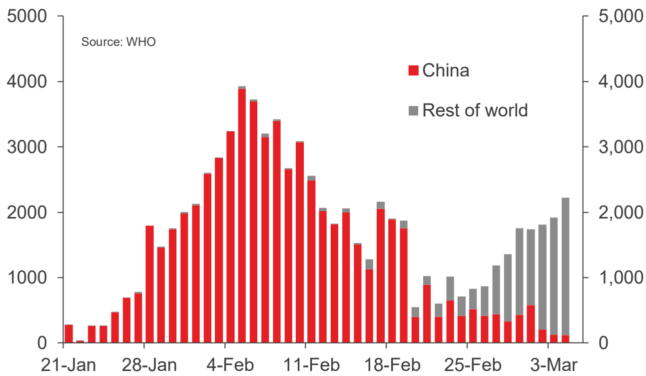
Economic Bulletin.

6 March 2020

Update on the economic impact of Coronavirus.

- We are now forecasting 25bps OCR cuts in March and May (previously only March).
- With each passing week Coronavirus has a more pervasive effect on travel and confidence.
- We now expect negative GDP growth in the March quarter and just 1.9% over the whole of 2020.
- The US Federal Reserve cut 50bps inter-meeting, and we now expect another three cuts of 25bps each this year.
- The RBNZ response will be more measured – we do not expect an inter-meeting cut or a 50bps move.
- Monetary or fiscal stimulus are not particularly effective responses to a virus outbreak.
- Government should instead focus on helping businesses and households get through the inevitable period of disrupted activity with minimal lasting damage.
- Now is the right time for Government to go into deficit. Running surpluses over the recent good years has left the Government in a good position to weather this storm.
- We expect house price inflation will stall during the period of virus-related disruption, but will pick up later in response to even-lower interest rates.

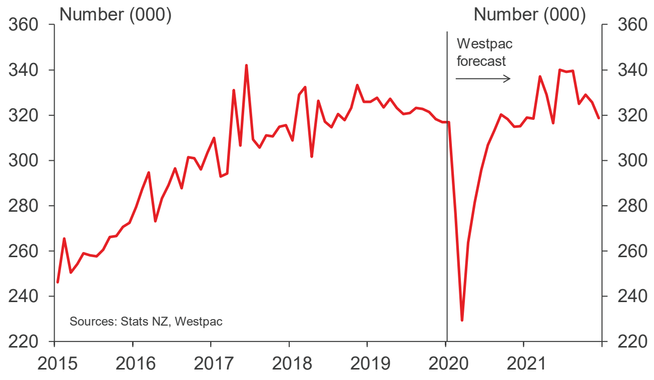
Daily new cases of Coronavirus



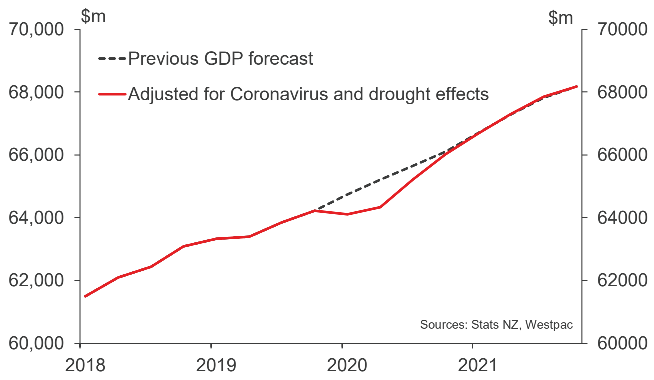
Over the past week the coronavirus Covid-19 has spread to more countries, New Zealand has recorded its first cases, and travel bans have become more widespread. All of that has further dented economic confidence. Financial markets have swooned, with major equity indices dropping more than 10% over a few days. Anecdotally, business and consumer confidence seem to have taken a severe hit in New Zealand. (ANZ is going to release early results of its monthly business confidence survey on 10 March, which may put more substance around that assertion).

