Economic Bulletin.

28 February 2020

Dry cough – Impact of drought and Coronavirus on the New Zealand economy.

- Drought and Coronavirus are going to deal the New Zealand economy a significant blow.
- We are now forecasting zero quarterly GDP growth for March quarter, and 2.2% annual GDP growth for 2020.
- Without drought or Coronavirus, our forecasts would have been 0.8% for the March quarter, and 2.7% for the whole of 2020.
- This is all predicated on the assumption that Coronavirus is eventually contained, but only at the cost of more severe and long-lasting disruptions to travel and trade than previously expected.
- If Coronavirus becomes a pandemic and/or spreads to New Zealand, the economic impact would be different to the forecasts outlined here.
- Coronavirus and drought are likely to have a net negative effect on inflation in the short run.
- The possibility of an OCR cut in March should not be dismissed, although for now we are sticking to our forecast of an August cut.

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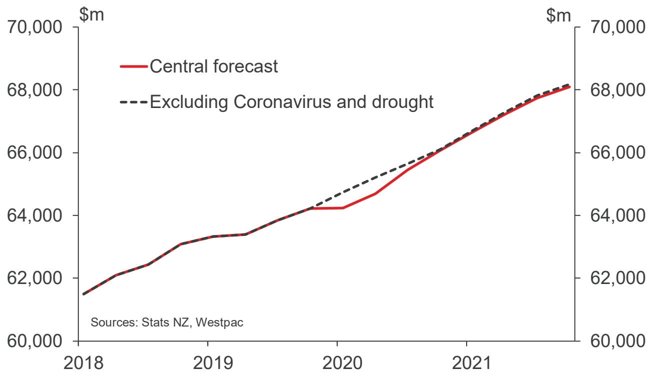
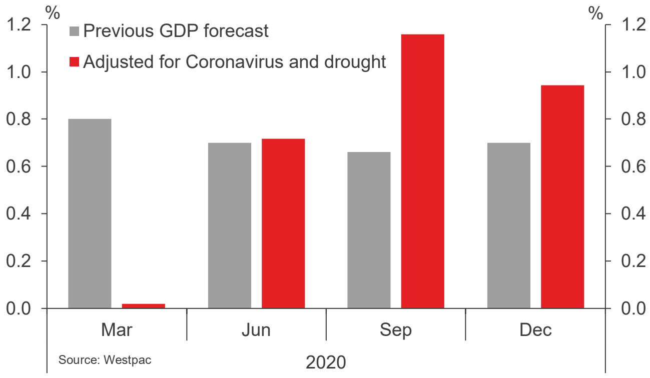
Drought and coronavirus are going to deal the New Zealand economy a sharp blow over the first half of 2020. Both situations have gotten more severe recently. In response, today we are issuing an update to our forecasts.

We are now forecasting zero economic growth in the March quarter of 2020, and 2.2% over the whole of 2020. If there were no drought and no Coronavirus, we would have forecast 0.8% for the March quarter and 2.7% annual growth in 2020. However, based on the assumptions outlined below, we expect economic activity will quickly rebound from the drought- and Coronavirus-affected level. This means we can expect quite rapid rates of quarterly economic growth over the second half of 2020.

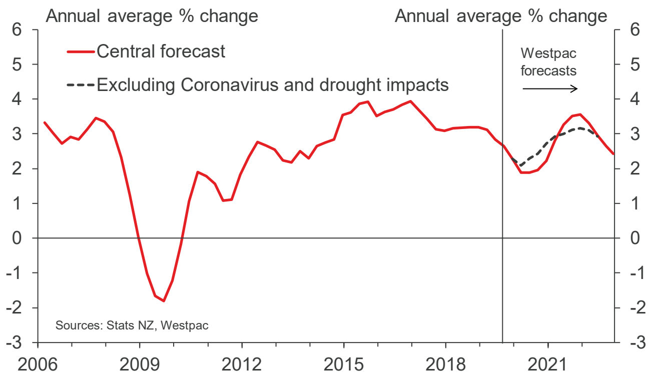
Coronavirus and drought impact on the New Zealand economy – level of GDP



