ANZ Research

January 2020

Quarterly Economic Outlook

Through the looking glass

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NZ Economics Team

Sharon Zollner
Chief Economist
Telephone: +64 9 357 4094
Sharon.Zollner@anz.com

Natalie Denne
Desktop Publisher
Telephone: +64 4 802 2217
Natalie.Denne@anz.com

Liz Kendall
Senior Economist
Telephone: +64 4 382 1995
Elizabeth.Kendall@anz.com

Susan Kilsby
Agriculture Economist
Telephone: +64 4 382 1992
Susan.Kilsby@anz.com

Kyle Uerata
Economic Statistician
Telephone: +64 4 802 2357
Kyle.Uerata@anz.com

Miles Workman
Senior Economist
Telephone: +64 4 382 1951
Miles.Workman@anz.com

Contact
research@anz.com

Follow us on Twitter
@sharon_zollner
@ANZ_Research (global)

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New Zealand economic outlook

As we enter 2020, we begin the next chapter for the New Zealand economy. While capacity pressures have eased, economic momentum appears to be finding a floor, with drivers in place for gradual improvement over the next two years, despite headwinds. Housing market strength, fiscal spending, high terms of trade, the tight labour market and low interest rates are expected to provide support. We assume the coronavirus outbreak will weigh a little on our export prices and volumes in the near term, but impacts are highly uncertain at this stage. GDP growth is expected to sit around trend on average, with inflation close to target. The RBNZ can afford to be patient, waiting to see how the story unfolds. The economy is at a crossroads and the political and international context will be crucial. We see upside risk from housing and fiscal spending, but large downside risks from unforecastable global shocks, including the potential impacts of the new coronavirus.

International outlook

2020 should bring a mild improvement in global growth, but for many economies this won't be sufficient to see inflation lift sustainably to target. The hurdle for further easing isn't high, but with many central banks running low on ammo, it could be time for fiscal policy to up the ante. Nonetheless, recent easing by global central banks is putting a floor under the slowdown, which alongside a more conciliatory tone between the US and China is a welcome development. Global risks remain tilted to the downside, with the Wuhan coronavirus a new, and potentially devastating, addition, with particular downside risks for China's economy.

Primary sector outlook

Food commodities have held their value despite the slowing in global economic growth. Supply-side factors have largely been supportive of meat and dairy prices and these factors are not expected to change any time soon. However, mounting risks on the demand side are reducing the likelihood of a fairy-tale ending to the current production season.

Financial markets outlook

We now expect the OCR to remain on hold at 1% for the foreseeable future. One of the factors adding to an improved domestic outlook is the Government's announcement to lift infrastructure spending, and that means more NZGBs on issue. However, that's a medium-term story. Unless something untoward comes along, it's looking increasingly like the Fed has now entered an on-hold phase, but the bias elsewhere is that further easing is more likely than not. NZD rallied into the end of 2019. Some retracement has occurred since then, but the improved outlook should keep further downside contained, notwithstanding significant risks.

Calendar Years	2016	2017	2018	2019(f)	2020(f)	2021(f)
New Zealand Economy						
Real GDP (annual average % change)	3.9	3.1	3.2	2.3	2.4	2.6
Real GDP (annual % change)	3.5	3.3	3.3	1.7	2.5	2.7
Unemployment Rate (Dec quarter)	5.2	4.5	4.3	4.2	4.1	3.8
CPI Inflation (annual %)	1.3	1.6	1.9	1.9	1.7	2.0
Terms of Trade (OTI basis; annual %)	6.7	7.9	-4.8	4.3	1.8	0.5
Current Account Balance (% of GDP)	-2.0	-2.7	-3.8	-3.3	-3.6	-3.7
NZ Financial Markets (end of Dec quarter)						
TWI	77.7	74.4	73.4	73.7	72.0	71.4
NZD/USD	0.69	0.71	0.67	0.67	0.65	0.65
NZD/AUD	0.96	0.91	0.95	0.96	0.97	0.97
Official Cash Rate	1.75	1.75	1.75	1.00	1.00	1.00
10-year Bond Rate	3.33	2.72	2.37	1.65	1.30	1.25

Source: Statistics NZ, Bloomberg, ANZ Research

New Zealand economic outlook

Summary

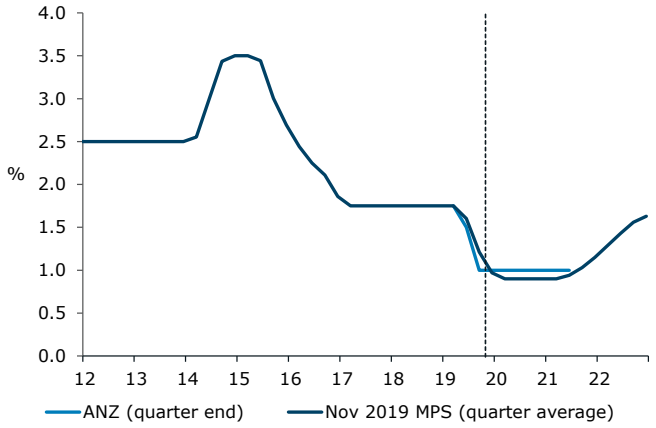
As we enter 2020, we begin the next chapter for the New Zealand economy. Conditions appear to be in place to keep our growth story going for a while yet. While capacity pressures have eased, economic momentum appears to be finding a floor, with drivers in place for gradual improvement over the next two years, despite headwinds. Housing market strength, fiscal spending, high terms of trade, the tight labour market and low interest rates are expected to provide support. We assume the coronavirus outbreak will weigh a little on our export prices and volumes in the near term, but impacts are highly uncertain at this stage. GDP growth is expected to sit around trend on average, with inflation close to target. The big reveal will be whether the economy can transition smoothly from a narrative of housing-led growth to one that involves more fiscal spending and a modest improvement in business investment. The RBNZ can afford to be patient, waiting to see how the story unfolds. We suspect they will need to do that for quite some time as the data ebbs and flows. The economy is at a crossroads and the political and international context will be crucial. We see upside risk from housing and fiscal spending, but large downside risks from unforecastable global shocks, including potential impacts of the new coronavirus. All business cycles must come to an end (and by definition not a happy one), but for now, this story is now looking more likely to have another chapter.

Down the rabbit hole

Over 2019, the story for the New Zealand economy was one of growth deceleration and uncertainty. GDP struggled to push higher, weighed down by global uncertainty, business pessimism, a soft housing market, credit concerns and late-cycle headwinds. Growth slowed over the year, with vigorous debate as to why, and whether the main villain was weak demand or constrained supply. As we had expected, the RBNZ cut interest rates to shore up confidence in the outlook – slashing the OCR 75bps to 1%.

At the time of the November MPS, it was a line-ball call for the RBNZ as to whether to hold the OCR or provide even more stimulus, as shown by their published OCR track (figure 1). They decided to hold. Since then, developments have improved, pointing to a more positive medium-term outlook, partly due to the OCR cuts, but also other factors. The RBNZ has toned down its bank capital changes, the Government has announced more spending is in the pipeline, activity indicators have improved, the housing market has strengthened, and inflation is sitting close to target.

