Quarterly Economic Forecast

February 2020

Hoping for some immunity

- The NZ economy was showing signs that it was turning up heading into the New Year.
- Coronavirus will cause a sharp and – we hope – short jolt to the economy in the first half of the year.
- Both the RBNZ and the Government are well placed to provide support if the outbreak has prolonged impacts.

Well, things were starting to look OK heading into the start of the New Year. Businesses were putting their heads above the parapets; households were rushing to open home viewings with a stopover at the mall on the way home. The Government figured out it could borrow cheaply to build roads, while Auckland Transport cheered up commuters with its amped-up "Orange Road" campaign. Donald Trump and Boris Johnson were settling down their respective patches. A warm summer beckoned, along with a gradual lift in economic growth back to a respectable pace.

The outbreak of coronavirus COVID-19 has turned the first half of the year, at least, on its head. Avoidance behaviour and China's extreme isolation measures are both markedly affecting China's economy and starting to cause disruption to global supply chains. The most evident impacts for NZ are the entry bans for NZ non-residents that have come from or transited through China. February and March are when nearly a quarter of our annual visitors from China come and normally spend about $400 million. Forestry and seafood are other sectors feeling abrupt drops in demand.

Globally, the ramifications are growing. China's role as the world's factory is meaning some retailers are now struggling to replace stock. Some factories outside of China that are dependent on Chinese-made parts are being idled. Logistics chains have been disrupted in the short term at least.

So, where to from here? As we discuss in our document, the impact of viral outbreaks tends to be sharp (as people metaphorically hunker in their bunker) but also short. That is our working assumption, which sees economic growth grinding to a halt in early 2020 but rebounding over the second half of the year. Only time will tell if the 'short' part of that assumption is right. New confirmed cases of COVID-19 are slowing in China, but lifting elsewhere.

What can people do? Generally, keep calm and carry on. We tend to be overly cautious around new and ill-understood risks, which is what this virus is. We probably worry more about being attacked by sharks (6 deaths a year globally) than we worry about dying on the drive to the beach (353 deaths on NZ roads in 2019): one risk we are less familiar with, one we subconsciously accept on a routine basis. Businesses and their advisors should be vigilant for shifts in demand patterns, check in with key suppliers to understand their exposures to Chinese-sourced products, and map out alternative customers or suppliers if practical. And for anybody heavily affected, talking to their bank sooner rather than later will keep open more options for sustaining through the disruption.

The disruption from the virus will eventually settle. That will be an opportune time to review or develop contingency planning for a range of business risks, and consider the benefit and costs of diversifying export markets and suppliers.

COVID-19 watch: Potential volatility ahead

The COVID-19 coronavirus represents a dark cloud on the domestic and global outlook. The number of confirmed cases from COVID-19 – at present, around 80,500 in 40 countries – has easily exceeded the roughly 8,000 worldwide cases reported in the 2003 severe acute respiratory syndrome (SARS) outbreak. The mortality rate of the COVID-19 coronavirus looks to be low (around 2,700 deaths reported to date), but its long incubation period (up to 14 days) makes early detection and containment difficult.

Viral outbreaks typically result in a sharp, but relatively brief, shock to both the NZ and global economies. Outcomes are highly sensitive to the location, severity and duration of the outbreak and measures taken to control it. What makes the outbreak so important is that the epicentre of the outbreak, **China, is both the growth engine for the global economy and New Zealand's largest trading partner**. More than 10% of the Chinese population at the peak of the outbreak were reportedly living under Government restrictions of how often they can leave their homes. Already there are signs of a larger proportionate hit to global tourism from the virus. Economic impacts are also occurring because of the extensive (and disruptive) efforts to contain the virus that will impede the movement of exports and imports of goods and services.

So far, the COVID-19 coronavirus has not been confirmed in NZ. As such, the economic impacts of the outbreak are likely to be more prevalent for trade-exposed sectors. There has been extensive media coverage of the outbreak. The risk is that the outbreak has a more widespread impact on NZ economic activity if it triggers changes in household, firm and government behaviour.

For the NZ export and import sectors, the impacts are likely to be uneven. There could be some disruption for NZ imports, given the impact of the outbreak on global supply chains. Given the timing of the outbreak around the Chinese New Year Holiday, the impacts are especially acute for the tourism and education sectors. The goods sector will be impacted to varying degrees. With this in mind, we have classified the risk to each main sector using what we consider key exposure risks (see table below).

