NEW ZEALAND ECONOMICS
DATA REVIEW
Gross Domestic Product – June 2010 quarter

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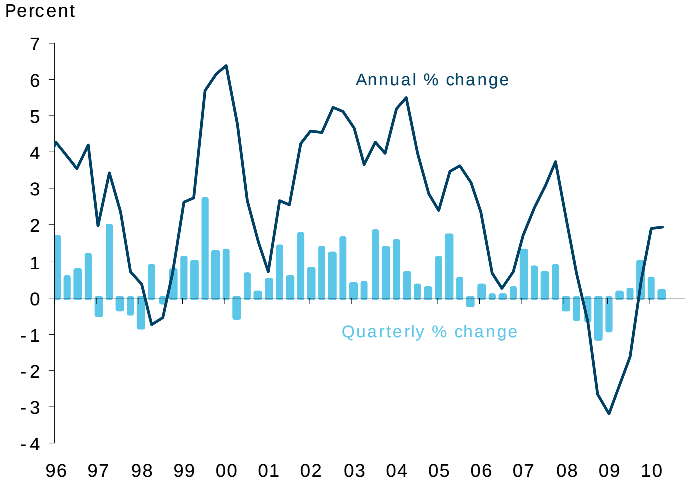
NZ ECONOMY LOSES MOMENTUM IN Q2

KEY POINTS

- The NZ economy lost momentum in Q2, expanding by a mere 0.2 percent - significantly below our and market expectations.
- Household spending was particularly soft, and there was a huge rundown in inventories which shaved 1.7 percentage points off growth. If there is a bright spot, it is that investment outside of housing picked up after three consecutive quarterly declines, and net exports made a positive contribution in the quarter.
- We suspect there has been a bit of volatility in the quarterly numbers, and Q3 prospects will have fared better (courtesy of a partial unwind of the de-stocking seen in Q2). But with the Canterbury earthquake set to have a negative drag, Q3 GDP will not be looking all that flash.
- The RBNZ is well and truly on hold until next year. We still see better prospects over 2011. The deleveraging dynamic that is working to hold back growth in the near term will ensure a more robust and sustainable recovery next year.

NZ economic growth



Sources: ANZ, National Bank, Statistics NZ

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DATA WRAP

Economic growth in Q2 at 0.2 percent was far weaker than anyone was expecting. It is certainly well below the 0.9 percent that the RBNZ forecast in the September *Monetary Policy Statement*. The fact that expenditure GDP expanded by a slightly faster pace of 0.4 percent is cold comfort. Even this was well below expectations.

GDP	QoQ	YoY	Ann Ave%
Q2 2008	-0.6	0.7	2.4
Q3 2008	-0.7	-0.7	1.5
Q4 2008	-1.1	-2.6	-0.2
Q1 2009	-0.9	-3.2	-1.5
Q2 2009	0.2	-2.5	-2.3
Q3 2009	0.2	-1.6	-2.5
Q4 2009	1.0	0.5	-1.7
Q1 2010	0.5	1.9	-0.4
Q2 2010	**0.2**	**1.9**	**0.7**
ANZ	**0.7**	**2.5**	**0.8**
RBNZ	0.9	2.7	0.9
Market	0.8	2.6	0.8

There were some large offsetting movements in expenditure components. **Household consumption was weak, despite strong retail sales hinting of something firmer.** While there was certainly a rise in durable spending, expenditure on services fell 0.6 percent, which caught us by surprise. It is a sign that households remain cautious and continue to focus on repairing balance sheets. It is noticeable that a switch is consumption spending is underway with consumers reining in discretionary spending (household expenditure of services fell 0.6 percent in the June quarter) to fund higher spending on consumer durables (which rose by 0.8 percent). If this pattern continues, the near-term growth impulse provided by higher spending on consumer durables to beat rising GST will be much reduced. As consumption accounts for 60 percent of GDP it matters for growth.

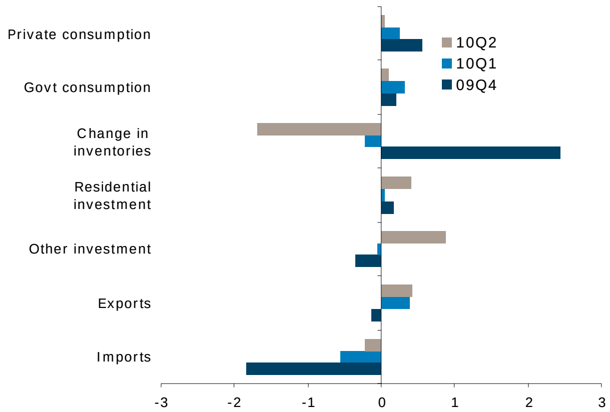
If there is a bright spot, it is that investment outside of housing picked up after three consecutive quarterly declines. Increased mineral exploration, a rebound in non-residential building and climbing transport equipment contributed to increasing business investment. However, plant and machinery investment fell 1.5 percent. Based on recent investment intentions surveys, any further pick-up in business investment looks meek (apart from upcoming earthquake related reconstruction work).

Residential investment activity surged 11 percent in Q2. While earthquake related reconstruction following the Canterbury earthquake is likely to support activity in late 2010/early 2011, the Q2 growth rate is unlikely to be repeated.

The other big surprise to us was the extent of the inventory rundown. Inventories shaved 1.7 percentage points off growth in Q2. It seems that a decent part of the 0.7 percent rise in goods exports and 0.8 percent increase in durable household spending came out of stocks, with the biggest decline occurring in manufacturing stocks. We can expect a technical rebound in inventories in Q3, which will support GDP growth. But this will only seek to mask what is a weak underlying momentum in the economy.

