22 September 2011

Westpac Institutional Bank

Crouch, pause, engage?

Q2 GDP rose 0.1%, below expectations

- **GDP growth slowed sharply in the June quarter after a strong start to the year. As expected, agriculture and business services were stronger, while housing construction was very weak.**
- **Activity in some service industries was surprisingly soft. This may reflect a let-down in tourist spending after a strong Q1, or activities being delayed to coincide with the Rugby World Cup.**
- **We regard this as a pothole on the ongoing road to recovery, though it will be tricky to confirm this over the near term while the RWC is producing a sharp temporary boost to activity.**

Key results

	Actuals		Q2 expectations		
	Q1	**Q2**	**WBC**	**Mkt**	**RBNZ**
GDP q/q	0.9	0.1	0.7	0.5	0.6
GDP ann % chg	1.6	1.5	1.9	1.7	1.9
GDP ann avg % chg	1.6	1.5	1.5	1.5	1.5

Summary

New Zealand's GDP grew by just 0.1% in the June quarter, much weaker than we or the market expected, and at odds with a swathe of indicators suggesting that the economy had been gathering momentum through the first half of this year. Revisions adding more than 0.3% to GDP over the previous year softened the blow to some degree, but also served to cast the Q2 performance in an even worse light.

The sectoral breakdown showed the as-expected strength in primary production and weakness in goods-producing industries. The big surprise for us was the weakness in some of the service industries, and in particular the most opaquely-measured ones. Because of this, it's worth spending some time dissecting these figures to determine whether they're warning of a renewed slowdown, or whether this (and the strength in Q1) was simply a product of normal volatility. We come down more towards the latter, but it will be hard to confirm this over the near term, with the Rugby World Cup set to provide a sharp but temporary boost to activity in the next two quarters.

At this stage we won't be altering our forecasts for growth in the second half of this year, although the longer-term track will be under review. And we maintain our pick for the next OCR move

Figure 1: Production based GDP

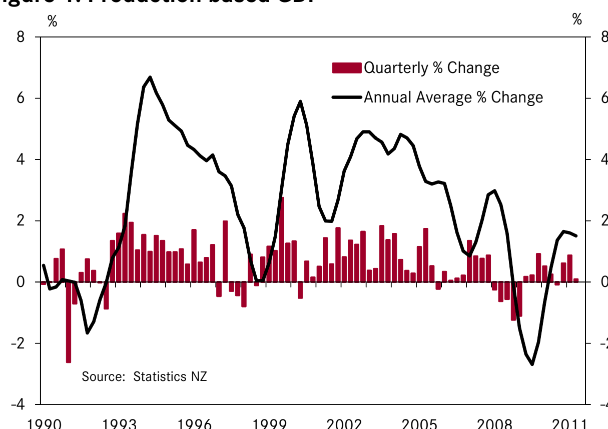


Figure 2: GDP Production Components

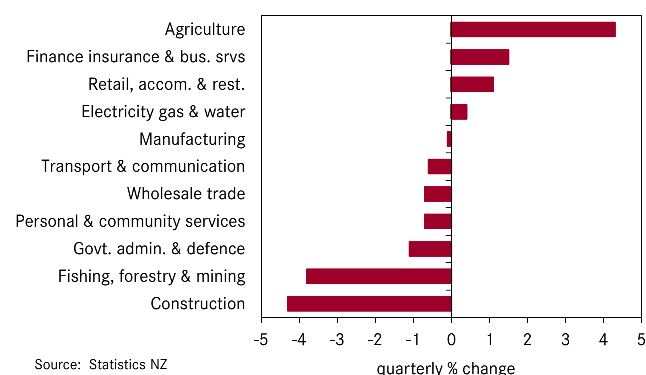
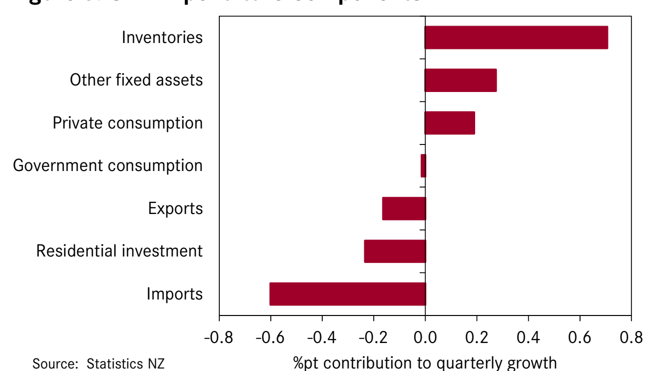


Figure 3: GDP Expenditure Components



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to be a 25bp hike in January next year, subject to how global financial tensions evolve.

