Economic Note

Quarterly Survey of Business Opinion

1 October 2019

Q3 QSBO: Economy stalls and inflation softens

- Q3 QSBO suggests that the NZ economy ground to a halt over Q3.
- As the lack of demand, rather than capacity constraints, are seen to restrain activity. Inflation indicators are softening and spare capacity within the labour market looks to be growing.
- We now expect 2 more 25bp OCR cuts by the RBNZ by early 2020. The 50bp August OCR cut looks to have back-fired and depressed confidence, and we expect the RBNZ will revert to smaller 25bp steps.

Summary & implications

The ANZ business outlook hinted the day before that the NZIER's Quarterly Survey of Business Opinion was not likely to be flash reading – and it wasn't. The results point to the economy approaching stall speed over the quarter, along with weakening cost and pricing pressures. Both aspects will concern the RBNZ. It is increasingly clear that the economy needs even more stimulus to try and hold growth up in the near term and give greater assurance that momentum will firm next year. And the initial sense from the just-released independent experts' review of the RBNZ's bank capital increases is an endorsement of the RBNZ's capital proposals. If there is little change to the proposed capital increases then it is likely the RBNZ gets surprised next year by the extent of the economic impact, and ends up cutting the OCR even further than we now contemplate.

We now expect a further 50bp in total of OCR cuts, 25bp in November and now 25bp in February, taking the OCR to a fresh record low of 0.5%. A November cut looks all but assured, though there is likely to be debate amongst some people over whether the RBNZ will cut by another 50bp then. After the decidedly mixed response to the 50bp OCR cut, we expect the RBNZ will revert to smaller 25bp steps. Rather than reassure that the cavalry is on the way, the 50bp seems to have caused some disquiet. Hence, 'only' 25bp seems prudent – barring a run of extremely poor news.

Given monetary policy is likely to get uncomfortably close to the point that unconventional measures need to be primed, it is also time for the Government to seriously consider some quality stimulus measures. There is plenty of debt headroom and extremely low financing costs to take advantage of. Low business confidence predates the recent escalation of global risks, and the export sector has been one of the stronger parts of the economy. A Government charm offensive with businesses and the rural community wouldn't hurt, along with policies aimed at incentivising investment and employment. Interest rate cuts alone won't win hearts and minds, though they will help.

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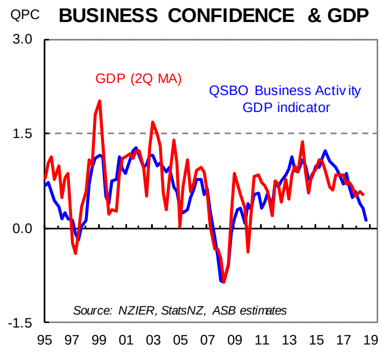
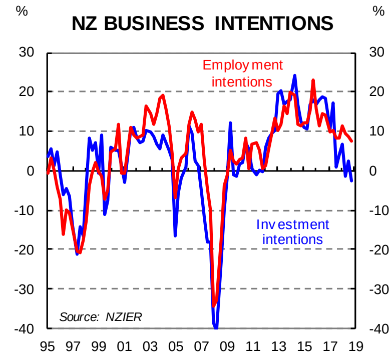
Glass half-full

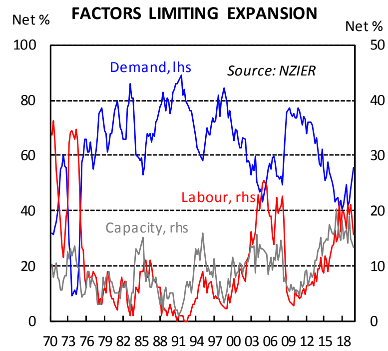
Hot on the heels of the weak ANZ Business Outlook, today's Quarterly Survey of Business Opinion depicted a glass-half full view of the economic outlook. Headline business confidence weakened further (-35 seasonally adjusted (s.a.)), falling to its lowest since early 2009. Firms' assessments of their experienced domestic trading activity in Q3 fell to -11 s.a., the lowest in nine years. **Our QSBO indicator, which has a good track record of picking GDP outturns, suggests that the economy virtually ground to a halt in the September quarter.** Q3 NZ GDP is not released until the 19th December, well before the RBNZ November Monetary Policy Statement (13 November). Firms' assessments of their expected domestic trading activity, did improve, but at zero was the second weakest reading of this series in nine years. We tend to put more weight on firms' experienced domestic trading activity given its close fit to GDP. Expectations can fall short of reality.



The deterioration in sentiment was broad based across sectors. **Of note, businesses look to have been spooked by the RBNZ's 50bp OCR cut, even within interest rate sensitive pockets of the economy**. Experienced domestic trading activity declined for services (-8 s.a. from -5.2 s.a.) and retailers (-9.2 s.a. from -3.8 s.a.) in Q3. There was only a tepid recovery in retail expectations for Q4, with net balances still in negative territory for other sectors. Investment intentions moved into negative territory for buildings (-16 s.a.) and plant & machinery (-3 s.a.), with both net balances the weakest in a decade. Moreover, architects reported a smaller pipeline of work on their books outside of government sector work. **This should greatly concern the RBNZ.**

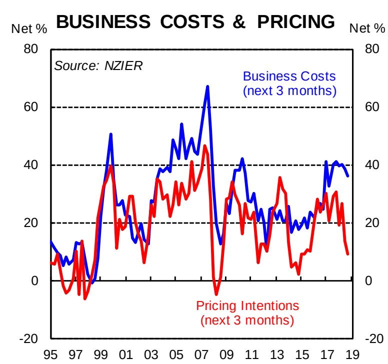


Softening demand is leading to growing capacity as the economy comes off the boil. More than half of the firms surveyed (55% n.s.a.) reported that insufficient demand was the major constraint on increasing production, the highest in four years. Insufficient capacity held back sales of just 13% of firms, the lowest in 5 years. Labour shortages (16%) are becoming less of a constraint. Moreover, firms surveyed capacity utilisation eased to 92.4%.



Soft demand is flowing through into the demand for labour. Firms have also cut back on hiring in the September quarter (-6 s.a. in Q3), but they felt more positive on increasing headcount in the next quarter, although the +7.4 s.a. net balance was the lowest in six years. Labour shortages eased for unskilled labour (-28 s.a.), and remained acute for skilled staff (-42 s.a., down 1), with firms finding it less difficult to obtain staff.

The survey did point to moderating inflationary pressure and continued pressure on firm margins. Cost pressures were moderating (to +33 from +40), with a smaller net balance of firms expecting costs to rise. However, firms are finding it more difficult to push through cost increases into the prices of their outputs, with both experienced (0 s.a.) and expected sales prices (9 s.a.) at their lowest in three years. This decline was broad-based across sectors. As such, margin compression has remained acute, with a net 26% s.a. of respondents reporting declines in profitability (the highest in 8 years). Profitability is expected to improve, but at -20 s.a. that expectation is weak. In the absence of further policy support we can see few catalysts that will prevent inflation falling further.



ASB now expects a further 50bps of OCR cuts

For a while now, we have been concerned that the pace of economic activity has been anaemic and that the margin of spare capacity within the economy had increased, jeapordising the RBNZ's employment and price stability objectives. This caution looks to have been vindicated by a very weak set of business confidence surveys, which justify the need for more policy support. **We now expect a further 50bp in total of OCR cuts, 25bp in November and now 25bp in February, taking the OCR to a fresh record low of 0.5%.** After the decidedly mixed response to the 50bp OCR cut, we expect the RBNZ will revert to smaller 25bp steps.

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