Quarterly Economic Forecast

February 2021

We’ve come a long way, baby

- **It has been a wild journey over the past year, from a sharp contraction through to a strong rebound.**
- **After 2020’s swift snap back, 2021 is likely to see very modest growth while the borders remain closed.**
- **Interest rates are around their lows and could rise next year – but there is still policy support in reserve.**

NZ has come a long way over the past year. First down was China, which did something inconceivably authoritarian in locking down a major region to combat a newly-emerged virus – causing export disruption in NZ. Then the world went down: with sudden speed many countries around the world, including ourselves, hastily followed suit with lockdowns and triggered unprecedented degrees of economic contraction in the first half of last year. And around the world many countries are still grappling with the COVID-19 pandemic and their economies continue to feel the pain.

NZ, too, is still facing challenges, and our recovery is still not one for all. The indications are that the borders are going to remain largely closed throughout this year at least, in a tug of war between vaccine rollout and the spread of more virulent strains of the virus. That means slow population growth, and mounting skill shortages that can’t be readily met locally in the near term. Crucially, it means tourists are not from Brighton, but rather New Brighton: fewer overall spenders in our traditional tourist regions that will continue to feel acute financial pressure.

Right here, right now, NZ is nonetheless sitting in a relatively enviable place, having built itself up out of the hole it sharply fell into during Lockdown 1.0. It got there through a combination of government action and support, hasty innovation by businesses, households quickly overcoming fear of job losses and instead focussing on how to love life. GDP in the September quarter last year exceeded its pre-pandemic level, a rarity in the developed world. Over 2021 we expect modest growth around an annualised pace of 1%, as the economy settles after its enormous stimulus-driven rebound and continues to feel the pinch of closed borders. Growth will be propped up by consumer spending, a high level of housing construction, and continued growth in our goods exports. As businesses lose some of their current caution, and as the borders eventually relax, the recovery will strengthen and become more even over 2022.

The position NZ finds itself in has meant there is still some ammunition in reserve to deal with any further shocks. The RBNZ’s traditional weapon of choice (the OCR) is likely to remain at 0.25% into next year before it gradually lifts back from its emergency setting. But the groundwork has been done to enable the RBNZ to push the OCR negative if need be. The Funding for Lending Programme to directly lend cheap funding to banks is now open and will have some impact in holding interest rates down, as will the remainder of the RBNZ’s bond-purchasing programme. Importantly, the better economic performance also means the Government won’t need to borrow quite so much.

Anyway, praise you NZ. So far we have collectively come through in a way that is astonishing compared to numerous predictions. Let’s hope we do see the sunset of COVID-19 this year. But, as we have just had another reminder, the calm amidst the pandemic is ever fragile, and on the journey forward we are going to have to keep on rolling with punches.

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International Outlook – Hey big spender

Grim COVID news continues to dominate international headlines. Much of the world is still struggling with major outbreaks, and many countries in the Northern Hemisphere have spent chunks of the winter under heightened restrictions. December also saw the emergence of the so-called ‘UK’ and ‘South African’ variants of the virus, both of which are believed to be significantly more transmissible.

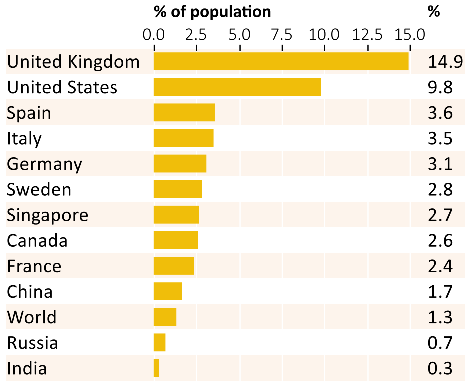
Nevertheless, the global vaccine rollout is proceding at at uneven pace. Among major economies, the UK is ahead of the curve, followed by the United States. In contrast, the European Union is still getting off the ground after a supply chain kerfuffle. Meanwhile, much of the developing world may not reach widespread vaccine coverage until 2023. The overall upshot is that while the progress has been positive, there is still a long way to go, and plenty of challenges ahead. The timing of any move back to a world with fewer restrictions and more open borders remains difficult to predict, and still some way off.

The US economy is likely to receive a massive level of stimulus over the coming months. In early January, Democrats in the US won control of the Senate, giving the party unified control of the Government, and lifting the odds of a big economic package. The newly-signalled deal has a USD$1.9 trillion price tag attached, more than double the size of the circa USD$800 billion package rolled out in the aftermath of the Global Financial Crisis. Central bank policy settings remain highly accommodative for the time being at least too, meaning the global economy continues to receive an unprecedented level of stimulus.

