9 April 2013

Westpac Institutional Bank

Goldilocks ventures deeper

NZIER business confidence rose further in Q1

- **The March *Quarterly Survey of Business Opinion* confirmed that the New Zealand economy's resurgence in late 2012 was maintained into the early part of this year.**
- **The pickup in the construction sector, led by the Christchurch rebuild, is clearly a driving force behind the upturn.**
- **Hiring and investment are rising and capacity is tightening. Inflation is the one shoe that is yet to drop – but we don't think that will remain the case for long.**

Today's *Quarterly Survey of Business Opinion* confirms that the New Zealand economy is continuing to gather momentum. Not only that, but the upturn appears to be becoming more broad-based – although it's still clear that the Canterbury rebuild is a major driving force. Even with the drought set to take a chunk out of real activity in the middle of this year, we are still comfortably on track to achieve 3% growth over 2013, compared to 2.5% last year.

As we described it in our February *Economic Overview*, the economy is experiencing a 'Goldilocks moment': not too hot, not too cold. Activity is heating up, but not enough to generate inflation pressures – yet. But the Reserve Bank will recognise the ongoing tightening of capacity, and what that will inevitably mean for prices. Today's survey is another factor in favour of our call for an OCR hike by the end of this year.

Goldilocks' fate differs depending on who's telling the story: sometimes she gets away scot free, sometimes she's almost eaten by the bears, sometimes she learns the error of her ways. We don't expect a fairytale ending in this case. Eventually interest rates will need to rise – and those parts of the economy that have become accustomed to the taste of cheap credit could face a painful adjustment.

Details

The headline measures of business confidence rose further in the March quarter, on top of a strong rebound in the December quarter. A net 32% of firms expect general business conditions to improve over the next six months, the highest in three years. Own-activity measures were also strong, with expectations for the quarter ahead – the single best indicator of quarterly GDP growth – up slightly to a net 23%.

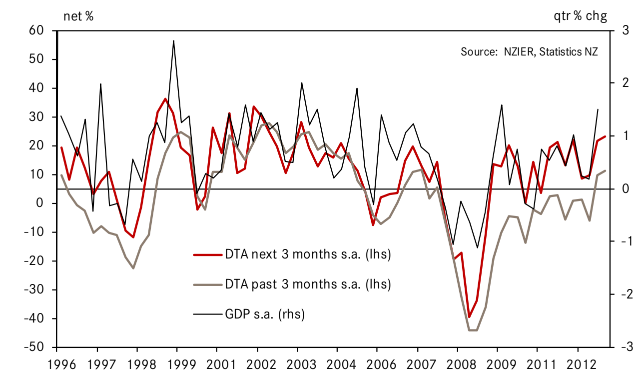
Key results – forward looking

	Q4 survey	Q1 survey
Business confidence sa, next 6 mths	19	32
Trading activity, sa, next 3 mths	21	23
Pricing intentions, next 3 mths	9	13
Cost expectations, next 3 mths	16	16
Profitability, next 3 mths	2	7
Employment intentions, next 3 mths	3	5
Building investment intentions, next 12 mths	-3	3
Plant investment intentions, next 12 mths	5	8

Key results – backward looking

	Q4 survey	Q1 survey
Trading activity, sa, past 3 mths	10	11
Pricing, past 3 mths	6	4
Costs, past 3 mths	19	19
Profitability, past 3 mths	-3	-12
Employment, past 3 mths	-3	4
Ease of finding skilled labour, past 3 mths	-20	-25
Ease of finding unskilled labour, past 3 mths	8	0
Capacity utilisation	90.53%	91.52%

Domestic trading activity



Notably, the detailed activity questions were stronger across the board in the March quarter, compared to the relatively mixed bag in the December quarter. Hiring and investment intentions and profit expectations for the next quarter were all stronger – and even reported hiring in the past three months was a net positive, a rarity in the last five years. In the last *QSBO* we noted that there seemed to be a preference towards investing in capital over people, with the high exchange rate making it cheaper to import capital equipment. While that's probably still the case – reported hiring is still feeble compared to pre-recession levels – it does give some hope that the recovery is becoming robust enough to encourage more firms to hire again.

Going into the sectoral breakdown, there can be no doubt now that construction is playing a major role in the upturn. A net 46% of builders expect better times over the next six months, and are far in the lead in reporting more hiring, greater difficulty finding skilled workers, more new orders, more output and greater cost pressures. Architects' expectations for work over the next two years – both residential and commercial – are at their highest since 1993.

But optimism was shared across every sector covered in the survey. Manufacturing was far from crisis mode, reporting a strong pickup in confidence and output – a reminder that it is not a monolithic industry. As the RBNZ detailed in a recent article, many of the manufacturing sub-sectors are tightly linked to the building industry. That was borne out by today's survey – together, the manufacturing and building sectors reported their best quarter in nine years (with domestic sales faring far better than exports), and expectations for the next quarter are the highest in 11 years.

