

NZ Economy: Uncharted Waters

Executive Summary

While NZ started the year in reasonably good shape, things changed rapidly for the economy once Covid-19 raised its ugly head, resulting ultimately in the March level 4 lockdown. But Covid-19's worst impacts have yet to flow through in terms of job losses and business shut-downs.

No event, probably since World War 2, has caused such upheaval for NZ or indeed for the world economy and its citizens in such a short space of time. The Organisation for Economic Cooperation and Development in its latest World Economic Outlook (June 2020) stated succinctly that: *"The COVID-19 pandemic is a global health crisis without precedent in living memory. It has triggered the most severe economic recession in nearly a century and is causing enormous damage to people's health, jobs and well-being"*.

From a NZ economic perspective, the impact so far has varied, with official statistical data still reasonably scarce and evidence of the Covid-19's effect is reliant on a number of case studies and feedback from individual members and sectors. Responses have varied from effective decimation and business closures through to fundamentally little or no change in behaviour.

Certain sectors, such as export education, tourism, air transport, and retail/accommodation, have borne the brunt of what is in effect a closed border and, until recently, heavily restricted internal movement. Even the most positive outlook for a trans-Tasman bubble will likely be at least September although with recent events that might now be unduly optimistic. Other traditional tourism channels are likely to be closed until well into next year.

Notwithstanding the above, there is some light at the end of the tunnel as NZ gets back to what can be described as the new normal under level 1. Post lockdown has seen significant boosts in some activities such as electronic sales and electricity use but with, unfortunately, more fallout to come. Jobseeker numbers continue to rise while official unemployment could skyrocket as wage subsidies become harder to obtain and are eventually phased out.

Trying to find many positives among the doom and gloom is difficult. China's initial success in containing the spread of the virus was seen as a positive given that country is a fundamentally crucial export market for NZ (and indeed for many other countries). Reopening supply chains to and from China has been crucial in ensuring production is ramped up again. Now China is experiencing a resurgence of Covid-19, the situation is no longer so optimistic.

Notwithstanding the above, preliminary statistics from StatsNZ on the impact on trade with China have been surprisingly muted thus far, although dairy prices have generally softened somewhat as evidenced by results from the Global Dairy Trade auctions. Overall, the agricultural sector has weathered this storm reasonably well, despite having to deal concurrently with droughts and greater regulatory constraints on land use.

HIGHLIGHTS

NZ's forecast economic growth has been slashed with negative growth over the near-term. Short-term impacts are very negative with the Treasury, Reserve Bank and private sector forecasters and banks showing big reductions in output for the June quarter.

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at -6 for the June 2020 quarter, up 3 on the previous quarter but down 9 on a year ago, because of initial declines in key economic indicators as the impact of the coronavirus emerges.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) declined significantly in March before tanking in April, largely coinciding with the Level 4 lockdown (lowest levels ever recorded for both surveys). While still firmly in negative territory for May, the PMI and PSI are starting on the road to recovery.

Despite all the concerns above, the NZ economy remains in relatively good shape compared with many of the countries we traditionally compare ourselves to, including in respect to debt levels. There is room for the Government to take on even more debt if necessary. Net debt - forecast to increase from around 20% of GDP at the start of this year to around 50% by 2022 - is still one of the lowest in the developed world.

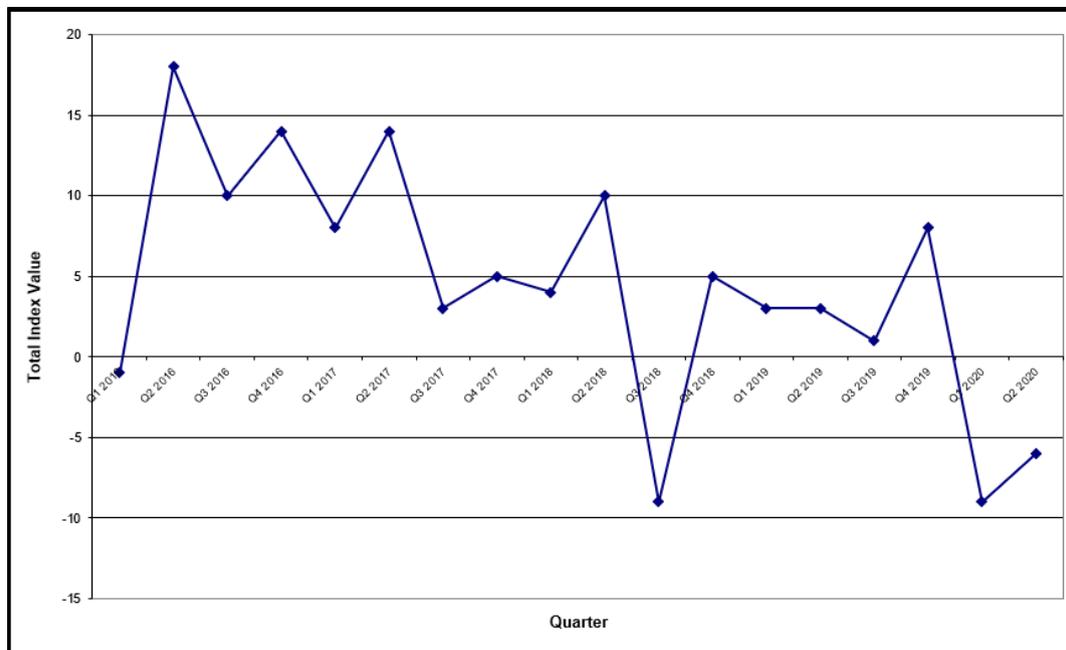
While an increased debt level has been targeted at blunting the worst effects of Covid-19 on business activity, the Government could arguably do more by reducing regulatory burdens.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of NZ's major economic indicators) sits at -6 for the June 2020 quarter, up 3 on the previous quarter but down 9 on a year ago, largely driven by the early stage effects of the coronavirus.¹

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Economic growth/performance indicators sit at -1 for the June 2020 quarter, up 2 on the previous quarter and the same as a year ago. Economic growth will take a hit for this year as trade flows and prices are still affected by multi-country lockdowns even though many supply chains are starting to get back to some semblance of normality.

