

QUARTERLY SURVEY OF BUSINESS OPINION MARCH QUARTER 2007

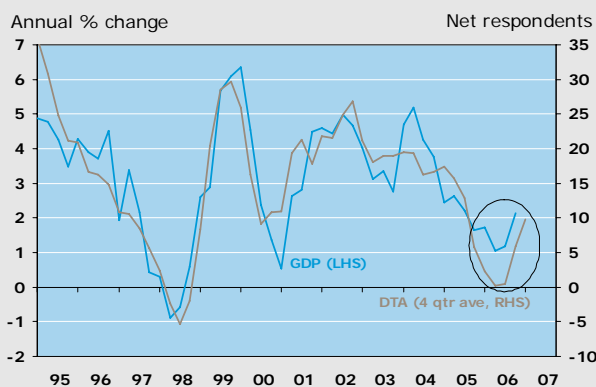
Key points

- **Headline business confidence was weak as most of the responses were received after the March OCR hike, with the higher interest rates and currency weighing on business confidence, which was lower across all sectors and regions.**
- **On a seasonally adjusted basis confidence picked up.**
- **Activity indicators were relatively stronger. Domestic trading activity for both the past 3 months and next 3 months were higher, pointing to ongoing economic momentum over Q1 and Q2 this year.**
- **Worryingly for the RBNZ, all the main indicators of resource pressure deteriorated. Capacity utilisation was marginally higher and difficulty in finding labour rose markedly – a sign that the labour market will continue to remain tight for some time.**
- **Pricing intentions jumped from a net 28 to a net 40, an indication that firms are attempting to pass on cost increases in response to higher input costs and falling margins.**
- **On the whole, the QSBO makes for an unfriendly read for the RBNZ. However, we believe it does not contain sufficient justification for the RBNZ to hike in April, given recent increases in fixed mortgage rates. But expect the talk to remain very tough and a firm tightening bias to be maintained to hold the curve up and let the pipeline tightening take full effect.**

The headlines

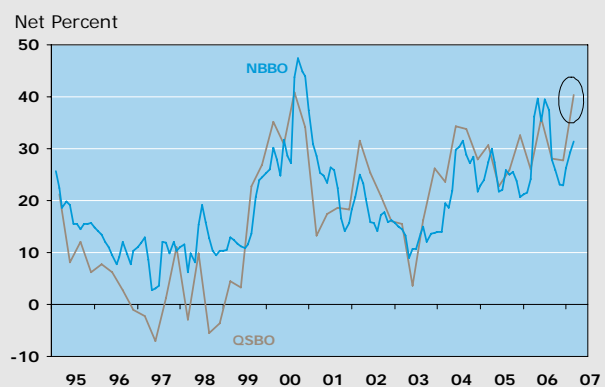
	Actual	Seasonally Adjusted	Previous
Business Confidence	-15	-3	3 (-7 s.a.)
Domestic trading activity – past 3 months	11	11	11 (6 s.a.)
Domestic trading activity – next 3 months	16	18	15 (13 s.a.)
Capacity Utilisation (CUBO)	91.8	-	91.7
Average selling price – next 3 months	40	-	28
Costs – past 3 months	49	-	40
Costs – next 3 months	50	-	42
Difficulty finding labour – skilled	-41	-	-29
Difficulty finding labour – unskilled	-21	-	-11
Investment intentions – Buildings	2	-	0
Investment intentions – Plant & Machinery	7	-	13

GDP growth and Domestic Trading Activity



Sources: ANZ National Bank, NZIER

NBBO vs QSBO Pricing Intentions



Sources: ANZ National Bank, NZIER

Headline business confidence fell from a net 3 percent of respondents expecting the general business situation to improve to a net 15 percent expecting the general business situation to deteriorate. The decline in general business confidence was across all sectors and regions. In seasonally adjusted terms, business confidence showed a small improvement from -7 to -3.

When reporting on their own activity, a net 18 percent of firms (seasonally adjusted) expect their own trading activity to improve in the next three months, compared with a net 13 percent in December. The number of firms reporting an increase in their own trading activity in the past three months also improved from a net 6 percent of firms reporting an increase in December to a net 11 percent in March. Such levels of own activity are consistent with a quarterly growth rate of around $\frac{1}{2}$ to $\frac{3}{4}$ percent.

