

Back to reality

NZIER business confidence slides in Q3

- **Business confidence fell substantially in the September quarter, to levels more consistent with the subdued pace of recovery seen to date.**
- **Capacity measures were little changed, suggesting that potential economic growth has also slowed.**
- **There is nothing to suggest that the GST hike will be less than fully passed on to consumers on balance.**

The *Quarterly Survey of Business Opinion* held at fairly lofty levels through the first half of 2010, consistent with the rates of growth typically seen in the first year or so of an economic recovery. But the disappointing growth performance to date caught up to the survey this time, as we expected. Business confidence fell in what is usually an 'up' quarter – in seasonally adjusted terms, both general conditions and own-activity expectations turned negative on balance for the first time since June 2009.

The main activity indicators within the survey fared a little better than headline confidence. Investment intentions were only slightly lower, while employment intentions actually rose (although surveyed employment over the last quarter was down). Actual and expected profits were both weaker.

As always, the seemingly low levels for these indicators need to be put into context: many of them have been negative on average for decades. Both employment and investment intentions remain above their long-run averages – but admittedly, this far into a recovery, we would expect to see them well above these levels.

By sector, the starkest declines in confidence were seen in construction and manufacturing. The building industry is clearly in a deep malaise, and with good cause. The recovery in house sales and building consents has stalled since the start of this year; long lags in commercial construction mean that the sector is probably just now feeling the full force of the 2008-09 recession. The tax changes in the May Budget were a further blow, leaving property less attractive as an investment (at least at current yields).

We see this as a necessary and healthy development over the longer term. But for an economy that spent the best part of the last decade addicted to ever-rising property prices, the adjustment will continue to be painful. The current pace of home building remains below what is needed to meet population growth, but between weaker demand for housing as an investment and sharp increases in the cost of building materials, builders aren't confident enough about their margins to address this growing shortage.

Key results – forward looking

	Q2 survey	Q3 survey
Business confidence sa, next 6 mths	26	-9
Trading activity, sa, next 3 mths	15	-2
Pricing intentions, next 3 mths	40	30
Cost expectations, next 3 mths	36	38
Profitability, next 3 mths	-6	-14
Employment intentions, next 3 mths	1	5
Building investment intentions, next 12 mths	-8	-10
Plant investment intentions, next 12 mths	0	0

Key results – backward looking

	Q2 survey	Q3 survey
Trading activity, sa, past 3 mths	-4	-15
Pricing, past 3 mths	13	15
Costs, past 3 mths	24	29
Profitability, past 3 mths	-16	-30
Employment, past 3 mths	-7	-12
Ease of finding skilled labour, past 3 mths	-2	-4
Ease of finding unskilled labour, past 3 mths	23	19
Capacity utilisation	90.76%	90.39%

The decline in headline confidence in the manufacturing sector is not as easy to explain. The only marked change in the survey details compared to June was a sharp rise in reported and expected costs, leading to a renewed squeeze on profitability. That aside, manufacturers were if anything a little more optimistic about activity over the next quarter. This at least is understandable: the rip-roaring Australian economy is a key export market for our manufacturers, and the NZD/AUD exchange rate was once again approaching ten-year lows at the time the survey was held.

The economy-wide capacity indicators were little changed on balance. Ease of finding labour fell for the fifth straight quarter, with the manufacturing and service sectors finding it increasingly difficult to attract skilled workers. Capacity utilisation was only slightly lower, and remains near its average of the last decade.

Pricing intentions were always going to be a particular point of interest in this survey, given the impending GST increase on 1 October. Overall, intentions to raise prices were down from a net 32% to 20% since June, but there was a wide range of experiences across sectors. Pricing intentions fell furthest in the beleaguered construction sector, where weak demand has been the dominant

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effect on prices. Intentions were also down in manufacturing, although this sector is relatively highly weighted towards exports, which are less likely to be affected by GST.

In contrast, pricing intentions in the retail sector surged from 20% to 35% – the highest since the oil-driven spikes in 2006 and 2008. That increase is broadly consistent with what was seen ahead of the GST changes in 1986 and 1989, which were fully passed through to consumers (plus, in 1989 many retailers copped to raising their prices *before* the GST hike, which wasn't apparent this time).

We are sticking with our assumption that the 2.2% price increase from the GST hike will be fully reflected in retail prices on balance. We already know that supermarkets and petrol stations passed it on fully and immediately – that accounts for about a third of retail spending. Elsewhere, we expect some retailers will try to absorb the hike, while some will use the opportunity to rebuild their margins (and have done so). In some cases such as electronics, the GST may be passed on through slower-than-usual price declines, rather than outright price increases – but that will still be picked up by the statisticians.

Market implications

The NZ dollar fell by around 30pts to 0.7385 after the release, while wholesale interest rates are unchanged. The drop in quarterly confidence was broadly on a par with the decline in the monthly NBNZ business survey over the last three months.

In broad-brush terms, the QSBO is consistent with GDP growth of 0.2% in Q3. That's not the final verdict though, as there are a number of factors to consider. First, the survey doesn't cover the agricultural sector; even with the snowstorms in September, growing conditions were better in Q3 than in the drought-afflicted Q2. We also need to account for household spending that was brought forward to September to beat the GST hike – not hinted at in this survey, but clearly shown in yesterday's Paymark data on credit and debit card transactions.

On the downside, the Canterbury earthquake will detract from Q3 GDP, through business disruptions and lost 'consumption' of housing. NZIER suggested there was no discernible impact from the quake in the survey, but also noted that the number of responses from the region was down by 20%. As with our consumer confidence survey, the sample may have been skewed towards those who were relatively unaffected by the quake, and were therefore able and willing to respond.

All things considered, our initial estimate for Q3 GDP growth is 0.4% – but that is very much subject to change.

This survey won't come as a surprise to the RBNZ, which was already one step away from delivering last rites to the New Zealand economy in the September *Monetary Policy Statement*. However, the lack of movement in spare capacity suggests that the economy is grappling with weak potential as much as actual growth; the RBNZ hasn't been left off the hook on its inflation-fighting duties just yet.

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