

Poor communication

Q2 GDP rises 0.2% q/q

- GDP growth weaker than expected, in favour of RBNZ's dovish stance.
- Agriculture and manufacturing hit by drought, to rebound in Q3.
- Falling communication activity has reduced GDP growth by 0.9 percentage points over the past year, could be a mismeasurement issue.

Key results

	Actuals		Q2 expectations		
	Q1	Q2	WBC	Mkt	RBNZ
GDP q/q	0.5	0.2	0.6	0.7	0.9
GDP y/y	1.9	1.9	2.4	2.6	
GDP annual average	-0.4	0.7	0.8	0.8	0.9

GDP expanded at a disappointing rate of just 0.2% in the second quarter of 2010, much weaker than we or the market median anticipated. Significantly, the downbeat message delivered at the Reserve Bank's latest *Monetary Policy Statement* was based on a forecast of 0.9% GDP growth.

The slow rate of growth is not cause for panic or evidence of an imminent return to recession. GDP growth was hit hard by the autumn drought, which curtailed agricultural production (-2.1%), and hit manufacturing hard (-4%). The drought broke towards the end of the June quarter, so these sectors are likely to rebound smartly in the September quarter. Throw in a pre-GST consumer spending boost, and we predict above 1% GDP growth for Q3.

The construction sector experienced its strongest quarter of growth since 2003, up 6.4%. Non-residential construction expenditure was up 9%, and "other construction" (roads and the like) was up 4.6%. But the biggest gain was expenditure on house building activity, which jumped a whopping 11.1%. We long ago deduced that the rate of house building was unsustainably low relative to population growth, and predicted a substantial lift in residential investment activity – we finally have confirmation on that score. Even after the Q2 boost, we still regard the rate of house building as too low, and predict further substantial growth for builders.

Figure 1: Production Based GDP

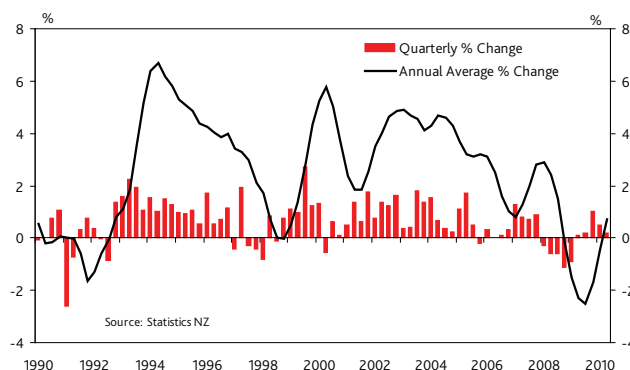


Figure 2: GDP Production Components

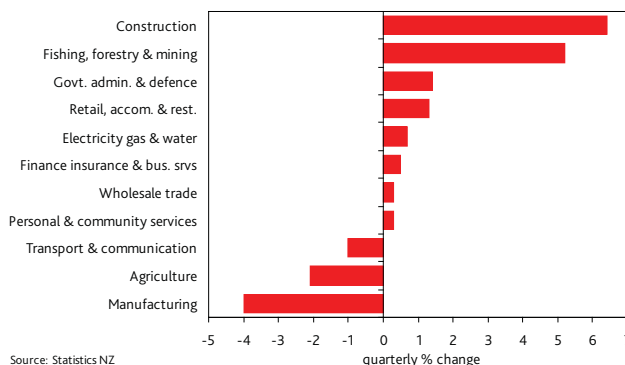
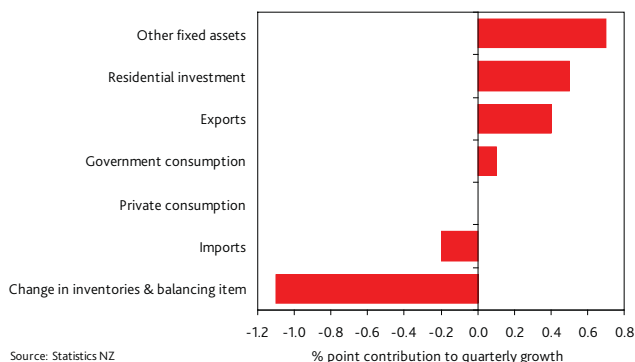


