


Quarterly Economic Outlook

Finding our way



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

 **Contact us**
See page 14.

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Our place in the world

Global growth is being compromised by the impact of the COVID-19 pandemic, which is ravaging many parts of the world. The policy response by many countries has been unprecedented but won't be enough to stop the recession. Global trade is slowing and New Zealand's export returns are falling, but at a slow rate due to solid demand for basic and healthy foods. Click [here](#) for more.

The path ahead

The New Zealand economy has been able to return to something closer to normal, but the outlook is a challenging one. Closed borders mean a smaller economy, and recessionary impacts of this are unavoidable. Households and businesses are cautious and unemployment is rising. Investment and spending will be weaker, with policy providing an important but only partial offset. The slowdown will be large and the recovery slow. Click [here](#) for more.

Alternative routes

We present alternative scenarios to help articulate the degree of uncertainty around our central outlook. The common thread is that risks are skewed to the downside. Given the global recessionary dynamics that are already in train, upside is limited. While there are 50+ shades of grey around the outlook, we think the implications for are actually quite binary. Click [here](#) for more.

Policy choices

Fiscal spending and financial support from the Government will support the growth outlook. But the fiscal position will eventually need to be consolidated, and that necessitates a considered and targeted response today. For the RBNZ, the path of least regrets is providing more stimulus. We see QE increasing to \$90bn in August and more tools added to the toolkit. A negative OCR remains a non-trivial possibility next year, but there are reasons to be cautious. A "go hard, go early" approach to monetary policy is warranted. Click [here](#) for more.

Navigating markets

OCR cuts are off the agenda for the remainder of this year, keeping short-end rates well anchored. Longer-term interest rates have ebbed and flowed, and we expect that to continue over Q3. Global factors will remain key drivers of the NZD, but as the RBNZ's policy toolkit grows and draws the NZD into its sights, that will limit further strength. Click [here](#) for more.

Calendar Years	2017	2018	2019	2020(f)	2021(f)	2022(f)
New Zealand Economy						
Real GDP (annual average % change)	3.1	3.2	2.3	-8.0	5.8	4.1
Real GDP (annual % change)	3.3	3.3	1.8	-6.8	5.1	4.3
Unemployment Rate (Dec quarter)	4.5	4.3	4.0	9.7	8.4	7.1
CPI Inflation (annual %)	1.6	1.9	1.9	0.4	0.9	0.9
Terms of Trade (OTI basis; annual %)	7.9	-4.8	7.1	-1.5	-3.5	3.2
Current Account Balance (% of GDP)	-2.7	-3.8	-3.0	-1.5	-3.0	-3.0
NZ Financial Markets (end of Dec quarter)						
TWI	74.4	73.4	73.7	71.7	72.5	
NZD/USD	0.71	0.67	0.67	0.65	0.65	
NZD/AUD	0.91	0.95	0.96	0.93	0.93	
Official Cash Rate	1.75	1.75	1.00	0.25	0.25	
10-year Bond Rate	2.72	2.37	1.65	1.00	1.25	

Source: Statistics NZ, Bloomberg, ANZ Research



Our place in the world

Summary

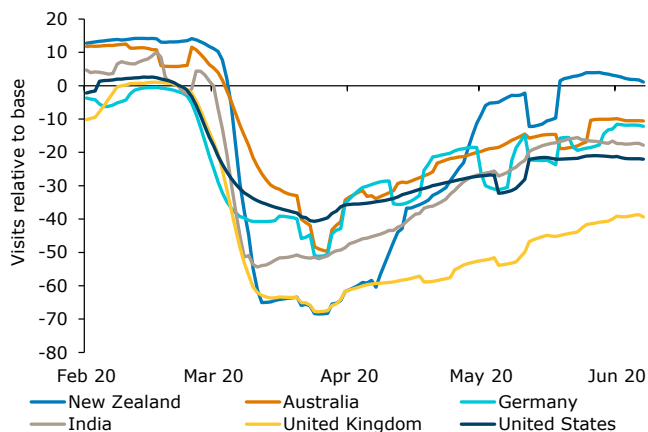
Global economic growth is being compromised by the impact of the COVID-19 pandemic, which is ravaging many parts of the world. The fiscal and monetary response by many countries has been unprecedented but won't be enough to stop the global recession. Global trade is slowing and New Zealand's export returns are falling, but at a relatively slow rate due to solid demand for basic and healthy foods.

Heading in the right direction

The success with which countries are containing the spread of Covid-19 varies hugely. New Zealand managed to minimise the health impacts of Covid-19 quickly compared to most other countries. Being a remote island with a sparse population has been hugely beneficial, as were our tight lockdown conditions and border controls.

The disease showed up on New Zealand shores a little later than many other parts of the world, which allowed more informed decisions to be made about our approach to managing the health risks. New Zealand had a shorter but more stringent lockdown period than many other countries and this can be seen in the Google mobility data (figure 1) depicting workplace attendance.

Figure 1. Workplace attendance (seven day rolling average)



Source: Google COVID-19 Community Mobility Trends

Now the challenge for New Zealand is to maintain no community transmission via robust quarantine measures whilst also allowing the greatest level of economic activity possible.

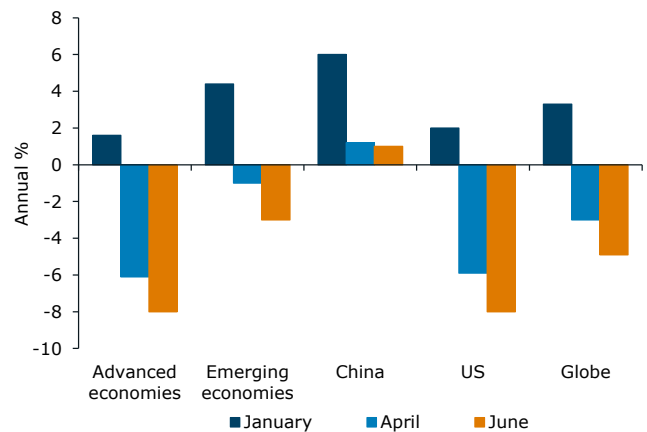
With existing technology, the border quarantine measures are a non-negotiable, with the hope being that a vaccine and/or improved treatment options will present us with a better set of choices. But our economy will not fully recover until the pandemic is successfully managed both here and elsewhere in the

world, due to our reliance on export markets and international tourists and students.

Shrinking global economy

The IMF now predicts the global economy will shrink by 4.9% this year, considerably worse than the 3% reduction previously forecast (figure 2).

