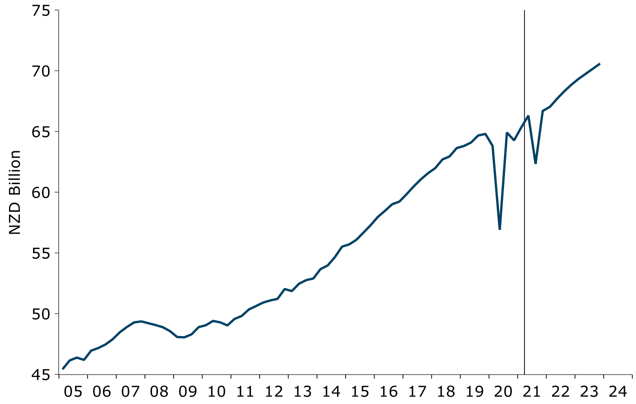
Quarterly Economic Outlook

Two steps forward, one step back

At a glance

The economy should rebound

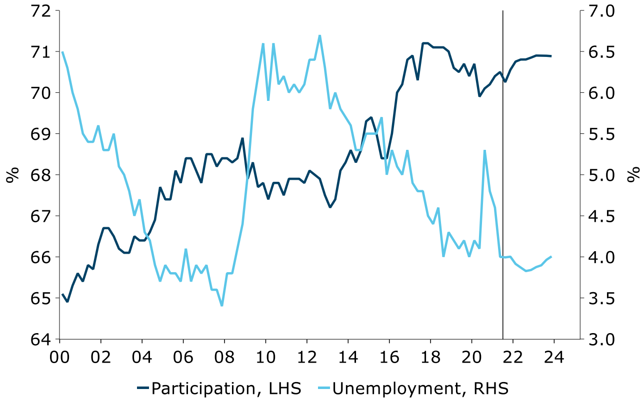
But everything depends on COVID cases



Source: Stats NZ, Macrobond, ANZ Research

Labour market to remain tight

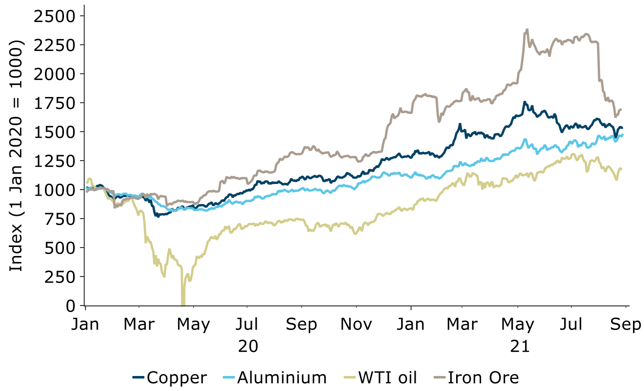
Labour shortage not going anywhere



Source: Stats NZ, Macrobond, ANZ Research

Global tailwind softening

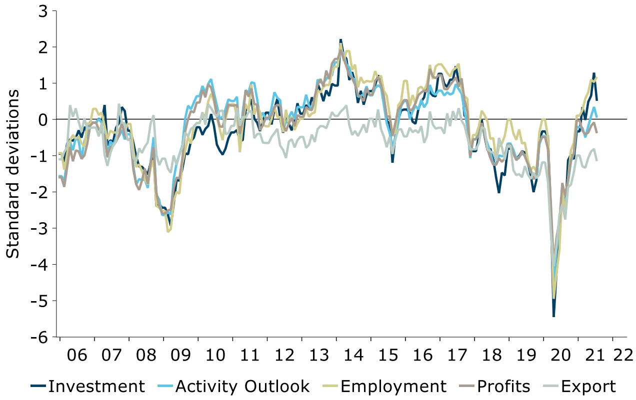
As commodity prices look peaky



Source: LME, EIA, SGX, Bloomberg, Macrobond, ANZ Research

Domestic momentum strong

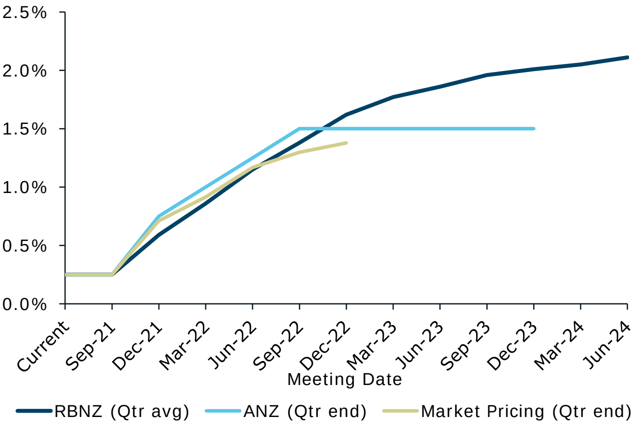
So we should be able to bounce back



Source: Macrobond, ANZ Research

If NZ can beat Delta, then

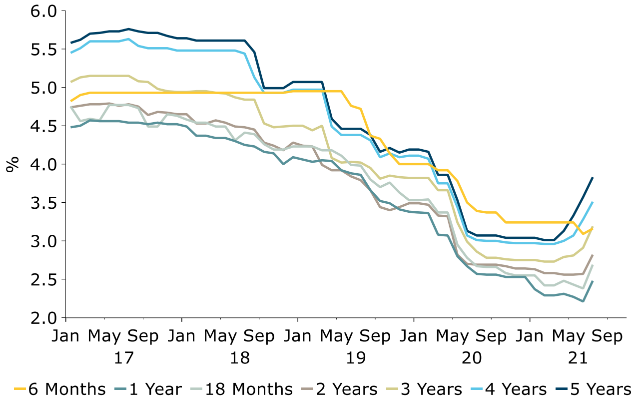
Interest rates should keep rising



Source: RBNZ, Bloomberg, ICAP, ANZ Research

Mortgage rates already rising

And housing less likely to drive growth



Source: RBNZ, Macrobond, ANZ Research

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Two steps forward, one step back

Summary

The discovery of the Delta variant of COVID-19 circulating in the New Zealand community has brought our spectacular economic recovery to a sharp stop. And it was spectacular – GDP grew 1.6% in Q1, exceeding pre-pandemic levels, unemployment fell from 5.3% to a post-2008 low of 4%, wage inflation was building, and the RBNZ's sectoral factor model of core inflation had risen above 2% for the first time since the GFC.

The strength of the economic recovery was evident in comments made in the RBNZ's August Monetary Policy Statement (MPS) and subsequent interviews by MPC members. It's clear that an OCR hike was planned until the last minute (and remains firmly on the table in October). Unfortunately, with less than 20% of the total population fully vaccinated at the time, another lockdown was the only option to protect Kiwis from the spread of the Delta variant. With the MPS released on day one of lockdown, the RBNZ made the decision to postpone what would have been the first OCR hike since 2014, but made it clear that it was a communications decision, not an economic one.

