RESEARCH

ECONOMY WATCH

20 September 2018

GDP Strengthens Our Case Against OCR Easing

- **Q2 GDP proves strong, up 1.0% (2.8% y/y)**
- **In spite of weak business confidence**
- **And substantially above RBNZ expectations**
- **Suggesting stronger output gap, inflation pressure**
- **Reinforcing our view anti OCR cuts**

GDP (Production) - 2018 Q2				
	Actual	Mkt Expected	Aug MPS	Previous
s.a qtr % chg	**+1.0**	+0.8	+0.5	+0.5
qtr on qtr year ago %	**+2.8**	+2.5		+2.6R
annual average % chg	**+2.7**			+2.7

R - revised

The main message we were plying, going into today's Q2 GDP number, was that it was likely to beat RBNZ expectations, aiding our view against further cuts in the Official Cash Rate. We just didn't figure on the extent of it. June quarter GDP expanded 1.0% in the quarter. This was higher than market (0.8%), BNZ (0.6%), and RBNZ (0.5%) expectations, in that order.

Sure, the number was obviously higher than our pick. But, most importantly, it provides greater support for our view that near-term economic activity will surprise the Reserve Bank on the upside and reduce the chances of any rate cut.

In this vein, it is really important to note that the RBNZ stressed that the main reason it became more dovish when it released its August MPS was that GDP had surprised on the downside (to the tune of 0.6%), which saw the Bank's excess demand measure (the output gap) reduced by the same amount.

Now, GDP has surprised by an equivalent amount to the other side (the August MPS expectation was 0.5%). Indeed, it was the biggest upward surprise to RBNZ forecasts in more than five years! So, in theory at least, the Bank will need to revise up its estimate of the output gap quite a bit too.

These gyrations might be the problem of estimating output gaps simply off the GDP series, but this seems to be how the Reserve Bank does it, in the main. Hodrick-Prescott filters explain a lot, in other words.

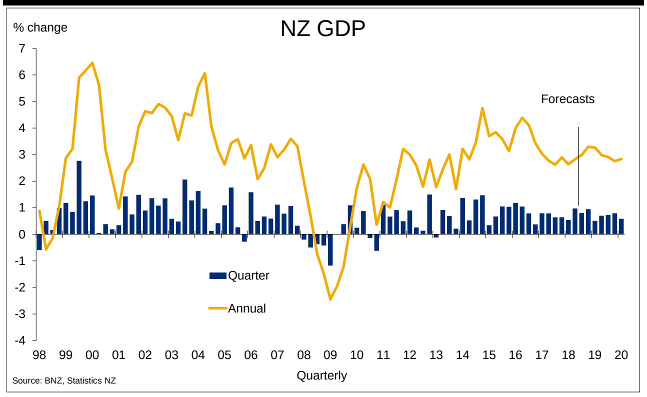
Our view is that GDP trends can tell you only so much about output gaps, because they are not good at telling whether it's demand or supply having the biggest influence. Looking at more direct capacity measures suggest to us the economy is actually getting acutely stretched.

Sure, it bears remembering that the Q2 GDP result has been influenced by bounce-backs in components that depressed Q1's increase to 0.5%. These include agriculture and forestry output (related to the weather), wholesaling (related the car import disruptions in Q1) and construction activity.

But it's also important to recognize that Q2 GDP was adversely impacted by temporary closures at both Methanex's methanol plant (as a result of a gas pipeline leak) and the Marsden Point oil refinery. The former was evident in the mining component of production GDP, which dropped 20% in the quarter, while the latter reflected the 5% fall in the petro-chemicals component. Combined, these were a 0.3% dent to Q2 GDP (on our rough estimations). We don't believe the Bank had this in its view that Q2 GDP would expand "just" 0.5%.

What we do know is that these impacts will be reversed in Q3. With this, our snap estimate of Q3 GDP growth is 0.8%. Or, should we say, remains at 0.8%. In this we have taken Q2's upside surprise and run with it. At the same time, we note that a 0.8% for Q3 GDP growth would not be that strong in a core sense, given the significant bounce-back we expect in gas and petroleum output in the quarter.