Figure 2. IMF GDP forecasts

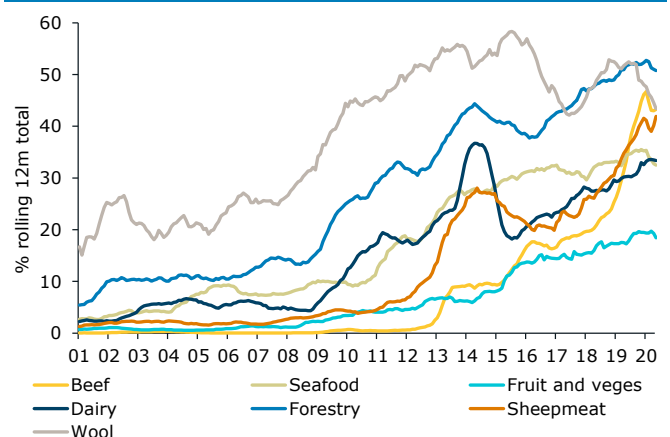


Source: IMF

The rate of decline in economic activity is greatest in the advanced economies, but many of the large emerging economies such as India and Russia are also expected to shrink considerably in 2020. Managing the health aspects of Covid-19 is even more challenging in the developing nations, where health systems are significantly under-resourced.

China is one of the few economies that is expected to grow this year. We anticipate China's economy will expand by 1.8% in 2020, which is slightly more optimistic than the 1% growth forecast by the IMF. Our high reliance on China as a trade partner is more of a help than a hindrance in the current economic environment (figure 3).

Figure 3. Share of New Zealand primary exports sent to China



Source: Statistics NZ



Our place in the world

A helping hand

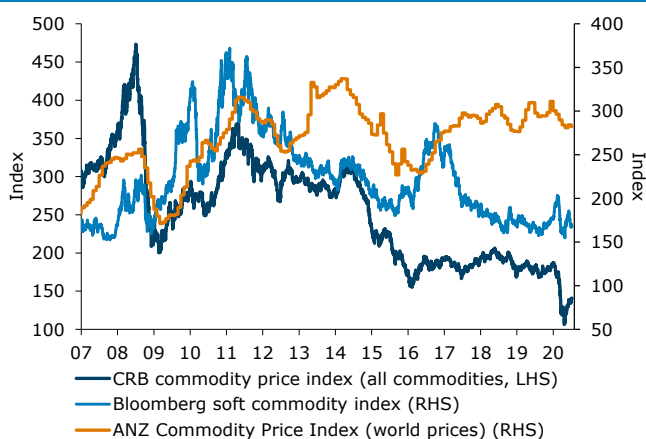
Stimulus in the form of fiscal and monetary policy is helping to buffer economies from the current recession, but despite unprecedented levels of support it will only limit the severity of the recession in the countries that can afford to support their economies.

Governments and central banks are digging deep to find new ways to bolster economic activity. One of the most popular tools has been **quantitative easing**, where central banks intervene directly in markets through purchases of bonds and other assets. This effectively bolsters liquidity and reduces interest rates, as well as smoothing the path for greater fiscal spending. Unfortunately, the increase in government spending will never be sufficient to offset the drag on other sectors of our economy. See [chapter 4](#) for more.

Global trade slows

World trade contracted by 3.5% y/y in the first quarter of 2020, reflecting softer demand and the collapse of international tourism. Trade tensions between countries and an increased desire for self-sufficiency may also temper the volume of goods shipped around the world this year. New Zealand exports have fared better than most, with both prices and volumes holding up relatively well in most sectors. Demand for food products has been much more stable than demand for hard commodities such as oil, as reflected in prices and export returns (figures 4 and 5).

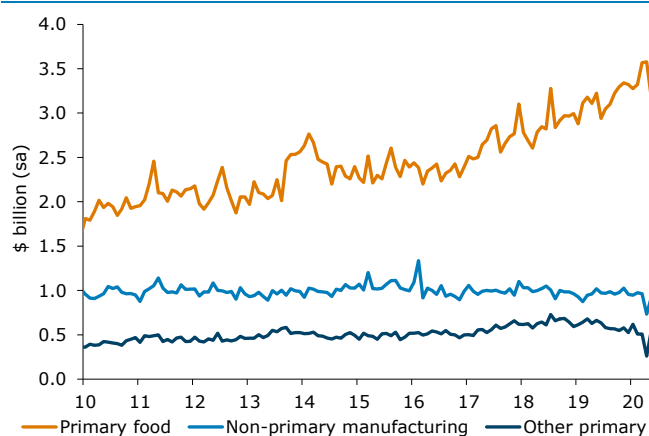
Figure 4. Commodity prices



Source: Bloomberg, ANZ Research

Demand is strong for products that are typically consumed in the home, while consumption of higher-end restaurant-type products remains weak. Dairy exporters are seeing good international demand for products such as infant formula, milk powder and long-life milk. Pharmaceutical products such as lactoferrin, which has antibacterial and antiviral properties, is also in hot demand.

Figure 5. New Zealand monthly export returns (quarterly)



Source: Statistics NZ

Fruit exports have also held up well, with large crops of kiwifruit and apples harvested despite the logistical challenges of picking and packing fruit under Level-4 restrictions. Market demand has been mixed but there has been strong demand in markets where consumers value the health benefits of consuming fruit.

Meat production in New Zealand slowed as physical distancing limited throughput during the busy autumn processing season. Beef exporters managed to divert meat firstly to the United States and then back to China with our two largest markets hit by COVID-19 at differing times. Meanwhile, demand for lamb and venison destined for restaurants sharply dropped as physical distancing restricted food service operations.

The forestry sector has experienced mixed fortunes. Log export prices initially plummeted when Chinese demand slowed, but then hit record levels when China found itself short of product as supply from New Zealand and other countries was severely curbed. New Zealand's forestry sector completely shut down during the Level-4 lockdown as it was not deemed an essential industry.

At the farmgate level, returns for most sectors have weakened due to international prices softening, while the strong NZD is also not helping. Dairy returns are forecast to fall to near break-even levels for the season ahead, which will leave little cash to tackle the challenges the sector has in terms of reducing debt and improving environmental performance. Meat prices have eased, but from a high starting level, meaning returns are currently near long-term average levels. However, further weakening is envisaged. Prices for kiwifruit and apples have eased but remain at healthy levels for the majority of varieties. Interest in gold kiwifruit shows no signs of abating with record prices paid for new licenses to grow this variety.



