Westpac Institutional Bank

Dried out

Preview of June 2013 quarter GDP (19 Sep, 10:45am) and current account (18 Sep, 10:45am)

- **We estimate that GDP fell 0.1% in the June quarter, following a 0.3% rise in the March quarter.**
- **The drought took its biggest bite out of food production in the June quarter, and Census workers will drop out of the equation.**
- **These transitory effects more than offset the modest growth seen in the rest of the economy.**
- **The hit to dairy export volumes was partly offset by higher prices, helping to maintain the current account deficit at 4.8% of GDP.**
- **Our forecasts are broadly in line with market and RBNZ expectations.**

The June quarter national accounts published next week are likely to paint a distinctly unflattering picture of the New Zealand economy. Yes, we're forecasting a drop in GDP. No, that doesn't mean we're heading back into recession – not even in the 'technical' sense of two straight quarters of negative growth. If anything, underlying activity looks to have been more robust in June than in the March quarter, and the indicators to date for the September quarter are also shaping up nicely.

However, the drought earlier this year took a heavy toll on agricultural production, and the greatest impact appears to have fallen into the June quarter accounts. The sharp drop in exports, only partly offset by higher world prices for dairy products, will also mean a deterioration in the goods trade balance, although we expect the overall current account deficit to remain at 4.8% of GDP.

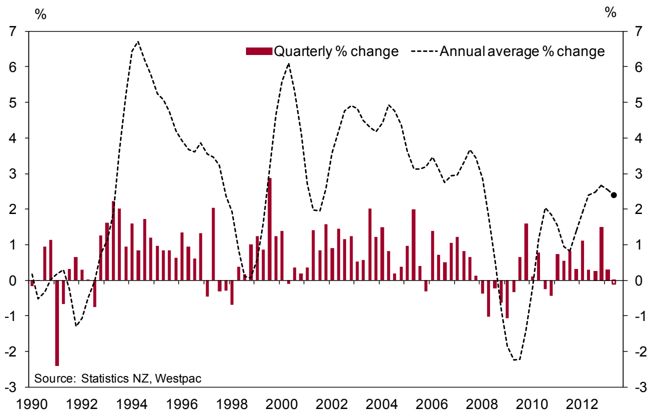
The impact of the drought has come through in the GDP figures even more abruptly than we expected. The flipside of this is that the rebound in coming quarters may also be sharper – we have revised up our September quarter GDP growth forecast from 0.8% to 0.9%, with an eye to taking it even higher depending on how next week's releases pan out.

Q2 GDP, 19 September

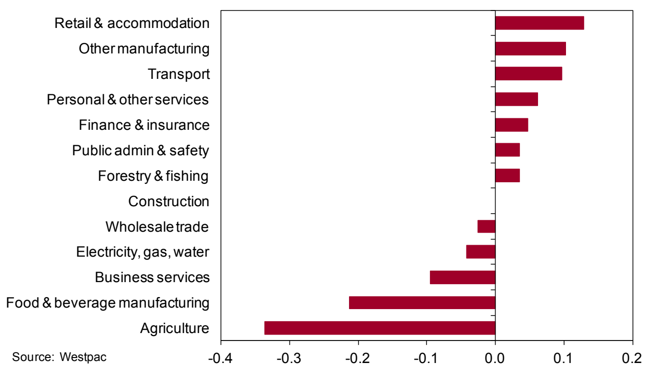
We expect a 0.1% drop in June quarter GDP, with the direct impact of the drought knocking around 0.6 percentage points off the growth rate. While the drought had well and truly broken by June, the timing of its effects mean that the greatest hit to the level of production occurred over the June quarter.

We estimate that agricultural output dropped by around 8%, following a 4.7% fall in the March quarter. Milk production was the main contributor, down 11% compared to 6% last quarter.

Production-based GDP



Percentage point contribution to Q2 GDP growth



On top of this, we expect a 4.5% drop in food manufacturing, with a sharp drop in both dairy product and meat processing. The latter actually experienced a drought-related boost in the March quarter as animals were sent to slaughter earlier than usual; now we'll see the payback from this.

