Westpac

Institutional Bank

8 April 2014

Power shift

NZIER business confidence remained high in Q1

- The March *Quarterly Survey of Business Opinion* showed that firms remain at their most upbeat in decades about their near-term prospects.
- There was also a marked lift in pricing intentions in the latest survey. With measures of capacity pressures mixed, it may be that firms are increasingly looking to rebuild their margins.
- Actual prices are reported to be rising at a more modest pace, consistent with a gradual return to the midpoint of the RBNZ's inflation target. But the RBNZ will be watching for signs that firms are regaining some pricing power.

Key results – forward looking

	Q4 survey	Q1 survey
Business confidence, next 6 mths	52	52
Trading activity, next 3 mths	31	35
Pricing intentions, next 3 mths	26	37
Cost expectations, next 3 mths	21	25
Profitability, next 3 mths	17	17
Employment intentions, next 3 mths	12	11
Building investment intentions, next 12 mths	9	11
Plant investment intentions, next 12 mths	19	21

Key results – backward looking

	Q4 survey	Q1 survey
Trading activity, past 3 mths	17	23
Pricing, past 3 mths	11	16
Costs, past 3 mths	21	20
Profitability, past 3 mths	-2	4
Employment, past 3 mths	4	2
Ease of finding skilled labour, past 3 mths	-30	-29
Ease of finding unskilled labour, past 3 mths	-10	-10
Capacity utilisation	90.18%	89.40%

New Zealand firms remained hugely optimistic about their near-term prospects in the early part of this year, according to the March *Quarterly Survey of Business Opinion*. Indeed, with many of the indicators of firms' activity little changed from the previous survey, it's easy to be blasé about just how strong these recent readings have been. Reported activity is now at levels that are consistent with annual GDP growth well in excess of 4%, a pace we haven't reached for almost ten years.

With the economy's upturn now well established, we've been emphasising for some time that the indicators of price and capacity pressures are the next thing to watch. The most significant change in the March quarter survey was a sharp lift in pricing intentions for the next three months – and interestingly, this doesn't seem to be the product of any further lift in costs or tightening of capacity constraints, which may be a sign that a growing number of firms feel there's an opportunity to rebuild their margins. Whether they can carry that out is another matter – reports of actual price increases are rising, but are still well below boom-time levels. Nevertheless, these findings back the Reserve Bank's decision to act now in order to head off inflation pressures over the next couple of years.

Details

A net 52% of firms in the March *QSBO* expected business conditions in general to improve over the next six months, unchanged from a 20-year high in the December survey. Firms' own-activity measures, which tend to correlate better with near-term GDP, rose even further, with a net 23% of firms reporting better times over the last three months and a net 35% expecting further improvement over the next quarter. The latter measure was at its highest since 1999.

The lift in reported activity was driven in particular by retailers, with a net 35% reporting better results, the highest in 20 years – though this seems at odds with indicators such as electronic card spending, which have been more subdued compared to the December quarter. Builders and manufacturers were also more positive, while services firms were slightly more circumspect this time.

Firms' reports on sales, orders and profitability were generally stronger compared to the December quarter. Hiring intentions were a touch softer, but intended investment in buildings and capital equipment rose to fresh 20-year highs.

There was a particularly sharp rise in pricing intentions in the March survey, with a net 37% of firms intending to raise their prices in the next three months (the high point in the previous cycle was 46%). We've long been highlighting the likelihood of rising inflation pressures as the economy uses up its spare capacity. However, the details of the survey suggest that demand-side pressures could be playing at least as much of a role. There was no commensurate increase in the number of firms reporting rising costs, and a growing number of firms are reporting that lack of demand is no longer their main constraint on growth.

Meanwhile, indicators of capacity pressures were mixed in the March quarter. Both skilled and unskilled workers are becoming harder to find, but no more so than in recent quarters. And reported capacity utilisation actually fell to below-average levels, led by manufacturers and exporters.

