David Skilling's insights on the economic impacts of Covid and the Russian-Ukraine war

Erskine: David. Good to see you again. How are you?

David Skilling: Doing very well. Thank you.

Erskine: Oh, excellent. Starting to head into spring there so the flowers must be popping up in beautiful Europe?

David Skilling: Yep. shoots everywhere. Wonderful.

Erskine: Now, how scary is it being so close to Ukraine?

David Skilling: Well, it focuses the mind and the mood in Europe. Because no one, even a month ago thought this was likely to happen. They thought it was Putin negotiating or trying to increase leverage. And then suddenly we wake up and he'd invaded. So I think that the mood is shock and outrage and horror and resolve to do something. I mean, the fact that we're now talking about tactical nuclear chemical weapons… Europe is talking about "do they have enough iodine tablets?" That focuses the mind. And even here in Netherlands we're getting a bunch of Ukrainian refugees coming to stay, being housed, or going to local schools. So, it feels pretty close, and it feels, and again, this is partly conditioned by geography, it feels like something has snapped. Something is very different now than it was three, four weeks ago, the world has changed.

Erskine: This is certainly not at your pay grade in terms of economic commentary and understanding, with you advising small countries. But help me understand why this US administration… if we go back to Georgia, Condoleezza Rice landed in Georgia when Putin had a crack at going in there and they put some military assets and stood up to him and scared him off. Why on earth is the Biden administration not taking the same approach and fronted up into Ukraine at an early stage? Obviously, it's probably too late for that now. Some are pointing to World War II all over again, where it took Churchill to come in and actually be bold and front up to the enemy. Is it a repeat of Chamberlain and Churchill or is it not that, and they're stuck in a situation where it's a different scenario?

David Skilling: Well, I'd make a few points. One, I think in general, the wrap on Biden is he's done actually a pretty good job. Both Biden and the broader administration in terms of the US in particular were releasing intelligence publicly, which is unusual, basically saying "Putin is going to invade, he's going to invade - trust us". And the Europeans were one, saying "we don't think he is". So, the US has been ahead of the curve on this one and also ahead of the curve along with the UK, in terms of supplying weaponry financial support to the Ukrainians. I think in terms of the Georgia incident, I mean, the US didn't have boots on the ground in Georgia, so the Russians basically carved off bits of Georgia in 2008. So, Putin in a sense, got away with that. He got away with occupation of Crimea and the Donbas, which is the Eastern part of UK Ukraine in 2014. It wasn't done as an obvious invasion, the way that it's happening now, but he had mercenaries and private armies and militia go in and occupy. And nothing very much happened. Some sanctions were put on, but nothing much.

And the view in Europe was we need to engage. I mean, yes, it's wrong, its bad sanctions, but we need to engage. And the message that Putin took from that was the west is weak, the west doesn't care. I can pretty much do what I want. And he looks at Afghanistan last year where the Western withdrawal was pretty chaotic and messy. And I think his view was now's the time I want to establish my legacy; I'm going to go. And we can argue about whether it's fully rational or not, but he's been saying this in his speeches for a long time, that he sees Ukraine as part of Russia. He wants to restore former boundaries.

So, I think a couple of surprising things are, one, that Putin actually did it. Although with the benefit of hindsight, perhaps we shouldn't have been as surprised. But the positively surprising thing is how much Western resolve there has been. This hasn't been a repeat of 2008 and 2014 where it was kind of a wet bus ticket sort of stuff. It has been a genuine response both in terms of military support going through and intelligence and a whole bunch of stuff going on behind the scenes as well as the unprecedented sanctions. So, I wrote a note a couple of weeks back talking about the first world economic war, basically that Russia is the 11 largest economy in the world, member of the G20. And it's pretty much been excommunicated. There's some oil and gas flows continuing, particularly to Europe, but US has a ban on oil and gas imports. But that part of the Russian economy is okay, but everything else is pretty much done. Central bank reserves have been frozen, the swift international banking systems, Russian banks have been ejected from that, all the Western MMC's are coming out of Russia, not doing business. So, the economic sanctions, the economic pain in Russia is pretty acute. And I think for the first time in a long time, NATO is coherent. It's determined, the anger, I mentioned a moment ago in Europe, that's real.

In terms of boots on the ground, direct NATO or US military support to Ukraine… The real concern is the moment you do that, and there's a shooting match between Russian and US troops it's very, very hard to predict what's going to happen thereafter. It may be that we still end up with something like that. But I think there's a great deal of wariness that we'd like to contain it to the physical territory of Ukraine, as opposed to having something that goes beyond that. But look, this is serious. It's really, really serious. The risk of escalation is non-trivial, the economic pain is obvious. And it's got a potential to get quite a lot worse before it gets better.

Erskine: I suppose the concerns though, if the sanctions don't work, and let's come back to that, and they don't have the desired effect on Russia and the strangling effect that we hope it will, and I'll get you comment on that in a minute. But the concern is that Putin goes, "Hey, you know, the west is not prepared to step in and defend in a military sense I'm going keep going because I want to extend my sphere of influence, I want to reinstate the USSR. If you believe that he wants to reinstate the power of Russia, then why would he stop? The only reason he'd stop, I guess, is it that he just doesn't have the resources to keep going. So, answer that for us. Would he keep going if he could? And if you don't know the answer to that, are these economic exemptions going to work? He's still attacking and how long can he keep going like this with the economy being so badly strangled, or has he got reserves that we don't understand? Surely at some point he just can't keep funding this war.

David Skilling: The economic sanctions, I don't think are going to stop him. And I think there was a degree of realism about what the sanctions could do. The sanctions are largely about punishment. You can't do this and expect to be part of the Western part of the global system. So, they basically said, look, you are out. You're not going to benefit from the system at the same time that you are bombing cities and causing mayhem. And the likelihood, at some point this would reduce the amount of financial resource available to him to fund the war. Perhaps it would turn popular opinion against him, but that was always seen as a pretty long shot. Similarly the Oligarchs are not going to turn against Putin.

