

# Level pegging

## NZIER business confidence rises in Q1

- **Businesses are at their most optimistic in years about general economic prospects.**
- **Activity indicators are consistent with the solid pace of growth seen in previous recoveries.**
- **With the recovery panning out in line with their forecasts, the RBNZ are on track to begin raising rates in June.**

The March *Quarterly Survey of Business Opinion* showed that the New Zealand economy is well into the recovery phase following recession. Expectations of general business conditions for the next six months rose from 23% to 36% in seasonally adjusted terms, the most optimistic that businesses have been since June 1999. Firms' own-activity expectations for the next three months rose from 10% to 20%, which is slightly above its long-term average.

On most of the key indicators, businesses are more positive than they were three months ago. Employment intentions rose slightly to a net 2%, and investment intentions rose to -5% for buildings and +9% for plant and machinery. Profit expectations were unchanged. The improvement in these measures was generally well-flagged by the monthly NBNZ business confidence survey.

Where the *QSBO* provides more insight is around the supply-side pressures that firms face. Capacity utilisation fell only slightly to 90.5% in Q1, and while it has been volatile in the last couple of years, it has now been around its average for three of the last four quarters. Note that the survey question asks how much firms could increase output without increasing unit costs – so it's more a reflection of cost pressures than physical constraints (the share of firms reporting capacity as their biggest constraint remains very low at 5%). The other major capacity measure – ease of finding workers – is still positive on balance, but has fallen in the last three quarters.

This removal of spare capacity, along with an emerging recovery in demand, is now coming through more clearly in prices. A net 25% of firms expect costs to increase in the next quarter, and a net 27% plan to raise their prices.

### Key results – forward looking

	Q4 survey	Q1 survey
Business confidence sa, next 6 mths	23	36
Trading activity, sa, next 3 mths	10	20
Pricing intentions, next 3 mths	24	27
Cost expectations, next 3 mths	21	25
Profitability, next 3 mths	-2	-2
Employment intentions, next 3 mths	1	2
Building investment intentions, next 12 mths	-15	-5
Plant investment intentions, next 12 mths	-2	9

### Key results – backward looking

	Q4 survey	Q1 survey
Trading activity, sa, past 3 mths	-10	-5
Pricing, past 3 mths	4	13
Costs, past 3 mths	15	20
Profitability, past 3 mths	-14	-19
Employment, past 3 mths	-18	-15
Ease of finding skilled labour, past 3 mths	13	9
Ease of finding unskilled labour, past 3 mths	37	33
Capacity utilisation	91.07%	90.54%

December quarter GDP was led by the good-producing sectors while services were more subdued, and the *QSBO* suggests that this mix of growth continued in early 2010. The manufacturing sector in particular is showing more confidence, buoyed by strong exports and the beginnings of a powerful inventory cycle (the adequacy of stock levels is seen as the lowest since 1979). Agriculture, another key pillar of growth, is not directly covered in the *QSBO*, but some of the strength in manufacturing will relate to food processing.

Builders were also relatively positive, reporting a rise in output and orders. However, more builders reported rising costs, and they were unique among the sectors in saying that skilled workers have been hard to find. A strong recovery in residential building activity is a key part of our (and the RBNZ's) above-consensus growth forecasts for this year, but it's possible that

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capacity could become a genuine constraint on the pace of recovery.

Meanwhile, retailing and services are still finding it relatively tough. Retail sales volumes were reported to be down in the last three months – consistent with the softness of the official retail sales survey – and stocks are still being run down.

**Huh?**

On more than a few occasions, we’ve seen soaring business confidence being cited as evidence of a sub-par recovery, to which we can only say: “Huh?” The sticking point seems to be that many of the key indicators look weak in absolute terms – for example, employment, investment and profit expectations sit slightly either side of zero. But compare these figures to their histories, and a very different story emerges.

First, let’s deal with the headline confidence measures. Yes, expected activity is well ahead of experienced activity, and both measures are ahead of actual GDP growth. This is normal. In particular, GDP typically lags business confidence by a couple of quarters during an upswing. All this tells us is that we shouldn’t necessarily expect Q1 growth to accelerate beyond the 0.8% pace recorded in Q4.