Indicators of resource pressure worsened, with capacity utilisation up marginally and firms reporting increased difficulty in finding staff. The capacity utilisation measure rose from 91.7 to 91.8 despite the manufacturing sector remaining in recession and building consents issuance trending downwards. The number of firms reporting difficulties in finding staff worsened with a net 41 percent finding it more difficult to find skilled staff (up from a net 29 percent) and a net 21 percent finding it difficult to find unskilled staff (up from a net 11 percent).

Profitability remains under pressure from rising costs, and firms are attempting to pass on price increases. A net 17 percent of firms saw profits decline in the past quarter (up from a net 12 percent in December), while a net 4 percent of firms expect profits to decline in the coming quarter (compared to a net 1 percent expecting a rise in profits). Higher costs are likely the reason, with both experienced and expected costs rising sharply. As a consequence, firms' pricing intentions have jumped markedly with a net 40 percent of respondents expecting to increase prices in the coming quarter compared to a net 28 percent in the previous survey.

Manufacturers experienced a drop in activity, but are still positive about the quarter ahead. Manufacturers reported declines in employment and activity indicators in the previous quarter, but are expecting an improvement over the coming quarter, with a net 20 percent of manufacturing firms expecting to increase exports over the coming quarter despite the high NZD, a net 1 percent expecting to increase staff, and a net 13 percent expecting output to increase.

Assessment and implications

Headline business confidence fell in the March quarter, driven by the RBNZ's March interest rate hike and the high NZD over the period of the survey. Part of the fall could also be accounted for by seasonal factors. We note that in seasonally adjusted terms business confidence showed an improvement, however the seasonal factors are not particularly stable. The QSBO's headline business confidence reading brings it into line with the National Bank *Business Outlook* survey, and reverses the past four quarterly improvements in business confidence.

Domestic trading activity indicators showed an improvement, and reflect some of the momentum in growth from the end of last year spilling over into Q1 and Q2 this year. However, when averaged over four quarters, the domestic trading activity indicator appears to be tracking the rebound in growth and current levels are consistent with annual growth of around 2 percent. While the experienced domestic trading activity suggest a robust Q1 GDP print, it is still far from clear whether the growth momentum will be sustained beyond the middle of this year. We note that financial conditions remain tight and will continue to act as a drag on growth. In addition, both hiring and investment intentions in the QSBO fell, suggesting reduced appetite to invest and hire by firms.

The composition of the QSBO survey makes for unfriendly reading for the RBNZ. More intense resource pressure and a jump in pricing intentions are unwelcome developments for a central bank that is concerned about medium-term inflation pressures. We suspect the slight uptick in the capacity utilisation measure would have been offset by the lower than expected Q4 GDP print (0.8 percent actual versus the RBNZ's 1.0 percent forecast), leaving the starting position of the RBNZ's output gap estimate largely unchanged. While employment intentions fell, the increased difficulty in finding both skilled and unskilled labour is a sign that the labour market will remain tight for some time, and wage inflation will continue to creep higher as a consequence. Firms are already reporting falling profitability on the back of higher costs, and rising wages will only exacerbate falling margins. As we had noted in our preview, we suspect that firms will be trying to pass on price increases to their customers in an attempt to recover some of their lost margins. Today's QSBO survey confirms this suspicion, with a large jump in pricing intentions which point to 3 percent inflation in a year's time – a development that will worry the RBNZ.

While we believe today's release does not provide sufficient justification for a rate hike in April, the inflationary undercurrent points to the RBNZ maintaining a hawkish rhetoric, and for interest rates to stay high for some time. Recent increases in fixed mortgage rates have taken some of the pressure off an April hike. We remain sceptical that the rebound in growth will be sustained into the second half of this year, and believe growth will undershoot the RBNZ's forecast for calendar 2007 given where financial conditions are. The pipeline tightening effect still has some way to go and will have its greatest impact by mid-year. But the RBNZ cannot ignore the inflationary messages from the OSBO, and some tough talking can be expected to keep the yield curve up.

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