debt and exposure to investments that are riskier than they appreciate could potentially face painful problems. Some may find that the rate of return on their investments is considerably less than they had thought it might be, or even that their investments make a severe loss. Some may find that the debt they have accumulated takes a lot longer to pay off than they had expected – and indeed considerably longer than it would have in the years of high inflation. Some households may find, as a combination of all these things, that they are not well placed to cope with the "rainy days" that occur from time to time, such as higher interest rates, a recession, or a loss of employment.

Here, the data on household balance sheets in New Zealand tell an interesting, but not a comforting, story. Households have been borrowing heavily over the last 10 years or so – as nominal interest rates have halved and finance has become easier to obtain – and household debt compared to income is now at the highest levels on record. Debt now stands at about 130 per cent of income, as against just 65 per cent in 1990.

Figure2
Household debt as a percentage of disposable income

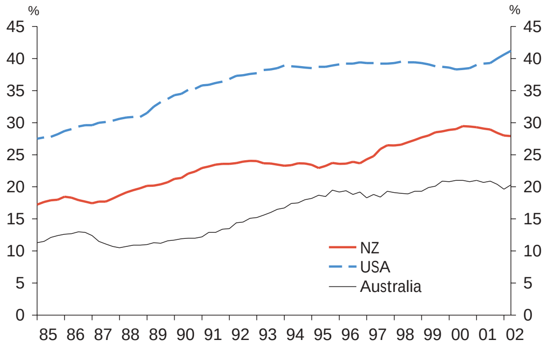


As I noted already, about half of New Zealand's homeowners have fully paid off their mortgage and have little other debt. Mortgage debt is concentrated within the 25 to 45 age bracket, with some homeowners in this category carrying high levels of debt for a lengthy period of time. Such households now may be much less well placed to cope with the unexpected than others in their position once were.

The high level of borrowing by New Zealand households is also reflected in data on household leverage – that is, the ratio of household debt to the value of the house. The leverage ratio has drifted upwards in the last 20 years or so, from 15 to 20 per cent in the mid 1980s to around 30 per cent today. Australia and the US have seen similar trends.

Finally, as far as the numbers go, the debt servicing burden of households (including those owning rental property) has been broadly constant over the last 10 years, at around 10 per cent of household income. However, this has been in an environment of falling nominal interest rates. Nominal interest rates are now at historically low levels. An important question to ponder, therefore, is how would households cope with an increase in interest rates, now that average debt-to-

Figure3
Ratio of household debts to real assets (gearing ratio)



Sources: RBA, RBNZ.

income levels have essentially doubled. Interest rates have been relatively stable in recent years, but there will inevitably be times when pressures on inflation will require interest rates to rise.

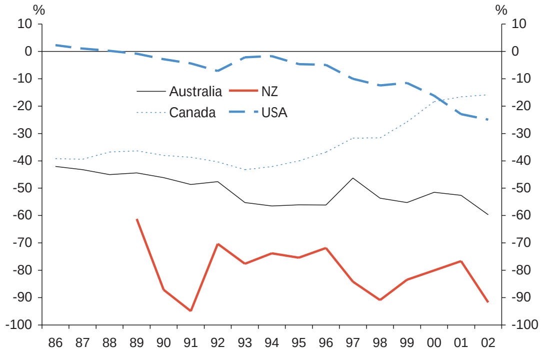
Why is the Reserve Bank interested in this?

Obviously, individuals and families may find themselves in difficulties as a result of poor investment and borrowing decisions. My concern is not only about that, but also about the wider economic implications of any such difficulties.

The financial health of households is important for the stability of the New Zealand financial system and the New Zealand economy. Households that borrow do so almost entirely from banks, and lending to households makes up about 40 per cent of total bank lending. Therefore, the ability of households to service their debts is crucially important to the health and soundness of banks and the broader financial system.

As well as influencing the banking system, household investing and borrowing behaviour affects financial stability in New Zealand through the country's external financing. Household borrowing that is not funded by domestic savings must be financed offshore. Partly as a result of strong household borrowing over many years, New Zealand has a very high ratio of net external financing relative to our GDP – indeed, one of the highest ratios of any advanced economy. Currently, New Zealand's net financing from offshore stands at about 90 per cent of GDP, compared with just 60 per cent for Australia, 25 per cent for the United States and 15 per cent for Canada.