There's no sense that this spare capacity is the result of a drop-off in production by manufacturers; in fact quite the opposite. So it may be that firms have made some much-needed investment in new capacity (only three quarters ago, manufacturers' capacity utilisation was approaching record highs). That bodes well for the economy's ability to grow at the sort of rates that the headline confidence measures imply.

While pricing intentions are soaring, we should note that actual price increases reported by firms have risen much more modestly. A net 16% of firms raised their prices in the last quarter, the highest since December 2011 but still lower than at any point during the period of accelerating inflation in 2005-08. We also note that even this measure has tended to overstate actual inflation in recent times. The March quarter CPI is released next Wednesday, and in contrast with the lift in reported price increases in the *QSBO,* we don't expect to see annual inflation pick up from its previous 1.6% pace.

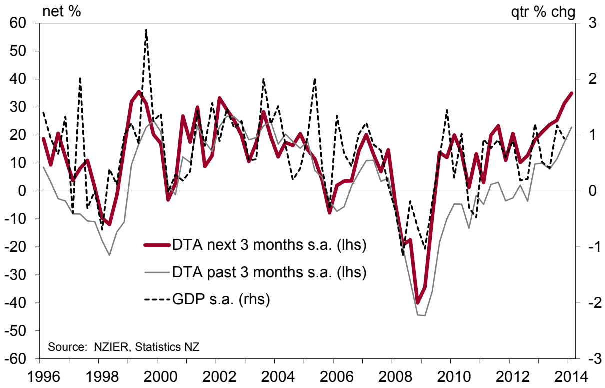
Market implications

The *QSBO* provides perhaps the best early indicator of quarterly GDP. With firms' reported activity lifting over the last three months, that would suggest GDP growth of around 1.2-1.3% for the March quarter. Our current forecast sits at 1.1% growth, though we note that while sentiment has been running rampant, some of the 'hard' indicators of activity have had a subdued start to the quarter.

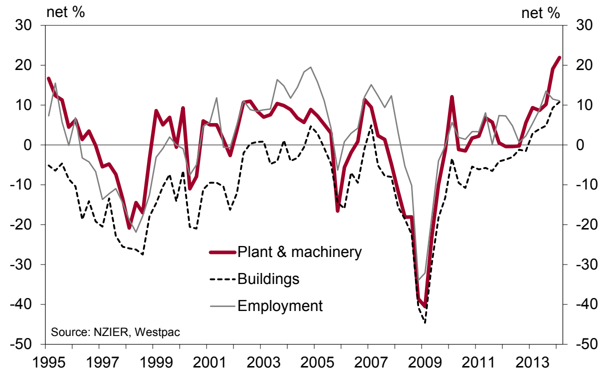
With the *QSBO* hinting at growing pricing power among firms – increasingly shared across regions and industries – the Reserve Bank will feel justified in having kicked off the process of normalising interest rates. We continue to expect further OCR hikes at the April, June and July review dates.

Still, although firms' pricing intentions are running high, their ability to push through price increases has been more modest to date. The high New Zealand dollar in particular is set to remain a headwind against the prices of imported and import-competing goods for some time. We expect annual inflation to remain below the 2% midpoint of the RBNZ's target band until the middle of next year.

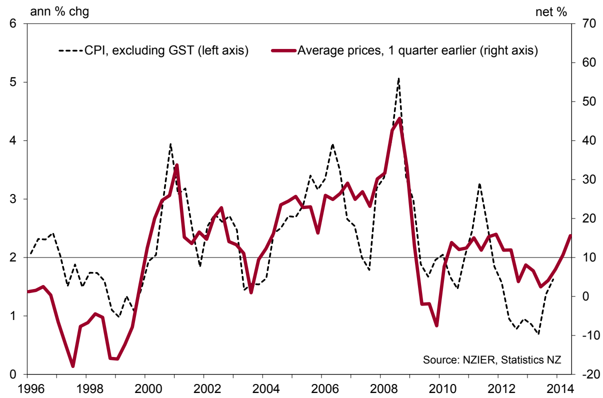
Domestic trading activity



Investment and employment intentions s.a.



Average prices vs CPI



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