All-up, global growth forecasts for 2021 have been nudged up since our last quarterly. Better-than-expected momentum towards the end of 2020, predictions of a vaccine-led recovery and the prospect of that further stimulus have bolstered sentiment over recent months and prompted analysts to re-evaluate their forecasts. At the end of January, the *International Monetary Fund* lifted its 2021 global growth forecast by 0.3% to 5.5%. Still, the global economy fell into a deep hole over 2020, and the putative recovery remains highly contingent on the ongoing vaccine rollout.

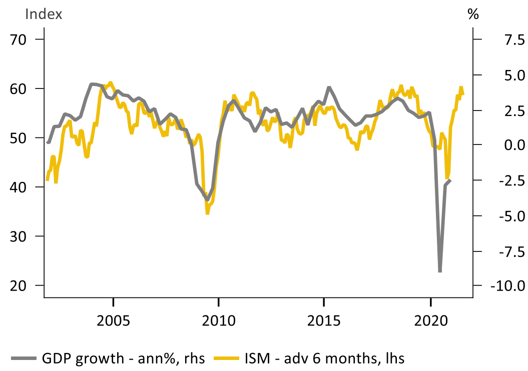
Commodity prices are rising sharply. In the aftermath of the vaccine news – and amid hopes of a spending bonanza – markets have come to expect a substantial upswing in economic activity over 2020 and 2021. The optimism has triggered a global share market boom, and commodity markets are similarly feeling the love. Notably, oil prices are testing twelve-month highs, and dairy prices have surged at recent auctions. ASB’s Commodity Indices has lifted sharply since the beginning of December. There are still questions around whether the boom represents the beginning of a new price cycle or mere unsustainable exuberance, but on balance the resilience in prices remains a source of support for the New Zealand economy.

Cumulative COVID-19 Vaccinations
Doses administered*, % of population
*some vaccines require 2 doses



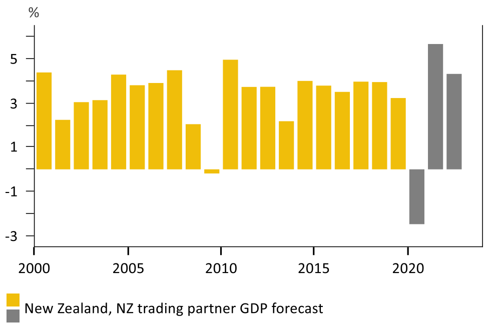
Source: Macrobond, ASB

US Manufacturing ISM and GDP Growth



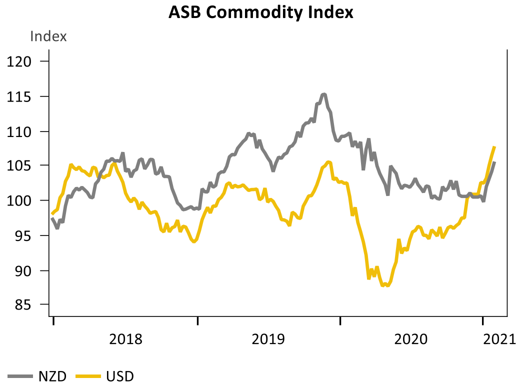
Source: Macrobond, ASB

NZ Trading Partner GDP (top 16)
Annual Average Growth



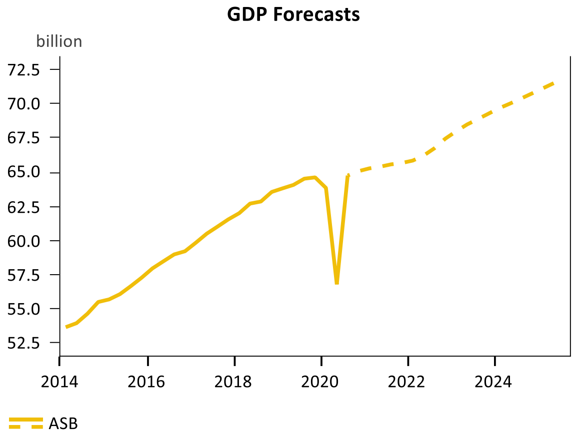
Source: Macrobond, ASB

ASB Commodity Index



Source: Macrobond, ASB

The New Zealand Economy – Snap Back



The NZ economy has already staged a full recovery from its short-lived but severe recession, lifting 14% over the September quarter, after contracting 12.1% over the first half of 2020. In addition to growth lifting more than expected over Q3, the estimated size of the contraction over H1 was revised smaller. Further revisions are likely as all these estimates from Stats NZ remain provisional. We were surprised by the size of the rebound over Q3, and had expected economic output to remain below pre-COVID levels due to the impact of border closures. However, while some parts of the economy have faced headwinds, others have easily lifted above pre-pandemic levels – particularly construction activity. We now expect GDP to be 0.7% above year-ago levels by the December quarter. By comparison, if the pandemic had not occurred, we would have expected annual GDP growth of approximately 2.5%. The community outbreak in February was a developing event at the time of writing, but the overall economic impact is likely to be small given NZ's demonstrated ability to quickly bounce back once Alert Level restrictions are relaxed.