So here we sit, back in Level 4 lockdown. So is it all over for the economic boom? Or is this just a rude interruption of unknown duration until we can get on with it?

Lessons from experience

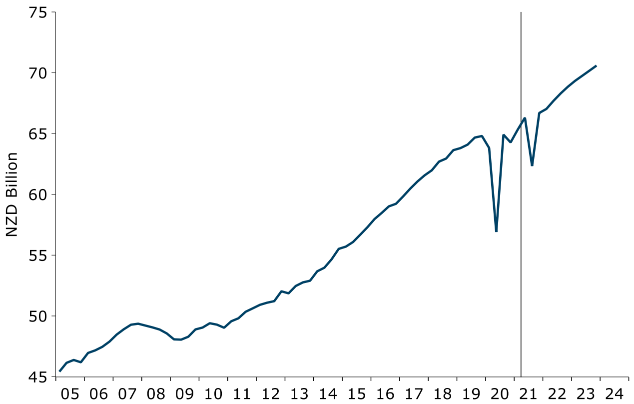
Once again we find ourselves in a world where the economic outlook hinges on the daily COVID case details, and the public health measures implemented to get on top of the latest outbreak. In this environment, it's impossible to be confident in any economic forecasts. We simply don't yet know how long-lasting the outbreak will end up being (especially given how infectious Delta is), and we don't know whether the economy will be able to shake off the impacts of lockdown in the same way it did in 2020.

Having said that, we do now have the experience of the first Level 4 lockdown to learn from. Several lessons stand out.

Firstly, the headline hit to GDP is going to be a poor indicator of the future path of the economy – much more important will be the fiscal response, and the impact on household balance sheets. As we saw in the newly released quarterly income GDP figures, household incomes only fell by 0.1% in Q2 2020 – despite a 10.8% fall in production GDP. So households just picked up where they left off once the lockdown was eased. Even so, the inevitable drop in production GDP this time around will generate headlines, and it still represents a significant hit to the economy. But we're certainly going to be putting in fewer hours this round into trying to update our estimates in real time. Because it's not what actually matters for the outlook.

For the record, our working assumption is that lockdown will lead to a 6% drop in GDP in the September quarter. However, with fiscal policy stepping in to absorb most of that hit, households and businesses should be relatively sheltered. If last year's recovery was anything to go by, then it's reasonable to expect economic activity to return to pre-lockdown levels before too long (figure 1).

