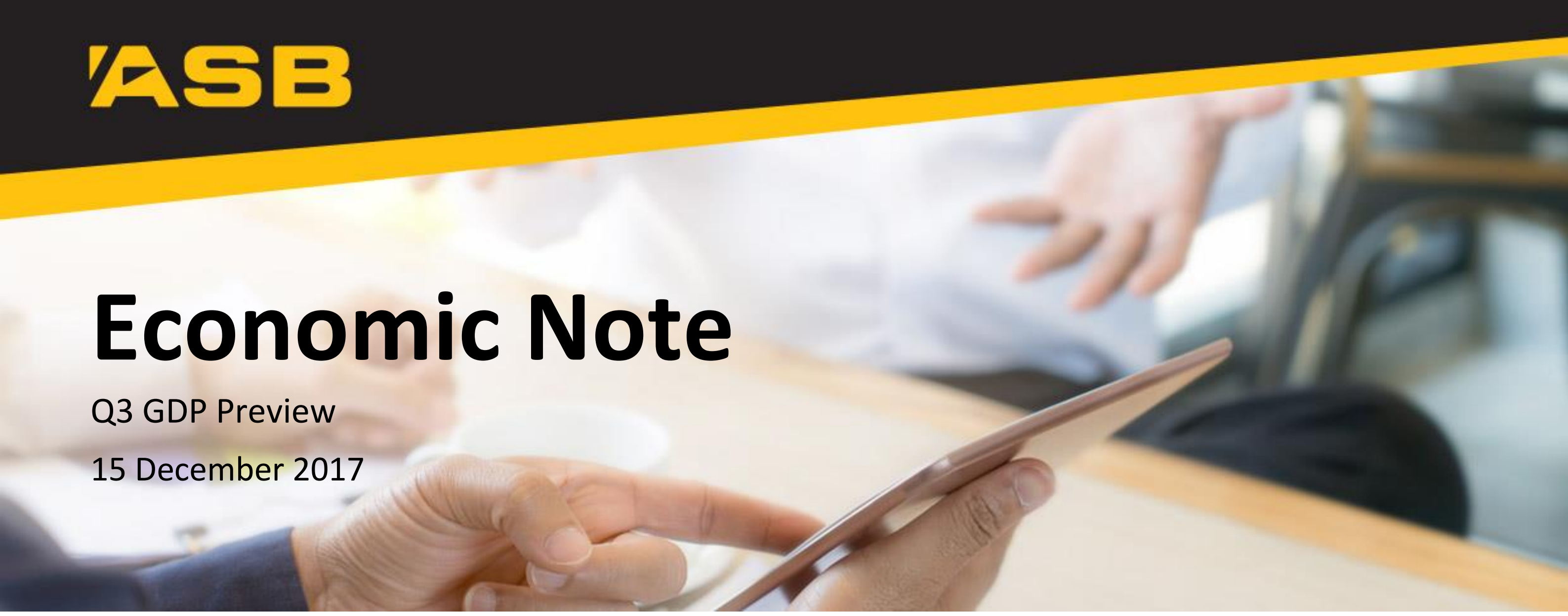


Economic Note

Q3 GDP Preview

15 December 2017

Another bump in a pothole-riddled road

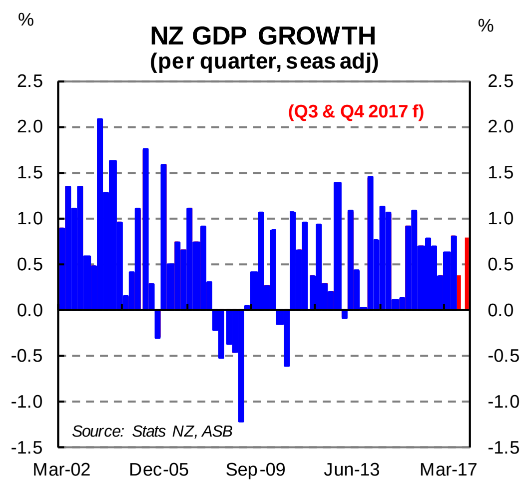
- We expect just 0.4% qoq GDP growth in Q3. Construction will be a bright spot for the quarter, but falls in dairy production and soft retail and housing-related activity will weigh.
- Revisions to the past few years are likely, as two years of annual benchmarking updates get included.
- Growth over the past year has been underwhelming, only matching the pace of population growth.