Looking ahead, we expect most of the growth in economic activity over H1 2021 to come from the construction sector. The NZ housing market remains under supplied, and low interest rates and rising house prices have stoked construction appetites with building consent demand surging in the latter months of 2020.

NZ retail spending appears to have eased back slightly over summer. Some decline was to be expected, particularly given that international visitor numbers typically peak in December. NZers certainty have done their best to help up out with domestic tourism, with aggregate spending holding up better than expected. However, anecdotally this spending may be taking place at the beach, rather than in the traditional tourist hot spots (such as Queenstown) which means the impacts have been felt unevenly across the country. Looking forward, housing-related spending is likely to remain buoyant as new housing construction continues to lift. However, slow population growth (due to border closures and limited MIQ spots) will be a headwind, particularly in retail segments which typically rely on population growth to drive sales (e.g. consumables).

The labour market has also held up much better than expected, with the unemployment rate falling in Q4, to 4.9%. It now looks like the peak in unemployment (at 5.3% in Q3) is now behind us. Firms are reporting difficulties in finding labour, and recruiting skilled labour may be a particular challenge given the inability to recruit offshore while borders remain closed. Tightening labour market conditions are likely to put upward pressure on wage inflation.

Cost pressures for many NZ businesses have skyrocketed, particularly for importers given the issues around shipping capacity and sharp surges in shipping costs. Business confidence surveys suggest many businesses expect to pass higher costs on through prices. While the RBNZ may be relieved the risk of deflation have faded, it is unlikely to be thrilled by the prospect of cost-push inflation either. Higher costs either directly reduce profits or, if passed onto the final consumer, reduce the purchasing power of consumers for spending on other goods and services (effectively reducing economic demand). Cost-push price increases are only inflationary over the medium term if price increases are matched or outpaced by income growth. The labour market will remain key to the RBNZ's OCR outlook over the coming year.

The NZ economy has proven to be more resilient than expected over 2020, but we remain cautious on the pace of growth over 2021 and 2022. We see growth prospects in NZ as being relatively muted over 2021, with the closed border and weak global growth limiting NZ's export performance. The NZ Government hopes to roll out vaccination over the second half of the year, but there remain risks and uncertainties, with potential for vaccine production delays and COVID-19 mutations reducing vaccine effectiveness. **In our view, it will be some time during 2022 before the NZ and global economies properly enter 'recovery mode' and allow for above-average rates of GDP growth.**

Interest Rates and Exchange Rates – brighter signs

OCR hikes possible from the second half of 2022

The NZ economy has proved to be more adaptable and resilient than previously expected. Inflation and labour market objectives look to be much closer to the RBNZ's twin targets. Interest-rate sensitive pockets have responded, with the booming housing market prompting the RBNZ to impose the loan-to-value ratio restrictions from March. The goal of the RBNZ has been to keep borrowing costs low, with the Funding for Lending Programme (FLP) helping to keep interest rates for bank borrowers close to record lows despite market pricing unwinding the chance of OCR cuts.

We now expect the RBNZ to begin raising the 0.25% OCR in August 2022, about a year sooner than in our November forecasts. The outlook is highly uncertain and OCR hikes will not be contemplated until the NZ border is open (likely from 2022), the RBNZ is confident the economy is heating up, capacity pressures are firming in the labour market and inflation looks to settle above 2%. Even then, the pace of OCR hikes is expected to be slow, with the OCR set to plateau at 1.25% by early 2024, fractionally below neutral levels. Rate hikes for our major trading partners remain a long way off as central bankers will want to make sure that the rebound is entrenched before raising policy interest rates. We expect the Fed and RBA to be firmly on hold over at least the next 12-18 months.

The RBNZ is expected to keep the weekly pace of its Large Scale Asset Purchase programme (LSAP, currently $570m) fractionally above that of the weekly bond tender ($450-$500m per week) so as to keep pressuring yields lower and to bolster liquidity. At its current pace, weekly purchases should remain comfortably below the 60% Crown Indemnity, with cumulative purchases well below $100bn when the RBNZ starts to raise the OCR. We expect that the RBNZ will taper its weekly LSAP from early 2022 before hiking the OCR and we don't expect the RBNZ to continue the LSAP when the OCR is moving up.

