10 July 2012

Westpac Institutional Bank

Pushmi-pullyu

NZIER business confidence down in Q2 but activity holding up

- **General business sentiment was weaker in the June quarter, but reported activity was fairly steady on the whole.**
- **Confidence and activity rose in the building industry, while it softened in other sectors.**
- **This two-speed growth path is likely to become more pronounced in coming years as the Canterbury rebuild places more demand on the nation's resources. Higher inflation and higher interest rates will result.**

Summary

The June *Quarterly Survey of Business Opinion* saw a sharp and entirely unsurprising pullback in general business sentiment compared to March, which proved to be a brief lull in the European debt crisis. The more notable finding, however, was that firms' reports of their own activity were fairly steady on the whole. The implication is that firms are understandably worried about global developments, but are not experiencing any major fallout themselves – and as today's housing and card spending data for June show, there is plenty of life to be found in parts of the domestic economy.

Although reported activity as a whole was steady in the June quarter, there are signs of a growing split between momentum in the construction sector and in the rest of the economy. We warn that this split will only become more pronounced in the next few years – as the Canterbury rebuild ramps up, it will start to 'crowd out' activity in other regions and other industries.

Details

In seasonally adjusted terms, confidence about general business conditions fell to a net -1% in the June quarter, more than unwinding the spike to +21% in March. Firms' own-activity expectations for the next quarter also eased, although they remained positive on balance, and higher than in the immediate wake of the Canterbury earthquakes.

Although expectations suffered a blow, firms' own activity was fairly stable on the whole. Reported activity for the past three months actually rose slightly, from 0% to +1%; this measure has been slightly either side of zero for the last seven quarters straight.

However, the stability in the nationwide indicators masked a notable divergence. Not by region per se – survey responses remain the strongest in Canterbury, but the movement for this quarter was similar to the rest of the country. Rather, there was a clear split between increasing activity in the building industry versus a softening in other sectors.

Builders' reported output rose to a net +16%, the highest since December 2004, while profitability was the best since 2005. Employment growth remains soft, but a sharp rise in overtime worked suggests that the pressure for new hires will grow. And as another sign of things to come, architects' expectations were strong across the board. While the outlook for housing work

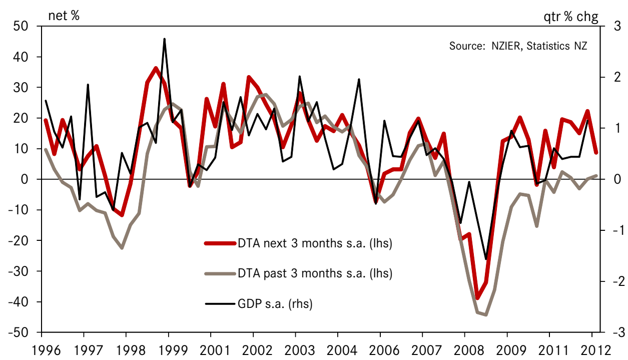
Key results – forward looking

	Q1 survey	Q2 survey
Business confidence sa, next 6 mths	21	-1
Trading activity, sa, next 3 mths	22	9
Pricing intentions, next 3 mths	23	10
Cost expectations, next 3 mths	32	24
Profitability, next 3 mths	4	-2
Employment intentions, next 3 mths	5	4
Building investment intentions, next 12 mths	–4	–3
Plant investment intentions, next 12 mths	-2	2

Key results – backward looking

	Q1 survey	Q2 survey
Trading activity, sa, past 3 mths	0	1
Pricing, past 3 mths	11	5
Costs, past 3 mths	32	26
Profitability, past 3 mths	–15	–13
Employment, past 3 mths	1	–4
Ease of finding skilled labour, past 3 mths	–21	–26
Ease of finding unskilled labour, past 3 mths	10	8
Capacity utilisation	89.36%	89.77%

Domestic trading activity



has been consistently positive since the first earthquakes, in the June quarter this was joined by a sharp rise in expectations for commercial building – to the highest since 2003. Even the outlook for government work was stronger.

