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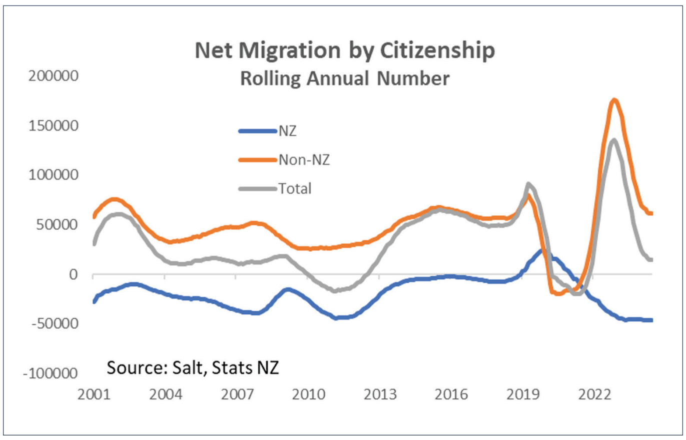
Low interest rates aren't a panacea

As we head into next week's Reserve Bank of New Zealand (RBNZ) August Monetary Policy Statement, the key question is how much lower interest rates will need to go to stimulate demand. At the same time however, it's worth remembering that low interest rates aren't a panacea for all that ails us, as they simply mask and potentially delay attention to our deeper economic challenges.

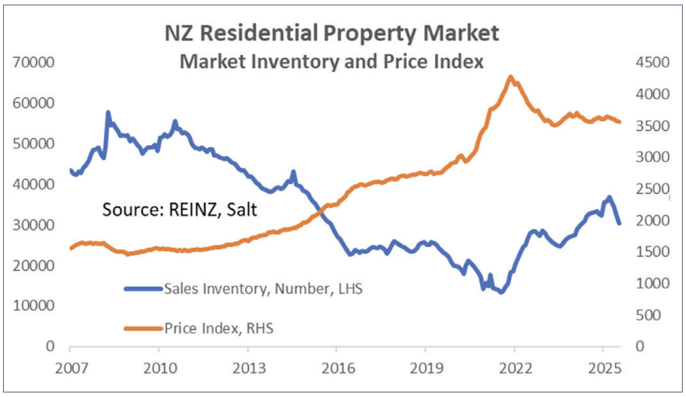
It is well understood that two of the key drivers of past periods of strong New Zealand GDP growth have been strong population growth driven usually by strong net inward migration and the wealth effect of rising house prices. The two are of course inextricably linked: strong population growth means increased demand for housing and housing-related infrastructure.

It should therefore come as no surprise that the thus far non-existent economic recovery, despite 2.25 percentage points of interest rate cuts, coincides a time when both of those factors are not firing.



After peaking at a net inflow of 135,500 as borders reopened post Covid, net migration has slowed to a net inflow of 14,800 in the year to May 2025. At the same time, population growth has slowed from 2.8% at the end of 2023 to 0.9% in the year to March 2025.

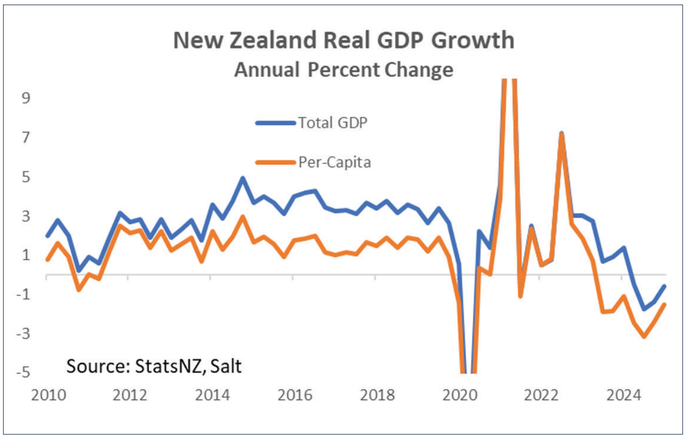
And house price inflation remains low. Data from the Real Estate Institute of New Zealand shows that house prices fell 17.8% peak to trough from November 2021 to May 2023. Since that trough over 2-years ago, prices have only risen 1.4%. Latest annual growth rate is +0.1% in the year to July.



There are a host of cyclical and structural issues weighing against house price inflation now. The inventory of houses on the market at present remains close to a decade high, vendor price expectations remain too high, government policy initiatives have added to the supply of housing and land availability, and the population is ageing with the boomer generation now selling their family houses and moving into smaller accommodation.

While we have tended to rely on these factors for strong growth, they are both symptomatic of some of our economic challenges. Re-marketing the national housing stock at higher prices, often backed by higher mortgage burdens, generates much activity but less actual economic gain. Rather, it risks distracting workers from what is needed to lift the value of their output and thus, to ideally boost their wages. Focussing energy on seeking capital gains from houses, as a substitute for seeking higher disposable incomes from labour and innovation, has led to a national naivety about factors that can demonstrably assist small, open economies like ours to become wealthier.