Coronavirus and drought impact on New Zealand economy – quarterly GDP growth



Coronavirus and drought impact on the New Zealand economy – annual GDP growth



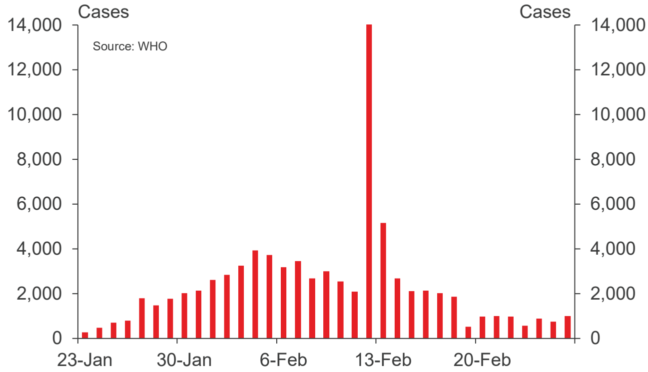
The evolving drought situation was explained in a bulletin we released yesterday. Drought will severely impact rural communities in the worst-affected areas. We estimate that the peak impact on GDP will be 0.3 percentage points, occurring in the June quarter. The economy tends to recover very rapidly from droughts, so we expect a rebound in agriculture in the September quarter.

It now looks as though the initial working assumptions that we used to estimate the impact of Coronavirus were too light. With the spread of the virus beyond China, the virus now looks likely to disrupt economic activity more broadly and for longer than we initially thought.

Our previous assumptions were that the ban on travel from China to New Zealand would last two months, China's factories would remain closed for one month, and there would be some reduction in travel from the rest of Asia.

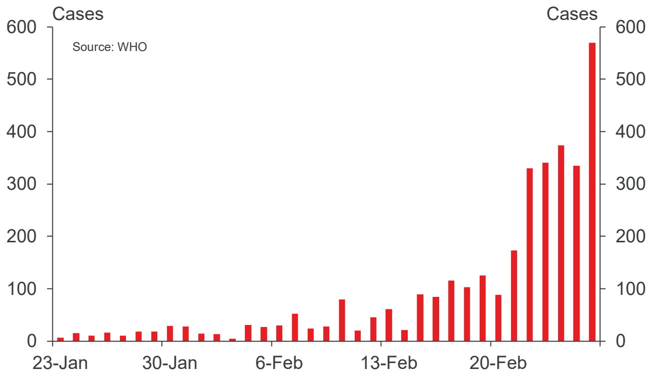
If China were the only country materially affected by Coronavirus, then those assumptions would still look reasonable. The reported number of Coronavirus cases in China continues to fall steadily (although there are concerns about the accuracy of those numbers). China's factories are gradually re-opening. Previously we were hearing that banks and freight-forwarders in China were closed, disrupting New Zealand's ability to import goods, but now we hear that there has been some easing in that. Finally, although log exports remain extremely low, some ships carrying logs to China have left New Zealand ports, so exports are not quite zero.

Daily new cases of Coronavirus worldwide



But the dramatic development in recent days is the spread of Coronavirus to Iran, Italy, South Korea and Japan. This raises the spectre of more widespread travel bans, disruptions to trade with more countries, and a longer period of Coronavirus concern. There is now a greater probability of supply chain disruptions causing New Zealand firms to run out of the materials they need to operate.

Daily new cases of Coronavirus outside China



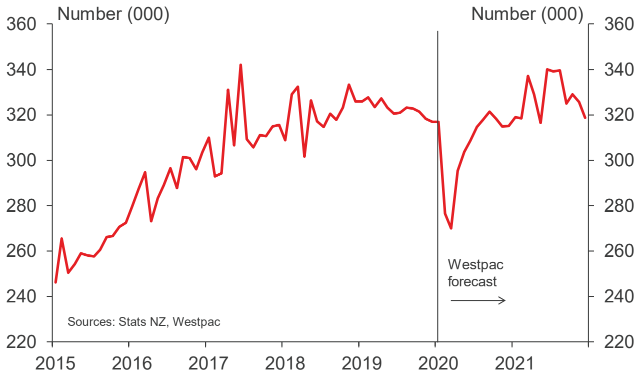
We have updated our forecasts to incorporate assumptions of more widespread travel bans and disruptions to economic activity. We are still assuming that efforts to contain the virus will eventually be successful, but only at a severe economic cost.

Our new assumptions are:

- The ban on travel results in zero foreigners arriving from China until the end of March. Travel from China to New Zealand is 50% of normal in April, and gradually returns to normal after that.
- Either travel bans or travel wariness cause a 25% reduction in foreign arrivals from the rest of Asia until end of March.

- The reduction is 15% in April, gradually returning to normal after that.
- No change in travel between Australia and New Zealand.
- A 7.5% reduction in visitor arrivals from the world excluding Asia and Australia until end of April, followed by a gradual recovery.
- A 7.5% reduction in New Zealanders travelling abroad anywhere except Australia, until end of April with a gradual recovery after that.
- Disruptions to supply chains and confidence effects that impact business investment and consumer spending over the March and June quarters.
- Zero exports of logs to China for February, with a rapid rebound after that.