So on the margin, yes, but if this goes on for months or years the fact that they've got an imploding economy is going to begin to become an issue. But then if your Horizons is the next few months then the sanctions aren't going to stop him. Unless Europe in particular banned Russian oil and gas imports. If they did that, if they turned the switch off overnight, that would cause real pain but also obviously cause real pain for Europe as well, so they've not done that yet. But the sanctions are at least in my judgment as much about punishment as much I hope that the invasion will kind stop or will try to drive him to peace talk. It'll be one of the factors that weigh on him, but it's not gone be decisive in part because Putin is not personally exposed to the stuff, maybe he's rich enough he doesn't really care that much about it. And he's not a particular risk I don't think of kind of the popular revolt. So, it's punishment.

In terms of where this goes next, I think by far the most likely scenario, and as you see, there's enormous uncertainty here, is that there is a stale mate assault. The Russians don't make enormous progress militarily. They don't take Kiev they don't take the other major cities, but they kind of settle in and they just keep pounding with the artillery from a distance. And as they have with Mariupol and others, they just level these places, which is what they've done in Syria, what they did in Chechnya as well. So, it's their playbook And there's a war of attrition and the Ukrainians keep pushing them back on the ground, but basically it becomes stale mate and it goes on for quite some time until there's a peace deal. It's possible that happens if the Russians are underestimating how much pain they're facing in terms of economics. It's possible that sufficiently armed, Ukrainians could mount successful counter attacks and they'll be doing that, but they're still kind of outgunned and outmatched.

So, I think the most likely scenario over the next two, three months is something along the lines of what we've seen over the last couple of weeks, which is not much forward progress, but just ongoing carnage and damage. And this settles into a very messy stale mate period. There are some wild cards and China is one. What will China do? Will they apply pressure? I think probably not to be honest; they don't really want this to continue, but they're not going to expend much capital on getting Russia to the negotiating table. So, I think most likely we are in for quite a while of roughly speaking something like the status quo, a peace deal. There are negotiations underway, but I don't rate there been a very big chance at the moment.

Similarly there is a chance of a coup or something like that. But again, that's a 5% likelihood, it's not likely. From a Western perspective, this could go in one of two ways. It's possible that seeing everyday pictures of civilians dead, Russians shelling old people's homes, tower blocks being demolished, will strengthen the resolve and say, “look, we're not putting up with this” and it will force a decision about do we invest more? Do we think about putting boots on the ground? Do we think about no-fly zone? That's one option. The second option, frankly, is more of a, this is just too painful. You know, all prices are too high. Cracks begin to emerge in Western resolve and the sanctions begin to erode on the margin.

So there's lots of scenarios. I think even though the near term is pretty uncertain, the big picture is slightly more, you can stick with higher conviction which is what Russia has done. It's a fundamental breach with the west, how the west has responded in terms of basically ejecting Russia from the global system, that's for keeps. And it's going to accelerate the decoupling of the west. And I use the term west quite loose to include South Korea and Japan and Taiwan and Asia. That decoupling certainly from Russia but also over time from China. Because China obviously hasn't invaded anybody, at least not yet. But there are ongoing political and strategic tensions with China. So, to me there's this pulling apart the global economy, the way that it proceeds in terms of trade and investment flows is just a very different animal now than it was a month ago. And there's no going back.

Erskine: So, what I'm hearing is that it's fundamentally changing things. So what are the flow on effects at a fundamental level economically? I guess we'll come to New Zealand. But some of these things are going to be shorter term, sanctions can be lifted, and we perhaps return to normality, but are there going to be things economically that are more systemic and have longer lasting impact?

David Skilling: Yes. So even a good case scenario where hostility cease and perhaps there is either a ceasefire or Russians withdraw. And so, things like wheat exports, export of fertilizer and the like can kind of resume. And so, some of the pressure on energy and commodity prices, food prices begin to dissipate. Now, even in that kind of context a lot of the current pain is going to sustain for quite a while. I mean, the likelihood of sanctions being lifted is nominal. I think because the political backlash in the US in Europe is very, very, very anti regime in Russia. I guess not Russian people as much as the Russian system. And so, the sanctions are not going to be lifted anytime soon. So that's going to be a very, very gradual process.

And if you think about the behavior of Western companies who have withdrawn from Russia, and almost all of them have, apart from a few like Nestle. Those companies are gone be very, very reluctant to get back into the Russian market because of stakeholder pressure, staff, customers, investors other stakeholders. And so, the economic pain from the war and from the sanctions is going to maintain, I think for quite a while. So, the return to a pre-February 24 normality that's not going to happen. I think in a more structural sense, there's a few things to watch for that are going to be different going forward. One is the decoupling point that I made earlier, which is, I think economics and politics are now seen as deeply integrated. And so, both, at a national level and at a company or investor level, there's much greater sensitivity to political risk. So, do you want to have market exposure, financial exposure to jurisdictions with whom your kind of country of domicile is likely to have political dispute at some point in the future? So, it's all obviously Russia and they'll be Russia for a while, even if they have a new president at some point. But also, China and for countries in the Asia Pacific, including Australia, New Zealand, that's the big deal. And frankly, the country outside the Asia Pacific. China is, it's the number one export market for over a hundred countries in the world. Depending on how you count over the largest and second largest economy in the world.

