# Economic Weekly

16 March 2020

## Kitchen sink response time

**Events have changed rapidly** – particularly with NZ's effective border closure. Both the RBNZ and Government will act strongly to support the economy. It is also important that businesses and the broader public get prepared.

The past week's COVID-19 developments have been rapid. For NZ, the effective closure of the border is a complete game changer for the economy: the effects will start becoming very evident over coming weeks. International tourism is NZ's second-biggest export sector, at over $13 billion a year and 16% of total exports. Other more broader impacts will flow through to the economy as people and businesses take added precautions.

**The economy will get support to help combat a recession**. The Government will release details of a large fiscal package tomorrow. It is critical that the Government quickly gets cash into the hands of those that are going to be most affected by the decision to shut the border.

**The RBNZ has already cut the OCR by 75bp to 0.25%**, and stands ready to provide more support if needed. Any further near-term action would likely come through extensive buying of NZ government bonds. That would both help keep NZ interest rates low and work in with fiscal policy. The Government will need to issue many billions in bonds over the next few years.

One silver lining is that our key goods exports to China should increasingly recover from the huge disruption created by China's extreme lockdown.

**It is important for businesses to be prepared** for dealing with COVID-19 and its potential impacts on your business. We recently published a couple of Notes giving thoughts on general preparedness and on considerations for financial market participants (also covered in this Weekly). For our broader customer base, we included some brief comments at the end of this morning's Note on the RBNZ decision.

These are times when events can cause rapid shifts in situations, laced with tinges of concern about personal safety. It is important to keep calm and focused. We will be working to quickly update our economic forecasts to give people some guidance as to how the economy will be impacted by the virus outbreak and the extreme measures being taken to slow its spread. For the time being we will also collate together in the Weekly our relevant work on COVID-19 for easy reference. nick.tuffley@asb.co.nz

## Coronavirus publications

RBNZ OCR cut March 16
COVID-19: Market impacts, responses, and ideas
Thinking about coronavirus impacts on business: Be prepared – it doesn't hurt
COVID-19: events timeline to watch
Coronavirus economic impacts (from China's outbreak)

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## Foreign Exchange Market

| FX Rates | Current* | Week ago | Month ago | Year ago | ST Bias | Support^ | Resistance^ |
|---|---|---|---|---|---|---|---|
| NZD/USD | 0.5998 | 0.6250 | 0.6433 | 0.6843 | DOWN | 0.5950 | 0.6150 |
| NZD/AUD | 0.9760 | 0.9583 | 0.9571 | 0.9658 | FLAT | 0.9700 | 0.9990 |
| NZD/JPY | 64.20 | 64.03 | 70.63 | 76.40 | DOWN | 62.00 | 66.00 |
| NZD/EUR | 0.5417 | 0.5474 | 0.5937 | 0.6047 | DOWN | 0.5300 | 0.5500 |
| NZD/GBP | 0.4890 | 0.4778 | 0.4931 | 0.5166 | DOWN | 0.4600 | 0.5000 |
| TWI | 68.6 | 69.2 | 71.4 | 74.25 | DOWN | N/A | N/A |

*^ Weekly support and resistance levels * Current as at 9.30am today; week ago as at Monday 5pm*

### Recap

Having previously sailed through the COVID-19 crisis relatively unscathed, the NZD/USD had its Wile E. Coyote moment last week, plunging almost 4 cents. As we'd expected, the increased yield appeal of the NZ dollar, via widening NZ-US interest rate differentials, was eventually swamped by spiking risk aversion and volatility.

Traditional 'safe-haven' currencies like the USD, JPY, and CHF outperformed. Notably, a good chunk of the USD's strength was thanks to a global liquidity squeeze as folk scrambled for US dollars, something central banks globally are now addressing through provision of USD liquidity facilities.

This morning's emergency rate cuts from both the RBNZ (75bps) and US Federal Reserve (100bps plus an extra US$700b of quantitative easing) have seen NZD volatility continue. Having briefly traded below 0.6000 after the RBNZ decision, the currency is now back up above 0.6100. NZD implied volatility, a key input into options pricing, has spiked. NZD/USD 6-month volatility has leapt to 16% from 7% in mid-February, the highest since 2011.

