
Kahurangi National Park, New Zealand

Weekly Economic Commentary.

To three or not to three.

The economic consequences of Covid-19 are becoming increasingly obvious, and weakness in demand signals a period of low inflation is on the cards. Against this backdrop, the Government seems to be gearing up to introduce even more fiscal support for the economy.

New Zealand is into week four of the Covid-19 lockdown, and we are now starting to get data illustrating just how significant the impact on economic activity has been. Daily turnover in the retail sector is down more than 50%. Unsurprisingly, business and consumer confidence have dropped sharply in recent weeks. In the business sector, plans for capital expenditure and hiring have been significantly scaled back, with job advertisements on TradeMe down 76% on pre-lockdown levels. The Government has already paid out more than $9bn in wage subsidies to keep people connected to their jobs. Nevertheless, a sharp increase in unemployment is coming. The Treasury has reported that the number of people on job seeker benefits has risen from under 150,000 to almost 170,000 in just three weeks. However, that increase is only a fraction of the 200,000 people we expect will eventually become unemployed.

With Alert Level 4 restrictions in place, we estimate that about a third of normal economic activity has not been occurring. However, efforts to limit the spread of the virus in New Zealand appear to have been effective, with the number of daily new infections falling to low levels. While we still think the Government will take a very conservative approach, a return to a lower alert level is starting to inch closer.

At Alert Level 3, most businesses will be allowed to reopen provided appropriate safety measures can be put in place. That means that industries like construction and forestry can recommence trading (though social distancing requirements will still be a hand brake on operations). In addition, many office workers will continue to work from home. But even at Alert Level 3, significant restrictions on activity will remain in place. Most notably, retail and hospitality businesses will only be able to open for delivery and contactless pre-ordered pick up – customers still cannot enter stores. These are sectors where most employees can't work from home, and in many cases it won't be possible to shift to online platforms. As a result, there's still a likelihood of job losses in these sectors.

We initially estimated that at Alert Level 3, around 8% of normal economic activity would not occur. However, the recently released details of the Alert Level 3 restrictions are more stringent than we expected. This may indicate downside risk to our forecast for a 14% decline in GDP growth in the June quarter.

To brace the economy during this time, the Government has continued to roll out measures to support the economy. The most recently introduced measures include around $3.1bn of support for businesses, focused on tax relief. This brings the total amount of planned spending on Covid-19 support measures to $22bn (equivalent to around 7% of annual nominal GDP).

It is likely that further fiscal support measures will be introduced over the coming months. Economic scenarios released from the Treasury last week painted a much more pessimistic outlook for the economy than forecasts from ourselves or other private sector economists. Even with the stimulus measures introduced to date, the Treasury are forecasting a 25% contraction in GDP in the June quarter and 13.5% unemployment. However, the Treasury also issued alternative scenarios showing that if the Government expanded its fiscal stimulus package by $20bn, unemployment would peak at only 9%. This is a very strong hint that fiscal stimulus will indeed be expanded much further in the near future. That's likely to include a further expansion of the Government's building program, including spending on both horizontal infrastructure and buildings like schools.

The gyrations in the economy will have a significant effect on inflation. Inflation has firmed in recent years, rising by 0.8% in the March quarter (above our forecasts for a 0.4% rise and the RBNZ's forecast for a 0.5% increase). That took the annual rate to 2.5%, the first time it's been above the target mid-point in three years.

However, we expect the pick-up in inflation to be fleeting. We have updated our forecasts for later in the year and are now forecasting annual inflation will drop back into the lower part of the RBNZ's target band in the June quarter, mainly due to the sharp decline in the price of petrol.

We expect that inflation will linger in the lower part of the RBNZ's 1 to 3% target band over the year ahead. With a sharp contraction in the economy in train, and a full recovery likely to take years, demand-side price pressures are likely to remain muted for an extended period. We have already seen a sharp decline in the number of businesses who are planning to increase their prices. In fact, for the first time in at least the 28 years for which there has been surveying, more businesses are planning to cut prices than raise them. There is also a likelihood that changes in government charges (which account for around 6% of the CPI basket) will be more moderate for a period.