Figure 1. GDP level forecast



Source: Stats NZ, Macrobond, ANZ Research

Nonetheless, there will still be some sectors that get hit hard. The hospitality industry is the obvious one here – this industry has been through the ringer these past 18 months, missing out on international tourism, and missing domestic customers each time we go into lockdown, and the work-from-home phenomenon hasn't helped either (public transport usage remained 40% down on pre-COVID levels, even in our months-long COVID-free stints). Government support will be helping to some extent, but we are still likely to see a lot of insolvencies as some firms that survived one round of Level 4 may not be able to make it through another. So unfortunately, we will see job losses as a result of lockdown.

But the good news for any new jobseekers is that with the border firmly shut, lockdown will do nothing to ease the labour shortage that many businesses are struggling with. So those people who lose jobs due should hopefully be able to find employment before too long. While that's going to be a distressing thing to go through, at a macro-level it should mean there is minimal additional labour market scarring.

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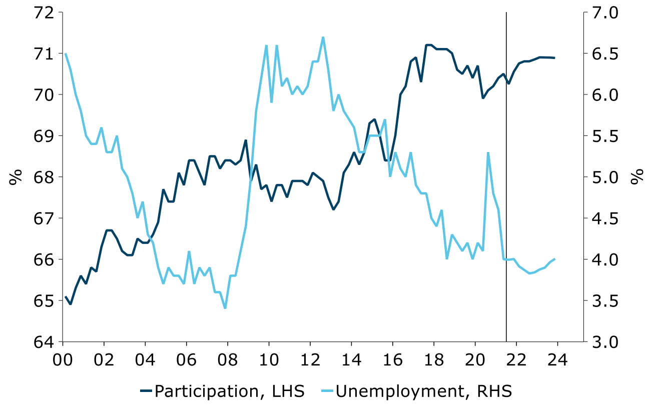
Our base case is that the unemployment rate holds steady at 4.0% in Q3 and Q4, but only because a drop in the participation rate is expected to offset a small downtick in employment (figure 2). We'll be paying closer attention to measures like average hours worked and underemployment to gain a clearer sense of the overall impact of lockdown on the labour force. Provided that the outbreak is contained, we should still see the labour market continue to tighten, with unemployment dropping below 4% over 2022.

Figure 2. Unemployment and participation forecasts



Source: Stats NZ, Macrobond, ANZ Research

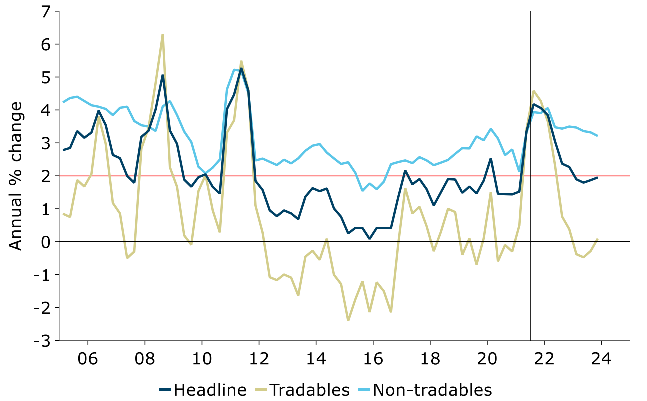
The second lesson from last year's lockdown is that COVID is, by and large, a supply shock. The shipping disruptions, social distancing requirements, lockdowns, and changes to the composition of demand have acted to create supply disruptions and shortages of all kinds around the world. And in New Zealand's case, with the border being closed, the labour market has been exceptionally tight – even though unemployment is still above pre-GFC levels.

Why does it matter whether we're looking at a shock to demand or supply? Well, it fundamentally changes the calculus for monetary policy. Monetary policy generally works by managing demand – when the economy is running out of steam, the RBNZ will cut the OCR (and in the case of 2020 purchase assets) in order to reduce interest rates, and stimulate demand for borrowing, both from households and businesses. But they can't do much about a supply shock. Sure, supply disruptions can reduce economic growth, but they do this by clogging up the economy, and driving up prices.

And adding demand won't help. What very accommodative monetary policy will do (and with the benefit of 20/20 hindsight, has done) in a broad-based supply shock is add to unsustainable demand relative to supply, and push inflation higher. Indeed, we've seen price pressures surge in recent months, with headline inflation increasing above the RBNZ's 1-3% target range in Q2.

