6 July 2010

A Moderate Recovery, With Inflationary Niggles

- Q2 QSBO settles for a moderate-recovery view
- As activity indicators fail to push above norms
- Yet inflation indicators moving to the high side
- Questioning spare capacity, room for growth
- We retain our view of ongoing OCR hikes
- Although odds of RBNZ pausing into 2011 are rising

This morning's Quarterly Survey of Business Opinion (QSBO) was disappointing. And it wasn't just because its economic activity indicators failed to push on into strong-growth territory. The other displeasure was that rising cost and pricing indicators questioned the economy's underlying supply potential, and thus its room to grow.

Today's QSBO therefore has mixed messages for the Reserve Bank, with probably enough in it, overall, to keep the Bank removing stimulus in a measured fashion, at least for the near term. But, while we retain our long-held view of a long series of OCR hikes, including for the coming months, we are very closely monitoring the case for the RBNZ pausing for a time, into 2011 – much as the market is now pricing.

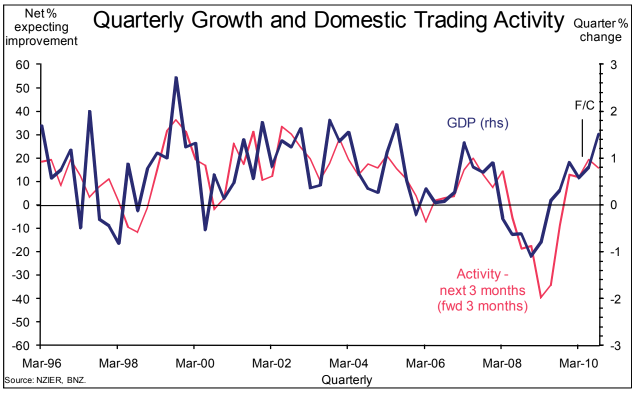
The QSBO disappointment on the activity side, to be clear, was mainly in relation to the further up-shift we expected. In fact, the growth indicators essentially stalled at around the "average" levels they achieved in the previous survey.

This point is worth some emphasis at the outset. It means that those taking the various net-balance statistics at face value would be concluding a more negative view on the economy than is justified. Many of the QSBO net-balance activity indicators have long-term averages close to zero, and in many cases negative.

It's also worth noting the QSBO doesn't directly survey farmers. So it will be missing the increasingly positive commodity story, especially around much-improved dairy sector income. This is important to our recovery story, but not to this particular survey, as compiled and published by the Institute of Economic Research (NZIER).

These points are not to mask the disappointments in today's QSBO, just to put them in some broader context.

In this vein, however, we should also point out the QSBO, in being a survey predominantly of private-sector firms, no doubt also "misses" much of the impending consolidation for New Zealand's public sector. Yes, the May Budget



did squeak some last-gasp stimulus into the pipeline, but built around the 1 October personal tax cuts. The more general trend will be toward bringing structurally high public expenditure into balance with structurally reduced revenue.

It won't be nearly as painful a process for NZ as it will be for most other Western economies. Still, New Zealand does have fiscal deficit, debt and demographic issues to manage carefully over the coming years, which are bound to be a net drag on growth.

As further context, we also need to note the NZIER survey responses came in a cluster around mid-June, so won't have captured the worsening news on the international front since.

All things considered, then, we are essentially left with the impression that, while the economic recovery looks to be continuing for the meantime, it is hardly robust, is definitely not as strong as is usual and is threatening to fall short of our expectations of a stronger pick-up further down the track.

Just as importantly, however, the survey also drew attention to some inflation and capacity constraint "issues" that won't give any relief to our central bankers.

Capacity utilisation amongst manufacturers and builders (CUBO), for example, remained above trend – despite a probable hole in agriculture production in Q2, as a hangover to the late-summer drought. We thought the latter would dent CUBO. It clearly didn't, with the index sticking at about 90.6%, on our seasonally adjusted estimate, which compares to the long-term norm of around 89.0%

While the NZIER dismissed the robustness in its capacity utilisation measure as an export-sector phenomenon, we note it was actually highest amongst non-exporters.

To be sure, CUBO doesn't fit with signs of still a lot of idle supply out there in the economy – either anecdotally, or by way of statistical "output gaps" constructs. However, it certainly raises some question marks around such intelligence.

