15 January 2010

Sectoral performance

Winners and losers in the recession and recovery

- **Goods producing sectors were nailed during the recession.**
- **Service sectors and government fared relatively well.**
- **During the economic recovery, pro-cyclical sectors will be the relative winners.**
- **We expect the strongest growing sectors to include: construction and its related industries (non-metallic minerals, wood, furniture); publishing and advertising; transport; and sectors supporting plant and machinery investment, and durables consumption.**

Introduction

In this note we take a look at some broad relationships between different sectors (at a 25 sector level of disaggregation) and the general economy. We examine which sectors have been hit hardest in the recession, discuss which sectors are most sensitive to growth in the rest of the NZ economy, and estimate which sectors are most pro-cyclical.

Destitution

To give an indication of which sectors have had the most miserable time during the recession, we have taken the weakest 2 quarters of activity (as measured by real GDP) for each sector in 2008/09 and compared it with the average level of activity over 2006-07. The results are in Figure 1. It's only indicative of misery as volume of activity is only one component of profit. You have to mind both your P's (prices) and Q's (quantity and quality) for bottom line performance. Also, the method understates the degree of peak to trough contraction but we chose this to smooth out inherent volatility in some sectors. In addition, it is not always a short-fall in demand that led to a sectors production decline (e.g., a pot-line outage at the Tiwai Point Aluminium smelter in Q4 2008 restricted production in Metal Product Manufacturing).

The results are sobering. Similar to the international experience during the Global Financial Crisis, top end manufacturing was hardest hit. In general, the goods producing sectors were severely impacted in the recession, while the government and service sectors sailed through relatively unscathed.

Determination

Prospects for each sector will substantially be determined by prospects for their end consumers. Figure 2 highlights the ultimate destination of each sectors output, whether directly through its own end sales or indirectly via intermediate sales to other sectors. Sectors at the top of the chart are heavily reliant on foreign demand, whereas sectors at the bottom are influenced most by domestic trading conditions. Not surprisingly, the primary sectors, mining, and transport are most influenced by demand in our trading partners.

Another crude way of getting at the influences on each sector is to compare the correlation of the annual growth in each sector with the contemporaneous growth in the rest of the economy. We show the results of this in Figure 3. We can see the sectors that move most in sync with the rest of the economy. They include retail, accommodation, restaurants and bars, construction and housing related sectors, those providing plant and machinery investment, and publishing and advertising. Of course correlation does not necessarily equate with causation. And for some sectors Statistics NZ's difficulties in accurately measuring cycles may be the cause of apparent non-correlation. But the broad inference is that a rising tide in the rest of the economy is particularly good for the sectors named above.

To get a feel for just how responsive each sector is to developments in the rest of the economy, we ran simple regressions of each sectors contemporaneous annual growth with growth in the rest of NZ. These results are shown in Figure 4. The most pro-cyclical sectors (i.e., they move in the same direction but by much more than changes in the rest of the economy) are construction and its related industries, and publishing and advertising. Countercyclical sectors are fishing and forestry, no doubt via the exchange rate channel (as the economy improves, the exchange rate tends to appreciate, tending to harm these relatively 'pure' exporters).

Restoration

An important influence on a sector's performance is the situation facing their end consumers. With New Zealand in only the early stages of an economic recovery, the most pro-cyclical sectors are likely to be amongst the best performers

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bodonovan@westpac.co.nz

over the next couple of years. The above analysis suggests that the ‘winners’ are likely to include construction, its related industries (non-metallic minerals, wood, furniture), and publishing and advertising. Sectors supporting plant and machinery investment are also likely to outperform. To these sectors we would add transport. The downturn in the transport and storage industry (peak to trough decline of 12%) was far greater than in a standard recession, no doubt exacerbated by the severe down-turn in global trade and tourism. As trade and tourism normalize, so too will transport sector activity.

Another general category of sectors that is likely to outperform is those associated with durables consumption (e.g., cars, white-ware, and other big ticket items). Most of the down-turn in consumption in the recession was in the durable goods category. Improvement in the housing market and household incomes will see the durables consumption category rebound by more than non-durables and services.

