Economic Overview.

When China sneezes...

February 2020

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As the new decade dawned the New Zealand economy was on an improving trajectory. Our controversial call that the housing market would pick up has panned out. Government spending has also padded household wallets. The result has been a boost to consumer spending and GDP growth. However, this is more of a sugar-rush than lasting nutrition. Rising house prices and government spending prop things up in the short run, but won't necessarily do anything for our long-run prosperity.

The recent Coronavirus outbreak has the potential to throw the economy off its stride. China has grown to become a dominant economic force, and to borrow a phrase, when China sneezes the rest of the world catches a cold. This *Economic Overview* is based on a scenario where travel and trade are disrupted for a couple of months, in which case the economy would take a serious hit for one quarter but would rebound quickly. But the longer the quarantine efforts persist, the greater the chance of lasting economic damage.

Although the consumer side of the economy is improving, businesses remain pretty downbeat. Firms are being squeezed between competitive pressures fuelled by rapid technological change and rising costs associated with being a good corporate citizen and complying with regulations. Neither trend is going away soon, so business investment will remain lacklustre.

Inflation has risen recently, but we expect it will soon drop back again. That is one reason that we are forecasting an OCR cut later in the year. The other is that we expect foreign central banks will be reducing their rates due to ongoing sogginess in the global economy. On the world stage we do expect New Zealand will be an economic outperformer, which is why we are forecasting the exchange rate to trend higher from here.

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New Zealand Economy.

Just a cough?

The New Zealand economy has lifted in recent months, much as we predicted. Although the outbreak of Coronavirus will derail some of that momentum, we still expect firm economic growth over the next few years, supported by large increases in fiscal spending and low interest rates. However, businesses will continue to struggle with rising costs and thin margins.

Going viral

As the new year kicked off, the New Zealand economy looked like it was on a solid upward trajectory. After losing some steam in early 2019, GDP growth had lifted again. We were also seeing signs that low interest rates and increases in government spending were boosting demand, with a pickup in the housing market, increases in household spending and a tightening in the labour market.

However, the sudden outbreak of Covid-19 (Coronavirus) has thrown a very large spanner in the works. The economic impacts of the outbreak are still wildly uncertain, but at this stage it's likely that they will be more severe than SARS in 2003 or the 2009 swine flu pandemic. Since 2003, China's share of global output has risen from 4% to 16%. Over that same period, its share of New Zealand's goods exports has more than tripled, and its share of visitor arrivals to our shores has quadrupled.

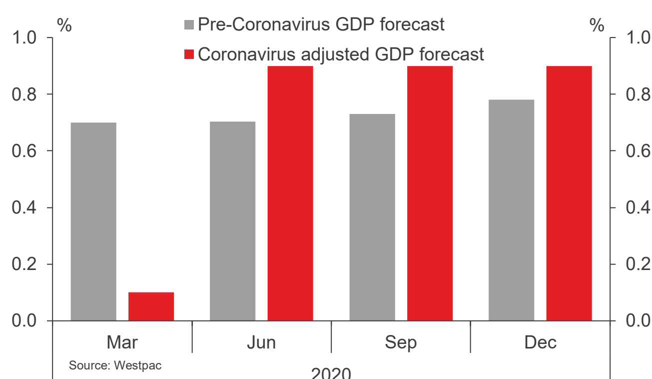
Coronavirus related disruptions have already dented economic activity here in New Zealand. Factory closures and quarantine efforts have seen log shipments to China grinding to a halt in recent weeks. With China taking 80% of our forestry exports, that's likely to result in reduced harvesting and job losses. The coming months are also likely to see a drop in other exports, as well as lower prices for some of our key commodity exports like dairy and meat.

Services exports have also taken a sizeable knock since the outbreak began. New Zealand has announced a temporary ban on the entry of all foreign citizens arriving from China. Those restrictions on travel have seen international visitor arrivals plunging, affecting retailers, hoteliers and foreign education providers.

The scenario underlying our forecasts is that Coronavirus related disruptions will last just a few months. But that's still enough to reduce our forecast of March quarter GDP from 0.7% to 0.1%. As economic activity returns to normal, GDP growth later this year will be higher than otherwise. There could even be a period of stronger-than-usual catch up demand in sectors like forestry as Chinese factories work overtime to address shortages of finished goods.

The big uncertainty is how long the quarantine efforts last. The longer they go on, the greater the likelihood of firms running out of cash and folding, in which case there could be more lasting economic damage.

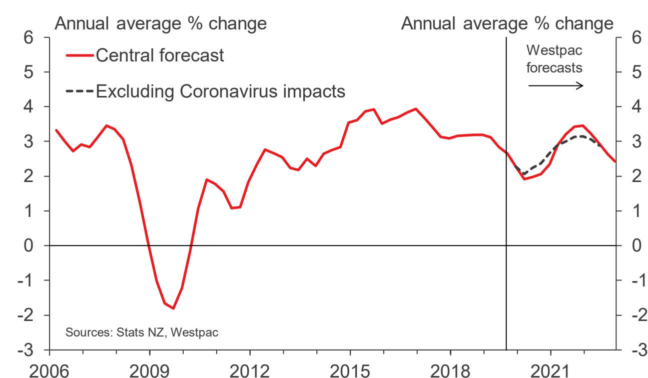
Figure 1: Quarterly GDP growth – effect of Coronavirus



A potent policy cocktail

Before Coronavirus broke out, we were seeing convincing signs that consumer demand in New Zealand was picking up. That's been driven by a potent cocktail of fiscal spending and low interest rates which we expect will continue to buoy demand over the years ahead. We're forecasting GDP growth of 2.3% in 2020, rising to 3.4% over 2021.

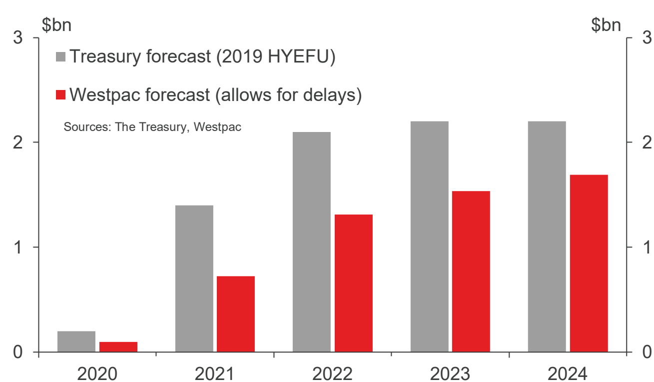
Figure 2: GDP forecasts



The Government has really opened its chequebook in recent years. Operational spending has been rising by around 8% per annum, with increases in transfer payments, pay rises for public sector employees, and a boost to sectors like health and education. Fiscal stimulus is set to become even larger over the next few years with the Government allowing itself another $3bn per annum of spending to be detailed at the next Budget, and more beyond that. In addition, in December they announced $12bn of new investment spending focused mainly on transport projects.