In our view, the export sector risks are as follows:

- High risk – Forestry, Tourism, Education, Seafood and Mutton;
- Medium risk – Beef and Lamb; and
- Low risk – Dairy, Fruit and Infant Formula.

Export Sector Exposure by Key Risks

Export Sector	Share Risk	Health Risk	Place of Consumption Risk	Border/Port risk	Value Chain/Activity Risk	Timing	*Overall Risk*
Dairy	8.0	Low	Low	Low	High	Low	*Low*
Forestry	36.0	Low	Low	High	High	High	*High*
Tourism	-8.0	High	High	High	Low	High	*High*
Beef	17.3	Medium	Medium	Low	Low	High	*Medium*
Education	5.7	High	High	High	Low	High	*High*
Lamb	9.5	Medium	Medium	Low	Low	Medium	*Medium*
Fruit	-1.8	Medium	Low	Low	Low	Low	*Low*
Seafood	14.9	High	High	High	Low	High	*High*
Infant Formula	17.5	Low	Low	Low	Medium	Low	*Low*
Mutton	49.3	Medium	Medium	Low	Low	High	*High*

Share Risk: China sector share minus China total export share; the higher China's share of the sector, the higher the risk.

Health Risk: Higher risk for fresh or live products; higher risk for services where people are gathering in large groups.

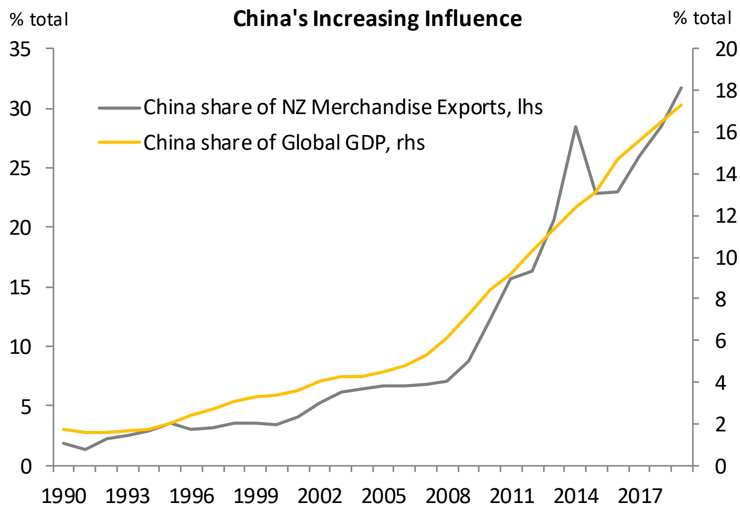
Place of Consumption Risk: Higher risk for consumption in public places; lower risk for consumption in the home.

Border/Port Risk: Higher border risk for the movement of people across borders at airports etc.; as ports prioritise goods movements, higher risk for low-priority goods.

Value Chain/Activity Risk: Higher risk for exposure to supply chains/higher risk for goods that rely on economic activity.

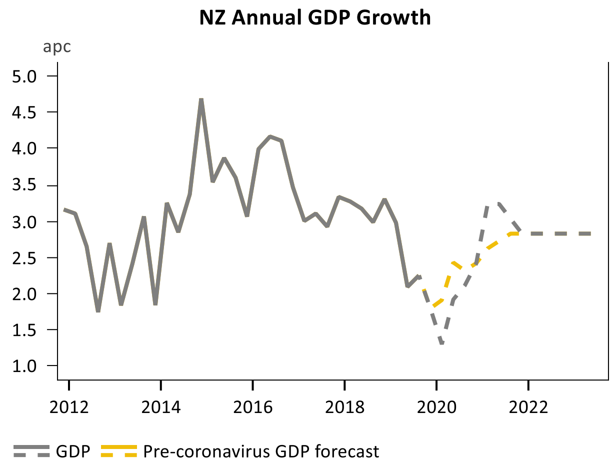
Timing Risk: Risk as it relates to the seasonality of each export sector.

The actual impact of the COVID-19 outbreak on the NZ economy is inherently uncertain and will depend on the scale and persistence of disruptions it causes. **All up, we have pencilled in a 0.6% hit to Q1 NZ GDP relative to our baseline, primarily via lower services exports** (see our note here). We assume that NZ GDP growth quickly recovers in Q2 but note the risk of longer-lasting disruptions to NZ exports and broader economic activity. The spread of the outbreak to NZ could significantly weigh on wider economic activity.