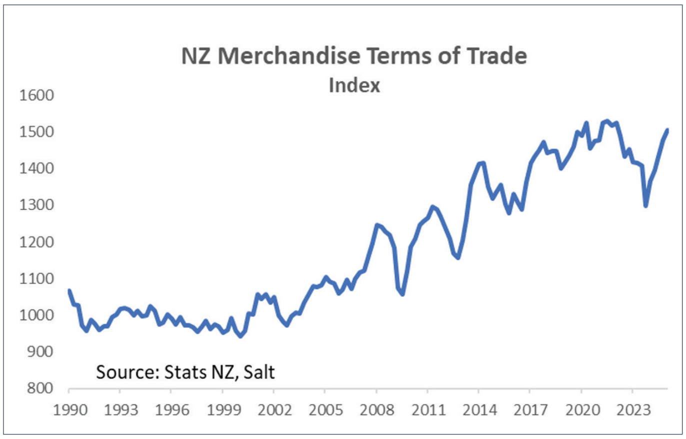
Strong population growth has at times supported domestic growth to the point that some argue the New Zealand economy had achieved "rock star" status. The reality is that our labour productivity and per capita GDP growth, the only GDP measure that matters if you are concerned about living standards, is more akin to a fading rock star in the dying days of a Las Vagas residency.



Ease of availability and relative cheapness of labour makes it easier for firms to resource their growth with labour rather than deploying capital and capital requirements for new housing and infrastructure detracts from the productivity of capital.

And low wage growth borne of low productivity means that, often, strong house price inflation, whether realised or unrealised, is the key driver of household consumption. It's symptomatic of that broader malaise that New Zealand households struggle at times of high commodity prices such as petrol or butter. That is not a problem with the prices of those goods, nor supermarket margins, but rather a function of low wages.

For New Zealand, high dairy prices are a good news story. Commodity prices are another key contributor to New Zealand's growth and are currently rising strongly and the terms of trade index (the price of our exports relative to the price of our imports) has nearly fully recovered from its recent slump. The terms of trade index is only 1.4% short of its all-time peak.



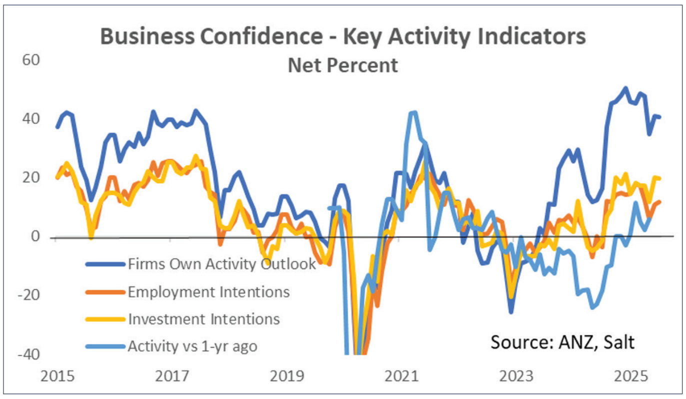
Nevertheless, here we are with weak economic growth, oodles of spare capacity (a large negative output gap in the vernacular) and rising expectations of deeper interest rate cuts to close the output gap and avoid inflation undershooting the mid-point of the RBNZ's 1-3% target zone.

It's important to remember that lower interest rates are not good for the everyone's consumption levels. Only around 33% of households have a mortgage, and a significant number of others rely on returns from their term deposit investments to pay the bills.

Furthermore, given the range of influences on the housing market right now, it's not guaranteed that lower interest rates will ignite the housing market and support consumption, even if that was a desirable outcome.

More importantly, the persistent reliance on low interest rates to stimulate economic growth reflects a fundamental misunderstanding of the drivers of long-term prosperity. While monetary easing can temporarily boost demand, it does little to raise an economy's productive capacity. Productivity-led growth, the only sustainable path to rising living standards, depends on investment in innovation, skills, infrastructure, and institutional quality, not on ever-looser financial conditions.

Another good news story in the New Zealand economy right now is the relatively high level of investment intentions being reported in the various business confidence surveys. This is in part due to the collation government's Investment Boost policy, which appears to be having the desired effect.



As we saw in the period after the Global Financial Crisis, long periods of ultra-low rates risk distorting capital allocation by encouraging financial engineering over productive investment. When capital is artificially cheap, firms may favour share buybacks or speculative ventures rather than long-term productivity-enhancing projects with uncertain payoffs.

Low rates can entrench "zombie" firms, unproductive businesses that survive only because of easy financing, thereby reducing the dynamism and reallocation of resources that productivity growth requires.

In advanced economies, the key impediments to higher productivity are structural: underinvestment in education and training, weak competition in key sectors, sluggish diffusion of new technologies, and regulatory bottlenecks. Addressing these challenges requires targeted fiscal policy, robust innovation ecosystems, and reform agendas that support efficient markets, not the blunt instrument of monetary policy.

Worse still, prolonged low interest rates can create a false sense of policy success, masking deeper problems. As we saw in the period following the Global Financial Crisis, they may prop up asset prices and boost consumption temporarily, but they do not resolve the underlying stagnation in productive potential. True productivity-led growth must come from enhancing the supply side of the economy, not from artificially stimulating demand.

In short, low interest rates are no substitute for structural reform. If policymakers are serious about raising long-term growth, they must shift their focus away from financial accommodation and toward the harder task of unlocking productivity.