Figure 1. Official Cash Rate



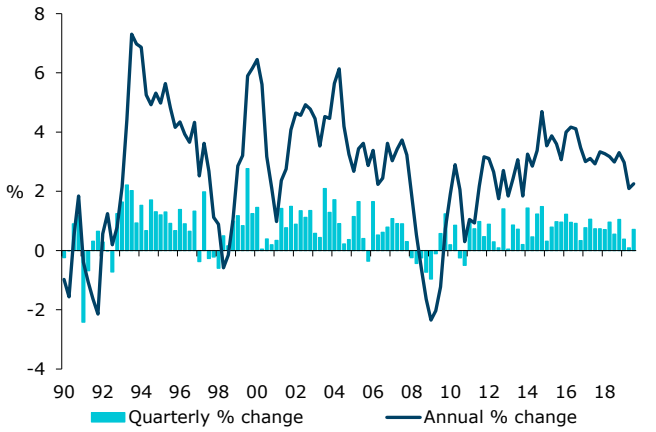
Source: RBNZ, ANZ Research

We expect the recent data stabilisation will translate into the RBNZ telling a more upbeat story at the February MPS, one in which the OCR remains at its current level for the foreseeable future, notwithstanding significant risks. Overall, conditions now appear to be in place to keep our economic growth story going for a while yet, with growth around trend, the economy near full employment and inflation near target – despite a softer starting point.

Once upon a time

Due to GDP revisions, we now know that the growth slowdown over 2019 was sharper than previously thought. Growth was stronger over 2018 (figure 2), up 3.3% y/y in Q4 2018 (previously 2.4%). This helps to explain the recent gradual lift in inflation.

Figure 2. Production GDP



Source: Statistics NZ

But 2019 saw a more marked softening in momentum, with GDP up only 0.5% over the first half of the year, and the 0.7% q/q rise seen in Q3 boosted by temporary factors. GDP growth is expected to have troughed at 1.7% y/y in December 2019.

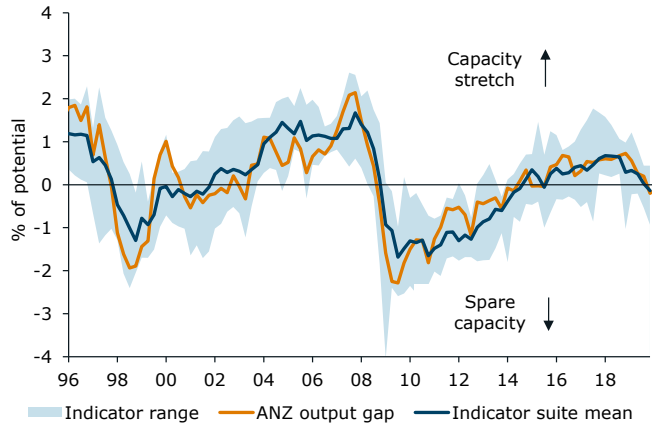
We've also learned that net migration was not as strong as initially reported (as we have long suspected, and indeed had built into our forecasts). That may make the per capita growth story look a little better; it has been quite grim. Looking through quarterly movements, per capita GDP is currently measured to have tracked sideways over 2019.

Lost in the woods

On the back of the recent deceleration in growth, some spare capacity in the economy has emerged. Our ANZ capacity indicator suite suggests that the output gap has turned slightly negative (figure 3).

Estimating the degree of capacity pressure in the economy is a highly uncertain business, but it seems clear that resource pressures have abated somewhat. GDP growth has undershot the RBNZ's (downwardly revised) estimate of potential growth (2.3% y/y). It is of course possible that the RBNZ may revise down their estimate of the economy's speed limit further (particularly since the new official net migration numbers are weaker than the RBNZ's assumption, though whether they'll take them at face value is unclear). However, a slight slackening in capacity pressures is corroborated by other data in our range of measures, and is in line with the RBNZ's expectations as at the November MPS.

Figure 3. ANZ output gap and indicator suite



Source: ANZ Research

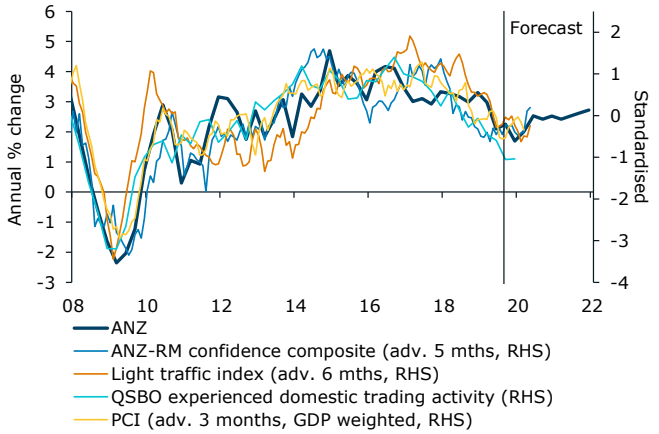
Turning a page

Notwithstanding the likely slackening in capacity pressures over 2019, economic momentum now appears to be finding a floor and the outlook is looking more positive. Forward-looking indicators of near-term growth point to a tentative turning point (figure 4).

The recent stabilisation in activity indicators has been reasonably broad based. It's not a picture of growth taking off, but the recent improvement appears consistent with the RBNZ's November MPS forecast for a gradual recovery in growth into 2020. Only a couple of months ago that same forecast was looking heroic in the context of the forward indicators (figure 4).

We now expect GDP will grow at a moderate pace into 2020 (+0.5% q/q in Q1; 0.7% in Q2), which should see annual growth lift from 1.7% y/y to 2.5% by the middle of the year. In the short term, this outlook is similar to the recovery forecast by the RBNZ in the November MPS (figure 7, page 7). GDP in line with our expectations for this year would take growth a little above the RBNZ's estimate of potential growth of 2.3% (which has been revised down recently), such that slack is absorbed.

Figure 4. Forward GDP indicators



Source: Statistics NZ, BNZ-BusinessNZ, NZIER, RBNZ, ANZ Research

In a land far away

In recent weeks, news of a new coronavirus, originating in Wuhan, China, has rattled markets. The possible impact on human life is very worrying and our thoughts are with the families of those impacted by this tragedy.

The economic impact could be significant too. The hope is that the outbreak can be contained rapidly but retail, tourism and related sectors in China will already be experiencing an impact. And should the outbreak last some time, there could be an impact on industrial production and global growth, though fiscal and monetary stimulus could provide an offset. Over the weekend, the Chinese Government announced that it would extend the Lunar New Year holiday, and that it would halt all international travel and tour bookings to contain the spread.

The impact for New Zealand is highly uncertain. At this stage, we forecast the coronavirus to have a temporary dampening impact on export volumes and prices in the near term, with the hope that the spread

will be contained quickly. However, there are significant risks of a large or prolonged economic impact, especially if disruption in China persists. The most important economic impacts for New Zealand would be to tourism and food exports (see Primary Sector Outlook, page 10). The impact on the New Zealand economy of SARS in 2003 turned out to be not as bad as feared, but this is quite a different virus (on early evidence, not nearly as lethal, but much more easily spread) and the New Zealand economy's exposure to China is much greater now.

Over the medium term, global economic conditions as seen from the New Zealand perspective are expected to remain favourable for growth. The global outlook has deteriorated (see International Outlook, page 8), and risks abound, but so far New Zealand's terms of trade are proving resilient.