It's not all supply pressures to blame, though – what really makes the surge in inflation something the RBNZ can't ignore is the fact that we have a tight labour market, strong core inflation, and rising inflation expectations. Those are the ingredients for a sustained increase in inflationary pressure – and a potential wage-price spiral, if these conditions persist. In fact, we expect these pressures will see inflation peak at just over 4% in the second half of this year (figure 3). But in our forecasts, that's not going to last too long. Firstly, the cost increases we've seen due to COVID will eventually unwind. And secondly, the RBNZ will is expected to raise interest rates in order to contain rising inflation momentum – and we reckon that'll work.

Figure 3. Inflation forecast



Source: Stats NZ, Macrobond, ANZ Research

This second lesson, that COVID is not primarily a demand shock, is why the RBNZ has been so keen to highlight that even though they did not lift the OCR at the August meeting, near-term, OCR hikes remain on the table. The RBNZ is highlighting that they still plan to return the OCR to a level that is neither contractionary nor expansionary (ie the neutral level of the OCR), which they consider to be around 2% (we suspect it's closer to 1.5%, as discussed in our Insight note).

Of course, anyone's projections are simply best guesses in this highly uncertain environment. Further lockdowns, extensions to the current lockdown, persistent declines in consumer and business confidence and/or a negative global shock are all threats that could result in a more serious derailment of economic momentum in New Zealand. So the best thing we can do right now is to highlight some of these key uncertainties, and what they might mean for the economic and policy outlook.

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Will it be a V-shaped recovery again?

Our base case optimistic assumption is that we get COVID under control relatively quickly, and can go back to Alert Level One before too long. So far, despite a regrettably large number of super-spreader events pre-lockdown, all the cases appear linked, and there's no evidence that the lockdown is "leaking". That's really important, and so long as it stays that way, we're hopeful for a fairly short lockdown, though the risks around that don't need explaining.

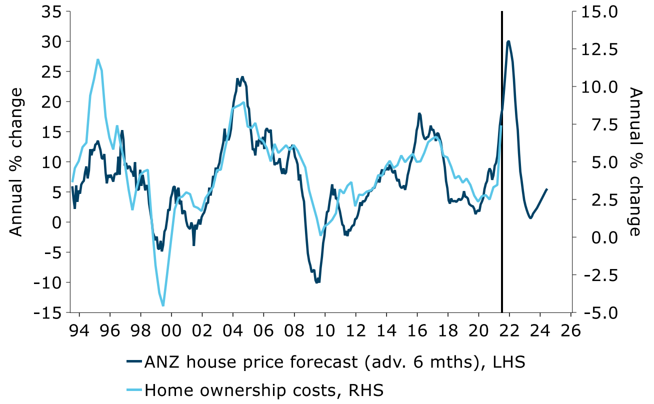
With fiscal policy absorbing most of the hit to household and business balance sheets, we should see the economy rebound back to pre-lockdown levels of activity and employment. But things have changed since mid-2020. Some of these developments could threaten a solid recovery, while others may support it.

House prices, building, and DIY

A key factor that drove the economy out of lockdown in 2020 was the massive resurgence in the housing market. Not only did building activity surge, but Kiwis went into full DIY mode and spent money they had saved for overseas holidays on renovating their houses – and that shift towards spending on things really helped the domestic economy. Surging house prices will have also boosted consumer sentiment and spending (at least for home owners).

These housing drivers are looking like they're not going to be nearly as powerful moving into the second half of 2021. They just can't be. Yes, the pipeline of building activity remains strong, but the construction sector is facing huge constraints, including labour shortages and a sheer lack of raw materials (with prices rising sharply as a result). The construction sector has tended to get itself into cash-flow trouble during previous periods of hot demand and surging prices, as project delays and cost overruns kick in, and that's par for the course these days. The added disruption of another lockdown will not help matters. If the usual correlation between house prices and construction costs holds (it has done so far), then these cost pressures have some way to run yet – putting more pressure on the industry.

Figure 4. Construction costs and house price inflation



Source: REINZ, Stats NZ, Macrobond, ANZ Research

House prices have continued to surprise with their resilience in recent months, but the underlying drivers of rising house price inflation are just not there – supply is coming online, affordability is worse than ever, mortgage rates have started rising, and macroprudential policy is being *tightened,* whereas in 2020 it was loosened. And you can only renovate your kitchen so many times. So don't expect much from housing – activity in the sector is going as fast as capacity constraints will allow, but it's not going to be the main driver of economic growth coming out of this lockdown. And there is just no way house prices are going to rise another 30%, which, while an absolute debacle on so many levels, undeniably boosted demand and confidence amongst those fortunate enough to own a house or three.

Broad-based momentum

Despite the dominance of housing in public discourse, the economy is more than just this market. We saw in the Q1 GDP data that the economic recovery was becoming more broad-based than just a surge in house building, selling, and renovating. There was strong growth across a wide range of sectors (retail being a standout performer), and more encouragingly, investment was also picking up.

