13 June 2017

Capacity Constrained!

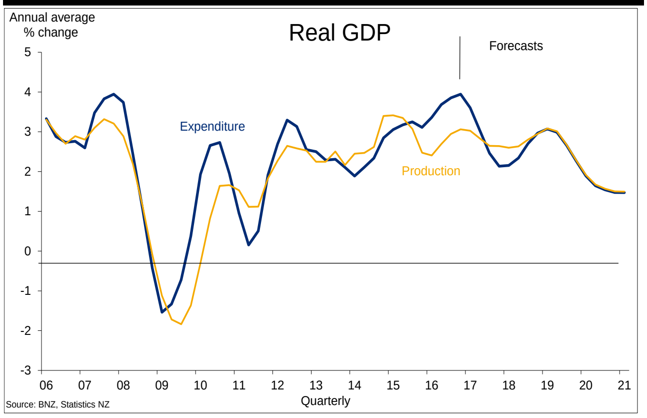
- Fiscal stimulus to boost growth
- But capacity constraints are binding
- Lack of land, labour, physical capacity and finance will strangle growth
- And, potentially, raise inflation
- We're optimistic but warn against overly ebullient growth expectations

New Zealand's economic environment is probably unique in the developed world. Whereas many nations continue to fend off the fallout from a protracted downturn, New Zealand, instead, is suffering from speed wobbles. A softening in economic growth looks almost inevitable but not because demand is set to weaken but rather because the economy is rapidly running out of the inputs required to keep the expansion on track.

Demand is most definitely still there in spades:

- Migration led population growth is sitting around the 2.0% mark;
- Job creation is very strong;
- The Government is easing fiscal policy via tax cuts, increased benefit payments and big increases in infrastructure spending;
- Post-earthquake activity is bolstering activity;
- Construction, generally, is going from strength to strength;
- Commodity prices, particularly dairy, are in the ascendancy;
- The Terms of Trade is at near-record highs; and
- Tourism growth is very robust.

Real GDP



These major drivers are also having multiplier effects throughout the economy and the overall level of activity is being further boosted by very low interest rates. Low both in an historical sense and relative to where you might expect interest rates to be given the domestic conditions that prevail.

With the expansion having been so solid for so long, some serious cracks are now appearing in the economy's ability to continue supporting the demands that persist. We'll go through these in greater detail but, in brief, the following list highlights the depth and breadth of the capacity constraints that are most evident:

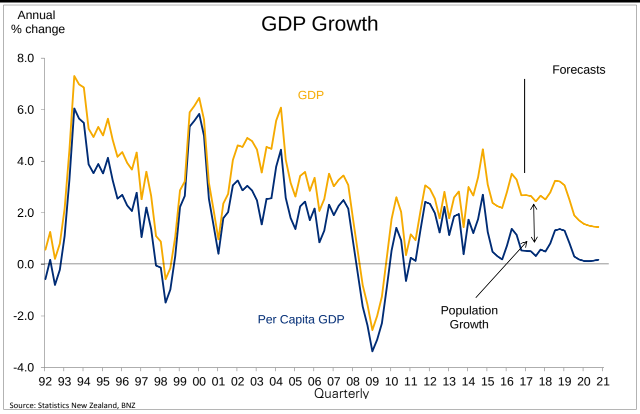
- Labour is very scarce;
- Capacity utilisation variables are stretched;
- Construction activity is being thwarted by lack of inputs;
- Tourism attractions are packed;
- Hotels are full;
- Commercial vacancy rates are low;
- Dairy is environmentally challenged;
- Requisite infrastructure is either creaking or absent;
- Credit is in short supply;
- Household debt levels are elevated.

The state of the labour market is, potentially, New Zealand's most binding constraint. The unemployment rate currently sits at 4.9%. The last time it was less than this was back in December 2008. No one is quite sure where the NAIRU (non-accelerating inflation rate of unemployment) is but 4.9% must be getting very close Past RBNZ estimates have put it at 5.0%; Treasury currently sees it at around 4.5%.

