16 September 2021

Boom!!

- **NZ economy explodes an annualised 11.7% in Q2**
- **Talk turns to strong RBNZ reaction**
- **We are not so convinced**
- **But data do support a series of rate increases**
- **Even though the surge in activity won't be sustained**

The New Zealand economy grew a staggering 2.8% in the second quarter of 2021 to take activity 17.4% ahead of where it was in the June quarter of 2020. Sure, the annual reading is savagely distorted by the shocking base it is compared with but let's not forget that if we were in the United States we would be reporting this quarter's increase as 11.7% annualised!

The number is nothing short of staggering but, in many ways, it simply helps explain what we are all experiencing on a day to day basis. We all know the economy is severely capacity constrained, especially when it comes to finding staff, but there appeared to be a slight disconnect between the extent of these constraints and the pace of reported growth. That disconnect is no longer there.

Clearly, the data show us that the excess demand in the economy was greater than previously believed. Importantly, it looks much greater than the RBNZ understood it to be. According to the August Monetary Policy Statement, the economy was operating 0.6% above its potential rate as at the March quarter 2021. The Bank projected that overshoot would increase to 0.9% in the June quarter. But this projection was based on the assumption that the June quarter increase in activity was 0.6%.

We had warned the RBNZ forecast looked light but we never imagined it would be shown to be 2.2% light. Additionally, revisions to the data pushed annual GDP 0.7% higher meaning the total "miss" was 2.9%. Typically, we assume that around half of any miss feeds through into the output gap. If this assumption is valid then it would mean that instead of operating 0.9% above capacity (as assumed), the New Zealand economy is actually operating around 2.4% above capacity. The last time we had this amount of excess demand was back in 2007. The cash rate rose to 8.25% then.

So, does this mean the RBNZ will be looking to slam on the brakes any time soon? Not necessarily.

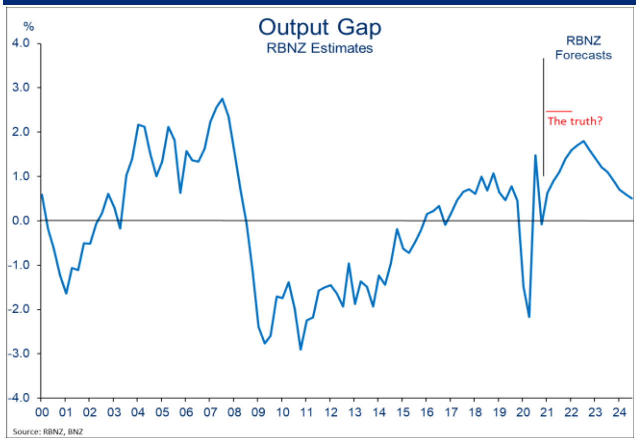
	qtr % chg prev qtr	% pt cont to chg (1)	ann avg % chg	ann % chg
GDP by Industry - June 2021 quarter				
Agriculture, forestry, and fishing	5.5	0.3	4.6	12.4
Mining	2.0	0.0	-11.9	13.3
Manufacturing	1.6	0.2	6.5	19.3
Electricity, gas, water, and waste service:	0.1	0.0	0.1	4.6
Construction	1.3	0.1	14.3	47.0
Wholesale trade	1.2	0.1	8.6	24.0
Retail trade and accommodation	9.5	0.7	16.0	49.6
Transport, postal, and warehousing	14.0	0.5	-7.4	37.0
Information media and telecommunication	-2.1	-0.1	4.9	7.1
Financial and insurance services	-0.4	0.0	0.1	-1.4
Rental, hiring, and real estate services	0.4	0.1	3.7	5.2
Prof, scientific, technical, admin, and sup	4.8	0.5	2.9	16.4
Public administration and safety	0.0	0.0	4.6	3.4
Education and training	-0.3	0.0	0.8	7.5
Health care and social assistance	0.8	0.1	7.2	11.2
Arts, recreation, and other services	4.4	0.1	5.6	38.2
Unallocated(2)	-1.5	-0.1	4.8	22.9
Balancing item(3)	..	0.5	..	..
Gross domestic product	**2.8**	**2.8**	**5.1**	**17.4**