So, if Russia gets sanctioned meaningfully. If China threatens to invade Taiwan or be some other major political dispute. Or frankly, even if just the US keeps on tightening the screws on China as it has been over the last couple of years. And there's a gradual pulling of heart that's deeply material. And the sense of resolve that you see in many Western countries, the sense that, this sounds a bit cliche, but the Western order trade democracy has been under threat from China and now obviously from Russia for quite some time, and the west been a bit complacent, a bit kind of standing back. There's a sense that the west has to stand up and be a lot more forceful in terms of how it responds to that stuff. So, I think that there's much greater appetite for taking China on perhaps not quite as aggressively as with Russia, unless China really skips beyond the mark.

But I think the global economy is pulling apart, it's fragmenting. And the likelihood that you'll get a multipolar system, the west over here, China, maybe Russia over here and a buffer zone of a lot of African countries. Some Asian countries that are in the middle countries like India, Vietnam that are in the middle. I think that's a pretty high conviction forecast is not particularly controversial or anything, but I think the world as changed. I think elsewhere we are definitely going to see much increased security spending. So, the Germans may be obvious U-turn in terms of hitting the 2% of GDP on military, which is the nominal NATO target, but there huge NATO countries actually hit it.

But across Europe, including Germany, there's a commitment to making that happen. So, I just think there's a degree of seriousness, a degree of coherence across the Western countries. And that flows into the economic trade financial system.

That's a lot more political, it's gone become a lot more fragmented. And so, for companies and countries that tried to navigate this, it's not going to look like it did pre-February. I mean, clearly this was the direction of travel, but this has been accelerated this fragmentation and decoupling is happening at a much faster rate than I would've picked even a couple of months ago. So, and again, even if there's a cease fire tomorrow a lot of this stuff still goes through its quasi permanent in nature, I think.

Erskine: Yeah. It's interesting because you have been commenting or observing the de globalization for a while, even just reading some of your stuff pre the Ukraine invasion. And so, it made it interest to hear you say that and that this is just accelerating it. So, does that mean that therefore, that we're into sustained inflation for a period of time to come? Because surely the decoupling is a driver of inflation because I guess what's resulted in some relatively low prices is the cooperation of manufacturing with China. And does that result in a permanent environment where until economies start re gearing their own manufacturing, and maybe that's not going to happen, but I'm really making up my own story, but how do you see the flow effect to prices and inflation?

David Skilling: Yes, so there is going to be effect. If we go back to the 90s when central banks, became independent and we moved into what's now called the great moderation, we had decent growth rates, low inflation, there's a sense that we cracked the code. But really the reason for that positive experience over much for the last few decades was not so much the fact that central banks were wonderful at what they did, although they were pretty good. I mean, institutions were pretty good. It was mainly because we had very intense globalization, so global flows, trade, and investment we're increasing, supply chains were growing across the world. So, choice quality went up, prices went down, it was a much more efficient assistance that put down pressure on inflation, across advanced commodity and very good demographics. So, labor supply was abundant, including from emerging markets. So, it down pressure on wages as well. Many of those forces are reversing so global flows, trade investment of a like are going to be much less intense. Global supply chains are being disrupted and fragmented in an accelerated way.

Demographics are turning against us so working age populations are shrinking in China and in many other countries. So, there are factors that have kind of depressed inflation growth or inflation over the last two, three decades are beginning to unwind.

Now, I don't want to overstate that because I don't think that we're seeing a 180 degree turn in globalization. I think we are moving from an intense phase to a less intense phase. So where is it decoupling supply chain will become more regional or local. In some cases, that's been good economic reasons because you can automate stuff, so you don't need low-cost labor in China or Vietnam. You can do it closer to home with 3d printing or automation or other forms of technology. So not all this retrenchment in local supply chains is inefficient it might be the right commercial thing to do. But on the margin, we're not going to benefit from the same kind of following wins that we've had. And the more abrupt this decoupling or fragmentation is the more those price pressures are going to be. So, I think this notion that we need to be somewhat more resilient, we need to have greater buffers in our supply chains, that's kind of like paying insurance premium, or pay a slightly higher price so we'll be slightly less sufficient because we want to have a bit more control over our supply chains, whether that’s food or energy or pharmaceuticals or manufacturers or whatever it is.

So, I think over next the decade or two it is very likely that we have inflation that run hotter than we've seen previously. Partly because of these structural features of in global economy, partly because of demographics as well. I think compounded by the fact that central banks are going to be, you have a slightly different reaction function. So, they're not going to be as jumpy on inflation as they have been previously in terms of hiking interest rates at the first sight of inflation. Even, over the last year, although it's very unusual year because of Covid and now the war. You would imagine if you were seeing the stuff about any context that, 7, 8% inflation of the US and the Euro zone interest rates would be a good deal higher from where they are but central banks are proceeding in a very gradual fashion partly because they expect the stuff.

But also, partly because I think if you push interest rates up too high, too quickly, given the debt stock around the world, the risk is you'll do some real damage to the global economy. So, I think the inflation outlook over next decade or two is going to be higher than I think we've drawn up with the last sort of two, three decades. So rather than the zero to 2% ban, which is on average where it's been for many advanced economies. I think on average, I'm making this up a little bit obviously, but sort of 3, 4% is a much more likely number. It's not going to stay at 7, 8% that's this degree of kind of transitory inflationary pressure so things like oil and gas prices will come off it's just taking a bit longer than I had expected because of now the invasion. So many shipping costs and supply chain disruptions will begin to moderate I think through the course of this year, again. It's prolonged a little bit by the invasion of Ukraine.

But in view, a lot of this spike up is just going to come off. But once we get beyond this kind of unusual transition period, we're going to have to get used to higher wage pressures and over time, that will lead to higher wages, higher interest rates, so it's quite a different kind of cocktail of factors that investors, that firms, that governments are going to have to get used to. It's going to be quite a different world.