Capacity utilisation rose in the March quarter and is now getting back towards pre-recession levels, particularly for exporters. Skilled workers are steadily becoming harder to find, and even unskilled workers were in (slightly) shorter supply, for the first time in five years.

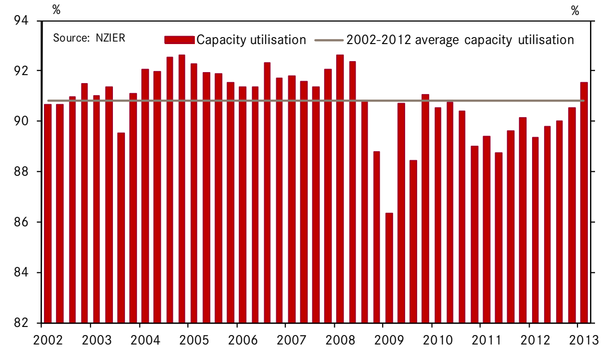
The one shoe that's yet to drop is around prices. Reported cost increases remained fairly subdued outside of the building industry, and only a net 4% of firms reported raising their prices in the last three months. That's likely to be borne out in the March quarter CPI figures due next Wednesday, where we expect annual inflation to remain below 1%. The high and rising NZ dollar over the last year has continued to depress prices for imported and import-competing goods. The question, though, is how long this can continue to provide an offset as locally-generated inflation pressures pick up.

Market implications

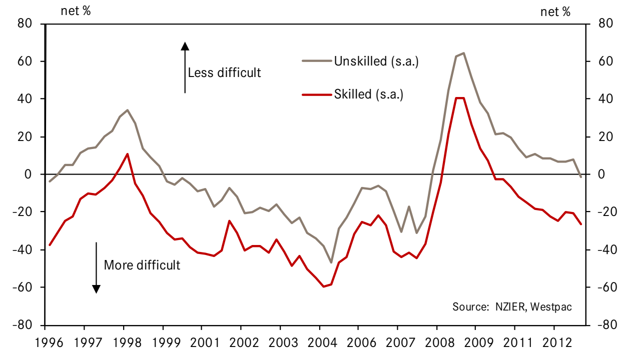
The *QSBO* measure of firms' own-activity expectations for the next three months has had an especially tight relationship with quarterly GDP over the last couple of years. If that holds, we're on track for another strong GDP read for the March quarter – though not a repeat of the 1.5% rise in December, which was in part a catch-up from the mid-2012 soft patch.

Our preliminary forecast is for 0.8% growth in March quarter GDP; the *QSBO* suggests some upside risk. Note that this survey doesn't directly cover the agricultural sector, so it may understate the impact of the recent drought – though we think this could be close to zero for the March quarter, with meat

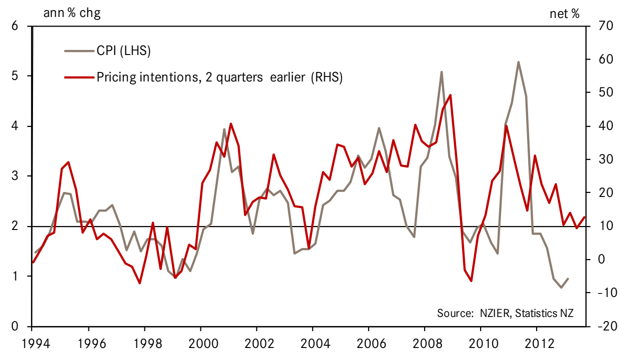
Capacity utilisation



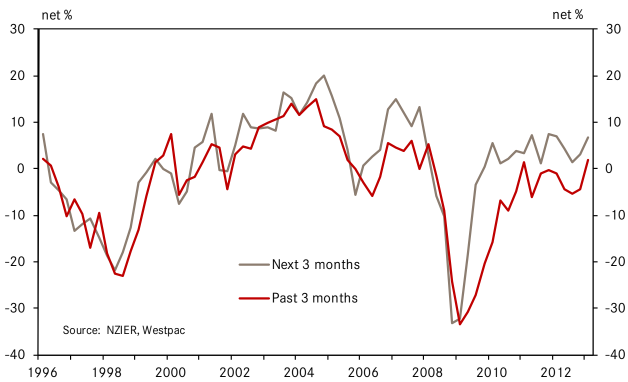
Firms' difficulty in finding labour



Pricing Intentions vs CPI



Investment and employment intentions s.a.



production being brought forward, helping to offset lower milk production. The greater impact is likely to fall in the June quarter, when milk production will remain weak and meat production will be below-par for that time of year.

Drought aside, the New Zealand economy is facing faster growth and low inflation – a seemingly ideal mix. But the RBNZ will recognise how this story ends: as the nation's resources are soaked up, inflation pressures will emerge again with a lag. Interest rates will need to rise before that point.

We continue to expect the first OCR hike in the December quarter this year. Two quarters of strong growth, a boost to dairying income from higher world prices – and a central bank that has explicitly stated that interest rates will need to rise sooner if the housing market stokes consumer spending and inflationary pressures – all leave us quite comfortable with our call.

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