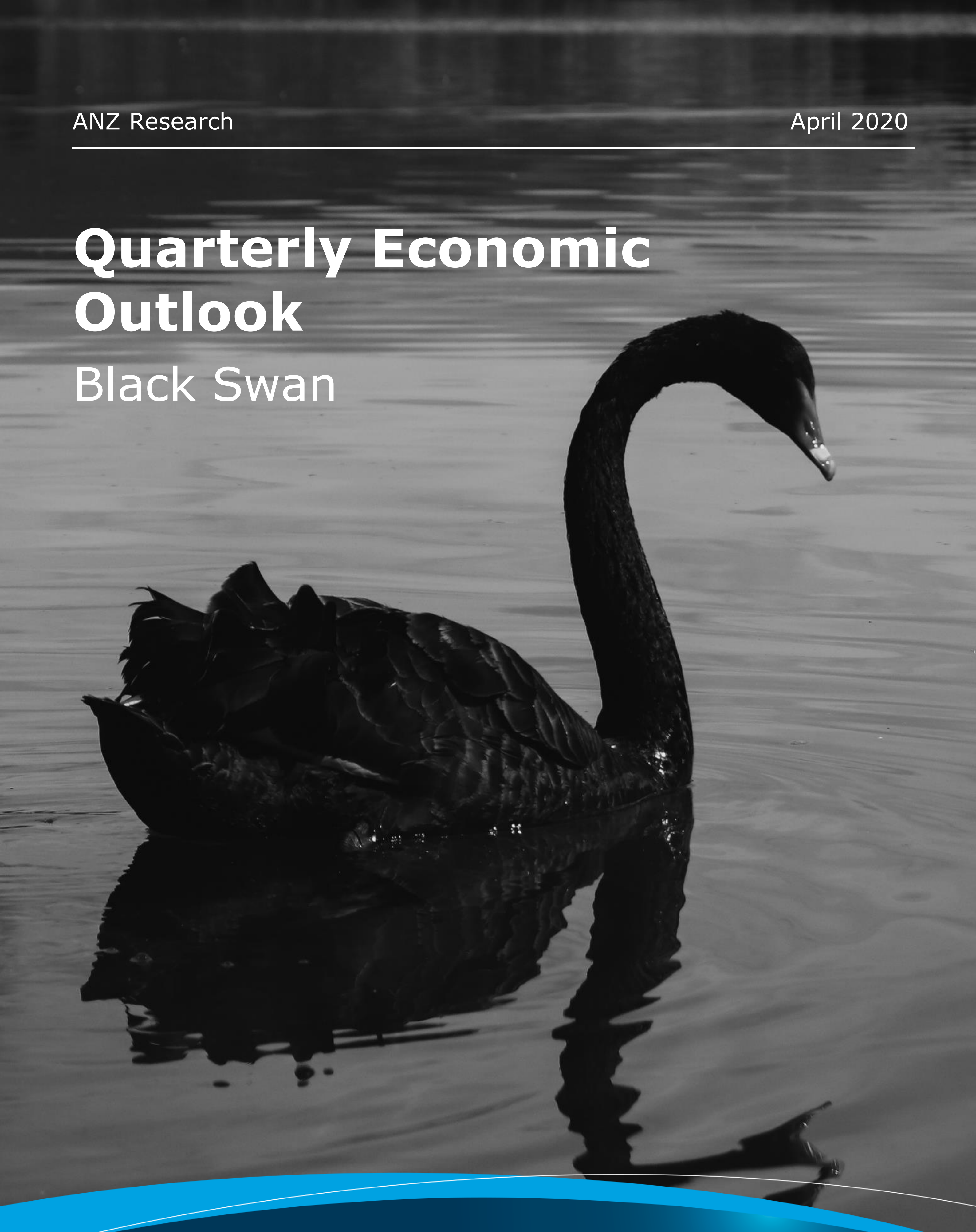

Quarterly Economic Outlook

Black Swan

This is not personal advice. It does not consider your objectives or circumstances. Please refer to the Important Notice.

Contents

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The current crisis

The world is in the midst of an unprecedented health and economic crisis. The COVID-19 pandemic is wreaking havoc on lives and livelihoods, including here in New Zealand. Unprecedented activity restrictions have been absolutely necessary, but have stopped the global economy in its tracks. The economic slump underway is truly enormous. Rightly, the crisis has galvanised policymakers with governments and central banks taking unprecedented steps to cushion the blow and ease pressures in financial markets. Nonetheless, the impacts of this crisis will be with us in months and years to come.

Box A (page 5) has a brief discussion of the RBNZ's quantitative easing programme and how it works.

An inevitable economic hit

The path from here is even more uncertain than usual, but economic pain is inevitable. We expect to see a sharp hit to GDP over the first half of this year. The magnitude of this and the subsequent bounce in activity will depend on whether we can contain the outbreak sustainably, the duration of activity restrictions, and the path to reopening the economy. Enormous fiscal and monetary stimulus is required through this period to support households and businesses that are under pressure. We expect that fiscal initiatives will continue to be ramped up, seeing NZGB issuance increase to $45bn next year. RBNZ asset purchases are expected to roughly double to $60bn to see bond yield curves lower and flatter. Even with all this stimulus, we expect unemployment will increase to 11% and GDP will be 8-10% lower this year.

The rebuild and recovery

The eventual recovery is expected to be slow, with the current slump causing significant persistent damage. Uncertainty will take a while to dissipate and households and firms will look to deleverage, dampening demand for a long time. We expect to see an export-led recovery, supported by enormous fiscal and monetary stimulus. With the labour market and inflation expected to improve only gradually, it will be crucial for central banks to stay the course with monetary stimulus well into the recovery. There is a risk that central banks unwind stimulus too early, undermining the recovery and inflation expectations.

Reshaping our world

The economy will not return to its previous trend, but over time it will find a new equilibrium. Some industries will need to change and may well be smaller, while other parts of the economy will benefit. International trade linkages will eventually resume, but we may see an increased focus on locally-sourced products for a time. Understanding about the spectrum of economic risks will change and influence policy. But other vulnerabilities may emerge too, with government balance sheets larger. Governments will need to consolidate eventually, and central bank policy will need to be normalised carefully when the time comes. There are plenty of challenges ahead. But as the economy evolves, there will be opportunities too.

The current crisis

Summary

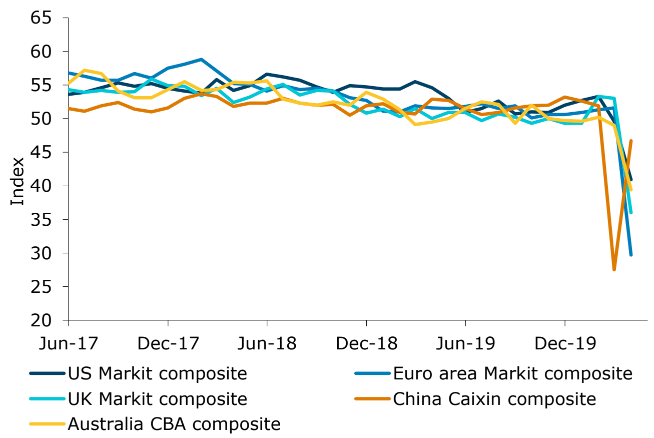
The world is in the midst of an unprecedented health and economic crisis. The COVID-19 pandemic is wreaking havoc on lives and livelihoods, including here in New Zealand. Unprecedented activity restrictions have been absolutely necessary, but have stopped the global economy in its tracks. The economic slump underway is truly enormous. Rightly, the crisis has galvanised policymakers with governments and central banks taking unprecedented steps to cushion the blow and ease pressures in financial markets. Nonetheless, the impacts of this crisis will be felt for years.

An unprecedented situation

The world is currently navigating a health and economic crisis not seen before in modern times. The human toll of the devastating COVID-19 outbreak has been deeply saddening. Countries around the world are taking unprecedented steps to control the spread of the deadly disease, and progress is being made.

However, the highly restrictive measures that have been required to slow the spread have brought the global economy to a halt. We are now in the midst of a deep global slump (figure 1). Job losses have been immediate and firms are under pressure. Non-essential spending and investment has all but ceased. Global trade has plunged.