Erskine: Yeah. And what's the response to that? Are we going to see people diving into the bond market more readily and moving away from the equities markets? For a long time with interest rates as low as they are, it hasn't been attractive to put your money with the bank. And is that going to result in a permanent change on investing profiles and where people are putting their money. And is that a permanent change or obviously it depends on returns on that? But I don't know if you've got a view around that.

David Skilling: Yes. I think the combination of factors that I've just been talking about affect the real interest rate, so the nominal rate less inflation, is going to be very low, and it's negative at the moment in most advanced economies because inflation is high. So, I think nominal interest rates will probably bump up a little bit compared to where they're at the moment that's truth for New Zealand, Australia, Eurozone, the US, so central banks will begin to lift rates, but inflation is going to be, I think for most part higher than most normal rates. So real rates will be negative or very low. So, keeping money in the bank, keeping money in bonds and its inflation protected is probably not a super place to be. We hear you about putting money into fixed income some people think the real read story is going to be negative are very, very low for quite some time.

I think, equities valuations are very, very high, not as high as they were perhaps a month ago but they're still pretty high. But as long as headline, GDP growth remains okay. And I still remain despite the various kind of global economic constructs we've been talking about, in the fact of sanctions and be coupling and like in general I remain fairly upbeat on the structural global economic outlook. I think it's a good technology story. I think it's a good productivity story. Household balance sheets are in decent positions. So, I'm actually reasonably positive on headline GDP growth, as long as we avoid some of the extreme negative scenarios of full-fledged war or full-fledges protection but in general it seems to me that equities, and you can argue about valuations and the right times to get into equities. But in general, I'm more positive about investing in equities because it gives you exposure to a decent economy and you're not so exposed to low or negative real interest rates.

And I think the other bit of the global economy that's going to do well for a while is commodities. So particularly commodities that are exposed to some structural drivers so the Green Transition. So, some of the metals, from copper to palladium and like the various inputs into batteries, lithium is another. Anything that's involved in where supply is tight demand is high. And that's consistent with somebody's directions. I think that's a pretty good place to be as well. And there are some short-term drivers that explain why commodity prices are particularly high at the moment, but I think in general, commodities are a decent place to be.

Erskine: So, then I was a little bit divergent there but in bringing this story back to New Zealand where we had locked down, essentially locked down a lot longer than a lot of Northern Hemisphere countries. So, Europe's basically as forgotten Covid and to a large extent and moved on from what I can gather. We had somebody that had gotten in our team that got locked out, and locked out, I say, in Spain and had to hibernate in Spain, which she was very happy to do, and fortunately could work remotely. But she just couldn't get over how Covid had become a non-issue in Europe. And looking back into New Zealand I'm thinking it was really weird how obsessed we were or are still with Covid impacts. And that's not getting into the argument about the rights or wrongs of how this government is dealing with it. Any sane government probably would've locked the borders down initially back in 2020, but we're in this situation now where it feels like we're desperately trying to. We're watching the rest of the world wake up and get going and now they've got another distraction being the Ukraine. What concerns me is we haven't even started to open up and we're just about to probably start to do that. And I'm sure Ardern going to drop mandates tomorrow in given two weeks' notice in time for the school holidays. That's my predications two weeks from Wednesday at 11:59 PM.

But we'll only just start to open up and open up to a world where all of a sudden oil price are going through the roof and the cost to get down here is ludicrous. Because there's not enough planes, there's not enough supply. Has New Zealand shot itself in the foot where it's dealing with the Covid headache hangover and then entering into environment where we've got the war? What's the flow on effect? I mean, if you were talking to Ardern on the phone, and who knows, you don't have to answer this question directly, you probably are given that you consult to a lot of economies. If you could speak freely, so to speak what would be your message? Would you be shouting at Ardern and Robertson sent saying, hurry up you've got to get this economy open because you're slipping behind, your policy is crap? I know you're too well, David, that you wouldn't be---you're far more diplomatic than.

David Skilling: Yeah. Well, as you say, they are opening up and it's going gradually and slowly, but I think there's now a momentum to it. I mean, sitting in Europe, watching New Zealand response over the last couple of years, the first year was pretty good. So, in Europe, tons of cases, tons of deaths, New Zealand had lots of restrictions, which New Zealand after the initial period of lockdown was pretty much open for business. But as we know, it's a game of two halves and they went hard for a particular solution, kind of a very binary solution. And I think they ended up backing themselves into a corner. Whereas Europe and the US and others, partly because of the position they're in, it was always a degree of balance, right? How cost we're prepared to take in terms of cases and hospitalizations and deaths versus the economy and I guess personal freedoms and things like that. Whereas for New Zealand was a very kind of binary response.

And I think as Covid has evolved, and particularly since Omicron has come on, it's all about shades of grey. And so, the Europeans, who've always taken a slightly more liberal approach have been very happy to open up, to say, look, we're going to take a slightly, if you like risky approach. And we're going to say, look, we'll open up. We're conscious there will be more case but not too many deaths. And now for most part, I am sitting here in benevolence, you would be hard pressed to know that there is a pandemic at all everything's pretty much open for business. Whereas in New Zealand, I think it's been a struggle to both for the government and I think also for the country as a whole to accept what is certainly seen in New Zealand as a world leading response. I mean, I'm not sure what it's seen by the world like that, but in New Zealand, I think it's still seen as a world leading response.

And I think partly because of politics throughout the government's state, that's kind of political sort of reputation if you like on the success of this particular approach. But also, the national mood of New Zealand strikes me looking from the outsiders as being quite risk adverse. You look at the media coverage you sometimes think that Covid is a bit like the plague as a sense of kind stay away, stay away, one case is too many. So, I think partly, the sluggishness of the New Zealand exit process is partly the government and government capability. But also, I think partly because the New Zealand population is much more risk averse than populations of Europe that have had a couple of years to get used to this, this balancing it.