Monetary policy/pricing indicators sit at 3 for the June 2020 quarter, up 1 on the previous quarter but down 3 on a year ago. Interest rates are now at historic lows while pricing intentions remain downbeat.

Business/consumer confidence indicators sit at -1 for the June 2020 quarter, up 6 on the previous quarter and up 2 on a year ago. Despite some recent increase, business confidence is still extremely low on the back of continued uncertainty and consumer confidence remains downbeat.

Labour market indicators sit at -7 for the June 2020 quarter, down 6 on the previous quarter and down 8 a year ago. Unemployment is starting to ramp up with increasing numbers enrolling for the Jobseeker benefit. Job ads have essentially dried up as businesses reassess their business plans to reflect the impact of the coronavirus on the demand for goods and services.

¹ The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any one quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. Note: The results for the June quarter 2020 are estimates based on available information to date.

Note: Given the very fluid international and to some extent domestic situation at present, the forecasts below, including in respect to economic growth, interest rates, exchange rates, inflation, and unemployment, should be seen for what they are – the best available information to date. Some banks are currently updating their forecasts while other forecasts will likely be subject to significant change as both the global and domestic scene continues to evolve over coming weeks.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – Hit hard

Forecasts over the near-term show that economic growth will take a significant hit with growth forecast to drop by around 3% for the year ending June 2020 before recovering in the outyears (see below).

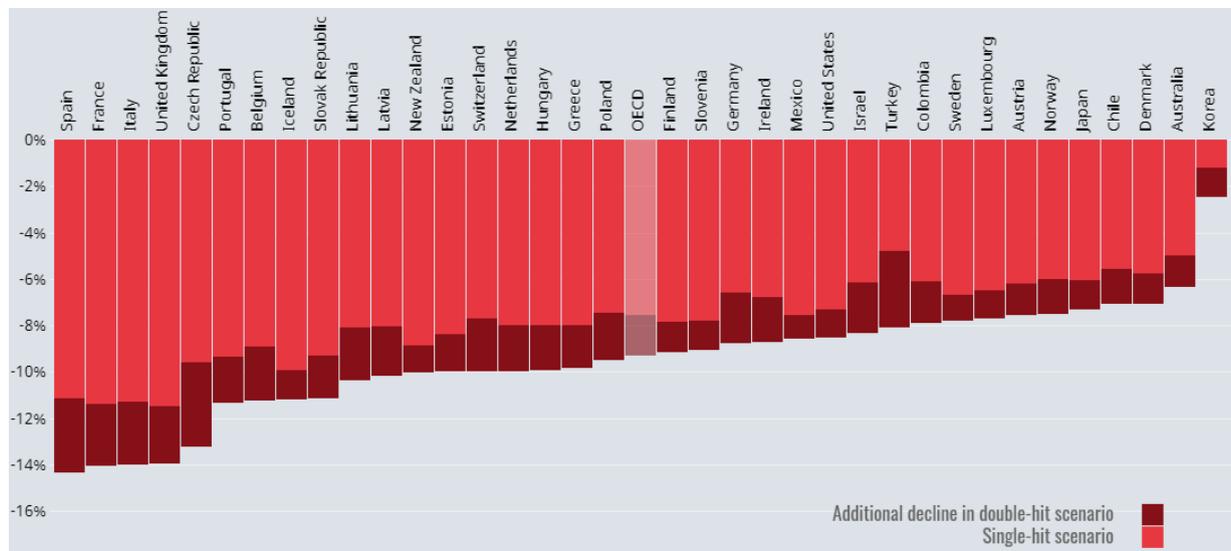
To be fair, any predictions of economic growth either domestically, or internationally, need to be taken with a very healthy grain of salt, as both domestic and international analysts reassess almost on a daily basis their forecast scenarios in light of the continuing international spread of the coronavirus.

International issues are addressed first as they put the issues facing NZ domestically into perspective.

The OECD stated succinctly in its latest Economic Outlook (June 2020) that: *"The COVID-19 pandemic is a global health crisis without precedent in living memory. It has triggered the most severe economic recession in nearly a century and is causing enormous damage to people's health, jobs and well-being"*.

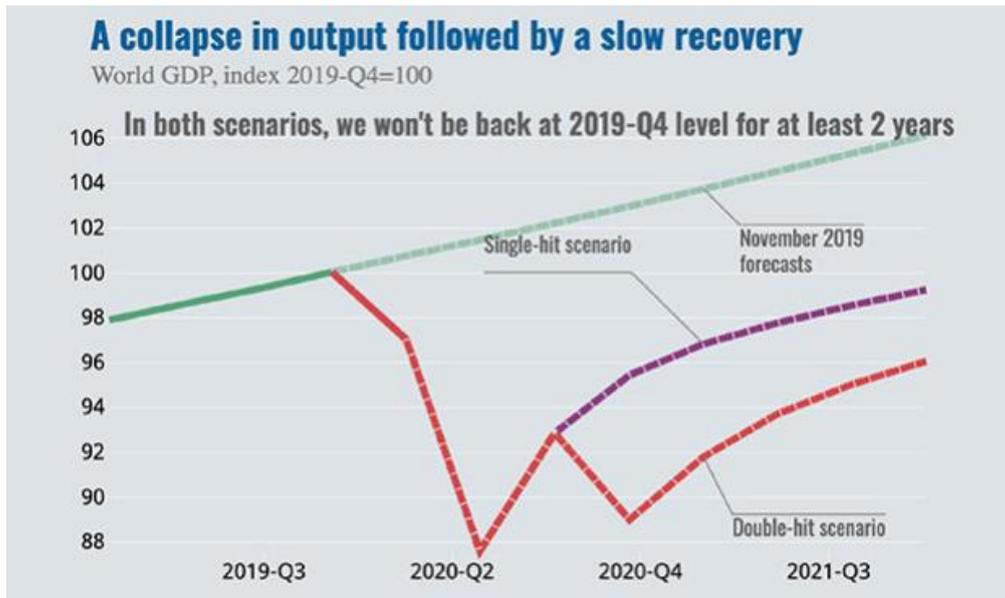
The Outlook focuses on two equally probable scenarios – Scenario A - in which a second wave of infections, with renewed lock-down, hits before the end of 2020, and Scenario B - in which another major outbreak is avoided. Irrespective of which scenario plays out, the impact on global economic growth is severe, with negative growth forecast over all OECD member countries for 2020, as indicated below.