The path ahead

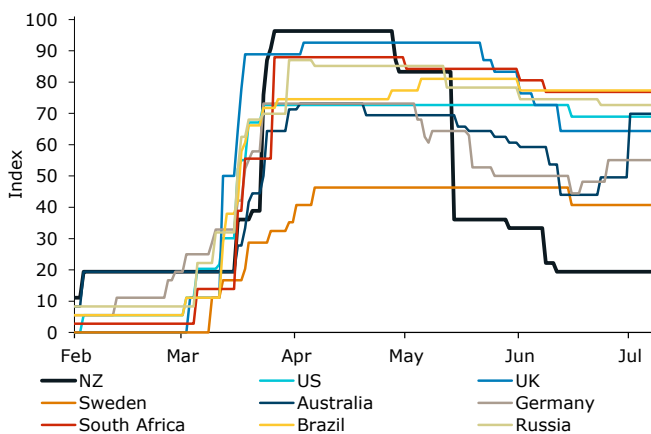
Summary

Domestically, the New Zealand economy has been able to return to something closer to normal, but the outlook is a challenging one. Closed borders mean a smaller economy, and recessionary impacts of this are unavoidable. Households and businesses are cautious and unemployment is rising. Investment and spending will be weaker, with policy providing an important but only partial offset. Despite our enviable position, the slowdown will be large and the recovery slow.

Something closer to normal

New Zealand's lack of community transmission of COVID is allowing our economy to function at something much closer to normal, while other countries are still facing the devastating effects of the virus and more stringent – and even re-tightening – activity restrictions (figure 1). The global outlook will clearly matter for us (see chapter 1), but we have benefited from being able to move out of lockdown sooner, in that our economy can function again. People have confidence to go out and work and spend normally – a much-needed boost for the economy. But caution is warranted. A second wave could threaten our economic recovery (see chapter 3) and strict quarantine at the border will be key while the virus remains a threat.

Figure 1. Oxford Government Response Stringency Index



Source: Oxford, Bloomberg, ANZ Research

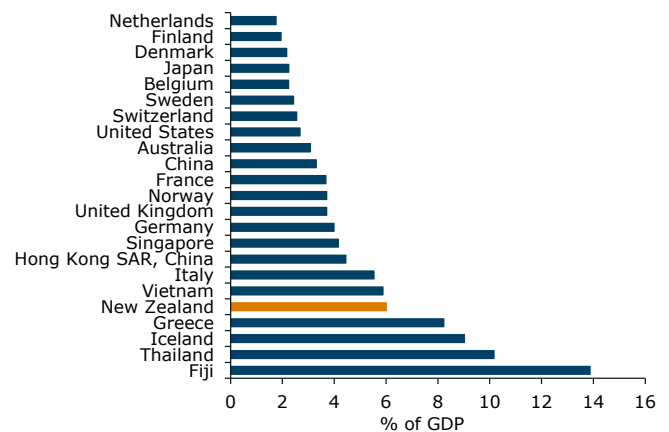
But the economy will be smaller for a while

The border is expected to be closed for the foreseeable future and this has clear economic consequences: a halt to international tourism, fewer international students, and reduced flows of migrant labour.

New Zealand is very exposed to the recessionary impacts of border restrictions. Travel and tourism comprise 6% of GDP directly (figure 2). This figure increases to 10% once impacts on other industries like retail and hospitality are taken into account. About

40% of travel and tourism revenue (4% of GDP) is from international visitors. On top of that, education exports have also taken a massive hit. And with the rise of video conference and cost-cutting, domestic business travel will remain curbed too. The substitution of domestic for international tourism by New Zealanders will provide a valuable offset, but ultimately, an economy with a closed border is inevitably a smaller one.

Figure 2. Travel and tourism direct contribution to GDP



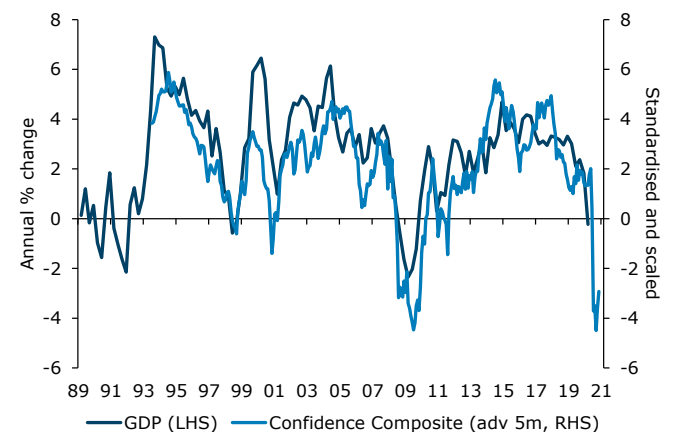
Source: Statistics NZ, ANZ Research

An uncertain outlook

Direct impacts on industries like tourism and education will affect firm viability, job opportunities, and regional housing markets. And the flow-on effects of this will weigh on business confidence, investment and household spending. These are normal feedback loops that happen in recessions – and this is a deep one.

But over and above that, the outlook is particularly uncertain at present (see chapter 3). This will weigh on confidence for the foreseeable future. Businesses and households are already wary (figure 3).

Figure 3. ANZ Confidence Composite



Source: Statistics NZ, Roy-Morgan, ANZ Research

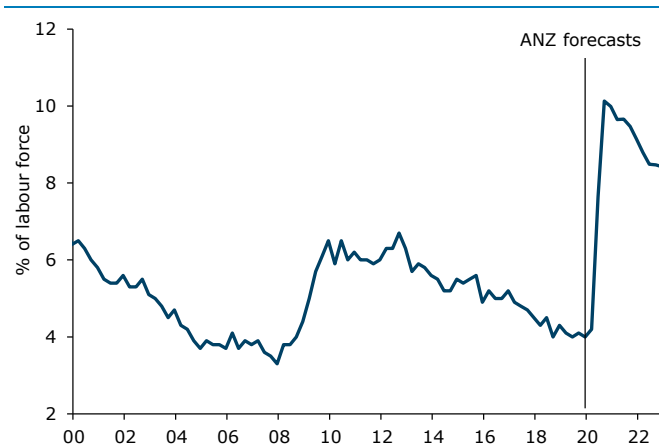


The path ahead

Right now, we are seeing a vigorous post-lockdown bounce in activity taking place, boosted by income support policies, lower interest rates, redirected travel savings, and an involuntary saving bump from lockdown. But this is not expected to last. Fiscal policy is cushioning the blow, but private consumption spending is expected to settle at a lower trend, especially as unemployment rises.

For some firms, particularly those in directly affected industries, financial pressures are already evident and viability is in question. And for firms more broadly, uncertainty about future revenue is weighing on hiring and investment. Job losses are already being seen and this is expected to continue, particularly as the wage subsidy scheme is phased out and the challenging road ahead becomes clearer. We expect unemployment will peak at 10% in Q3 2020, before recovering (figure 4).

