19 September 2013

On the march
Q2 GDP rose 0.2%, better than expected

- **GDP rose by 0.2% in the June 2013 quarter, beating our forecast of a 0.1% decline.**
- **As expected, the early 2013 drought took a significant bite out of agricultural production over the June quarter.**
- **However, robust ex-agri production over the quarter, plus upward revisions to recent history, overall left a more favourable picture of the economy's current upswing.**
- **We continue to expect growth to pick up sharply over the next year, as the farming sector recovers from the drought and as construction and house prices continue to ratchet up. This in turn will put more upward pressure on inflation, requiring an interest rate response.**

Key results

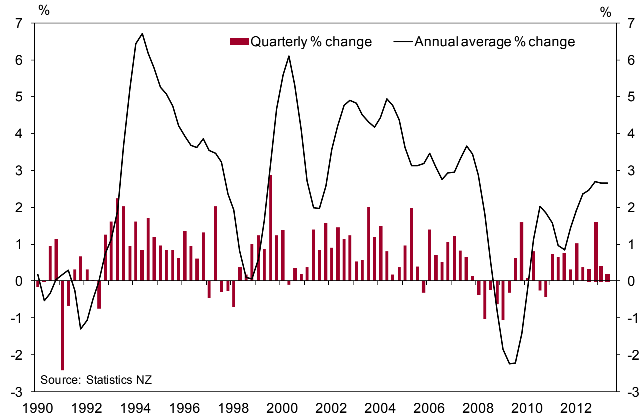
	Actuals		Q2 expectations		
	Q1	Q2	Westpac	Mkt	RBNZ
GDP q/q	0.4	0.2	-0.1	0.2	0.4
GDP ann % chg	2.7	2.5	2.0	2.3	2.5
GDP ann avg % chg	2.7	2.7	2.4	2.5	2.5

The New Zealand economy clocked up a second quarter of soft GDP growth in the three months to June, though it avoided the small outright decline that we had expected. A short but intense drought took a significant bite out of agricultural production in the first half of this year, but stronger ex-agricultural production in the June quarter – combined with upward revisions to recent history – leaves us with a more positive picture of the underlying pace of this economic upturn. Our forecast for annual growth to accelerate to the high 3's next year certainly looks closer than it did before today's release.

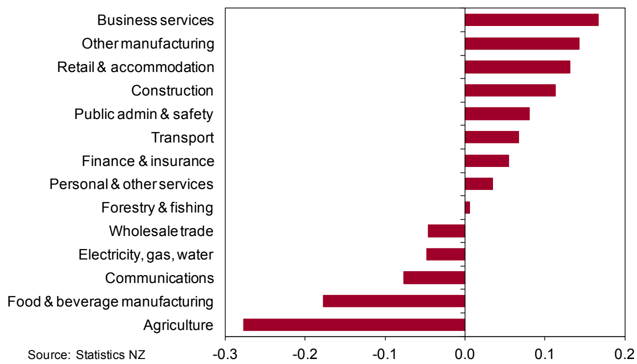
The latest GDP figures also reinforce some of the themes that we've been emphasising for some time. First, that construction and related activities would play a major part in this expansion. Second, that the upturn would become more widespread as it progressed – that is, that it wouldn't remain quarantined within the building sector or the Canterbury region. And third, that consumers would respond to rising house prices by bringing spending forward, in much the same way as they've done in past cycles.

The next stage in this progression – again, as we've seen in past cycles – is a pickup in domestically-generated inflation as the economy moves closer to full capacity. While the evidence to date is limited, we expect this to become more apparent as the economy shakes off the drought and growth accelerates over the next year. That in turn will require higher interest rates – we continue to expect the first OCR hike in March next year.

Production-based GDP



Percentage point contribution to Q2 GDP growth



Details

The production measure of GDP rose by 0.2% in the June quarter. With small upward revisions to the previous two quarters, that left annual growth steady at 2.7%. Indeed, upward revisions to prior quarters have been a recurring theme in recent GDP releases; this upswing has been proving to be more robust with the benefit of hindsight.

The direct impact of the drought was evident in the 6.4% fall in agricultural production and the 3.8% fall in food manufacturing over the quarter. Together, these two sectors knocked 0.5 percentage points off the rate of growth – not quite as bad as the 0.6ppt impact that we estimated. By far the biggest contributor was a whopping 15.5% fall in dairying production. This segment has the capacity to spring back hard in the next quarter – warm weather and early calving have meant that milk production over the September quarter has actually been up on the same time last year.

Excluding these sectors leaves us with underlying growth of 0.7% for the June quarter – mostly in line with what we expected, but with a few sizeable upside surprises. The first was that construction activity continued to ramp up, rising by 2.3% against our forecast of a flat outturn. The big surprise was a 7% jump in infrastructure work – an important aspect of the Canterbury rebuild and the general upturn in the construction industry, but one that isn't captured in any other indicators.

The second big surprise was that professional/technical services grew by 2.6%, on top of a 3.9% rise in the March quarter. We'd assumed that some of the outsized gain in March reflected temporary Census workers, but today's figures suggest that wasn't a significant factor. The growth in both quarters was attributed to architectural and engineering services – and while the March quarter growth was dominated by Auckland and Christchurch, the June quarter jump was nationwide.

The other notable positives were broadly as we expected. Retail spending rose 2.1%, as flagged by the quarterly retail survey; non-food manufacturing, transport and public administration bounced back from surprising declines in the March quarter; and finance rose 1.2% for a second straight quarter as credit growth picked up.

The expenditure measure of GDP rose by 0.1%. Typically we don't put as much focus on this measure as it's considered to be less reliable on a quarterly basis. But in this case we find that the figures highlight some crucial issues.

Firstly, private consumption – which accounts for about two-thirds of expenditure – rose a whopping 1.5% over the quarter, led by a 4% rise in durable goods. Some of this could be pegged on the strong New Zealand dollar, which has depressed import prices and given consumers more bang for their buck. But that won't explain the growth in spending on services – up 1.4% for the quarter and 4% on a year ago, the fastest annual growth since 2006.

This should put to rest a debate that raged earlier this year. At one stage the Reserve Bank doubted that rising house prices would induce much of a consumer response, and therefore would not be much of a problem for CPI inflation. Those doubts should now be well and truly dispelled in favour of our long-held view that consumers will respond to rising house prices in the same way as they have over history.

The second point of note is that business investment has been recovering strongly. The 5.7% rise in the June quarter was the biggest quarterly increase since 2005, and leaves the level of investment just 2% shy of its pre-recession peak.

Finally, the impact of the drought was heavily concentrated within the June quarter. Exports of goods plunged by 8.5%, the second biggest quarterly drop on record. That massive cleanout now leaves room for exports to make a positive contribution to growth in coming quarters.

Market reaction

On the day, this was a positive surprise to us and to markets – while the result was in line with the median surveyed forecast, all of the four main trading banks were predicting a small decline. The New Zealand dollar rose half a cent to 0.8370 after the release. Swap rates are broadly unchanged, with the US central bank's surprise decision this morning to maintain the pace of its bond purchases probably dictating the direction of local interest rate markets.

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