Figure 4
Net international investment position
(as a percentage of nominal GDP)



Source: IMF *International Financial Statistics*

New Zealand's high dependence on external financing creates a risk that foreign lenders may at some time become more reluctant to increase their exposure to New Zealand. This would raise the premium we would have to pay in order to maintain access to offshore funding. Foreign lenders may even seek to withdraw their existing funds in New Zealand, especially if perceptions about the New Zealand economy, rightly or wrongly, take a turn for the worse. A sudden reduction in foreign lenders' willingness to continue to fund New Zealand borrowing would force the New Zealand economy through a sharp and painful adjustment – possibly including a drop in the exchange rate, a jump in interest rates and gyrations in economic activity. If too extreme, the strain of these adjustments could undermine the proper functioning of the financial system, which would worsen the economic disruption.

I should say at this point that, as far as we can tell, the system remains well placed to weather most plausible scenarios. Asset quality, capitalisation, risk management capacity and the state of parent banks are all strong. New Zealand is comfortably servicing its external debt, supported by a healthy economic growth rate and a robust capacity to earn foreign exchange. Hedges are in place to reduce the impact of exchange rate movements on New Zealand's external obligations. But this healthy situation notwithstanding, we would of course be remiss if we did not continue to watch developments closely for signs of financial vulnerability.

Lastly, we are interested in investment and borrowing behaviour because it affects economic growth. New Zealand's growth in the past has probably been lower than it could have been, partly reflecting poor savings and investment. The high and variable inflation environment prevailing in the 1970s and 1980s was no doubt one of the main factors hindering effective saving and investment, by making it difficult for investors to discern well-performing from poorly-performing investments.

Low and stable inflation now obviously helps, but the fact remains that the quality of our investment decisions is crucial for our future economic growth. Wise investment increases productivity and the economy's real rate of return, producing better growth and higher standards of living. And wise investment, in turn, means individual investors exercising good judgement and effective scrutiny when making their personal investment decisions.

So, with an eye on sparing households unnecessary grief, mitigating risk to the financial system, and maximising economic potential, how should we invest in a world of low inflation?

Let us start with the simple idea that the objective of investment is to maximise the expected rate of return for a given level of risk, over a particular period of time. Risk is the potential variability of the investment's return, including, in the extreme, the possibility that the investment might lose some or all of its value. For example, the investment might go bust, it might be difficult to realise the value of the investment when needed or required, and economic factors such as exchange rate or interest rate movements might cause the value of the investment to fluctuate.

It is a fact of life that investments with higher promised rates of return generally carry higher levels of risk. This rule applies right across the spectrum of different investments – from low-risk propositions, such as bank deposits and government bonds, through to higher-risk ones, such as corporate bonds, subordinated notes, real estate and equities.

The second important idea is that, when looking at the return on an investment, one should distinguish between the nominal return and the real return. The nominal return is the return received in cash flow and in capital gain *before* taking into account general price inflation, while the real return is the nominal return less the general inflation rate over the life of the investment. For any given level of risk, the higher or lower the inflation rate, the higher or lower the promised nominal return, generally speaking. But it is the real return that investors need to focus on – for it is the real return that determines whether the investor has gained or lost in making the investment. In today's low inflation environment, investors need to remember that an investment's apparently low nominal return may represent in fact quite a worthwhile real return.

The drivers of real returns vary depending on the type of investment, but ultimately come down to certain basic fundamentals, such as growth in the economy and in particular industries, market shares, and company productivity. And, of course, all of these factors also affect the risk attaching to the investment.

How does low inflation fit into this?

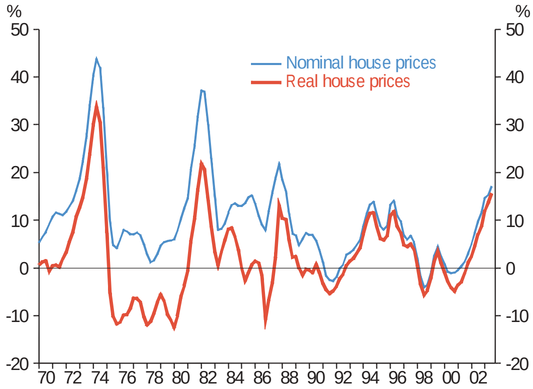
Take real estate. New Zealanders have a fondness for investing in housing, currently holding around half their assets in that form. Most of this is owner-occupied housing, but an increasing proportion is investment in rental housing. New Zealanders are investing in rental housing to a significantly greater extent than in earlier years, with the proportion of private rental housing having risen from less than a fifth of total private urban dwellings in 1991 to around a quarter in 2001. I suspect it has risen further since then.