We have further reduced our GDP forecasts to reflect more severe effects on travel, export commodity prices, and confidence. We are now forecasting a 28% drop in visitor arrivals. We have reduced our March quarter GDP forecast to -0.2%, and our forecast of annual GDP growth over 2020 to 1.9%. Without Coronavirus and drought our annual GDP growth forecast would have been 2.7%. The currently-rampant housing market is likely to skid to a halt, with price growth slowing sharply in the June quarter. That, combined with job losses and lower farm and business incomes, will have a secondary impact on consumer spending that could last longer than the immediate disruption from the virus.

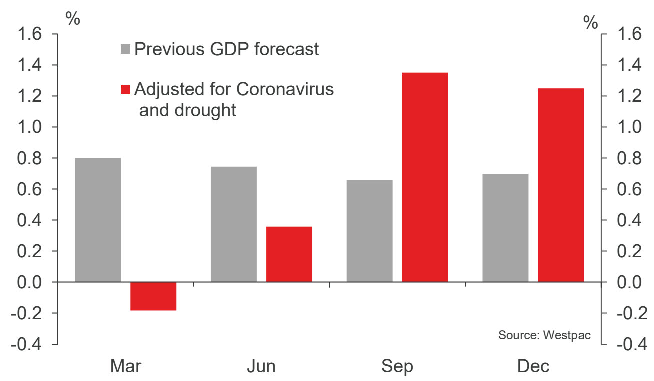
Visitor arrivals into New Zealand



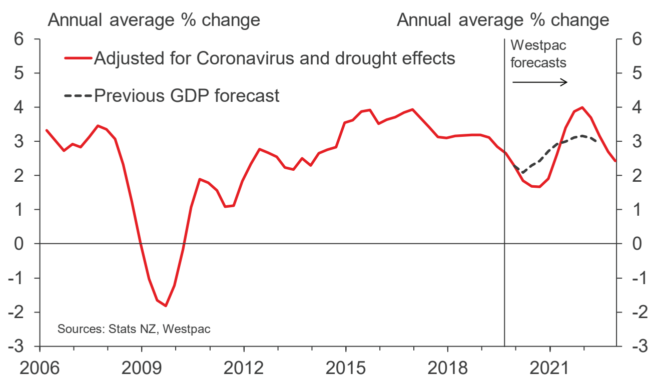
Coronavirus and drought impact – level of GDP



Coronavirus and drought impact – quarterly GDP growth



Coronavirus and drought impact – annual GDP growth



It is important to remember, though, that this is a temporary disruption to economic activity, not a new long-run trajectory for the economy. We anticipate a period of above-normal GDP growth after the worst of the virus-related disruptions have passed, as the economy returns to a normal level of economic activity, catch-up production to restore depleted inventories occurs, and even-lower interest rates stimulate asset prices. We are currently assuming that the recovery phase will begin in the second half of this year, although we will update that timing as we learn more about how the virus is playing out.

Overseas central banks have leapt into the fray with aplomb. The US Federal Reserve cut its rate 50 basis points outside of its usual meeting schedule. Canada also cut 50bps at a scheduled meeting, and the Reserve Bank of Australia cut by 25bps. Before Covid-19 struck, we were already expecting that the US Federal Funds Rate would drop 75bps this year. This week we have shifted to expecting three further 25bps cuts, in April, May and June, on top of the 50bps already delivered. We are also expecting the RBA to cut again in April, and to begin some form of quantitative easing later in the year.

We have long expected that the Reserve Bank of New Zealand would cut the OCR to 0.75%. In a bulletin on Monday we predicted that the cut would be delivered on March 25 in response to Covid-19. Today we are shifting to forecasting a second 25bps OCR cut, in May. This follows our shift of forecast to further cuts in the Fed Funds Rate during the June quarter. The basic idea of our OCR forecast remains the same – we still expect the RBNZ to ease monetary policy by a bit less than Australia or the US this year.

Markets are questioning whether the RBNZ might cut the OCR at an emergency meeting before March 25, or cut by 50bps on that date. We don't regard either scenario as likely. The RBNZ's take on Covid-19 has sounded distinctly more moderate than other central banks. In a brief communication this week the RBNZ emphasised that the next OCR decision would occur on March 25th, a clear signal that no inter-meeting cut was under consideration. They went on to say that in their business continuity role they would ensure a stable financial system, including access to credit and cash and liquidity in the banking system. Our interpretation is that the RBNZ is thinking hard about Coronavirus, but has concluded that monetary easing is not the most important response.