The hope is that these drivers will pick up where they left off prior to the current lockdown – fueling a more sustainable bounce-back in GDP growth. Key indicators here will be household and business confidence surveys. After tanking during the last Level 4 lockdown, these measures recovered quickly to post-2017 highs (figure 5). Ideally, we want to see a similar kind of recovery from the current lockdown – but there's always a risk that people start to become fatigued, with the end of COVID on the horizon but seemingly never coming closer.

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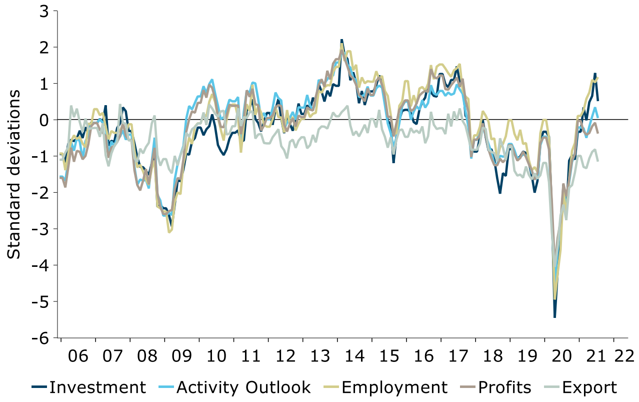
A sustained decrease in confidence could see economic momentum fail to re-emerge once lockdown ends. Daily card spending data should give us some early indications of whether households end up spending savings accumulated during lockdown – as they did in 2020.

Figure 5. ANZBO headline measures



Source: Macrobond, ANZ Research

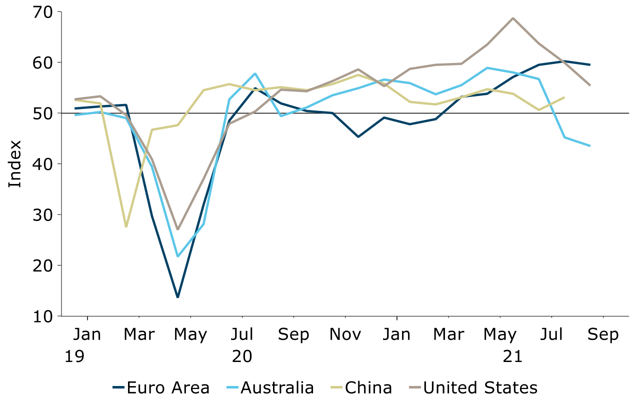
Global tailwind weakening

Something else New Zealand benefitted from over the past year was the sheer level of demand from our trading partners. Similar to patterns seen in New Zealand, overseas demand switched from services (like tourism) to physical goods – and that benefitted our goods exporters, with commodity prices, including dairy, increasing rapidly over 2020. However, shipping disruptions drove costs up exponentially, eroding some of those gains, and labour shortages have also impaired producers' ability to make the most of the high prices.

Now in 2021, that global tailwind looks to be blowing a little less strongly (figure 6), although to some extent that was to be expected given the strength of the bounce-back once lockdown measures were eased.

Australia has been in lockdown for weeks – and that's starting to weigh on activity, with the economy forecast to contract 3.3% in Q3. Spending in Australia has tended to recover quickly from lockdowns, but the longer their lockdown goes on, the bigger the hole out of which the economy will have to climb. We've already pushed back our expectation for the first interest hike by the Reserve Bank of Australia (RBA) into H1 2024.

Figure 6. Global composite PMIs



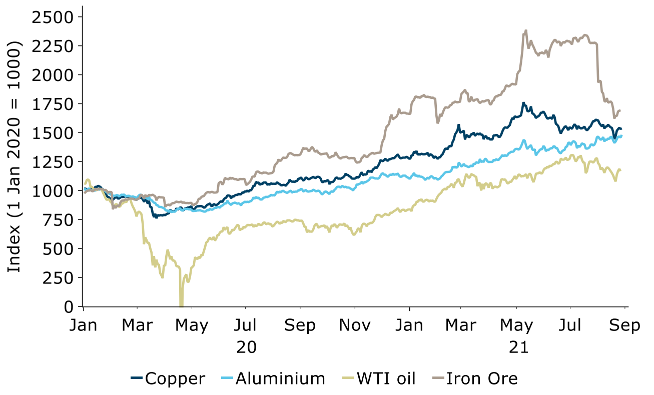
Source: IHS Markit, Macrobond, ANZ Research

The Chinese economy, which was the first of our major trading partners to experience a post-COVID boom in activity, is also looking on shakier ground. Retail sales fell 0.1% m/m in July, and investment growth has slowed. The resurgence of COVID in China has fortunately been successfully dealt with, but it's presumably just a question of time until it'll be back.

