22 December 2011

Westpac Institutional Bank

Something to cheer about

Q3 GDP rose 0.8%, as expected

- **September quarter GDP growth was in line with our forecasts, though there were some sizeable and unexpected downward revisions to the pace of recovery in the last two years.**
- **The Rugby World Cup provided the expected boost to retail spending, but the running of the tournament itself was not fully captured.**
- **A large build-up in inventories may or may not prove to be a drag on future growth, depending on its cause.**

Key results

	Actuals		Q3 expectations		
	Q2	**Q3**	**WBC**	**Mkt**	**RBNZ**
GDP q/q	0.1	0.8	0.8	0.6	0.6
GDP ann % chg	1.1	1.9	2.4	2.2	2.2
GDP ann avg % chg	1.1	1.3	1.7	1.7	1.7

Summary

September quarter GDP growth was in line with our above-market expectations, but the details threw up a few surprises – particularly a smaller than expected contribution from the Rugby World Cup – and some substantial downward revisions to history that only served to deepen the mystery about the economy's slow pace of recovery. While the GDP figures raise some issues that we will continue to investigate, on balance they leave our near-term outlook for growth unchanged.

Details

The production measure of GDP rose by 0.8% in the September quarter, with the expected strong contributions from manufacturing activity and retail trade. A larger than expected rebound in gas production, and a modest 0.6% increase in the large 'finance and business services' group, also contributed to the result. Construction remained weak (down 2.2%), with no significant boost yet from reconstruction in Canterbury, and agriculture edged lower after a very sharp rise over the previous year.

The biggest surprise for us was around the contribution from the Rugby World Cup – the 2.5% increase in retail spending was already well-flagged, but we also assumed a boost to the 'cultural and recreational services' group from the running of the tournament itself. However, Statistics NZ stuck to its usual

Figure 1: Production based GDP

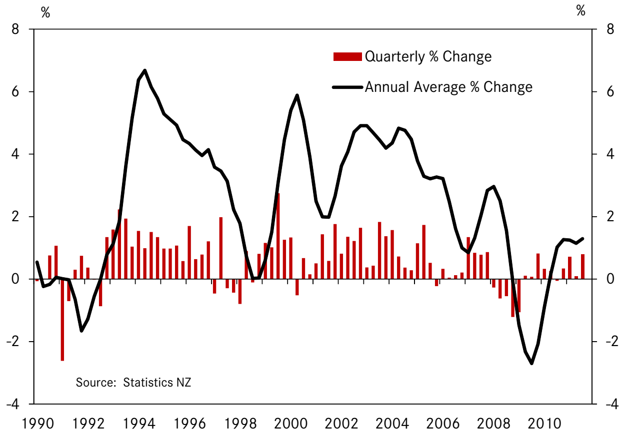


Figure 2: GDP Production Components

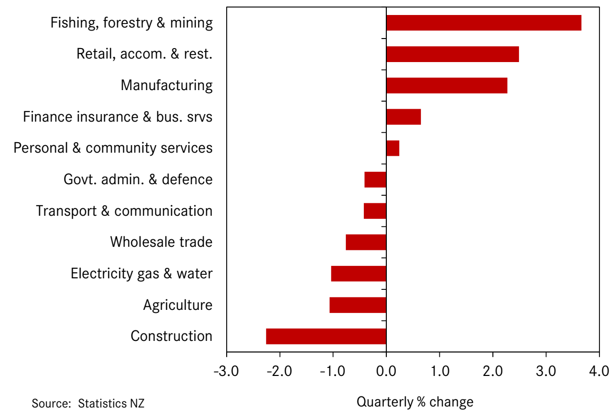
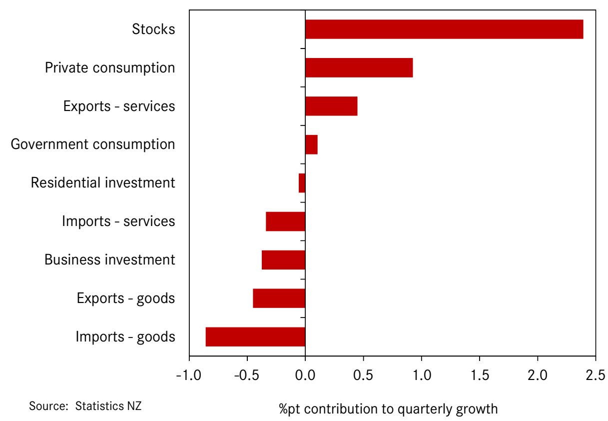


Figure 3: GDP Expenditure Components



For further information, questions or comments contact Dominick Stephens, telephone (09) 336 5671, email dominick_stephens@westpac.co.nz

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methodology for this sector, based on hours worked in the Quarterly Employment Survey. Since the Q3 survey was actually held in August (and the Q4 survey was run in November), it will have missed most if not all of the boost to activity during the RWC.