Notwithstanding some short-term weakness, continued solid export returns are expected over the next six months at least. We don't expect the high terms of trade to pass through to activity or inflation as strongly as it might have in previous cycles, since the high export prices are driven by supply factors and farmer debt levels are high. Also, some of the terms of trade story is driven by lower import prices, which are hardly inflationary. But solid returns should boost national incomes and provide some certainty in coming years, even if income gains are used to pay down debt in sectors like dairy.

Stimulus from global central banks is keeping monetary conditions easy and liquidity flowing, providing a floor for global demand. The NZD has pushed a little higher in recent months as risk sentiment has improved and as export prices remain elevated, though there has been some retracement in January. Our exchange rate forecast is now higher, reflecting the starting point, but the coronavirus brings significant near-term downside risk, as the NZD can trade as a proxy for China risk and risk appetite more generally, which is currently in retreat.

Further monetary stimulus is expected from some global central banks (notably the RBA) over our forecast horizon (see Financial Markets Outlook, page 12). This will also support the NZD TWI, which could weigh on the inflation and growth outlook at the margin. Nonetheless, we don't think that will derail the outlook or perturb the RBNZ. Policy rates in New Zealand sometimes move out of synch with global policy rates, including the cash rate in Australia. And the RBNZ is laser-focused on the domestic economy, arguably ahead of other central banks in responding to the recent loss in economic momentum. Provided exchange rate strength is still underpinned by good domestic data flow, the RBNZ will not be spurred into action by it – it may temper the OCR outlook a little, but currency movements will be considered amongst a myriad of other domestic developments.

Overall, we see the upside to the NZD based on the New Zealand data flow as reasonably limited. Much of the recent turnaround in the data has already been priced in, with only a small chance of OCR cuts priced in the curve. Given that there is a very high hurdle to interest rate hikes, upward moves in domestic yields may be limited.

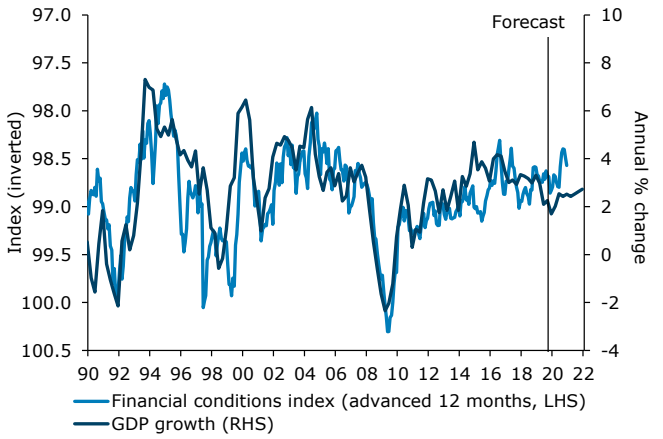
On the whole, we expect that some renewed volatility in markets, along with an improvement in the global data flow, should cap the NZD, even as the terms of trade remains supportive. Exports are expected to see modest growth, while imports remain supported by domestic demand.

Hi-ho, Hi-ho, it's off to work we go

Domestically, a number of other medium-term drivers are also in place:

- Monetary policy is doing its job, passing through more effectively to the housing market and business sentiment than we previously expected. While we expect that business investment will be sluggish in its response to the fall in interest rates (which will disappoint the RBNZ), sentiment is expected to continue improving. Ultimately, financial conditions are expansionary (figure 5) and interest rates will remain low – supporting growth – for some time.

Figure 5. ANZ Financial Conditions Index and GDP

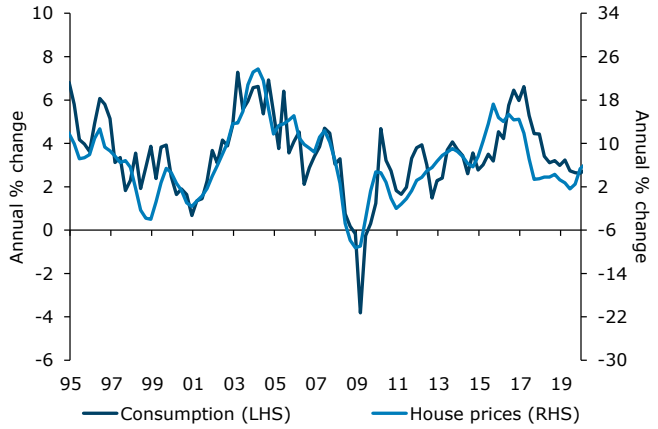


Source: Statistics NZ, ANZ Research

- The housing market has strengthened, with house prices rebounding (6%) over the second half of 2019. This is on the back of falls in mortgage rates, an easing in headwinds (especially on the credit side), and continued population growth in the context of low listings. We expect some further near-term strength, as discussed in our

ANZ Property Focus, with house price inflation expected to reach 8% y/y. This will provide a boost to both consumption (figure 6) and residential investment, although we expect residential building will be somewhat constrained by capacity constraints and continuing challenges in the construction industry.

Figure 6. House prices and consumption



Source: Statistics NZ, REINZ, ANZ Research

- Fiscal spending is supportive. The Government has signalled a greater pipeline of infrastructure spending and a more relaxed approach to its debt targets. Gearing up an infrastructure spend in the short term isn't realistic; it's difficult to get all the ducks in a row for projects to get going, let alone quickly. But the direction of the fiscal impulse is supportive for growth and broader confidence over the medium term. In fact, we suspect more spending may be promised as we progress through election year, especially after the soft growth patch seen last year.
- The labour market is strong, which is a double-edged sword for growth. We are late in the cycle, and capacity constraints are being felt by businesses, particularly difficulty in finding skilled labour. Usually this would put upward pressure on wage inflation. Wage inflation has increased, albeit painfully slowly, constrained by businesses' perception that they will struggle to pass any cost increases on. Capacity pressures may thereby inhibit the economy's ability to grow. On the other hand, conditions for households are favourable, reflected in resilient consumer confidence. Good employment prospects should encourage spending, especially if wage growth follows. Turnover in the labour market on the back of such confidence would also be helpful for spurring wage growth higher.

With a huff and a puff

Although conditions look broadly supportive for growth, headwinds have not disappeared – they are just no longer winning the battle. We are late in the cycle and constraints are being felt. Businesses remain cautious, global risks have not gone away, agricultural and household debt levels are high, credit and capacity constraints are a concern, and election uncertainty could weigh. For this reason, we think that achieving growth meaningfully above potential would be a challenge over the next few years.

- Credit availability will be crucial. Finance availability has the power to fuel the economy or stop it in its tracks. Recently credit headwinds have eased as banks have engaged in more mortgage lending, contributing to housing market strength. And RBNZ bank capital changes announced in December were not as onerous as initially proposed, reducing the risk of a sharp contraction in credit availability (we have taken out our 25bp placeholder OCR cut as a result). But nonetheless, credit is expected to remain contained in light of the RBNZ's capital changes, while pricing remains very sensitive to risk.
- Business investment will be constrained. On the face of it, capacity is tight and the OCR is low, so conditions should be ripe for business investment. But the OCR does not necessarily reflect the actual rates paid by businesses (based on risks) or whether credit is available. With credit constraints still present and caution widespread, firms are expected to be somewhat limited in their scope to expand and invest. This is particularly true for those in the agricultural sector, reflecting a unique combination of credit constraints, regulatory challenges and debt overhang. Overall, we expect investment to improve modestly as sentiment continues its gradual recovery, and particularly once election uncertainty is resolved.

