

QUARTERLY SURVEY OF BUSINESS OPINION DECEMBER QUARTER 2006

Key points

- **Business confidence was strong across the board, in all sectors and all regions.**
- **Activity indicators point towards accelerating growth, with domestic trading activity, employment and investment intentions all up.**
- **Pricing intentions unchanged despite lower oil prices – suggesting firms taking the opportunity to recoup lost margins.**
- **Capacity utilisation came off last quarter's surge, but at 91.7 is still above the Reserve Bank's assume equilibrium level of 89.**
- **While the QSBO release lacks the smoking gun for the Reserve Bank to hike next week, the pick-up in activity indicators mean the Reserve Bank will be maintaining a firm tightening bias next week and leave the door open to a rate hike in March.**

The headlines

	Actual	Seasonally Adjusted	Previous
Business Confidence	3	-5	-19.1 (-24 s.a.)
Domestic trading activity – past 3 months	10	6	-1 (0 s.a.)
Domestic trading activity – next 3 months	15	13	10 (5 s.a.)
Capacity Utilisation (CUBO)	91.7	-	92.3
Average selling price – next 3 months	28	-	28
Costs – past 3 months	40	-	54
Costs – next 3 months	42	-	43
Difficulty finding labour – skilled	-29	-	-21
Difficulty finding labour – unskilled	-11	-	-7
Investment intentions – Buildings	0	-	-8
Investment intentions – Plant & Machinery	13	-	2

- **Headline business confidence prints positive for the first time since December 2002 with a net 3 percent of firms expecting the general business situation to improve in the next six months.** This is an improvement from a net 19 percent of firms expecting general business conditions to deteriorate in September. In seasonally adjusted terms, business confidence rose from -24 to -5. This increase in confidence was up across all sectors and regions of the country.
- **A net 13 percent of firms (seasonally adjusted) expect their own trading activity to improve in the next three months, compared with a net 5 percent in September.** The number of firms reporting an increase in their own trading activity in the past three months also improved from a net zero percent of firms reporting an increase in their own activity in September to a net 6 percent in December.
- **Capacity utilisation eased, although it is harder to find staff.** The capacity utilisation figure eased from the surprising high of 92.3 percent in September to 91.7 percent in December although remains high by historical standards. The number of firms reporting difficulties in finding staff both worsened with a net 29 percent of firms finding it more difficult to find skilled staff and a net 11 percent for unskilled staff. This is down from 21 and 7 respectively in September.
- **Some recouping of lost margins appears evident.** Firms' pricing intentions were largely unchanged in December but the number of firms reporting increases in costs in the past three months fell from a net 54 percent in September to a net 40 percent in December. This suggests that firms are taking the opportunity to ease some pressures on their margins by not lowering prices – despite falls in their input costs.
- **Exporters are still relatively optimistic despite the high NZD.** A net 2 percent of manufacturing firms reported an increase in exports in December despite the high level of the exchange rate and they remain relatively optimistic with a net 11 percent of firms expecting an increase in exports in the next three months.

Assessment and implications

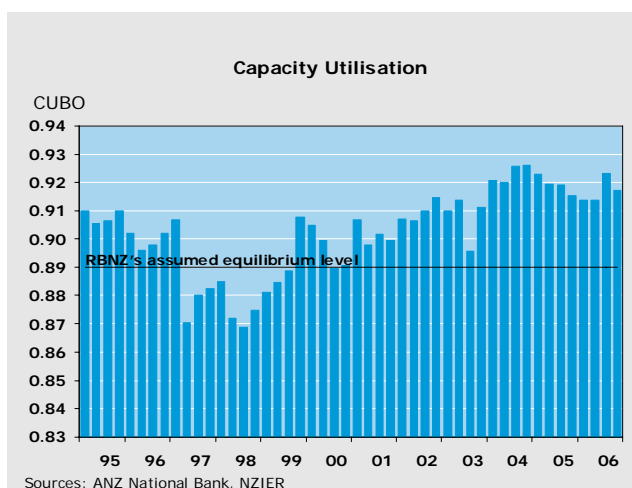
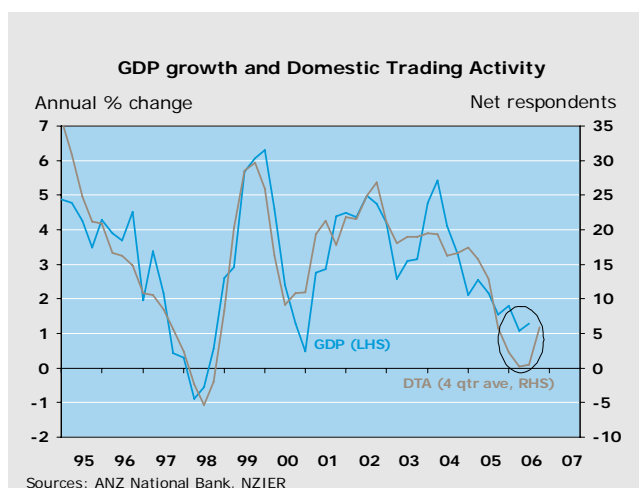
As expected, headline business confidence improved in the December quarter, in line with the *National Bank Business Outlook* survey, although this improvement was stronger than expected with headline confidence printing in positive territory for the first time since December 2002. The domestic trading activity indicator also improved, and suggests some potential upside risk to the Reserve Bank's 0.7 percent growth forecast for Q4 GDP, particularly as this strength was across all sectors and regions surveyed. However, when averaged over four quarters, the domestic trading activity indicator proved to be too pessimistic on growth in late 2005 and the first part of 2006, and current levels are consistent with annual growth of around 1.5 percent.

Importantly for the Reserve Bank, the capacity utilisation measure pulled back from Q3's strong reading. While this will be of some comfort to them, it is still sitting above their assumed equilibrium level of 89 – indicating that the economy remains stretched. In addition, firms reported that it was more difficult to find both skilled and unskilled staff in December and this will concern the Bank if it leads to further pressures in an already tight labour market through higher wages, which are already at elevated levels.

Capacity constraints, difficulty in finding labour, and a high NZD all contributed to strong plant and machinery investment intentions. A net 12 percent of firms expected to invest more in plant and machinery in the next 12 months and this is the highest level since September 1995. However, this comes as no surprise given the level of the NZD and the constraints facing many firms at present. This will be greeted with some relief by the Reserve Bank as it shows that firms are responding to economic signals in order to alleviate the high capacity constraints facing the economy.

The majority of firms responded to the survey by 18 December 2006 and therefore some key influences were not taken into account. The Government announced the *Business Tax Package* as part of their *Half-Year Economic and Fiscal Update* on 19 December and this is likely to be positive for business confidence. However, the pick up in the NZD over the second half of December and into the New Year could offset any positive impacts of expected lower corporate taxes.

Today's release lacks the smoking gun for January rate hike. As we signalled in yesterday's *Market Focus*, we expect the tenor of the data over the coming weeks to not consistently print strong as was the case at the end of last year. Certainly the Reserve Bank will be wary of the economy accelerating too strongly and the impact this will have on non-tradable inflation. But there is still uncertainty over the strength of any recovery, and how sustained it will be. The weaker than expected Q3 GDP data, along with the downward historical revisions, imply caution in interpreting recent confidence gauges. With headline inflation set to go below 3 percent and more inflation relief in Q1 in the form of lower petrol prices, the Bank has time on its hands to wait and assess more incoming data. However, expect the talk to remain tough next week and a firm tightening bias to be maintained, with the possibility of a March rate hike still on the cards.



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