Source: World Bank, Statistics NZ, ASB

How are policymakers viewing the outbreak? It is still early days, but the Chinese government has announced and is rolling out support packages, with a number of targeted measures also unveiled by the People's Bank of China. The mantra from other overseas central banks has been to signal the willingness to respond (i.e. ease policy) if virus impacts turn out to be significant and long lasting. In the February Monetary Policy Statement, the RBNZ has decided to look through what it assumes to be a short disruption to NZ economic activity and to hold the OCR at 1% over 2020 and into much of 2021. However, the RBNZ acknowledge that a more severe and longer-lasting virus impact would likely see the OCR move lower. This remains a key risk in our view.

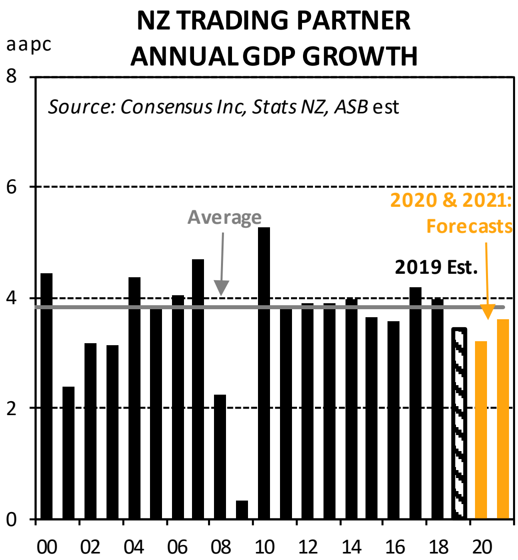


Source: Macrobond, ASB

Source: Macrobond, ASB

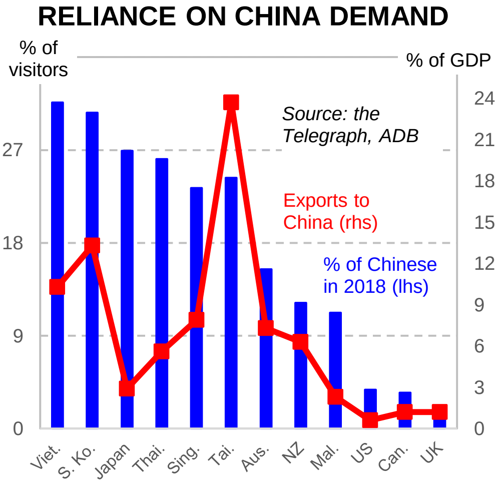
International Outlook – Coronavirus nips global growth green shoots in the bud

The global economy had been turning a corner. But now it may get worse before it gets better again. The culprit for the premature end to the uptick in global growth is, of course, the coronavirus outbreak. Normally, viral outbreaks result in short and sharp hits to the global economy. On this basis, we expect the global green shoots to return by the second half of 2020. Nonetheless, the global economy is more reliant than ever on Chinese demand and its economic growth. With that in mind, the risk is that the global slump may persist throughout calendar 2020.



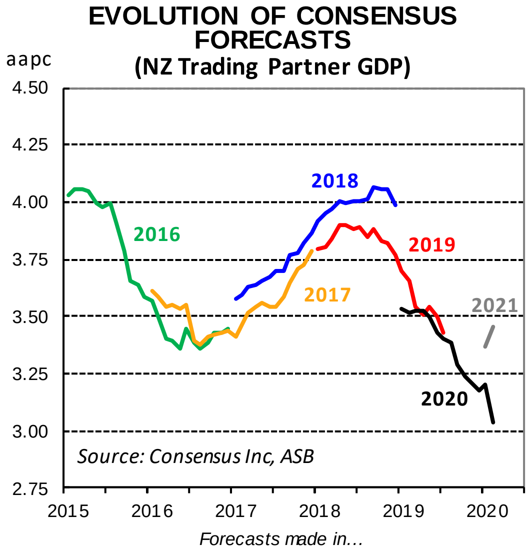
The US-China trade deal headlined the global growth green shoots earlier in the year, and latterly the long-awaited Brexit proceeded with a deal that appeased many, if not all. In data terms, the JP Morgan Global PMI, for example, ticked into expansionary territory in November and ticked up a notch further in the January release.