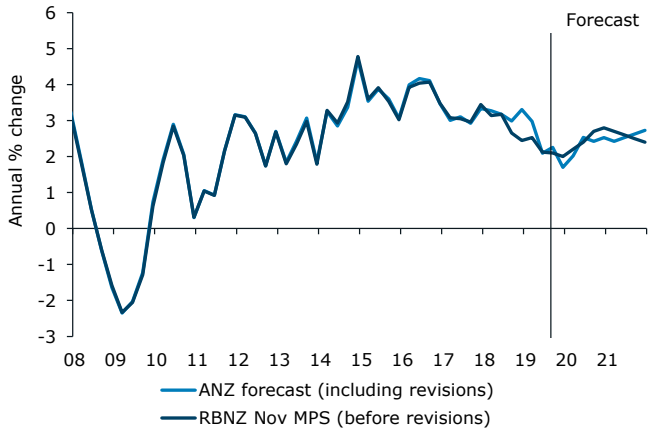
The way home

Putting it all together, we expect that headwinds and tailwinds will be broadly offsetting – for now. GDP growth is expected to gradually improve, pushing a little above trend over the medium term as the economy gradually transitions from housing-led growth towards fiscal spending and a modest improvement in business investment. Our forecast is a bit below the RBNZ's expectations as at the November MPS (figure 7).

On average, growth is expected to track at 2.4% y/y over the next couple of years. This is consistent with resource utilisation in the economy tracking close to or even a little above its maximum sustainable level. We

are forecasting a small decline in the unemployment rate from 4.3% currently to 3.8% at the end of 2021, as labour supply growth moderates on account of waning immigration flows. However, labour market data can be volatile and, in reality, the path forward is likely to be noisy.

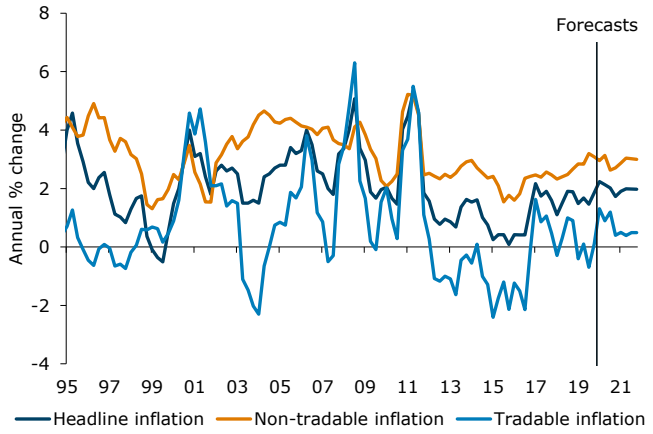
Figure 7. Production GDP forecast



Source: Statistics NZ, RBNZ, ANZ Research

Growth around trend should support the outlook for inflation over the medium term, with CPI inflation expected to hover around 2% (figure 8). On this front, the outlook is now looking more assured. Headline CPI printed at 1.9% y/y in Q4, tantalisingly close to the RBNZ's 2% target midpoint, up from 1.5% the previous quarter. This acceleration was supported by solid domestic inflation, with non-tradable inflation currently tracking at 3.1% y/y, about where the RBNZ needs it to be. Core inflation also edged up, with the range of measures sitting close to 2%.

Figure 8. CPI forecast



Source: Statistics NZ, ANZ Research

We no longer expect that OCR cuts will be needed in the short term. Encouragingly, risks of a self-reinforcing slide in inflation expectations have reduced and domestic inflation pressures are near their sweet spot, with core inflation measures having lifted. Inflation pressures are unlikely to stay there, of course. But the risks are looking a bit more balanced, and the RBNZ can afford to sit pretty and see how developments unfold from here.

Choose your own adventure

The overall story might sound less than exciting at present, but be careful what you wish for. The economy is at a crossroads and a change in prevailing forces could tip the balance in either direction, and the political and international context will be crucial. We see a number of risks:

- Housing market strength could be greater and/or more persistent than we currently expect, with important implications for building activity and consumption. We will be watching pass-through closely.
- More fiscal spending could be on the cards, with the Government relaxing its debt targets and election campaigning heating up. To get a meaningful fiscal bump in the next couple of years would require a lift in operational spending (such as transfer payments) and/or a change to tax settings (such as lower income tax rates/ thresholds). But over the longer term, spending promises of all types could provide a boost.
- Credit availability could be more of a headwind than currently assumed. While the RBNZ's bank capital changes were smaller and softer than expected, they will nonetheless be a constraint on bank lending. Impacts on business and farm lending will be closely watched.
- Drought conditions may be developing (see Primary Sector Outlook, page 10).
- Global risks remain salient. Debt-driven vulnerabilities in the financial system pose big risks of a large, negative shock at some point. Unfortunately such events are completely unforecastable (though there will be plenty saying "told you so"). Such an event could see the OCR abruptly reach its lower bound with unconventional policy in play. The new coronavirus could be a game changer; we're watching closely.

In the foreseeable future, an on-hold RBNZ seems the most likely outcome. We see some modest downside risk on balance and market pricing of a small chance of OCR cuts is entirely appropriate. The end to this story hasn't been written yet. Will it have a twist? One thing's for sure, as a small, open economy with a massive exposure to a single trading partner, we can only choose our own adventure up to a certain point.

International outlook

Summary

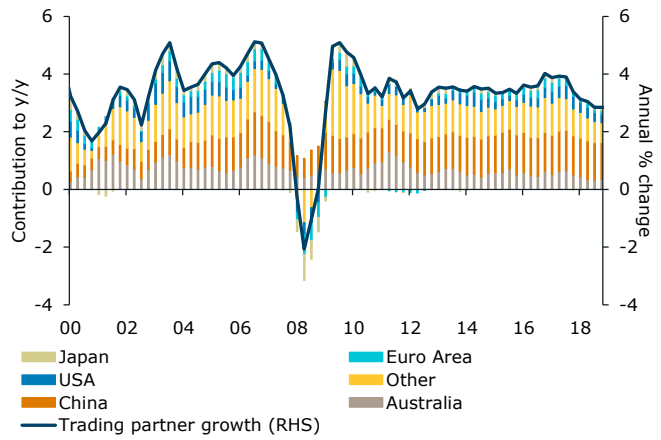
Growth among New Zealand's trading partners deteriorated over 2019, but 2020 is looking up – for now. 2020 should bring a mild improvement in growth, but for many economies this won't be sufficient to see inflation lift sustainably to target. The hurdle for further easing isn't high, but with many central banks running low on ammo, it could be time for fiscal policy to up the ante. Nonetheless, recent easing by global central banks is putting a floor under the slowdown, which alongside a more conciliatory tone between the US and China is a welcome development. Global risks remain tilted to the downside, with the Wuhan coronavirus a new, and potentially devastating, addition.

Not out of the woods just yet

Growth among New Zealand's trading partners continued to slow over 2019, down from 4% in 2017 to 2.8% by Q3 2019 (figure 1). That's the slowest pace in almost seven years. But while downside risks are certainly elevated there are tentative signs that the slowdown is finding a floor. Indeed, our forecast is that 2020 is likely to be a slightly better year for the global economy than 2019 was, but the upside appears capped by both structural and cyclical forces.