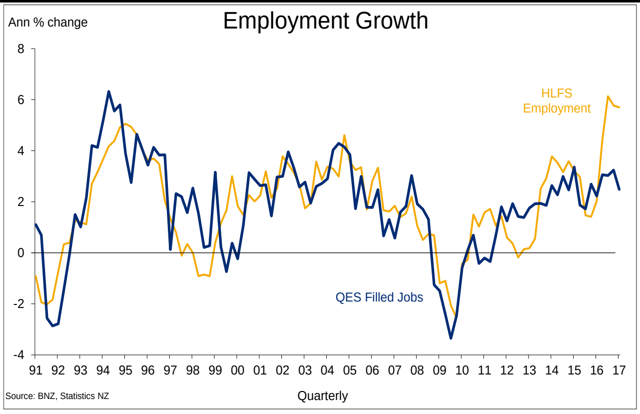
By comparison, the US unemployment rate is 4.3% and the Federal Reserve seems to think that this is inflationary. It is lower than New Zealand's rate but it is very important to note that New Zealand's participation rate is exceptionally high meaning that in the event more labour is needed there is very little to draw upon. The current participation rate here is a record high 70.6%. In the United States it's a mere 62.7%. Was the US to have New Zealand's participation rate its unemployment rate would be well higher than our own.