It's not all downside for inflation, however. Supply disruptions in global manufacturing and structural changes in industries like air travel will provide a floor under some prices. In fact, in some cases, supply disruptions may cause larger price increases than usual. That will limit any drop in overall inflation. Even so, a period of weak inflation is on the cards.

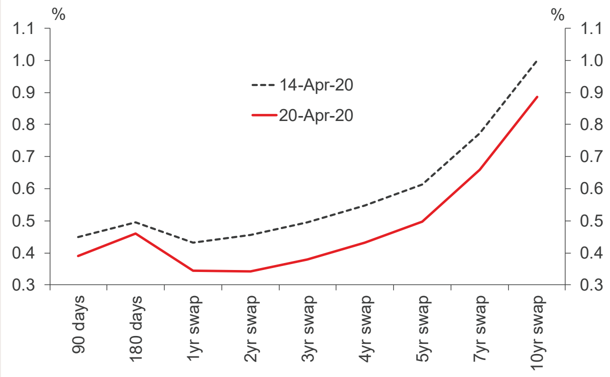
This lingering softness in inflation reinforces our expectations that the RBNZ will increase its bond buying program well above the $30bn that was originally planned. We previously estimated that Government debt would rise to about $125bn by June 2021, and with the Treasury's latest scenarios making a case for further stimulus, the debt level could rise even further than that. In order to keep Government bond rates low in the face of that type of debt issuance, the RBNZ is going to have to dramatically increase its bond purchases, perhaps up to around $60bn.

Fixed vs Floating for mortgages.

The interest rate outlook is highly uncertain, so trying to guess which fixed term will result in the lowest interest repayments is almost impossible. It is probably better to keep it simple. Borrowers looking for certainty should aim to fix their mortgage rates, while borrowers who need flexibility should float.

For now, the Reserve Bank has lowered the OCR as far as it is going to go – no further OCR reductions are planned in the near future. Fixed mortgage rates have fallen in response to the OCR reduction, and seem to have stabilised in recent weeks. There is therefore little reason to suspect that fixed mortgage rates will fall further in the near future.

NZ interest rates



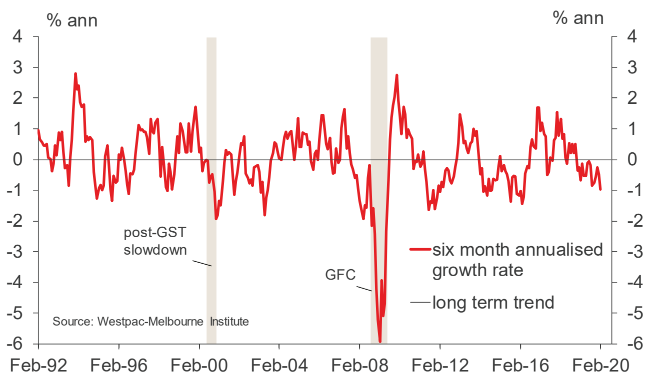
The week ahead.

Aus Mar Westpac–MI Leading Index

Apr 22, Last: –0.96%

- The Leading Index is set to register a steep fall as the coronavirus shock impacts more fully in March. The Index growth rate slowed materially to –0.96% in Feb but will likely fall several percentage points in March.
- The March read will incorporate several extremely weak component updates including: the ASX200 (-21.2%); the Westpac-MI Consumer Expectations Index (-12.8%); US industrial production (-5.4%); and the Westpac-MI Unemployment Expectations Index (+8.2%, higher reads signalling a weaker outlook). There will be some significant offsetting supports from commodity prices (+3.5% in AUD terms); dwelling approvals (+19.9% vs -15.1% last month); and the yield spread, which widened 27bps as RBA rate cuts and aggressive QE lowered the short end. Hours worked have also been steady. However, this will not stop a large headline fall and points to more vulnerability ahead if/when these other components start to turn.

Aus Westpac-MI Leading Index

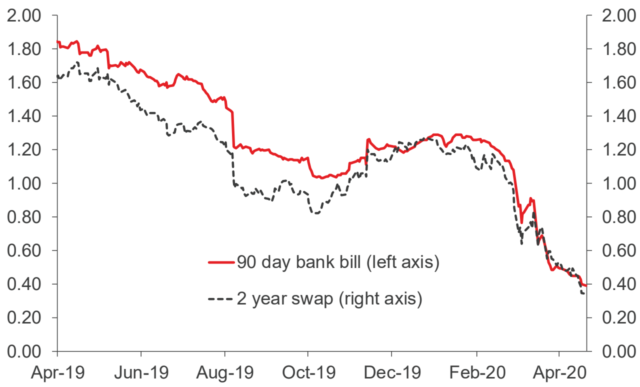


New Zealand forecasts.

