ASB

Economic Note

COVID-19 and possible paths ahead for the NZ economy

16 April

Possible paths in an uncertain future

- There are a number of possible paths for the NZ economy. The range of outcomes is wide.
- We summarise three scenarios that capture our central view, flanked by upside and downside scenarios.
- Where the economy actual heads up is still highly uncertain. Having a degree of flexibility in your plans is paramount if you want to take advantage of the opportunities that arise. It is also vital to be informed.

Summary and Key Take-outs

The future is uncertain, much more so with COVID-19 thrown into the mix. In our earlier note on the NZ economic outlook we noted that 2020 will prove to be a challenging year, with pronounced volatility. There remain a number of unknowns not only about 2020 but for future years ahead. In such an environment, focusing on the economic story and risk profile is more important than point forecasts, which have an extremely limited shelf life at present.

Here we present three potential paths for the NZ economy.

Central scenario. This is close to our core view and consistent with a 'U' shaped recovery. A sizeable, but hopefully short-lived economic downturn ensues, with firm closures and job losses despite the best efforts of policymakers. There are moderate falls for NZ house prices. The economy settles into a modest recovery from 2021, with weaker balance sheets, caution and a softer income backbone to temper the rebound.

Upside scenario. Here the outbreak proves to more short-lived, with actions by policymakers, firms and households containing the economic hit. This is more like a 'V' shaped recovery, with a sharp-and short-lived hit to NZ economic activity and then close to a typical cyclical recovery. Impacts for NZ house prices and employment are less acute than in the central scenario.

Downside scenario. The outbreak proves to be very difficult to contain, with widespread and long-lasting disruption and economic dislocation despite the best efforts of policymakers. Falls to NZ house prices and employment are larger than in the central scenario. A larger and more drawn-out NZ and global economic downturn ensues. This is closer to a wider 'U' shaped forecast profile for the NZ economy.

Each of these scenarios will have different economic implications. Having a degree of flexibility in your plans is paramount if you want to take advantage of the opportunities that arise. It is also vital to be informed. Readers are encouraged to follow our Daily Alert, Economic Weekly and other ASB and CBA publications to keep up to speed with fast-moving economic developments. Our latest COVID-19 market stocktake, provides a layperson's guide to recent policy measures and sets out some thoughts on the NZD and NZ interest rate outlook and related strategies.

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A number of paths lie ahead

The future is (by nature) inherently uncertain. We do not know exactly where in the cycle the economy is, anticipate what shocks will hit the economy, nor fully understand its structural characteristics and longer-term trajectory of the economy. Of the shocks hitting the NZ and global economy, COVID-19 is much nastier than most. Already the health costs of the outbreak have been enormous and the economic disruption massive.

Many of us have had a crash course in trying to understand disease outbreaks and virology, but considerable uncertainties remain when it comes to assessing the economic impacts of the COVID-19 outbreak. Economic impacts will depend on key determinants including:

- The severity of the outbreak – the more severe the outbreak and the more difficult to contain it, the larger the subsequent economic disruption and likely cost.
- Containment actions taken – the longer lasting and more widespread the actions taken, including physical distancing, to prevent the spread of the outbreak, the larger the economic cost.
- Policy offset – the more effective the actions by global central banks and fiscal policymakers to mitigate the impacts of the outbreak, the lower the economic cost.
- Other factors– 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. The more flexible and adaptable the economy to cope with the changed landscape posed by COVID-19, the better the economy will be able to cope and the lower and less protracted the economic hit.

As we highlighted in our previous forecast note on the impacts of COVID-19, there are a number of potential paths for the NZ economy. The range of outcomes is wide. Here we provide three quite different, but still plausible, scenarios for the NZ economy. We have updated our central scenario to reflect more recent developments. To give you an idea of the range of potential outcomes, we have come up with plausible upside and downside scenarios that illustrate the sensitivity of the outlook to shifts in some key determinants. A list of some of the key judgements and assumptions used in each scenario are in the table below. We also include a summary table at the end of this note that compare different macroeconomic variables and some financial market forecasts across the 3 scenarios.