New Zealand is a small open economy bobbing alongside behemoths like the US, Euro Area, and China – and our economic fortunes are largely tied to global developments. So waning global demand as the recovery matures and countries continue to battle COVID means we don't have the same level of external support coming out of lockdown as we did in 2020.

Consistent with a slowing global recovery, it also looks like commodity prices may have reached their cyclical peak – with the prices of many hard commodities, particularly iron ore and oil, coming down in recent weeks (figure 7). Dairy prices have reversed some of their 2020 gains too – but whole milk powder prices remain well above the USD3000/tonne level that we were stuck on prior to the pandemic. All up, easing commodity prices may weigh on export returns (although they will also make importing goods cheaper). If shipping disruptions and the associated costs don't ease, then firms could see significant margin squeeze, given softness in commodity prices.

Figure 7. Hard commodity prices



Source: LME, EIA, SGX, Bloomberg, Macrobond, ANZ Research

Fiscal support to the rescue

It's not all bad news though. In addition to the strong starting point for the economy, the Government also still has room to maneuver, despite having already taken on a lot of debt to get us through the crisis. And there is now more support in place, with the wage subsidy complemented by the Resurgence Support Payment, which opened for applications on 24 August. Fiscal support (combined with an effective health response) was the backbone of New Zealand's recovery from the first lockdown, with the wage subsidy keeping workers attached to their jobs and most businesses afloat.

With this support back in place for the current lockdown, the Government is taking the bulk of the impact of COVID onto its own balance sheet. While that sacrifice is going to have longer-term debt sustainability implications, in the near term it ensures that the private sector can get back to work relatively unscathed.

The Government has plenty of headroom to increase spending if needed. There's around $5 billion left in the COVID response fund, a few billion in under-spending from other parts of the fund it can use, and up to an extra $10 billion or so extra in the kitty following positive economic surprises since May's Budget Update (ie higher tax revenue and lower spending than expected thanks to the better performing economy). If all that runs out, NZ's relatively low Government debt means there is still room to borrow a little more, but at this stage we don't think that will be required.

We've done this before

Another positive worth noting is that this isn't our first rodeo – especially Auckland, a city of seasoned lockdown professionals. We are now a lot more prepared for working from home, reducing the impact on GDP. We've already seen a surge in fibre broadband usage that's outstripped the last lockdown by a comfortable margin – hopefully at least some of that is productive work (rather than finally catching up on those shows you've been eyeing up). Not everyone can do this, though - there are still many jobs where working for home is just not an option. That's where the fiscal response is most important. But overall, it should alleviate a lot of concern for many people knowing that they can keep working over lockdown, and keep the money flowing in. Those who can't, know that their employer will be very reluctant to let them go, given how hard staff are to find. And if the worst happens, there are still huge numbers of jobs being advertised.

Delta: the final boss?

Finally, one of the biggest differences compared to last time is the sheer infectiousness of Delta. In the first outbreak, we managed to crush COVID entirely, allowing us to spend the next year and a half living relatively freely compared with the rest of the world. But the enemy has evolved, becoming far more infectious than the original strain of COVID-19.

And we are tired. It's been a tough year – even in New Zealand, which has been relatively sheltered from the worst ravages of the pandemic. Even as COVID seems to become more dangerous with each mutation, we run the risk of becoming fatigued and disillusioned with the public health measures needed to contain it. While we've been pretty good at staying home (especially compared with other countries), there's always the possibility that people start to tire and push against the restrictions – that would only help COVID spread, and delay our emergence from lockdown.

Vaccination levels are important here – if take-up is high enough and efficacy remains strong, then the likelihood of going back into lockdown will decrease as the rollout builds momentum. Until then, all the gains that we've made over the past year remain at risk. And that's not a scenario that is good for our mental nor economic wellbeing. The realisation that COVID may never really go away could dampen the post-lockdown bounce in sentiment, with spending and investment possibly feeling those negative effects.

So where do all these pluses and minuses leave us?