Figure 1. Selected global PMIs



Source: Bloomberg, ANZ Research

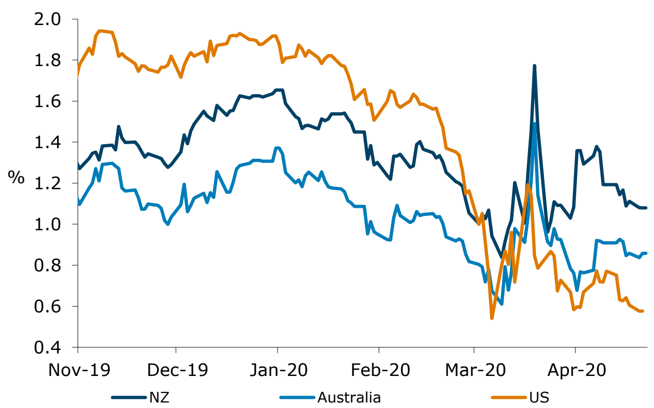
Governments and central banks around the world have stepped up to the plate to cushion the blow from the crisis. Central banks have provided enormous monetary stimulus. Governments are unleashing large fiscal support packages. And a range of measures have been taken to support global markets.

Financial markets have experienced significant volatility as the crisis has unfolded. Equities took a hard hit initially, and while they have recovered somewhat as central banks have provided liquidity, they remain vulnerable to reduced earnings as global growth slows. Oil markets have plunged as transport demand has been particularly hard hit. Supply cuts have been agreed, stemming the decline to some extent, but so far the cuts are being outweighed by reduced demand.

Currencies normally depreciate when a country's growth prospects deteriorate, but it's a zero sum game. The NZD has depreciated over recent months, as is usual when risk sentiment deteriorates, reflecting our exposure to global trade and tourism. However, some support has been seen in recent weeks, with the outbreak more contained here and demand for NZ's primary goods exports holding up.

Government bond yields have fallen significantly, although credit risk concerns associated with fiscal easing and potential business difficulties have also been percolating, causing volatility and providing some upward pressure at the long end (figure 2). Monetary stimulus has helped to soothe these concerns and stem the volatility that has emerged at times. Central banks are vigilant and willing to do more to keep yields low.

Figure 2. Global 10-year bond yields



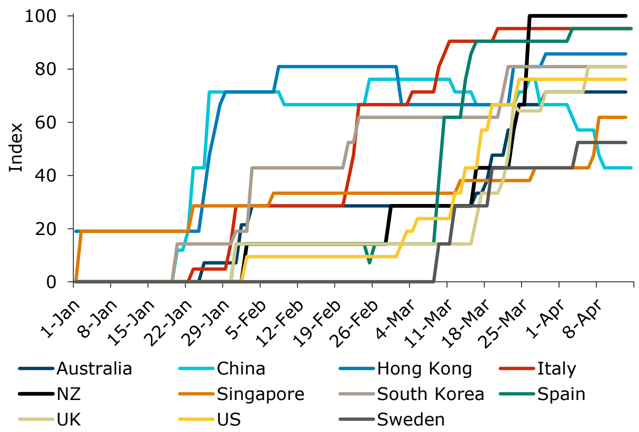
Source: Bloomberg, ANZ Research

Similar dynamics have been seen in domestic bond markets, with long-end yields seeing considerable upward pressure at times. This has come on the back of concerns about the market's ability to absorb upcoming government bond issuance related to the fiscal spend. The introduction of QE by the RBNZ has helped to ease pressures, but further support may be needed to push yields lower.

New Zealand, like many countries, is in lockdown to control the spread of the virus. We have taken a cautious approach (figure 3). Fortunately for us, we were able to adopt strict containment measures at an early stage of the outbreak here – and encouragingly, it is working, with the number of new daily cases falling into single digits of late.

The current crisis

Figure 3. Oxford Government response stringency index



Source: Oxford University, ANZ Research

While the progress we have made suggests an easing in activity restrictions is now possible, opening up the economy will not be straightforward. There is an ever-present risk of a renewed outbreak until a vaccine or effective treatment is widely available. The reality is that it is a long time until we will return to anything resembling "normal", with activity restrictions and tight border controls expected for some time.

The Government and RBNZ have responded aggressively to cushion the economic blow. The range of policy responses includes:

- The introduction of the wage subsidy scheme and other initiatives (including on tax) to support businesses.
- Household income support, including increased benefit and superannuation payments.
- Lending schemes for businesses and mortgage deferment options for households.
- Significant monetary stimulus, including a lower OCR, forward guidance and quantitative easing (see Box A).
- Initiatives to support the smooth functioning of the financial system.

Although these policy initiatives are helpful, economic pain is inevitable. The lockdown has seen a slump in GDP and significant job losses. And even once the economy reopens, social distancing – required or voluntary – will be with us for a long time.

The Government has provided guidance that a move to Alert Level 3 involves expanding the work taking place from what is "essential" to what is "safe". That still means that people are advised to stay at home, keep their bubbles, and avoid travel.

We estimate that about 25% of activity cannot take place under Alert Level 4, with perhaps 600,000 workers idle. This includes a large portion of industries like tourism, non-essential retail and wholesaling, non-essential construction, hospitality, recreation, and the like. Work that is taking place is less productive, too.

We estimate that 10-15% of work will not be able to be undertaken in Alert Level 3, based on recent guidance. But again, productivity will be severely affected by social distancing imperatives. Some retail, hospitality, construction, manufacturing, and services activity will be able to resume – even if business is a bit different and in many cases, operating on a limited scale.

Overall, we estimate that total GDP is 30-40% lower under Level 4 lockdown conditions and 15-25% lower under Alert Level 3, adjusting for losses in productivity. A key question now is how long we will be in Alert Level 3 for, with current guidance that we will be in Alert Level 3 for two weeks before it is reviewed again. Hopefully, we can ease restrictions further after that, but it'll depend on what happens with case numbers and contact tracing.

Clearly, the near-term economic hit is enormous. But the economic impact in coming months and years will depend on many things:

- the trajectory of the outbreak, in New Zealand and globally;
- how long we are in lockdown for;
- what happens after that;
- whether we are successful at virus elimination;
- the size and duration of policy responses; and
- how households and businesses respond.

We will outline our thinking about 'where to next' for the economy in the following chapters, but it should be remembered that the outlook from here is highly uncertain.

Ultimately, we are living through an unprecedented economic shock – with massive consequences – that we could not foresee. And it has the potential to reshape our world.

Truly a "black swan" event.[1]

[1] Black swans are rare events that have enormous consequences, where their predictability is rationalised after the fact. "The Black Swan" by Nassim Nicholas Taleb introduces and discusses these types of events, along with uncertainty generally. It is ironic that we have borrowed a metaphor about the inherent unpredictability of the world as a title for a forecast discussion, but it is also appropriate in the current crisis.

The current crisis

Box A: Quantitative easing – how it works

Since the onset of the crisis, the RBNZ has implemented a range of measures to support the financial system and provide monetary stimulus.

On the former, the RBNZ has eased capital and liquidity requirements, offered funding for the business lending scheme, and provided short-term liquidity to banks so the market trades near OCR and has enough cash to run smoothly.

To provide monetary stimulus, the RBNZ dropped the OCR to just 0.25% and issued forward guidance that it will remain at that level for at least the next year, with the intention to keep the yield curve low and flat. However, the drop of 75bps is small compared to the magnitude of cuts usually required in downturns, and this is a massive one. In the GFC, the OCR was slashed by 575bps as events unfolded. Problem is, with the OCR already very low, the RBNZ didn't have scope to go lower. Cue "quantitative easing" (or "QE").