We have also seen a slight impairment in market conditions. The shock factor and fear of additional emergency actions here/offshore has seen bid/offer spreads move out and liquidity conditions worsen. There's also a strong likelihood that we'll see Asian central banks step up this afternoon with similarly aggressive actions, thus we suspect market conditions will remain fragile in the short term.

### Outlook

It's difficult to say anything sensible about the outlook for currencies in the midst of an extreme global shock. We put out a note last week (here) outlining some of the impacts of the COVID-19 disruptions on corporates with financial markets exposures, as well as some of our own ideas on managing financial markets exposures during these increasingly uncertain times.

Simultaneous global and NZ economic recessions have typically not been kind to the NZ dollar in the past, thus downside risks continue to surround the currency. However, as discussed in the note, now is not the time to base a hedging strategy off forecasts for the NZ dollar or interest rates. More important will be addressing any overhedges in your business, stress testing exposures, and potentially pausing any hedging programmes until the fog clears a little. Trading conditions will remain difficult and volatility elevated.

mike.jones@asb.co.nz

## Interest Rate Market

| Wholesale interest rates | Current | Week ago | Month ago | Year ago | ST Bias | MT Bias |
|---|---|---|---|---|---|---|
| Cash rate | 0.25** | 1.00 | 1.00 | 1.75 | UNCH | UP |
| 90-day bank bill | 0.90 | 0.87 | 1.21 | 1.88 | UNCH | UP |
| 2-year swap | 0.84 | 0.72 | 1.14 | 1.84 | UNCH | UP |
| 5-year swap | 0.96 | 0.74 | 1.23 | 1.97 | UNCH/UP | UP |
| 10-year swap | 1.17 | 0.96 | 1.51 | 2.37 | UNCH/UP | UP |
| 10-year govt bond yield | 1.15 | 0.84 | 1.37 | 2.07 | UNCH/UP | UP |
| Curve Slope (2s10s swaps) | 0.33 | 0.23 | 0.37 | 0.53 | UNCH/UP | DOWN |

** Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged*

*** Effective 17th March 2020*

### Market Recap

**NZ yields for short-term tenors fell to record lows, with the yield curve steepening.** Falls in NZ yields outpaced global counterparts, after the RBNZ cut the OCR by 75bps to a record low 0.25% this morning after an extraordinary session of the monetary policy committee. The justification for the cut was to offset the negative consequences of the COVID-19 outbreak and followed the decision by the NZ Government to impose strict travel and quarantine restrictions. Moreover, the RBNZ signalled that 0.25% would likely be the effective operational floor of the OCR for the time being and pledged to hold the OCR at this level for at least 12 months. The RBNZ meeting of record cited that this guidance would provide clarity to financial market participants and that a negative OCR would not be implemented over this period.

**There were also aggressive interest rate cuts by other central banks**. This morning, the US Federal Open Market Committee (FOMC) cut the fed funds rate by 100bps (to 0% to 0.25%). The FOMC announced that it will be conducting $700bn in asset purchases in the next few months, including $500bn in US Treasuries and $200bn in mortgage-backed securities. The Bank of Canada cut their policy rate by 50bps last week, taking cumulative cuts to 100bps this month. Last week, the Bank of England cut their cash rate by 25bps to 0.25%.

**Policy makers have also been active to ensure access to liquidity in markets.** The RBA, People's Bank of China, European Central Bank (ECB), and Fed have expanded liquidity operations or conducted other measures to keep markets operating. his morning it was announced that the Fed, Bank of Canada, Bank of England, Bank of Japan, ECB and Swiss National Banks will take coordinated action to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements.

### Near-term NZD interest rate outlook

**Global policy makers have thrown the kitchen sink** to try and offset the impact of the COVID-19 outbreak, and we expect markets will remain skittish and will be driven by COVID-19 headlines. Tomorrow sees the baton being passed, and we will see a sizeable, timely fiscal programme announced by the NZ Government tomorrow, with the focus on limiting job losses. This will not come cheap, and we expect the $81bn government bond portfolio to get a lot, lot bigger over the coming years. The RBNZ has signalled their next move will likely be undertaking large-scale asset purchases of NZ Government bonds, capping the upside to yields.

