Economic Review

Economics

28 March 2008

Gross Domestic Product – December 2007 quarter

Key points

- **Economic activity ended 2007 on a strong note, expanding by 1.0 percent in the December quarter and taking calendar year growth to 3.1 percent, reinforcing opening capacity pressure.**
- **Strength was mainly across the board with primary production, manufacturing, and finance and business services making strong contributions to growth. However, the composition to growth does bear an eerie resemblance to late 1996.**
- **Looking forward, there is no doubt growth is undershooting the Reserve Bank's expectations in 2008. But a stronger opening position means the hurdle to lower rates will remain high**

Assessment

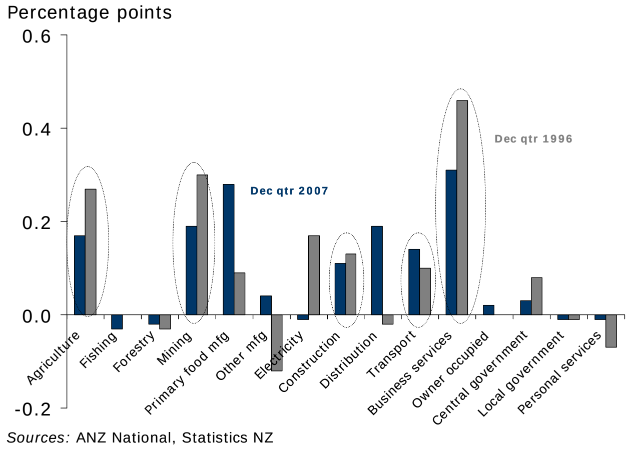
Headline production GDP expanded by 1.0 percent in the quarter, stronger than our and market expectations. Strength was across the board, with the primary sector (up 4.8 percent), manufacturing (up 2.2 percent) and finance, insurance and business services (up 1.2 percent) making the largest contributions to growth. Strength in primary production was partly due to the ongoing contribution of the Tui oilfield, which we estimate added 0.2 percentage points to overall GDP growth.

Looking at the mix to growth, we note an eerie resemblance to the 1.3 percent increase in the December 1996 quarter (which was just prior to a recession). Growth in December 1996 was dominated by mining, agriculture (drought-related), food manufacturing and business services, which collectively contributed 1 percent to growth, in a similar fashion to what those sectors contributed in the December 2007 quarter. Certainly, looking at the contributors to the December 2007 quarter suggests some potential for payback just as in 1996/97 (GDP growth for the March quarter 1997 was -0.6 percent).

On the expenditure side, growth was also robust at 0.8 percent, led by exports and business investment. Exports was a standout performer with strong primary exports (up 9.4 percent, driven by dairy), though a lot of this came from existing inventories. This led to inventories subtracting 0.9 percentage points off growth in the quarter, though this rundown should be put in the context of the build-up seen over the previous two quarters. While some rebuild is possible in the March quarter, there is still a risk that further stock rundowns could be on the cards. We note that most of the stock rundown occurred in the manufacturing sector (which is where the dairy sector is classified), with inventories in the distribution sector actually increasing. Given the slowdown in retail spending, it is likely that this build-up would have been involuntary.

	GDP (qtr % chg)	GDP (ann % chg)	GDP (ann ave % chg)
Dec-05	-0.4	2.4	2.7
Mar-06	0.9	2.4	2.7
Jun-06	0.0	0.8	2.1
Sep-06	0.4	0.9	1.6
Dec-06	0.7	1.9	1.5
Mar-07	1.2	2.3	1.5
Jun-07	0.9	3.2	2.1
Sep-07	0.5	3.3	2.7
Dec-07	**1.0**	**3.7**	**3.1**
NBNZ	***0.6***	***3.2***	***3.0***
RBNZ	*0.8*	*3.4*	*3.1*
Market	*0.7*	*3.3*	*3.0*

Contributions to quarterly GDP growth



Sources: ANZ National, Statistics NZ

Business investment was strong, which is a positive given the poor productivity performance over recent years. Strong increases were seen in non-residential buildings (up 16.4 percent), plant, machinery and transport (up 4.0 percent) and intangible assets (up 10.2 percent). The latter was a result of increased exploration activity. Across other expenditure components, private consumption remained subdued (up 0.5 percent), as was public consumption (up 0.4 percent), with residential investment declining 1.6 percent in the quarter.