For many of our export intensive sectors, it is even harder to generalize. For exporters it depends who you export to. The global economy is staging a convincing recovery after its first year of contraction since 1946, but the good news is not distributed evenly. China is the global growth powerhouse, pulling South-East Asia, Australia and the resource economies with it. The US recovery looks anaemic by comparison, Japan remains mired in deflation, and Europe is the worst laggard of all. As the smoke of crisis clears, the underlying economic power shift from West to East is back in plain view. The NZ exchange rate will be OK for manufacturers exporting to Australia, but third country competitiveness (e.g., developing Asia) will still be stifling for low-end manufactures. However, commodity exporters will tend to get good end-market prices because of recovering global demand while supply is generally skinny.

With a much improved domestic economic outlook, and prospects for reasonably strong global growth, we think the sectoral economic outlook (in terms of growth) is at its best for many a year.

Brendan O’Donovan, Chief Economist, Ph: (64-4) 470 8250
Dominick Stephens, Research Economist, Ph: (64-4) 381 1414

Figure 1: Change in activity by sector
Worst 2 quarters of 2008/09 compared to average of 2006-07

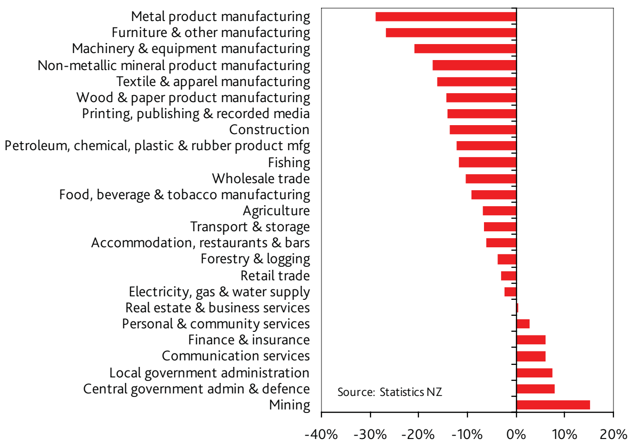

Figure 3: Correlation of sectoral growth with growth in rest of the economy

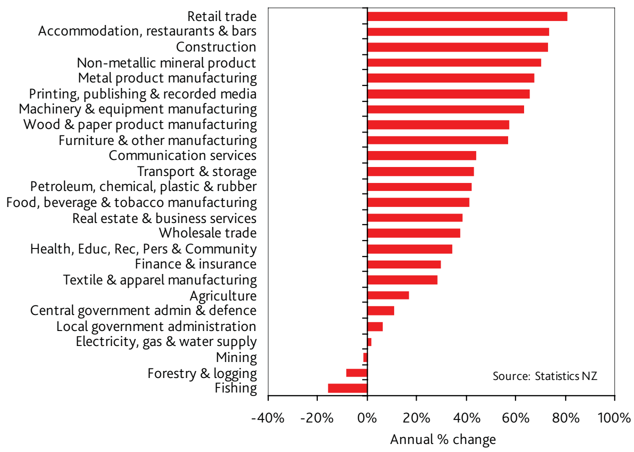

Figure 2: Ultimate destination of output

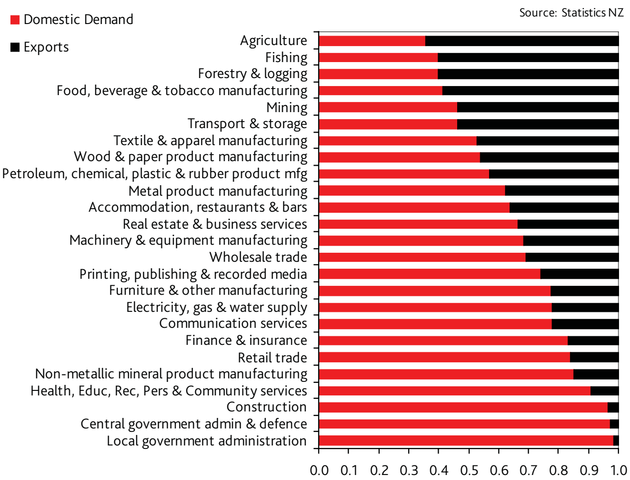

Figure 4: Responsiveness of sectoral growth to growth in rest of the economy