GDP Growth in OECD countries for 2020



Source: OECD

In Scenario A, world output plummets 7.6% this year, before climbing back 2.8% in 2021. Under this scenario, the OECD unemployment rate nearly doubles to 10% with little recovery in jobs by 2021 (see below).



Source: OECD

Under Scenario B, global economic activity falls 6% in 2020 and OECD unemployment climbs to 9.2% from 5.4% in 2019. Living standards fall less sharply than with a second wave but five years of income growth is lost across the economy by 2021.

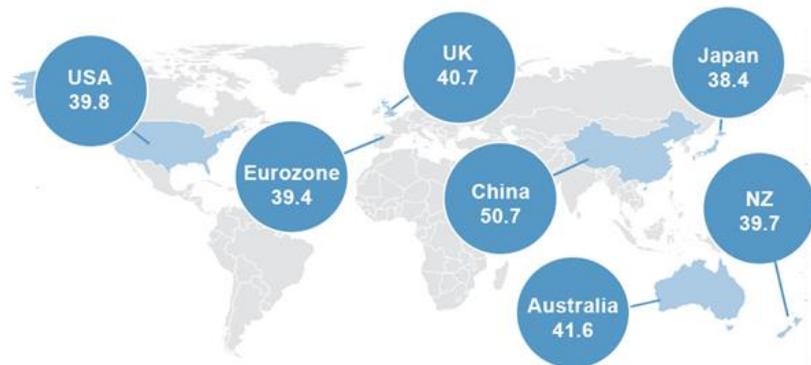
The latest J.P Morgan Global Manufacturing PMI (Performance of Manufacturing Index) shows the early-to-middle stage impacts of the coronavirus on some major economies around the world.

International Results

J.P. Morgan Global Manufacturing PMI™

1 June 2020

42.4



While NZ has been impacted significantly over the past 3-months, with the PMI recovering slightly, the results for many economies, including the USA, Japan and Australia are still showing a significant hit.

While China's PMI took a hammering in February, with the PMI effectively falling off a cliff as the China lockdown took effect, it then moved into positive territory largely as a result of authoritarian lockdown measures. This pattern was not replicated to the same extent in other countries.

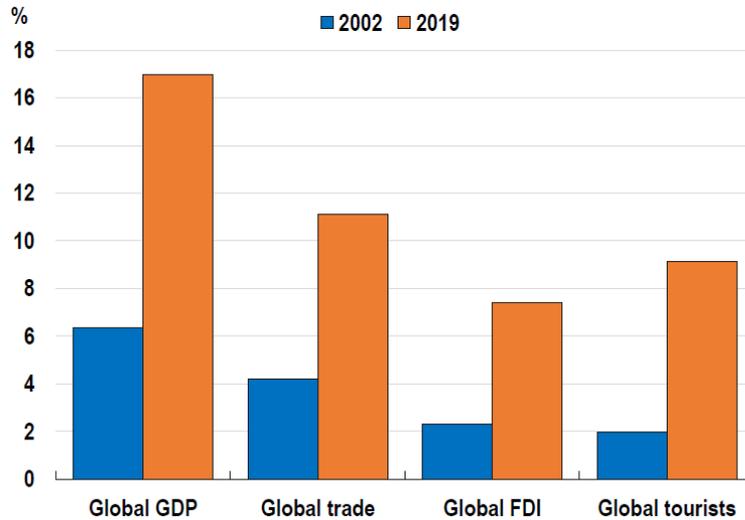
It is of great significance for NZ that combined, China and Australia account for around 40% of its trade. NZ is therefore heavily reliant on the fortunes of both China and Australia. Until recently, the news here was generally positive.

Chinese businesses had largely got back on the horse after the severe and widespread measures put in place to contain the coronavirus, with most large-scale industrial enterprises returning to normal production. NZ's major exports of protein to China during lockdown were not affected to the same degree as other products and some sectors, e.g. beef and dairy reported it was largely business as usual although with some downward pressure as evidenced by StatsNZ's preliminary trade statistics. Other sectors, e.g. forestry and fishing, took a big hit as China closed its restaurant doors and stopped processing NZ logs.

China's growth over the last couple of decades or so has seen it move from a minor player in the international trading system to one of the dominant forces shaping the future direction of trade.

China is more integrated in the global economy

Share of China in world



Source: Organisation for Economic Cooperation and Development (OECD)

China is crucial not only to the world economy but also to NZ's economic prospects, as growth in its middle class provides added demand for premium NZ protein products.

Not only is China NZ's biggest trading partner but it is also a major consumer of key NZ exports including dairy, meat, and a major contributor to tourism and forestry.

Internationally, while financial markets took a pounding as they struggled to comprehend the implications of the coronavirus and its impact on potential future earnings, it is surprising how rapidly they have generally improved, no doubt boosted by a large government fiscal stimulus across the globe.

And given that before Covid-19 was an international issue, globally, sharemarkets were generally over-priced - significantly in many cases - it is also surprising that there has been a general rebound in stock market prices.

While the NZX is currently down around 7% on its highs (and at the height of Covid-19 in NZ late March was down 27%), it is still currently around 8% higher than it was 1 year ago.

