8 October 2013

Westpac Institutional Bank

Another step forward

NZIER business confidence rises in Q3

- **Business sentiment improved further in the September *Quarterly Survey of Business Opinion*, with conditions now seen to be improving across a range of industries.**
- **We see some modest upside risk to our forecast of 1% growth in September quarter GDP.**
- **While inflation pressures to date have been subdued, the economy is gradually moving closer to operating at full capacity. That will eventually lead to home-grown inflation pressures, in much the same way as in past cycles.**

The September *Quarterly Survey of Business Opinion (QSBO)* underscores some of the key facets of our views on the New Zealand economy. First, the economy has entered a substantial upswing over the last year. Second, the upturn is spreading well beyond a quake-driven construction boom, increasing the odds that it will prove to be self-sustaining. And third, that inflation pressures will increase as the economy's spare capacity is used up.

Admittedly, progress on that third leg has been slow to date. But with activity set to accelerate further – and the *QSBO* suggests some upside risk to our near-term GDP growth forecasts – we expect that pricing pressures will become more prominent over the next year. In our view, that would leave the Reserve Bank on track to begin raising interest rates from early next year.

Details

The September quarter survey found that a net 32% of firms expect general business conditions to improve over the next six months. That matches the previous peak in March 2010, when there were high hopes for a quick rebound from recession.

The own-activity measures, which more closely correspond with GDP, were even more impressive. A net 11% of firms reported better results over the last three months, the highest figure since June 2007; firms' expectations for the next three months rose to a net 23% positive, the highest in a decade.

The detailed survey questions supported the story of business activity taking another leg up in the latest quarter. After seasonal adjustments, planned investment in buildings and capital equipment ticked higher from already historically high levels, and reported profitability for the last three months was the highest since 2005. A net 5% of firms reported an increase in the number of employees, the best result since March 2008 – although that still only suggests a modest pace of employment growth.

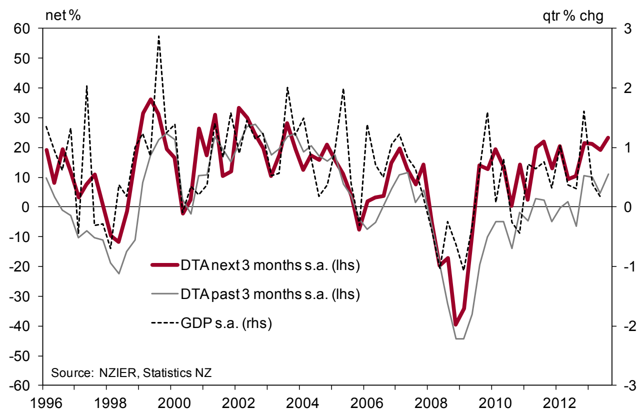
Key results – forward looking

	Q2 survey	Q3 survey
Business confidence sa, next 6 mths	30	32
Trading activity, sa, next 3 mths	19	23
Pricing intentions, next 3 mths	22	24
Cost expectations, next 3 mths	29	26
Profitability, next 3 mths	1	12
Employment intentions, next 3 mths	9	17
Building investment intentions, next 12 mths	4	3
Plant investment intentions, next 12 mths	10	8

Key results – backward looking

	Q2 survey	Q3 survey
Trading activity, sa, past 3 mths	5	11
Pricing, past 3 mths	11	8
Costs, past 3 mths	29	22
Profitability, past 3 mths	-15	-8
Employment, past 3 mths	3	1
Ease of finding skilled labour, past 3 mths	-26	-29
Ease of finding unskilled labour, past 3 mths	2	-5
Capacity utilisation	91.31%	91.40%

Domestic trading activity



The September *QSBO* also shows that confidence is spreading across a broad range of industries. The outlook among architects and building firms has remained consistently strong over the last year, in large part due to the Christchurch rebuild but also due to a pickup in building activity in other parts of the country, particularly Auckland. But the big improvement in the latest survey came from service industries (which account for nearly 60% of survey responses), closely followed by retailers. Confidence fell in the manufacturing sector, but was still at the second-highest level in four years.

With a sustained pickup in activity clearly under way, we are increasingly turning our attention to the leading indicators of inflation. The September *QSBO* showed a further modest tightening on this front. Capacity utilisation rose slightly to 91.4%, above its long-run average, while firms reported that both skilled and unskilled workers have become harder to find in the last three months. A net 24% of firms said that they intend to raise their prices in the next quarter, the most since December 2011. Notably, pricing intentions are strongest in the services sector, which is least likely to feel the disinflationary effects of a strong high New Zealand dollar.

That said, there was little sign of actual inflation in this survey. Only a net 8% of firms reported that they had been able to raise prices in the last three months, and fewer firms reported rising costs compared to the June quarter. That's consistent with our expectation for the September quarter CPI (published next Wednesday). While we expect annual inflation to rise from 0.7% to 1.2%, there's little sign of widespread price increases to date; much of the increase for the quarter came from a spike in fuel prices, which has been reversing in recent weeks.

