ASB

Economic Note

Impacts of COVID-19 on our forecast view

27 March 2020

COVID-19 and the economic path ahead

- COVID-19 has been a game changer to both the NZ and global economic outlook. 2020 will be a very challenging year, with pronounced quarterly volatility. A sizable contraction in NZ GDP over 2020 looms, which will be larger than the early 1990s and Global Financial Crisis (GFC) recessions but will hopefully prove more short-lived.
- The Government and RBNZ have stepped up and their actions should help to mitigate the economic hit, with likely job losses and falls to house prices less severe than they could have been.
- The economy will recover. It always does. However, balance sheet constraints and weaker potential output growth will temper the rebound. We are not expecting a typical cyclical recovery – it's not a typical time.

Summary

2020 faces considerable economic challenges, some of which have not been experienced in our modern history. COVID-19 has morphed from a potential (and modest) downside risk to a global pandemic with severe economic repercussions for the NZ and global economy. Much of NZ is currently in lock-down mode: the NZ authorities have done the right thing and put health first, while also cranking up policy support to help reboot the economy.

We have attempted to illustrate the potential short-term impacts of the shut-down and COVID-19 on the NZ economic outlook. It will crucially depend on the length the shutdown, the portion of the economy that will be impacted and the extent to which activity in affected areas will be disrupted. These are still unknown and there could be a range of potential outcomes. However, it seems more likely than not that quarterly movements in NZ GDP will be massive (but hopefully short-lived), with easily the greatest quarterly volatility seen on record.

The NZ economy is set to contract by considerably more over 2020 than what occurred during the early 1990s downturn and the Global Financial Crisis (GFC). We expect the subsequent recovery to be gradual, with widespread caution evident and the focus on safety and saving rather than a sudden release of the spending shackles. Household, corporate and even the Government's balance sheets have been hit and will need time to recover. Potential growth prospects for the economy (i.e. its speed limit) will also be more modest. These constraints will blunt the impact of low interest rates and government support for a while yet. Eventually we expect the economy to recover, but it won't be until late 2022 that NZ economic activity is above late-2019 levels. The OCR is unlikely to move higher until 2024.

There will be widespread economic repercussions. There will be firm closures and job losses, particularly in sectors that have seen a persistent knock to their fortunes, but the actions of policymakers will partly stem the tide and prevent the unemployment rate hitting double digits. Policy support will also play a key role in limiting the (modest) falls we expect for nationwide house prices over 2020. The cost of this policy support is evident when looking at the Crown balance sheet, with government debt levels set to climb sharply.

This is a time to really pull together as a nation. The lockdown gives time to plan for restarting in a changed world.

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Key messages

The economy is going into a deep but short-lived contraction. It's going to be painful, but it is entirely necessary to avoid even worse health and economic outcomes further down the track. No one knows how deep the hole is or precisely how long it will take the economy to recover. But, the important point is that the economy WILL recover.

The response by NZ's policy makers has been timely, and appropriately aggressive. The fallout on NZ's labour market, housing market and economy more generally will be limited greatly by the decisive actions we've seen to date. We're confident they will work to support the economy as we endure the lockdown, and then stimulate the economy as we emerge.

It gives us the best chance of emerging from this crisis in reasonable shape compared to some. But how the rest of the world fares in this still matters a great deal for us, given NZ remains a trade-dependent economy. It's a well-worn cliché, but it's true that we're all in this together.

There will be sectoral, regional, and employment differences. Humans are incredibly adaptive and will find new ways of working, but this will be easier said than done for many. COVID-19 is a viral outbreak, and sectors that rely on person-to-person contact and the movement of people will face greater challenges. Providing that the Chinese economy manages to recover from its winter flu, prospects for NZ food exporters may not be as bad as they could be given the pending global downturn. Our Terms of Trade should hold up reasonably well, but we acknowledge the downside risks around this view.

NZ has more fiscal and monetary ammunition (than most). And policymakers have already shown boldly that they are not afraid to use it.