There are some economic drivers that we can't rely on as we did in 2020, namely housing and global demand. And there are some drivers that give us reason to be optimistic, including that the economy was accelerating (almost too fast) coming into

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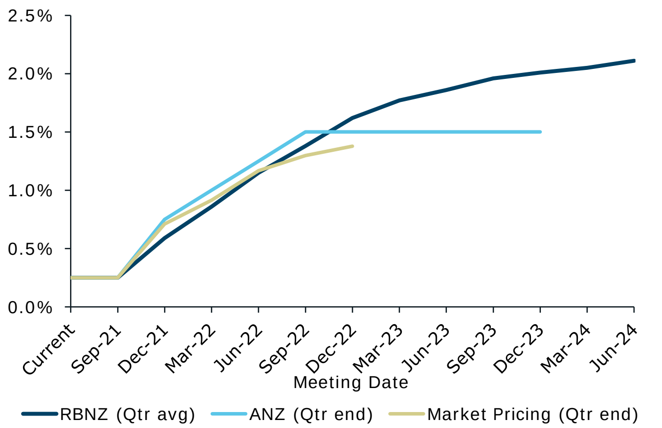
lockdown, fiscal supports have been rapidly redeployed, and many households and businesses now know the drill and probably feel confident in the post-lockdown recovery. So hopefully these will be enough to get us back on track. But ultimately, it's down to the path of the virus.

Monetary Policy and Markets

The RBNZ's latest (August) projections are consistent with the OCR reaching 2% by the end of 2023, and stabilising there over 2024. The RBNZ has framed this move as what's required to get them ahead of surging inflation, keep the overheated economy on a sustainable growth path, and return interest rates to a more "neutral" level. To be fair 2% isn't that high - so the era of low interest rates is definitely not over in these projections – but the extreme low of a 0.25% OCR looks like it will soon be, barring any unexpected catastrophes. That said, we are not as convinced as the RBNZ that the OCR will need to move even as far as 2% for the foreseeable future, given continuing declines in the neutral level of interest rates both here and overseas, as well as the heightened risk of unexpected catastrophes at this juncture.

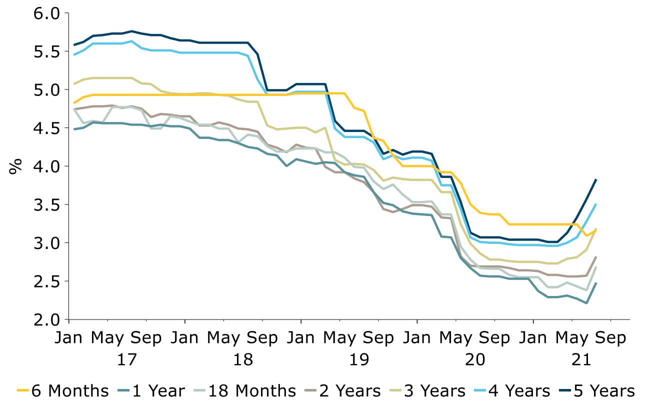
We expect the RBNZ will lift the OCR by 0.25%pts in early October, with follow-up hikes of the same magnitude at each of the four quarterly MPSs thereafter, bringing the OCR to a terminal rate of 1.5% by August 2022 (figure 8). But it's really important to highlight that that is all contingent on the COVID outbreak looking well under control, even if not quite stamped out yet. As mentioned, despite high numbers of cases, there are good reasons to be cautiously optimistic.

Figure 8. OCR outlook



Short-term interest rates have increased in anticipation of the RBNZ's OCR hikes. This has flowed through to retail rates too, with mortgage and deposit rates both higher (figure 9). Given high levels of indebtedness, higher interest rates are likely to have more "bite" this time around for all sectors of the economy, particularly households, as discussed in the feature article of our July Property Focus. Some households' budgets have become seriously stretched, and that will likely make OCR hikes even more potent than usual. That's one of many reasons for our relatively low terminal OCR forecast of 1.5%.

Figure 9. Special new mortgage rates



Source: RBNZ, Macrobond, ANZ Research

It's fair to ask how the RBNZ can embark on a hiking cycle when other central banks, notably the US Federal Reserve and RBA, don't see interest hikes being required for several years yet. As noted in a recent Insight, the risks here are tilted towards convergence, especially between the RBNZ and RBA. Either the RBNZ ends up taking longer to begin and/or complete their hiking cycle, the RBA finds they need to hike earlier than expected, or some mix of both.

An important factor here will be the New Zealand dollar. If the RBNZ does go ahead with their planned OCR hikes, then that could put significant upward pressure on the Kiwi. To be sure, markets have already priced in OCR hikes and the NZD has yawned, but it's only to slightly above 1% at this point. The RBNZ is planning to hike the OCR to twice that level (COVID allowing). Should they follow through, that could see a significant appreciation of the New Zealand dollar, which might do some of the RBNZ's tightening work for them.

So there are clearly some factors that make lifting the OCR more complicated. Our economic recovery is more advanced than many trading partners, which means our monetary policy cycle is de-synched – and that could create some issues. But the economy was clearly becoming quite overheated– and so long as this outbreak is brought under control, that's not likely to change any time soon. As the RBNZ notes, the bigger risk with monetary policy right now is waiting too late to normalise monetary policy, and having to tap the brakes more aggressively further down the track – no one wants that, particularly given that the housing market is more fragile than it knows.