Table 1: Scenarios

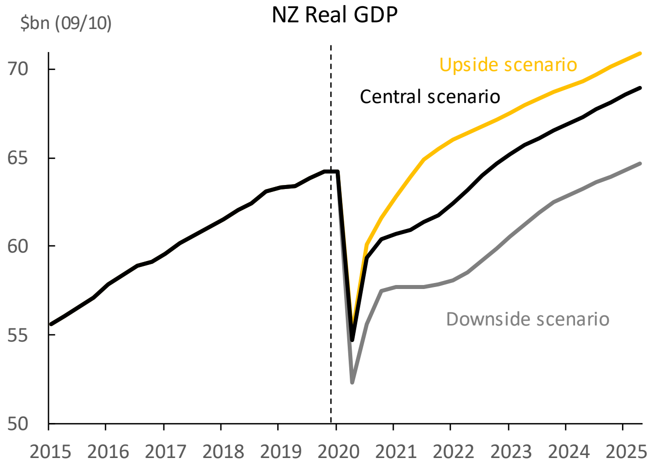
COVID-19 presence	World economy	NZ lockdown and other restrictions	Impacts on NZ economy	Policy offsets	NZ economic impacts
Upside Scenario					
Minor, easily contained outbreaks.	Short-lived hit to global growth, but recovery in 2020H2. Strong rebound over 2021.	NZ lockdown contains outbreak. Alert level 4 progressively eased after 4 weeks. Travel restrictions eased from 2020H2	Lockdown temporarily weighs on domestic demand, with consumer spending down and some firms shelving capex. NZ visitor arrivals slowly recover from H2 2020. Little impact on Terms of trade (ToT). Economy rebounds in 2002 H2 and momentum builds over 2021.	Highly effective	Circa 4% fall in GDP over 2020. Minimal impact on house prices. Limited firm closures and job losses. Short-term impact on credit growth, employment and unemployment rate. OCR moves up and the NZD firms.
Central Scenario					
Periodic outbreaks with virus progressively contained.	Global recession 2020 (-2.6% yoy), gradual recovery from early 2021 (+3% yoy).	NZ lockdown mostly effective. Level 4 restrictions gradually ease from late April. Travel restrictions eased 2021. Some potential for flare-ups and regional lockdowns.	Sharp dip in Q2 GDP, but economy subsequently expanding. Despite considerable policy stimulus, recovery modest by historical standards, given weaker balance sheets, low investment opportunities, uncertainty.	Medium impact	Circa 6% fall in GDP over2020. House prices down 6%. Greater firm closures and job losses. Unemployment rate approaches 9% by late 2020, and subsequently declines. Inflation and OCR remain low. Weaker credit demand outside of working capital requirements.
Downside Scenario					
Outbreak spreads globally with outbreaks until vaccine developed – mid to late 2022	Deep global recession over 2020 and into 2021. Gradual 2022 recovery.	Periodic outbreaks in NZ extend lockdown. Travel restrictions and border controls until well into 2021. Widespread disruptions to exports/imports. Physical distancing	Large and protracted impact of domestic demand with consumer spending weak and capex shelved. Large & persistent fall in ToT. NZD and NZ interest rates lower until global/NZ economy stabilises. Risk/credit spreads persistently wider impacting bank funding costs.	Limited impact	More than 10% fall in GDP. 10%+ house price falls. Substantial and widespread firm closures and job losses. Unemployment rate 10%+ Slump in credit demand outside of emergency funding. Increased impairments.