Looking through the drought effects leaves us with underlying growth of around 0.5% for the quarter – not spectacular, although it looks to be more broad-based compared to the March quarter, which was heavily skewed towards construction-related activities. We see the main positive contributions coming from a 1.7% rise in retail spending, a pickup in non-food manufacturing, a rebound in transportation from an unusually soft March quarter, and ongoing steady growth in finance and personal services.

Construction activity was broadly flat for the quarter, a surprising result in the context of the escalating Canterbury rebuild. We suspect this simply reflects normal volatility in the survey of building work completed. The monthly consents figures certainly give no sense that pipeline of work has slowed recently.

Aside from drought effects, the other notable negative that we expect is for professional services, which jumped 3.9% in the March quarter. Statistics NZ put this down to a combination of Census workers (a one-off) and increasing work for architects and engineers (which should persist). Taking a stab at the relative size of these factors, we've assumed a partial reversal of 1.2%.

Q2 current account, 18 September

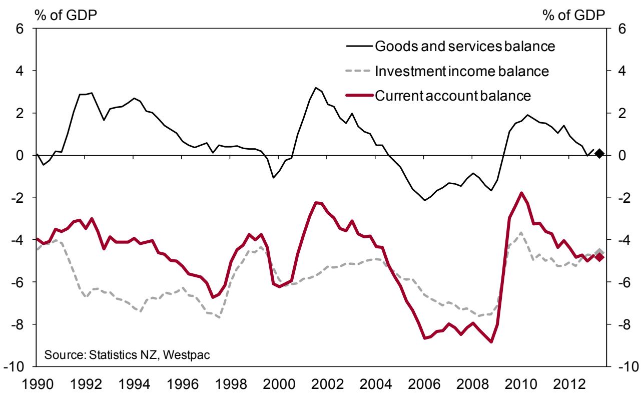
We expect the current account deficit to hold at 4.8% of GDP for the year to June. The goods balance decreased in seasonally adjusted terms as export values fell on the back of the drought, while import values continued their steady increase. Both meat and dairy export volumes are likely to have taken the biggest hit. However, this drought has been short and sharp. The trade balance for remainder of the year is likely to be dominated by the very high dairy export prices.

The investment income deficit is expected to have widened in Q2, as profits for overseas-owned firms in New Zealand strengthened in line with the rest of the economy. Continued economic growth this year and higher interest rates next year are likely to see this deficit widen further over the next couple of years.

Current account components ($millions)

	Sep-12	Dec-12	Mar-13	Jun-13 (forecast)
Goods Balance (s.a.)	145	395	616	104
Services Balance (s.a.)	-287	-307	-123	-196
Investment Income Balance	-2,213	-2,495	-2,511	-2,718
Transfers Balance	-148	-87	-135	-119
Current Account Bal (s.a.)	-2,523	-2,540	-2,208	-2,966
CAB Ann Total	-9,862	-10,489	-10,080	-10,280
Ann CAB, % of GDP	-4.7	-5.0	-4.8	-4.8

NZ annual current account balance



Market implications

GDP is typically the more significant release for markets. Our estimate of a small decline is comparable to other market forecasts that we've seen. Yesterday's Monetary Policy Statement included a forecast of 0.4% growth for the June quarter, but the RBNZ has indicated that its forecast would now be closer to zero, based on data received after the cut-off date for its published forecasts. So while the optics of a negative number wouldn't be great, it's unlikely that it would prompt much soul-searching about the direction of interest rates.

The actual market reaction on the day of the GDP release will be complicated by the fact that it comes a few hours after a major US central bank meeting, where the Fed is widely expected to begin slowing its bond-buying programme. If that happens as markets expect, then the path of least resistance for interest rates will be up, and the market will be more inclined to look past a soft New Zealand GDP print. Conversely, if the Fed surprises markets by holding back on 'tapering', then interest rates are likely to react more strongly to a downside surprise on GDP than on an upside one.

Michael Gordon
Senior Economist

Nathan Penny
Economist

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Nathan Penny, Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

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