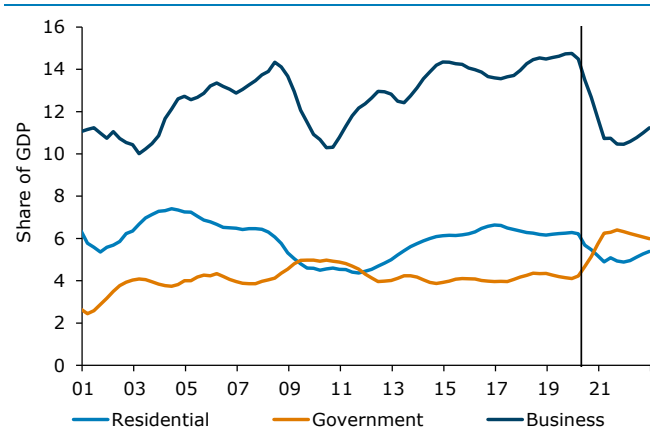
Figure 4. Unemployment rate



Source: Statistics NZ, ANZ Research

Business investment is expected to be weak, primarily due to lower turnover and uncertainty (figure 5). Lower interest rates will relieve cash flow pressure, but won't unleash a flurry of investment. Firms need more confidence and clarity about the future for that.

Figure 5. Contributions to total investment (share of GDP)



Source: Statistics NZ, RBNZ, ANZ Research

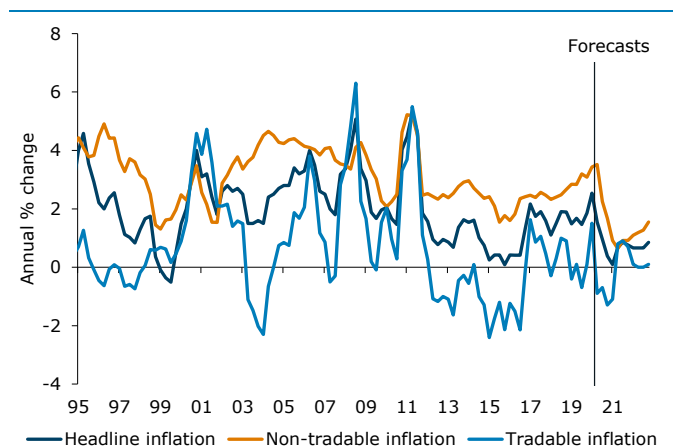
Residential investment spending will also be weighed down by uncertainty, lower incomes, and a downturn in the housing market. See our latest [ANZ Property Focus](#) for more on the housing market outlook. An increase in government investment will provide an offset, but won't be enough to fill the gap, given the extent of the weakness we see from business investment.

Long road ahead

Both monetary and fiscal policy are providing crucial stimulus to help the economy through this challenging time. See [chapter 4](#) for more details. Low interest rates and easy financial conditions are providing a buffer, and fiscal policy is aiming to support those directly affected and boost spending in the economy.

Despite all this, we expect that GDP will be 7-9% lower this year. The economy will be operating below its potential for a long time, leading to only a gradual improvement in the labour market and downward pressure on inflation for a long time. We see inflation dipping to below 1% later this year (outside the RBNZ's target range of 1-3%), and remain subdued, with a very gradual recovery expected.

Figure 6. Inflation



Source: Statistics NZ, ANZ Research

It will be a challenge for other industries to fill the economic hole created by our closed borders and the broader impacts of the current downturn. Continued aggressive policy action remains important to ensure that a deeper recession is avoided. A lower exchange rate would also help (see [chapter 5](#) for the outlook).

Our central forecast includes GDP returning to pre-crisis levels in mid-2022, but it is possible that we are dealing with the scars of this crisis much longer than that. A range of scenarios are possible (see [chapter 3](#)), and policymakers also need to manage these heightened risks (see [chapter 4](#)).



Alternative routes

Summary

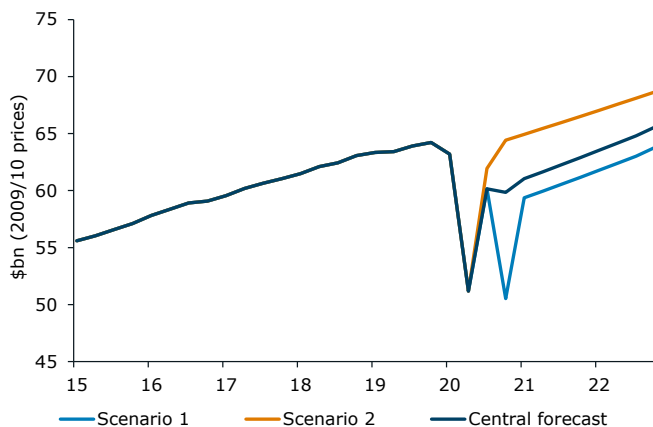
We present four alternative scenarios to help articulate the degree of uncertainty around our central outlook. The common thread across the lot of them is that risks are skewed to the downside and that given the global recessionary dynamics that are already in train, upside is limited. While there are 50+ shades of grey around the outlook, we think the implications for macro-policy are actually quite binary. This crisis is likely to be the biggest we'll ever face (touch wood); more is needed.

What if

In normal times, economic scenarios are used to demonstrate the potential effects of high-impact shocks that are deemed too unlikely to incorporate into the central view, but are too significant to ignore. However, these are not normal times. Our (and everybody else's) central forecasts are essentially an attempt to pin down the most likely evolution of one of these very shocks. But uncertainty is extreme; the outlook could go a number of ways.

We present four alternative scenarios – two high-impact scenarios and two closer to our central forecast in order to demonstrate how the economy might evolve differently to our expectation and why.

Figure 1. Central GDP forecast and high-impact scenarios



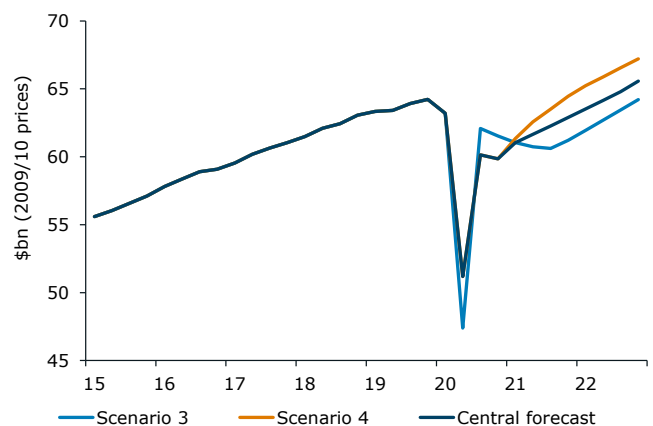
Source: Statistics NZ, ANZ Research

High-impact scenarios

Scenario 1: A second wave of infection results in a second Alert Level 4 lockdown in Q4 and a second extremely sharp economic contraction. Broadly speaking, it's a rinse and repeat of what we've been through and shows the importance of keeping the virus contained. This is our worst case scenario, but isn't the worst possible case. Other global economic vulnerabilities (such as debt risks in China, or a sharp global asset price correction) haven't gone away. We can't rule out the possibility that the current crisis becomes the trigger for something even larger.