NZX50 Index



Source: NZX

Several international commentators have reported that sharemarket activity tends to be inversely related to interest rates with higher prices driven more by perceptions of lower returns elsewhere than by fundamentals such as price/earnings ratios. Over recent years, many countries' price/earnings ratios have gone up and up without any buyer constraint. Now, with international interest rates close to zero or in some cases negative, it is understandable that buyers are flocking back to equities. Governments around the world have pumped \$billions into their respective economies and this has assisted in rebuilding some semblance of confidence.

Budget 2020

Turning to the domestic scene, Budget 2020 *'Rebuilding Together'* was delivered against a backdrop of massive international and domestic dislocation, with Covid-19 firmly front of mind. Adding to the international downsides are heightened global trade tensions with significant geopolitical uncertainty on several fronts. On the positive side, demand for NZ exports is still relatively strong, with key agricultural commodities holding up better than expected. In that respect, NZ has probably fared better than many of the other countries we traditionally compare ourselves to.

Unfortunately, the fallout from Covid-19 is yet to come, with just about all the key economic indicators - employment growth, unemployment, business confidence and investment - looking sick. Meanwhile, the Government's projected tax take has taken a pounding.

While over the last 3 months the Government has poured tens of billions of dollars into various support packages (e.g. wage subsidies, interest-free loans to small businesses and a number of tax changes, along with a significant dollop into health-related activities), it is likely many businesses, particularly those involved in hospitality and tourism, will cease to exist within a few weeks. The impact on specific sectors, those already mentioned together with higher education, will be dramatic.

One saving grace is that the Government's books were in a relatively strong position going into Covid-19, allowing the Government to increase expenditure massively without taking NZ's debt profile into dangerous levels. Net debt pre-Covid-19 at around 20% of GDP (now around 35% of GDP and rising) is still very low by international standards, leaving some headroom for the Government to spend more, if necessary, before NZ's credit rating comes under attack.

However it is important in this context for the Government to reprioritise expenditure and the difficult expenditure decisions which successive Governments have left to fester, e.g. the age of eligibility for NZ Superannuation and whether greater targeting is required, will have to be addressed.

The Government has been quick to push the line that extraordinary times require extraordinary measures (e.g. increased fiscal support) but the other side of the coin is that many of the things that NZers have taken for granted may need to be pruned back in a major way if the Government is to get its books in order over a reasonable time period and before another one-off event hits us. In economic terms, there is no such thing a free lunch.

Regulation

Another area to which the Government could have given more serious consideration is inappropriate and bureaucratic regulation stifling business growth.

Most businesses will support the intent of the Government's package to fast-track important infrastructure to encourage employment growth, but a much more focused approach looking at regulatory barriers across the board is needed. Now is not the time to go back to the failed fortress mentality of the past.

There will always be some debate about how much risk should be carried by businesses and households and how much should be sheeted home to taxpayers if appropriate risk management strategies are to be put in place.

The decision to abandon Treasury oversight of new Bills by suspending the requirement for Regulatory Impact Statements is very concerning. All Government (taxpayer) funded projects require sound cost/benefit analysis given the potential cost of making poor decisions.

How all this is going to be paid for is still the \$64 million (or should that be the \$64 billion?) dollar question.

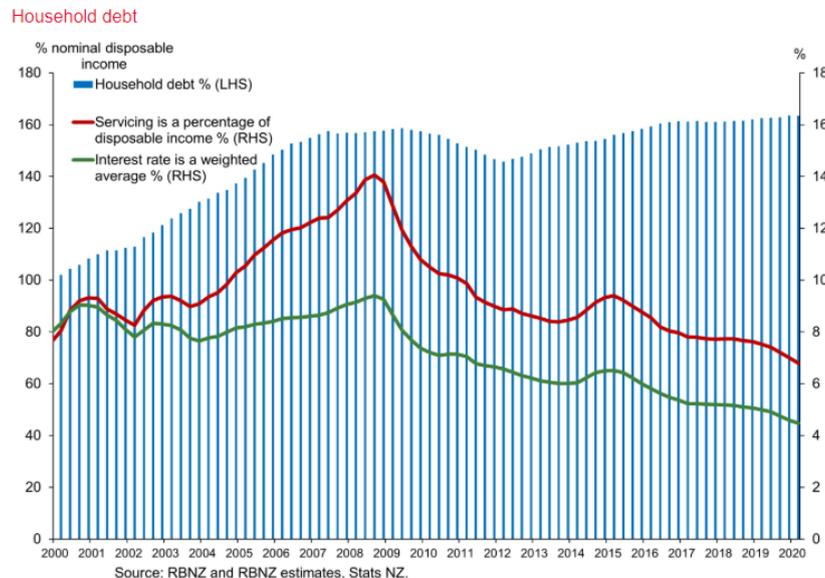
Increasing debt levels and reprioritising expenditure are going to be fundamental to getting the Government's books back in the black over time.

Additional taxes or increasing current tax rates should not be considered part of the proposed mix. Growing the pie to provide the funding required in key areas will only be achieved if businesses feel they can get ahead unburdened by unnecessary regulation and excessive taxation.

The fact that governments around the world, including in NZ, have reduced interest rates to close to zero (or negative in a handful of cases), may not be enough for individuals and businesses to justify spending at the present time. The distinct danger is that people will freeze and start putting cash under the mattress.

The cost of capital is now even lower, with negative interest rates prevalent in a number of countries, but low/negative interest rates will not necessarily encourage businesses to invest if demand does not exist or supply chains are blocked.

On the other hand, despite historically low interest rates, banks will increasingly be concerned about the underlying strength of many businesses and this might encourage them to tighten credit availability a move which could lead to higher borrowing costs for businesses and households. NZ household debt now sits at an historic high with much of it tied into the housing market. Ironically, at the same time, debt servicing costs are now at their lowest level for more than two decades, as shown by the graph below.



With respect to agricultural debt and the relatively large percentages of farm debt related to dairy, while commodity prices are still at satisfactory levels (given current circumstances), there is the potential for government regulation of water quality and other interventions, such as restrictions on land-use changes, to add to the banks' nervousness about lending further to this sector.