This actually means that the 0.8% growth is a fairer reflection of the underlying growth trend than we were expecting. However, for those trying to gauge the costs and benefits of the tournament, it leaves the picture frustratingly incomplete. The next opportunity for an official measure of the RWC's impact is likely to be the Annual Enterprise Survey for the March 2012 year – to be published in September 2013.

The expenditure measure of GDP rose by a stronger than expected 1.0%, with large contributions from household consumption (up 1.5%) and stock-building. Building activity fell by more than expected, and 'other construction' (mostly infrastructure) fell back after a sharp rise in the June quarter that we thought may have reflected demolition and infrastructure repairs in Christchurch (today's result suggests not). Investment in plant and machinery continued to rise sharply (up 6%), as businesses took advantage of the strong NZ dollar to import capital equipment.

Exports of services (which includes tourist spending) rose by 7.2%, though this only reversed the 6.8% fall in Q2, when overseas visitor numbers were walloped by earthquakes and ash clouds. These figures imply a very small RWC effect – but as we noted in yesterday's current account review, that's not the case. Tourist spending is surveyed on departure, and for many RWC visitors this will have fallen into October (and will be recorded in Q4 GDP). This doesn't affect overall GDP for the quarter, just how it's classified – tourist spending will be understated, and spending by New Zealand households will be overstated by the same amount.

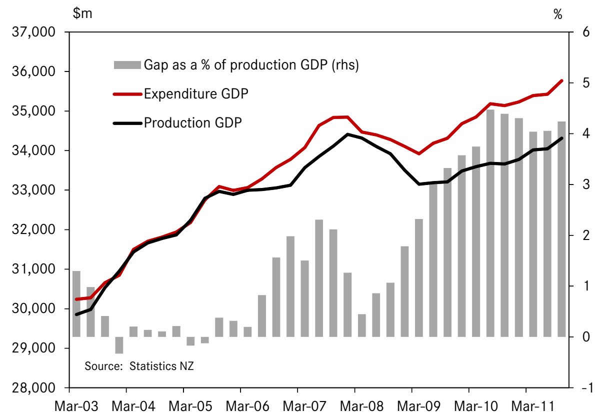
The $1,132m increase in stocks was the largest quarterly gain since the series began in 1987. While this was a major plus for Q3 GDP, adding 2.4 percentage points to growth, it could be an ominous sign for growth in coming quarters, depending on what caused it. Was it involuntary – that is, did goods pile up on shelves as producers were unable to find buyers? Did firms overstock in anticipation of the RWC? Or were they replacing stocks destroyed in the Canterbury earthquakes?

A closer inspection shows that about half of the stock build-up was in meat and dairy manufacturing. While stock levels were relatively high at the end of the quarter, this is understandable in the wake of the superb conditions for dairying this year, and the increase in Q3 followed a sharp rundown in Q2. Most of the remainder was due to a large but not unprecedented rise in wholesale and retail stocks; we don't have enough information to say what was behind this. To sum up, stock levels will bear close watching, but at this stage they don't offer a strong reason to alter our near-term GDP forecasts.

While the quarterly change in GDP was much as expected, there were some significant downward revisions to the levels going back to 2009 (much more so for production GDP than for expenditure). Production GDP growth for the last two years, which was already running at a fairly lean pace, is now 0.4 percentage points lower than previously reported. Our forecast for annual growth in 2011 will now be 1.7%, from 2.1% previously, and compared to 1.3% in 2010.

One side effect of this revision, though, is that it has further widened the gap between the production and expenditure measures of GDP (Figure 4). In its December Monetary Policy Statement the Reserve Bank highlighted that, since the start of the recession, expenditure had outpaced production by about 3%; with the Q3 figures and the revisions to history, that gap is now closer to 4%. In principle these measures should be equal, so it's reasonable to expect future revisions to reduce this gap – but from which direction? Which of these is the truer measure of the pace of recovery in the last couple of years, or the degree of spare capacity left in the economy?

Figure 4: Two measures of GDP



Market implications

There was little market reaction, which we would regard as appropriate – the NZ dollar was unchanged, while swap rates initially rose 2 basis points but fell back later in the day. While quarterly GDP growth was stronger than the Reserve Bank's forecast, the downward revisions to history are probably more meaningful – they imply that low interest rates have done less to boost activity than previously thought. In addition, today's figures will have little bearing on the outlook for growth next year, which will be determined by a set of factors very different to this year – weaker world demand, potentially tighter credit conditions, and a sharp pickup in building activity from very low levels.

Dominick Stephens, Chief Economist, Ph: (64-9) 336 5671
Michael Gordon, Senior Economist, Ph: (64-9) 336 5670