Scenario 2: An effective vaccine is developed and distributed by year-end. Net migration surprises on the upside from Q3 (more kiwis returning home than assumed, and with a stronger impetus to demand), household and business sentiment rebounds sharply across the globe, and a synchronised global recovery follows. This is our best case scenario, but unlike Scenario 1 (where it could be worse) the room for further upside is limited.

Figure 2. Central GDP forecast and lower-impact scenarios



Source: Statistics NZ, ANZ Research

Lower-impact scenarios

Scenario 3: A more pronounced contraction in Q2 and a stronger rebound in Q3 than expected, but underlying economic momentum is weaker than assumed. This scenario was developed to articulate two key points:

- The data will be volatile.** A larger-than-expected Q2 decline could imply a stronger-than-expected Q3 rebound – or vice versa. Q3 GDP won't be released until December 2020, so it's going to be a while before we have any certainty on this front. Even then it'll be revised for sure!
- It's underlying economic momentum that really matters,** but unfortunately all data are still navigating an unavoidable volatile patch caused by lockdown and subsequent pent-up demand dynamics. It'll probably be another month or so before the timely economic indicators (such as card spending, our Truckometer, and the ANZ Business Outlook) begin to settle at levels consistent with the underlying state of the economy. When that happens we think momentum will be weak. This scenario shows momentum could be a lot weaker than we (and others) expect. The signal from the data flow will be blurred for a while yet and that means policy makers need to be patient.

Scenario 4: The fiscal and monetary policy response to date is more stimulatory than we've assumed.



Alternative routes

Macro-policy can take a while to filter through the economy. For example, fixed mortgages need to roll over onto a lower rate before loan payments and discretionary incomes are impacted. Government infrastructure spending takes time to plan and implement. And while our central forecast represents our best estimate of the impact of policy settings, we are in uncharted territory. Our central view is that further stimulus is needed (see [chapter 4](#)), and that given the balance of economic risks, the danger that stimulus measures go too far is minuscule. Nonetheless, this scenario challenges that.

It's typically the case that high-impact, "black swan" type scenarios also have a relatively low probability (if not, historical economic outcomes would be a lot more volatile). However, we don't think that's the case at present. For example, while it's not our central assumption, the possibility of a curve-flattening level 4 lockdown later in the year (Scenario 1) has a much higher probability than we'd assign a pandemic in normal times.

We're certainly not out of the woods yet, and the list of unknowns that could have significant bearing on how things evolve from here is lengthy. Further, not all unknowns are known. But here's a few that are on our radar:

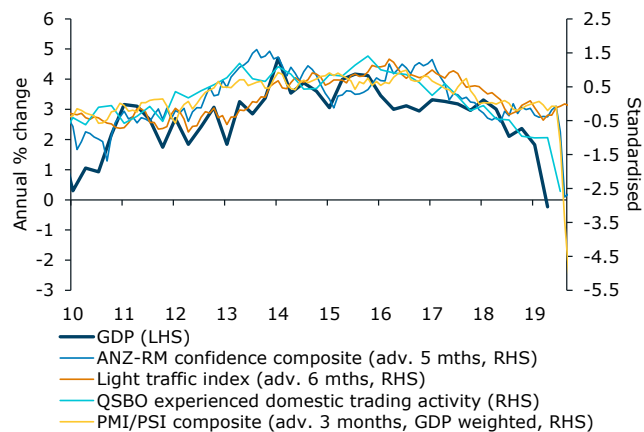
- How long borders are closed and the prospect of a [trans-Tasman bubble](#);
- Success of border containment measures and the risk of a second wave in NZ;
- Other virus developments, including vaccine development or a potential mutation;
- How the [housing market](#) responds;
- [Net migration](#) dynamics – there are hundreds of thousands of kiwi passports overseas. We could become a pretty crowded lifeboat;
- Global developments, including COVID cases, the policy response and its efficacy, how synchronised the global recovery is, geopolitical developments, and global supply chains (including for our own export commodities).

Some of the above items will be easier to monitor than others, but all of them present significant potential challenges to our central view. In addition to the above, we'll be keeping a very close eye on the suite of timely economic indicators to gauge where momentum is settling.

Unemployment benefits (particularly once the wage subsidy expires), our Truckometer indices, our Consumer Confidence and Business Outlook surveys, and PMIs and PSIs, as well as the NZ Treasury's new

NZAC indicator that combines much of the above, will be the first indicators to reflect the underlying state of the economy. But we'll have to wait for the current extreme noise to quieten first (figure 3).

Figure 3. Selected economic indicators and GDP



Source: Statistics NZ, Roy Morgan, NZTA, NZIER, Business NZ, BNZ, ANZ Research

Overall, the four scenarios presented produce a range of outlooks for economic contraction in 2020 of around 5.5-12% (table 1).

Table 1. Year-end GDP growth

	2019	2020	2021	2022
Central forecast	2.3	-8.0	5.8	4.1
Scenario 1	2.3	-11.7	7.1	4.1
Scenario 2	2.3	-5.5	9.2	3.2
Scenario 3	2.3	-8.1	4.0	3.6
Scenario 4	2.3	-8.0	7.5	5.2

While only illustrative, these types of scenarios help us get a feel for the balance of risks. And the key message is that risks are firmly to the downside; the outlook is grim, with limited upside.

And the worse the outlook, the more stimulus the economy will need. From that perspective, the outlook is pretty clear for macro-policy – this crisis is huge, and additional stimulus is needed. See [chapter 4](#) for more.