As we've seen for several years now, large infrastructure projects often take longer to get underway than is planned. We expect that only around two-thirds of the planned work will be completed over the next five years. There will also be some crowding out of private sector activity. For instance, increased government spending on infrastructure is likely to draw workers away from other parts of the construction sector.

Figure 3: Infrastructure spending announced at HYEFU

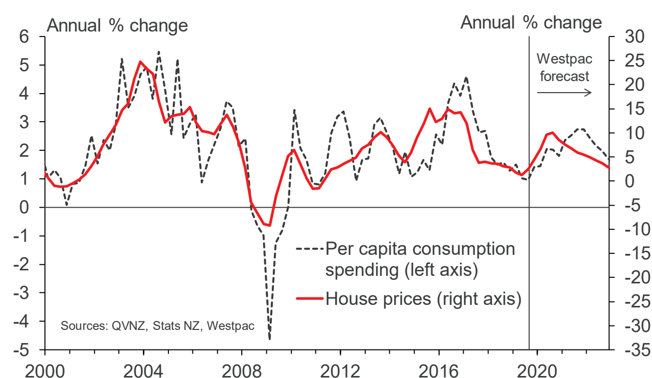


House prices have rocketed higher in recent months. Gains have been widespread, including a pickup in the previously moribund Auckland and Canterbury markets. Westpac predicted this upturn long before other forecasters on the basis that falling mortgage interest rates and the cancellation of the proposed capital gains tax would be far more important influences than the slowdown in net migration. It turns out that house price growth has been stronger than even we expected, and as a result we've revised up our forecast. We now expect that nationwide house price inflation will peak at 10% in mid-2020.

Rising house prices are not a path towards a sustained increase in living standards. However, housing market upturns do tend to spark temporary spending sprees by households, and this time is no exception. Nominal retail spending rose by 1.8% in the December quarter. And with house prices set to take another step higher over the coming months, we expect that there will be continued strength in household spending through early 2020.

But while the housing market is on a tear for now, we don't expect this will last long. Mortgage rates are already starting to creep higher, and they're set to continue rising over the year ahead. At the same time population growth is continuing to gradually trend downwards. Together, those conditions are likely to see house price inflation slowing again through the back half of this year.

Figure 4: House prices and household consumption



Along with the strength in house prices, we've also seen strong construction activity, with dwelling consent issuance rising to a 45-year high. However, conditions in the construction sector are changing. At the same time as building activity has been ramping up, population growth has slowed more rapidly than expected. In areas like Auckland (where there has been a very large increase in the number of new homes being consented), home building is now well ahead of what's needed to keep up with population growth. Although there is currently a large shortage of homes in parts of the country, a peak in the construction cycle is approaching, and some regions could see a significant slowdown in home building through the mid-2020s.

Businesses not joining the party

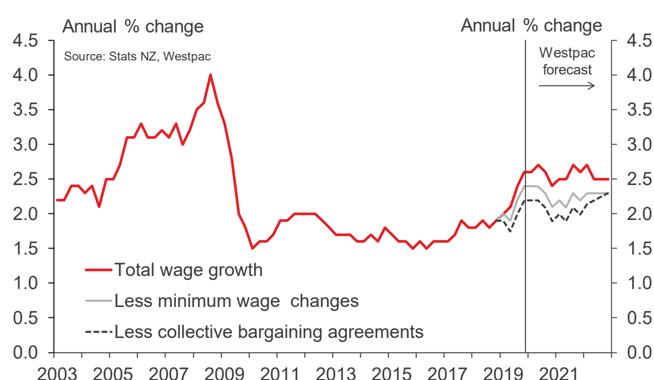
Despite the increases in consumer and government spending, business confidence remains low. Businesses in a number of industries are wrestling with slow sales growth, rising costs and strong competition from imports. At the same time, competitive pressures in sectors like retail have been fierce. Those pressures have been exacerbated by technological changes (like the continued growth in e-commerce) which have effectively given large international firms a foothold in the New Zealand marketplace.

As discussed in our special topic this quarter, many businesses are also struggling with the impacts of changes in government regulations, as well as changes in societal preferences such as the increasing focus on the environmental impact of business practices. In many cases, addressing these matters has added to operating costs. This has been a particular challenge for small to medium sized businesses, who don't have access to the same sort of legal or financial resources that larger firms do.

Businesses are especially concerned about rising labour costs. Wage growth picked up to a 10-year high at the end of 2019. And while some of that was due to the tightening of the labour market in recent years, much of the lift in wage growth has been due to changes in government policy. That includes the large rise in the minimum wage since 2018, as well as increases associated with collectively negotiated wage settlements. Businesses have also highlighted a number of other concerns about how government policy is affecting employment relations, including matters such as disputes mediation, the dismissals process and the hiring of overseas workers.

These changes in labour market dynamics have reinforced the dichotomy between the household and business sectors. The lift in wage growth has obviously been a welcome boon for households. However, for many businesses, changes in labour market regulation have resulted in significant increases in operating costs. That's even being felt by those firms with relatively few staff on the minimum wage, who have had to increase wages above the statutory minimum in order to attract and retain staff.

Figure 5: Wage growth



With pressure on profit margins and nervousness about trading conditions, businesses have wound back their plans for capital expenditure. At the same time, a much more hands on approach to regulation from the RBNZ has seen banks becoming more cautious about the make-up of their lending portfolios. That's prompted a tightening in business credit conditions, particularly for the commercial property and agriculture sectors. Smaller lenders have stepped in to fill some of the void. Nevertheless, tighter lending conditions are likely to be a brake on investment spending over the coming years.

Election uncertainty

The upcoming election adds another layer of uncertainty to the outlook. Here we take a look at how the outcome will affect short-run economic activity without commenting on the long-run value of the various policies. The three possible outcomes are a return of the current centre/left coalition, a Labour/Green government that is further left, or a National/ACT government that is further right.