We have updated our other interest rate forecasts for their higher starting point. Local and overseas yields are off recent lows and curves have steepened as the economic outlook has improved. The development of workable COVID-19 vaccines has provided more confidence in the outlook and the extensive policy stimulus deployed has seen markets factor in the risks of higher inflation, pushing longer-term yields up. We expect recent increases in yields to stick, but for the steepening in the NZ yield curve to gradually unwind, with rising shorter-dated yields to outpace more modest increase in longer-dated yields as the OCR edges up. We also expect central banks to reaffirm the 'low for longer' message on interest rates and for inflation to settle at low levels, capping longer-term yields, with other global central banks to gradually wind back asset purchases so as to avoid a 'taper tantrum'.

We retain our positive NZD view

We have retained our positive NZD view, consistent with the improved global backdrop and our assessment of a stronger NZ economic and interest rate outlook. Our elevated Terms of Trade are a key medium-term support. Conversely, the widening US current account deficit and low real US interest rates are expected to weigh on the USD.

As such, we expect the NZD to remain slightly above 70 US cents over 2021 and into 2022. The NZD is likely to trade towards the lower part of the 90 to 95 Australian cent range, with the stronger exposure of the Australian economy to the Chinese global growth engine capping NZD upside. Strong Chinese growth and further easing of capital controls should support the Chinese currency. The NZD is expected to remain well supported against the yen, ending 2021 at around 80 JPY. Against the euro, the stronger starting point for NZD is expected to fade, with the NZD down to 0.53 euro by late 2022. The double-dip recession we expect for the UK will weigh on the GBP (0.52 by end 2022).

NZD direction hinges on the global outlook. A vigorous 'V'-shaped cyclical rebound could push the NZD higher, at least over the short term, whereas slowing global economic activity could weigh on the NZD.

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Economic and Financial Forecasts

ASB economic forecasts		Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Mar-22	Mar-23	Mar-24
		<<actual	forecast >>						
NZ GDP real	**AA%**	-2.3	-2.6	-2.0	4.3	4.5	4.2	2.2	3.0
private consumption	AA%	-1.5	-2.0	-1.9	4.4	4.5	4.8	3.3	4.4
dwelling construction	AA%	-5.1	-4.5	0.8	16.9	15.3	9.1	-4.3	-4.6
other investment	AA%	-6.8	-7.7	-7.2	3.2	5.6	6.1	4.8	7.5
exports	AA%	-8.6	-12.0	-14.4	-9.6	-7.0	1.5	8.1	7.8
imports	AA%	-12.1	-17.9	-20.8	-12.5	-6.5	5.6	9.1	10.3
NZ GDP real	A%	0.4	0.7	2.2	15.1	1.3	0.9	3.2	2.5
NZ GDP real	Q%	14.0	0.5	0.3	0.2	0.3	0.3	0.8	0.6
NZ CPI	Q%	0.7	0.5	0.6	0.4	0.8	0.3	0.5	0.6
NZ CPI	**A%**	1.4	1.4	1.3	2.1	2.3	2.0	2.0	2.3
NZ house prices (QV index)	A%	9.5	11.7	15.5	20.3	18.1	9.5	4.9	7.3
NZ unemployment (sa%)	Qtr	5.3	4.9	5.1	5.0	5.1	5.1	4.8	4.4
NZ private sector wages (LCI)	A%	1.8	1.6	1.6	1.9	1.8	1.9	2.2	2.6

ASB interest rate forecasts	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Mar-22	Mar-23	Mar-24
(end of quarter)		<<actual	forecast >>					
NZ cash rate target	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.25
NZ 90-day bank bill	0.31	0.27	0.30	0.30	0.30	0.35	0.90	1.40
NZ 2-year swap rate	0.05	0.28	0.40	0.50	0.60	0.80	1.20	1.55
NZ 10-year govt bond	0.46	0.99	1.50	1.55	1.60	1.70	1.9	2.00
ASB foreign exchange forecasts								
(end of quarter)								
USD per NZD	0.66	0.72	0.70	0.70	0.71	0.71	0.71	0.71
GBP per NZD	0.51	0.53	0.52	0.51	0.52	0.52	0.52	0.52
AUD per NZD	0.93	0.94	0.93	0.92	0.92	0.91	0.92	0.92
JPY per NZD	69.9	74.5	73.5	74.2	76.0	77.4	80.2	83.1
EUR per NZD	0.56	0.59	0.57	0.56	0.56	0.55	0.53	0.53
CNY per NZD	4.5	4.7	4.6	4.6	4.6	4.5	4.5	4.5
TWI - 17 country	71.6	75.1	73.4	73.0	73.7	73.0	72.9	73.0

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