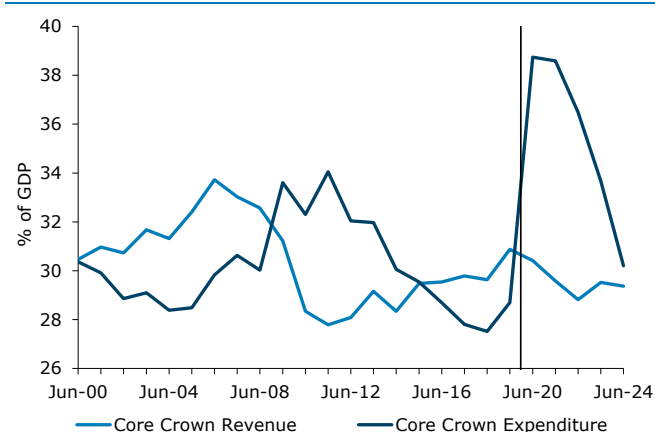
Summary

The macro-policy response is crucial for supporting the economy through this crisis and onto the path of recovery. Fiscal spending and financial support from the Government will support the growth outlook in coming years. Once we get through the election, there may be a clearer set of initiatives laid out, but there are no easy answers. The fiscal position will eventually need to be consolidated, and that necessitates a considered and targeted response today. For the RBNZ, the path of least regrets is providing more stimulus to the economy. We see the quantitative easing programme increasing to \$90bn in August and more tools added to the toolkit. A negative OCR remains a non-trivial possibility next year, but there are reasons to be cautious and a “go hard, go early” approach to monetary policy is warranted.

Fiscal policy

The Government revealed a fiscal bazooka in the form of the \$50bn Budget Package in May. This, along with the earlier COVID response package, is expected to take total COVID-related spending to \$62bn – that’s around 20% of 2019 GDP. And while all this stimulus won’t come at once, it is very front loaded (figure 1).

Figure 1. Core Crown revenue and expenditure (Budget 2020)



Source: The Treasury, ANZ Research

Broadly speaking, we see the fiscal policy response evolving in three interrelated stages:

State 1: Damage control to help households and firms survive the initial income hit caused by lockdown. This will help ensure a stronger starting point for recovery than otherwise. This category covers the big announcements to date, including wage subsidies and SME loans. However, a balance needs to be struck between saving an extra job or firm versus merely delaying an eventual layoff or closure – kicking the can down the road isn’t a fair use of tax-payers’ dollars, particularly given how costly these policies are.

Stage 2: Facilitating the recovery. Budget 2020 left around \$20bn unallocated. Presumably, this was with the intention of a) holding something in reserve should COVID-19 get out of hand and the economy goes into lockdown once again, and b) providing a kick-start when the timing is right and more information is available to make decisions. Regarding the latter, there’s an infinite mix of policies that could be adopted, and much will depend on the outcomes of the upcoming election.

So far, the Government has proven it stands ready to spend, but they are yet to really tap the potential of supply-side policies, which could support the recovery at a lower fiscal cost. Here, we think further RMA reform, or *tweaks to labour market regulation* (even temporarily) should be considered.

Stage 3: Unwinding stimulus and rebuilding buffers. This probably won’t be given a lot of air time by politicians until they’re confident the recovery is in hand. But net core Crown debt is forecast to increase by more than 30%pts of GDP and the skew of economic risks suggests it could easily be more than that. Rebuilding fiscal buffers in a relatively timely manner will be required if New Zealand wants to have the fiscal war chest ready for the next rainy day.

Part of the strategy will likely be to grow our way out of the debt position, and the more the Government does today to support productivity tomorrow the easier that will be. However, businesses are the powerhouse of productivity, accounting for the lion’s share of investment, innovation and risk taking. So while, increased government spending on things like infrastructure will help, without a well-incentivised private sector, there can be no productivity miracle.

Ultimately, we think the severity of this crisis will, to some extent, end up putting current outgoings (such as NZ Super) under additional scrutiny, with a view to cost savings. Future spending allowances could also be constrained and a lift in some tax rates and/or the implementation of new tax types may also be on the menu. We’ll probably get some idea of the political appetite as the election approaches.

So what’s next for fiscal policy? At a macro level, we think the Government provisioned enough on the spending front at Budget (bearing in mind diminishing returns to increased fiscal spending). But another \$10bn or more is possible further down the track should economic activity disappoint the Treasury’s outlook. In the meantime, it’s all about the details, getting the most bang for buck, implementation (particularly on the capital spending side), and hopefully, looking beyond the government’s cheque book to help facilitate recovery and job creation.



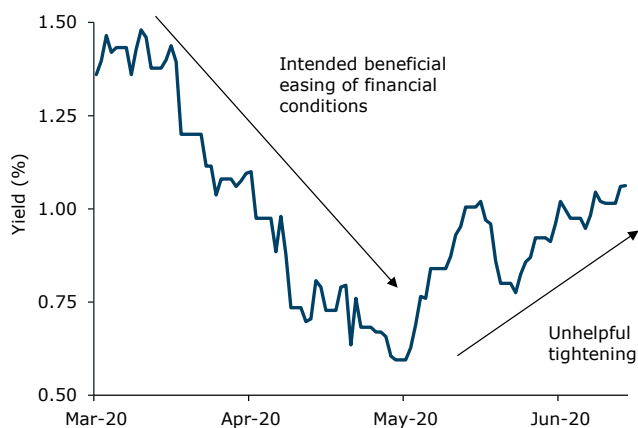
Monetary policy

The RBNZ has responded to the current downturn by reducing the OCR to 0.25%, committing to keep it there until March 2021, and launching its Large-Scale Asset Purchase Programme (LSAP, “quantitative easing”, or “QE”). For more information about how QE works, check out our FAQs ([here](#) and [here](#)).

In May the LSAP programme was expanded to a limit of \$60bn over 12 months, encompassing purchases of New Zealand Government bonds (NZGBs) and bonds issued by the Local Government Funding Agency (LGFA). This has sent a strong signal to markets, and purchases to date have pumped liquidity into the financial system, reducing bank funding costs, and put downward pressure on the yield curve (figure 2).

Recently, however, yields have increased, particularly with new upcoming issuance (including a new 2041 bond) weighing on the market (see [chapter 5](#) for more details). Markets are subject to the ebb and flow of conditions, not just influenced by the LSAP, but this yield tightening is unhelpful. Combined with a stubbornly high exchange rate, monetary conditions have not eased to the extent that we see as necessary.

Figure 2. NZGB 2037 bond spread to cash



Source: Bloomberg, ANZ Research

With unemployment and inflation set to be well away from target for the foreseeable future, and downside risks very real (see [chapter 3](#)), more stimulus is required to shore up confidence, ease financial pressures and support the recovery.

The path of least regrets is to go hard, go early and to front-load stimulus. A reluctant approach only increases the risk that more stimulus (and more tools) will need to be deployed later. In the June Monetary Policy Review, the RBNZ was dovish, making it clear that it is willing and able to do more to stimulate the economy. And the RBNZ aren't going to muck around if they need to do more, saying: "A change in the size of the [LSAP] programme would ... need to be of sufficient

magnitude to make a meaningful difference." To us that speaks of a "big bang" in August, consistent with our view that the RBNZ will expand the LSAP limit to \$90bn in August – a quantum that we believe will make a material difference in markets.