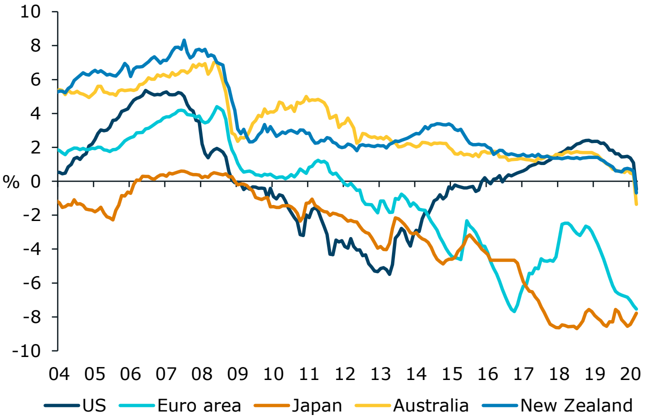
QE became fairly commonplace after the GFC, but New Zealand and Australia both managed to avoid using it until now. The RBNZ's QE programme (officially called the Large-Scale Asset Purchase Programme – LSAP) was announced on March 23. Here's how it works:

- The RBNZ purchases assets (primarily government bonds at this stage) in significant quantities from holders in the secondary market (not directly from the Government).
- This makes these bonds easier to sell, suppressing borrowing costs for those (like the Government) who are issuing these bonds.
- Reduced yields encourage existing holders of these bonds to buy other, higher-yielding ones. This creates beneficial spill-overs, suppressing other yields too (eg on corporate debt).
- This lowers interest rates in financial markets more broadly, easing costs for a wide range of borrowers and supporting the economy.

At the time that QE was introduced, the economic outlook was clearly deteriorating. But stresses in bond markets were also emerging – exacerbated by the expectation that government bond issuance would need to increase hugely on the back of the associated fiscal response. Before the announcement, bond yields (particularly longer-term yields) had moved higher – leading to a broad tightening in financial conditions, counter to the easing that the RBNZ were trying to achieve. The implementation of QE has helped ease bond market pressures and reduce interest rates, relative to what would have been seen had they not acted.

It is difficult to measure exactly how much the asset purchases have eased financial conditions, but one way is to look at "shadow short rates" (or SSRs). These estimate the effective stance of monetary policy implied by yield curve data. They suggest that at the end of March the stance of policy was equivalent to an OCR of around -0.7%, with a ~70bp drop seen when QE was announced. That's significant and suggests the policy has had a clear impact. Nonetheless, we think that the RBNZ will need to do more and push New Zealand's SSR even lower than that (more on that in the next chapter).

Figure A1. Shadow short rates in selected economies



Source: LJK Limited

Now the focus for forecasters and market participants is on predicting the volume of bond purchases that will be required, and the impact this might have on yield curves. At this stage, we expect that the RBNZ will continue to use volume announcements (eg currently the programme is $33bn in size) as it adapts its policy stance. However, another option would be to adapt their QE programme to a type of "yield curve control" (or YCC) as used in Australia. This involves specifying a yield target and purchasing as many bonds as is required to achieve that. The US Federal Reserve has effectively adopted an extreme version of this by saying it will conduct unlimited purchases of bonds to keep yield curves low and flat.

Negative policy rates have also been employed in some countries, particularly Europe. At this stage, we don't expect the RBNZ to take the OCR into negative territory, at least not any time soon. Even if the financial system were ready for that, it poses risks to credit availability that we think would be untenable at the moment, given stresses that could emerge.

Kick-starting QE was a necessary step for the RBNZ to take to support the economy and financial markets. And with stimulus expected to be needed for a long time, we expect QE is here to stay. Click here to return to main text.

An inevitable economic hit

Summary

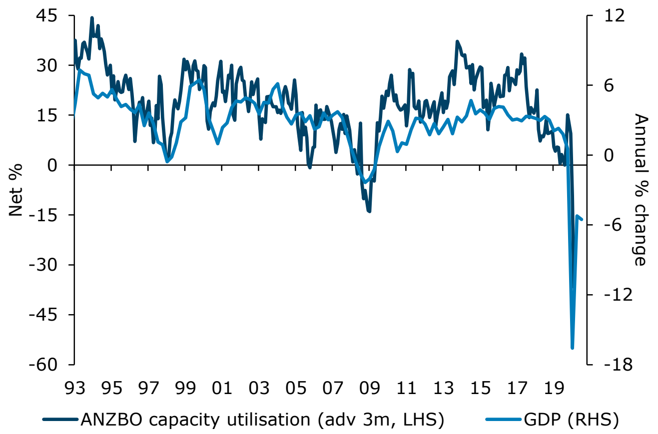
The path from here is even more uncertain than usual, but economic pain is inevitable. We expect to see a sharp hit to GDP over the first half of this year. The magnitude of this and the subsequent bounce in activity will depend on whether we can contain the outbreak, the duration of activity restrictions, and the path to reopening the economy. Enormous fiscal and monetary stimulus is required through this period to support households and businesses that are under pressure. We expect that fiscal initiatives will continue to be ramped up, seeing NZGB issuance increase to $45bn next year. RBNZ asset purchases are expected to roughly double to $60bn in order to get bond curves lower and flatter. Even with all this stimulus, we expect unemployment will increase to 11% and GDP will be 8-10% lower this year.

A difficult year ahead

Activity restrictions have been a necessary part of the crisis response. And although we are making steady progress in containing the outbreak, a very cautious approach to easing restrictions will be necessary, which means that returning to anything resembling normal will take time and considered action.

The economic impact of the lockdown is enormous. Activity has tanked (figure 1). Many households and firms are under considerable financial pressure. Job losses have been immediate and significant. And some businesses have had to liquidate. These impacts would be much worse without fiscal support. But at the same time, the Government cannot save every job or business. Lasting scars are inevitable.

Figure 1. ANZBO capacity utilisation and ANZ GDP forecast



Source: Statistics NZ, ANZ Research

The short-term economic impact of the crisis will depend on whether we can contain or eliminate the virus, how long we have to be in lockdown for, and how many firms face difficulty and have to close.

A wide variety of scenarios is possible. Our central assumption is that we are in Alert Level 3 for a month, with some degree of activity restrictions still in place for the remainder of the year at least. Based on this and our understanding of activity under the various alert levels, we expect GDP to fall 22-23% in the first half of the year and to be 8-10% lower over 2020.

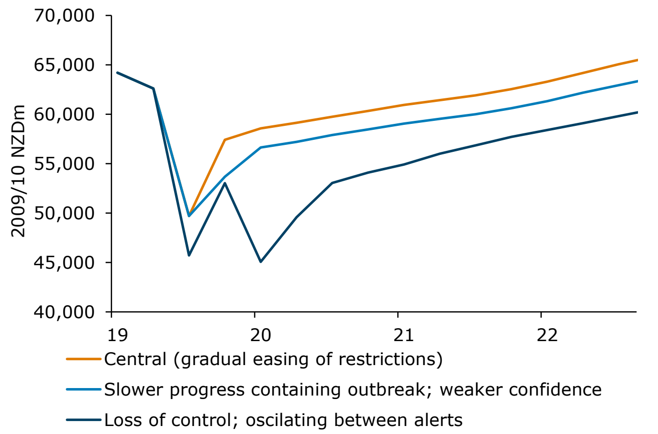
Potential output is expected to be lower on the other side of this and capacity will have to be rebuilt. This is because some firms will have gone out of business, jobs will be lost, migration will be curbed, and some workers will be discouraged from even participating in the workforce. The impact on potential output will be larger the longer this goes on. Government policy directed at preventing this as much as possible is critical, alongside initiatives to support demand.

The economic impact will be much worse if we can't eradicate the virus and if we have to be in lockdown for longer. Figure 2 shows some alternative scenarios to our central view.

- In the first, the economy is opened more slowly than assumed, due, say, to ongoing evidence of low-level community transmission. This sees greater caution and reinforces social distancing, causing more permanent economic damage.
- In the second scenario, the economy moves out of lockdown as assumed but the loosening in the restrictions causes a resurgence in the outbreak down the track. This scenario involves returning to lockdown later in the year, with a much slower recovery and much more permanent damage.

We are not saying that these scenarios are likely, but this does show the economic implications of the risks policy makers are facing. We are fortunate to have been successful in our approach so far, but we cannot be complacent. A cautious approach to easing, and a robust 'test, trace and isolate' regime, are required.