I think in terms of what I would be shouting to New Zealand now, given that there does seem, as I said to be an exit pathway now, maybe it's going to be a bit of stop, start taking bit longer than it should. But I think it's pretty clear what the direction of travel is. The thing that worries me most apart from the fact that this process has left a lot of unseen damage that will become lot more evident, businesses and household that have gone into real financial distress. And I think that will become more evident over time. But beyond that, the thing that concerns me most in comparing New Zealand against other countries that I know well is that we have spent much less time and much less money, frankly, in terms of the recovery packages that the governors announced, thinking about how we position New Zealand for the future. So, we've done our GDP growth rates through Covid in the top half dozen across advanced economies, along with Australia and other Asian countries. So, our headline GDP growth has been pretty good through the Covid period. So New Zealand on this score gets a tick. But we've partly done that, not wholly, but partly done that by virtue of throwing enormous amounts of fiscal stimulus at the economy. So big government deficits through its recovery packages. But almost all of that has been serious support packages to firms, to households to kind of enable them so firms can keep paying wages to their staff things like that, which is a perfectly sensible thing to do.

But if the vast majority of your money is almost short-term support measures you are not actually doing very much to position yourself for a world that's going to look quite different post Covid. Whereas the response to companies like Singapore, where I'm still deeply involved as well as Europe is saying, well, like, okay, certainly these short-term measures are important, but the world post Covid is going to be different. So, the Green Transition has become a much bigger deal both as a matter of policy, but also just a matter of consumer and citizen preferences. So, the governments have to think very hard about how do we accelerate the Green Transition. Digital is another, the future of work, identifying which sectors have got better growth prospects, which have got worse growth prospects, because the changes Covid has accelerated , and how do we begin to help our labor force adjust? How do we help labor shift from one part of the economy to another?

So, I wouldn't say that the countries doing this perfectly, but it was a lot more action and effort on how we position ourselves for a world post Covid, is going to be quite different. And now obviously we have the overlay of the Ukraine invasion, shifts to the global flows that we were talking about earlier so the world is structurally different. And particularly for small countries like New Zealand that are very exposed to what happens beyond our borders. Our success depends in large measure on how well we are positioning ourselves for that world. And I think one of the big downsides for New Zealand having had locked borders for a couple of years and counting is that we simply haven't traveled, sounds like an obvious statement. And I'm speaking to lots of businesses every week in New Zealand about what I see happening via technology, consumer preferences, government action. And there's bit of a degree of intellectual awareness because people read newspapers, they read the economist magazine. But I think the intensity and speed about change is I don't yet see that landing in New Zealand if you like in terms of being really fiscally felt.

So, it's a long way of answering your question, but I think the thing that worries me is we're coming out of Covid, we're entering a world that is really quite different it's changed in many ways. The adoption of technology of new business models, consumer preferences, ways of doing business. And now the global flows bit. And we have to get ourselves ready, both at national level, things like labor market policy, migration tax, etc. As well as adjusting to a shifting global system. I'm not sure that we are ready for that. And that's where I think a lot more policy effort and frankly corporate effort needs to be put. Because if we go back into the global economy, once borders reopen, hopefully in the next little while and we try and use the same national playbook or company playbook I worry that we're not going to get the outcome that we would like. So that's what I would be yelling and yelling that we need to really understand how the world has changed and begin to respond pretty quickly.

Erskine: David, I've known you for 35 years and I've never heard you yell in my life. But what is it? So out of those things, digital Green Transition, I mean, how can New Zealand play in any of those because we're a long way, like distance does matter. We're heavily reliant on producing milk powder and supplying that to the world and now there'll be a whole lot less going to Russian no doubt. What's New Zealand's natural advantage and how can we start playing? What is it that we should be sharing in your opinion? Because of distance, we've got to go hard out on a digital sort of tax strategy. We've obviously got a green reputation to a degree is there a play on that? What is the answer because New Zealand's not going to be able to hang around because to your point, there's probably a lot of pain yet to emerge and this government may be tired and who knows what's going to happen at the next election, but maybe they're run out steam and there could well be a change in the guard. But and given that if it's Luxon coming in what should we be doing? You know, what's your opinion?

David Skilling: Well, I can't give you a full prospectus, but I'd say if you just focus on the external facing parts of our economy. So, if you think about this as a portfolio of goods and markets. So, as you said, we sell dairy and other commodities largely to China, dairy, red meat etc. That part of our economy, which is our biggest single export category is challenge in two ways. One it's challenged by virtue to the market we sell it to, China, which the reasons that we were talking about earlier does have a certain risk profile, largely political risk profile in terms of, are we going to run into sanctions problems or other issues down the track? Does it make sense to be as exposed? I think 33, 34% of our exports of good go to China, that's a pretty chunky number. Is that a number that we're comfortable with? Do we need to think about diversify?

The government is doing some messaging, and I know some of our large firms are thinking about this as well. But that part of our company is also challenged by technology, alternative proteins, plant-based meats, plant-based dairy, and the light consumer preferences shifting pretty rapidly towards lower emissions stuff. So, yes, we had a premium reputation for high quality green stuff, but there is an increasing array of competition to large part to the export sector. So, we need to think hard about how sustainable is that what do we need to do to keep ahead of technology shifting consumer preferences? How do we diversify our market position? So that's kind of bucket number one.

I think bucket number two is we've got, some strengths around digital creative, what I've called weightless economy so basically services. Which for a small remote economy makes sense? You can do online stuff, Xero is a classic example, you can use technologies like Zoom, obviously to kind of do business. How do we exploit these technologies to take New Zealand IP and sell it in a way that's not as subject to the paternity of distance? That is still despite the fact that everyone can point to individual success stories. It still if we look at GDP, reasonably small. And so how do you supercharge that? How do you get more zeros? How do you get 50 or hundred zero style, zero scale companies? A lot of that is around education, human capital, universities, R and D spending, all of which have big issues and constraints around them.