We expect the world economy grew 3.0% y/y in 2019, and will accelerate slightly to 3.1% and 3.2% in 2020 and 2021 respectively – a meaningful downgrade from 3.5 and 3.6% in our October 2019 edition.

Figure 1. New Zealand trading partner growth



Source: Haver Analytics, ANZ Research

Trade tensions have weighed on global manufacturing and trade. And the associated uncertainties haven't done business investment any favours either. While weakness has largely been concentrated in trade, manufacturing and investment, things could get rather ugly if global labour markets, consumer sentiment and household spending follow suit. But so far, labour markets have remained remarkably robust to the growth slowdown, wages have been gradually rising, and both monetary and fiscal policy has become more stimulatory. Accordingly, recession alarms are not ringing as they were in 2019, but tail-end global financial market risks haven't gone away.

Since our October ANZ Quarterly Economic Outlook there have been a number of developments that suggest the global outlook is poised to improve, despite the weak starting point:

- The US and China have agreed to the Phase 1 trade deal.
- Central banks have added additional stimulus.
- The risk of a no-deal Brexit has abated following the UK election.
- The slowdown in global trade and manufacturing has tentatively found a floor, with forward indicators improving recently.

Since October we've downgraded **the outlook for China** (our largest trading partner) with a 0.2%pt reduction in GDP growth in 2020 and 0.3%pt in 2021, putting growth below 6.0% for the first time in 2020. This represents the next phase in China's structural slowdown as the economy continues to transition towards knowledge-based and consumption-driven growth. Nonetheless, this growth slowdown is expected to be deflationary, and should prompt the PBoC to maintain an easing bias. Authorities have already delivered meaningful stimulus (both fiscal and monetary), but with debt levels high, policy options are becoming more limited.

A new challenge for Chinese authorities is the containment of the new coronavirus, first detected in the Chinese city of Wuhan. The economic impact on China's economy could be significant. Retail, tourism and related sectors in China will already be experiencing an impact. And should containment prove unsuccessful, the impacts on growth could become quite broad-based. For New Zealand, the most likely impacts are reduced food exports via fewer Chinese eating out, and reduced tourist arrivals. And of course, there are already virus cases outside China.

Australia's economic growth is set to improve gradually through 2020 and 2021. But let's face it, this is off the back of a pretty poor performance in 2019 with public sector activity the chief catalyst behind a relatively modest expansion (1.7% y/y in Q3 2019). Private consumption has been particularly weak, with the sharp turnaround in house prices, interest rate cuts and substantial tax cuts seemingly having little impact on consumer spending to date. Already-high

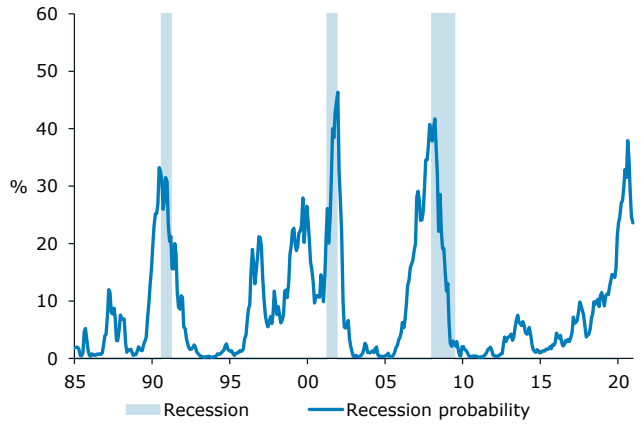
private sector debt alongside muted wage growth are making households cautious – and rightly so.

Nonetheless, as growth improves, we expect a rotation of drivers away from the public and external sectors and towards the private domestic economy.

But to get there, we think further easing by the RBA is needed. Despite recent robust growth in employment, we expect the typical link between economic activity and the labour market to reassert itself, and that employment growth will slow over the first half of 2020. We no longer expect a rate cut in February, as the RBA will want to see data on consumer spending over Q4 and January before acting. This suggests April is the likely date for the next rate cut, with another a few months later. We see the cash rate at 0.25% by the end of Q3 at the latest.

Recession fears have waned in **the US**, following Fed easing and the Phase 1 trade truce with China. The yield curve has steepened after a brief stint in inverted territory. While the New York Fed's yield curve model is still predicting a reasonably high chance of a recession, this is possibly distorted by the impact that QE has had on long-end rates. The US data pulse remains robust on balance.

Figure 2. Probability of US recession predicted by Treasury spreads



Source: Bloomberg, ANZ Research

Overall, the baseline outlook for the US economy in 2020 is favourable. Underpinned by a healthy household sector and tight labour market we expect slightly above-trend GDP growth, with activity being supported by mildly stimulatory monetary policy and a central bank prepared to do what it can to extend an already lengthy expansion. Key themes for 2020 will be the presidential election, ongoing geopolitical uncertainties, and possible trade policy frictions. For now it looks like the US Fed is set for a lengthy pause.

Tentative evidence is emerging that the **euro area's** manufacturing downswing is starting to moderate, but not before manufacturing's weakness weighed on broader momentum. While the worst of the slump might be over, we are cautious on the outlook for growth in 2020. We expect GDP to rise by 1.2% – insufficient to see inflation pressures build, which is likely to reinforce the easing bias at the ECB. But with monetary policy space limited, 2020 is likely to bring more heated discussion about the role fiscal policy has to play.

More broadly, if a particularly nasty economic surprise comes along, policy makers around the globe (including in New Zealand) will be looking to fiscal policy for a lifeline. Monetary policy remains short of ammo, and is all but spent in some economies.

Overall, the global economic backdrop may be past the worst of the slowdown, but with the global growth outlook trimmed from our October edition, it's still a bit of a mixed picture. New Zealand's commodity prices will likely continue to be supported by supply-side developments for a while yet, but as discussed in our Primary Sector Outlook (page 10), the coronavirus is a new downside risk.

In fact, given that the softer global backdrop will depress import prices, assuming downside risks don't materialise, we expect to see upwards pressure on the terms of trade. It is unusual relative to history to see soft global growth and lifting terms of trade, but this has been the case in recent times, and it's to our economy's benefit.

Table 1: GDP Growth

Calendar Years (annual average % change)	1998-2007 average	2008-2016 average	2017	2018	2019(f)	2020(f)	2021(f)
United States	3.1	1.4	2.9	2.3	1.9	1.8	3.1
Australia	3.4	2.6	2.7	1.8	2.2	2.5	3.4
Japan	1.0	0.4	0.8	0.9	0.7	0.7	1.0
Euro area	2.4	0.4	1.9	1.2	1.1	1.4	2.4
China	10.0	8.4	6.6	6.2	5.8	5.6	10.0
World	4.3	3.3	3.6	3.0	3.1	3.2	4.3

Source: Bloomberg, ANZ Research

Primary sector outlook

Summary

Food commodities have held their value despite the slowing in global economic growth. Supply-side factors have largely been supportive of meat and dairy prices and these factors are not expected to change any time soon. However, mounting risks on the demand side are reducing the likelihood of a fairy-tale ending to the current production season.