Figure 2. GDP levels under possible scenarios



Source: Statistics NZ, ANZ Research

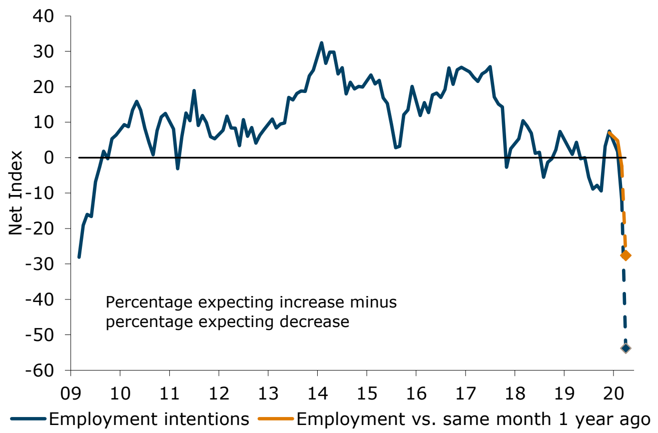
An inevitable economic hit

It should be noted that there are upside risks too, if containment measures work faster than expected. At these low levels of infection, luck does play a role. An opening up of the economy might be easier and closer than we expect. Or, with Australia making significant progress too, trans-Tasman travel might be on the cards sooner than anyone anticipates, which would provide economic benefits on both sides of the Tasman.

Our expectations are based on more fiscal and RBNZ support than has been announced so far, including through the recovery. If it were not for this, the fallout would be much worse. And indeed, it is possible that fiscal and monetary stimulus could provide more cushion than we currently expect, especially if fiscal initiatives are front-loaded in the early part of the recovery – and large.

Unemployment is increasing rapidly. The Government's wage subsidy scheme is helping, with 40% of the workforce now being supported by business claims through the scheme. But labour is only one part of firms' costs and firms are facing the difficult prospect of shedding staff. A net 54% of firms in our preliminary April ANZ Business Outlook survey expected to reduce their headcount (while a net 28% already have compared to this time last year – 40% have cut staff, while 12% have increased numbers).

Figure 3. ANZBO experienced and expected hiring



Source: ANZ Research

At this stage, we expect the unemployment rate will increase to 11% in short order, with almost 240,000 fewer people in employment. This is expected to be seen alongside a fall in labour-force participation. If that did not occur, the increase in unemployment would be even greater.

The initial bounce once restrictions are eased will help shore up activity and get firms underway again. But for some, the damage is already done. Investment is likely to be weak for a long time and some large construction projects may have been cancelled.

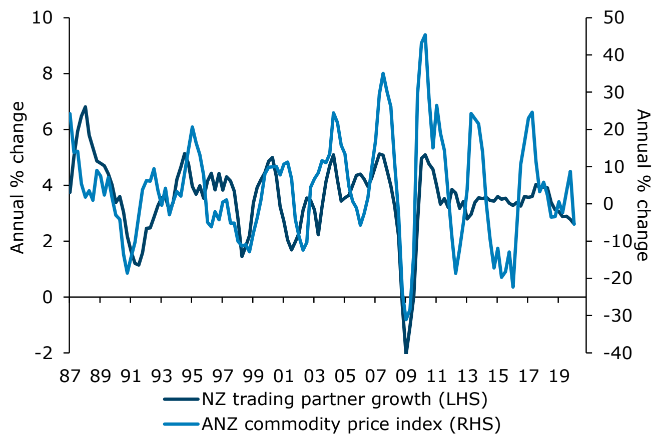
There will be significant industry divergence when businesses can restart, and the economic impacts of the crisis will be felt disproportionately across sectors. Tourism and related firms are unlikely to see much increase in demand for a while. This is likely to impact hospitality and retail for some time – even though they may be able to get underway sooner. Other parts of hospitality and retail (essential items and, eventually, takeaways) may do quite well, relatively.

Industries like construction, manufacturing and services will be able to resume activity (albeit with reduced productivity) shortly, but the damage to demand has changed the outlook for these firms considerably. On the other hand, IT, government, health and some other essential industries are expected to benefit from recent events.

Agriculture is expected to perform relatively well. We are seeing solid demand for our food exports, and farming has been able to continue during lockdown. This has supported dairy, meat and horticulture in particular. Dry conditions have eased a little recently but winter feed reserves are quickly being used up with meat processors working at a slower pace than normal, meaning there is more stock on farms than usual. Some primary industries that do not produce food, like forestry and mining, are finding things more difficult having been deemed non-essential in Alert Level 4.

More broadly, export demand is expected to soften considerably in the short term, particularly for non-food exports. Services exports have ground to a halt and other goods are expected to see weakening demand.

Figure 4. Global trade and commodity prices



Source: Bloomberg, ANZ Research

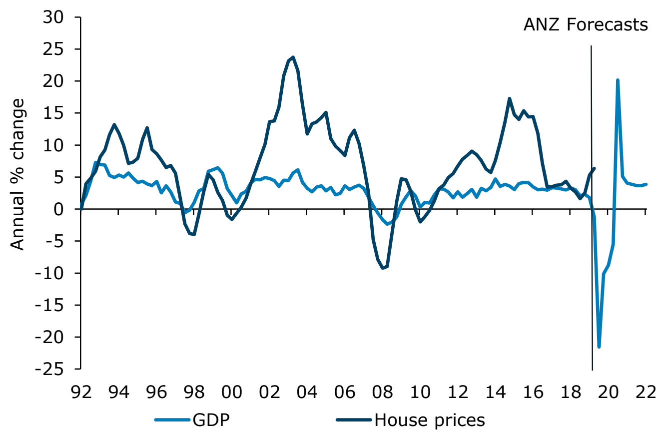
An inevitable economic hit

Moreover, even though exports of food are expected to hold up, export prices are expected to eventually fall – potentially quite a lot – eroding some of the recent strength in revenues. This is what tends to happen when global demand falls. Indeed, the slump in world trade and GDP is expected to be unlike anything we have seen in modern times (figure 4, above). Still, compared to other industries, our agricultural sector is expected to fare relatively well through the crisis and eventual recovery. People have to eat.

For households, there may be some pent-up demand to spend when activity restarts. But the trend in consumption will settle at a lower level, with incomes under pressure and uncertainty rife. This will have flow-on effects.

House prices are expected to fall significantly, as typically happens in economic downturns. House prices normally swing much more than GDP does (figure 5). At this stage we expect to see house prices drop 10-15%, with demand under considerable pressure. There is downside risk to this, particularly if credit becomes squeezed.

Figure 5. House prices and GDP



Source: REINZ, Statistics NZ, ANZ Research

Regional markets exposed to tourism will be hit hard. Weaker incomes, unemployment and uncertainty will weigh. Debt servicing will be difficult for some, even though interest rates are low. Mortgage delinquencies will see fire sales increase off very low levels. Expectations will shift abruptly. And households and banks will be cautious, with credit availability hampered by lower collateral values and worse income prospects. It's not a pretty picture and there is a risk of a greater impact if credit stresses emerge. See our ANZ Property Focus for more details.

Households and firms will have to take on more debt to get through this. In some cases, taking on more debt will not make sense if business operations are not viable in the longer term, and difficult decisions will need to be made. But for many, a short-term increase in debt will be part of the solution, and banks will naturally play a role in supporting households and businesses in that way.

The RBNZ has proposed lifting high-LVR (loan-to-value ratio) restrictions. This will help facilitate the increase in new lending associated with the mortgage deferral scheme. However, we don't expect it to be a game changer for the housing market. We expect to see a short-term spike in credit as some households defer payments or move to interest only to get through. But beyond that, demand for new house purchases and appetite for debt is expected to be low.

The "neutral" interest rate is very low – and likely negative at present. That's because there will be a lot of saving going on (either voluntary or involuntary), with less in the way of opportunities to spend or to divert those funds to productive uses (like new business opportunities). It's simply really difficult to encourage demand to increase in this sort of environment.