Erskine: So, sorry to interrupt you, but then have we run out money though? So, what you're pointing towards is investing in infrastructure and massive spending. And this government rightly or wrongly has just as, you've stated it yourself, has just spent a huge amount of money with some fiscal packages and you know, printed a lot of money, how much more can we spend without?

David Skilling: So, I certainly think that the balance hasn't been right between short term support term measures, and for the most part, the support measures of New Zealand were well design, well executed, well delivered, made a big economic difference. So, my problem is really what sort of percentage of the overall quantum do you spend on those short terms support measures versus there a bit more forward looking in the future. And so given the composition of this government, I've been really surprised at how little money was spent on the Green Transition, for example, be that I don't know. Improving home insulation, which is pretty labor-intensive activity, right? You can employ lots of people going around putting peak bats on houses, installing heat pumps or sort of bigger ticket, more exotic stuff. We just haven't really spent much time thinking about those future process. I think the balance is wrong.

Now for New Zealand I have always been recently fiscally conservative, but it's also the case that when you are going through periods of regime change, when you're going through a big structural change in the economy, you do need to invest in the future. And yes, government debt has gone up by around 20% points of GDP also, but people are still prepared to lend to us. I don't think there's a binding budget constraint at New Zealand I think we could spend more. My issue is, are we spend the right things and is there a supporting strategy around it? So, it's not just a matter of funding this program or funding that program. We're actually doing it in a coherent sustained manner. What we're going to invest in what I'm calling the weightless economy.

We're going to invest big time in human capital education system, we're going to invest significantly more in research and development. We're going to try and attract more things into New Zealand, and we're going to try and build something special in New Zealand. So really being a lot more deliberate about what we are doing because it's not that New Zealand is failing. We can keep on running the same model as we have. It's just that we are not going to make any ground on the countries ahead of us. Australia's about a third richer than us and we haven't made any dent on that gap for last 20 or 30 years and, we are not going to if we keep on running the same model. And there is, as I said, risk written all over it. China technology, consumer preferences.

So, I don't actually think that we have much alternative and that's true both of the government and I'd also say for companies as well. Because if companies try and simply benefit from abundant supply of labor, reasonably low wages in New Zealand, low margin. You don't actually need to be that innovative to be success in the Zealand market, but that's not going to be sustainable for that much longer as, as well. So, I think the government needs to start doing things differently, but so too do corporates in New Zealand as well. And they need to understand that the world is shifting and that business models need to move as well. So, I'm not prophesying disaster all I am saying is that the world is changing, is changing really quite rapidly in ways that create opportunities for us, but also create significant risk exposures for New Zealand.

And as we come out of Covid we're now confronted with Ukraine, as you say, and all of this stuff kind of comes together. So Covid had already accelerated a bunch of stuff, technology issue, preferences, business models. Now we've got the Ukraine invasion accelerating a different set of issues around decoupling and fragmentation. All this stuff is kind of mutually reinforcing and coming together. And we really need to figure out quickly what are our exposures and how do we need to position ourselves?

My closing comment on that is, I wrote a note on Friday called, return of the 1970s and I used New Zealand as an example. The 1970s, was obviously pretty bad for a range of reasons which are reminiscent of a current period, all price shocks, stagflation and the likes. But my reflection of New Zealand was the way in which we responded to all price shocks and the loss of preferential access to the UK was very extensive monetary policy, expense of fiscal policy and protectionism. So, we tried to kind of buffer our-self from these external shocks, 10 years later, huge crisis and reforms. And many other advanced economies did that as well. I think the benefit of hindsight, the countries that did better for the 70s, where those countries who were actively thinking all price shocks are not simply a shock. It's a structural shift in the global economy. We need to start reducing our reliance on energy. We need to start investing in new markets, we need to start innovating. And so, in periods of shock and turmoil, really figuring out how you respond to that change deliberately as opposed to kind of bunking down and trying to buffer yourself against the shock, I think that's an important message for New Zealand. If we just bunker down, spend lots of money to kind of keep ourselves safe. I worry that we're going to find ourselves in a position where we're a few steps behind the egg bowl.

Erskine: Yeah. So okay, bringing it from a macro level, just decided to start talk about property market. And so, I'd like you to predict exactly how much percentage gain you are going to have in the next five years, every year. Because my approach has always been, look, you have to return to fundamentals and understand what's going on and there's always going to be noise, but what are the fundamentals? You are well aware that we have a supply and demand and balance in New Zealand, particularly with residential land where the real issue is not really successive governments try to stymie demand as a way to control house prices. But really that's a trap from my point of view, that's just always a temporary measure to put a lid on things until they can't keep the lid on anymore, because they need to release some credit so that houses can be built to meet the demand.

Because, obviously as the population keeps growing, they're probably being able to-- and that's going to, as the borders open up again, my view is that net migration will return positively and then demand will grow again. And we've got the supply constraint issue where it's not so much about the ability to build houses. It's about the ability to get more residential land. And they're trying to do more of that through more intensive housing but ultimately, you've had to be able to open up land. And so, that's my little thesis on it and there is no easy answer to that. You've got the RMA and you've got the cost of consenting land development through council, which is pretty exorbitant. But it's more about saying, well, what I'm hearing from you is that there's nothing overly, absolutely scary for New Zealand because it's doing okay. It's probably more about how the longer-term picture, whether New Zealand's going to be in the right place long term. And just the other element to that is that with inflation obviously, rents go up whether it's residential or commercial, that will help to combat interest rate rises, so I'm not particularly concerned about that.