Crystal ball

Thus far, food export returns have avoided the big bad wolf lurking in the forest that is the slowing global economy. Supply-side factors have countered any potential slowing in demand, which has allowed dairy prices to recover and meat prices to reach record levels late last year. NZ food exports were largely immune to the negativity caused by the China-US trade tensions.

The signing of the phase one trade deal between China and the US poses a modest risk for NZ exports due to increased competition from US supply. The risk of US product displacing our dairy exports is minimal, but some price pressure could be expected over the longer term. Likewise, an increase in supply of beef from the US could compete with the supply of NZ beef into China, but this is more of a longer-term concern than an immediate risk.

Worrying developments

The Wuhan coronavirus outbreak may have a larger impact on China's economy than the US-China trade war, and could have a greater impact on NZ's agricultural exports than the trade war did. This is currently the greatest known risk to international agricultural prices.

The virus outbreak could not have come at a worse time as it coincided with Chinese New Year – a period of mass travel, catching up with family and elaborate meals. Foods are often gifted as well, making this a massive consumption period for luxury goods, including fruits, meats and dairy products. The virus outbreak has curtailed travel, with some cities in lockdown, and the Government has instructed tourism agencies to not sell any more domestic or international tour packages.

In addition, a desire to minimise exposure to other people is likely to reduce restaurant dining. The restaurant trade is a major channel for dairy ingredients such as mozzarella, cream cheese and butter. Dairy products, meat and fruit tend to be luxury goods in China rather than a staple like they are in New Zealand, meaning that any reduction in meals eaten at restaurants will certainly flow on to reduced demand for imported foods. The rising popularity of home delivery may provide an offset.

The severity of the coronavirus and the impact this will have on China's demand for foods supplied from New Zealand won't be known for some time. But it is likely to curtail demand for imports in the short term to some extent, and we have built in a small impact on prices.

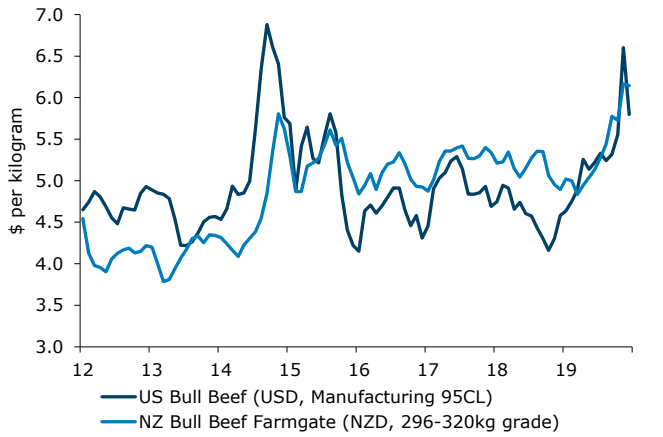
Supplies of imported foods tend to build early in the calendar year as importers stock up ahead of Chinese New Year and also take advantage of the reduced tariffs available at the beginning of the year. Under the NZ-China free trade agreement a specific quantity of product is allowed to be imported at a reduced tariff rate. In 2020 this allows for 170,606t of milk powder to enter China at a nil tariff rate, avoiding the standard tariff of 10%.

Future demand for imported dairy products will be dependent on how quickly these stocks are eroded. Importers are likely to take a wait-and-see approach this year before committing to additional purchases, meaning we could see some negative downward price pressure on dairy commodities in the short term. Demand for other luxury foods targeted at Chinese New Year, such as cherries, is also likely to be affected by the impact coronavirus is having.

Meat prices have already come off the highs that occurred in the final quarter of 2019. Beef and lamb prices recorded a sharp price correction in late December as demand from China stumbled. Prices had previously skyrocketed to record levels, as Chinese demand for protein boomed due to the reduction in domestic pork production. There was no question the prices reached would not be sustainable in the long term, but the sudden reduction in demand occurred in an unpredictable way that is becoming a familiar trait in this market.

Directives from Beijing to free up in-market meat supplies, along with approval of additional sources for imported meats, resulted in lamb and beef prices in this market dropping by about 20%.

Figure 1. Bull beef returns



Source: AgriHQ

Markets that were previously excluded from supplying China, such as South America and the US, are expected to resume supplying China with small quantities of beef now that the trade agreement has been signed.

Trade agreement no golden goose

Phase one of the US-China trade agreement includes a directive for China to import USD36.3bn in agricultural products this year and USD43.3bn in 2021, and strive to purchase a further USD5bn each year. This equates to a one-third increase on the 2017 imports, which were valued at USD23.8bn. This increase is unlikely to happen without displacing product from other origins, but is not expected to have a big impact on NZ. The main agricultural product that China imports is soybeans, used mainly for animal feed. Brazil has stepped into the gap caused by reduced supply of this product from US in the past couple of years. Some of this product is likely to be displaced, since it is very unlikely that China's total demand for agricultural imports will lift sufficiently to accommodate the volumes agreed.

In the short term the trade agreement is not likely to displace NZ dairy products as the US does not produce whole milk powder (the main product supplied by New Zealand). There will be some additional competition for skim milk powder and cheese, but the expected long-term growth in demand from China for these products means New Zealand product is unlikely to be displaced. However, we may see some downward price pressure due to the increased competition.

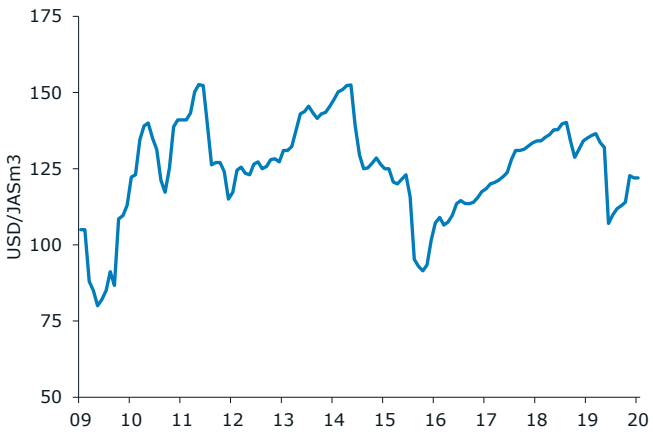
Resumption of the supply of US beef into China is expected to occur only slowly. The phase one trade agreement does not cut the 47% tariff that was applied to US beef imports in mid-2018. Meanwhile New Zealand-sourced beef enjoys tariff-free access. Very little US beef has been exported to China in the past decade due to the outbreak of BSE (mad cow disease) in the US, with the non-tariff barriers only lifted in mid-2017. Therefore, not only do US beef exports face stiff tariffs, the sales channel for this product is not well developed.

If you go down to the woods today

On the domestic front farmgate prices have been favourable and are expected to offset any production weakness this season in the dairy and meat sectors.

The same can't be said for the forestry sector. Log prices regained about half of the losses made earlier in the year but prices are now stagnating as strong global supplies put downward pressure on export prices. Some improvement in domestic demand is being seen but stocks of structural timber and plywood have also lifted. On balance, prices are likely to linger near current levels in the coming months.

Figure 2. Unpruned A-grade log in-market price



Source: AgriHQ

The meat production season got off to a slow start as lambs have taken longer to finish this season. However, we are now seeing a flurry of lambs heading to the processors, which has resulted in backlogs. The number of sheep being farmed in New Zealand has decreased slightly, meaning the number of lambs available for processing this season is expected to be down a little. Lambs are expected to be processed at slightly lighter weights, as it is unlikely that growing conditions will be favourable enough for lambs to attain last season's record weights.