(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 - June 2021 quarter				
Final consumption expenditure				
Private	-1.4	-0.8	7.1	19.6
General government	0.4	0.1	6.3	6.1
Gross fixed capital formation				
Residential buildings	1.3	0.1	17.7	47.7
Other fixed assets	-3.0	-0.5	3.1	23.9
Exports of goods and services	17.0	3.5	-11.4	10.2
Imports of goods and services	0.2	-0.1	-4.8	28.8
Change in inventories and balancing item(	..	0.3	..	..
Expenditure on gross domestic product	**2.6**	**2.6**	**5.8**	**17.0**

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

Way above capacity



The key point here is that we think the quarterly outcome probably overstates the pace of the economic expansion in the period, there is room for a correction (as a consequence of this), and there remains great uncertainty as to the extent of the correction that we are currently undergoing.

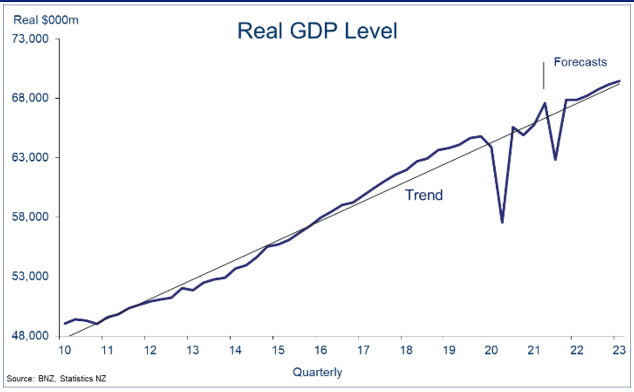
In terms of the June quarter, there are three factors that we need to get our heads around. Firstly (and potentially most importantly) seasonal adjustment could have generated overstated results for many indicators, especially those which are impacted by tourism, both domestic and international. Because the June quarter is typically a low quarter, the seasonal adjustment process will have given it a big nudge up. Secondly, there was a jump in international tourism as the borders with Australia opened (albeit briefly). And, lastly, don't forget Q1 was adversely affected by heightened COVID-related restrictions in Auckland which will have resulted in a Q2 bounce back. The combination of these factors delivered some bizarre outcomes which will most certainly have to be reversed, at least in part.

To put some of these extraordinary items in perspective:

- Services exports rose 63% in the quarter. You can expect almost all of this to reverse over the next few quarters until such time, of course, that the borders start to reopen, probably next year.
- Output in the transport sector rose 14.0% for the quarter.
- The increase in activity in accommodation restaurants and bars was 25.4%.

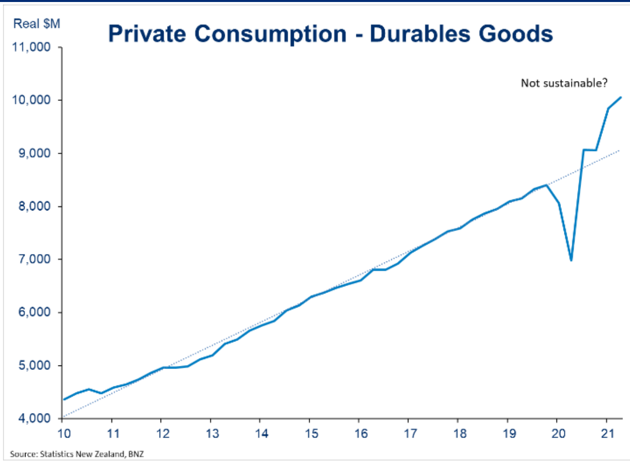
A reversal in these factors alone will have a significant impact on GDP at the same time that the economy bears the costs of the current lockdown. Prior to the release of today's data we were looking for the economy to contract around 7.0% in Q3 and bounce by a similar amount in Q4. We haven't finalised our numbers yet but, needless to say, we will be generating a modestly weaker forward profile.