In the 1970s and 1980s, when inflation was well into the double digits, house prices generally increased at a brisk pace in nominal terms, though with considerable volatility. In real or inflation-adjusted terms, however, house prices were even more volatile and there were significant periods when house prices fell in real terms, as in the middle of the 1970s and late 1980s. For much of the 1970s and 1980s, housing was not a particularly attractive investment, unless of course one bought and sold astutely, getting timing right, taking advantage of trends in particular locations, and reading demand and supply with good foresight.

As a matter of arithmetic, not everyone can outperform all the time. For every buyer there is a seller, and had investors looked at the real return achieved on average across the whole market, they might have felt that their exposure to housing was excessive through the 1970s and 1980s.

Since the early 1990s, house prices have generally outpaced the inflation rate – that is, they have risen in real terms. That is especially the case in the last year or two, during which

Figure 5
Nominal and real house prices
(annual percentage change)



we have seen a dramatic increase in real estate prices in many areas throughout the country – arguably too much so. And this reflects the inherent volatility of real estate prices, whether in housing, farm land, commercial property or industrial property. Investors need to be mindful that the laws of gravity apply not only to Newton's apple – they also apply to asset prices, including house prices. In real estate, the "laws of gravity" relate to things like population, income, household formation and the earning potential of the asset.

And this is where the low inflation environment matters for those who borrow to invest in real estate. In the 1970s and 1980s, there were sharp falls in real terms in house prices and other property prices – typically immediately following a period of dramatic increases – but it was comparatively rare for prices to fall in nominal terms. This meant that if someone were forced to sell in a downturn, the value of the house would probably still be above the value of the debt on the house. Inflation would have shielded the investor from insolvency, at least in that respect.

In contrast, in a world of low inflation, fluctuations in house prices can result not only in falls in real terms, but also falls in nominal terms. The risk for investors who borrow almost all of a house's sale price is that the value of the house could fall below the debt they owe. That is probably fine, as long as the investor can continue to service his or her debt. But it could cause real problems in the event that the debt can no longer be serviced – such as when interest rates rise sharply, or incomes fall. In that situation, if the investor is not covered by mortgage protection insurance and is forced to sell the property during a downturn, his or her insolvency on paper might become very real indeed.

In view of the increase in household debt in the last 10 years or so, the increasing tendency for people to own a house for investment purposes, and to enter that investment very highly geared, it is possible that some households are now quite vulnerable.

That vulnerability is also related to the effect that low inflation has nowadays on the funding side of the household balance sheet. In the days of high inflation, most New Zealanders could rely on their nominal incomes also inflating quite rapidly. This meant that, even with the high nominal interest rates prevailing at the time, households that borrowed on debt-servicing terms at the limit of affordability would find their debt-servicing burdens becoming more comfortable, and the real value of their debts declining, fairly rapidly.

This is not the case today. Low inflation means that nominal incomes are rising much more slowly than in earlier years. As a result, the burden of debt servicing lasts for longer, and the real value of debt is eroded less rapidly. The period of vulnerability associated with debt-servicing being just affordable now lasts considerably longer.

Some home owners and investors are well aware of the compounding impact of high debt levels on adverse events such as loss of employment or income. They adjust their investment and borrowing behaviour accordingly. However, I think there remain many in this country – and indeed in other countries like ours – whose behaviour suggests that they might not understand the risks they are taking.

Leaving real estate aside now, what other investments are available, and how does low inflation affect the equation? After bank deposits, probably the most commonly understood financial security is equities. History shows that equities can deliver a superior long-term rate of return, but also that equity returns over short periods of time can fluctuate quite a bit. New Zealand investors tend to know this, having suffered in the 1987 crash, and have been rather cautious ever since. This caution and the small size of the domestic market, which limits local options, have contributed to New Zealand households not building up financial assets to the same extent as has happened in the US. However, it has also meant that New Zealand household balance sheets did not take such a hit from the tech-wreck and post-9/11 downturns in the markets.

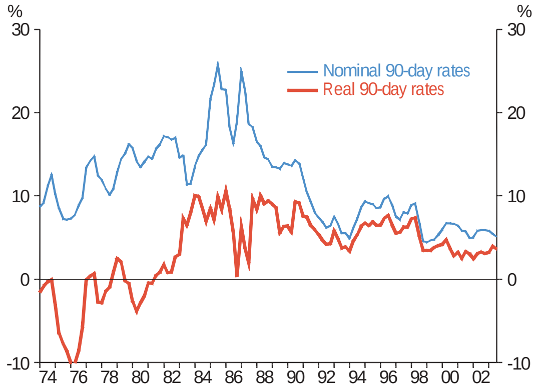
Investors in equities should be in for the long haul, to allow time to smooth out the inevitable fluctuations in share prices that occur from year to year. Also, because you can never be sure about any particular company, industry or region, if you are buying shares you should spread your investments across a diversified range of equities.