Details

As we expected, the star performer in the June quarter was agricultural production, which rose by 4.3% and also accounted for the bulk of the historical revisions (the level of output in the March quarter is 6% higher than was originally reported). Milk production was very strong over the quarter, and the current run-rate suggests it will also be a supportive factor for September quarter GDP. Livestock and wool output were also higher.

The other major positive contributions were a 2.8% rise in property and business services and a 1.1% rise in retail trade. It's notable that the strength in these industries was domestically-oriented: property services were boosted by a strong pickup in house sales, and the gains in retail were dominated by cars, furniture and appliances.

The weakest sectors were also largely as we anticipated. Construction activity fell 4.3%, following a similar drop in the March quarter. Housing construction was particularly weak, as indicated by the building work survey earlier this month, but repairs and non-building activity related to the early stages of Christchurch's recovery provided some offset, and were actually a touch stronger than we had assumed. Mining activity fell 5.4%, with the relatively recent Tui and Kupe oil and gas fields going through their natural rate of decline. Central and local government activity fell 1.1%, partly due to belt-tightening and partly due to quake-related spending being scaled back.

Manufacturing and wholesale trade both fell slightly in Q2, accounting for some of the downside surprise to our forecast. But the biggest surprise was in the remaining service sectors: transport and communication fell 0.6% (the latter being the main driver), and personal and community services fell 0.7% after a 0.5% drop in Q1. We don't have much in the way of forward indicators for these sectors, but we felt there was scope for some post-quake rebound in the Canterbury region (as appears to have been the case in retail, construction and house sales).

So what's behind the latest weakness in these services – is it simply normal volatility, or does suggest something more sinister about the robustness of the recovery? We can think of a few driving factors – though again, given these sectors' relative opacity, it's hard to confirm one way or another.

Tourism

With hindsight, spending by overseas visitors may have accounted for more of the March quarter GDP strength than we gave it credit for. While visitor numbers were down in Q1, spending per person jumped by 12%. Some variation is normal (for instance, due to changes in the mix of source countries), but this was one of the largest increases on record. In contrast, visitor spending fell back sharply in the June quarter, with a 5% drop in spending per person on top of a 3.3% drop in visitor numbers (affected by the February earthquake and the Chilean ash cloud in June, among other things).

These swings in visitor spending added around 0.3 percentage points to Q1 GDP growth and detracted 0.3ppts from Q2 – which accounts for a lot of the difference in growth between the two quarters. And it's notable that many of the service sectors that did well in Q2 were domestically-focused (business services, durable goods retailing), while some of those that did poorly had more of a tourism focus (transport, recreation). It's not a clean split, however – for instance accommodation was strong, healthcare was weak – so we don't think this is the final word.

On hold for RWC?

A related possibility is that some activities that would normally have happened in the June quarter were delayed until September and October, so that they could coincide with the Rugby World Cup and the resulting influx of tourists. By the same token, New Zealanders may have been 'saving up' for the event during Q2. (For the record, while rugby tickets were purchased as early as last year, they won't be counted in GDP until they are 'consumed', i.e. when the games are played.)

Communication breakdown

The communication sector was the strongest-performing sector of production GDP for decades, maintaining a pace of about 5% annual growth up until 2008. But it has been flat or falling for the last seven quarters straight, and is down more than 5% from its peak. With a weighting of about 6% of GDP, this turnaround in performance has had a significant impact, shaving about 0.5ppts off annual GDP growth.

This reversal of fortune is not new us, and we regard it as more of an issue with measurement than with reality. For instance, postal services are undoubtedly in decline – but this activity is not being lost, it's just moving online where it's harder to quantify. The same is true of phone use to a lesser extent.

But it doesn't seem as though these measurement issues are going to be resolved any time soon. So we'll be reviewing our long-term GDP growth forecasts, to allow for a weaker trend in the communications sector than in the past. Of course that means revising down our notion of potential GDP by the same degree – bear in mind this is not a matter of the New Zealand economy's notional speed limit, but of GDP's shortcomings as a measure of wellbeing.

Market implications

The weaker GDP result was not welcomed by a market that had already been rendered nervous by the overseas turmoil. The New Zealand dollar fell to a four-month low below USD80c, and the two-year swap rate fell 6bps a new record low of 3.1%.

The weaker than expected growth outturn supports the Reserve Bank's recent stance that higher interest rates are likely but not urgent. We're not convinced that domestic inflation pressures will be as well-behaved as the RBNZ assumes, but for now it has leeway to stand back and see how overseas developments, and in particular Europe's sovereign debt woes, are resolved.

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