Despite the recent correction in farmgate prices for lambs and cattle, both of these classes of stock are still worth more at the farmgate than they were this time last year. The strong prices attained early in the season mean average incomes for sheep and beef farmers are expected to improve this season.

Milk production volumes across the full 2019-20 season are expected to be flat on last season on a milksolid basis. Production for the period from June to December was up 0.4%, but this number is expected to be whittled away in the latter part of the season as dry conditions limit pasture production.

Saving for a rainy day

Despite strong milk prices, dairy farmers remain in cost-control mode, in order to protect margins. Operating costs in general are rising and we are now seeing a greater focus on debt repayment. Demand for supplementary feed has reduced as dairy farmers look to minimise discretionary spending, and improve their overall financial resilience. The dairy sector has plenty of challenges ahead, particularly in the environmental space, and businesses are looking to position themselves appropriately.

This means that despite milk prices looking strong at the headline level, we don't expect to see additional funds flowing through the rural services sectors and the economy as much as history might suggest.

Financial markets outlook

Summary

The RBNZ held the OCR in November. This, alongside resurgence in the housing market and some improvement in the data pulse has seen the market pull back expectations for further easing. We too have pulled back our expectation and now expect the OCR to remain on hold at 1% for the foreseeable future. One of the factors adding to an improving outlook is the Government's announcement to lift infrastructure spending, and that means more NZGBs on issue. However, that's more of a slow-burn, medium-term story. Globally, central banks are in wait-and-see mode after delivering additional stimulus last year. Unless something untoward comes along, it's looking increasingly like the Fed has now entered an on-hold phase, but the bias elsewhere is that further easing is more likely than not. NZD rallied into the end of 2019, supported by improved global sentiment and the strengthening domestic data pulse. Some retracement has occurred since then. The improved domestic outlook should support, but the coronavirus is a significant downside risk.

We're going on a bear hunt

The phase one deal between the US and China has locked in an expectation for a more conciliatory tone between the world's two largest economies – for the time being at least. Recently coronavirus concerns have weighed on markets. But before that, safe-haven demand had reduced, with US equities setting fresh highs in recent weeks.

Notwithstanding significant risks (particularly related to the coronavirus), recent global monetary and fiscal stimulus suggests the world economy is poised for a modest recovery in 2020. A lot has changed from a quarter ago when the global data pulse was deteriorating and recession alarm bells were ringing louder than they have in more than a decade (see International section on page 8).

The Fed delivered three rate cuts in 2019 and has now entered an on-hold phase as it looks like the tight labour market and healthy household sector will keep the economy running slightly above trend. The Fed has cited a willingness to let inflation run above its target rate, which should prevent front-end rates from lifting in the short term. In fact, risks are skewed toward a lower rather than higher fed funds rate.

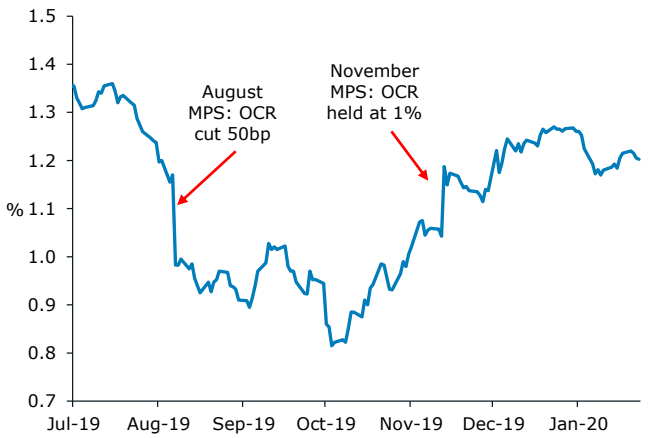
Term USD rates are likely to rise moderately in the first half of 2020, as confidence about the US economy improves and concerns about geopolitical risk dissipate. With the Fed happy to exercise patience, the US yield curve appears poised to steepen a little further in the near term.

Despite there being tentative signs that Europe's manufacturing slump is finding a floor, the ECB still has its work cut out in terms of getting inflation up. The ECB maintained its dovish guidance in the January meeting, and signalled that there would not be policy inertia this year on account of the wide-ranging review it is undertaking on monetary policy. The debate on the role that fiscal policy has to play in achieving macroeconomic stability looks set to continue (if not intensify) in Europe over the year ahead – particularly if the risk that ongoing trade woes between the US and EU materialise, derailing the tentative stabilisation seen in the industrial sector.

Meanwhile, the RBA looks set to ease policy later this year, although some improvement in the labour market means this is no longer viewed as imminent. ANZ expects one cut in April and another before the end of Q3, bringing the cash rate down to 0.25%.

Locally, the RBNZ surprised us (and the market, figure 1) when it held the OCR at 1% in November. This was after the surprise 50bp cut in August. Markets continue to price around 12bps of easing over the year ahead, which we think reflects a fair assessment of the balance of tail-end risks, notwithstanding a stable central view.

Figure 1. 2 year swap rates: there and back again



Source: Bloomberg

Looking forward, we expect the recent data stabilisation will translate into a more upbeat tone from the RBNZ at the February MPS. We expect that the OCR will remain at its current level for the foreseeable future. Non-tradable inflation is in the goldilocks zone around 3% y/y, core inflation measures have recently ticked up, and the economy looks set to grow around trend, with the labour market remaining near full employment. This definitely affords the RBNZ time to see how things evolve from here.

Financial markets outlook

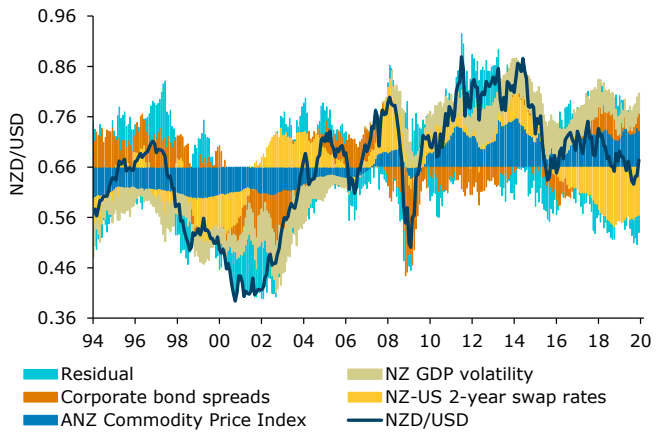
One of the factors underpinning the medium-term outlook is the Government's decision (announced in December alongside the Half-Year Economic and Fiscal Update) to lift infrastructure spending by $12 billion. In response, the Debt Management Office lifted its T-bill and bond issuance guidance over the next few years, albeit by less than the lift in spending. The stronger starting point for the Government's coffers, the impact on cash-in-the-door from lower rates, and the buffer built into previous guidance meant bond issuance didn't need to match the lift in spending. As the NZ election approaches, new spending and tax promises will present upside to bond supply.

Overall, we see short-end rates broadly stable, reflecting the on-hold RBNZ. Long-end yields are expected to follow US yields, but with some widening in the NZ-US spread over the forecast horizon.

Fairy-tale ending for the kiwi?