Referring specifically to NZ, the OECD in its latest World Economic Outlook (June 2020), considered recovery will be gradual and the country will be vulnerable to the effects of new waves of infection.

While the OECD acknowledged that the NZ economy is starting to recover, it was very clear that even in the absence of further virus outbreaks, NZ's output will only regain pre-crisis levels by the end of 2021. The OECD cited lower sector activity, particularly in those sectors recovering from strict distancing requirements, a surge in unemployment following the scaling back and subsequent termination of the wage subsidy scheme and a large reduction in net inward migration and loss of housing wealth, as holding back private consumption. Business investment will also remain subdued, reflecting continued weak business confidence and low capacity utilisation. On a more positive note, the OECD notes that goods exports will increase on the back of a strong global demand for food although tourism exports will be slow to recover given NZ's border will remain effectively closed for some time.

Some clear changes resulting from Covid-19 and the lockdown will alter NZ's economic and social fabric for some time to come.

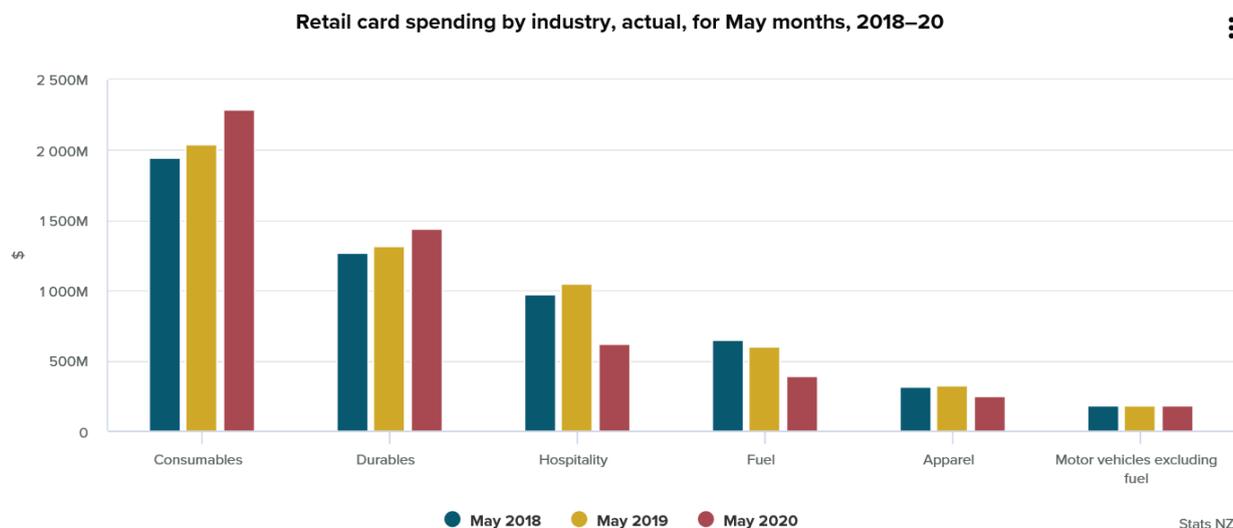
Some permanent changes are likely to reflect changes that were already happening.

Online shopping and greater buy-in to the digital revolution means individuals' buying and social habits have changed in the space of a month rather than emerging slowly over 5-10 years under normal circumstances.

Changes are likely in manufacturing and services activity, both positive and negative. Concerns with global supply chains may result in moves away from global sourcing of goods and services (often the cheapest and most efficient option) towards greater protectionism, which would not be in the wider interests of global economic growth. On the other hand, greater use could be made of domestic firms for the provision of specialist equipment, not only, potentially, health-related equipment but also equipment required for risk management purposes. But with bulk commodities, little is likely to change.

Away from the doom and gloom, several factors point to positive growth prospects for NZ, once the current coronavirus storm passes.

Retail card spending bounced back by \$2.3 billion in May from extremely low levels in April as businesses re-opened after the Covid-19 level 4 lockdown. As can be seen below, spending on groceries, furniture and appliances in May was higher than for the same month last year, but sales for hotels, motels, cafes, and restaurants remained well below typical levels.



The significant increase in activity in retail spending in May was not unexpected given a significant element of pent-up demand following the level 4 and subsequent level 3 lockdowns. But that positive spending does bode well as NZ returns to a more normal phase with the ability to go to restaurants and bars etc. without being unduly restricted by social distancing rules and compulsory contact tracing requirements.

However there are several reasons why it is unrealistic to expect activity somehow to soon bounce back to previous levels.

Given the rapid move to level 4 lock-down in late March, individual, household and business behaviour changed, irreversibly in many cases, some for the better and some for the worse.

On the positive side, many businesses and their employees found working from home was not the big problem it might once have seemed. In most cases, remote working was successful and in general maintained, if not improved, productivity while providing much greater flexibility for achieving multiple objectives.

It is interesting that according to the ANZ NZ Truckometer, which measures both heavy and light traffic movements, for May in level 2 both weekday and weekend heavy traffic was around 100% of a year earlier, while weekday car traffic was 90% of year-earlier levels and 92% of year-earlier weekend traffic. But it is clearly noticeable that traffic movements in the major centres (Auckland and Wellington in particular) are still significantly below what they were pre-Covid-19.

The undertaking of virtual work meetings via various technologies was by and large successful and raised questions about the need to physically meet for meetings or for obtaining goods and services – it suggests the tyranny of distance has been largely overcome.

As a result, there is likely to be increased use of remote working in future with many businesses and employees introducing working from home for at least part of the time to meet the wishes of employees and their employers. With this in mind, it might also be possible in this context to look at utilising the skills of overseas workers in providing expertise from afar.

Some major companies have adopted a changed approach to work allowing employees to work mainly from home but meeting in suburban hubs if physical meetings are required. This will affect both foot traffic in the CBD and potentially the demand for commercial buildings for office space and retail activity.