I'm probably more concerned down the track about what happens to New Zealand property If in 10 years there has been absolutely no investment and infrastructure or any of this transitioning or innovation, that we start to see a real stagnation. And the only people that you get is the seriously rich not the New Zealand rich list, but the international rich list that fall in love with the New Zealand lifestyle, that want to come and live here. So, we still get those people coming here, but that the New Zealand economy grinds to a halt and that property just becomes, gosh - could it ever become sort of almost third world-ish because we just don't invest and what's the overall. So really that's my thesis, but just really open the platform for you to comment more broadly on New Zealand property without trying to obviously.

David Skilling: So, a couple things… One, the New Zealand house prices, as you know stretched on house income compared to other countries is well out there. The over the Covid period New Zealand house prices obviously rocketed up, but so have house prices around the world, which is partly people are investing more, just upgrading so they spend more time in the home. So, a bit of a leg up in house price over the last 18 months, two years, I think for con-structural code related features in a replicated at the world over party stimulated by below interest rates. So New Zealand is not unusual in terms of the last couple of years. And I think not all of that, but aspects of that are structural. So, I'm sure there's a degree of excess and there's going to be a degree of some of those gains being given up. But I also think there's an element of structural support, I suppose. The house prices that we've seen around the world over the last 18 months or so.

Going forward, I think interest rates will go up a little bit. But to my point earlier, I think real interest rates are going to remain low. Yeah, interest rates will go up, but they're not going to go up, I don't think, in a Paul Volcker, early 1980 style way. No, they'll go up a little bit, but not hugely. So that might knock a little bit of a froth off housing markets, but not a huge amount. I'm not sure how much it is priced in New Zealand at the moment in terms of expectations in the investment community, but I'm not expecting a spike up interest rates.

To me, the biggest risk factor short term is the migration profiles. So, they're the direct demand supply imbalance. Supply is going to be constrained, I think for a while partly for land reasons, but also just tradesman cost of constructions; a whole bunch of frictions on the supply side that I think are going to be challenging to resolve. But I think there are some downside risks, I suppose, on the migration story. So, I think if I heard you correctly, your view is that migration would return to net positive once borders situation normalized there. I think there's a decent chance that it goes negative for a while. It's hard to be precise on this and I've been wrong before, but I think there's kind of pent-up demand for the great OE and just think people who haven't been able to leave with confidence for a couple of years say, “okay, here's my window now.”

I think there's significant labor demand from Australia whose wages are already higher, but also have super tight labor markets, in the market even from nurses and teachers, to traders, to truck drivers to everything else. So, there is I think, a real risk to New Zealand that is sucking us out of labor, both skilled and less skilled across the Tasman.

And then I think it's an open question in terms of when non-New Zealanders return in numbers when China is closed, at least Chinese flows will be constrained for a while. There are I think issues with flows out of India, Southeast Asia, traditionally the big markets. So, I guess my baseline is that we're going to see a degree of some negative numbers in net migration, so that will take a bit of a heat, both out of rental market and the regular housing market, I think for a period of time. Hard to be specific on that but to me, that's the largest source of, I suppose, downside risk using your demand supplies, customer---

Erskine: But just to counter that, I don't disagree that there will be some outflow, and we certainly saw that under a Labor Clark government, I think. But on the flip side, isn't one of the solutions for a government, like certainly John Key, correct me if I'm wrong, pursue this strategy and opening the borders up and letting a lot of migrant labor in to help fuel the economy? And I mean, he wouldn't admit to that, that was as the driver for it, I'm sure, but now we have a real---like if I look in the Hawk Bay and the amount of fruit that gets left on trees, because we just don't have the labor and then we haven't got the truck drivers, and we haven't got the hospitality, isn't the government going to try and fast track things? Could they try and fast track things by opening it up to the migrants? And then how many nurses do we need? And obviously there's a lot of countries where there's qualified nurses that would slide on really nicely into the New Zealand economy. Won't that more than offset the outflow or is it not just numbers? It is also the type of person?

David Skilling: Well, and I think, if you looked at the pre Covid peaks, we're getting about 150,000 each into--- is that right? Think it's right!

Erskine: A bit less, but maybe it was 70,000.

David Skilling: So, I think it was 1/1/2% of reasonable population. So is less than 150, sorry, I think it's goodness, late 70,000, but it was 1/1/2% of reasonable population. So, I think, yes, as you say, we have labor shortages be it nurses, horticulture, etc. So, there's going to be demand for migration, but I don't think we're going to return to the migration inflows of a type that we're seeing pre Covid. I think within this government certainly there's more sense of, we need to be a bit more disciplined and constrained. We need to be encouraging firms to train New Zealanders or to be more productive in how they run businesses. So yes, your John Key analogy when push comes to shove, it might be that they decide to be a bit more relaxed migration to boost the economy a little bit, get more people in. But I, don't think we are likely to go back to pre-Covid levels of migration for some time.

So yes, the numbers will go up because you're thinking about zero net at the moment, they'll go back up. I just don't think that we're going to see it as positive. And I think there is a real risk that it's negative for a period of time. But honestly, this is really, really hard to predict because a lot of it depends on policy settings on the strength of the economy in New Zealand and elsewhere. So, it's really hard to pick, but I think if I was to pick one meaningful risk to the property market interest rates are clearly one, but I think that's pretty well understood and people have a, pretty well-structured view of that.

The biggest other risk to me is the strength of migration, of population growth. Because that comes in much weaker than people are expecting. We could see that, that will have a subduing effect on residential property price growth. And we've seen that correlation between migration rates and house price growth in New Zealand for some time. So, I think that begins to unwind or not come as strong. I think to me, that's the bigger risk. On the other side, I think things like industrial property, logistics and the like, I think that's a pretty good story just because your structural shifts of the economy, much more online commerce and you see that all the world over, similarly data centers. So, anything that's property with those kinds of characteristics, I think, there's a much stronger fanatic story that supports that. So yeah, residential; my major concern is really just the strength of migration. A longer term, as you say, strengthen the overall economy, how attractive are we both in terms of attracting and retaining people.