So for now, we continue to expect OCR hikes, starting in October. But there's plenty that could change this outlook – and this uncertainty will linger so long as the threat of returning to lockdown weighs. That, in turn, will depend crucially on the vaccine rollout.

As August drew to a close, markets were struggling to reconcile the RBNZ's decision to stand pat with talk that a 0.50%pt hike had been a possibility had New Zealand not been plunged into lockdown. In our view the bar to a 0.50%pt hike is high, given firm comms about future intentions can achieve similar results at less risk. August was a case in point – although markets were surprised that the RBNZ didn't hike, 2-year swap rates were little changed, with the market taking the view that hikes will still come, and soon.

Our base-case scenario assumes that the RBNZ will be able to hike, and as they do, that will put upward pressure on short-term interest rates. Markets are priced for hikes, and nobody will be surprised when the RBNZ embarks on them, but what's priced in is still slightly shy of what we expect. This is very reasonable given downside risks, but it means that confirmation of hikes would likely deliver higher 1 to 3-year interest rates than current.

The direction of New Zealand long-term interest rates remains tied to the fortunes of global interest rates – most notably the bellwether US 10-year Treasury bond yield, which held steady at around 1¼% for most of August. Our forecasts assume that US bond yields will rise gradually as the Fed inches closer towards tapering, which will then be followed by actual cash rate increases. But the tapering timetable has been impacted by fresh fears of the impact of Delta on the US economy, with the Fed taking the view that the path of the economy is dependent on the path of Delta. All else equal, that speaks to a more gradual withdrawal of stimulus, but it will still be a withdrawal nonetheless. As this occurs, we expect there to be some upward pressure on New Zealand longer term interest rates, but this is expected to be less severe than the impact the higher OCR will have at the short end.

Key forecasts

Calendar Years	2017	2018	2019	2020	2021(f)	2022(f)	2023(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.5	3.4	2.4	-2.9	4.3	4.3	2.9
Private Consumption	5.6	4.4	3.6	-2.0	9.1	3.3	3.1
Public Consumption	3.4	3.4	5.4	6.4	5.3	0.8	2.3
Residential investment	-1.4	1.2	5.0	-4.2	14.7	6.7	4.0
Other investment	7.3	9.7	2.7	-8.5	8.4	5.5	5.5
Stockbuilding[1]	0.2	0.4	-0.7	-0.8	1.3	-0.4	0.0
Gross National Expenditure	5.3	5.3	3.0	-2.6	9.8	3.5	3.6
Total Exports	2.4	2.9	2.2	-11.9	-3.9	8.7	7.7
Total Imports	7.3	6.5	2.2	-16.2	14.2	9.0	7.7
Employment (annual %)	3.7	2.2	1.2	0.7	2.3	2.0	1.3
Unemployment Rate (sa; Dec qtr)	4.5	4.3	4.0	4.8	4.0	3.8	4.0
Labour Cost Index (annual %)	1.9	2.0	2.4	1.5	2.9	2.8	2.6
Terms of trade (OTI basis; annual %)	7.9	-4.8	7.1	-1.6	1.3	1.9	2.0
Prices (annual % change)							
CPI Inflation	1.6	1.9	1.9	1.4	4.1	2.3	2.0
Non-tradable Inflation	2.5	2.7	3.1	2.8	3.9	3.5	3.2
Tradable Inflation	0.5	0.9	0.1	-0.3	4.3	0.4	0.1
REINZ House Price Index	3.5	3.2	5.2	15.6	22.4	0.4	5.2
NZ Financial Markets (end of December quarter)							
NZD/USD	0.71	0.67	0.67	0.72	0.74	0.75	0.75
NZD/AUD	0.91	0.95	0.96	0.93	0.95	0.96	0.96
NZD/EUR	0.59	0.59	0.60	0.59	0.61	0.60	0.60
NZD/JPY	79.9	73.7	73.1	74.2	82.9	84.0	84.0
NZD/GBP	0.53	0.53	0.51	0.53	0.51	0.50	0.52
NZD/CNY	4.62	4.62	4.69	4.69	4.74	4.69	4.61
NZ$ TWI	74.4	73.4	73.7	75.2	77.1	76.8	76.4
Official Cash Rate	1.75	1.75	1.00	0.25	0.75	1.50	1.50
90-day bank bill rate	1.88	1.97	1.29	0.27	1.04	1.65	1.65
2-year swap rate	2.21	1.97	1.26	0.28	1.55	1.65	1.65
10-year government bond rate	2.72	2.37	1.65	0.99	2.00	2.50	2.50

[1] Percentage point contribution to growth

Forecasts finalised 30 August 2021

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

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