Visitor arrivals into New Zealand



Under these conditions, Coronavirus would slash 0.7 percentage points off GDP in the March quarter. GDP growth would remain below par in the June quarter. The recovery from Coronavirus would begin in the September quarter, with more rapid rates of quarterly economic growth beginning at that time.

Importantly, the economic scenario we are painting makes no allowance for the virus becoming established in New Zealand. That would be a different story. People would start to avoid one another for fear of getting sick, disrupting work, leisure, travel and education. This would cause economic damage in a different way to the current international disruptions.

Effect on inflation.

Drought and Coronavirus will have complex, offsetting effects on inflation. However, the net impact is likely to be negative in the short run. Lack of international demand for key New Zealand exports is likely to reduce their domestic price – the classic example being the dramatic drop in the domestic price of crayfish after the Chinese cancelled export orders. Similar dynamics will play out for other perishable food exports, especially meat (where supply is also sky-high due to drought). Rapid declines in airfares have already been observed, due to lower demand and surplus airline capacity after flights to China and Korea were cancelled. Lower hotel room rates will be the next step. And the reduction in global oil prices should translate to a lower domestic price of petrol.

Retailers of imported products such as clothing and footwear may run short of stock owing to supply chains being disrupted by Coronavirus. However, we doubt that they will respond by increasing prices much, for fear of a consumer backlash, so the increase in inflation through this channel will be muted.

Effect on the Reserve Bank and exchange rate.

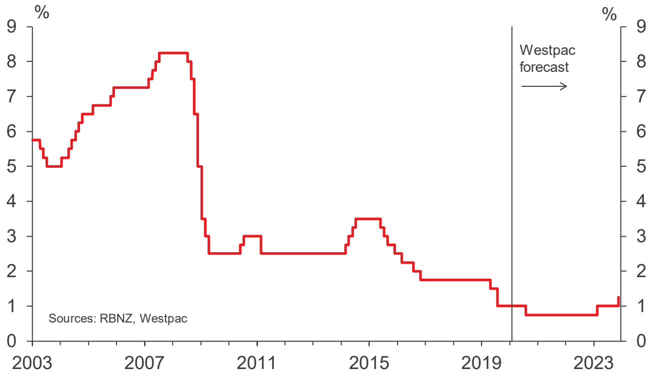
The Reserve Bank has been adamant that drought and Coronavirus are temporary events that monetary policy should look through. Other parts of government are better placed to respond.

We are starting to wonder whether the Reserve Bank will stick to that view. Some of the economic data that prints over the coming six months could be scarily weak. Unemployment may lift a little as tourism and forestry workers are laid off. Business and consumer confidence surveys are sure to come in weaker (the monthly ANZ business confidence survey has already recorded a sharp decline). And as mentioned above, the short-run inflation outlook may drop a bit. And the backdrop to all of this is that the Reserve Bank has been struggling for years with below-target inflation.

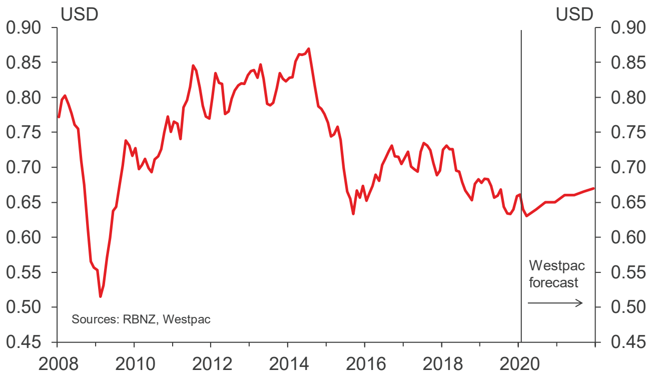
For now we are sticking with our forecast of an August OCR cut. But we regard a March cut as a distinct possibility. Markets are currently pricing a 30% chance of a March OCR cut, but we think the odds could be even higher than that. We will continue to watch the Coronavirus situation with interest, and will update our OCR forecast as the evolving situation requires.

Global risk aversion related to Coronavirus is weighing on the New Zealand dollar, and we expect this will persist for some time. The exchange rate could drop to 62 cents in the near term. Consequently, we have reduced our near-term exchange rate forecast. However, we continue to expect that the New Zealand dollar will trend higher later this year as the US economy slows. Our year-end exchange rate forecast is now 65 cents.

Official Cash Rate



NZD/USD exchange rate forecast



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