On the other hand, a reduced ability to source labour from overseas may affect productivity as there will be fewer skilled people able to do specialist and other necessary tasks in NZ. A reduced NZ population at any one time, the consequence of closed borders, will affect house prices and construction activity beyond the very-short term projects already in the pipeline. As a result, as with almost every recession, house prices will fall, probably between 5-10% on current levels although once the economy starts to regain momentum the demand for housing could increase given the historically low interest rates likely to remain in place for an extended period.

Other key positive factors include:

- NZ has been one of the first countries to come out of lockdown and return to a relative normality with relatively few Covid-19 cases and very few Covid-19 related deaths, putting it on the map as a country which managed its way through the crisis calmly but appropriately. This must be worth something in terms of other countries learning from NZ.
- There has been minimal impact on agricultural trade, while a trans-Tasman bubble, if possible, would be a positive in respect to kick-starting tourism which has had its \$17 billion per annum overseas inward tourist market decimated. International tourism probably accounts for around 50% of total tourism expenditure in NZ (the Australian market probably accounts for around 20% of that) and while not a panacea, moves towards the implementation of a trans-Tasman bubble would be positive, particularly as NZ's borders are likely to be closed for wider tourism activity until well into 2021.
- International commodity prices for protein (beef, lamb and dairy) have held up remarkably well to date with minimal reductions. However, further slippage in commodity prices is expected. On the other hand, the significant drop in world oil prices has benefited domestic transport operators and households through lower fuel costs at the pump.
- The cost of capital is very low with interest rates being slashed around the world. Home mortgages are now under 3% for the first time in half a century.
- The Government's balance sheet remains reasonably sound with the ability to expand debt even further if this is necessary to cushion activity and lessen the ongoing fall-out from Covid-19.
- NZ's regulatory, fiscal, and monetary policy institutions are world class, and are respected by international investors around the world.
- Demand for NZ product, post-coronavirus, could be quite strong as supply chains are freed up and run-down inventories are replenished. There might also be opportunity currently for domestic manufacturers to expand production if it becomes difficult to source product offshore.
- The Government infrastructure spend up, while playing out over several years, should be supportive of continued domestic growth in the outyears.

Forecasts: Real GDP percent Growth

	Years Ending		
	Jun 20	Jun 21	Jun 22
<i>Highest</i>	-2.4	2.4	4.3
<i>Average</i>	-3.1	-0.9	3.0
<i>Lowest</i>	-3.7	-2.9	2.2

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – brave new world

The Reserve Bank has made significant changes to monetary policy settings to ensure the NZ financial system remains in a solid position both to weather the significant economic impact of Covid-19 and to support NZ's recovery. Taking the slasher to the OCR, removing restrictions on loan-to-value ratios for 12-months, and delaying certain regulatory changes for the immediate future are all part of the mix.

The Reserve Bank has recently stated that its move to require greater capital adequacy will now be delayed, starting on July 2021, rather than this year as initially intended. The Reserve Bank has also said there might be a further delay depending on Covid-19's longer-term impact.

The Reserve Bank released a discussion document in mid-March (before lockdown) which focused on the design of the new prudential framework for deposit takers and the deposit insurance scheme.

The original deadline for submissions was 23 April but has now been pushed out to 23 October. This supports the decision to delay or slow down planned regulatory changes for the financial sector. The emphasis is on addressing the immediate challenges created by Covid-19.

The Reserve Bank and Government have announced decisions which will support the financial system and lending over the Covid-19 and post-Covid-19 economic recovery period. These include:

- **Loan Deferral Scheme:** Banks have offered households and small business customers a deferral of loan payments for a period of up to six months.
- **Business Financing Guarantee Scheme:** This provides small and medium sized firms with loans partially guaranteed by government loans at a concessionary interest rate to manage short-term income disruption.
- **Bank liquidity and funding support:** The Reserve Bank has introduced concessional term funding facilities for banks and has eased bank core funding requirements to alleviate liquidity and funding pressures.
- **Regulatory relief (or at least delays):** The Reserve Bank has delayed the implementation of planned increases to bank capital ratio requirements, as mentioned above, by at least 12 months, temporarily removing loan-to-value ratio restrictions, and delaying a number of other regulatory initiatives.

It can be argued that some of these discussions would have been better determined on a coordinated basis e.g. capital adequacy vis-à-vis depositor insurance, rather than being looked at in isolation, since they are essentially different sides of the same coin.

More importantly, when the Reserve Bank is assessing risk in respect to financial stability, how far can or should it go in trying to protect individuals and businesses from themselves? The danger is that increased bank capital requirements and the Government's decision to implement compulsory depositor insurance (up to around \$50,000) will set a precedent: that the government will act to protect investors and households against other risks as well. For example, will KiwiSaver investments be next and how far will the Reserve Bank go down this paternalistic path? Ultimately consumers and taxpayers will carry the risk.

Interest Rates – at historic lows

Not surprisingly, the Reserve Bank lowered the Official Cash Rate in a snap move from 1.00% down to 0.25% and has suggested this will be locked-in for at least a year. As expected, the move has flowed through into reduced mortgage costs for households and businesses. As a result of the recent cuts, the 90-day bill rate is forecast to fall and remain low out to March 2022 (see below).

While interest rates have certainly declined, it is important to realise that around three-quarters of household mortgages are locked-in so obviously any reduction in rates will largely affect new borrowing.

While interest rate reductions are welcome and have resulted in debt servicing costs being the lowest they have been for a very long time (despite household debt levels being the highest they have been ever), low interest rates will not necessarily encourage businesses and households to start investing: there are risks with low interest rates as well.

There is perhaps an assumption that lowering interest rates further will stimulate productive investment; businesses just need that extra reduction to make things happen and restore business confidence. However, business confidence to invest has little to do with interest rates, already at historic lows, but more to do with regulatory and international uncertainty as to future demand.

There is a concern that if the economy turns down further, there will be little if anything left in the tank and that might require the Reserve Bank to make use of unconventional tools, with the associated risks such action might entail. NZ is just one small step away from negative interest rates.