However, the coronavirus outbreak has brought the uptick in global growth to a premature end. Notably we have cut our Chinese Q1 growth forecast by 1.5% pts to 4.5% yoy, and expect 2020 GDP growth of 5.7%, from 5.8% previously. The relatively minor revision to 2020 Chinese growth owes to the Chinese government rolling out support packages, with a number of targeted measures also unveiled by the People's Bank of China.



More broadly, we anticipate that our trading partner growth will slow this year, mainly over the first half of 2020. At this juncture, Consensus forecasts do not reflect this view, but are likely to include material revisions to 2020 growth from next month.

The NZ export sector is materially exposed to any slowdown in Chinese growth. The chart shows that NZ is as reliant on China as Australia and considerably more reliant than the US and Canada, for example.



NZ is also exposed indirectly via Australia, our second-largest trading partner. Comfortingly, the Reserve Bank of Australia (RBA) stands ready to act. Previously, domestic growth and inflation concerns were leading many to call for interest rate cuts. With coronavirus concerns added to the mix, the call is clear cut. Indeed, we anticipate the RBA could cut interest rates as soon as next month, but more probably in April.

And other central banks and governments are providing stimulus or standing ready to. The US Federal Reserve noted in its recent meeting minutes that coronavirus has emerged as a "new risk" to the global growth outlook. Meanwhile, the ECB warned of a "pretty serious short-term hit" from the coronavirus outbreak. In addition, the Singapore government has pledged S$6.4 billion in dedicated coronavirus support for its economy.

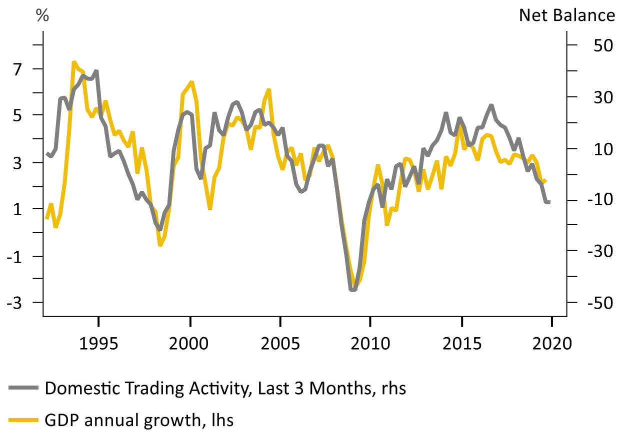
On the assumption that the appropriate stimulus is forthcoming and that the outbreak proves short-lived, **the global green shoots should soon return**. Nonetheless, the situation is fluid and uncertainties remain high. Watch this space.

The New Zealand Economy – Covid-19 delays economic growth pick-up

Economic growth decelerated over 2019, with recent historical revisions by Statistics NZ showing economic growth slowed faster than previously published. Annual growth fell from 3% at the start of 2019, to 2.3% in the September quarter. **The slowdown in economic growth was mostly felt in the services sector, as growth in agricultural and goods production largely held up over the past year.** Indeed, NZ's merchandise exporters continued to perform well over 2019: demand for NZ's food exports continued to strengthen, seeing merchandise export prices reach their highest level in over a decade. In contrast, the domestic services sector struggled with the growth slowdown largely centred in the financial and insurance sector, business services, wholesale trade and transport, postal and warehousing industries.

Toward the final months of 2019, business confidence measures started to stabilise (albeit at levels still consistent with below-trend growth). The ANZ monthly survey of business confidence lifted over November and December, pointing to a pick-up in economic growth. However, other more reliable indicators of economic growth, such as the NZIER Quarterly Survey of Business Opinion, did not mirror this pick-up in the monthly ANZ survey and suggest business confidence remains low. Other activity indicators were still consistent with very little economic growth. The BusinessNZ PMIs were mixed, with the services index improving early in 2020 (pre-Covid-19 outbreak), but the manufacturing index remaining sluggish.

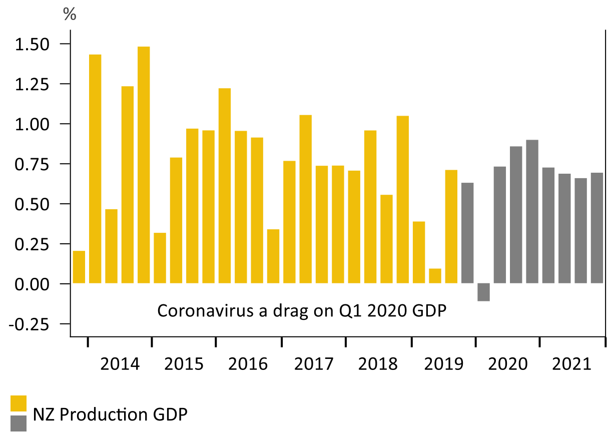
Annual GDP growth and QSBO Domestic Trading Activity