Erskine: Just on that, thinking about, the nature of migration, that's kind of interesting because, and it's going to be festive from my point of view, watching that net migration profile and I agree with you, it's a bit massive driver. And just shifting, you are now up in Europe and the Netherlands, and the European way of living is very different to the historical way of, or at least housing. And we've been very used to our three-bedroom standalone property and the younger generation is starting to get used to living in terraced housing and I was sort of talking about it with my co-director Lisa Phillips this morning, in terms of when we started this business 15 years ago, the whole property investment scene was very DIY. And it was pretty sharky when it first kicked off 15 years ago in terms of property seminars, and it's becoming more and more professional.

And the whole ability of young people to invest in property outright, is just becoming harder and harder. And you could say, well, it’s just because of the current environment, but it's been getting progressively harder because of the ability to get finance, the amount of regulation and compliance around managing investment properties. Is that the answer to New Zealand's housing wise, that it's just having to get commercial go professional quickly to be able to catch up to a European style of living. And are we in for massive change there, or should we be seeking that?

David Skilling: Well, preferences vary across the world. When we left New Zealand 15 years ago, I was living in a four-bedroom standalone Remuera home. And then we spent 11 years in Singapore living in basically apartments. And you kind of get used to that style of living. We're now living in basically a kind of a rowhouse in the Netherlands. They're all kind of narrow skinny houses. Everything is in walking distance, everyone bikes. And so, I guess, preferences shift. I think the attitude to be of younger people, given a home ownership for many, is more of a distant dream; they're used to living in smaller places. Often, they won't own a car. everyone obviously. So, preferences have shifted since when we were yacking a long time ago.

And I think being part of the New Zealand solution, both in terms of housing affordability and the property market, but also frankly, in terms of addressing things like reducing emissions, which is among other things going to involve much reduced transport emissions, is having much denser styles of living, public transport as a much more dominant mode of transport, as opposed to everyone driving in a car. So, I think we are likely to see shifting modes of combination; so much more apartment style living, row-houses, semi-detached rather than the standalone properties, greater clustering, much better density around public transport modes.

So, this is not new, you even see that in Sydney and places like that and you certainly see it in Europe. So, I think the New Zealand is likely to travel in that direction as well. The issue is how do you make sure the regulatory and policy and legislative arrangements keep up to date. Body corporates and the, like, which are kind of professionalized in Europe and in Singapore aren't as professionalized in parts of New Zealand. So, moving from DIY models for more professional model, it seems to me, part of the confidence building process. So, people feel confidence buy into that mode. But I think, it's a direction of travel you see in Australia, which is probably the closest international analog to New Zealand. And I think, if your horizon is long enough, 20, 30 years, plus we're probably going to become more European if you like. In terms of our solar effect now, in many cases in Germany, for example, home ownership rates are very low. I don't think we're going to go there, but I think, there's notion of apartment living, smaller properties, higher population density, I think absolutely. That's the direction in which we're tracking.

Erskine: Yeah. Okay. I'm coming up an hour, so I won't keep you. But I appreciate you sort of ranging across the whole, from global right down to my little pit subject of style of housing. What else have I missed? What else do I need? I think we've covered up a lot, but anything else that you think is relevant. I guess, we are coming at it from a property perspective, but I think it's really important from our point of view, to be aware of what's going on globally. We translate that back right down. I'm hearing that New, Zealand's not defeated in any way. You've got concerns it's more about if New Zealand doesn't get its skates on and start addressing its strategy really, it's competitive advantage for want of a better word, and it just needs to get on with that, and address that. It's got to do that. It pays to be able to compete internationally.

David Skilling: Yeah. My concern about New Zealand is not that we are facing existential risk. It's more just foregone potential, where we could be doing a lot better than we actually are. So that's my sense of frustration, which is not new. It's just, we always go for of the 80% solution as opposed to going for something that's really world class. And I think, at the moment, there are no shortage of challenges. We've discussed a lot of them over the last hour also, but I also think there are big opportunities as well. Shifting consumer preferences are somewhat moving in our direction as well. We have a lot of strength for a lot of capability. We organize ourselves, we build on our brand, both for the national level and also a company or investor level. There's a lot of stuff that we could take advantage of. So, in periods of disruption and flux, often benefit the folks that are most agile. And I think for small countries like New Zealand, we can be agile. We just need to get ourselves organized to do it. So, the window of opportunity is not going to remain open indefinitely. So, the sooner we get our skates on, as you say, I think the better.

Erskine: Yeah. I mean, historically, obviously New Zealanders are ridiculously innovative and it's about harnessing that. That's been a story for about New Zealand for a long time, that we are innovative. But it isn't about getting on and doing that, and being able to put some kind of a structure around that and take that to the world, so anybody can write some code, but can they do it in an innovative way that comes up with creative solutions? And so New Zealand might be more expensive from a coding point of view and maybe that you paid for the top 20% piece of your software coding because New Zealanders can think about it. And is that the direction that we need to get on. And it's just one approach, but I'm hearing you and hearing that we need to get on. So, let's get these borders open. And what I'm hearing from you is get your borders open and get on with it and get creative.

David Skilling: Yeah. And realize that the world is not going to look like the pre-Covid and even pre-February 24. So, expect to have to make some changes, but there are big opportunities out there. We just need to get ready for them and embrace them.

Erskine: Yeah. Okay. Thanks a lot for making your time available, David, and be looking for another catch up in a few weeks.

David Skilling: Yep. Fantastic. Hopefully we can do the next one in person.

Erskine: Absolutely.