Any of these combinations would spend up large on infrastructure, thus stimulating the economy. They would all aim to run small surpluses for current expenditure, but they would differ on the details. A left-leaning coalition would focus more on social spending, while a right-leaning government would seek to cut taxes. This means that the further left the government, the more stimulatory government spending will be. Dollar-for-dollar, social spending has more impact on short-run economic activity than tax cuts.

Government regulation has become noticeably "greener" in recent times. That direction of change would continue under any government combination, although the pace would be slower the further right the election result is. There would be more difference in industrial relations and other business regulation. A left-leaning government would continue with the more regulatory approach taken in recent years, whereas a right leaning government would be more laissez-faire. Thus the further right the government, the higher business confidence would be after the election, with possible consequences for our business investment forecast.

Rising house prices will once again feature as a major election issue, and all parties will propose solutions. However, no government combination is likely to do anything that would affect our house price forecast.

Exporters weathering the storm

New Zealand's key export sectors have weathered the softness in the global activity better than expected, but conditions are mixed across sectors.

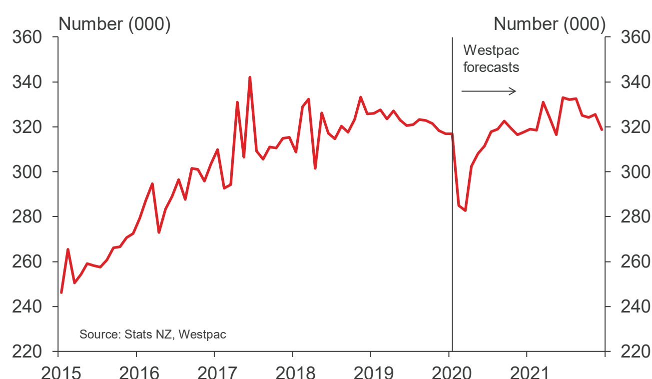
In the primary sector, the combination of solid demand and tightness in international supplies boosted the prices of meat and dairy exports last year. Some of those earlier gains have now reversed and the Coronavirus disruptions will dent prices for a period. Nevertheless, prices for our key agricultural exports will remain at firm levels, and New Zealand's terms of trade are set to remain at a multidecade high.

Hot dry weather is posing a challenge for the rural sector, especially in regions like Northland, the Waikato and Canterbury. As discussed in the *Agricultural Outlook* section, that will result in reduced milk collections through the tail end of the season, while increased slaughter is likely to weigh on beef and lamb prices.

It's been a weaker picture on the manufacturing front, with exports of non-food manufactured goods falling by nearly 2% in the year to September. Business surveys are pointing to continued softness in early 2020, with orders remaining subdued.

Lastly, some of the gloss has also come off New Zealand's services exports, with the number of visitor arrivals effectively stalling over 2019. Coronavirus will have a big impact on visitor arrivals, but we expect a rapid recovery. Beyond that, slowing economies in key source markets like China will keep the tourism and foreign education sectors subdued, although tourism will get a brief boost from one-off events such as the America's Cup and APEC in 2021.

Figure 6: Visitor arrivals into New Zealand



Global Economy.

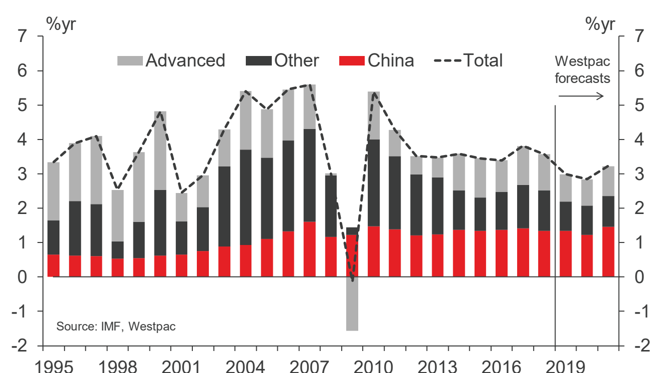
One thing on top of another.

The spread of Coronavirus, and the steps taken to contain it, will put a significant dent in global growth in the near term. Our forecasts are based on a short-lived impact, with activity recovering over the second half of the year. However, with the outbreak adding to the existing headwinds for the world economy, this year is likely to see the slowest pace of growth since the end of the Global Financial Crisis.

Sentiment in financial markets about the global economy has lifted considerably. In part that's because some of the previous geopolitical concerns have eased: the US-China trade war has reached a temporary truce, and the UK's exit from the European Union is now under way. Even the Coronavirus outbreak has done little to break markets' stride – on the first signs that the spread of the virus may be slowing, the major sharemarkets reversed their earlier losses and reached new record highs.

Our view is that financial markets' optimism is out of step with the true state of the world economy. Global growth slowed from 3.6% to 3.0% last year as a number of headwinds emerged, and we expect those to continue into 2020. The Coronavirus outbreak and the efforts to contain it will have a further negative impact in the near term, though we expect this to be followed by a brief period of faster growth as activity returns to more normal levels.

Figure 7: Contributions to world GDP growth



Financial market sentiment is probably more to do with last year's reductions in interest rates around the world. The drop in interest rates has spurred a search for yield, boosting asset prices. It has also generated a renewed belief in the central bank 'put' – the idea that central banks will always bail economies out of any adversity. We regard that as overly optimistic – while we do expect further interest rate cuts, that won't prevent another year of markedly slower world growth.

Financial market optimism remains at odds with the true state of the global economy.

The impact of Coronavirus on the global economy is difficult to pin down while it is still unfolding. The SARS outbreak in 2003 provides a reference point, but there are some key differences between now and then that suggest the impact could be much larger. China makes up a significantly larger share of the world economy than it did in 2003, and it plays an even more central role in the global manufacturing supply chain.

The other major difference is that the steps taken to contain the spread of the virus, both within and outside China, have been far more stringent than they were in response to SARS. The Chinese Government has ordered factories to remain closed beyond the usual holiday period, and has either imposed travel bans or encouraged millions of people to self-quarantine at home.

We have revised our forecast of China's GDP growth for this year down from 5.8% to 5.3%. That assumes zero growth in the March quarter as a result of factory shutdowns and restrictions on people's movements, followed by a period of higher growth rates as the level of activity returns to normal. However, the risks are towards a more significant hit to growth, as the restrictions may remain in place for longer than expected, and the underlying momentum in China's economy is weaker than it was in 2003.

The spillover effects will be most significant for East Asia, which is also a major link in the global supply chain. If the shutdowns in China persist, factories will eventually run out of components, and other suppliers may be hard to find. These countries also have strong travel links with China, putting them at greater risk of the spread of the virus, which in turn could dissuade visitors from other regions.