Demand Spectacular

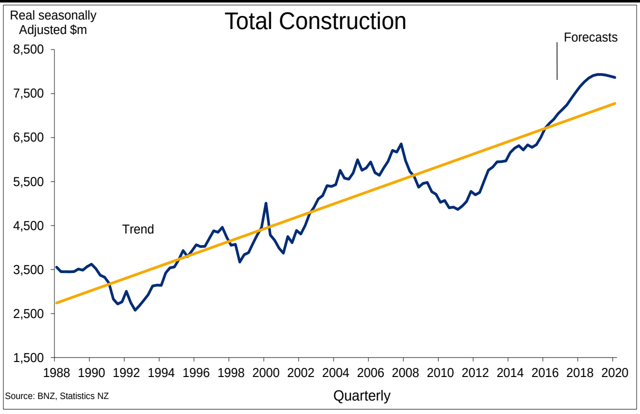
Population Surges



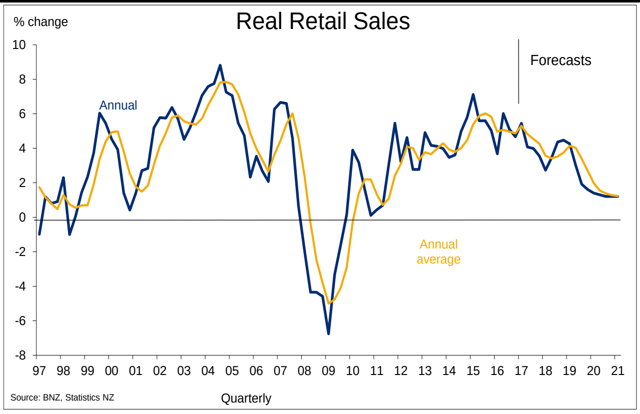
Strong Job Growth



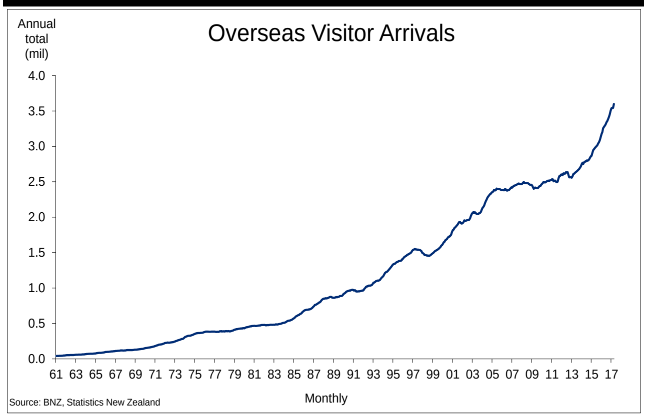
Construction Rampant



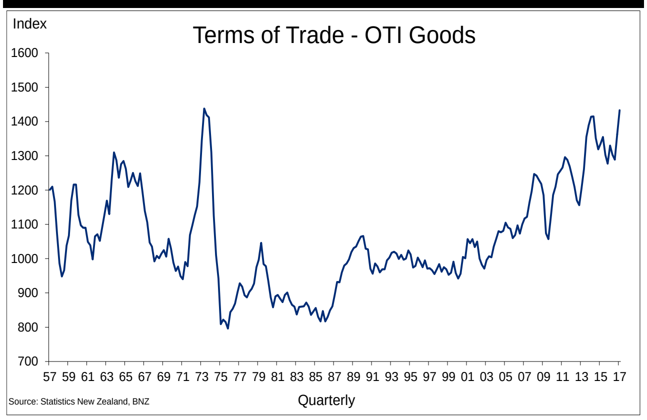
Spending Up Large



Tourism Soaring

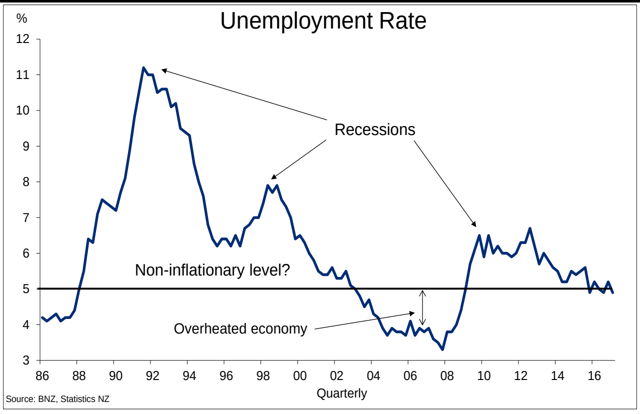


Terms of Trade Near Record

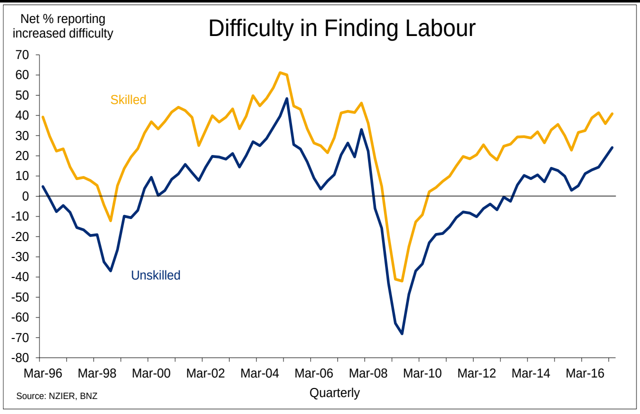


Capacity Constraints Binding

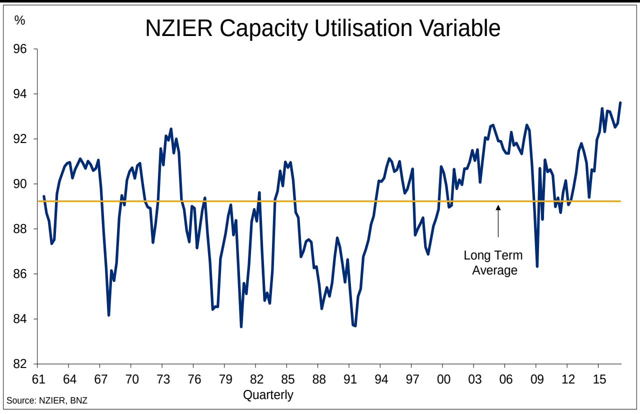
Labour Is Scarce



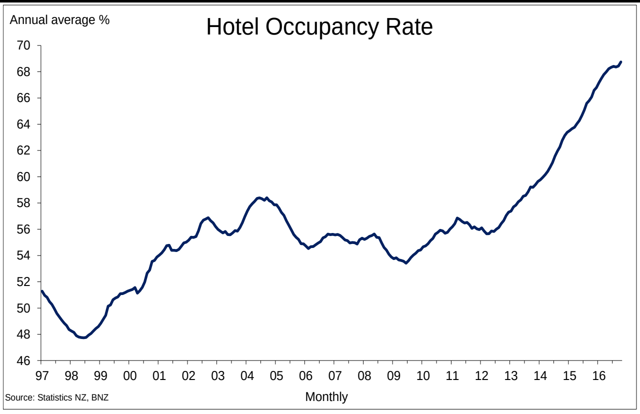
Difficult To Find



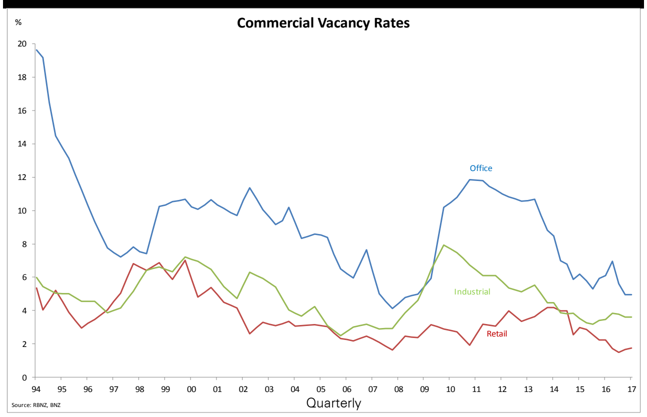
Capacity Utilisation Record High



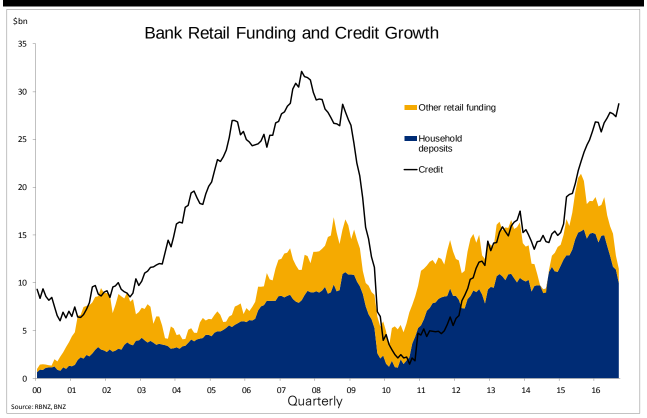
Hotels Are Full



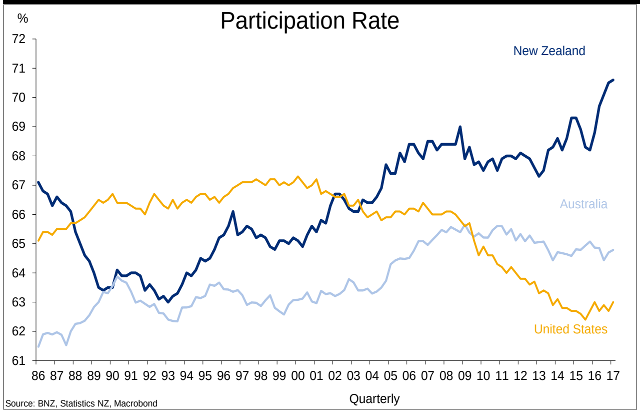
Vacancy Rates Low



Funding Constrained



Participation Rate



There are many who note that wage growth in New Zealand is weak and that there must be more spare capacity than we think. One can't deny the low wage numbers and the fact that this will help contain CPI inflation. But, equally, it is clear that labour constraints are having a tangible impact on business activity and, hence, are constraining the economy's growth rate. Indicative of this, a net 41% of businesses (in the Q1 NZIER Quarterly Survey of Business Opinion) reported increased difficulty in finding skilled labour. A net 24% reported increased difficulty in finding unskilled labour. These readings are the highest they have been since late 2007/early 2008. Additionally, 15% of businesses report that labour is the single biggest constraint on increasing output.

Pressure on the labour market has been alleviated by very strong net migration inflows. It is our view that these flows have now peaked and will soon start to progressively moderate. If we are right this will adversely impact both supply and demand.

One area where migrant flows have been very important in facilitating activity has been in the construction sector. Reduced flows could be very problematic here as there is already strong anecdotal evidence that there is simply not the supply of labour available in this sector to facilitate the construction activity that the economy so desperately requires.

In the residential sector supply is also being impacted by bottlenecks caused by restrictive land supply practices, difficulties in permit processing, infrastructure deficits and RMA (resource management act) issues to name but a few.

