15 June 2017

Slow Q1 GDP Doesn't Deny Demand Pressure Developing

- Real Q1 GDP slows to 0.5%, 2.5% y/y
- Encouraging the view of RBNZ reservation
- But nominal GDP running at 6.2% y/y
- Just as capacity constraints begin to bite
- And we add demand to our GDP forecasts
- Pressure remains in view, in other words

We are not down in the mouth about today's reported 0.5% expansion in March quarter GDP. Yes, it under-clubbed market expectations of a 0.7% gain and was even further below the Reserve Bank expectation of a 0.9% lift. This will no doubt encourage the view that the RBNZ will remain firmly on its heels with respect to its Official Cash Rate (increasing the risk that our expectation of a first hike by the Bank in February 2018 is too early).

That being said, we expected Q1 GDP to be this slow, largely on technical/timing issues. More to the point, we still think the economy is fundamentally pressing on, but as its room to expand is diminishing, because of capacity constraints.

The 0.5% expansion in Q1 production-based GDP trimmed its annual rate of change to 2.5%, from 2.7%. There were no obvious revisions to recent history that we could see. We feel we got the sub-details broadly right as well. Nevertheless, there were, as usual, a few wrinkles. The main ones on the production side were a bigger rebound in agriculture output than we figured on, but ongoing contraction in transportation services that left us scratching our head. Overall, however, these were nothing to perturb our expectation of next quarter's (Q2) GDP growth, which remains at 0.8%.

On the expenditure-GDP side, it was interesting that domestic demand components were, if anything, slightly stronger than we thought, while net exports were a bit weaker (albeit with the latter hinted at by yesterday's balance of payments account). Notably, household consumption lifted a seasonally adjusted 1.3% in the March quarter, taking its annual pace to 5.1%. The twists in the GDP expenditure components for Q1 were in the direction of pressure on the current account, as a signal of potential imbalance.

Expenditure-GDP, in sum, increased just 0.2% in Q1 (about as little as we expected), with its Q4 increase shaved to 0.1%, from 0.2%. Its recent movement has closed the gap to the production-based level of GDP, for those interested in the earlier divergence.

GDP (Production) - 2017 Q1				
	Actual	Mkt Expected	May MPS	Previous
s.a qtr % chg	**+0.5**	+0.7	+0.9	+0.4
qtr on qtr year ago %	**+2.5**	+2.7		+2.7
annual average % chg	**+3.0**			+3.1

R - revised

While real GDP measures are always important to acknowledge, it pays also to look at alternate gauges of growth. Per capita growth is one of these. And that has slowed to hardly anything. There was also a 0.9% dip recorded in real gross national disposable income, per capita, for the March quarter. However, this was hit by the big profit "outflow" that we saw in yesterday's current account, and followed a 1.8% jump in Q4, meaning for annual growth of 1.3% in the final wash. This directly reflects the very high terms of trade more than other measures.