The impact on Australia will be through similar channels to New Zealand, and is expected to be of a similar magnitude.

Our forecasts for North America and Europe are not affected by Coronavirus at this point, as the virus has not taken hold in these regions, and their trade and tourism links with China are less significant as a share of their overall economies.

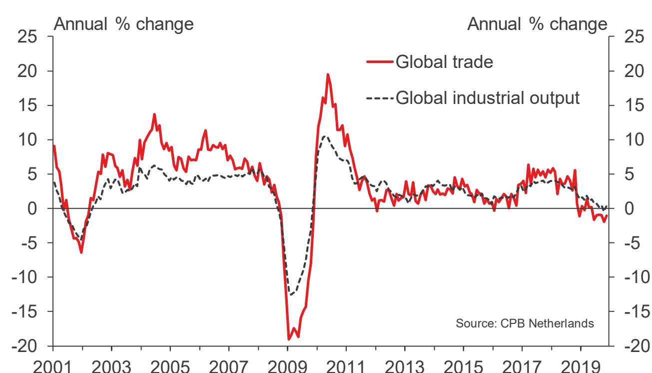
China's rise since the start of the century has led to it dominating demand for commodities, which means that the impact on global commodity markets will be greater than it was for SARS. Prices have fallen sharply for metals (as an industrial input) and oil (due to reduced transport and travel). We expect these prices to hold around current levels until Chinese growth recovers in the second half of the year. Lower oil prices will themselves provide some relief for the global economy though they could be a drag on US business investment given the size of the shale oil industry.

Policy responses will temper the economic impact of the outbreak to some degree. In China, there is no real limit on the support the central government can provide, and financial relief for affected businesses and households is likely in the near term. Japan's recently-announced fiscal stimulus will help to support its economy, and other countries in the region may also resort to fiscal and monetary easing.

With growth slowing and inflation below target, we expect the US to cut interest rates further this year.

The impacts of Coronavirus have come on top of a significant slowing in world growth over the last year. Political uncertainty, trade protectionism and China's managed slowdown had already seen a drop off in global trade and manufacturing activity to their weakest pace since the Global Financial Crisis. The 'Phase 1' trade agreement between the US and China may have averted a worse outcome, but it still leaves trade tariffs in place at significantly higher levels than seen in previous years, and there are a number of unresolved issues that could flare up again.

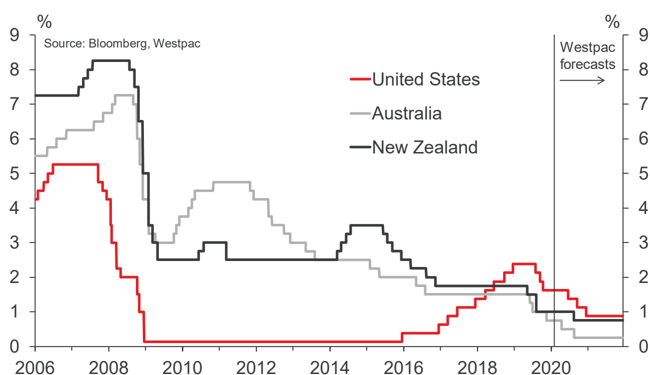
Figure 8: Global trade and industrial output



The US economy saw a revival in growth in 2018, driven by tax cuts, increased government spending and a more buoyant consumer. However, those first two factors have since faded, and now the engine of consumer spending is starting to sputter. We expect household income growth to slow this year as low business confidence weighs on hiring and wage growth.

With GDP growth slowing and inflation still stuck below the 2% target, we believe that the Federal Reserve will be compelled to cut interest rates further – we expect three more cuts between June and December this year. Other central banks around the world are likely to ease further as well, particularly those that are sensitive to the effects of relative interest rates on their currencies.

Figure 9: Central bank policy rates



Australia's economy was heading for another difficult year even before the expected short-but-sharp hit to growth from Coronavirus (and this summer's bushfires to a smaller degree). Households are coming under pressure due to weak wage growth, and the pipeline of building consents suggests that homebuilding will continue to slow sharply this year.

We expect the Reserve Bank of Australia to cut the cash rate twice more this year to its effective lower bound of 0.25%. At that point we expect the RBA to resort to quantitative easing, most likely in the form of buying government bonds, in order to drive down longer-term interest rates.

This year's headwinds for the Australian economy are expected to give way to a return to about-trend growth in 2021. House prices are now rising again in most cities after an extended decline, which will help to strengthen household balance sheets. The decline in homebuilding activity is likely to flatten out by the end of this year, and investment in the mining sector is expected to pick up again after six years of decline.

The Australian economy is set for another difficult year, before a return to trend growth in 2021.

Inflation.

Just flirting.

Inflation has been rising and is set to reach 2% in early 2020. But unfortunately for the RBNZ, it looks like this will only be a brief flirtation with the midpoint of the target band. That's because although domestic inflation has picked up, strong competitive pressures in the retail sector are continuing to limit price increases.

Inflation picked up to 1.9% over the past year, and it's set to rise a little above the 2% midpoint of the Reserve Bank's target band in early 2020. However, we don't think that this marks the start of a sustained trend higher in inflation. In fact, we expect that inflation will drop back below 2% again over the course of this year. In part, that's because some of the recent lift in inflation was due to factors which won't be repeated, like the introduction of GST on low value imports. Inflation was also boosted by the drop in the New Zealand dollar over the past year, which we don't expect to be repeated over 2020.

Looking at the pricing environment more broadly, we're continuing to see softness in the prices of many globally traded consumer goods, along with fierce competitive pressures in the retail sector. Those pressures have been reinforced by the continuing shift to online retailing, which has meant that New Zealand businesses are increasingly competing head-to-head with large international retailers who have significant pricing power. Together, those conditions have held down the prices of many goods in recent years, and in some cases (like electronics and home furnishings) there have been outright price declines. Such competitive pressures will remain a key feature of New Zealand's retail landscape and a brake on inflation over the years ahead.

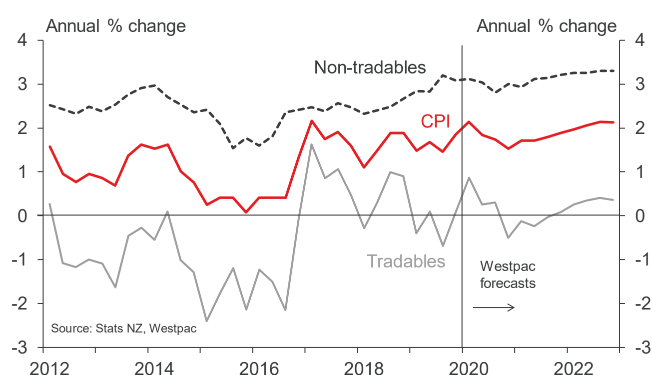
Unfortunately for the Reserve Bank, it looks like inflation is only flirting with 2%.

