Abel Tasman National Park, New Zealand

Weekly Economic Commentary.

COVID returns to Aotearoa.

COVID has returned and with it lockdown, although with regional variation this time. We explore what this could mean for the economy below. Meanwhile, last week the Reserve Bank usefully clarified the scale and timing of its Large Scale Asset Programme (quantitative easing). The bank also stated that a negative OCR is a preferred policy option as we have long thought. Lastly, July housing market activity was firm and we have revised up our 2020 house price view.

Community transmission of COVID-19 has re-emerged in New Zealand. The Government has responded by raising the COVID Alert Level to 3 for Auckland and to 2 for the rest of the country. Nobody knows how this is going to play out, but in a recently released bulletin[1] we discussed the economic implications of three possible outcomes.

If this is just a scare, and the Alert Levels are raised only briefly, then the economic implications are small. We have calculated that, for each week that Auckland is at Level 3 and the rest of New Zealand at Level 2, about $300m of economic activity is foregone, or 0.5% of quarterly GDP. But some of this would be delayed rather than cancelled expenditure, so the final economic cost would be lower. With this modest impact in mind, we would not make any change to our GDP or unemployment forecasts in this scenario. That's because our central forecasts already allowed for occasional scares of this nature.

If New Zealand goes into another Level 4 lockdown, the economic implication would be more severe. The first lockdown severely curtailed economic activity. While the economy rebounded very quickly, we estimate that it settled roughly 5% below our pre-COVID forecast.

If there was another lockdown, we anticipate that the September quarter would look similar to June. After that, economic activity would rebound quickly to around 5.5% below our pre-COVID forecast. This additional half percentage point of economic damage would reflect additional business closures and job losses plus lower investment activity. Our

1 Available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2020/Bulletins-2020/Lockdown-implications-August-2020-Westpac-NZ-Final.pdf

unemployment forecast would peak at 8% in this alternative scenario, compared to a peak of 7% in our current forecasts. That's despite our expectation that the Government would restart the clock on the wage subsidy scheme.

While this additional economic damage is serious, it is a relatively small increment compared to the damage wrought by the original COVID outbreak. That's because there can be no new damage to the already flatlining international tourism and the foreign education sectors. The remainder of the economy has stunned everybody by bouncing back from lockdown much more readily than anticipated. Notably, retail spending by New Zealanders is back around the levels prior to the COVID outbreak, while electricity consumption is back above year ago levels.

This surprising resilience was aided by substantial government support. We assume that this support would be repeated in another lockdown, and that would have big implications for Government debt. The Government has $14bn left in its $62bn COVID response and recovery plan, but in a second lockdown they wouldn't be constrained to spending only that amount. On top of the extra spending required, government revenue would also fall significantly. Put together, this would leave the government's books in much worse shape, with an additional borrowing requirement of circa $30bn. We anticipate this would see net debt peak at around 55% of GDP, compared to 47% in our baseline forecast. Another lockdown would also leave the economy with additional scarring. As a result, New Zealand's recovery from COVID would be even more gradual, with GDP around 0.5 percentage points lower at the end of 2025 than in our baseline forecast.

If the virus gets out of control, that would be a real game changer for the economy, based on what we are seeing overseas. Countries that have implemented successful lockdowns such as China are generally doing much better than countries that have not (e.g. the US) – illustrating that the 'choice' between health and economy was always a false dichotomy. All of this suggests that if New Zealand goes into another successful lockdown, it will suffer only incremental additional economic damage, whereas, if the virus gets out of control, the economy would take a much bigger hit.

Meanwhile, the Reserve Bank (RBNZ) last week provided useful clarity to markets. It clarified that it intends to purchase bonds under the Large Scale Asset Purchase (LSAP) programme for much longer than the May 2021 date it had previously been explicit about. And the RBNZ clarified that if the economy requires more monetary stimulus on top of the LSAP, then its next tool would be a combination of a negative OCR and direct loans to banks. None of this surprised us. The RBNZ's announced policy now looks much closer to our own long-held views. Back in April we said that the LSAP would have to be extended, and in order to purchase bonds over such a long timeframe, the cap on the LSAP would have to be increased to $100bn. We have also long predicted that the OCR will fall to -0.5% in April 2021. The RBNZ did not go that far, but they inched a little closer by saying that a negative OCR is a preferred policy option.