But as activity resumes, it will be possible for firms and households to spend and invest once more – and the Government and RBNZ will be looking to encourage that as much as possible. Although potential output will be lower, an enormous amount of spare capacity in the economy will nonetheless emerge on the other side of this. Demand will be weak, meaning businesses will not be as busy. Unemployment will remain elevated.

This spare capacity will see inflation pressures in the economy ease considerably. In Q1 CPI inflation printed at 2.5% y/y, above the RBNZ's target mid-point. The picture of core inflation was mixed, but inflation was in a comfortable position before this shock unfolded. But that's as strong as inflation is going to get for quite some time. By the end of the year, we expect inflation will be tracking below the RBNZ's 1-3% target range and that employment will be considerably weaker than its maximum sustainable level.

Cracks are already starting to show on the inflation front, with anecdotes about rent reductions a notable example. Wage growth will also be under downward pressure, and that will contribute to a weak domestic inflation pulse too. All the inflation indicators in our ANZ Business Outlook survey are dropping fast.

A big risk for the RBNZ is that inflation expectations become unanchored. If that were to occur, it could prove very difficult to get them back up again.

An inevitable economic hit

Enormous fiscal and monetary stimulus is needed to support the economy. Government initiatives that have already been announced will help, but more still spending will very likely be in the pipeline, depending on how developments unfold. To fund the spend-up, we expect that NZGB bond issuance will need to increase considerably, with $45bn of issuance expected next fiscal year.

Going hand in hand with that, more monetary stimulus will likely be needed to help reduce spare capacity in the labour market and to support inflation. We expect that large-scale asset purchases (QE) will need to roughly double to $60bn in short order, consistent with our expectations for the economic outlook and bond issuance. The RBNZ will need to soak up at least ~$60bn of new government bond issuance between now and the end of fiscal 2020/21 (ie June 2021) to keep bond yield curves low and flat.

Fewer asset purchases might be required if the economy were to bounce back more quickly than we expect or need less fiscal support. However, given the magnitude of the shock and the response required, in our view risks are tilted towards more purchases, not less.

Overall, we expect the New Zealand government bond yield curve to continue to go lower and flatter, bringing government bond yields and swap rates more in line. Fiscal stimulus announcements and positive news about the outbreak trajectory could see yields pop higher temporarily, with some volatility possible – likely even – in the short term. But ultimately, we expect that the RBNZ will do whatever is necessary to cushion the economic blow of this crisis.

It is also possible that the RBNZ could decide to adopt a yield curve target, as Australia has, instead of making further announcements scaling up the volume of purchases. From the perspective of domestic markets and financial conditions, the impact would be the same, with RBNZ confirming in recent statements that it remains focussed on driving the government bond yield curve lower and flatter.

The rebuild and recovery

Summary

The eventual recovery is expected to be slow, with the current slump causing significant persistent damage. Uncertainty will take a while to dissipate and households and firms will look to deleverage, dampening demand for a long time. We expect to see an export-led recovery, supported by enormous fiscal and monetary stimulus. With the labour market and inflation expected to improve only gradually, it will be crucial for central banks to stay the course with monetary stimulus well into the recovery. There is a risk that central banks unwind stimulus too early, undermining the recovery and inflation expectations.

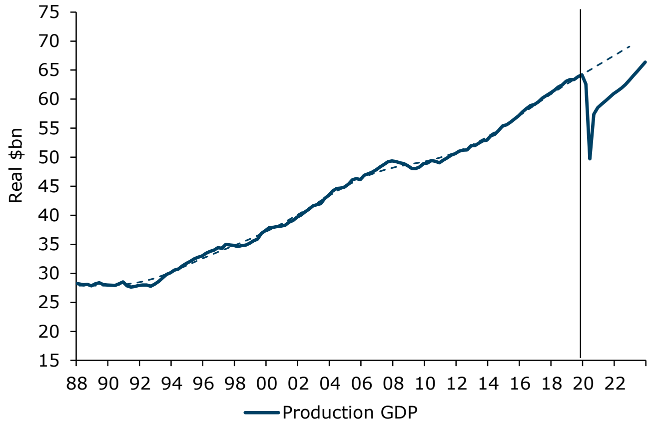
A slow recovery

The current economic slump will cause significant – and in some cases permanent – damage. But eventually, the economy will start to rebuild, supported by continued fiscal and monetary stimulus.

After an initial bounce as restrictions are slowly lifted, the economy will return to a lower trend in output, reflecting the significant persistent damage done. And from there, the recovery will be slow, with international linkages taking time to resume and domestic demand expected to improve only gradually.

Our current forecasts have GDP returning to levels prevailing before the crisis in mid-2023, although it could take longer if the outbreak and associated disruption are more protracted than currently assumed (figure 1).

Figure 1. GDP level

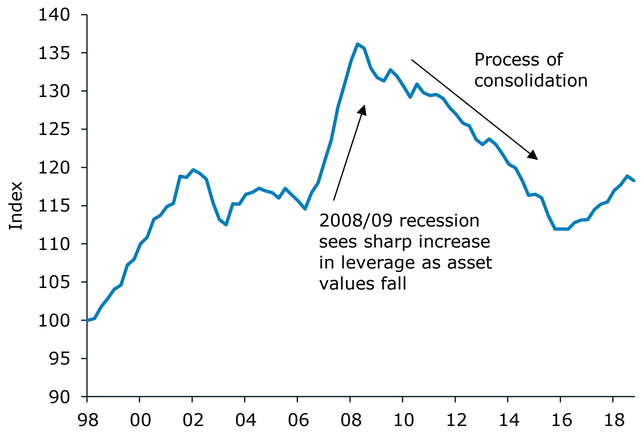


Source: Statistics NZ, ANZ Research

In many cases, households and firms will enter the recovery with more debt than prior to the crisis. And asset prices will likely be lower, at least for a time. Financial asset values have already dropped, and potentially quite large falls in property prices are possible.

We expect many will be looking to shore up their financial positions as a result, which will weigh on demand through the recovery period. This sort of dynamic happened in the wake of the 2008/09 recession. Gains in house prices helped to shore up equity positions during the recovery, but this time house prices are even more vulnerable to a correction – and we expect that an eventual recovery will take much longer to achieve. Add to that the fact that the shock to incomes will be greater this time, and the deleveraging dynamic will probably be more exaggerated (figure 2).

Figure 2. Household leverage (debt/equity)



Source: RBNZ, ANZ Research

Uncertainty will also take a while to dissipate, and expectations about the outlook – especially about wealth positions – will have changed. Households and firms may also be quite wary about potential risks and look to have a bigger rainy day fund for the next time something unexpected hits.

Overall, we think a degree of behavioural change is likely, with households and firms more cautious about debt, and increasing their saving. This will contribute to a sluggish recovery in consumption and broader demand, both domestically and globally. Easy financial conditions and low debt-servicing costs will help facilitate balance sheet consolidation.

The productive capacity in the economy will be lower and take time to rebuild, especially with weak investment expected to be a drag. The extent of this will be determined by how many firms go out of business and how many workers need to retrain.

Additionally, growth in productive capacity will be limited if migration inflows are curbed for a long time. The net migration outlook is highly uncertain. New Zealand typically experiences a net inflow, but arrivals will be limited due to border and activity restrictions. However, kiwis may be less likely to leave too, providing a partial offset.

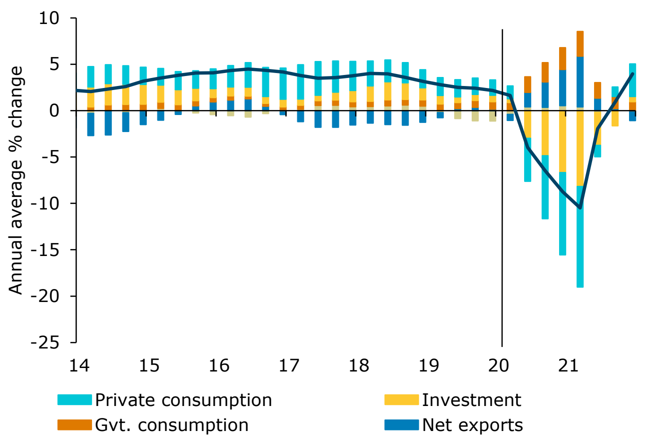
The rebuild and recovery

Overall, we think that migration will be weaker than otherwise, as it was following the GFC. We expect to see some recovery once borders open and the labour market has begun to tighten. But in the interim, high unemployment will mean fewer jobs to attract migrant workers.

