Westpac

Institutional Bank

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Falling short

GDP rose 0.2% in Q1

- GDP grew by just 0.2% in the March 2015 quarter, well short of expectations.
- Agriculture and mining were a substantial drag on growth over the quarter, though some of this will prove to be temporary.
- Of more concern is that domestic demand appears to be more subdued than we expected. Business investment was weak and growth in the services sectors was highly dependent on tourist spending.
- We now expect the Reserve Bank to cut the OCR again in both July and September, and there is a chance of a fourth rate cut this year.

Key results

	Actual	Previous	Q1 expectations	
	Q1	Q4	Westpac	Market
GDP q/q	0.2	0.7	0.6	0.6
GDP ann % chg	2.6	3.5	3.1	3.1
GDP ann avg % chg	3.2	3.3	3.3	-

Bottom line, the March quarter GDP release was a shocker. GDP grew by just 0.2%, well below the already subdued 0.6% growth that we, the Reserve Bank and the rest of the market were expecting. Moreover, the details of the report offered little comfort. Sure, there were some specific depressing factors, mostly in the primary sectors, which will be reversed or at least won't be repeated next time. But at the same time, many of the bright spots in the March quarter were the product of a surge in tourist spending, which may prove to be temporary too. And we were struck by the weakness in business investment, which doesn't suggest a great deal of confidence about the economy's longer-term growth prospects.

Before today we felt it was a close call as to whether the RBNZ would deliver its next interest rate cut at the July or September OCR reviews. Today's figures seal the deal for a July cut in our minds. And it won't stop there: we also expect the RBNZ to cut a third time to 2.75% in September and to maintain a bias towards further easing. An economy falling this far short of its potential growth raises the risk that inflation will continue to undershoot the 2% target, in the absence of easier monetary conditions.

Financial markets reacted to the data accordingly. The two-year swap rate fell by 7 basis points to 3.10%, and interest rate markets are pricing in a 70% chance of an OCR cut in July. The New Zealand dollar fell by 70 points to 0.69, its lowest level in almost five years. We expect the NZD to continue tracking down towards 0.65 and swap rates to fall to 3% in coming months.

Details

Production GDP rose by 0.2% in the March quarter, following a downwardly revised 0.7% rise in the December quarter last year. The expenditure measure of GDP, while considered less reliable on a quarterly basis, delivered a similar message, with an increase of just 0.1%.

As expected, the primary sectors were a significant drag on growth in the March quarter. Agricultural production fell by 2.3%, largely due to a 3.6% drop in milk production as drought gripped much of the South Island. We expect this to be more than fully unwound in the June quarter, thanks to a very strong end to the dairying season in the North Island. Sheep and beef farming were flat overall.

There was also a very sharp fall in output in the mining sector, something that we'd flagged as a risk to our forecast due to lack of data. Production fell by 7.8%, with exploration and extraction both weaker. The fall in extraction was likely due to a shutdown at the Tui oil field due to further drilling, so we should see a strong lift in production from next quarter. However, exploration is likely to remain weak: the plunge in world oil prices since late last year has reduced the incentive to search for new sources of oil.

Construction remained an important contributor to growth, though the days of rampant growth in the sector appear to be in the past, with the Canterbury rebuild approaching its peak pace. The 2.5% rise for the quarter reflected a modest rise in residential and non-residential buildings, and a strong increase in infrastructure work, making up for some of the weakness over the last year.

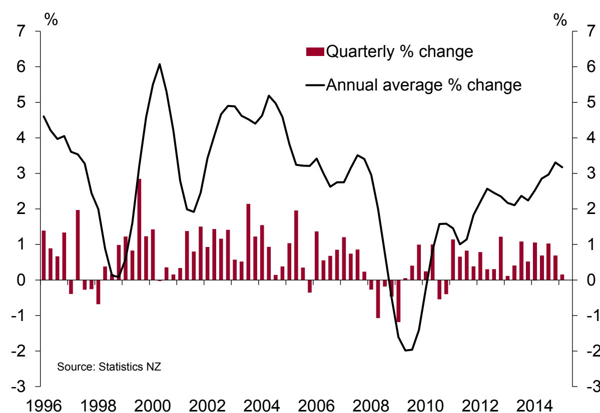
The services sector as a whole grew by 0.7%, which was less perky than we expected. Moreover, there was a sense that much of the growth was driven by a strong lift in spending by overseas visitors, which manifested in areas such as transport (up 2.5%), retail spending (up 2.2%), hospitality (up 2.7%) and arts and recreation (up 3.4%). It's unclear how much of this can be attributed to the Cricket World Cup, and how much to the growing significance of travel during the Lunar New Year. But both of these are March quarter phenomena; we wouldn't be surprised to see a drop in visitor spending in the June quarter.

Another aspect of the data that struck us was the weakness in business investment. On the expenditure side, plant and machinery investment fell by 10.6% to its lowest level in nearly two years. This also accounted for a substantial part of the 2.1% drop in wholesale trade on the production side. Admittedly the quarterly figures are quite volatile, but at the very least there's a sense that the uptrend in business investment has stalled lately – and that's a poor sign for both actual and potential growth in the future. The weaker New Zealand dollar won't help this matter, by making it substantially more expensive to import capital equipment.

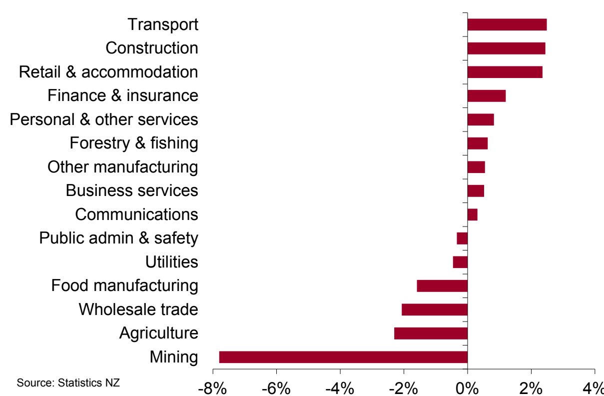
Overall, the weakness in business investment and the significance of tourist spending paint a less buoyant picture of domestic demand than we anticipated. And with business confidence coming off its highs, the Canterbury rebuild nearing its peak, and low dairy incomes shaping up as more than a single-season phenomenon, it's looking increasingly likely that 2015 will prove significantly weaker than 2014.

Michael Gordon
Senior Economist

Production-based GDP growth



Q1 GDP growth by sector



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