Over and above this, we think front-loading of LSAP purchases in the short term makes sense, given the need for monetary stimulus right here and now. But the RBNZ appears to have settled on a steady rate of weekly purchases, meaning that the August MPS is the next opportunity to generate a market impact through an increase and broadening of the LSAP programme.

The other aspect of the RBNZ's assessment that will be important in August is the RBNZ's thinking on alternative monetary policy tools. The RBNZ have said "staff are working towards ensuring a broader range of monetary policy tools would be deployable in coming months, including a term lending facility, reductions in the OCR, and foreign asset purchases".

These tools have their costs and benefits, and we expect that the RBNZ will continue to emphasise QE as its tool of choice for now, especially since the system is not ready for negative interest rates and these come with costs and risks. We think NZGBs will remain the first choice for LSAP purchases, but other assets will need to be added to the LSAP in time, given the small size of the domestic bond market.

In August, we expect the RBNZ to clarify its criteria, process and preparedness to purchase other assets when the time comes. As things stand, foreign assets would be the logical next cab off the rank in our view, given current conditions and the elevated exchange rate. But the RBNZ will likely choose to keep its options in terms of what it might do next, which is wise, as market conditions and thereby the optimal policy mix could well change. We think a new indemnity will be agreed with the Minister of Finance to formalise the RBNZ's option set, extending the timeframe of the programme and including more assets in the LSAP should they be required.

The RBNZ has committed to keeping the OCR at 0.25% until March 2021, but next year we cannot rule out the possibility of a negative OCR. The RBNZ and financial system participants are readying themselves for that possibility. There are challenges associated with a negative OCR and it would be best to use other methods of stimulus first. But depending on how conditions evolve, economic conditions could warrant further stimulus by then, and the deployment of all stimulus options available. If the outlook were dire enough, the benefits would be considered to outweigh the costs. But for now, QE is the tool of choice, and there's more on the way.



Navigating markets

Summary

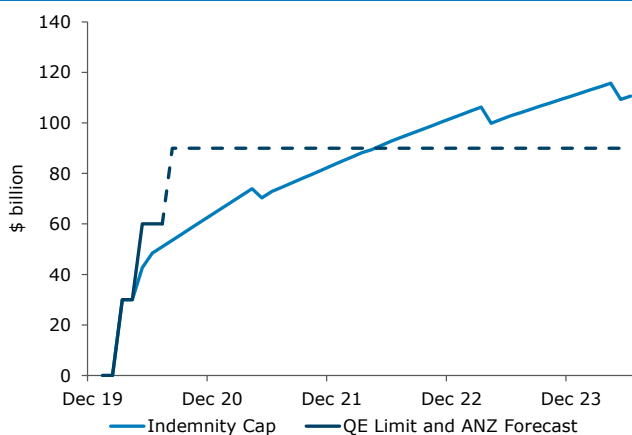
Domestic interest rate markets will continue to be dictated by RBNZ policy, with the focus on the expected expansion of QE and the RBNZ's weekly LSAPs. OCR cuts are off the agenda for the remainder of this year, keeping short-end rates well anchored over Q3. Longer-term interest rates have ebbed and flowed, with bond issuance exerting upward pressure and QE exerting downward pressure, and we expect that to continue over Q3. Global long-term interest rates are falling as the COVID-19 pandemic spreads, with global growth in cases not tailing off. Since the crisis broke, the NZD has traded on global themes, rebounding sharply as risk appetite has recovered on the back of a sharp rise in central bank liquidity. Global factors will also be key drivers in Q3, but as the RBNZ's policy toolkit grows and draws the NZD into its sights, that will limit further strength.

More easing coming in August

The Reserve Bank has flagged that it is willing to ease further in coming months, and is in the process of expanding its toolkit. As outlined in chapter 4, we expect QE to be expanded to \$90bn in August. For markets, the announcement effect of changes in the size of the LSAP programme tend to be significant at the time of announcement.

However, the pace of purchases matters for markets, too. LSAP purchases will occur over a 12-24 month period. At the moment, the maximum amount of bonds the RBNZ can buy (under its indemnity agreement with the Finance Minister) is around \$51bn. That figure will grow over time, but it may not grow as quickly as the "need" to ease grows. As outlined in chapter 4, we think the LSAP will eventually be widened to include bonds issued by other domestic borrowers, and/or foreign assets.

Figure 1. LSAP Indemnity Cap and ANZ forecasts



Source: Statistics NZ, ANZ Research

Anchored short end

The RBNZ has reaffirmed its earlier commitment to leave the OCR on hold at 0.25% till at least March 2021. However, it does want to have the option of OCR cuts on the table beyond that time, which raises the prospect of negative rates. We don't forecast the OCR to go lower from here, and instead expect it to remain at its current level for the foreseeable future. Together with reinforced forward guidance, that will act as a strong anchor for short-end interest rates.

At the moment, the market is pricing in an OCR of around zero by mid-2021. We don't expect cuts (we expect more QE instead), but we do think it makes sense for the RBNZ to keep all options on the table, and it has asked the banks to get ready for negative rates. Unless we see a dramatic change of tack, which seems unlikely, the short end will continue to price in some probability of cuts, further anchoring the short end.

Lower and flatter, but with ebbs and flows

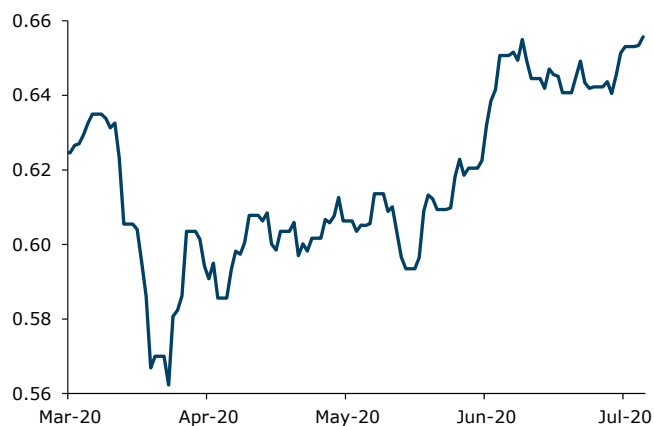
We expect longer-term interest rates to move lower over Q3, flattening the yield curve. But this process is likely to be more of an "ebb and flow" pattern rather than a consistent gradual trend. While the pace of QE is likely to be more consistent over Q3 now that markets are functioning well (allowing the pace of QE to be pared back to the "run rate" implied by the \$60bn LSAP programme), issuance is lumpier, with two planned syndicated placements of NZGBs planned for Q3. These placements are in addition to weekly bond tenders and tend to be large, often creating digestion issues for the market.

