14 July 2011

Westpac Institutional Bank

Back on track

Q1 GDP rose 0.8%, annual growth 1.5% after revisions

- **GDP grew by 0.8% in the March quarter, more than expected. Data revisions also showed a stronger pace of recovery in the second half of 2010 than previously estimated.**
- **The net impact of the Canterbury earthquakes appears to have been very small in Q1. Statistics NZ investigated other data sources but concluded that existing methods adequately captured the quake impact.**
- **Today's data strengthens the case for higher interest rates. We expect the RBNZ to resume with a 25bp hike in December.**

Key results

	Actuals		Q1 expectations		
	Q4	**Q1**	**WBC**	**Mkt**	**RBNZ**
GDP q/q	0.5	0.8	0.5	0.4	0.3
GDP ann % chg	1.2	1.4	0.7	0.5	0.4
GDP ann avg % chg	1.7	1.5	1.2	1.2	1.2

Summary

GDP growth was surprisingly strong in the March quarter, despite the disruptive potential of the Christchurch earthquake in February. There was also a sizeable upward revision to the December quarter figures, leaving us with a rosier picture of the pace of recovery in the past year.

With today's figures, the New Zealand economy more closely resembles the narrative that we laid out last year. Activity has responded to low interest rates, a stabilisation in asset prices, stronger inward migration, and strong commodity prices. It's also clear now that domestic conditions warrant higher interest rates. We expect the RBNZ to resume OCR hikes in December, subject to developments in the exchange rate and the Northern Hemisphere governments' debt woes.

Details

The production measure of GDP rose 0.8% in Q1, substantially more than we or the market expected. Goods-producing sectors grew by 1.4%, service industries grew by 0.5%, while primary sectors fell by 0.6%.

Figure 1: Production based GDP

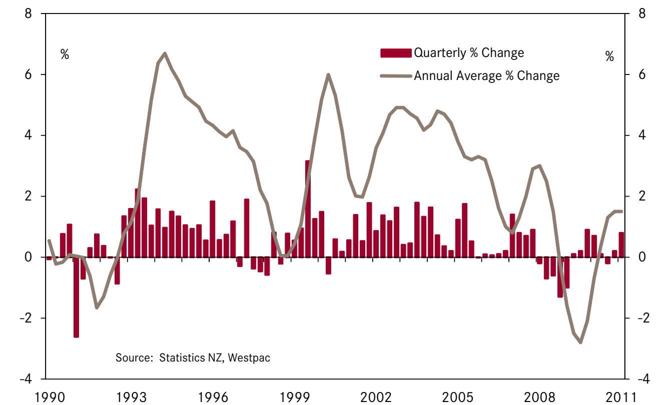


Figure 2: GDP Production Components

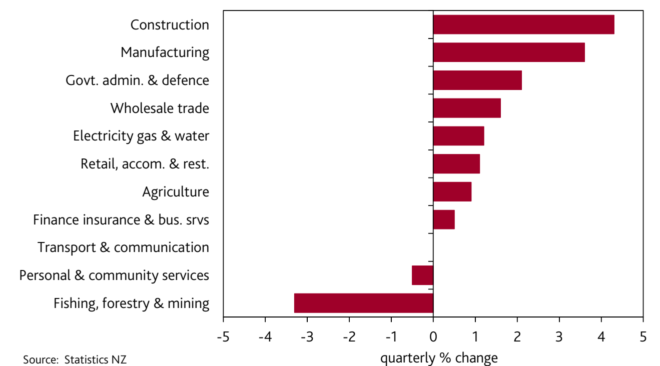
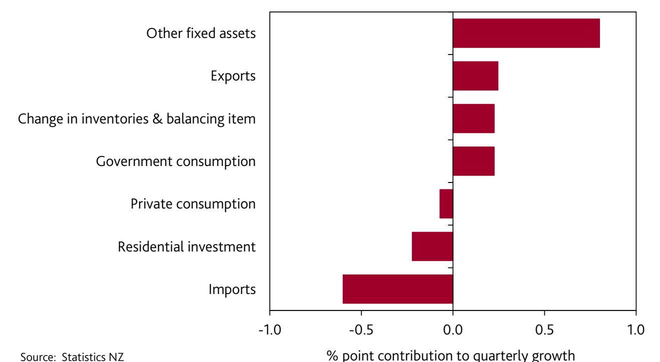