There is a risk that migration recovers more quickly than expected, supporting GDP and house prices, and presenting some upside risk to our forecasts. After all, there's still a large number of kiwis living abroad who could decide to come home – particularly if New Zealand's elimination strategy proves successful while other economies face the ever-present threat of a second or third wave of infection and go in and out of lockdowns at huge economic cost.

Net exports of goods are expected to support GDP during the recovery (figure 3), even with global demand weak for a considerable period. New Zealand is fortunate to be significant food producer, meaning demand remains a little more stable in a downturn compared to highly discretionary items such as fancy cars. However, the food we do produce does tend to be more of the luxury variety, so prices will need to adjust. Meanwhile, weak domestic demand will weigh on import volumes, particularly capital goods imports as business investment dries up.

Figure 3. Expenditure decomposition of GDP



Source: Statistics NZ, ANZ Research

Travel and tourism industries will be unable to resume for quite some time, meaning services exports will take a long time to recover. While increased domestic tourism spending will provide some offset, this too is highly discretionary and unlikely to lift markedly as household incomes are falling.

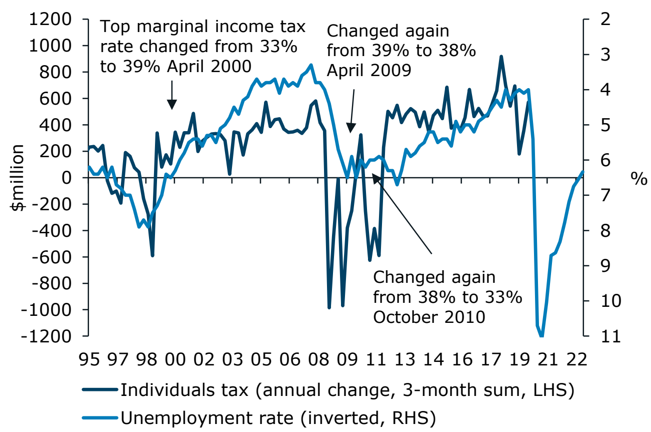
As we move past the worst of the crisis, we expect to see an export-led recovery, driven by goods (tourism and education exports will take much longer to recover). Imports are likely to remain weak for some time as the domestic deleveraging cycle works through. Previous depreciation in the exchange rate will assist the net export recovery. But New Zealand may perform well relative to other countries, eventually seeing a modest lift in the NZD.

The terms of trade will be affected by offsetting forces. Although export volumes should be supported to some degree, weaker global demand will weigh on export prices. This will flow through into weaker domestic incomes. On the other hand, import prices will also be under pressure and provide an offset in terms of household purchasing power. On the whole, we see the terms of trade remaining buoyed in the near term, with import prices, particularly oil, falling by more than export prices. But over the medium-term, weak global demand will cause some moderation.

It's a long road ahead, and the economy will continue to need support as the recovery unfolds. Fiscal policy will play a key role. Large fiscal deficits are expected as revenues dry up (figure 4) and expenses lift.

But for discretionary spending during the recovery to have a meaningful impact on activity, COIVD-19 risks will need to be under control and the economy a lot less constrained by lockdown measures. Policies such as tax cuts, increases in transfer payments, and higher operational and capital spending can all play a role in getting the economy moving again. It is encouraging to see a push for infrastructure projects to be ready for when we reach this rebuilding phase.

Figure 4. Individuals' tax and unemployment rate[2]



Source: The Treasury, Statistics NZ, ANZ Research

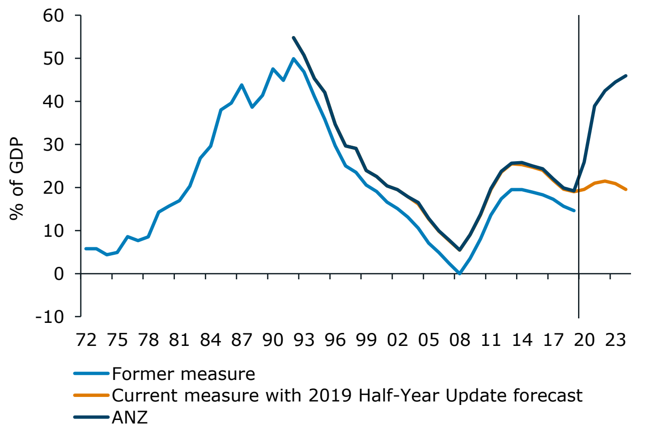
Policies to support the recovery will need to be big and broad based in order to be effective. And if measures are big then it will be important for them to

[2] Changes to income thresholds and marginal tax rates as well as wage and population growth complicate the historical relationship. But the outlook for compensation of employees is equally as dire and that will be reflected in the tax take.

be temporary. Even if such policies are in place for quite some time, the Government's books will eventually need to return to a sustainable position. That means there will be a period of rebuilding fiscal buffers. While the consolidation stage is expected to be well down the track, it's likely to bring discussion to the table about higher tax rates, new tax types, and a review of spending commitments. A few sacred cows should be getting nervous.

Net core Crown debt is expected to lift to 40-50% of GDP (figure 5). The hit to the fiscal books will be significantly larger than during the GFC, but to levels that would not incur blushes in an international comparison today.

Figure 5. Net core Crown debt forecast



Source: The Treasury, ANZ Research

With spare capacity in the economy expected to be eroded only gradually, the labour market will take time to recover. This will weigh on household incomes and add to consumer caution. Reduced employment prospects will limit gains in house prices.

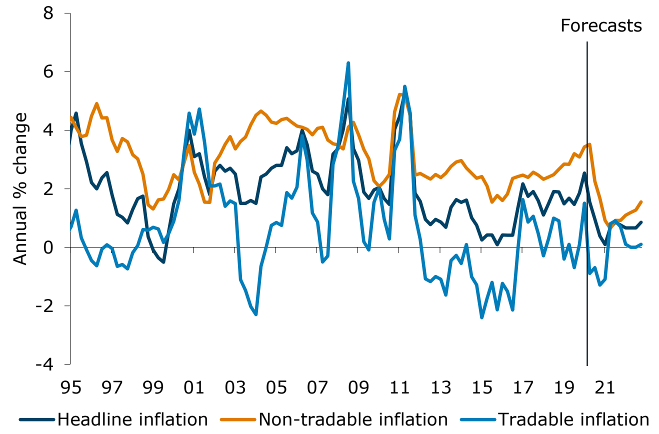
A recovery in the housing market is expected eventually as sentiment and incomes gradually improve, supported by low interest rates. But expectations will have shifted, and we wouldn't be surprised if it takes quite a while for a recovery to take place.

There will also be downward pressure on inflation for a long time. Since the economy will no longer be able to supply as much in the way of goods and services as it did for a while, this will put a floor under prices. But overall, the weak domestic demand is expected to see non-tradable inflation weaken and then increase only gradually once the recovery in growth is underway (figure 6).

Weak global activity is expected to keep world import prices under pressure, and that's going to weigh on tradable inflation. A lower NZD will provide some offset, but global deflationary pressures are expected to dominate. However, we could see big swings in tradable prices, particularly if oil prices remain volatile.

On the whole, headline inflation is expected to slip below the RBNZ's 2% target midpoint in Q2. By the end of the year we think it'll be touching the bottom of the 1-3% target band. And by 2021 it'll be below it. A very modest recovery is expected over the latter part of our forecast horizon. But risks are skewed towards inflation being weaker for longer, with a deterioration in inflation expectations.