Source: Macrobond, ASB

Prior to the outbreak of Covid-19 we had expected economic growth to gradually accelerate over 2020 as the impact of lower interest rates stimulated the economy. There were some early encouraging signs, including the pick-up in the housing market and electronic card spending. But ASB remained cautious given the continued weakness in business confidence and given we had yet to confirm a pick-up in broader economic demand outside of housing. The outbreak of Covid-19, which at the time of writing remains a developing situation, significantly alters the outlook. The measures put in place to try control and limit the spread of the virus outbreak have disrupted economic activity and are likely to temporarily halt economic growth in NZ (for further detail of the likely economic impacts of Covid-19 outbreak, see our special topic on Page 2). **However, we hope (perhaps optimistically) that the disruption is reasonably short lived, and that the economy quickly returns to business as usual.**

NZ Quarterly GDP Growth



Source: Macrobond, ASB

Prior to the Covid-19 outbreak, the Reserve Bank of New Zealand (RBNZ) was hitting its dual targets of price stability and maximum sustainable employment. The labour market has performed well over 2019, with the unemployment rate trending around 4% and wage inflation starting to edge higher. Meanwhile, recent consumer price data indicated that measures of core inflation have clustered around the 2% mid-point of the RBNZ's target band. However, both the labour market and inflation pressures are lagging measures of economic performance. **Given the slowdown in growth over 2019 and the new headwinds to growth presenting over 2020, the risk is that the RBNZ may struggle to achieve these targets going forward and must remain vigilant**.

Interest Rates and Exchange Rates – short-term pain, long-term gain

Interest rates

We have changed our OCR call and no longer expect a 25bp cut for 2020. This is based on the conviction that the NZ economy remains reasonably well placed and the most likely course at present is for the OCR to remain at 1%. In its February Monetary Policy Statement, the RBNZ held the OCR at 1% and again showed reluctance to move settings in the future given increased fiscal stimulus and signs that the 75bps of OCR cuts in 2019 look to have stimulated the economy. Inflation was deemed as being close to the 1-3% target mid-point (not below it), with employment being at (or slightly above) its maximum sustainable level.

Our view of the balance of risks to the NZ interest rate outlook is still skewed to the downside. Like the RBNZ, we have assumed that the coronavirus will have a short-lived impact on the NZ economy. If the outbreak turns to have more longer-lasting impacts globally or if it reaches NZ, the economic hit to NZ would be greater and the OCR would likely move lower. Moreover, we remain sceptical that the NZ economy will accelerate to the degree that the RBNZ expects. Our forecasts are consistent with a period of stability in wholesale interest (swap) rates over 2020, before a gradual trend higher kicks in through 2021 and 2022.

We also expect policy interest rate cuts by other central banks over 2020. Low inflation and the downward skew of risks keep the odds tilted in favour of more policy support. The People's Bank of China is likely to unveil further stimulus measures to offset the impact of the coronavirus. We expect the Reserve Bank of Australia (RBA) to deliver 50bp of cuts over 2020 (April and August), and the US Federal Open Market Committee (FOMC) is expected to continue to trim the 1.50%-1.75% Federal Funds Rate by a further 50bp in 2020 (September and December), although risks are skewed towards the Fed remaining on hold for longer.

Foreign Exchange

The NZD has tended to underperform so far in 2020. Coronavirus fears have tended to take a heavier toll on currencies perceived as 'pro-cyclical' like the NZD. The kiwi has also been punished for NZ's close links to China and hence higher risk of economic fallout from the outbreak.

Globally, the key theme in FX markets in 2020 to date has been USD strength, and this has placed an additional weight on NZD/USD. The USD is not only one of the higher-yielding major currencies now (especially with the FOMC essentially calling off its easing cycle), but the US economy continues to outperform most G10 economies and will bear relatively small costs from the coronavirus.

The near-term NZD outlook remains highly contingent on the spread and impact of the coronavirus which is, of course, highly uncertain. As long as risk aversion dominates markets the NZD will underperform. On a medium-term basis, we continue to forecast modest NZD appreciation. The NZ economic recovery, high Terms of Trade, and a recovery in global growth are the key drivers here. The appreciation is most noticeable against the AUD given Australia's noticeably weaker economic fundamentals (soft economy and likely RBA easing later this year). NZD gains are expected to be less pronounced against the JPY, EUR, and GBP.