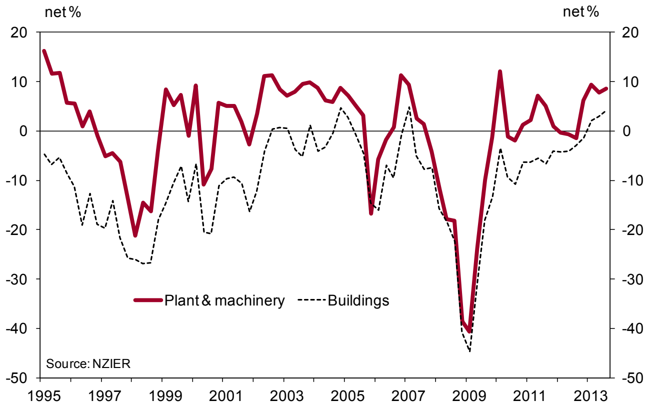
Market implications

The domestic trading activity measures of the *QSBO* tend to be the most reliable early indicators of quarterly GDP. However, since the survey doesn't cover agriculture directly, it understated the degree of slowdown in GDP growth as a result of drought over the March and June quarters of this year. Now, with agricultural production in recovery mode, September quarter GDP growth is likely to exceed what the *QSBO* implies. We'd put a modest upside risk on our current forecast of 1% growth for the quarter.

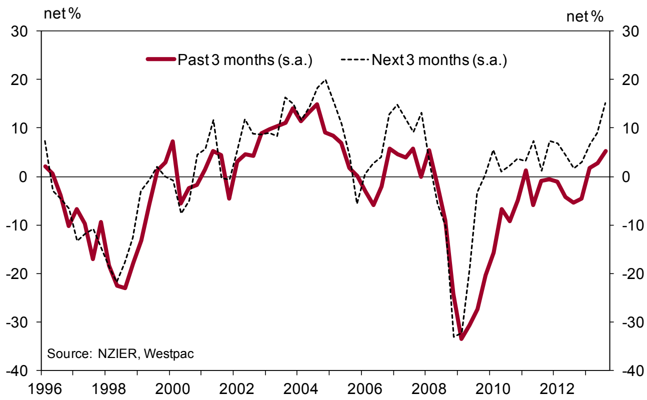
While the pressure to date remains fairly muted, the stage is being set for a pickup in domestically-generated inflation in coming years. That leaves us comfortable with our call that the first OCR hike will come in March next year. Financial markets are broadly in agreement with us, and there was no significant shift in pricing after today's release.

Michael Gordon
Senior Economist

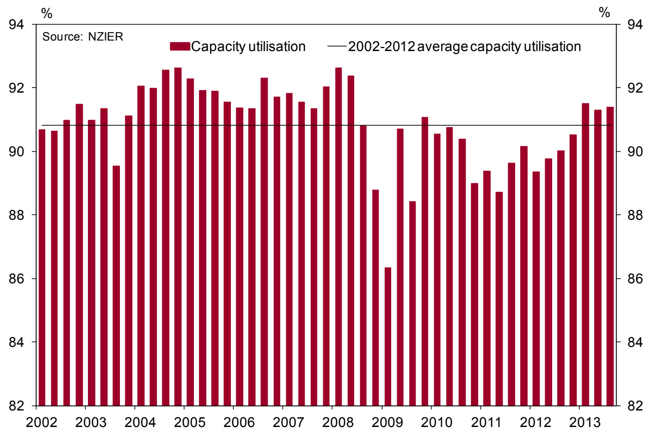
Investment intentions s.a.



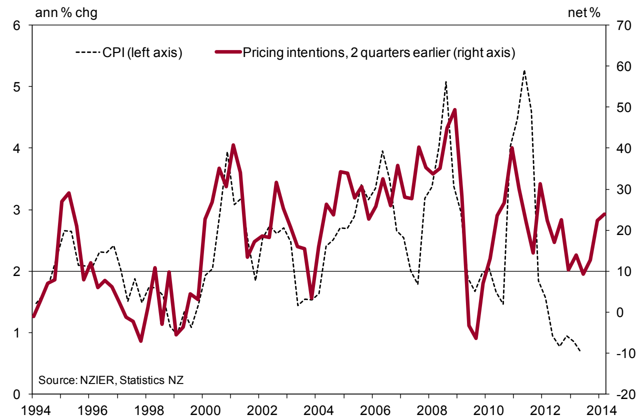
Employment intentions



Capacity utilisation



Pricing intentions vs CPI



Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Anne Boniface, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

For email address changes contact:
WNZResearch@westpac.co.nz

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