However, there was a little sting in the RBNZ's tail. The RBNZ has upped the rate of its weekly bond purchases and this has surprised markets and successfully pushed rates such as the 10-year Government Bond yield 12 basis points lower since last Wednesday's Statement. All up, the RBNZ will be satisfied with these developments.

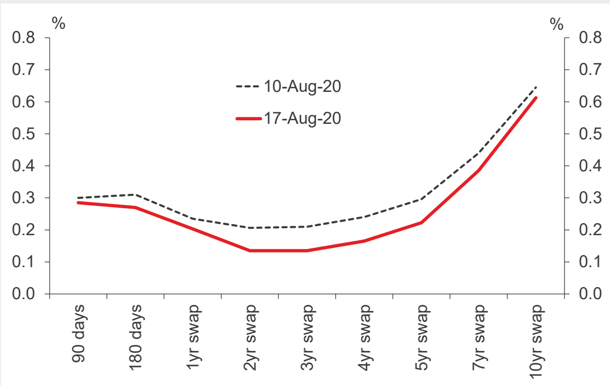
Finally, the New Zealand housing market was very active in July. House sales hit a four-year high, while sale prices gain a solid 1.7%. With this data in hand, it's now clear that the housing market has performed better than expected following the lockdown. As a result, we now expect house prices to fall just 2.5% over 2020 versus our earlier forecast of a 7% fall. The market outlook is a balance between record-low mortgage rates and increasing financial stress among homebuyers and tenants, as the wage subsidy scheme expires and job losses start to mount. The current flare-up of COVID-19 will also give the housing market pause for thought.

Fixed vs Floating for mortgages.

Fixed mortgage rates fell sharply over May and June, and have been stable since. There is perhaps some scope for a further decline in fixed mortgage rates, but it isn't guaranteed and it isn't large.

We are forecasting fairly stable interest rates this year, but early next year we expect that the RBNZ will lower the OCR to -0.5%. If that is correct, then both fixed and floating rates will fall next year.

NZ interest rates



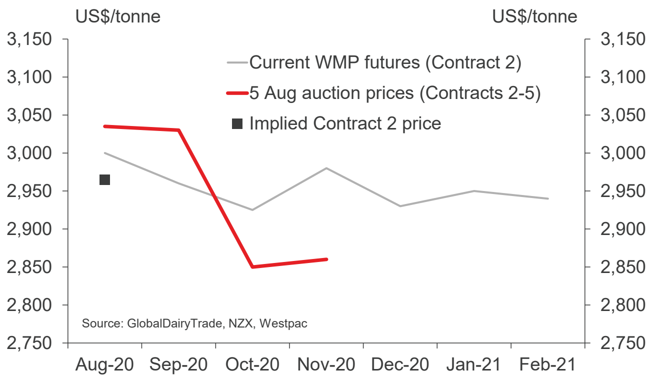
The week ahead.

NZ GlobalDairyTrade auction, whole milk powder prices

Aug 19, Last: –7.5% chg, WBC f/c: –1.0%

- We expect that whole milk powder (WMP) prices will fall modestly as the New Zealand spring and the seasonal increase in production approaches. The dairy futures market is pointing to a similar fall at the time of writing.
- WMP prices slid at the previous auction as dairy market nervousness returned following fresh COVID outbreaks in key dairy markets.
- Over coming months, we expect global dairy prices to drift lower as New Zealand production continues its seasonal rise and as the global recession weighs down dairy demand.

Whole milk powder prices

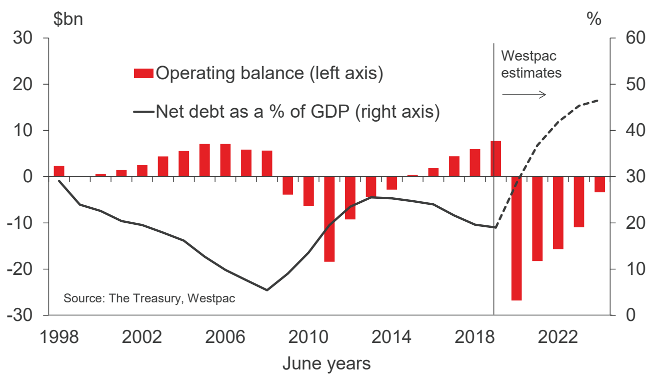


NZ Pre–Election Economic and Fiscal Update

Aug 20

- The PREFU is a required update of the Treasury's projections ahead of the general election on 19 September. It does not normally include policy announcements.
- The May Budget forecasts were prepared while the country was still in COVID–19 lockdown. Since then, it has become apparent that the economy has bounced back more readily than expected, and the Government has deferred $14bn of the spending that it had approved for the COVID response. As a result, we expect the PREFU forecasts to show substantially smaller deficits and a reduced borrowing requirement.
- The economic forecasts won't reflect the recent flare–up and the return of COVID restrictions. Potential for last–minute adjustments lies in the bond tender programme, which could be maintained at a high level in case additional spending proves necessary.