Source: ASB

Central scenario

This is our view of the most likely path for the NZ economy. It assumes that the impacts of COVID-19 on the NZ and global economies are significant but will hopefully prove to be short-lived. Recent signs indicate that efforts to flatten the curve (slow the advance of the outbreak) look to be bearing fruit, both globally and in NZ. Nevertheless, COVID-19 is expected to deliver a significant global hit. Widespread economic lockdown measures put in place look set to see the global economy shrink. We expect the global economy to contract by close to 2 ½% over 2020 before a modest 3% rebound for 2021.

The Level 4 lockdown will be gradually relaxed a week or so after April 23, with a gradual relaxation in Alert levels over the next few months. The NZ economy is expected to experience a sizeable economic contraction in Q2 but pent-up demand and the restarting of activity will trigger a rebound in 2020H2. Falls in business investment will be more sizeable given the hit to demand and subsequent recovery more gradual as capacity pressures recede. We envisage that the NZ economy will contract by roughly 6% over 2020, before pent-up demand, policy stimulus triggers a moderate recovery. The level of real GDP moves above pre-crisis levels in late 2022 (see chart).



Source: Statistics NZ, ASB

COVID-19 is set to deliver a significant hit to the demand for labour. Despite Government support, there will be significant firm closures and job loses, with the unemployment rate expected to approach 9% later this year. Recovering economic activity will push the unemployment rate towards 6% by the end of 2023. House prices are expected to fall, with nationwide house prices to be around 5-6% below their likely March 2020 peak. Falls could have been much larger in the absence of government policies to reduce job losses and offer mortgage relief. The outlook is for house prices to flatline over 2021 given the uncertain economic backdrop, reduced job security, and low wage growth.

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 low oil prices and a weaker economic backdrop on the one hand and the lower NZD and potential rises in retail food prices on the other. Growing spare capacity and weak wage inflation will drag annual headline inflation towards 1% by early 2021.

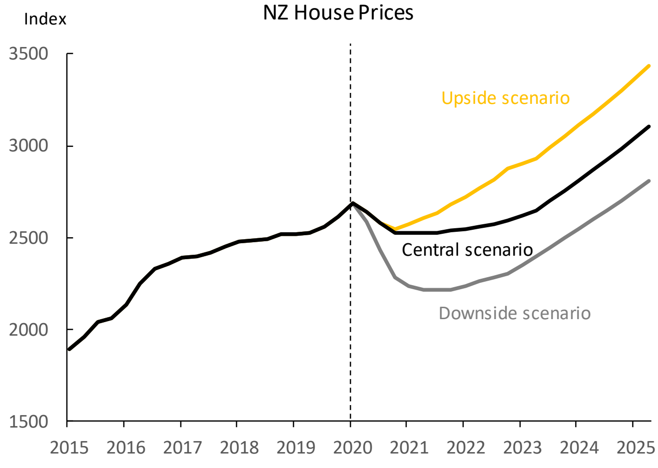
We assume that policy support will help mitigate the economic hit. The OCR is unlikely to move above 0.25% until 2024. It could move lower. We assume a fiscal package of around $20bn, spread largely over the June 2020 and 2021 years. Net public government debt is expected to climb towards 50% of GDP in the next few years. This will be partly funded by increased asset purchases by the Reserve Bank (RBNZ). We assume the RBNZ Large Scale Asset Purchase Programme (LSAP) will grow from $33bn to more than $50bn in the coming months.

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.

Upside scenario

Here we put on our rose-tinted glasses and assume that just about everything goes right. The COVID-19 outbreak, while nasty, is not as virulent as initially feared. Global cases of the outbreak stabilise and then ease as containment measures prove effective. There are only occasional mild flare-ups, which impose only modest economic disruption. The Chinese economy quickly restarts from its early 2020 slump, with wider trading partner activity well onto the road to recovery in the second half of 2020. NZ's Terms of Trade are expected to remain around record highs, with strong demand for NZ goods exports. International visitor arrivals are expected to progressively recover from later this year as different overseas markets get on top of the outbreak.