Nevertheless, following an extended period of economic growth, we are seeing inflation pressures increasing in some areas of the economy. Those pressures have been centred squarely on the domestically focused non-tradable components of the Consumers Price Index, which rose by 3.1% in the year to December. Much of that rise has been related to the housing market, with rents increasing rapidly in many parts of the country. There's also been a pickup in some government charges, like local authority rates. These increases come atop other signs that domestic inflation pressures are building, with wage growth lifting to its fastest pace in ten years and a growing number of businesses reporting increases in operating costs.

We expect that domestic prices will continue to trend higher over the coming years as the combination of low interest rates and increases in fiscal spending supports a strengthening in domestic demand. But over the year ahead that won't be enough to prevent overall inflation from dropping back below 2% due to the lingering softness in the more import intensive areas of the economy.

Looking further ahead, we think that inflation will push higher over time. However, the combination of the above factors means that any increases are likely to be gradual, and the RBNZ will be fighting an uphill battle to keep inflation near the midpoint of the target band for a while yet.

Figure 10: New Zealand inflation



Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Mar-20	2.1	1.00	1.20	1.10	1.25
Jun-20	1.8	1.00	1.10	1.05	1.20
Sep-20	1.7	0.75	0.90	1.00	1.20
Dec-20	1.5	0.75	0.90	1.00	1.25
Mar-21	1.7	0.75	0.90	1.00	1.30
Jun-21	1.7	0.75	0.90	1.05	1.35
Sep-21	1.8	0.75	0.90	1.10	1.40
Dec-21	1.9	0.75	0.90	1.15	1.45
Mar-22	2.0	0.75	0.90	1.20	1.55
Jun-22	2.1	0.75	0.90	1.25	1.65

The Reserve Bank and Interest Rates.

Striking out on their own.

The Reserve Bank has switched tack to an on hold OCR outlook. However we think the next move in the OCR is more likely to be down, mainly because we anticipate a renewed bout of negative global economic sentiment. Meanwhile, private sector interest rates are likely to rise independent of the OCR.

The Reserve Bank has changed tack to an on hold outlook, whereas previously it was a hair's breadth from cutting. This was no surprise given what has happened. There has recently been a general improvement in global economic sentiment and other central banks have gone on hold. The New Zealand housing market and consumer spending have responded to interest rate reductions much more vigorously than the RBNZ anticipated (but in line with our expectations). Unemployment has stayed low and inflation has lifted a little. And finally, the Government has announced a large infrastructure spending plan that will stimulate the economy.

The RBNZ is now forecasting no further OCR cuts, with hikes to begin in the middle of next year. By contrast, we think there is still a significant chance that the OCR will be adjusted downward this year. We have pencilled in one OCR cut for August to reflect the balance of risks, but the timing and extent of any OCR reduction is highly uncertain.

- As the *Global Economy* section explains, later this year we expect that global economic sentiment will deteriorate and that both the Federal Reserve and Reserve Bank of Australia will be cutting interest rates.
- We expect the exchange rate will rise later this year, as explained in the *Exchange Rate* section.
- The *Inflation* section explains why we think inflation will only touch 2% before dropping back again to around 1.5%.
- The Government's infrastructure spending program is likely to be slower than the Treasury and Reserve Bank are forecasting.

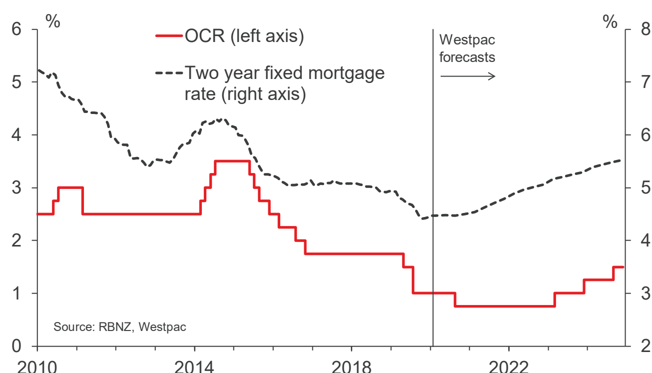
What holds us back from being more adamant about an OCR cut is the housing market. The RBNZ is of the view that house price inflation will soon diminish due to slower net migration (a view they have doggedly stuck to despite being wrong over the past year). House price inflation is more likely to heat up to 10% on the back of low mortgage rates, which may make the RBNZ squeamish about OCR cuts. Our judgement at this stage is that low inflation and overseas interest rate cuts will (rightly) dominate the RBNZ's thinking on the OCR. However, we do expect the RBNZ to tighten its macroprudential settings in response to the housing market upturn.

The OCR will not be the only influence on interest rates this year. Unsurprisingly given what has happened with interest rates, Kiwis are going on a mortgage borrowing spree and the growth rate of deposits entering the banking system is not keeping up. When this has happened in the past, the result has been a lift in interest rates independent of the OCR. There is no reason to suppose this time will be different.

Another driver of interest rates will be the Reserve Bank's policy of requiring banks to hold more capital. This was confirmed late last year, although the requirements were softened a little relative to the initial proposal. We estimate that the spread between deposit rates and lending rates at banks will widen by about 40 basis points on average, and this will play out over a few years. Some interest rates will be affected differently to others. Commercial lending rates will probably rise by more and mortgage rates by less than the average. Meanwhile, deposit rates will be lower than otherwise. During a transition period over the coming few years, the Reserve Bank will probably keep the OCR lower than otherwise to ease the burden on mortgage borrowers (a key reason that our forecast of eventual OCR hikes is so slow). But this will not prevent an increase in the interest rates experienced by commercial borrowers, and it will actually worsen the lot of savers.

Beyond the transition period the average level of the OCR won't be affected by the capital requirements. Instead, the economy will permanently experience slightly higher borrowing rates and slightly lower savings rates than without the capital requirements.

Figure 11: Westpac OCR and two year mortgage rate forecasts



Agricultural Outlook.

For better or worse.

The growing dominance of the Chinese market means that New Zealand's exporters will bear the brunt of the impact of the Coronavirus outbreak. The effects will differ across products, with some expected to benefit from catch-up demand as activity resumes in China, while others are likely to miss out.