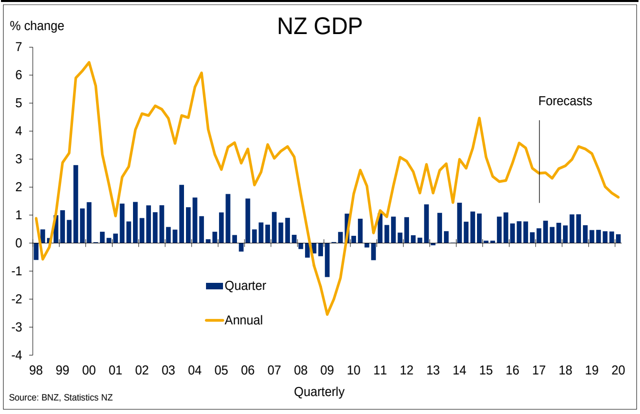
	qtr % chg prev qtr	% pt cont to chg (1)	ann avg % chg	ann % chg
GDP by Industry - March 2017 quarter				
Agriculture, Forestry & Fishing	2.8	0.2	-1.1	0.3
Mining	-1.0	0.0	-10.5	-8.6
Manufacturing	1.0	0.1	2.3	2.1
Electricity Gas, Water & Waste Services	2.1	0.1	0.6	1.5
Construction	-2.1	-0.1	9.3	3.8
Wholesale Trade	1.4	0.1	2.6	3.6
Retail, Accom. & Restaurants	1.8	0.1	5.4	5.2
Transport, Postal and Warehousing	-2.0	-0.1	3.1	0.7
Information Media & Telecommunications	0.9	0.0	-0.2	-1.1
Financial and Insurance Services	0.1	0.0	4.0	3.4
Rental, Hiring, Real Estate Services	-0.1	0.0	1.7	1.1
Prof, Scientific, Technical, Admin	0.1	0.0	4.7	4.3
Public Admin and Safety	1.6	0.1	2.1	2.5
Education & Training	0.1	0.0	0.5	0.3
Health Care and Social Assistance	1.6	0.1	5.3	5.4
Arts, Recreation and Other	-0.8	0.0	6.8	7.3
Unallocated (2)	0.6	0.1	4.2	2.5
Balancing Terms (3)	..	0.0	..	..
Gross Domestic Product	**0.5**	**0.5**	**3.0**	**2.5**

(1) Includes the change in inventories and the seasonal adjustment balancing item
(2) Includes unallocated taxes on production and imports, and bank service charge
(3) The seasonal adjutment balancing item

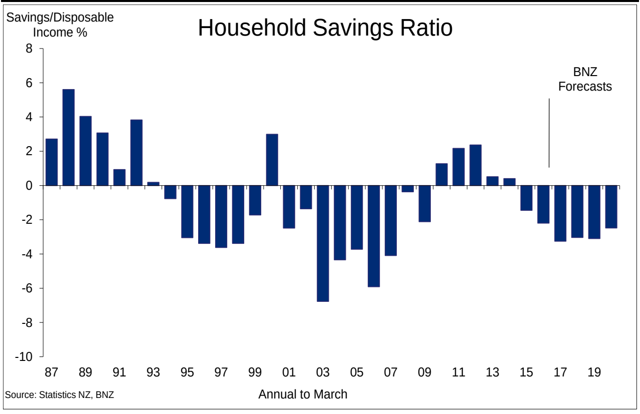
	qtr % chg prev qtr	% pt cont to chg (1)	ann avg % chg	ann % chg
Expenditure on GDP - March 2017 quarter				
Final Consumption Expenditure				
Private	1.2	0.7	4.6	5.0
General Government	1.0	0.2	2.6	3.4
Gross Fixed Capital Formation				
Residential Buildings	-1.6	-0.1	10.2	4.0
Other Fixed Assets	2.3	0.4	3.7	5.8
Exports of Good and Service	-0.4	-0.1	1.0	-1.4
Imports of Goods and Services	1.3	-0.4	5.1	7.3
Change in Inv & Bal. Item (4)	..	-0.5	..	..
Expenditure on GDP	**0.2**	**0.2**	**3.1**	**2.0**

(4) Includes the change in inventories and the seasonal adjustment balancing item.
Source: Statistics New Zealand

Poised



Not Encouraging



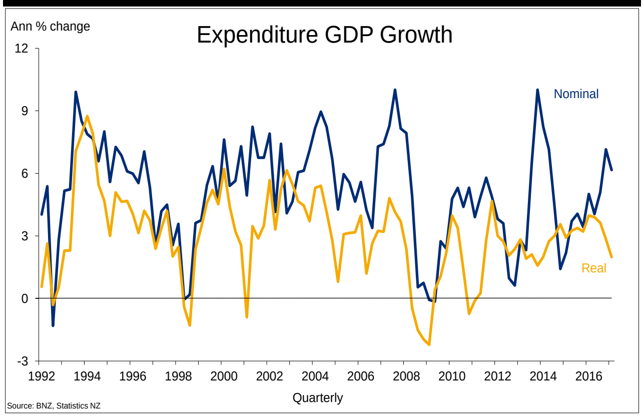
And looking at annual nominal GDP growth, it was 6.2% in the March quarter of 2017. This entailed quarterly increases of 1.4%, 1.9% and 1.7% over Q1, Q4 and Q3 respectively, seasonally adjusted. This also captures the terms of trade strength (and better explains the strength of tax revenue growth of late).

