

# Primary primed, goods good, services so-so

Q4 GDP rises 0.8% q/q

- The recovery is evolving along classical lines, led by stockbuilding.
- The consumer has recovered from recession and from swine flu.
- Manufacturing growth was strong, real estate and finance were weak.
- Upside surprise for the RBNZ will strengthen its resolve to hike the OCR.

**Key results**

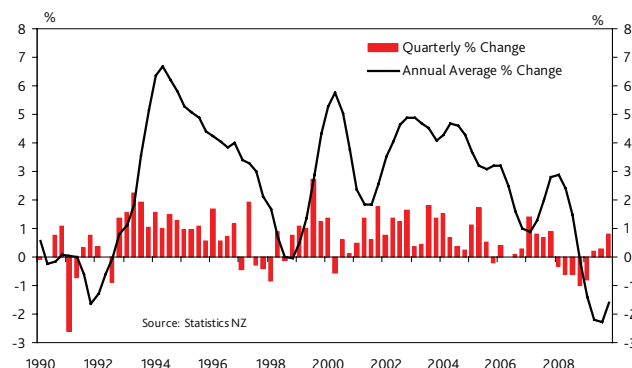
|                    | Actuals |      | Q4 expectations |      |      |
|--------------------|---------|------|-----------------|------|------|
|                    | Q3      | Q4   | WBC             | Mkt  | RBNZ |
| GDP q/q            | 0.3     | 0.8  | 0.7             | 0.8  | 0.6  |
| GDP y/y            | -1.4    | 0.4  | 0.2             | 0.3  |      |
| GDP annual average | -2.3    | -1.6 | -1.5            | -1.5 | -1.6 |

New Zealand's recovery from the recession is unfolding in classical fashion, as the inventory cycle turns positive. The economy expanded 0.8% in Q4 2009, the fastest growth since December 2007, after upwardly revised growth of 0.3% in Q3. However, the level of economic activity remains below what we experienced two years ago.

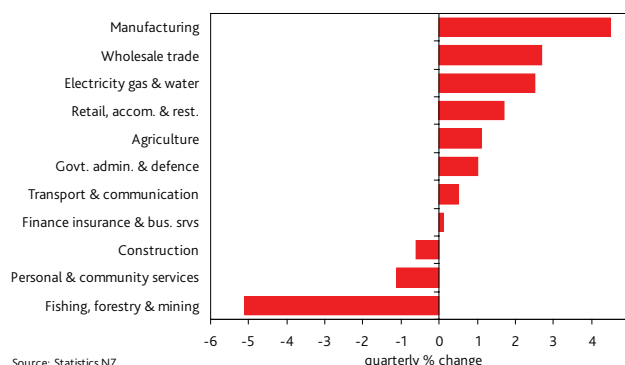
The makeup of GDP was very much in line with our expectations. Growth was concentrated in the goods-producing industries. The start of the dairy production season was evidently very good. Agricultural production was up 1.1% despite a decline in meat production, and manufacturing got a decent boost from dairy product manufacturing. However, the 4.5% increase in manufacturing was not just a milk story. Almost all manufacturing sub-sectors did well, after a shocking series of seven quarterly declines. The fortunes of New Zealand's manufacturing sector have closely mirrored global trends.

Earlier in 2009 goods production around the world slowed to allow firms to sell unwanted stockpiles of goods. The inventory reduction phase has now passed in New Zealand. Indeed, there was a slight increase in inventories in Q4. This turnaround in inventory investment contributed 2.3 percentage points to expenditure GDP growth, which was itself just 0.8%. The large