Don't pay too much attention to point forecasts. Forecasting is tough at the best of times, borderline impossible now. The relevance of forecasts is also reduced in an environment where some firms are simply trying to stay afloat rather than doing any sort of planning for the future. We outline our updated outlook below and encourage you to focus on the story and risk profile, rather than the numbers.

Businesses on the front line of this shock will have the clearest sense of the impacts and are thus best placed to figure out the way forward. **Kiwis have proven themselves to be resilient and innovative**. These qualities stand us in good stead as we tackle this thing.

Carpe (28) diem. Essential industries and businesses that are able to function during the lockdown will learn a lot about new work techniques. Others have time to plan for the future. Make the most of this unusual opportunity.

There is plenty of help out there from government and banks. Seek it out and encourage others to make use of it. Help others get through if there are things you can do that will make a difference.

Co-operation and caring matters. If we all pull together, follow official advice and look out for each other, it will be easier to get through this. Kia Kaha New Zealand.

Prepare for volatility

To illustrate the impacts of the shutdown on the NZ economy, we have used a bottom-up approach. For the approximate 55 industries that make up production-based GDP, we make the following key judgements.

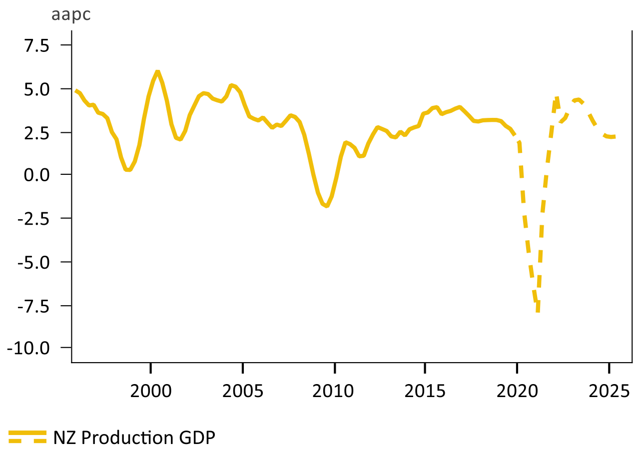
- **The length of time that the lockdown will occur.** The longer the shutdown the higher the overall impact.
- **The proportion of the economy that are critical sectors and will stay open**. The more of the economy that is deemed to be critical (and will remain open), potentially the lower the overall impact. We define critical sectors to be health, food production and infrastructure, supermarkets, fuel retail, government administration, critical infrastructure and transport, and essential services (well over 50% of GDP).
- **The proportion of economic activity that the shutdown will disrupt in non-critical sectors.** The more adaptable the sector, the smaller the disruption. A full shutdown will hit some sectors hard (e.g. hospitality, non-critical

retailing). Others will find new ways of working within the new restrictions (for example, by working remotely), although this could significantly test core infrastructure.

- **The degree of offset.** Not all sectors will experience a slump in demand, if our recent experience of supermarket shopping is anything to go by. A likely surge in emergency stockpiling ahead of the lockdown may actually prevent the economy from shrinking in the March 2020 quarter. We assume the current episode of panic buying will pass, but there will also be substitution to some sectors (e.g. supermarkets, internet-based services). We have made an adjustment to capture these impacts.
- **Lingering effects.** Despite the best efforts of policymakers, not all firms will survive with some closures and employee layoffs. On this basis, firms and households will remain understandably cautious for a length of time. Returning back to normal will not happen overnight.

To cross-check our estimates, we have also used a top-down approach, where we make a range of similar assumptions for the NZ economy as a whole. **Even so, we warn that the estimates we derive are highly illustrative and sensitive to the assumptions made**. We will have to wait till the end of the year (and perhaps beyond that) to find out how the economy has fared.

NZ Annual Average GDP Growth



Source: Macrobond, ASB

Our range of estimates suggests that GDP will fall sharply in Q2 followed by a sizeable lift in Q3. We have pencilled in a 15% drop in Q2 GDP and around a 10% climb in the second half of 2020. Whether a sharp Q3 rebound ensues will crucially depend on the persistence of the lockdown. But it is extremely likely that quarter-to-quarter movements in GDP this year will be the largest we have experienced in recent history. To put this into context, the largest previous quarterly percentage drop in production-based GDP was a 2.4% fall at the start of 1999. The largest quarterly rise was a 2.8% increase in Q3 1999 as the economy recovered from the Asia crisis.