NZ fiscal position

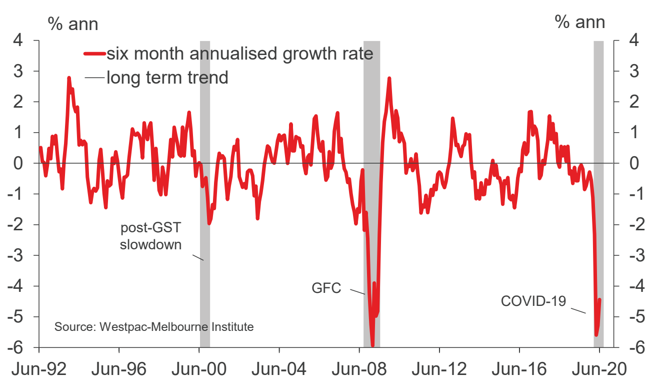


Aus Jul Westpac–MI Leading Index

Aug 19, Last: –4.44%

- The Leading Index growth rate rose from –5.29% in May to –4.44% in June – an improvement to be sure but from an extremely weak starting point and still leaving the overall signal in deep negative territory, consistent with an ongoing recessionary contraction.
- The July update is likely to be another weak read. It will incorporate a sharp deterioration in sentiment–based components – the Westpac–MI Consumer Expectations Index spiking to a new cycle high – both keying off renewed virus fears following the hard lockdown in Victoria. Dwelling approvals also recorded another weak result, falling 4.9%. Total hours worked will provide some offset, posting a further 1.3% lift in July (noting that this precedes developments in Victoria). Other components have seen a mix of much smaller moves.

Westpac-MI Leading Index



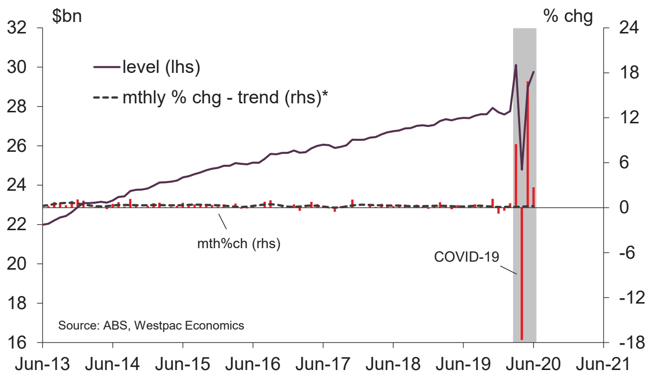
The week ahead.

Aus Jul preliminary retail trade

Aug 21, Last: 2.7%, WBC f/c: 3.0%

- The COVID outbreak wreaked havoc across the retail sector in the June quarter, an initial stockpiling-driven jump in March (+8.5%) followed by an eye-watering 17.7% plunge as the nationwide lockdown came into effect in April then an equally dramatic 16.9% rebound in May – easily the wildest three month period on record. June posted a more sedate 2.7% gain, consolidating on the May rebound. Remarkably, June sales were 7.2% above their pre-COVID level in February. However, it should be noted that retail is a poor guide to total spending at the moment as it excludes some of the biggest negative impacts – on sectors like tourism and hospitality – and over-represents segments benefitting from expenditure switching.
- Indicators point to another solid lift in retail spending in July – propelled by a further relaxation in restrictions in most states and, late in the month, a rush of 'stockpiling' demand in Victoria. Card transaction flows point to a 3% gain overall, slightly stronger than the June result. This will likely be followed by a significant fall as lockdowns impact in August.

Monthly retail sales

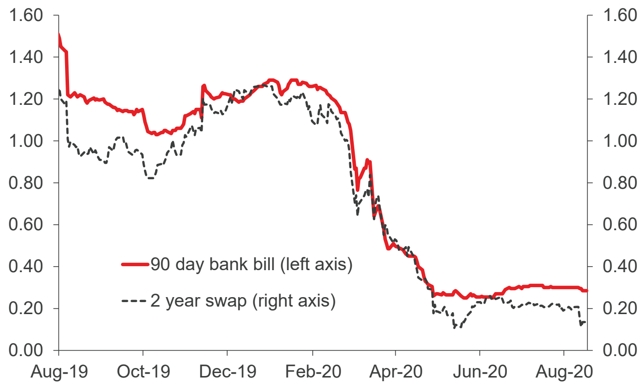


New Zealand forecasts.