What about interest-bearing securities? One of the consequences of reducing inflation to low and stable levels is that nominal interest rates on all types of these instruments have fallen substantially. As an example, the average 90 day interest rate in the 1970s was just over 10 per cent, and in the 1980s was around 17 per cent. In the 1990s, the rate fell to 8 per cent, and today stands at a little over 5 per cent – the lowest in many years. Interest rates on other instruments have fallen similarly.

In real terms, of course, interest rates have not fallen anywhere near as substantially over the years, and remain attractive for investors, particularly relative to the real interest rates available in many other countries. Indeed, the real interest rate on interest-bearing securities today is considerably higher than was typical during the high-inflation times in the late 1970s and early 1980s. Taking tax into account widens the gap even further, because tax rates are applied to nominal, rather than real, interest income.

Investors in interest-bearing securities are thus better off now than they once were. But people who rely heavily on interest-bearing securities for their incomes have nevertheless seen a fall in their incomes, in nominal terms. I fear that this reduction in nominal income, coupled perhaps with "money illusion" – that is, thinking in nominal rather than real terms – may be encouraging some New Zealanders to invest in

Figure 6
Nominal and real 90-day interest rates



higher yielding securities, in order to reduce the short-term impact on their cash flow position.

In this drive to achieve higher rates of return, some investors may be taking higher risks than they appreciate – especially if they think in terms of the nominal interest rates that they used to receive in earlier years. For example, just a dozen years ago, low-risk securities regularly offered double-digit interest rates. Today, an equivalent low-risk security might only yield 5 or 6 per cent, or even less. To invest in securities offering the same nominal yields as were once available, investors now have to accept considerably greater risk.

Perhaps reflecting this behaviour, deposits outside of the banking sector are growing quite rapidly. There are also reports of growing retail investment in higher-risk types of securities such as subordinated notes, capital notes, asset-backed securities, and interests in apartment buildings. These and other kinds of more complex investment products typically offer high yields, but that usually reflects higher levels of risk. For example, it may be that the investment ranks behind other debt obligations of the borrower, exposing the investor to a greater risk of loss if the borrower defaults. In other cases, the yield being offered may be linked to the performance of particular underlying asset markets, which may themselves be quite volatile.

There is, of course, nothing inherently wrong with investors taking greater risk. For their own protection, however, they should be fully aware of the risks they are taking, rather than simply thinking in terms of the nominal interest rate offered.

Given all this, what should a wise investor do?

First of all, seek advice! This applies especially if an investment product looks complicated. There are many sources of information to assist in making investment decisions, including material published by public agencies such as the Office of the Retirement Commissioner, and by reputable members of the savings and investment industry. There is also the advice of professional experts. Naturally, the quality of advice is only as good as the quality of the person giving it, so if an investor chooses to use an investment adviser, the investor would be wise to check the adviser's qualifications and accreditation, experience, track record and independence.

Checking the provenance of investment products and firms is all the more important in New Zealand because regulation of financial investments here is not highly paternalistic. The general approach of the Reserve Bank Act for bank deposits, of the Securities Act for financial securities, and of legislation for other forms of investment is to promote the proper functioning of the financial system as a whole, and not the performance or soundness of particular institutions. Laws relating to the financial system set extensive and tough disclosure requirements, so that individual investors can judge for themselves the risks and returns they are facing and make decisions accordingly. As noted earlier, low and stable inflation supports their ability to do this.

Investors not prepared to be intensively involved in the day-to-day management of their investments have the option of engaging a professional to manage directly their financial affairs. There are many professional investment management services available. Although some professional service arrangements are pitched at those with sizeable sums to invest, there are also management services for those making smaller investments. Finally, managed-fund products such as unit trusts offer the smaller investor a combination of reduced risk through diversification, and the portfolio-management services of an investment professional.

Vigilant and open-eyed investment strategies benefit not only investors. Households making well-informed investment and borrowing decisions are better able to cope with rainy days, and better prepared for their retirement years. Soundness in the household sector undergirds the stability of the financial system, and of the economy as a whole. Finally, intelligent scrutiny of investment proposals, including the creditworthiness of financial companies, crucially helps weed out poor performers and improve good performers, promoting effective resource allocation and growth across the economy.

For all these reasons, it is important that investors take all the steps they can to better understand the nature of the risks attached to their investment and borrowing decisions. This includes thinking in terms of real rates of return, rather than nominal rates. If we – each of us – can learn to become smarter and better informed, we will all be better off, individually and as a nation.