But rather than dwell on the March quarter GDP in any greater granularity, we would like to now talk about the upgrades we've instituted to our macro-economic forecasts. We had much of this pushed through at the time of last fortnight's Strategist, but today we can confirm the all of it. And explain it in some detail (if not in precise numbers, because of the re-forecasting we still have to do on the basis of today's new GDP starting point).

Much of the change we've made is a consequence of the 25 May Budget. This has mainly meant for more sustained growth in private consumption expenditure. Based around the intended Family Incomes Package, this exhibits a particular push in calendar 2018.

Not that we expect all of the extra cash to be spent. Indeed, we reckon the Budget money bolsters the household savings rate. However, only to stop it

Wider Perspective



becoming more negative (as we previously expected) rather than turn things back into the black. And this is even with the money coming back into the household sector by way of farmer income. All things considered, the household sector appears to be chewing into its savings yet again, as another sign of imbalance creeping back in.

We haven't materially changed our view of capital investment over the medium term, given how strong our forecasts already were on this. However, we have altered the composition, with more coming through public investment (Budget related), meaning less of it coming through private investment. In this there are elements of public sector activity "crowding out" private sector activity. And it is not as if the private construction industry isn't battling for resources to begin with, to do all that is being asked of it, including massive home-building projects.

On the back of stronger domestic demand, principally consumption, we've lifted our outlook for imports growth. But our real exports track is largely unchanged. This combines to put a bit of (volume) pressure on the current account. However, this is mostly offset by the heftier terms of trade we're now running with. All up, and with the higher than expected base for the year to March 2017, we still don't see the current account deficit getting worrisome over the next couple of years. However, it will be worth just keeping an eye on.

In terms of real GDP, our changes affirm a growth forecast of 3.1% for 2018 (previously 2.5%) and 2.4% for 2019 (previously 1.8%). Note: this hasn't involved too much change to our forecasts for net inward migration, which is still for a gradual abatement over the coming years. This is in keeping with recent changes to government policy (although vulnerable to any change of government come September's general election).

Our bolstered GDP track doesn't generate a substantively different output gap projection, but it does affirm the likelihood of aggregate demand pressure ahead. While recent GDP outcomes might have shaved the output gap's starting point from a statistical point of view, this has been (more than?) offset by increasing reports and evidence of capacity constraint in the economy (see our note of 13 June entitled Capacity Constraints!).

But our stronger GDP forecasts have afforded a bit more employment growth in our projections. This, aside still slowly abating immigration, and a participation rate that struggles to hit higher highs, means for a very slight reduction in the unemployment rate. Previously we saw the unemployment rate drifting up a bit, which was beginning to look misaligned to the reports of increasing difficulty finding staff.

These reports also suggest to us that the current unemployment rate, of around 5.0%, is consistent with the macro concept of "full employment" (of course, we wish this equilibrium was a lot lower, but there we have it). This is backed up by the fact New Zealand's participation rate is at record highs, making it difficult to drag more people into the labour market. Still, we are not forecasting a plunge in the jobless rate, in order to generate more wage inflation. We believe the latter will begin to show up, even if the jobless rate stays around recent levels.

Our confirmed changes to our macro-economic forecasts thus keep the pressure on. This is certainly in terms of capacity constraint (in turn warning not to get too exuberant with one's economic growth forecasts from this point), and most probably in terms of CPI inflation too. However, we also appreciate that this might take more time to become obvious, and accepted, such that we don't expect the Reserve Bank to respond in any hurry.

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