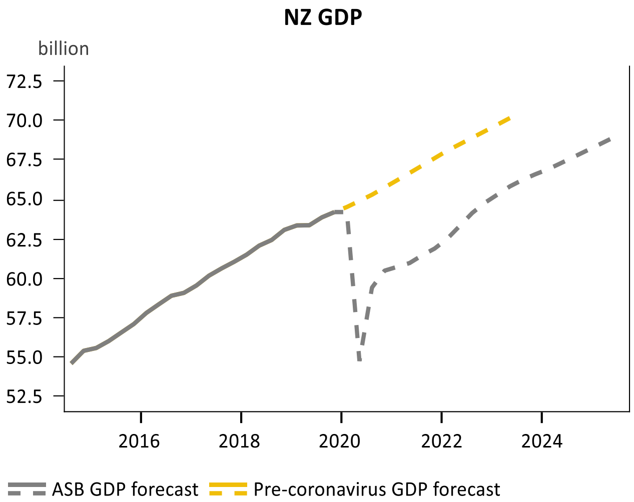
Further Ahead – structural headwinds to temper the rebound

Irrespective of the quarterly movements, we expect COVID-19 to deliver a sizeable cumulative hit to GDP on the basis that not all of the activity that was deferred during the lockdown will get brought back on stream. We assume COVID-19 will cause the economy to shrink by around 6% of GDP over 2020, considerably above the sub 3% cumulative falls to NZ production-based GDP in the early 1990s downturn and the Global Financial Crisis. There is the likelihood that NZ will experience one, perhaps two quarters of negative growth as opposed to the six quarters of negative growth in both the previous large downturns.

On the expenditure side of the ledger, we had previously assumed that much of the initial hit to be felt for services exports, with a moderate hit to the wider economy. **More recent events now suggest that the impacts will be felt more acutely throughout the economy.** Consumer spending will feel the combined headwinds of reduced consumer choice, a less assured employment picture and softer balance sheets (readers may want to ignore their KiwiSaver balances for a while). Firms will be incredibly gun-shy about investment spending given the uncertain climate and with increased spare capacity. The Government is fronting up, but there is only so much that fiscal policy action can do. Weaker demand for imports and an anticipated recovery in NZ food exports will temper the hit to overall GDP.

In short, we do not expect the economy to rediscover its mojo for a lengthy period, with the level of economy-wide GDP expected to remain below pre-crisis levels until late 2022. **We expect a sharp rebound in economic activity over H2 2020 as the NZ economy gradually reopens from the lockdown.** However, this will be more statistical in nature than a genuine recovery and it will be some time before it is completely business as usual. Caution is likely to persist through much of 2021, given the risk of periodic viral outbreaks over the next year or so until a vaccination programme is introduced. Consolidation, hunkering down and shoring up savings rather than expansion will likely be the order of the day.

The NZ Government is likely to continue to pull out all the stops to get NZ moving. Monetary policy settings are and will remain on full throttle. Once the virus risk has passed (through either vaccination or adequate herd immunity), we envision the economic recovery will truly begin in earnest, though that may not be until late 2021/early 2022.



Source: Macrobond, ASB

Weaker balance sheets, and a likely lower trend growth rate for the economy will limit the magnitude of the cyclical rebound. Courtesy of sizeable falls to global and NZ equities, household balance sheets have weakened. Job security and wage growth is likely to be low and precautionary saving motives are high. Corporate balance sheets have not fared particularly well and the appetite for investment is limited. Despite a low interest rate environment, firms are expected to remain gun-shy on the investment front. The Government's balance sheet is still strong, but a sustained fiscal response will leave the NZ economy more exposed to future large adverse shocks.