We released our first Corporate Hedging Toolbox during the quarter. To draw on some of the analysis therein, the NZD/USD is currently around the middle of its long-run trading range, but below its 5-year average of 0.6900. It is also a little below both our modelled short-term 'fair-value' range of 0.6350-0.6750, and our long-run equilibrium estimate of 0.6750. All else being equal, these factors point to some risk of appreciation over a medium-term horizon.

For more discussion on the current state of the **housing market** – please read our latest Housing Confidence report.
For more discussion on **regional economic developments** – please read our latest Regional Economic Scoreboard.
For more discussion on **rural developments** – please read Farmshed Economics and the Weekly Commodities Report.
For up-to-date discussion on **global financial market themes** – please read our Markets Monthly Report.
The Economic backdrop can change quickly – for the most up to date views on **Interest Rates and FX** – please read our Economic Weekly and for our latest views on the changing economic landscape – subscribe to our Economic Notes and Rural Economic Notes. **Subscribe** to all of these reports here.
Subscribe to all of these reports here.

Economic and Financial Forecasts

ASB economic forecasts		Sep-19 <<actual	Dec-19 forecast >>	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
NZ GDP real	**AA%**	**2.7**	**2.3**	**1.9**	**1.8**	**1.8**	**2.0**	**2.4**	**2.9**	**2.7**
private consumption	AA%	2.9	2.8	2.7	2.8	3.0	3.2	3.4	3.1	2.8
dwelling construction	AA%	3.4	3.9	2.5	1.2	0.0	-1.2	-1.8	-4.7	-4.8
other investment	AA%	2.3	2.5	2.1	1.8	1.2	1.3	2.0	4.7	5.1
exports	AA%	2.5	2.3	-0.2	-1.7	-1.1	-1.1	1.5	3.4	2.4
imports	AA%	1.1	1.4	1.5	2.1	1.8	2.2	3.2	4.7	3.8
NZ GDP real	A%	2.3	1.8	1.3	2.0	2.1	2.4	3.3	2.8	2.6
NZ GDP real	Q%	0.7	0.6	-0.1						
NZ CPI	**A%**	**1.5**	**1.9**	**2.3**	**2.1**	**2.0**	**1.9**	**1.9**	**2.0**	**2.1**
NZ house prices (QV index)	A%	2.7	4.0	6.1	8.6	7.5	6.9	5.3	1.7	2.6
NZ unemployment (sa%)	Qtr	4.1	4.0	4.2	4.3	4.3	4.1	4.2	3.9	4.0
NZ private sector wages (LCI)	A%	2.3	2.4	2.3	2.2	2.3	2.3	2.4	2.5	2.3

A% = percentage change since same quarter the previous year

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

ASB interest rate forecasts (end of quarter)	Sep-19	Dec-19 <<actual	Mar-20 forecast >>	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
NZ cash rate target	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75
NZ 90-day bank bill	1.15	1.29	1.15	1.20	1.25	1.25	1.25	1.50	2.00
NZ 2-year swap rate	0.94	1.26	1.05	1.10	1.20	1.20	1.20	1.55	1.95
NZ 10-year gov't stock	1.10	1.65	1.25	1.35	1.40	1.45	1.50	1.75	2.00

ASB foreign exchange forecasts (end of quarter)	Sep-19	Dec-19 <<actual	Mar-20 forecast >>	Jun-20	Sep-20	Dec-20	Mar-21	Mar-22	Mar-23
USD per NZD	0.63	0.67	0.67	0.66	0.65	0.65	0.64	0.66	0.68
GBP per NZD	0.51	0.51	0.50	0.49	0.49	0.49	0.49	0.50	0.52
AUD per NZD	0.93	0.96	0.99	0.99	0.96	0.96	0.96	0.96	0.96
JPY per NZD	67.7	73.3	69.0	68.6	68.3	68.3	67.2	67.3	70.9
EUR per NZD	0.57	0.60	0.61	0.59	0.58	0.58	0.57	0.58	0.58
CNY per NZD	4.47	4.71	4.72	4.67	4.62	4.62	4.51	4.60	4.74
TWI - 17 country	70.2	73.8	72.7	71.8	70.5	70.4	69.4	70.2	71.9

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
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics

@ASBMarkets