Next, let’s look at the long-run histories of some of the survey measures. Reported investment, hiring and profits in the last three months were negative on balance. But they have been negative on average for the last 40 years of the survey. We can be fairly confident that firms have not been consistently shedding workers or cutting back investment in that time. (Profitability is the most spectacular example – profits have supposedly fallen in all but six of the last 40 years.) So clearly, some sort of level adjustment is needed before we can make sense of these figures.

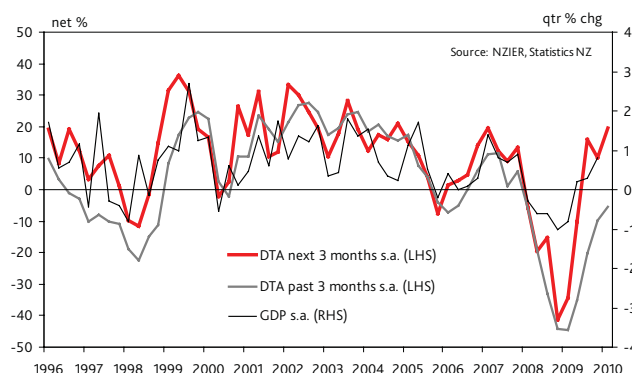
The same applies to the forward-looking measures of the survey. Employment intentions of +2%, profit expectations of -2% and building investment intentions of -5% may sound weak, but they’re all above their long-run average levels – precisely where you’d expect them to be in the recovery stage of the cycle. As for price pressures – using the low-inflation era since 1992 as a fair benchmark – pricing intentions at 27% are well above their average of 17%.

**Market implications**

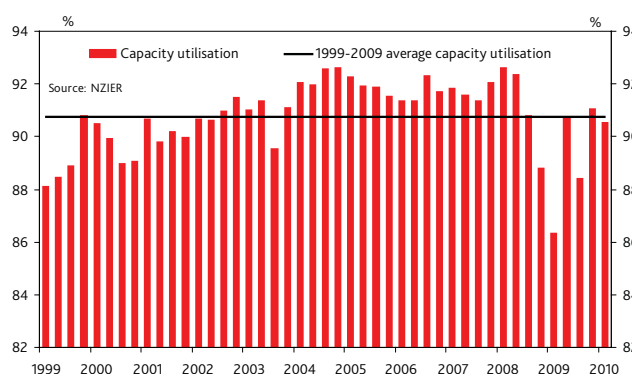
The activity measures of the QSBO should further persuade the RBNZ that the economy is recovering in line with their forecasts (they expect 0.9% growth in Q1 GDP). Similarly, the evidence of emerging price pressures, while unwelcome, is unlikely to rattle the RBNZ. Six months ago they were projecting a substantial easing in domestic inflation pressures, but their thinking has moved on – in the March *Monetary Policy Statement* they forecast annual non-tradables inflation to return above 3% from mid-2011 (and that’s without the impact of the Emissions Trading Scheme). We continue to expect the first OCR hike in June.

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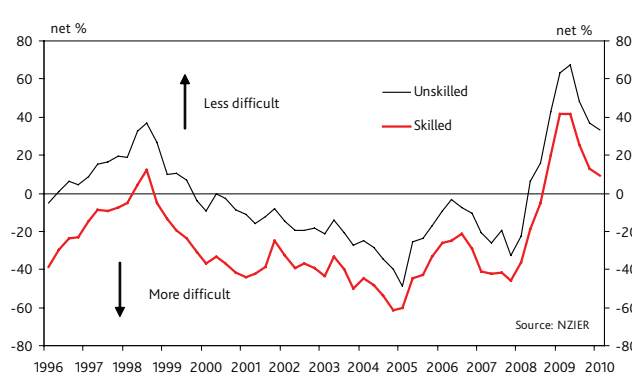
**Domestic trading activity**



**Capacity utilisation**



**Firms' difficulty of finding labour**



**Pricing intentions vs CPI**