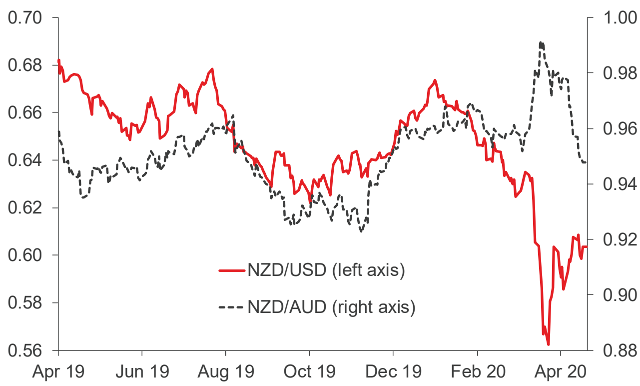
Economic forecasts	Quarterly				Annual			
	2019	2020						
% change	Dec (a)	Mar	Jun	Sep	2018	2019	2020f	2021f
GDP (Production)	0.5	-1.0	-14.0	9.9	3.2	2.3	-5.6	6.7
Employment	0.0	-0.9	-6.8	3.6	1.9	1.0	-2.4	3.6
Unemployment Rate % s.a.	4.0	4.7	9.0	8.0	4.3	4.0	7.0	5.6
CPI	0.5	0.4	-0.4	0.7	1.9	1.9	1.0	1.1
Current Account Balance % of GDP	-3.0	-3.0	-3.5	-3.7	-3.8	-3.0	-4.1	-3.3

Financial forecasts	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
Cash	0.25	0.25	0.25	0.25	0.25	0.25
90 Day bill	0.40	0.40	0.40	0.40	0.40	0.40
2 Year Swap	0.60	0.60	0.60	0.65	0.70	0.80
5 Year Swap	0.70	0.75	0.80	0.90	1.00	1.10
10 Year Bond	1.00	1.00	1.00	1.05	1.10	1.20
NZD/USD	0.60	0.62	0.64	0.65	0.65	0.66
NZD/AUD	0.97	0.97	0.97	0.96	0.96	0.95
NZD/JPY	64.2	65.1	67.8	69.6	69.6	70.7
NZD/EUR	0.56	0.58	0.60	0.61	0.61	0.61
NZD/GBP	0.49	0.50	0.52	0.52	0.52	0.52
TWI	68.7	69.9	71.5	71.9	71.5	71.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 20 April 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.31%	0.35%	0.43%
60 Days	0.35%	0.42%	0.55%
90 Days	0.39%	0.48%	0.67%
2 Year Swap	0.34%	0.49%	0.68%
5 Year Swap	0.50%	0.60%	0.92%

NZ foreign currency mid-rates as at 20 April 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6035	0.5870	0.5691
NZD/EUR	0.5553	0.5428	0.5341
NZD/GBP	0.4829	0.4796	0.4894
NZD/JPY	64.91	63.62	63.13
NZD/AUD	0.9479	0.9761	0.9826
TWI	68.74	67.85	66.91