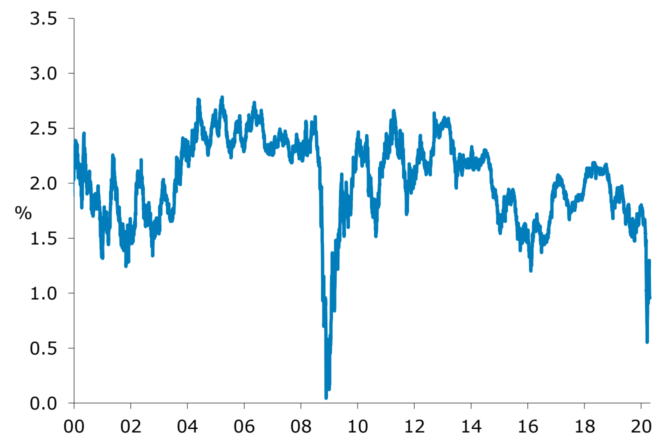
Figure 6. Medium-term inflation outlook



Source: Statistics NZ, ANZ Research

The sluggish recovery expected in both the labour market and inflation reinforces the need for the RBNZ to provide continued stimulus for quite some time during the recovery. It will be important for the RBNZ to ensure that inflation expectations stay anchored, and that the recovery is assured, so that inflation does not settle stubbornly below target.

Figure 7. US inflation expectations from 10-year TIPS



Source: Bloomberg

The rebuild and recovery

Very weak inflation will be a global phenomenon, and the risk to inflation expectations is significant. Market pricing suggests a widespread expectation that inflation will be low for a very long time (figure 7). Inflation expectations (one year ahead) in the ANZ Business Outlook survey dropped to a record-low 1.3% in the preliminary April read.

Low inflation expectations mean that monetary policy has to work even harder to get actual inflation back to target. But more than that, when inflation expectations fall, it reduces the stimulatory impact of low nominal interest rates, since it is *real* interest rates that matter for investment and spending decisions, and these depend on inflation expectations.

The "neutral" real interest rate is expected to remain low for the foreseeable future, so interest rates need to be low in real terms for the recovery to be supported.

As the crisis unfolds, we will likely see the neutral interest rate increase from current negative levels. However, it will remain lower than before the crisis, at least for a while, since desired saving will be even more elevated. This reflects private sector deleveraging efforts and the Government eventually needing to repay its debts. Admittedly, investment will need to take place too to reshape the economy, but firms may need more financial encouragement than usual for that to take place.

In our view, central banks around the world will need to stay the course and provide extraordinary monetary stimulus well into the rebuilding phase of this crisis. It may be tempting for central banks to unwind stimulus once growth starts to recover, but doing so too early would be a mistake and risk derailing a potentially fragile recovery and inflation expectations.

Super-low policy rates and continued central bank asset purchases will thus be needed for a long time to provide stimulus. More central banks (including the RBNZ) may even venture to take policy rates negative if the stimulus was judged to be not providing enough support – and the financial system was ready. Globally, bond curves are expected to remain low and flat for quite some time as central banks keep their foot on the gas and the economy rebuilds. However, some steepening is expected to eventually emerge as markets start to factor in normalisation, even if it is still a long way down the track.

Reshaping our world

Summary

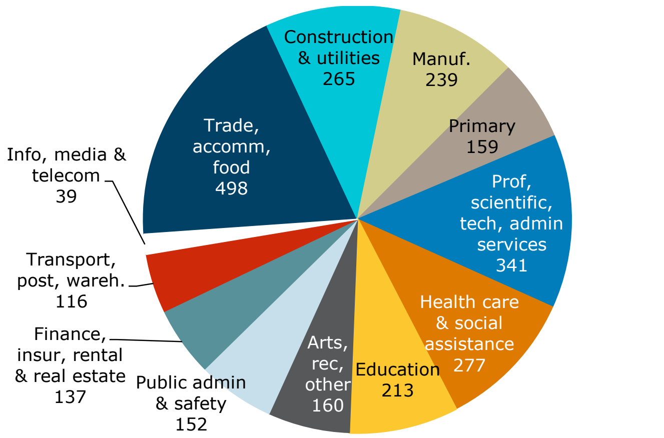
The economy will not return to its previous trend, but over time it will find a new equilibrium. Some industries will need to change and may well be smaller, while other parts of the economy will benefit. International trade linkages will eventually resume, but we may see an increased focus on locally-sourced products for a time. Our understanding about the spectrum of economic risks will change and influence policy. But other vulnerabilities may emerge too, with government balance sheets larger. Governments will need to consolidate eventually, and central bank policy will need to be normalised carefully when the time comes. There are plenty of challenges ahead. But as the economy evolves, there will be opportunities too.

The long road ahead

Eventually, rebuilding will take place and the economy will find a new equilibrium. The economy will not simply revert to its previous path, but it will be reshaped, at least to some degree. Things will look different.

Many businesses that were viable before this happened will unfortunately no longer exist. The shape of the economy will change in terms of its industry composition. The workforce will adapt, as job losses move workers into new occupations. Unfortunately, the economy will never return to its previous trend, so opportunities that may otherwise have existed will be missed. But other opportunities will emerge.

Figure 1. Jobs by industry at end 2019



Source: Statistics NZ, ANZ Research

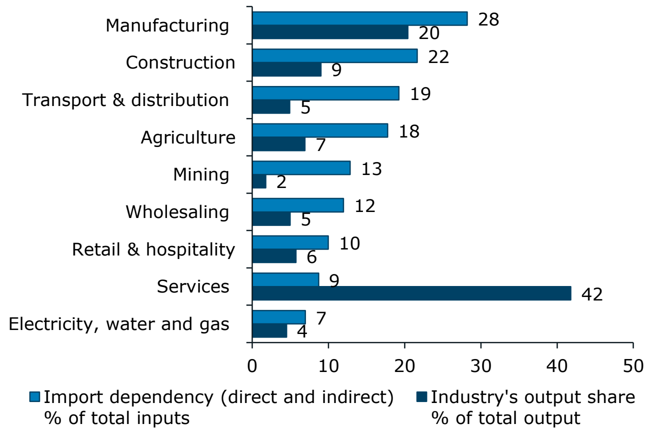
In some cases, entire industries will need to reinvent themselves. Tourism, for example, may take a long time to recover, since so many businesses will have been affected. Other industries that are likely to be badly hit include arts, recreation, retail, hospitality, and some services. And the shape of some industries may be different. For example, education may become more focused on reskilling those in shrinking industries, rather than on foreign students. The move to online retail won't be fully reversed. Industries, like healthcare, government, food production and IT are likely to benefit for some time.

New Zealand will find its place in the world once more, with plenty of opportunities for trade, but they may be a little different. It will probably take time for international linkages and supply chains to normalise, which will affect companies that import and export.

Fortunately, we export a lot of primary goods, which will likely still be in demand. Exports of services (tourism and education) may be smaller for a long time, however, meaning our overall export share of GDP may shrink. But on the other hand, if New Zealand successfully navigates the tightrope and achieves the ideal of a gradual but one-way exit out of lockdown, the country would offer an oasis of certainty and reliability that other countries forced to oscillate in and out of lockdowns couldn't match. In that scenario, we may see some exports of both goods and services gain global market share.

That said, we may see an inclination from countries to increase their self-sufficiency, with a retrenchment of the globalisation seen over recent decades. There may also be more focus from governments and externally-facing sectors to diversify markets, and to ensure some domestic production of essential goods. This and the events that have unfolded may also impact our preferences and consumption decisions, with household and firms looking to increase their reliance (or ability to source, if required) locally-made products.

Figure 2. Imports as a share of inputs by industry



Source: Statistics NZ, ANZ Research

Reshaping our world

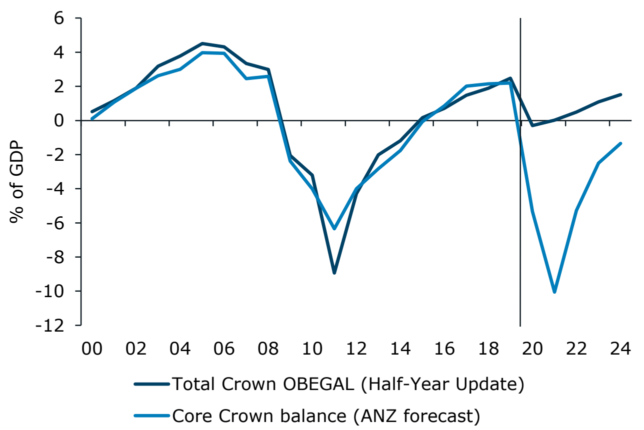
New Zealand will always be quite reliant on imports because we are small. But nonetheless, we may see this reliance reduce for a time. And that could boost some areas of our economy, like import-competing manufacturing.