Figure 3: GDP Expenditure Components



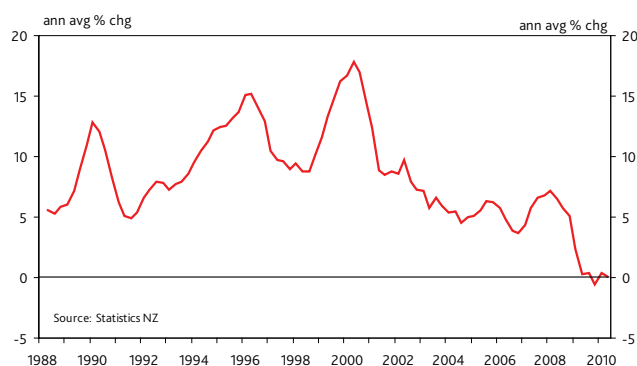
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The most surprising and disappointing aspect was consumer spending, which grew just 0.1%. After observing the 1.3% increase in retail trade, we concluded that private consumption would have experienced decent growth. Not so. Spending on consumer durables was up sharply, but spending on non-durables was flat, and spending on services actually fell for the third quarter running. The decline in spending on services is eyebrow raising, because that component of spending is normally very stable.

The main cause for the decline in services consumption was fewer telephone calls. This showed up as a 2.6% decline in communication services in the production GDP figures, compounding 2.2% declines in each of the preceding two quarters. That is absolutely stunning when one considers that the communication sector has been the strongest performing sector of production GDP for decades, growing at a compound average rate of 2% *per quarter* from 1987 to 2009 (see Figure 4). The all-too-common sight of a gaggle of teenagers texting frenziedly rather than conversing is all that is required to cast into doubt the idea that we are curtailing our use of communication technology. The impact on GDP is significant. Had communication services grown at trend instead of declining, GDP growth in Q2 would have been 0.5% instead of 0.2%. Had it grown at trend for all of the past three quarters, annual GDP growth would have been 2.8% instead of 1.9%.

Figure 4: Communication sector of GDP



It turns out that we actually *are* spending fewer minutes on landlines and mobile phones – Statistics NZ collects the data directly from providers. This has a large effect on quarterly GDP, because real GDP is measured using 1995/96 prices, back when each minute of a toll call or a mobile phone call was much more expensive than today. However, the decline in telephone use may be because people are instead turning to internet based telecommunications, such as Skype. Broadband internet has reached far more NZ homes over the past year, enabling more people to switch technology. The trouble is, Statistics NZ does not measure telephone conversations held over the internet – internet activity is proxied by subscription numbers, not intensity of use. So every person who switches from telephone to internet for a toll call actually reduces significantly measured quarterly GDP! This issue extends well beyond phone calls – downloading movies and music rather than buying in traditional shops is among the many examples of economic activity shifting from

a well-measured sector to a poorly measured sector, possibly resulting in a false loss of GDP. These issues are accelerating as quickly as broadband take-up over recent years.

Such issues are often dealt with by Statistics New Zealand when it revises GDP using annual data. For now, we must caution that the past year's economic performance may not have been as woeful as the official figures currently suggest. However, none of this invalidates the notion that the pace of economic growth has slowed since late-2009 (assuming the substitution from telephone to internet is progressing at a steady pace). Even ignoring phone calls, consumers are still spending less freely than previously thought.

The other surprise was stockbuilding. There was a \$530m rundown in inventories, which contributed -1.1 percentage points to expenditure GDP. The rundown in stocks of milk powder due to drought was well anticipated, and explains why export volumes held up. But there was also a substantial reduction in distribution stocks – perhaps many of those consumer durables were sold out of stocks, and did not actually provoke much production or import activity. Again, this is cause to anticipate higher GDP growth in Q3, as stocks are unlikely to be run down at the same pace for another quarter.

Implications

The reluctance of consumers to participate in the recovery was the rationale for the RBNZ's change in stance at the September *MPS*. Now it turns out that the consumer was even more reluctant over the June quarter than the RBNZ previously realised – further justification for a dovish stance. The RBNZ's internal projection for interest rates in 2012 could now be about 20bp lower than the September *MPS* track. We reaffirm our call that the RBNZ will not hike until March next year. Appropriately, the NZD fell half a cent, and the 2-year swap rate fell 7 basis points.

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