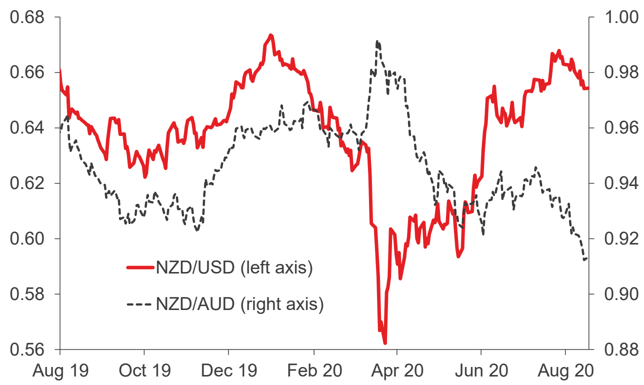
Economic forecasts	Quarterly				Annual			
	2020							
% change	Mar (a)	Jun	Sep	Dec	2018	2019	2020f	2021f
GDP (Production)	-1.6	-13.5	14.0	0.9	3.2	2.3	-4.6	5.1
Employment	1.0	-0.4	-3.8	-0.8	1.9	1.0	-4.0	2.8
Unemployment Rate % s.a.	4.2	4.0	6.5	7.0	4.3	4.1	7.0	6.4
CPI	0.8	-0.5	0.8	-0.3	1.9	1.9	0.8	0.4
Current Account Balance % of GDP	-2.7	-2.1	-1.7	-1.7	-3.8	-3.0	-1.7	-2.0

Financial forecasts	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
Cash	0.25	0.25	0.25	-0.50	-0.50	-0.50
90 Day bill	0.30	0.20	-0.10	-0.20	-0.20	-0.20
2 Year Swap	0.20	0.00	-0.10	-0.10	-0.10	0.00
5 Year Swap	0.30	0.25	0.25	0.30	0.40	0.50
10 Year Bond	0.65	0.70	0.80	0.90	1.00	1.10
NZD/USD	0.66	0.66	0.66	0.65	0.66	0.67
NZD/AUD	0.93	0.92	0.90	0.88	0.88	0.88
NZD/JPY	69.3	70.0	70.6	69.6	71.3	72.4
NZD/EUR	0.56	0.55	0.55	0.54	0.54	0.54
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.50
TWI	71.9	71.4	70.9	69.2	69.8	70.3

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 17 August 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.27%	0.27%	0.27%
60 Days	0.28%	0.29%	0.30%
90 Days	0.29%	0.30%	0.30%
2 Year Swap	0.14%	0.19%	0.21%
5 Year Swap	0.22%	0.28%	0.33%

NZ foreign currency mid-rates as at 17 August 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6543	0.6630	0.6546
NZD/EUR	0.5525	0.5629	0.5735
NZD/GBP	0.4995	0.5074	0.5210
NZD/JPY	69.77	70.16	70.11
NZD/AUD	0.9133	0.9295	0.9372
TWI	71.23	72.33	72.33