Global Outlook

COVID-19 is hitting the global economy hard. The IMF stated recently that:

> *"the outlook for global growth: for 2020 it is negative—a recession at least as bad as during the global financial crisis or worse. But we expect recovery in 2021." Further, "the economic impact is and will be severe, but the faster the virus stops, the quicker and stronger the recovery will be."*

The epicentre of the outbreak has spread from China, to Europe and North America. Steps by Chinese authorities to contain the outbreak hit the Chinese economy hard, but with reported cases in China looking to have plateaued, the Chinese economy is hinting at recovery. It is a different story in most OECD economies, where sharp (and potentially long lasting) contractions in economic activity beckon.

Focusing on the financial and confidence channels between NZ and the rest of the world suggest that the global demand is likely to get worse before it gets better. However, we are hopeful that New Zealand's more food-centric export mix and close linkages to the relatively fast-recovering Chinese economy may provide insulation to our food exports. Our Terms of Trade are assumed to remain elevated, with lower oil and imported commodity prices supporting domestic consumers. It is hoped that prospects for our other trading partners improve soon, or the going will be more difficult for the remainder of the export sector.

Wider Economic Impacts

Fiscal Policy

The Government is using its strong fiscal position and large balance sheet to support the economy and to resource up the health sector to deal with the COVID-19 outbreak. We assume a fiscal package of around $20bn, spread largely over the June 2020 and 2021 years. This, and softer economic conditions are expected to push the operating balance into deficits of around 10% of GDP over 2020/21 and 2021/22, with public net debt expected to climb above 50% of GDP over the next few years. We expect fiscal deficits until at least 2024/25 as some of the economic and tax revenue impacts linger. This extra $100bn or so in public debt we see emerging in the coming years will be funded via increased NZ government bond issuance, with around one-third likely to be purchased by the RBNZ as part of its Large-Scale Asset Purchase programme.

Labour Market
COVID-19 is set to deliver a significant hit to the demand for labour. Where possible, firms will cut employee hours rather than lay off staff. The Government's wage subsidies and more widespread fiscal support package will encourage firms to retain staff where practically possible. However, some firm closures and job losses look inevitable, with the unemployment rate set to hover around 7% over much of 2020. The unemployment rate may begin to drift lower from 2022, part of which will likely be due to people leaving the labour force and slower growth in our working age population than strength in the employment outlook.

Housing Market
At the start of the year we were expecting 2020 to be a very good one for the domestic housing market. This view has changed, and by the end of the year, we expect nationwide house prices to be around 5-6% below their likely March 2020 peak. The fall could have been much larger in the absence from government policies to reduce job losses and offer mortgage relief. The outlook is for house prices to basically flat-line over 2021 given the uncertain economic backdrop, reduced job security, and low wage growth. Investors will remain wary given controls on rental increases. We anticipate some tentative green shoots will start to appear from 2022, and some regions will perform stronger than others as the economy strengthens.

Inflation
Inflation is expected to fall from a little over 2% in early 2020 and settle towards 1% or the lower part of the 1-3% RBNZ inflation target band. We expect quarterly volatility over 2020 given the offsetting impacts of bargain-basement oil prices and a weaker economic backdrop on the one hand and the lower NZD and potential rises to retail food prices on the other. Growing spare capacity and weak wage inflation will drag annual headline inflation towards 1% by early 2021. There it will remain, with very little impetus to push it higher until narrowing spare capacity and the improving economic outlook begin to nudge it higher.

Our updated interest rate and exchange rate view

The weaker economic outlook has seen us revise down our interest rate forecasts. Since our Quarterly Forecasts in February, the OCR has been cut to its 0.25% operational low. The interest rate outlook is changing rapidly given heightened uncertainty over the COVID-19 outbreak and we expect a period of continued volatility until this uncertainty abates.

The weaker NZ economic outlook will necessitate more interest rate support and we do not expect the OCR to move higher until 2024. It could potentially move lower, if it was found not to damage the NZ financial system. Interest rate settings of other central banks are also expected to remain close to their conventional limits. Recent actions by the RBNZ and other global policymakers – substantial policy interest rate cuts, measures to help monetary policy implementation and Quantitative Easing – have helped lower NZ interest rates, arrest the earlier climb in yield spreads, and flatten yield curves. We expect these actions to have persistent impacts and will help stem the climb in yields from higher public debt issuance in NZ and abroad.