Pushing It



National Australia Bank

The other story about Q2 GDP, of course, is that it has bounded higher in defiance of weak business confidence. This is not to prove the economy is immune to weak business confidence. It could yet come to bear. With this in mind, we note the slower tone to the PMI and PSI over recent months, including a stalling in their employment indices (which is something to keep in mind for the Q3 labour market reports).

We also note that there was some weakness in investment spending in the Q2 GDP accounts, in a 1.3% slip with respect to plant, machinery and equipment. Having said this, it can be a bumpy series quarter to quarter.

For the most part, there is little hard evidence that the plunge in business confidence – which, let's remember, began in earnest late last year – is taking the wind out of the economy's sails.

Of course, the RBNZ had, in its August MPS, a scenario of the Bank cutting the OCR 100 basis points. This was keyed off annual GDP growth staying below 3% over 2019. Strictly speaking, our GDP forecasts are along these lines. But, unlike the Bank, we don't think annual GDP growth of just below 3% will ensure an easing in capacity constraints. And this from a starting point for the output gap (excess aggregate demand) that is significantly stronger than the Reserve Bank estimated in its previous MPS. It's a big and important buffer.

Add in the likelihood of CPI inflation also surprising the Bank to the upside – along with the potential for core CPI inflation, and wage inflation, to pick up further – and, who knows, maybe the market starts to turn their attention to the case for OCR tightening down the track, rather than the rate cut view they have been attuned to of late?

To be sure, the market backed off its near 50-50 probability of a rate cut over the coming 12 months, but still has slight odds in this direction. This is after NZ wholesale interest rates backed up in the order of 3 to 5 basis points, on the Q2 GDP news. NZD also responded, up about half a cent, to around 0.6650. The fact that there wasn't a bigger reaction in NZ markets, given the extent of the Q2 GDP gain, might have reflected some expectation of a solid number to begin with, along with international punters still with an eye on what might cause the NZ economy to come unstuck.

	qtr % chg prev qtr	% pt cont to chg (1)	ann avg % chg	ann % chg
GDP by Industry - June 2018 quarter				
Agriculture, Forestry & Fishing	4.1	0.2	0.7	1.6
Mining	-19.9	-0.2	-5.8	-18.8
Manufacturing	0.4	0.0	1.9	1.6
Electricity Gas, Water & Waste Services	3.7	0.1	0.9	2.8
Construction	0.6	0.0	2.3	3.6
Wholesale Trade	1.7	0.1	4.4	4.9
Retail, Accom. & Restaurants	1.5	0.1	4.9	3.3
Transport, Postal and Warehousing	1.8	0.1	5.1	5.3
Information Media & Telecommunications	1.1	0.0	3.6	4.8
Financial and Insurance Services	0.7	0.0	1.8	2.8
Rental, Hiring, Real Estate Services	0.9	0.1	1.2	1.8
Prof, Scientific, Technical, Admin	0.3	0.0	4.4	4.1
Public Admin and Safety	0.3	0.0	3.6	2.6
Education & Training	0.3	0.0	1.3	1.2
Health Care and Social Assistance	0.7	0.0	4.2	3.4
Arts, Recreation and Other	3.5	0.1	2	4.5
Unallocated (2)	0.5	0.0	3.3	3.1
Balancing Terms (3)	..	0.1	..	..
Gross Domestic Product	**1.0**	**1.0**	**2.7**	**2.8**

(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 2018 quarter				
Final Consumption Expenditure				
Private	1.0	0.6	3.5	3.0
General Government	2.2	0.4	5.2	5.6
Gross Fixed Capital Formation				
Residential Buildings	0.5	0.0	1.8	3.0
Other Fixed Assets	-0.2	0.0	5.7	5.1
Exports of Good and Service	2.4	0.6	3.6	3.3
Imports of Goods and Services	1.5	-0.4	7.9	8.8
Change in Inv & Bal. Item (4)	..	0.0	..	..
Expenditure on GDP	**1.2**	**1.2**	**2.9**	**3.0**

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

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