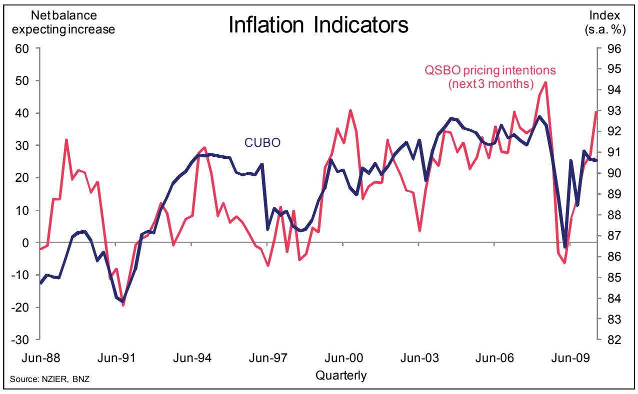
This feeds back into issues of supply potential, especially with risks it may not be nearly the speed usually presumed. Underneath the surface, how is productivity? In this context, we note the RBNZ now assumes the economy's potential annual growth rate to be around 2.0% for the foreseeable future, so even "normal" GDP growth, of say 3.0%, would put the pressure back on inflation.

Indeed, getting back to CUBO, we might simply need to take it seriously in a much more direct way. After all, it's more in the nature of a unit cost pressure indicator, than any absolute measure of capacity usage. It is derived from the following question: "excluding seasonal factors, by how much is it currently practicable for you to increase production from your existing plant and machinery with raising unit costs?"

No wonder, then, that CUBO has a reasonably good relationship with QSBO pricing intentions. Not perfect, but not to be sniffed at either. This relationship highlights stickiness in inflation of late, compared to the downturns of the early 1990s and 1997/98, when CUBO and pricing intentions were flattened.

This partly reflects the fact that the first half of New Zealand's most recent recession (2008) was about getting rid of intense domestic demand and inflation pressure, with only the second, globally-dictated, phase (2009) creating genuine slack. This two-phase process is stark in the unemployment rate as well.

So is it any enormous surprise to see pricing intentions in today's QSBO – as they did in the monthly NBNZ business survey – spike? They hit +40, from +27, as expected cost increases lifted to +36, from +25 (as implied margins continued to increase).



While some of this might reflect the 1 October GST hike strictly speaking it shouldn't. Firms are asked about what they intend to do with their prices over the next three months, which is to September. If it's not GST (or the ETS), then what is driving pricing intentions so much higher?

We also note that, while the QSBO's GDP indicators haven't really pushed on, the labour market indicators continue to turn. Difficulty in finding labour, for instance, continued to head into "becoming a bit of an issue again" territory, albeit at the margin.

This, by the way, probably partly reflects slumping immigration, and the way this will be impinging labour supply. It's the other side of what's probably stifling the demand-side of the economy – and a supply constraint the RBNZ can't be relaxed about.

And it's not as if demand for staff is stalling. Yes, hiring reports for the last three months were a net -7. But this is about the long-term average, and represents an improvement on the previous quarter's -15. And while employment intentions for the next three months "stalled" at +1, from +2, it's actually a smidgeon above the norm. It's all consistent with "average" growth in employment. This is pretty much what we have in our track.

Similarly, investment net-balance intentions, while negative-to-flat, were actually hovering around norms in June, consistent with reasonable growth in spending on both plant and machinery, and general buildings over the next twelve months. It may not bolster immediate GDP, and could do with being better. Still, it is consistent with ongoing recovery.

What does today's QSBO do for our view? Strictly speaking, it's not out of line with our core expectations, as we have been cautious all along on the degree of recovery we've forecast. However, the QSBO certainly raises risks of disappointment along the way – in terms of what's actually occurring in the economy at the moment or, more likely, what the next stage of "the recovery" has in store.

In this vein, market pricing has certainly been running in the right direction over the last month or two, with today's QSBO, not just the global news, a point of validation.

As touched on above, we are seriously weighing the scenario of the RBNZ, after squeaking through a few more rate hikes over the coming months, pausing for a time into 2011, before following on to 5.50-6.00% beyond that. We should probably switch to this plan-B, if potential growth disappointments, as signalled in today's QSBO are anything to go by. However, the survey's niggling inflation "issues" leaves us with our existing view on the OCR for the meantime.

craig_ebert@bnz.co.nz

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Economist
+(64 4) 474 6923

Mike Jones
Strategist
+(64 4) 472 4767

Main Offices

Wellington
60 Harbour Quays
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
129 Hereford Street
PO Box 1461
Christchurch 8140
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Rob Henderson
Chief Economist, Markets
+(61 2) 9237 1836

John Kyriakopoulos
Currency Strategist
+(61 2) 9237 1903

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+800 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+800 333 00 333
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 800 125 602
Fixed Income/Derivatives	+1877 377 5480

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891

24 HOUR FOREIGN EXCHANGE SERVICE

Phone Toll Free	6am to 10pm NZT – Wellington Office
0800 739 707	10pm to 6am NZT – London Office – Sam Hehir