Offshore investors continue to hold the majority of NZGBs, accentuating correlations with offshore bond markets. This dynamic won't change in Q3. However, with policy rates across most major markets now at or around 0.25%, global bond markets are becoming increasingly driven by domestic rather than offshore factors, with each individual central bank's unique style of QE a key input. In Australia, the RBA has set a 0.25% target for the 3-year government bond and has stopped buying bonds now that the 3-year bond has stabilised, allowing longer-term interest rates to creep higher. In the US, the Fed ramped up QE rapidly initially, but has now significantly pared back the pace of buying, which has tended to be weighted more towards the shorter end of the yield curve. But in New Zealand, the RBNZ has opted for a more consistent pace of buying, and to buy bonds all the way along the yield curve. Over time, that has allowed the NZGB market to decouple from the US and Australian market, and is likely to deliver a flatter yield curve.



Navigating markets

Figure 2. NZD/USD exchange rate



Source: Statistics NZ, ANZ Research

NZD in the RBNZ's sights

The NZD has been driven primarily by global factors since the pandemic hit, with the massive boost in central bank liquidity and improved risk appetite helping it lift off lows seen late in Q1. We expect this to continue in Q3, but for domestic factors to come more to the fore, limiting what would otherwise be further appreciation as the RBNZ considers the exchange rate channel of monetary policy.

The recent appreciation of the NZD is putting pressure on export earnings and dampening the outlook for inflation. Neither of these developments are helpful given New Zealand's external exposure and the RBNZ's mandate of price stability.

At the moment, policy easing is coming from QE, with a focus on domestic bonds. Although the primary transmission channels of this are via the shape of the yield curve and the volume of liquidity in the banking system, lower interest rates also make the NZD less attractive and encourage offshore selling of NZGBs. However, purchasing foreign assets would have a more direct effect, as either a new monetary policy tool, or as part of the LSAP programme. Not only does the small size of the domestic bond market potentially limit how much QE can be done (if the LSAP remains primarily focussed on NZGBs) but the exchange rate channel is arguably as important as the interest rate channel.

Either way, an expanded LSAP – with or without foreign asset purchases – should help limit further NZD appreciation, especially now that New Zealand long-end interest rates are below their Australian counterparts. This is the market that New Zealand is most often compared to.

Table 1: Forecasts (end of quarter)

FX Rates	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
NZD/USD	0.65	0.65	0.65	0.65	0.65	0.65	0.65
NZD/AUD	0.93	0.93	0.93	0.93	0.93	0.93	0.93
NZD/EUR	0.56	0.57	0.57	0.59	0.60	0.60	0.60
NZD/JPY	69.6	69.6	69.6	69.6	69.6	69.6	69.6
NZD/GBP	0.52	0.53	0.54	0.53	0.52	0.52	0.52
NZD/CNY	4.58	4.55	4.52	4.49	4.45	4.45	4.45
NZ\$ TWI	71.3	71.7	71.8	72.2	72.5	72.5	72.5
Interest Rates	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
NZ OCR	0.25	0.25	0.25	0.25	0.25	0.25	0.25
NZ 90 day bill	0.31	0.31	0.31	0.31	0.31	0.31	0.31
NZ 2-yr swap	0.26	0.38	0.43	0.53	0.54	0.55	0.55
NZ 10-yr bond	0.75	1.00	1.00	1.25	1.25	1.25	1.25

Source: Bloomberg, ANZ Research



Key economic forecasts

Calendar Years	2016	2017	2018	2019	2020(f)	2021(f)	2022(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.9	3.1	3.2	2.3	-8.0	5.8	4.1
Private Consumption	5.6	5.2	3.2	2.7	-11.0	5.8	4.8
Public Consumption	2.1	2.9	3.6	4.4	9.4	7.9	-0.7
Residential investment	11.2	-0.7	0.1	4.3	-24.2	-0.3	15.2
Other investment	0.8	7.2	7.1	2.4	-15.2	2.1	7.1
Stockbuilding ¹	0.1	0.2	0.3	-0.8	0.2	0.0	0.0
Gross National Expenditure	4.5	5.0	4.0	2.1	-8.6	5.7	4.6
Total Exports	2.3	2.3	2.6	2.0	-18.7	16.1	4.9
Total Imports	3.4	6.8	5.9	1.6	-19.7	13.9	5.6
Employment (annual %)	5.5	3.1	1.9	0.8	-5.8	3.5	2.9
Unemployment Rate (sa; Dec qtr)	5.2	4.5	4.3	4.0	9.7	8.4	7.1
Labour Cost Index (annual %)	1.6	1.9	2.0	2.4	1.3	0.9	1.0
Terms of trade (OTI basis; annual %)	6.7	7.9	-4.8	7.1	-1.5	-3.5	3.2
Current Account Balance (sa, \$bn)	-5.4	-7.6	-11.3	-9.3	-4.6	-9.3	-10.0
as % of GDP	-2.0	-2.7	-3.8	-3.0	-1.5	-3.0	-3.0
Prices (annual % change)							
CPI Inflation	1.3	1.6	1.9	1.9	0.4	0.9	0.9
Non-tradable Inflation	2.4	2.5	2.7	3.1	1.7	1.0	1.5
Tradable Inflation	-0.1	0.5	0.9	0.1	-1.2	0.6	0.1
REINZ House Price Index	14.5	3.5	3.3	5.3	-7.0	2.0	7.7
NZ Financial Markets (end of December quarter)							
TWI	77.7	74.4	73.4	73.7	71.7	72.5	
NZD/USD	0.69	0.71	0.67	0.67	0.65	0.65	
NZD/AUD	0.96	0.91	0.95	0.96	0.93	0.93	
NZD/CNY	4.81	4.62	4.62	4.69	4.55	4.45	
NZD/EUR	0.66	0.59	0.59	0.60	0.57	0.60	
NZD/JPY	81.1	80.0	73.8	73.1	69.6	69.6	
NZD/GBP	0.56	0.53	0.53	0.51	0.53	0.52	
Official Cash Rate	1.75	1.75	1.75	1.00	0.25	0.25	
90-day bank bill rate	2.00	1.88	1.97	1.29	0.31	0.31	
2-year swap rate	2.46	2.21	1.97	1.26	0.38	0.55	
10-year government bond rate	3.33	2.72	2.37	1.65	1.00	1.25	

¹ Percentage point contribution to growth

Forecasts finalised 8 July 2020

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



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