Indicators of inflation pressures varied markedly, and will leave the RBNZ no closer to resolving the question of whether the economy's non-inflationary 'speed limit' has fallen in recent years. A net 5% of firms reported price increase in the last quarter, and a net 10% expect to raise prices in the next quarter. These are some of the lowest readings of the last ten years, and are consistent with the recent subdued inflation outturns. (We expect annual inflation to slow further from 1.6% to 1.2% in the June quarter figures, published next Tuesday).

On the other hand, capacity utilisation ticked up, with a particularly sharp rise for builders – not surprising as activity in Canterbury ramps up. The difficulty of finding skilled workers increased relative to March, and even more so for the retail and service sectors than for construction.

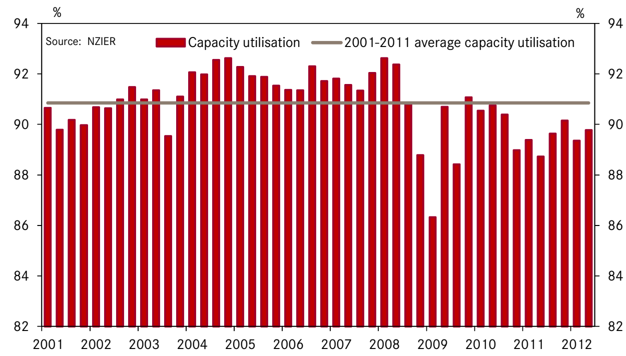
Market implications

While we find that the *QSBO* is the single best indicator of quarterly GDP, the fit has been eroded by recent outturns and historical revisions. There's also a question of levels: if firms' expectations have typically overestimated the pace of the recovery, it also has to be said that reported activity has persistently understated the actual pace of GDP growth. Taking a compromise between the two, we see no reason to change our forecast of 0.6% growth in June quarter GDP.

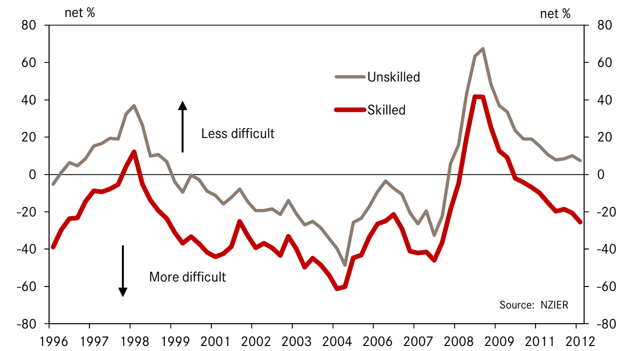
Although 'crowding out' was probably not a factor in the June quarter results – the economy is still running well below full capacity – we expect it to become an increasing feature over coming quarters, as rebuilding activity moves into full swing. We're sceptical that the New Zealand economy has the capacity to complete the rebuild without generating significant inflation pressures, and this is why we see much of the economic impact of the rebuild coming through as higher inflation and higher interest rates, without ever achieving spectacular rates of GDP growth.

Michael Gordon
Senior Economist

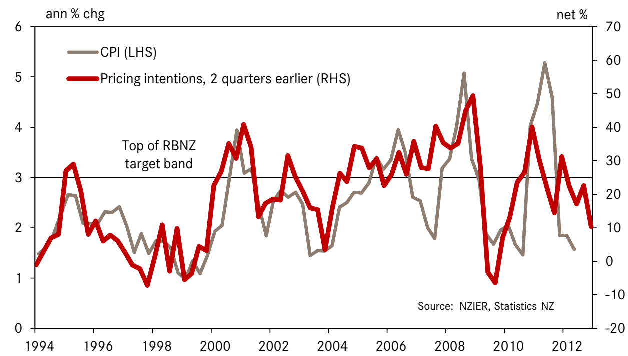
Capacity utilisation



Firms' difficulty in finding labour



Pricing Intentions vs CPI



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