Summary & implications

We expect yet another soft quarter of GDP growth in Q3 2017, with official estimates released by StatsNZ on Thursday 21 Dec at 10.45am. **We expect 0.4% quarterly growth** to bring GDP just 2.2% above year-ago levels (for the record, population growth was 2.1% over the same period) and annual average growth will slow to 2.4%. **Growth's performance over the past year has been underwhelming and we have scaled back our optimism for coming years as a result.** A result weaker than the RBNZ's November MPS forecast merely reinforces the outlook for interest rates to remain on hold until at least early 2019.

Revisions alert: StatsNZ incorporates two years of annual benchmark revisions (typically StatsNZ would have incorporated just one year of annual benchmark data). **These annual revisions can, on occasion, materially alter the growth profile.** The impact of already-released nominal estimates to March 2017 led to slightly higher nominal GDP, so it is possible these upward revisions could also filter through to price-adjusted estimates of GDP.

GDP - Sep 2017	Previous	ASB	RBNZ
quarterly % growth	0.8	0.4	0.7
annual % growth	2.5	2.2	2.6
annual average % growth	2.7	2.4	



Can we build it? Yes, in Q3 we can

In the September quarter, construction activity looks to have recovered, after activity unexpectedly fell over the previous two quarters. Capacity constraints are biting in the construction sector and output has not kept up with demand. Skilled labour is a particularly binding constraint, as it takes time to train workers. But once up to speed, these additional skilled resources can boost output. Strong construction demand is likely to have provided a boost to non-primary manufacturing activity as well.

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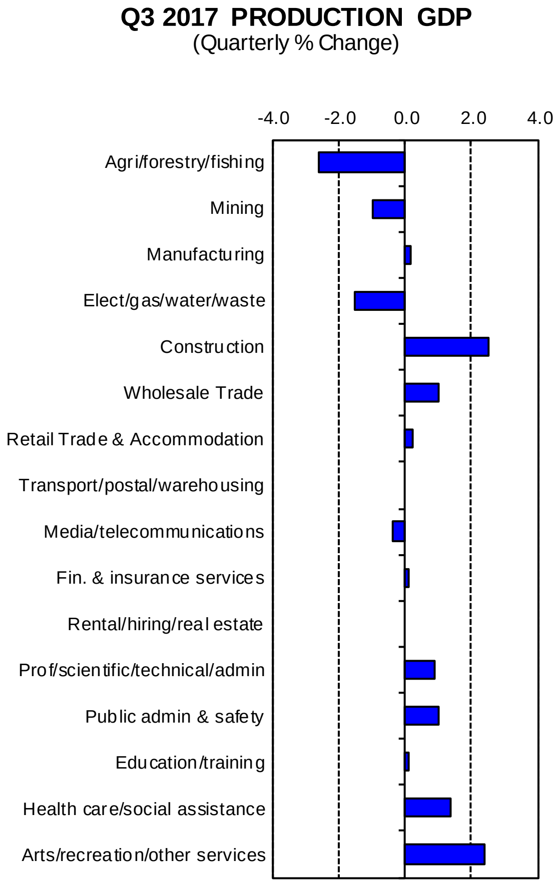
The **other bright spot for the quarter is some service sectors**, with the services survey indicating strong growth in arts and recreation, and modest growth in professional services. Meanwhile, we have pencilled in modest growth for public administration in light of the additional resources required for the General Election.

Rough areas of terrain

However, Q3 GDP activity will be weighed by:

- **A weak quarter for dairy production** (due to the very wet spring), and also a fall in livestock slaughter volumes.
- **Electricity generation contribution to GDP will likely be negative** due to a decline in value add (the difference between the value of output and the value of input). This is due to a fall in hydro's share of electricity generation (which has low input costs compared to other methods of electricity generation) as a result of low lake levels this winter.
- **Retail spending growth will likely be below trend,** but largely as payback from the previous quarter's Lions Tour boost.
- Very **low house sales** over the quarter will weigh on housing sector related activity.