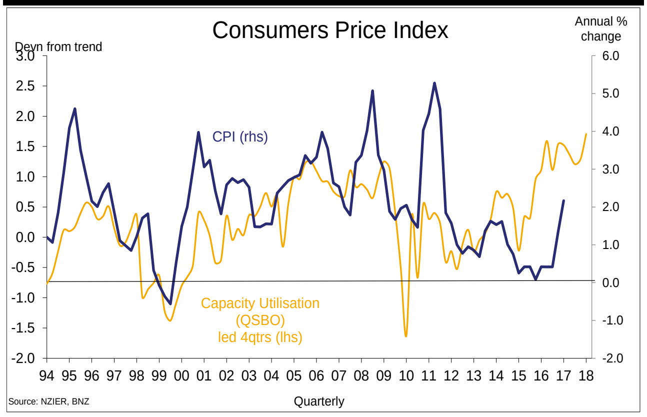
And while we need more houses, it is also clear that we need more commercial buildings, as evidenced by low vacancy rates, more hotels and substantially more infrastructure development all of which will put further pressure on the supply-constrained construction sector.

Exacerbating even more the demands on the broader construction industry has been the infrastructure and building damage caused by the recent Kaikoura earthquakes. To cap things off, recent Government announcements on infrastructure and housing spend, ironically, may make the problem worse.

Of these overall construction needs the demand for new hotels is a particularly interesting subset as it highlights the capacity constraints imposed on a rapidly growing tourism sector. The annual average occupancy rate of New Zealand hotels has climbed to a record high 68.7%. Over the recent peak period it hit a staggering 80.2%. When New Zealand entertains major events such as the current Lions' tour; the recent Masters Games or significant concert tours the capacity is simply not there. Moreover, there is increasing anecdotal evidence that tour group activity (especially out of China) is also being adversely impacted by difficulties in getting appropriate accommodation.

Not only is accommodation in short supply but there are increasing reports of "overcrowding" on New Zealand's Great Walks and significant price escalation in key tourism venues such as Queenstown. Accordingly, it looks highly unlikely that tourism growth can be sustained at recent high levels in turn reducing services export growth and spending through the broader retail sector.

Consumers Price Index



Heightened tourism has also brought with it increased environmental concerns as the current infrastructure struggles to cope with the increased waste management associated with higher numbers of people. This, in turn, has the potential to adversely impact New Zealand's global image. But it's not just tourism that threatens to do this. Agriculture, generally, and dairy, specifically, will have the pace of its expansion increasingly curtailed by the costs associated with potential environmental degradation. And, eventually, the sheer availability (or lack thereof) of land could one day become a problem.

Putting all this together, it is not surprising that businesses are increasingly citing a lack of capacity as the binding constraint on expanding output. The levels of concern over capacity are at their highest in the almost 50 year history of NZIER's survey of this variable. NZIER's capacity utilisation variable dates back a further 10 years and this too is at an all-time high. Our measures of the output gap don't look anywhere near as restrictive but they too point to a capacity constrained economy.

So land, labour and capital are all in various states of supply-shortage. As if this wasn't concern enough, the other increasingly binding constraint on the economic expansion is the availability of finance. A combination of factors is limiting the amount of money that the banking sector has available to fund the New Zealand economy's expansion. In no particular order of importance these include:

- Increased capital holding requirements;
- Limitations on the amount of funding that banks can raise from New Zealand residents;
- Sectoral exposure restrictions;
- APRA's requirement for Australian owned banks to limit the extent of their New Zealand exposures;
- LVR restrictions; and
- The heightened risk of lending to some sectors.

Anecdotally, the most significant impacts of the above factors are being felt by house-buyers, developers and, to a lesser extent, the dairy sector. There will be imposts elsewhere, nonetheless, and the critical point to note remains the fact that this is a further constraint on New Zealand's economic expansion.

We are in the process of nudging our two-year GDP growth forecasts higher to reflect the stimulus recently imparted by Government. And, more importantly, we remain deeply optimistic about the ongoing likely relative strength of New Zealand's future. But, that said, we strongly warn that businesses, householders, Government and investors alike need to better understand the capacity constraints that New Zealand currently faces and, in turn, recognise that whether or not expected inflationary pressures arise, growth is likely to moderate.

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