In NZ, the Level 4 lockdown contains the spread of the outbreak, with Alert levels progressively scaled down from April 23 throughout the country. The disruption to economic activity as not as large as previously feared. Demand for essential goods and services is strong. Moreover, firms and workers in non-essential activities quickly adapt to new ways to working, with less severe impacts on activity. The economy will emerge from the lock-down with more impetus, with pent-up demand triggering a rebound in demand after the lock-down ends. Actions by the RBNZ and Government prove effective in cushioning the economy and minimising job losses and boosting subsequent economic activity. NZ GDP moves above pre-crisis levels by the second half of 2021.



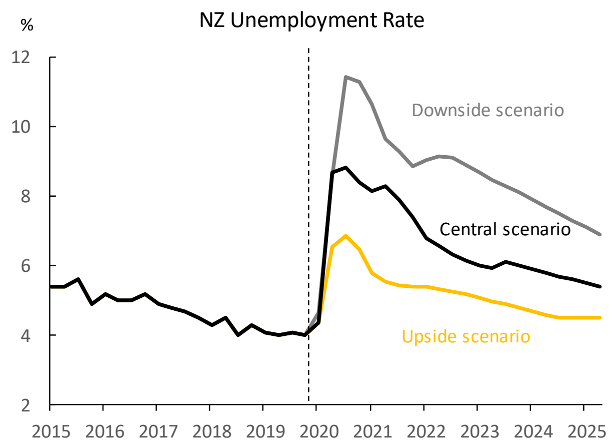
Source: QV, ASB

The unemployment rate is expected to peak at just under 7% this year and steadily decline thereafter. House prices fall about 5% but move above pre-COVID-19 peaks by mid-2022 and continue to strengthen thereafter (see chart). Inflationary pressures start to firm and the OCR starts to move up from early 2021, ending 2024 at 1.25%. Wholesale interest rates start to firm from late 2020/early 2021, with the yields rising across the curve. Improving global sentiment will result in markets reassessing the outlook, with risk and credit metrics improving. Global equities rebound, the NZD rises, and financial conditions relax with improved credit availability and a lower cost of funds and lower credit spreads.

Downside scenario

Just about everything that can go wrong, does in this scenario. COVID-19 proves to be very difficult to contain, with regular flare-ups across the globe causing widespread, longer-lasting and sizeable economic disruption and economic dislocation. The rebound in Chinese economic activity is short-lived, with a deep global recession over 2020 and into 2021. The NZ Terms of Trade fall, with global consumers reallocating expenditures to cheaper alternatives and reducing demand for non-essential items.

In NZ, a resurgence of new cases sees the Level 4 lockdown extended to the end of May, with some regions exiting later. The impacts of the lockdown persist for longer, with firms and households remaining in hibernation. GDP declines by around 10% over 2020. Job losses and firm closures are large and will temper the rebound from pent-up demand. A more sizeable contraction is expected for domestic demand, with consumption spending sharply lower and business investment down by one-fifth over 2020. The recovery will be sluggish over 2021 and beyond given hits to economy-wide balance sheets, and the impact of continued disruptions from the outbreak on lowering productivity growth. It will not be until early 2025 that the level of real GDP is back above pre-crisis levels.



Source: Statistics NZ, ASB

Furthermore, policy actions prove to have less of a supportive impact than envisaged. The unemployment rate moves into double-digits in late 2020 and only gradually declines thereafter, ending 2022 at around 9% and only gradually drifting lower thereafter (see chart). House prices are expected to fall, with nationwide house prices down over 15%

from their likely March 2020 peak. House prices will not move above pre-crisis levels until late 2024.

Inflationary pressure is expected to be dormant, with the large margin of economic slack, subdued wage growth and limited pricing power likely push CPI inflation below the lower bound of the RBNZ's 1-3% inflation target. The RBNZ will move the OCR lower, moving slightly into negative territory from later this year. The OCR is unlikely to move back to its current 0.25% level until mid-2024. The RBNZ is expected to pull out all of the stops, including significantly expanding its Large-Scale Asset Purchase Programme. This will help to arrest the climb in yields that would have occurred given the large run-up in public debt. Increased risk aversion posed by the outbreak holds down the NZD and restricts credit availability and increases the cost of funds. Global equity markets fail to build upon their recent recovery.

