Westpac

Institutional Bank

8 July 2014

End of the golden weather

NZIER business confidence fell in Q2

- The June *Quarterly Survey of Business Opinion* suggests that economic conditions remain favourable but are past their best.
- Spare capacity is becoming tighter, and notably, a growing number of firms are reporting that they have been able to push through price increases.
- The survey supports the RBNZ's decision to start normalising interest rates now, in order to keep emerging inflation pressures in check over the medium term.

Key results – forward looking

	Q1 survey	Q2 survey
Business confidence, next 6 mths	51	33
Trading activity, next 3 mths	35	31
Pricing intentions, next 3 mths	36	32
Cost expectations, next 3 mths	24	21
Profitability, next 3 mths	17	9
Employment intentions, next 3 mths	12	15
Building investment intentions, next 12 mths	10	0
Plant investment intentions, next 12 mths	21	18

Key results – backward looking

	Q1 survey	Q2 survey
Trading activity, past 3 mths	24	15
Pricing, past 3 mths	17	22
Costs, past 3 mths	19	20
Profitability, past 3 mths	3	-2
Employment, past 3 mths	2	5
Ease of finding skilled labour, past 3 mths	-30	-31
Ease of finding unskilled labour, past 3 mths	-10	-11
Capacity utilisation	89.40%	90.63%

The June *Quarterly Survey of Business Opinion* suggests that the New Zealand economy is moving on to the next phase of a classic business cycle. Economic conditions remain very favourable, but have passed their peak since the early part of this year, with the easy gains of the recovery phase now in the rear-view mirror. We're expecting GDP growth to slow a little over the rest of this year, compared to the 4% annualised pace seen over the last three quarters.

Meanwhile, the economy is increasingly running short of spare capacity, which in time will translate into upward pressure on prices and wages. Indeed, on some measures the survey suggests that inflation is moving out of the realm of 'medium-term prediction' and is becoming a reality. At the least, this validates the Reserve Bank's decision to raise interest rates in the last few months, and does little to suggest that the RBNZ can afford to relax just yet. We expect a fourth increase in the OCR this month, with interest rate hikes proceeding at a more gradual pace over the next couple of years.

Details

A net 33% of firms in the June *QSBO* expected business conditions in general to improve over the next six months. That was down substantially from the readings of 52% and 51% in the two previous quarters, which were the highest in two decades. The drop in general business sentiment was consistent with a broad range of higher-frequency indicators, which suggest that the economy hit peak momentum at the start of this year and has slowed a little since.

The measures of firms' own activity tend to correlate better with near-term GDP; these were also down in the June quarter, but to a lesser degree. A net 15% of firms reported better results over the last three months, compared to a net 24% in the March quarter. That's still a fairly high level by historical standards, consistent with quarterly GDP growth of around 0.7% compared to the 1% or so pace over the previous three quarters.

We suspect that some of the slowdown over the June quarter was due to an unusually long lull over the Easter holiday period. The fact that firms' expectations for the quarter ahead remained very high – down just 4 points, and the second-highest reading since 2002 – supports the idea that some of the softness in activity over the June quarter was temporary.

The detailed survey questions also suggested that firms see a great deal of momentum in the economy. Intentions to invest in plant and equipment were only slightly down from last quarter (although building intentions were surprisingly soft). And firms are increasingly committed to taking on more workers, with both actual and intended hiring rising to new post-recession highs.

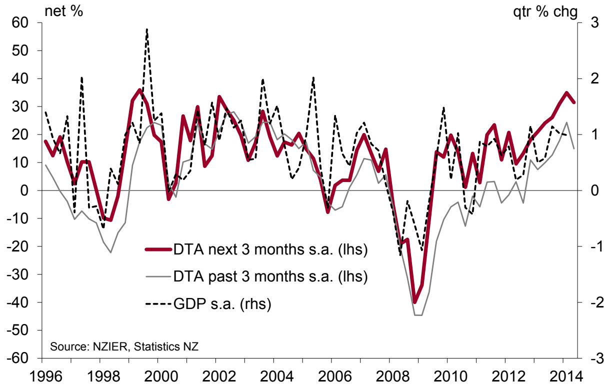
With the economy's upturn now well advanced, we (and the Reserve Bank) have been putting more focus on the *QSBO's* indicators of capacity and price pressures. These were generally firmer in the June survey. Capacity utilisation reversed most of its March quarter decline, skilled and unskilled workers became more difficult to find, and a greater number of firms reported labour and capacity constraints as their main barrier to growth. And while firms' intentions to raise prices were down a touch in June, they were still the second-highest in the last four years.

The RBNZ has made the case that economic activity is now running ahead of the levels that would be consistent with low and stable inflation. Given the usual lags, this implies that a lift in domestic inflation should become apparent over the next few quarters, with wage growth following with a lag of perhaps a year. In other words, the fact that growth in prices, and in particular wages, has been subdued to date doesn't invalidate the view that inflation will pick up over the RBNZ's medium-term policy horizon.

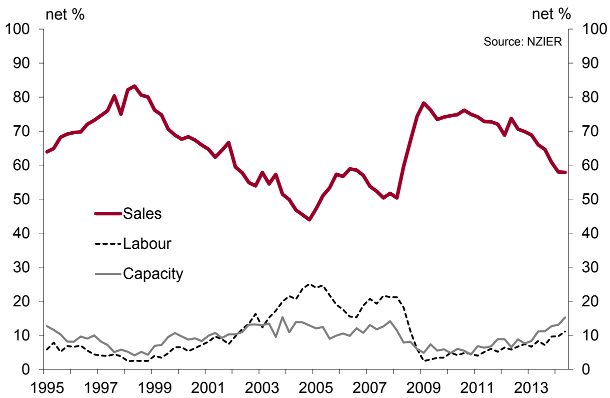
In fact, some of the *QSBO* measures suggest that the return of inflation could be more immediate than that. A net 22% of firms reported that they were able to raise prices over the last few months – a reading that in the past has been more consistent with 3% inflation than with the RBNZ's 2% target midpoint, let alone the sub-2% outcomes we've had in recent times. We're wary of substantially changing our inflation forecasts without more concrete evidence of price increases (we're forecasting inflation to rise modestly to 1.7% by year-end), but it is certainly something to watch.

Michael Gordon
Senior Economist

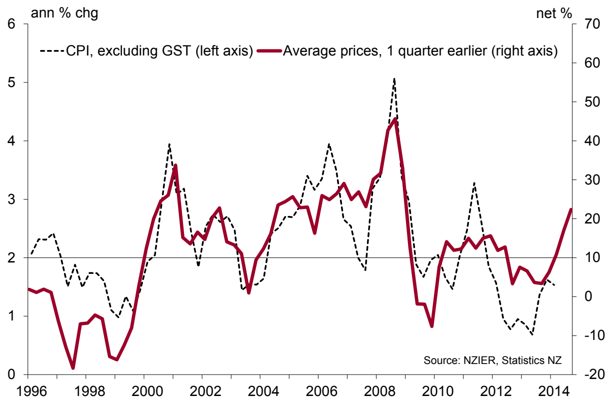
Domestic trading activity



Factors constraining growth



Average prices vs CPI



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