In the same way that the GFC made policy-makers and financial markets re-think how they saw the world and the spectrum of risks, so too will this crisis. Hopefully we will see more investment in pandemic planning, protective equipment and working-from-home technology.

Some vulnerabilities will likely emerge globally, however, and we won't be immune. Households and firms are likely to undergo a lengthy period of deleveraging that will dampen demand, and we expect an element of behavioural change. Everyone will be more acutely aware of income risks and the need to build in buffers should an event like this happen again. That said, humans – and financial markets – do have a remarkable ability to forget.

Once the economy has navigated the threat of COVID-19 the Government will need to turn its attention towards rebuilding fiscal buffers. Given New Zealand's propensity to earthquakes, the superannuation costs of an ageing population, and the upcoming bill for climate change mitigation strategies, the rainy day fund does need to be rebuilt. Surpluses will be needed, eventually (figure 3).

Figure 3. Operational expenditure forecast



Source: The Treasury, ANZ Research

Returning the Government's books to a more sustainable position will take time, with the Government set to be a larger share of the economy for quite some time. In fact, it could be more than two years before the Government can begin to unwind stimulus and begin to rebuild fiscal buffers.

Nonetheless, now that the Government has deviated from its previous fiscal strategy, it will need to devise a new one, and come up with a plan for how it will eventually guide the books back into the black. We think this will eventually require some difficult choices. As we have talked about in our ANZ Weekly Focus, fiscal consolidation may require a reduction in entitlements, such as winding back fees-free tertiary education or lifting the eligibility age for NZ super or introducing means testing. Tax rates may also increase, or new tax types (such as on capital gains, wealth, or inheritance) could also be introduced.

But it's important not to go down the path of austerity for austerity's sake. Following the GFC, the pursuit of fiscal consolidation saw spending on key infrastructure dwindle on a per capita basis, leading to the infrastructure deficit that we know all too well today.

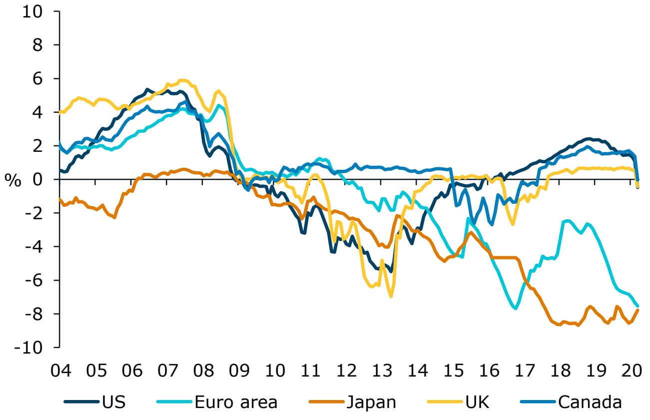
This time may be different with infrastructure spending a key policy to support the recovery. However, this will eventually be unwound once the infrastructure deficit has narrowed, and/or public spending starts meaningfully crowding out private investment.

Eventually, central banks will need to normalise policy too. Through the recovery, the hole in the output gap and downward pressure on the neutral interest rate will see inflation expectations under downward pressure, despite the big increase in the money supply. But we expect that inflation will eventually recover, assuming central banks do what is necessary and stay the course with extraordinary stimulus.

Once that happens, monetary policy will be normalised. Even when balance sheets are huge, this can be done, provided central banks proceed carefully. This was seen by the Fed and Bank of England post-GFC. Passive retrenchment was achieved by clear forward guidance, tapering purchases and re-purchases of assets. This resulted in a gradual recovery from a deeply negative shadow short rate post-GFC (figure 4). Eventually, this dynamic will see bond curves steepen.

Normalisation is expected to be a slow process, given the now enormous reliance of markets on central bank purchases. Central bank balance sheets are likely to be huge for a long time. In fact, those central banks that do not go hard enough, including in the recovery, will be more likely to see inflation expectations come unanchored. Counter-intuitively, they are more likely to end up with larger balance sheets and for longer (like the ECB after the GFC).

Figure 4. Shadow short rates in selected economies



Source: LJK Limited

On the other hand, if monetary policy is normalised too slowly and inflation expectations rip away, it is possible that we end up in a high-inflation scenario. That would be a long way down the track, if it did happen, but the risk cannot be ruled out, given that politicians keep inching closer to the controls of the money printing presses. Again it reinforces the need for careful tapering when the time comes.

There are plenty of long-term challenges ahead. But New Zealand is resilient, and has come into this crisis with a lot of advantages:

- We have been in a position to respond to the outbreak quickly;
- We produce a lot of essential goods domestically and our exports are still in demand;
- We have a well-functioning health system and government;
- We have plenty of fiscal firepower to respond;
- The financial system is resilient; and
- The exchange rate and monetary policy can provide a buffer.

We will get through this. And as the economy returns to its new normal, new opportunities will emerge. There will be scope for strong growth over the longer term as the economy replenishes its productive capacity. New businesses will be formed, jobs will be created, and there will be scope for efficiency gains and new opportunities, even if it is a slow recovery and a difficult road at times.

One of the defining features of "black swan" events is that they have the potential to reshape and redefine our world. The economy might not look the same after this, but we will move forward to a different – and positive – future in time.

Key economic forecasts

New Zealand Economy									
	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21
GDP (% qoq)	0.5	**-2.5**	**-20.6**	**15.5**	**2.0**	**1.0**	**1.0**	**1.0**	**1.0**
GDP (% yoy)	1.8	**-1.2**	**-21.6**	**-10.1**	**-8.8**	**-5.5**	**20.2**	**5.1**	**4.1**
CPI (% qoq)	0.5	0.8	**-0.4**	**0.1**	**-0.1**	**0.5**	**0.2**	**0.3**	**-0.2**
CPI (% yoy)	1.9	2.5	**1.6**	**1.0**	**0.4**	**0.1**	**0.7**	**0.9**	**0.8**
LCI Wages (% qoq)	0.6	**0.4**	**0.8**	**0.4**	**0.3**	**0.2**	**0.4**	**0.4**	**0.5**
LCI Wages (% yoy)	2.4	**2.5**	**2.4**	**2.2**	**1.9**	**1.6**	**1.3**	**1.3**	**1.5**
Employment (% qoq)	0.0	**-1.0**	**-8.0**	**0.0**	**3.0**	**2.0**	**0.7**	**0.9**	**1.0**
Employment (% yoy)	1.0	**-0.1**	**-8.7**	**-8.9**	**-6.2**	**-3.3**	**5.8**	**6.7**	**4.7**
Unemployment Rate (% sa)	4.0	**5.4**	**10.7**	**11.1**	**10.1**	**8.7**	**8.6**	**8.3**	**7.8**
Terms of Trade (% qoq)	2.6	**1.0**	**2.2**	**2.1**	**-1.5**	**-1.5**	**-2.0**	**-0.9**	**-0.7**
Terms of Trade (% yoy)	6.9	**6.9**	**7.7**	**8.2**	**3.9**	**1.3**	**-2.8**	**-5.8**	**-5.0**

New Zealand Interest Rates/QE									
		Actual				Forecast (end month)			
	Feb-20	Mar-20	Today	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
NZ OCR	1.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
LSAP ($bn)	--	30	33	60	60	60	60	60	60
NZ 90 day bill	1.06	0.49	0.35	0.43	0.43	0.43	0.43	0.43	0.43
NZ 10-yr bond	1.06	1.08	1.06	0.70	0.95	1.25	1.50	1.70	2.00

Figures in bold are forecasts. qoq: Quarter-on-Quarter; yoy: Year-on-Year
Source: Statistics NZ, Bloomberg, ANZ Research

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