On a pleasing note export volumes registered another solid quarterly increase, up by 1.3 percent. The strong demand for logs contributed to a 21 percent surge in forestry exports, with increases seen in food, beverages and tobacco and manufacturing exports. Some of this was sourced from the running down of inventories, particularly for the manufacturing sector. Exports of services were broadly unchanged.

Percentage point contributions to quarterly growth



Sources: ANZ, National Bank, Statistics NZ

On the production side, activity in the primary sector rose by 0.6 percent in the June 2010 quarter. Increased mining exploration activity and a sharp increase in fishing activity made sizeable positive contributions, with forestry and logging recording the sixth consecutive quarterly increase. These increases were offset by lower agricultural output, largely due to a fall in milk production, as the impacts of the drought earlier in the year impacted.

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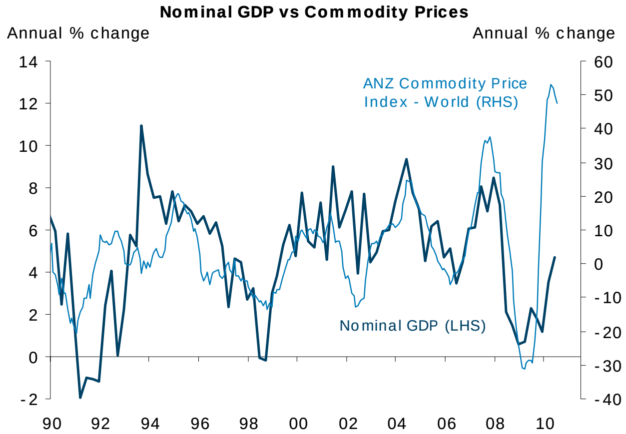
Activity in the goods sector fell by 1.0 percent dragged down by a 4 percent fall in manufacturing sector output, which shaved 0.5 percentage points off quarterly GDP. The fall in manufacturing sector output was broad-based with wood and paper product manufacturing the only sub-industry to record a quarterly increase in activity. If it wasn't for the 6 percent rise in construction sector activity (which made a 0.3 percentage point contribution to Q2 GDP) and higher electricity and gas production, the decline in goods output would have been much worse. **Output in the services sector only managed a 0.4 percent monthly increase, which was below our expectations.** Activity was patchy with a sharp fall in communication services activity and a soft outturn for wholesale trade and personal services contrasting with more respectable increases in other parts of the services sector, notably retail and government administration.

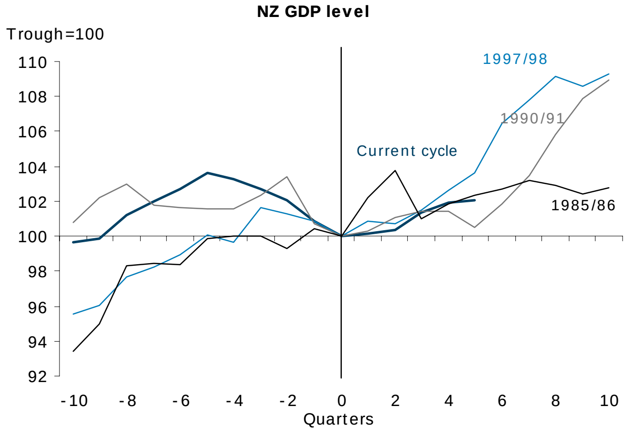
The improving terms of trade was the key driver in delivering a 1.2 percent quarterly increase in nominal GDP. Given today's reasonably bullish assessment by Fonterra there is scope for this process to continue for a while yet.



Sources: ANZ, National Bank, Statistics NZ

There were some revisions to the historical GDP estimates. In effect these were minor, lowering the level of GDP by 0.1 percent by the March 2010 quarter.

Since the end of the recession, the recovery has been subdued, with growth only averaging 0.4 percent a quarter. Considering the degree of economic slack that normally emerges during a recession, this growth performance is very poor indeed, being below most estimates of trend growth. It is a sign that deleveraging is holding growth back, and given that there is still some way to go in this regard, further modest growth can be expected in the next few quarters. Earthquake related reconstruction will provide a boost to activity but there does not appear to be signs of a broad-based recovery emerging just yet.



Sources: ANZ, National Bank, Statistics NZ

ASSESSMENT

The economic recovery is still on track. But the pace of the recovery is a lot more subdued compared to past cycles. Since emerging from recession, growth has been anaemic and not of the above-trend variety normally expected from typical cyclical rebounds. Deleveraging remains a powerful growth suppressant. The economy is also undergoing a physical resource shift away a consumer-centric model towards more earning centric growth. While there was only limited evidence of this dynamic in Q2, such a physical transformation for the economy will take a considerable period to take hold.

Earlier we had expressed concerns over the low level of business investment, with the impact of reduced supply-side capacity likely to truncate the current rebound. Today's increase in business investment is a step in the right direction although the level remains 15 percent below its mid-2008 peak. Of some concern was the decline in plant and machinery investment with this now nearly 30 percent below historical peaks. The addition of productive capacity is sorely needed to achieve decent medium-term growth performance and ensure the medium-term trend inflation remains contained.

We continue to expect a better 2011. The more the economy undertakes the necessary adjustment now, the sooner it will set the stage for a more robust and sustainable recovery. The Rugby World Cup and reconstruction of Canterbury will assist growth next year as well. **Based on today's GDP numbers, the RBNZ is well and truly on hold until next year.**

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