We broadly agree with that. Stimulating demand right now, via monetary or fiscal policy, would have limited effect because demand is being impeded by such a specific force. For example, low interest rates would have no effect on a firm unwilling or unable to have the business meetings required to take advantage. No amount of demand stimulus would induce scared households to attend concerts or movies during an outbreak. And bringing forward Government infrastructure spending would have no effect if the required staff don't turn up to work for fear of catching the virus.

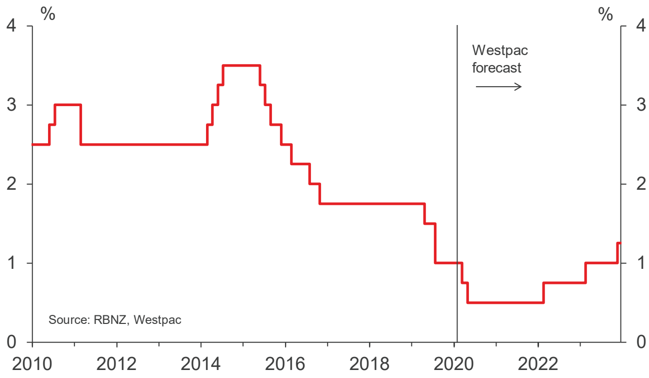
The most important role for Government and the Reserve Bank right now is to focus on ensuring that the wheels of commerce keep turning where possible. Where commerce must stop, the focus should be on helping the economy get through. Government should use targeted measures to ensure that good businesses are able survive a temporary loss of revenue. For example, Inland Revenue could ease its requirements for businesses to pay provisional tax or GST, essentially providing short-term credit to firms. In a similar vein, the Government is asking private banks to ensure credit is provided to cash-strapped firms. Government should also ensure that people have the wherewithal to meet their basic needs during the period of disruption. For example, eliminating the stand down period before receiving a benefit after being laid off was a good move. Another good idea would be to assist businesses with temporarily redeploying workers where possible.

The targeted measures suggested above are going to be costly for the Government. The books will also come under pressure from the automatic stabilisers – less tax and more benefit payments due to stalled economic activity. This is likely to send the Government into deficit this year. That is entirely appropriate. Governments should run surpluses in normal times precisely so that they can help the economy weather this type of storm. Those who complained that the Government was wearing a "fiscal straightjacket" and should have spent more during the good years would have left the country less well-placed to deal with Covid-19.

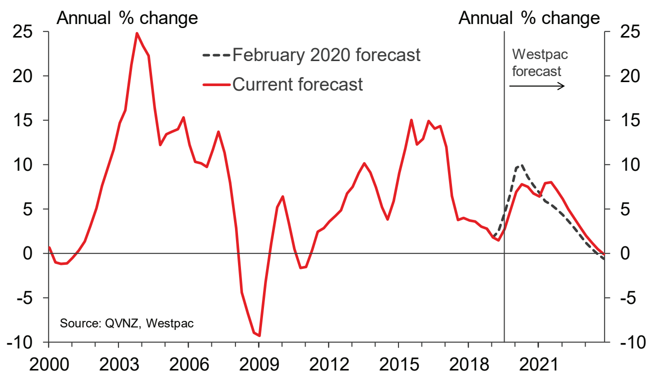
Compared to the targeted Government measures we propose, monetary easing will play a relatively small role in ensuring the economy is able to weather this storm effectively. Nonetheless, we still think there will be some monetary easing. The Reserve Bank will be keen to ensure that it does not fall too far out of synch with its peers, lest the exchange rate rise unhelpfully.

The consequence of this monetary easing will be even more stimulus for the housing market once the disruption from the virus has passed. As mentioned above, both our house price inflation forecasts and our economic growth forecasts have been reduced in the short run, but increased from 2021 onwards. Consistent with that, we forecast that the Reserve Bank will begin increasing the OCR again from early-2022.

Westpac Official Cash Rate forecast



House price forecasts



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