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Jul BusinessNZ PSI	54.1	–	–	Rebounded in June after COVID restrictions lifted.
UK	Aug Rightmove house prices	–	–	–	Unexpected mini–boom pushes July prices to pre-COVID high.
US	Aug Fed Empire state index	17.2	14.5	–	Capex outlook recovering; demand to limit job recovery.
	Aug NAHB housing market index	72	74	–	July beat forecasts, mortgage rates supporting demand.
	Jun total net TIC flows, $bn	–4.5	–	–	UST demand still robust despite low rates.
	Fedspeak	–	–	–	FOMC's Bostic will speak.
Tue 18					
Aus	RBA minutes	–	–	–	Provides additional colour on Board's policy discussions.
US	Jul housing starts	17.3%	3.7%	–	June was highest in three months, on broad-based gains.
	Jul building permits	2.1%	6.0%	–	Growth seen in June set to accelerate.
Wed 19					
NZ	GlobalDairyTrade auction, WMP price	–7.5%	–	–1.0%	Prices to fall modestly on rising seasonal production.
Aus	Jul Westpac–MI Leading Index	–4.44%	–	–	Improving but still in deep recession territory.
Eur	Jul CPI	–0.3%	–	–	Dipped into negative territory in June.
UK	Jul CPI	0.1%	–	–	Inflation not a threat for foreseeable future...
US	FOMC meeting minutes	–	–	–	Detail on risks and policy response in focus.
Thu 20					
NZ	Pre–Election Fiscal Update	–	–	–	Economic impact less severe than in May Budget.
US	Aug Phily Fed index	24.1	21.0	–	Emp. was positive for 1st time since March-20 in July.
	Initial jobless claims	963k	–	–	Downtrend has resumed over the past two weeks.
	July leading index	2.0%	1.0%	–	Resurgence of cases points to challenging outlook.
	Fedspeak	–	–	–	FOMC's Daly discusses future of work.
Fri 21					
Aus	Jul retail sales, preliminary	2.7%	–	3.0%	Indicators point to solid gain in July ahead of Vic lockdown hit.
Eur	Aug Markit manufacturing PMI	51.8	52.6	–	PMI data on upward trend from lows of April, the nadir...
	Aug Markit services PMI	54.7	54.7	–	... for activity during COVID–19 pandemic.
	Aug consumer confidence	–15.0	–15.0	–	Morale deteriorated in July, well below long–term average.
UK	Jul retail sales	13.9%	–	–	Sales are up, but many shops still struggle for foot traffic.
	Aug Markit manufacturing PMI	53.3	53.8	–	New order inflows and increased new business volumes...
	Aug Markit services PMI	56.5	55.9	–	... led to fastest pace of expansion in PMIs since 2019.
	Jul public sector borrowing £bn	34.8	–	–	Elevated due to gov. support and new health measures.
US	Aug Markit manufacturing PMI	50.9	51.5	–	New orders rose sharply & exports returned to growth in...
	Aug Markit service PMI	50.0	50.7	–	... July, aiding manufacturing as services slowly gained.
	Jul existing home sales	20.7%	12.3%	–	June saw largest gain since series began. Growth to continue.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019	2020f	2021f
Australia						
Real GDP % yr	2.8	2.5	2.8	1.8	-4.1	2.3
CPI inflation % annual	1.5	1.9	1.8	1.8	0.7	2.1
Unemployment %	5.7	5.5	5.0	5.2	8.6	7.4
Current Account % GDP	-3.1	-2.6	-2.0	0.6	2.4	0.8
United States						
Real GDP %yr	1.6	2.4	2.9	2.3	-6.8	2.9
Consumer Prices %yr	1.4	2.1	2.4	1.9	0.7	1.4
Unemployment Rate %	4.9	4.4	3.8	3.7	9.7	7.3
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.5	2.2	0.3	0.7	-5.0	1.0
Euro zone						
Real GDP %yr	1.9	2.5	1.9	1.2	-8.5	4.1
United Kingdom						
Real GDP %yr	1.9	1.9	1.3	1.4	-7.0	2.5
China						
Real GDP %yr	6.8	6.9	6.8	6.1	1.3	9.5
East Asia ex China						
Real GDP %yr	4.1	4.6	4.4	3.7	-2.0	5.4
World						
Real GDP %yr	3.4	3.9	3.6	2.8	-4.3	5.0
Forecasts finalised 7 August 2020						

Interest rate forecasts	Latest	Sep–20	Dec–20	Mar–21	Jun–21	Sep–21	Dec–21
Australia							
Cash	0.25	0.25	0.25	0.25	0.25	0.25	0.25
90 Day BBSW	0.10	0.10	0.15	0.20	0.25	0.30	0.35
10 Year Bond	0.92	0.90	0.90	0.95	1.05	1.20	1.35
International							
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	0.70	0.60	0.60	0.65	0.75	0.85	0.95

Exchange rate forecasts	Latest	Sep–20	Dec–20	Mar–21	Jun–21	Sep–21	Dec–21
AUD/USD	0.7133	0.71	0.72	0.73	0.74	0.75	0.76
USD/JPY	106.95	105	106	107	107	108	108
EUR/USD	1.1803	1.19	1.19	1.20	1.21	1.22	1.23
GBP/USD	1.3050	1.30	1.31	1.31	1.32	1.33	1.35
USD/CNY	6.9486	6.93	6.90	6.85	6.80	6.70	6.60
AUD/NZD	1.0922	1.08	1.09	1.11	1.14	1.14	1.13

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