If our economic forecasts are uncertain, currency forecasts in this environment are wildly uncertain. Until the picture clears continued volatility seems more likely than not. Our revised forecasts assume a weaker NZD profile given increased risk aversion. The NZD is expected to trough at 55 US cents by mid-2020, before moving higher. Despite having briefly breached touched parity last week, the NZD is expected to remain in the high to mid-90s AUD zone. Waning risk aversion as the impacts of COVID-19 fade is expected to see the NZD edge higher against key bilateral exchange rates. We expect the NZD trade-weighted index to move from the mid-60s level at present closer to 70 over the next few years.

ASB economic forecasts		Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
		<< actual	forecast >>						
NZ GDP real	Q%	0.5	0.0	-14.7	8.5	1.8	0.4		
NZ GDP real	A%	1.8	1.3	-13.6	-7.0	-5.9	-5.5	2.8	4.5
NZ GDP real	AA%	**2.3**	**1.9**	**-2.1**	**-4.4**	**-6.3**	**-8.0**	**4.8**	**4.3**
private consumption	AA%	2.7	2.6	-1.3	-3.3	-5.2	-7.5	3.4	4.2
dwelling construction	AA%	4.3	3.2	-5.4	0.0	-13.2	-16.9	-2.4	3.5
other investment	AA%	2.1	1.4	-6.5	-10.6	-12.8	-14.7	8.0	6.1
exports	AA%	2.3	-0.5	-8.6	-14.2	-19.8	-22.9	7.3	13.8
imports	AA%	1.5	1.7	-4.2	-8.9	-13.3	-17.5	3.7	10.5
Terms of Trade (OTI, goods)	A%	6.9	5.9	1.7	1.0	-1.4	-1.2	0.8	0.8
Current account balance	%GDP	-3.1	-3.3	-3.9	-4.2	-4.7	-5.2	-3.1	-3.2
NZ CPI	A%	1.9	2.3	1.7	1.6	1.3	1.1	1.2	1.4
NZ house prices (QV index)	A%	4.0	6.3	5.0	0.5	-3.6	-6.1	1.0	2.9
NZ unemployment (HLFS)	Qtr	4.0	4.4	6.3	7.3	7.3	6.8	6.8	6.3
Employment growth (HLFS)	A%	1.0	1.0	-3.7	-5.8	-6.1	-5.8	1.7	2.5
Fiscal accounts - June years		2019	2020	2021	2022	2023	2024		
OBEGAL	$bn	7.3	-15.7	-28.7	-32.9	-26.3	-17.4		
OBEGAL	% GDP	2.4	-5.1	-9.4	-10.3	-7.8	-4.9		
Net Public Debt	$bn	58	77	114	154	186	208		
Net pubic Debt	% GDP	19.6	25.2	37.4	48.6	55.3	58.2		

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>						
NZ cash rate target	1.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25
NZ 90-day bank bill	1.29	0.55	0.55	0.55	0.55	0.55	0.55	0.55
NZ 2-year swap rate	1.26	0.60	0.60	0.60	0.60	0.60	0.60	0.60
NZ 10-year gov't stock	1.65	1.00	1.00	1.00	1.00	1.00	1.05	1.15

ASB foreign exchange forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>						
USD per NZD	0.67	0.58	0.55	0.58	0.60	0.61	0.64	0.65
GBP per NZD	0.51	0.48	0.46	0.47	0.48	0.48	0.49	0.50
AUD per NZD	0.96	0.97	0.96	0.97	0.95	0.94	0.94	0.94
JPY per NZD	73.3	59.2	53.9	58.0	61.2	63.4	67.5	68.5
EUR per NZD	0.60	0.51	0.47	0.51	0.53	0.54	0.57	0.58
CNY per NZD	4.71	4.12	3.93	4.12	4.25	4.30	4.50	4.57
TWI - 17 country	73.8	65.1	62.1	64.7	66.2	66.7	69.0	69.9

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