An intra-meeting 25bp cut by the RBA is highly likely prior to the April RBA meeting. We could also see further communication from the RBA on its Unconventional Monetary Policy Plan, including QE and forward guidance. We will be watching financial markets for signs of stress in liquidity and funding markets and expect the recent widening in spreads to remain. Spreads between 90-day bank bills (about 0.65% for 90-days) and the OCR are currently 40bps, and credit spreads for NZ assets (Australian iTraxx 5-year credit default swaps) have widened by close to 100bps over the last month.

### Medium-term outlook

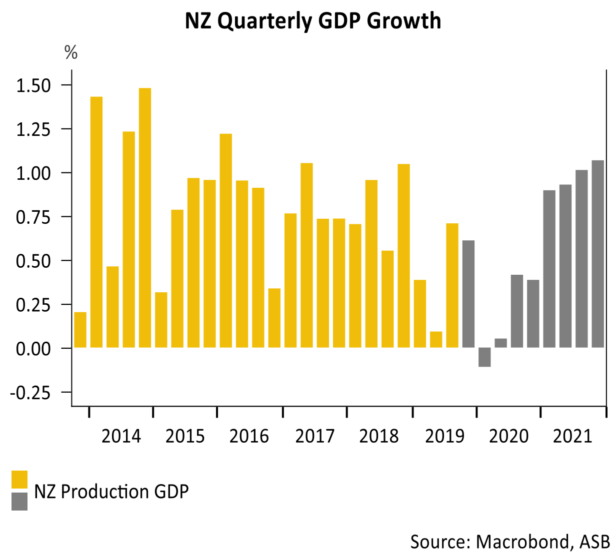
**Central bank policy rates are expected to maintain highly accommodative settings** to offset the sizeable hit from the COVID-19 outbreak. Our medium-term bias is for policy rates to fall to effective lower bounds, with central bank actions to provide significant liquidity to markets, and potentially include the rolling out of unconventional policy support measures. We expect markets to become selective in pricing risks, with swap, credit and corporate bond spreads to remain elevated. Low inflation, weak global growth and negative risks should cap NZ and global long-term interest rates at low levels.

mark.smith4@asb.co.nz

## Domestic events

| Data | Date | Time (NZT) | Market | ASB |
|---|---|---|---|---|
| GlobalDairyTrade auction, whole milk powder, % change | 17/3 | overnight | - | -7.0 |
| Current Account balance, Q4, % of GDP | 18/3 | 10:45am | -2.8 | -3.1 |
| GDP, Q4, %qoq | 19/3 | 10:45am | 0.5 | 0.6 |

**We expect whole milk powder (WMP) prices to slide circa 7.0% at the GlobalDairyTrade auction overnight Tuesday**. We marginally less pessimistic than the futures market. Current pricing there suggests a fall of around 9%. The now rapid global spread of COVID-19 is sending shockwaves commodity markets. This suggests that the rebound in global dairy prices may take longer than we had expected previously. Note there is a wide range of possible results around our estimate at this auction. China is gradually re-opening for business at the same time Europe and the US is shutting. These factors are pushing and pulling global dairy prices in opposite directions.




**We expect NZ's current account deficit to narrow to 3.1% of GDP over Q4**. The Q3 deficit was unchanged at 3.3% in Q3. Q4 export values were strong as meat export prices set record highs. Looking to the first half of 2020, we expect the deficit as a % of GDP to widen as COVID-19 impacts the goods and services balance.

**We expect quarterly GDP growth of 0.6% vs the RBNZ's February MPS forecast of 0.4%.** The partial indicators for Q4 GDP were somewhat stronger than we had expected given the low level of business confidence and business activity indicators which prevailed over the quarter. The COVID-19 outbreak over the early months of 2020 has reshaped the NZ and global economic outlook, making Q4 2019 GDP outdated information and its publication will likely have little to no impact on financial markets and carry limited implications for policy makers. Uncertainties are very high and it's likely the New Zealand economy will contract over H1 2020.