There are also, possibly, several unintended consequences for taxpayers from significant and prolonged interest rate reductions. For example, low interest rates can significantly change discount rates, affecting assets required to pay for future costs such as the cost of the Accident Compensation Corporation scheme. Reduced discount rates as a direct result of lower risk-free interest rates have resulted in the ACC scheme going from a situation where it was more than fully-funded to one where current assets are considered to fall well short of what is needed to deliver on future liabilities. This will likely mean both employers (in respect to work accidents), earners (in respect to non-work accidents) and motorists (in respect to Motor Vehicle Accidents) will face either a significant increase in levies or a change in ACC's funding policy.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Jun 20	Jun 21	Jun 22
Highest	0.3	0.5	0.8
Average	0.3	0.2	0.4
Lowest	0.3	-0.2	-0.1

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – roller coaster ride

Picking where the NZ dollar might go is fraught with uncertainty given current international circumstances with a relatively wide difference in forecasts as outlined below. Nevertheless, on average, the TWI is generally forecast to remain relatively stable over the coming year before increasing slightly out to June 2022.

The NZ dollar fell relatively sharply as the Reserve Bank unleashed a substantial amount of stimulus on the economy in the form of quantitative easing and indicated the potential for the OCR to head into negative territory next year. This, to some extent, reduced the attractiveness of the NZ dollar.

Notwithstanding the above, NZ is likely to be protected from any wild swings in the NZ dollar due to our very transparent and open monetary policy framework, alongside sound fiscal policy and regulatory practices which can generally be described as meeting world best practice.

Forecasts: Exchange Rates

AUD (cents)				USD (cents)			
	Jun 20	Jun 21	Jun 22		Jun 20	Jun 21	Jun 22
Highest	0.95	0.96	0.93	Highest	0.64	0.68	0.71
Average	0.94	0.91	0.90	Average	0.63	0.64	0.66
Lowest	0.93	0.88	0.87	Lowest	0.62	0.54	0.59

TWI			
	Jun 20	Jun 21	Jun 22
Highest	71.5	73.1	75.1
Average	70.8	70.7	72.5
Lowest	69.9	67.0	70.3

Source: ASB, BNZ, Kiwibank and Westpac

Inflation – cellar dwellers for now

Inflation as measured by the Consumers' Price Index is likely to remain well within the Reserve Bank's target band of 1-3% out to June 2022.

While non-tradeable (domestic) inflation was running at 3.4% per annum for the March 2020 quarter (the latest official figures available), tradeables inflation remains subdued (only up 0.1% in March), and will likely take a further hit as commodity prices continue to decline with low international demand in light of recent coronavirus events. Oil prices have taken a tumble with the onset of Covid-19 although they have since recovered somewhat. Nevertheless, from a NZ perspective, both businesses and households will benefit from lower input costs for petrol.

Notwithstanding the above, there is a huge degree of uncertainty about the direction of non-tradeables inflation. For example, will lower interest rates see a further ramping up in demand (prices) for housing once there is a normal readjustment in prices following the current recession? Despite historically low interest rates, will banks be more restrictive in their lending criteria (which could see asset prices fall as households and businesses offload non-essential capital goods)? The potential impacts of price changes are likely to be sector-specific. Some will face price rises while others will experience significant price drops as demand falls off (e.g. tourism and rental accommodation in traditional tourism hotspots e.g. Queenstown and possibly retail/hospitality).

The above factors make it harder to see a clear path forward in terms of overall inflationary pressures – or if indeed deflation is now a possibility, at least in the short-term.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Jun 20	Jun 21	Jun 22
Highest	2.0	1.4	1.4
Average	1.6	1.0	1.1
Lowest	1.3	0.4	0.5

Source: ASB, BNZ, Kiwibank and Westpac

1.3 Business activity and confidence – down but not totally out

Recent surveys of business confidence, while improved from the depths of May, still make for sober reading.

The ANZ New Zealand Business Outlook (Preliminary data for June 2020) shows that business confidence has lifted another 9 points to -33% in the preliminary June read of the survey. Businesses own activity lifted 10 points, with a net 29% of firms expecting lower activity for their firm in the year ahead.

ANZ New Zealand Business Outlook – Preliminary data for June 2020

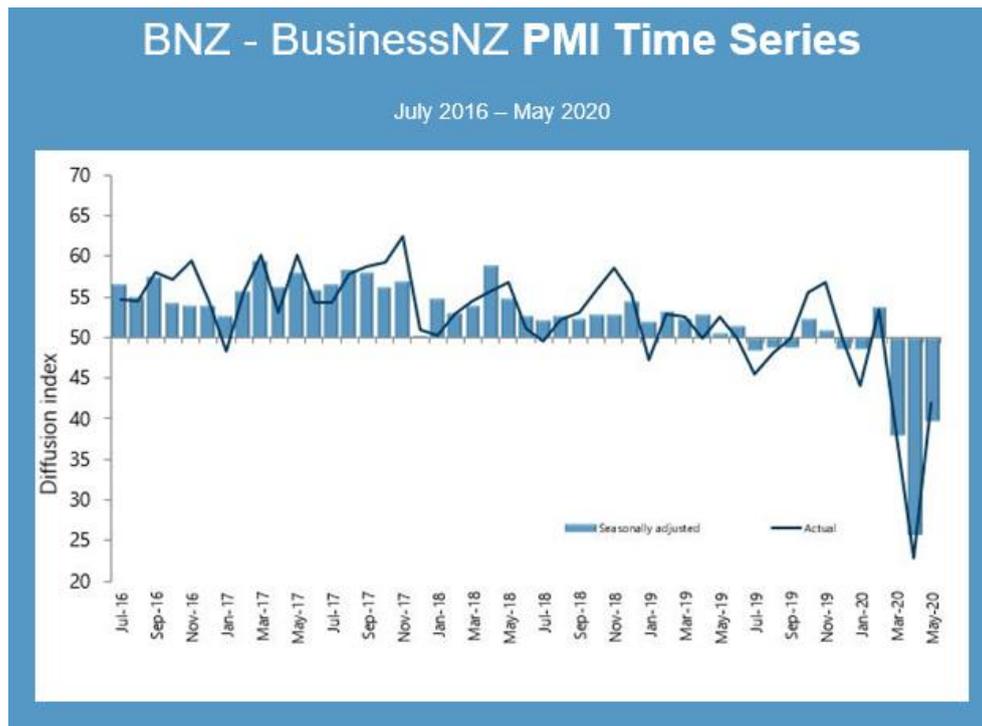
Source: ANZ

It is positive that all forward-looking activity indicators lifted from May levels, but they are still extremely weak. NZ is now at level 1, having emerged successfully from the various phases of lockdown, but is far from out of the woods as several sectors have taken big hit. And there is little real likelihood of upward movement in these sectors, even should a trans-Tasman bubble prove possible later this year.