The Coronavirus outbreak came at a time when New Zealand's agricultural exports were in a relatively favourable position. Despite a slowing Chinese economy, demand for food remained strong and prices were generally above average. Demand for meat was also temporarily boosted last year by the outbreak of African Swine Fever among China's pig herds, although prices have since dropped back as China has released stocks of frozen meat and allowed imports from a wider range of countries.

China's responses to the outbreak will affect our agricultural exports in varying ways. With people staying at home to avoid the spread of the virus, eating out has plunged, with the greatest impact being felt in demand for seafood, beef and the lower-value cuts of sheepmeat that are more popular in China. (Cuts such as lamb legs which are directed more to the European market have seen little impact.) While demand will eventually return as the virus is brought under control, those lost export earnings won't be recovered later.

In other cases, the impact on prices could be short-lived. Chinese manufacturers have seen longer than usual shutdowns this year due to the extension of the Lunar New Year holiday period and the lack of availability of workers. But as they reopen, they will need to catch up to demand and rebuild their inventories. That should help to revive prices for staples such as milk powder – for instance, the need for infant formula is not lessened during a virus outbreak.

Other durable products like logs and wool should also get some support as manufacturing resumes in China. However, the adjustment process could be slow – particularly for the forestry sector, where the oversupply of logs into the Chinese market that developed last year was still unresolved at the time that the outbreak hit.

New Zealand farmers face an additional challenge from the increasingly dry conditions that have developed across the North Island in the last couple of months. For dairy that will mean a shortfall in milk collections over the tail end of the season, which in turn presents an upside risk to world dairy prices. Sheep and beef farmers are likely to take a bigger hit, as they will be trying to offload stock at a time that meat processors are booked up, and exports to China are constrained. We expect meat prices to fall further in the next few months.

We have lowered our farmgate milk price forecast for this season from $7.40/kg to $7.20/kg, reflecting the Coronavirus hit to world dairy prices. However, we have retained our forecast of $7.30/kg for the following season, based on a gradual recovery in prices in the coming months.

Commodity price monitor

Sector	Trend	Current level[1]	Next 6 months
Dairy	Further declines due to Coronavirus are possible in the near term, but we expect some recovery when food manufacturing resumes in China. Dry weather will limit milk supply from New Zealand and Australia.	Average	→
Beef	Prices are expected to weaken further in the short term in response to the virus outbreak.	Above average	↘
Lamb	Prices are still coming off last year's spike, but the virus impact is likely to be small due to less reliance on the Chinese market. Losses from bushfires will restrict supply from Australia, supporting prices.	High	↘
Forestry	Shutdowns in China have halted log exports in the near term. While activity will recover in time, the glut of logs from Europe remains an issue.	Average	→
Wool	Prices are expected to remain at depressed levels.	Low	→
Horticulture	Little impact expected from Coronavirus in the near term, though prices could start falling if the outbreak is more drawn-out.	High	→

1 NZ dollar prices adjusted for inflation, deviation from 10 year average.

Exchange Rates.

Set to rise.

The New Zealand dollar appears to have ended its long-running downtrend and is set to head higher this year. Concerns about the economic impact of Coronavirus will keep the currency under pressure in the near term. But once these concerns ease, New Zealand's relatively favourable economic outlook will attract investors to the NZD.

In our November *Economic Overview* we posited that the long downtrend in the New Zealand dollar exchange rate may be drawing to a close. Improving sentiment about the global economy was starting to draw investors away from the 'safe haven' of the US dollar, and the flow of economic data in New Zealand was expected to show a lift in momentum after a soft patch in 2019.

That turnaround played out even faster than we expected. The NZD ended last year with a hiss and a roar, rising to a five-month high of 67 cents against the US dollar.

However, in the early part of this year the NZD has come under fire again, falling to as low as 64 cents. Markets have perceived the New Zealand economy as being relatively vulnerable to the impacts of the Coronavirus outbreak – which indeed it will be, at least in the short term. For now the currency will continue to trade on news about the outbreak, with investors keen to stay in front of any positive developments.

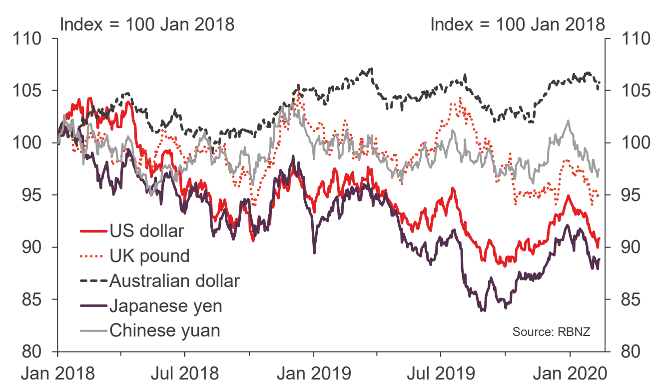
Beyond that, though, we have substantially lifted our outlook for the NZD this year. With the risk-off sentiment in financial markets dissipating, the focus will turn again to relative growth and interest rates across countries, where New Zealand is likely to fare better than many of its peers. We expect the NZD to average 66 cents over the second half of this year, and to trend higher beyond that.

On the growth front, New Zealand has entered the new year with low interest rates, a resurgent housing market and a sharp lift in planned infrastructure spending – a triple dose of stimulus that other countries haven't matched. The effects of this stimulus will become more apparent in the economic data once the Coronavirus disruptions ease.

With stronger growth and inflation close to target, the RBNZ is likely to cut interest rates by less than the US or Australian central banks, increasing the NZD's yield advantage. Indeed, one of the reasons we're expecting the RBNZ to cut at all is that, in the absence of such a move, the NZD could rise even further to levels that could lead to an undershoot of the inflation target.

Relative interest rates will be particularly relevant for the NZD/AUD exchange rate, which we think will come close to parity this year. As noted in the *Global Economy* section, we expect the Reserve Bank of Australia will cut its cash rate to effectively zero and adopt quantitative easing. It looks much less likely that the RBNZ will need to resort to such measures.