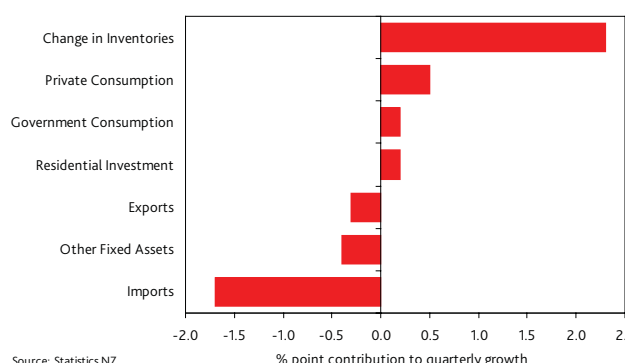
**Figure 1: Production Based GDP**



**Figure 2: GDP Production Components**



**Figure 3: GDP Expenditure Components**



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contribution of stocks does not make the recovery any less real. Stockbuilding is the first stage of every recovery, just as destocking is an important part of every recession. Destocking (inventory divestment) knocked more than 4 percentage points off GDP during the recession, and will be a similarly important component of the recovery.

Private consumption was up 0.8%, with spending growth focused on the durable goods that were hit hardest during the recession – used cars and appliances. Spending on services fell because of a decline in health spending after the Swine Flu spike in Q3. The drop in health spending showed up in the production figures as a fall in personal and community services, but was offset by a post swine flu “recovery” in retail trade and wholesale trade. Although swine flu had a pronounced impact on individual industries, the overall impact on GDP in Q3 and Q4 was probably fairly small.

Imports ramped up 6.0% to meet increased demand for consumption goods and investment goods. Statistics New Zealand referred to a conceptual adjustment that we suspect boosted both imports and inventories, but did not affect overall GDP. Exports were down 0.9%, mostly due to a sharp fall in dairy exports. This unwound unusually strong winter exports of dairy products, as New Zealand had plentiful stockpiled product to sell at that time.

Construction fared rather poorly, falling 0.6%. We were surprised to see only a small increase in residential construction activity, which seemed incongruous with the building work put in place data. But we were unsurprised to see that non-residential construction had fallen further. Commercial construction is the true laggard among industries, and normally is the last industry to pick up in recoveries.

Business investment in plant and machinery was up 4.1%, and investment in transport equipment was up 7%, suggesting that firms did act on the strong confidence they reported. However, notoriously lumpy investment in mining exploration was down 25.8% this quarter, reducing overall business investment. Volatility in mining exploration added 0.1% to Q3 GDP and subtracted 0.1% from Q4 GDP, masking the extent of the pickup between the two quarters.

The key wrinkle in the recovery story is the housing market. The finance, insurance and business services industry (which includes real estate) grew only 0.1% in Q4, mainly because house sales fell 10%, bank lending was slow, and growth in the stock of owner occupied dwellings was low. This slowdown marks a real change, as it came after four excellent quarters for the finance and real estate industries.

### The road most travelled

The economy is following the same well-worn path that it trod after the recessions of 1992 and 1998. We expect the baton of recovery will soon pass from inventory investment to residential construction. The experience of past recoveries suggests quarterly GDP growth will accelerate further in 2010.

We are forecasting 1% for Q1. There has been some moderation in confidence and spending indicators for Q1, and this will no doubt show up as slower growth in retail trade than we experienced in Q4. However, that should be more than made up for in other areas:

- Building consents suggests a strong lift in Q1 residential construction.
- Climatic conditions have supported good agricultural production.
- The need to rebuild inventories and strong demand from Australia bodes well for manufacturing.
- Sharp falls in mining exploration and health care are unlikely to be repeated.
- Real estate and finance have been stable rather than declining in Q1.

It does get difficult to imagine a growing economy when unemployment is high and finance is tight. It is worth bearing in mind that at the start of the past two recoveries, unemployment was higher and finance was tighter than today. Unemployment and credit are lagging indicators, and tend to improve well after recoveries have begun.

### Implications

GDP growth was bang on economists’ median forecast, and therefore market reaction was muted. Swap markets did get het up last night on worries of a positive GDP surprise. When that did not eventuate, 2-year swap rates retreated 6 basis points.

The Reserve Bank, however, has had a 0.3 percentage point upside surprise once the Q3 revision is taken into account. We expect that will strengthen the Bank’s conviction that June is the right time to begin increasing the OCR. Markets appear to be underpricing the risk of a June hike, which has after all been well signalled by the man who makes the decision.

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