## Major International Events for the week ahead*

| Data | Date | Time (NZT) | Market | ASB |
|---|---|---|---|---|
| China Retail Sales, Jan-Feb, %yoy | 16/03 | 3:00 pm | -4.0 | -6.0 |
| RBA Board March Meeting Minutes | 17/03 | 1:30 pm | - | |
| AU CBA Household Spending Intentions, February | 17/03 | - | - | - |
| US Retail Sales, February, %mom | 18/03 | 1:30 pm | 0.2 | -0.2 |
| RBA Asst. Gov. Ellis speech | 18/03 | - | - | |
| Australia Unemployment, February, % | 19/03 | 1:30 pm | 5.3 | 5.4 |
| Bank of Japan Interest Rate Announcement, % | 19/03 | - | -0.1 | -0.1 |

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The Lunar New Year in **China** is usually a peak season for consumption. But radical virus containment measures have hit consumption the hardest. We expect **retail sales** to contract 6%yoy over January-February with business shutdown extended much longer than usual. We also expect industrial production and fixed asset investment fell 4%yoy and 3%yoy, respectively.

The **Reserve Bank of Australia (RBA)** cut the cash rate 0.5% at the March meeting due to the economic impact of the global coronavirus outbreak. Since then, the central bank has further detailed the economic impact of coronavirus on the Australian economy, although there are clear downside risks to these forecasts. Of note in the **March Minutes** will be any comments around the RBA's expectation of unconventional monetary policy. Deputy Governor Debelle outlined in his speech "The Virus and the Australian Economy" that a *price not quantity* method of quantitative easing will be employed. This would mean the RBA would focus on buying government bonds to keep the yield at a certain rate rather than committing to buying a certain dollar value of bonds. We expect the RBA to outline further details at its April Board Meeting.

The January readings from **CBA's Household Spending Intentions (HIS)** indicators confirmed the expected initial impacts of coronavirus on the consumer: reduced tourism and education. This has continued in February with falls in both education and tourism components. Spending intentions over February will provide a read on the effects of coronavirus.

**RBA Assistant Governor Luci Ellis will be delivering a speech** at the Urban Development Institute of Australia (UDIA). She will likely reiterate the RBA's view on the economy and coronavirus. Given the property-related audience, comments on the housing market may be possible.

In January, **Australia's unemployment** rate rose from 5.1% to 5.3% and the underemployment rate also ticked up to 8.6% in January. We expect weak employment growth in February of 10k jobs, which will see the unemployment rate rise to 5.4% on an unchanged participation rate of 66.1%. There are clear downside risks to the labour market due to the economic impact of the coronavirus.

**We expect the Bank of Japan will leave interest rates on hold at -0.1%.** However, we expect the BoJ will introduce measures to offset some of the negative impacts on Japan's equity market and tightening financial conditions because of the coronavirus. In particular, we expect the BoJ may increase its purchases of exchange-traded funds.

The 3% fall in **US** gasoline prices suggests **retail sales** fell in February. However, the strong labour market and resilient consumer confidence will have supported 'control' sales. We expect retail sales to weaken further in coming months because of fears about the coronavirus.

| ASB Economics & Research | | | Phone |
|---|---|---|---|
| Chief Economist | Nick Tuffley | nick.tuffley@asb.co.nz | (649) 301 5659 |
| Senior Economist | Mark Smith | mark.smith4@asb.co.nz | (649) 301 5657 |
| Senior Economist | Jane Turner | jane.turner@asb.co.nz | (649) 301 5853 |
| Senior Economist | Mike Jones | mike.jones@asb.co.nz | (649) 301 5661 |
| Senior Rural Economist | Nathan Penny | nathan.penny@asb.co.nz | (649) 448 8778 |
| Senior Economist, Wealth | Chris Tennent-Brown | chris.tennent-brown@asb.co.nz | (649) 301 5915 |
| Publication & Data Manager | Judith Pinto | judith.pinto@asb.co.nz | (649) 301 5660 |

**www.asb.co.nz/economics**

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