Figure 12: NZ dollar exchange rate vs major countries



Exchange rate forecasts (end of quarter)

	NZD/ USD	NZD/ AUD	NZD/ EUR	NZD/ GBP	NZD/ JPY	TWI
Mar-20	0.64	0.96	0.59	0.48	68.5	71.1
Jun-20	0.66	0.99	0.60	0.50	69.4	72.7
Sep-20	0.66	0.99	0.59	0.50	69.3	72.6
Dec-20	0.66	0.99	0.59	0.50	69.3	72.3
Mar-21	0.66	0.97	0.58	0.50	70.0	72.0
Jun-21	0.66	0.96	0.58	0.50	70.6	71.5
Sep-21	0.67	0.94	0.58	0.51	71.8	71.4
Dec-21	0.67	0.93	0.58	0.51	73.0	71.5
Mar-22	0.67	0.93	0.58	0.51	74.0	71.6
Jun-22	0.68	0.92	0.58	0.51	75.0	71.7

Special Topic.

The pressures firms are facing.

Low business confidence despite an improving economy is a major theme of this *Economic Overview*. In this *Special Topic* we take a closer look at some of the pressures on firms, from the rising cost of complying with regulations and being a good corporate citizen, to the new technologies that are keeping product margins wafer thin. These pressures are not going away any time soon. Firms that are unable to adapt will fail, while those that are best able to leverage off new technologies will thrive.

The competitive environment facing firms in New Zealand is being shaped by unprecedented technological change. Thanks to advances in communications and artificial intelligence/ machine learning, the Internet of Things is no longer science fiction. Automation is now a fact of life, while technologies such as virtual, augmented and extended reality are being widely adopted. Ditto for 3D-printing, big data analytics, cloud-enabled ecosystems, blockchain and cybersecurity.

One impact of the new technologies sweeping the globe is that buyers now have more information to inform their purchasing decisions and have access to a much wider range of suppliers, often from overseas. For firms in New Zealand this means more competition and less pricing power, even when demand picks up.

At the same time as firms in New Zealand are facing downward pressure on prices, they are also facing upward pressure on costs. One cause is government regulation, covering anything from environmental issues to health and safety considerations at work and increases in the minimum wage. Another is the cost burden that comes from having to meet society's rising expectations of good corporate citizenship. In fact, changing social mores are probably driving the Government's behaviour, not the other way around. This means the rising "compliance burden" is not going away any time soon.

Societal pressures include the growing movement to address harms caused by human activity on our natural environment. Circular economy thinking is now moving to centre stage and the pressure to reduce, reuse, recycle and replace products at each point along the production value chain is intensifying. In response, the Government has introduced legislation to ban the single use of plastic bags and reduce net carbon emissions to zero by 2050.

Some of these pressures are evidenced in practices, which are not part of regulations per se, but are widely adopted because they are seen as the right thing to do or may improve a firm's standing in the eyes of its customers. An example is the adoption of the living wage by some New Zealand firms. Pressure to do the right thing might also come from within firms, reflecting a sense of corporate and social responsibility.

Regulations that raise the cost of doing business remain an ongoing concern for firms, especially those that operate in highly competitive markets where the ability to recoup additional costs through price increases are limited. This may explain why so many small businesses baulk at any mention of an increase in the minimum wage.

In short, technological change and increased regulation means more competition and tighter profit margins. This could help explain why business confidence in New Zealand remains low even as consumer spending starts to pick up off the back of rising house prices and government largesse.

Firms are responding to these pressures in different ways. Some are doing nothing and are carrying on as usual. In an environment where profits are already under pressure, many of these will eventually go out of business.

Firms more likely to prosper are taking a much closer look at their customers. They are using algorithms, big data analytics and artificial intelligence to develop insights about changing demand patterns, opportunities in new and existing markets, as well as the risks that they might be exposed to.

They are then using these insights to target specific customer sectors. Others are going further, working closely with selected customers in these sectors to deliver tailored products.

Successful firms are also looking at their production set ups, with circular economy and broader environmental factors increasingly front of mind. New products are being developed at an ever-quickening pace, while advances in process technologies are leading to new work organisation methods and reconfigured supply chains.

Finally, best-in-class firms are also looking improve their operational and supply chain efficiencies. Autonomous devices that monitor and manage real time developments along the entire supply chain are helping to optimise logistics, reduce inventory holding costs, anticipate and mitigate machine breakdowns, minimise wastage and maximise production volumes over a given fixed cost.

Economic and financial forecasts.

New Zealand forecasts

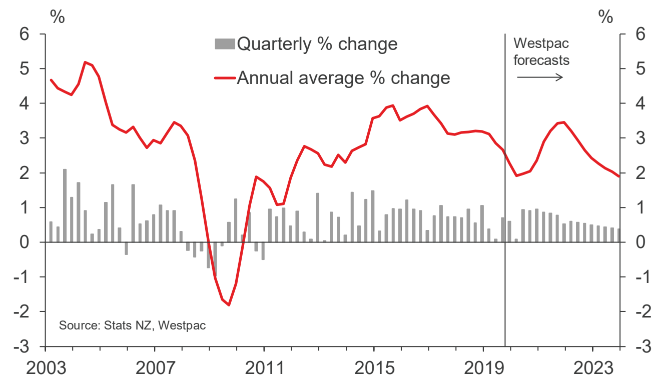
GDP components	Quarterly % change				Annual average % change			
	Sep-19	Dec-19	Mar-20	Jun-20	2018	2019	2020	2021
GDP (production)	0.7	0.6	0.1	0.9	3.2	2.3	2.3	3.4
Private consumption	0.8	1.2	0.6	0.9	3.2	2.9	3.3	4.0
Government consumption	1.3	1.0	0.9	0.8	3.7	3.8	3.6	2.5
Residential investment	-0.5	1.0	2.0	1.5	0.1	4.0	4.3	2.1
Business investment	0.4	0.9	0.8	0.5	7.6	2.7	2.7	3.2
Stocks (% contribution)	1.8	-1.2	0.2	0.1	0.4	-0.9	0.3	0.0
Exports	-2.8	1.9	-1.4	0.9	2.6	2.4	-0.5	3.1
Imports	2.3	-0.9	1.5	0.8	5.8	1.2	3.1	3.1
Economic indicators	**Quarterly % change**				**Annual % change**			
	Sep-19	Dec-19	Mar-20	Jun-20	2018	2019	2020	2021
Consumer price index	0.7	0.5	0.4	0.3	1.9	1.9	1.5	1.9
Employment change	0.2	0.0	0.6	0.4	1.9	1.0	2.2	2.1
Unemployment rate (end of period)	4.1	4.0	4.1	4.3	4.3	4.0	4.1	3.7
Labour cost index (all sectors)	0.8	0.7	0.4	0.7	1.9	2.6	2.4	2.6
Current account balance (% of GDP)	-3.3	-3.0	-3.0	-3.2	-3.8	-3.0	-3.5	-3.3
Terms of trade	1.9	1.3	-1.3	-1.7	-4.8	5.7	-2.0	0.8
House price index	1.8	2.9	2.4	2.2	2.8	4.5	8.6	5.5
Financial forecasts	**End of quarter**				**End of year**			
	Sep-19	Dec-19	Mar-20	Jun-20	2018	2019	2020	2021
90 day bank bill	1.32	1.17	1.20	1.10	1.87	1.17	0.90	0.90
5 year swap	1.14	1.18	1.25	1.20	2.40	1.18	1.25	1.45
TWI	72.0	71.4	71.1	72.7	73.5	71.4	72.3	71.5
NZD/USD	0.65	0.64	0.64	0.66	0.67	0.64	0.66	0.67
NZD/AUD	0.95	0.94	0.96	0.99	0.93	0.94	0.99	0.93
NZD/EUR	0.58	0.58	0.59	0.60	0.59	0.58	0.59	0.58
NZD/GBP	0.53	0.50	0.48	0.50	0.52	0.50	0.50	0.51