A glitch in time?



We should note that there is also some risk that our forecast bounceback does not evolve in the manner we are anticipating. This time around the marginal monetary and fiscal stimulus provided will be substantially less than was the case when the country first went into a full lockdown. Asset price inflation is also likely to be less. And the huge jump in durables spending that we have witnessed surely can't be repeated. After all, current consumer spending on durables goods is almost 20% up on pre-Covid levels. This, surely, can't be sustained.

Not sustainable?



And from an RBNZ perspective, there remains the general uncertainty of making pronouncements about the economy's future while we are still suffering from some degree of restriction. It would be nice to think the economy would be free of restrictions when the RBNZ delivers its next decision on October 6 but this is looking unlikely. If Auckland is to drop to alert level 3 at midnight September 22, as currently intimated, it would be reasonable to assume this would be followed with two weeks at level 3 and then two weeks at level 2. This would mean the lifting of all restrictions on October 20. Note also that the Prime Minister has said that New Zealand Ex-Auckland will not move to Level 1 whilst Auckland is in Level 3 or 4. Current level 2 restrictions will, however, be eased further to allow gatherings of 100 people (up from 50 currently).

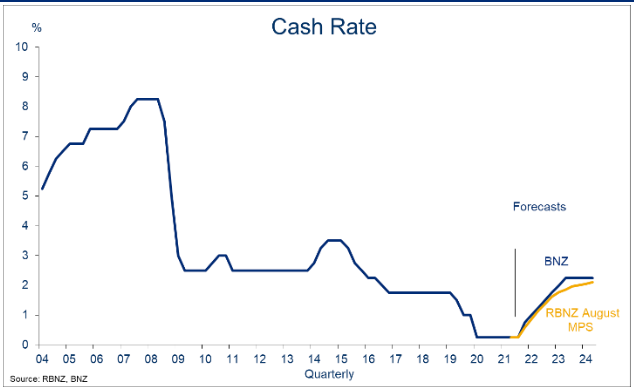
Given all this, we are a loath to jump to the conclusion that the unexpectedly large increase in Q2 GDP definitively means the RBNZ will move to raise the cash rate by 50 basis points at its October meeting, as some are now suggesting.

Nonetheless, the data do strongly support our view that rates are likely to be increased at each of the October, November and February meetings and that the cash rate will probably need to get to at least neutral (which we currently think is around 2.0%) before all is said and done.

In this vein, it pays to remember that, as at the June quarter, economic activity was 4.3% above where it stood pre-COVID. Pre-COVID the economy was looking capacity constrained and it has since suffered a severe supply shock. So it will take a significant further hit in activity to get us back to a situation where there is genuine spare capacity in the economy, and that's only if no bounce was to follow the expected correction.

Our conviction in ongoing capacity constraint is made all the stronger by the knowledge that the government remains committed to supporting the economy through the current set of restrictions. Indeed, the Minister of Finance today announced he has allocated a further $7.0 billion towards COVID relief, in the event that it's necessary. This represents around 2.0% of GDP. Moreover, he indicated that the gains that the government is making from the stronger than anticipated growth will pay for this without the need to go to the market for more funding. After all, the increase in nominal GDP, which drives the Government's funding base, was a whopping 4.6% for the quarter alone.

Onwards and upwards



Putting all this together, we maintain our broadly positive view for the economy going forward, albeit that the potential pitfalls remain many. We will not be changing our call on rates at this juncture but do acknowledge that today's data increases the odds that the cash rate is raised by more than the, cumulative, 50 basis points that we are projecting before year's end. However, if the RBNZ is to raise rates by 50 basis points at a single meeting we think there is a higher chance that they would do this in November than October. All that said, the risks are clearly much more weighted to a higher rate track than we have projected than is the risk to the downside.

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