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Covid–19 alert level announcement	–	–	–	PM to announce whether the alert level will be changed.
Eur	Feb trade balance €bn	17.3	–	–	The upward trend over 2019 has been largely eroded.
UK	Apr Rightmove house prices	1.0%	–	–	Outlook bleak with an imminent collapse in gross lending.
US	Mar Chicago Fed activity index	0.16	–0.62	–	The index is set to show growth falling below trend.
Tue 21					
Aus	RBA minutes	–	–	–	Looking for RBA guidance on the impact of the shutdown.
	RBA Governor Philip Lowe	–	–	–	Speech titled "Economic and Financial Update".
Eur	Apr ZEW survey of expectations	–49.5	–	–	Another soft print likely after an abrupt fall in March.
UK	Feb ILO unemployment rate	3.9%	4.0%	–	Should commence an upturn in the unemployment trend.
US	Mar existing home sales	6.5%	–6.9%	–	Sales set to seize up amidst disruptions from the virus.
Wed 22					
NZ	GlobalDairyTrade auction	1.2%	–	–	Futures markets are pricing in little change in WMP prices.
Aus	Mar Westpac–MI Leading Index	–0.96%	–	–	Set for a very steep fall this month.
Eur	Apr consumer confidence	–11.6	–17.5	–	Advance read to show further deterioration in confidence.
UK	Mar CPI %yr	1.7%	1.6%	–	To moderate in the face of demand shock and low oil prices
US	Feb FHFA house prices	0.3%	0.4%	–	Positive price trend to turn in coming months.
Thu 23					
Aus	Q1 NAB business survey	–1	–		March monthly survey showed confidence fell to –66.
Eur	Apr Markit PMIs	–	–	–	For Euro Area, Germany and the UK.
UK	Mar retail sales	–0.5%	–2.6%	–	As stockpiling dissipates, retail sales will have little support.
	Mar public sector borrowing £bn	–0.4	–	–	Volatility to increase as stimulus commences.
US	Initial jobless claims	5245k	–	–	Initial claims still sizeable after four unprecedented weeks.
	Apr Markit manufacturing PMI	48.5	38.5	–	A marked deterioration expected...
	Apr Markit services PMI	39.8	32.5	–	... across both manufacturing and services PMIs.
	Mar new home sales	–4.4%	–15.0%	–	Momentum seen prior to the lockdown period will disappear.
	Apr Kansas City Fed index	–17	–	–	A soft print expected, in line with other regional surveys.
Fri 24					
US	Mar durable goods orders	1.2%	–11.1%	–	New orders to be hit by the contraction in activity.
	Apr Uni. of Michigan sentiment	71.0	69.0	–	Final read set to confirm weak consumer sentiment.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019	2020f	2021f
Australia						
Real GDP % yr	2.8	2.5	2.7	1.8	-5.4	4.0
CPI inflation % annual	1.5	1.9	1.8	1.8	0.9	2.0
Unemployment %	5.7	5.5	5.0	5.2	7.3	6.0
Current Account % GDP	-3.1	-2.6	-2.1	0.5	0.2	-0.6
United States						
Real GDP %yr	1.6	2.4	2.9	2.3	-6.0	1.0
Consumer Prices %yr	1.4	2.1	2.4	1.8	1.4	1.6
Unemployment Rate %	4.9	4.4	3.8	3.7	13.1	5.1
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.6	1.9	0.8	0.7	-5.0	1.0
Euro zone						
Real GDP %yr	1.9	2.5	1.9	1.2	-8.5	1.7
United Kingdom						
Real GDP %yr	1.8	1.8	1.4	1.4	-7.0	2.5
China						
Real GDP %yr	6.7	6.8	6.6	6.1	2.5	7.3
East Asia ex China						
Real GDP %yr	4.0	4.5	4.3	3.6	-2.7	5.8
World						
Real GDP %yr	3.4	3.8	3.6	3.0	-1.5	3.9
Forecasts finalised 9 April 2020						

Interest rate forecasts	Latest	Jun–20	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	0.25
90 Day BBSW	0.13	0.15	0.20	0.25	0.30	0.35	0.40	0.45
10 Year Bond	0.87	0.75	0.75	0.80	0.85	0.95	1.10	1.20
International								
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	0.66	0.60	0.65	0.70	0.75	0.80	0.90	1.00

Exchange rate forecasts	Latest	Jun–20	Sep–20	Dec–20	Mar–21	Jun–21	Sep–21	Dec–21
AUD/USD	0.6364	0.62	0.64	0.66	0.68	0.68	0.69	0.70
USD/JPY	107.76	107	105	106	107	107	108	110
EUR/USD	1.0868	1.07	1.06	1.06	1.07	1.08	1.09	1.10
GBP/USD	1.2494	1.22	1.23	1.24	1.25	1.25	1.26	1.27
USD/CNY	7.0786	7.02	6.90	6.85	6.80	6.75	6.70	6.60
AUD/NZD	1.0584	1.03	1.03	1.03	1.05	1.05	1.05	1.06

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