Figure 3: GDP Expenditure Components



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For the second quarter in a row, the biggest contribution to growth came from manufacturing (up 3.6%), led by a 9% rise in metals and a record 16% jump in machinery and equipment, with both admittedly coming from very low starting points. We suspect the rebound in metals was a belated return to capacity after partial shutdowns from as far back as 2008. The bounce in machinery could reflect demand for demolition and construction equipment in Christchurch – but it's also likely to reflect rising demand in the wider economy too. As well as domestic production, imports of capital equipment have been growing rapidly since the start of last year.

Other positive contributions came from a 2% rise in retail sales, reversing the drop in Q4 last year, and an associated 1.5% rise in wholesale trade. Agriculture grew by 1% due to increased milk production. A 2.1% rise in government output was heavily quake-influenced, with extra spending on civil defence and emergency management, and the inclusion of EQC assessors.

The biggest negative, as expected, was from construction (down 4.3%). Both residential and commercial building construction were down, with the Canterbury region weaker than the rest of the country only by a matter of degree. There were small positive offsets from non-building construction (emergency road repairs) and trade services.

On top of the stronger than expected outturn for Q1, the estimate of Q4 growth was revised up sharply, from 0.2% to 0.5% (and, we should note, more in line with our 0.4% estimate at the time). When Q4 GDP was first published in March, Statistics NZ was still reeling from the February quake and was unable to process the data from the manufacturing and wholesale trade surveys using its normal methods. These sectors have since been re-processed, with manufacturing growth revised from 2.5% to 3.4%, and wholesale trade shifting from a 2.7% drop to a 0.8% gain.

Quake effects

For this release there was a great deal of uncertainty around the impact of the 22 February earthquake – and especially around any ad-hoc adjustments that Stats NZ might make. While no regular information was missing as a result of the quake, Stats said that it was investigating other data sources for some sectors where the existing methods might be inadequate.

Surprisingly, Stats concluded that the net effects of the quake were either adequately captured by the usual methods, or were deemed too small as a share of national GDP to be worth adjusting for. That meant, for example, that the 2% fall in personal and community services that we had pencilled in, to account for school closures in Christchurch, turned out to be a 0.5% decline. That alone accounts for 0.2ppts of our forecast 'miss'.

From a forecasting point of view, this finding is something of a relief: if the usual methods adequately captured activity in Q1, then we can base our forecasts for Q2 and beyond on the usual methods too. That means we can firm up our initial estimate of 0.6% growth in Q2, based on high-level indicators such as the Quarterly Survey of Business Opinion.

On the whole, it appears that the Canterbury earthquakes had little net effect on March quarter GDP. That's not to say that there weren't serious disruptions to many parts of the regional economy – but it's also clear that there was a great deal of reallocation of activity, and some outright positive contributions, from the September quake as well as the February one (such as insurance assessors and housing repairs).

The small net impact on activity stands in contrast to the sharp initial shock seen after recent natural disasters elsewhere (Chile in 2010, Australia and Japan this year). In each of those cases, there were severe disruptions in the ability to reach export markets, which wasn't the case in New Zealand (export volumes rose 0.8% for the quarter).

Market implications

Currency markets reacted strongly to the news, initially pushing the NZ dollar up by a cent to a new record of US85c. The two-year swap rate rose 5 basis points to 3.42%.

For the RBNZ, evidence of a robust economic recovery, combined with a resurgent housing market and high inflation expectations, strengthens the case for resuming rate hikes. Our view remains that the next OCR hike will be in December this year, subject to how market conditions pan out in coming months. The high exchange rate will do some of the work in containing inflation pressures, and a range of unresolved sovereign debt concerns in the Northern Hemisphere could still prove to be a spoiler for the global recovery.

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