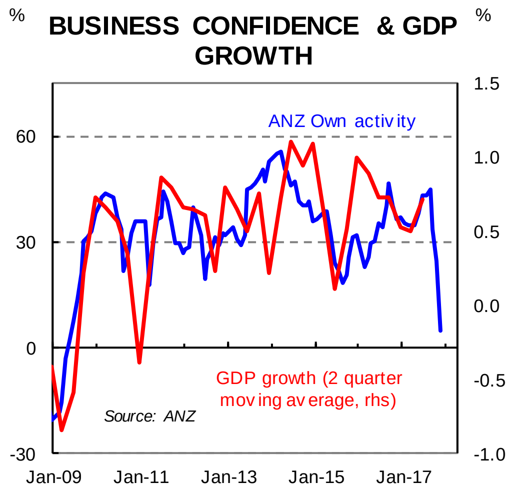


Trains and planes

Transport, postal, and warehousing is a key area of uncertainty, due to many moving parts. The main components for driving the volatility in this sector include:

- **Air-passenger activity**: This is likely to have been impacted by the jet-fuel shortage in late September, which saw a large number of flights cancelled. However, the extent of the negative impact is uncertain as increased productivity in this sector (i.e. only flying flights at full capacity) may provide some offset (i.e. the value of output may have dropped, but the value of inputs likely dropped).
- **Road and rail activity:** There has been considerable volatility in road and rail transport, in part due to the disruption from the closure of SH1 in the upper South Island following the Kaikoura earthquake. During mid-September, the rail line was briefly opened with some trains run overnight, but this activity was also disrupted by slips.
- **Postal:** The trend toward increased online shopping increases demand for parcels, but demand for traditional mail has decreased.

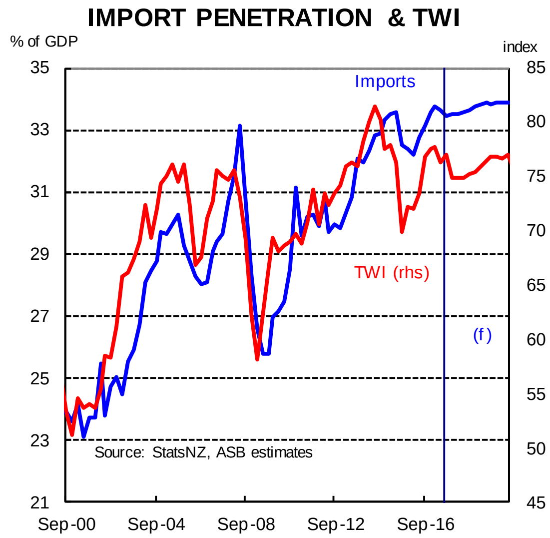
For the record, we have **0.7% quarterly expenditure growth pencilled in** (production is the headline measure). Net exports will be a drag but a recovery in stocks will likely offset this, while we expect modest growth from consumption and investment.



The road ahead remain treacherous

We cautiously expect stronger GDP growth in the December quarter. Dairy production started Q4 strongly (although emerging dry conditions are likely to hamper the recovery). The housing market has showed signs of life in some areas of the country now that election uncertainty has passed. There are some encouraging signs of retail spending and [beer drinking] in Q4. However, **one risk to growth over the next few quarters is the sharp drop in business confidence** in the wake of the change of government. Business confidence is often lower for a given pace of growth under Labour (compared to a National). Nonetheless, there is likely to be some **disruption to activity due to near-term uncertainty** and, if business confidence remains weak for a number of months, a **crisis of confidence could become a self-fulfilling prophecy**.

Meanwhile, our 'big picture' view of growth has been revised lower. At the start of 2017 our expectations for economic growth were perky. In the February 2017 edition of our Quarterly Economic Forecasts, for the September 2017 quarter we expected annual average growth of 3.3%. Now, at the end of the year, we expect the first official estimate of Q3 2017 annual average growth to print at 2.4%. We had expected low interest rates, still-strong population growth, construction demand and a lift in per-capita demand to boost activity. But GDP outcomes have underwhelmed. **Unexpectedly soft construction activity** over the first half of the year was one area of surprise. The other was the **strength of import demand**; per-capita consumption and investment demand did lift strongly as we expected, but a greater share of this demand growth was met by imports rather than domestic production. In light of this development, **in our latest set of quarterly forecasts we allowed for stronger import growth forecasts for 2018 and beyond, which lowered our GDP growth forecasts.**



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