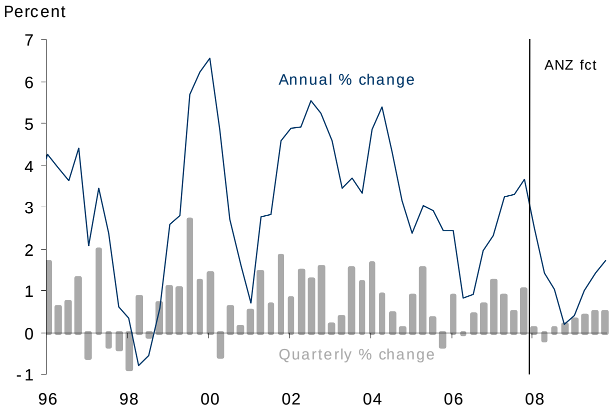
Looking at the GDP deflator, a strong terms of trade resulted in a hefty 2.2 percent rise in the quarter, taking the annual increase in the deflator to 5.3 percent. The GNE deflator was also strong at 1.2 percent, reflecting higher prices for consumption (food and energy-related) and investment.

The bottom line is that the economy has built up a strong base at the end of last year. There were some "one offs" in the form of the Tui contribution and the fact that dry weather conditions may have brought forward primary production (which means lower production in March). And the slowdown in the housing market means the strong growth in finance and business services seen at the end of last year is not likely to be repeated over the first half of this year. **Nonetheless, today's GDP data will have reinforced the Reserve Bank's concern at the lack of spare capacity facing the economy.**

Given the stronger starting position for the economy, the Reserve Bank will require a more substantial slowdown to be convinced that inflation pressures will indeed subside. With inflation set to remain above their target band for all of this year, today's GDP data means that they will hold to their March view that the OCR is staying at current levels "*for a significant time yet*".

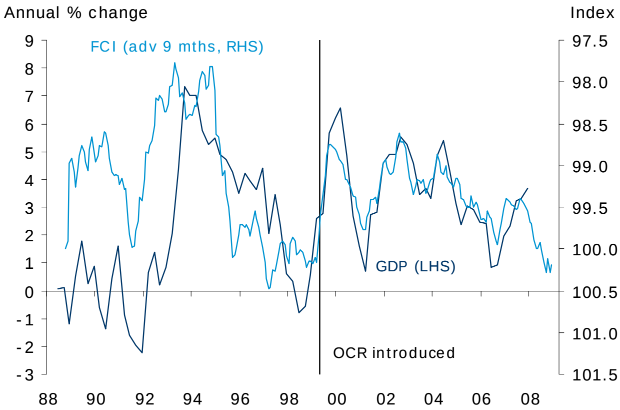
We maintain our core view that growth will slow more sharply than the Reserve Bank's expectations over 2008. The dataflow relating to the early part of this year and the sharp downturn in consumer confidence earlier this week certainly points to that. But the strong end to growth last year means the economy has built up some buffer to absorb some slowdown in activity. The key is whether any slowdown in growth is temporary or more sustained. Unlike late 2005 and early 2006, this slowdown is coinciding with a global event, the equity market is tracking the real economy, and housing is adjusting rapidly lower on the prices front. The Reserve Bank will want to see it in the hard data first to be convinced.

Economic growth



Sources: ANZ National, Statistics NZ

GDP vs Financial Conditions Index



Sources: ANZ National, Statistics NZ

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