International economic forecasts

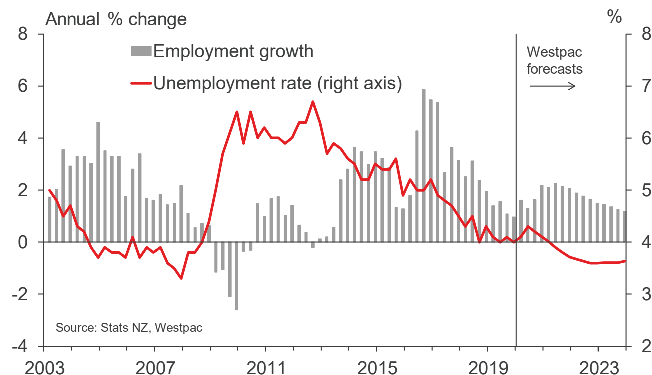
Real GDP (calendar years)	Annual average % change					
	2016	2017	2018	2019f	2020f	2021f
New Zealand	3.9	3.1	3.2	2.3	2.3	3.4
Australia	2.8	2.5	2.7	1.8	1.8	2.6
China	6.7	6.8	6.6	6.1	5.3	6.1
United States	1.6	2.4	2.9	2.3	1.6	1.5
Japan	0.6	1.9	0.8	0.8	0.4	0.4
East Asia ex China	4.0	4.5	4.3	3.6	3.3	3.9
India	8.2	7.2	6.8	5.4	5.5	6.0
Euro Zone	1.9	2.5	1.9	1.2	1.0	1.2
United Kingdom	1.8	1.8	1.4	1.3	0.8	1.5
NZ trading partners	3.6	4.0	4.0	3.5	3.1	3.6
World	3.4	3.8	3.6	3.0	2.8	3.2

The economy in six charts.

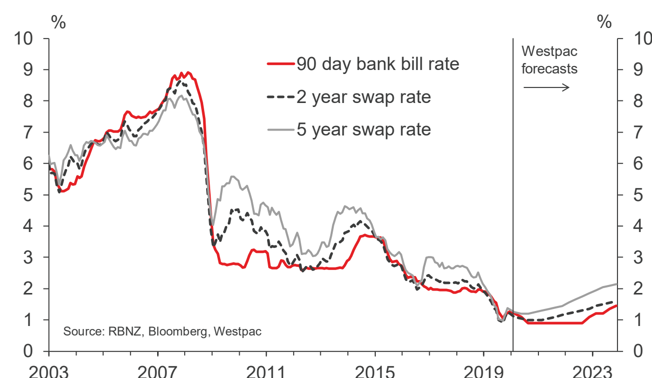
New Zealand GDP growth



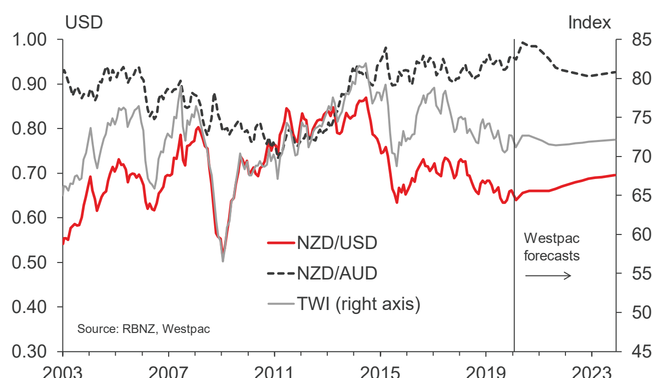
New Zealand employment and unemployment



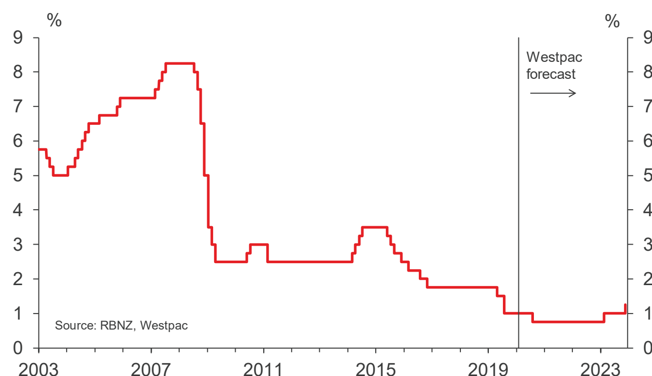
90 day bank bills, 2 year swap and 5 year swap rates



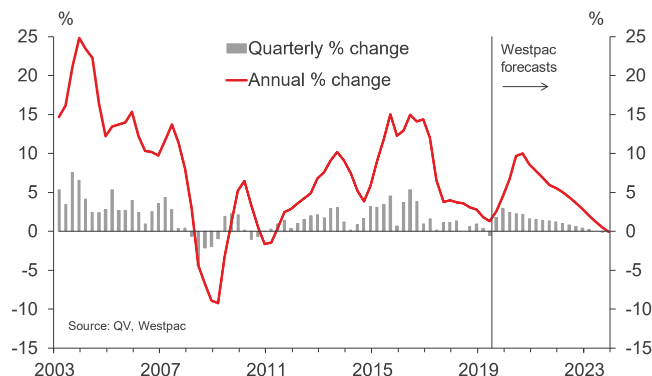
Exchange rates



Official Cash Rate



New Zealand house prices



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