NZ Economic Scenario Summary Tables

Economic forecasts			**June years**					**Annual Change over Calendar year**	
	2020	2021	2022	2023	2024	2025	2020	2021	2022
	Estimate	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast	Forecast
NZ GDP growth (annual average)									
Central fcasts	-2.1	-2.8	2.6	4.7	2.9	2.4	-6.2	1.5	5.0
Upside scenario	-1.9	-1.9	5.8	2.5	2.2	2.1	-4.0	6.3	2.5
Downside scenario	-3.0	-6.6	1.6	3.7	4.0	2.4	-10.5	0.6	3.6
Business Investment growth (annual average)									
Central fcasts	-6.3	-2.1	2.7	6.9	4.8	4.5	-7.7	0.8	7.3
Upside scenario	-6.3	-6.3	12.0	4.2	3.6	3.4	-7.6	12.0	4.2
Downside scenario	-8.6	-16.7	0.1	9.9	10.5	4.5	-22.7	-2.3	8.7
Employment (annual average)									
Central fcasts	-0.6	-5.1	2.8	2.8	2.1	2.0	-6.6	2.6	3.0
Upside scenario	-0.2	-0.2	3.6	1.7	1.5	1.5	-3.9	4.1	1.7
Downside scenario	-0.9	-8.5	2.1	2.3	2.4	2.0	-10.5	2.6	2.1
Unemployment rate (Q2)									
Central fcasts	8.7	8.3	6.6	5.9	5.8	5.4	8.4	7.4	6.1
Upside scenario	6.6	6.6	5.3	5.0	4.6	4.5	6.5	5.4	5.2
Downside scenario	8.6	9.7	9.1	8.5	7.7	6.9	11.3	8.9	8.9
House Price Growth (annual)									
Central fcasts	4.5	-4.4	1.5	3.4	8.2	8.2	-3.6	0.6	2.3
Upside scenario	4.5	4.5	6.3	5.9	8.2	8.2	-2.6	5.1	7.3
Downside scenario	2.4	-14.3	2.0	6.1	8.2	8.2	-12.7	-3.0	4.1
Consumers Price Index (annual)									
Central fcasts	1.7	1.3	1.2	1.4	1.7	1.9	1.1	1.3	1.3
Upside scenario	1.8	1.7	1.8	1.9	2.0	2.1	1.4	1.8	1.9
Downside scenario	1.6	0.8	0.8	1.0	1.3	1.4	0.8	0.9	0.9
OCR (Q2)									
Central fcasts	0.25	0.25	0.25	0.25	0.50	0.75			
Upside scenario	0.25	0.25	0.50	0.75	1.00	1.25			
Downside scenario	0.00	-0.25	-0.25	0.00	0.00	0.25			
10y NZ Bond (Q2)									
Central fcasts	1.40	1.40	1.40	1.45	1.50	1.50			
Upside scenario	1.50	1.50	2.00	2.00	2.00	2.00			
Downside scenario	1.35	1.25	1.25	1.25	1.25	1.25			
NZD/USD (Q2)									
Central fcasts	0.55	0.64	0.65	0.66	0.66	0.66			
Upside scenario	0.61	0.67	0.69	0.70	0.70	0.70			
Downside scenario	0.52	0.53	0.54	0.57	0.57	0.57			
NZD TWI (Q2)									
Central fcasts	63.7	71.9	71.7	72.6	73.1	73.1			
Upside scenario	68.8	74.0	73.9	74.8	75.3	75.3			
Downside scenario	60.5	61.8	62.4	65.4	63.5	63.5			

Source: ASB

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