A strong run of domestic economic data, declining geopolitical uncertainty and seasonal tailwinds has proven to be a heady combination for the NZD, which gained around 6% on a trade-weighted basis between October and January. That said, some retracement has occurred in recent weeks.

Figure 2. Rates have become a slightly smaller drag on NZD



Source: Bloomberg, ANZ Research

While the domestic and global data has clearly struck a more positive tone in recent months, the scope for continued outperformance in the NZD from a domestic perspective looks limited. Expectations for the New Zealand data pulse have been recalibrated higher (making it hard to get upside surprises). And with only 12bp of easing currently priced into the curve over the next year, there is limited scope for repricing of RBNZ expectations to lift the currency. From a global perspective, scope to push higher on risk sentiment seems limited, with the recent optimistic run hitting its limits given economic fundamentals, and the coronavirus damaging risk sentiment.

In other words, it appears that the NZD has already enjoyed the benefits of better domestic data flow, a strong seasonal tailwind through December, and the sugar-hit from one-off announcements like less onerous bank capital restrictions and additional fiscal spending.

Overall, the path for the NZD is unlikely to be as smooth as our forecast. There is, after all, plenty of event risk out there, including US elections, trade developments, the coronavirus, and geopolitical risks – not to mention the possibility that domestic drivers shift, with fiscal announcements and the NZ election, the RBNZ's forecast judgements, and as the data pulse ebbs and flows. These exchange rate forecasts are consistent with our broader economic outlook. But life can throw curveballs, and it's always a good strategy to protect oneself against the risk of unacceptable outcomes so far as is feasible.

Sleeping beauty

NZD/USD: Down the garden path. Relative strength in the New Zealand data flow looks set to have run its course, with upside to the kiwi limited from here. In a longer-term sense we see this cross tracking sideways with some modest depreciation down the track. Expect volatility on news flow, however, with our economy's exposure to China meaning coronavirus headlines will impact, and rightly so.

NZD/AUD: I'm off to meet the wizard. The path from here is expected to be flat, with further policy easing from the RBA expected to put downward pressure on the AUD leg of this cross.

NZD/EUR: Make a wish. As with other major currency pairs, we see the positive tone holding up this cross as being limited from here. Add to that the likelihood of more stimulus from the ECB, with the outlook for the euro area still a bit grim, and we see this cross tracking lower.

NZD/GBP: Rescue the princess. With the UK set to leave the EU this month and trade talks still to happen, there's still plenty of uncertainty to be resolved. But it's not the catalyst for volatility it once was. Meanwhile, the Bank of England is expected to provide more monetary stimulus.

NZD/JPY: Queen of hearts. As always, this cross will be buffeted by risk sentiment, and we think it will be hard to see upside surprises from here. There's been only modest improvement in the global hard data so far, and uncertainties remain unresolved. Expect short-term choppiness as developments unfold.

Financial markets outlook

Table 1: Forecasts (end of quarter)

FX Rates	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
NZD/USD	0.67	0.66	0.66	0.65	0.65	0.65	0.65
NZD/AUD	0.97	0.97	0.97	0.97	0.97	0.97	0.97
NZD/EUR	0.62	0.60	0.60	0.58	0.58	0.57	0.57
NZD/JPY	74.4	73.9	73.9	72.8	72.8	72.8	72.8
NZD/GBP	0.51	0.50	0.49	0.48	0.47	0.47	0.46
NZD/CNY	4.74	4.69	4.70	4.65	4.65	4.67	4.67
NZ$ TWI	74.6	73.4	73.3	72.0	71.8	71.6	71.4
Interest Rates	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
NZ OCR	1.00	1.00	1.00	1.00	1.00	1.00	1.00
NZ 90 day bill	1.20	1.20	1.20	1.20	1.20	1.20	1.20
NZ 2-yr swap	1.36	1.29	1.29	1.20	1.23	1.23	1.23
NZ 10-yr bond	1.95	1.67	1.65	1.30	1.30	1.25	1.25

Source: Bloomberg, ANZ Research

Key economic forecasts

Calendar Years	2015	2016	2017	2018	2019(f)	2020(f)	2021(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.5	3.9	3.1	3.2	2.3	2.4	2.6
Private Consumption	3.6	5.6	5.2	3.2	2.8	2.9	2.1
Public Consumption	2.4	2.1	2.9	3.7	3.8	3.6	3.0
Residential investment	5.6	11.2	-0.8	0.1	3.8	-0.7	0.8
Other investment	3.4	0.8	7.2	7.1	2.7	3.0	4.1
Stockbuilding[1]	-0.3	0.1	0.2	0.4	-0.6	0.6	0.0
Gross National Expenditure	3.0	4.5	5.0	4.1	2.3	3.8	2.7
Total Exports	7.7	2.3	2.3	2.5	1.8	-0.8	1.9
Total Imports	4.0	3.4	6.8	5.9	1.6	3.2	2.7
Employment (annual %)	1.3	5.5	3.1	1.9	1.2	1.7	1.6
Unemployment Rate (sa; Dec qtr)	4.9	5.2	4.5	4.3	4.2	4.1	3.8
Labour Cost Index (annual %)	1.6	1.6	1.9	2.0	2.3	2.2	2.4
Terms of trade (OTI basis; annual %)	-3.1	6.7	7.9	-4.8	4.3	1.8	0.5
Current Account Balance (sa, $bn)	-6.8	-5.4	-7.7	-11.3	-10.3	-11.8	-12.5
as % of GDP	-2.7	-2.0	-2.7	-3.8	-3.3	-3.6	-3.7
Prices (annual % change)							
CPI Inflation	0.1	1.3	1.6	1.9	1.9	1.7	2.0
Non-tradable Inflation	1.8	2.4	2.5	2.7	3.1	2.7	3.0
Tradable Inflation	-2.1	-0.1	0.5	0.9	0.1	0.4	0.5
REINZ House Price Index	14.8	14.5	3.5	3.3	5.3	4.6	3.0
NZ Financial Markets (end of December quarter)							
TWI	74.5	77.7	74.4	73.4	73.7	72.0	71.4
NZD/USD	0.69	0.69	0.71	0.67	0.67	0.65	0.65
NZD/AUD	0.94	0.96	0.91	0.95	0.96	0.97	0.97
NZD/CNY	4.45	4.81	4.62	4.62	4.69	4.65	4.67
NZD/EUR	0.63	0.66	0.59	0.59	0.60	0.58	0.57
NZD/JPY	82.5	81.1	80.0	73.8	73.1	72.8	72.8
NZD/GBP	0.46	0.56	0.53	0.53	0.51	0.48	0.46
Official Cash Rate	2.50	1.75	1.75	1.75	1.00	1.00	1.00
90-day bank bill rate	2.75	2.00	1.88	1.97	1.29	1.20	1.20
2-year swap rate	2.85	2.46	2.21	1.97	1.26	1.20	1.23
10-year government bond rate	3.57	3.33	2.72	2.37	1.65	1.30	1.25

[1] Percentage point contribution to growth

Forecasts finalised 28 January 2020

Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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This document has been prepared by ANZ Bank New Zealand Limited, Level 26, 23-29 Albert Street, Auckland 1010, New Zealand,
Ph 64 9 357 4094, e-mail nzeconomics@anz.com, http://www.anz.co.nz