ANZ Research

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OCR cut odds rising rapidly

- As the COVID-19 outbreak continues to spread globally and the human and economic toll becomes clearer, the odds of RBNZ OCR cuts are rising.
- The situation will continue to evolve at bewildering speed.
- The 'short sharp shock' scenario is rapidly giving way to a more prolonged hit to growth. We will expound more on these themes in our ANZ Weekly Focus on Monday.

Updating macroeconomic forecasts has become a weekly exercise, such is the speed of developments around the COVID-19 outbreak. This is primarily a human event, but it has enormous and complex economic implications. While there is a great deal of uncertainty regarding how things will pan out, the direction of the shock is clear, and the magnitude is growing by the day, as is the speed at which the situation is unfolding.

The situation is serious. The virus is spreading rapidly, and the spread is likely to accelerate further in coming days. This is not "just a flu", and authorities are not overreacting. The illness is mild for most people. But unlike the regular flu, no one has immunity, meaning health systems could be overwhelmed by the sheer numbers. That fact means there is a moral imperative for governments to do everything possible to slow the course of the virus, at any short-term economic cost. And they will. The New Zealand Government's pandemic plan is consistent with that. And minimising the movement of people takes a heavy economic toll, as China is finding.

Turning to the economic impacts, we've already seen an abrupt hit to our trade logistics with China. Goods exports were hit first, and while the situation at China's ports is improving, it's far from business as usual, particularly for chilled and frozen product. Tourism also took a hit immediately via the travel ban with China. And on the import side, there's an air bubble in the supply pipeline of all kinds of goods, from t-shirts to building materials, as we discussed in our Weekly Focus last week. For now, it's an inconvenience, but the longer the disruption persists, the greater the risk that it curtails domestic economic activity down the track, leading to a synchronised and persistent slowdown across domestic industries.

But since we updated our forecasts last week, the virus has morphed from a shock to our largest trading partner, to a global, synchronised event. Infections are rising in Japan, South Korea and Italy, and popping up in more and more countries. A global recession is looking more likely by the day. Equities are having a meltdown.

It is widely accepted as inevitable that New Zealand will also experience cases, which could have negative implications for sentiment and discretionary economic activity even if the virus is repeatedly promptly stamped out. And even if we somehow dodged the virus arriving on our shores, it's clear that global industrial production at least is going to be under huge pressure, as a result of supply chain disruption. That's the pointy end of global GDP but it will feed through into employment and broader activity if sustained. New Zealand's commodity prices do cycle with global demand, even putting aside the near-term question of whether we can even get our goods to market.

This is a very complex shock, more like a war than a traditional economic slowdown, in that it includes massive disruption to the supply side of the economy, as well as to demand. It is impossible to forecast its impacts accurately. But it’s very clear they aren’t going to be anything good. And it’s increasingly clear that they aren’t going to be brief.

In the face of such a shock, the NZD typically acts as a buffer to support the economy. And fiscal policy is well placed to respond in a targeted fashion to support businesses. New Zealand is fortunate to have plenty of firepower on that front. What about monetary policy? It’s true that lower interest rates aren’t going to encourage much borrowing and activity if confidence is low and everyone is hunkering down. But monetary policy can still help, and it is becoming increasingly likely it will be needed. OCR cuts would put downward pressure on the exchange rate, reduce financing costs for under-pressure businesses and households, and aid confidence at the margin. And it’ll help the economy bounce out the other side of this. Fiscal policy needs friends too.

Given how rapidly the virus is spreading, it’s entirely possible we could be looking at OCR cuts in short order, potentially kicking off as soon as March. But at this stage, we’d say May is more likely. The market is currently pricing a full cut by August, with a chance of more. We’re not quite over the line to call cuts yet. With uncertainty high, the RBNZ – and we – have a bit of time to see how things pan out. But frankly, probably not much.

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