International tourism probably accounts for around 50% of total tourism expenditure in NZ (the Australian market probably accounts for around 20% of that) and while not a panacea, moves towards a trans-Tasman bubble would be positive, particularly as NZ's borders are likely to be closed for wider tourism activity until well into 2021.

The manufacturing and services sectors are also still looking decidedly sick, despite some improvement from the depths reached in April this year. However, NZ's manufacturing sector showed some signs of recovery, albeit off a very low base, according to the latest BNZ-BusinessNZ Performance of Manufacturing Index (PMI).

The seasonally adjusted PMI for May was 39.7 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was up 13.8 from April, and higher than the level of activity recorded in March.



With half of May at level 2, firms had greater ability to boost production and new orders - as seen in the two sub-indices showing the strongest increases from the previous month (sitting at 38.4 and 40.0 respectively). By contrast, employment (39.4) took another hit. The wage subsidy will end soon for many businesses; a soft employment result in the months ahead might make the road to recovery that bit longer.

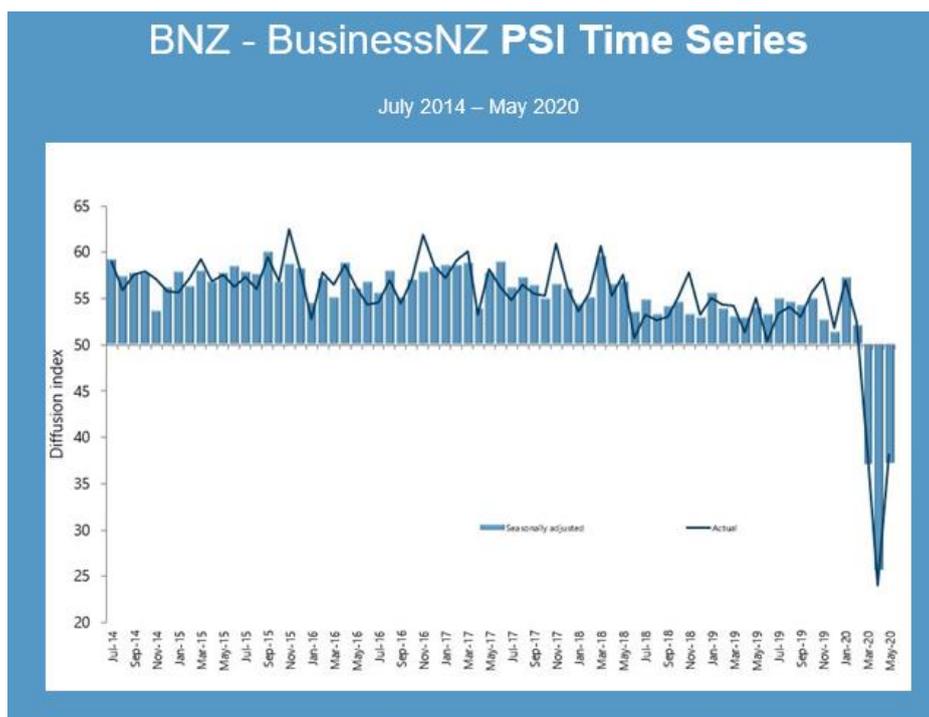
Main Indices



Looking at the comments, the lift in overall activity levels also saw the proportion of positive comments increase from 10.3% in April to 28.5% in May.

Meanwhile, activity in NZ's services sector improved somewhat for May after its lowest ever result in April, according to the BNZ-BusinessNZ Performance of Services (PSI).

The PSI for May was 37.2, 11.5 points up from April (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). This was just above the March result, but still showing strong contraction for the month.



The services sector result for May was similar to that for the manufacturing sector (see above). Improvements were made but still well below anything considered to be business as usual.

Main Indices



The proportion of negative comments for May (72.9%) did drop from 91% in April and looking ahead, around two-thirds of June will be at level 1. Ongoing improvements in activity can therefore be expected in the months ahead.

As with its sister survey the PMI, there was a marked increase in the number of respondents mentioning coronavirus. How much this plays out in the coming months will obviously depend on the ability to slow down its spread, both domestically and offshore.

Other sectors of the economy show varying levels of activity and confidence.

The construction sector is still showing firm levels of growth, while the potential pipeline of work resulting from the Government's recent infrastructure announcements should keep demand at reasonably solid levels in the near term. The decision to reinstate depreciation on commercial and industrial property should also provide some degree of confidence for business to invest, particularly in respect to seismic building upgrades.

Despite the Government's commitment to investing in housing stock, demand might reduce as migration levels have dried up as a result of closed borders. Investors might be wary of investing while significant uncertainty remains. On the other hand, significant reductions in interest rates will actively encourage some investors and first home buyers to enter or re-enter the market. Therefore, after an initial blip across the country, which generally occurs with any recession, it would not be surprising to see prices rise again after a year or two.

With respect to commercial developments, the move towards different working arrangements might put pressure on future projects, including CBD developments, while decisions to mothball a number of hotels in light of the collapse of tourists numbers, provides a signal that at least for the medium term, demand will likely soften across the board.

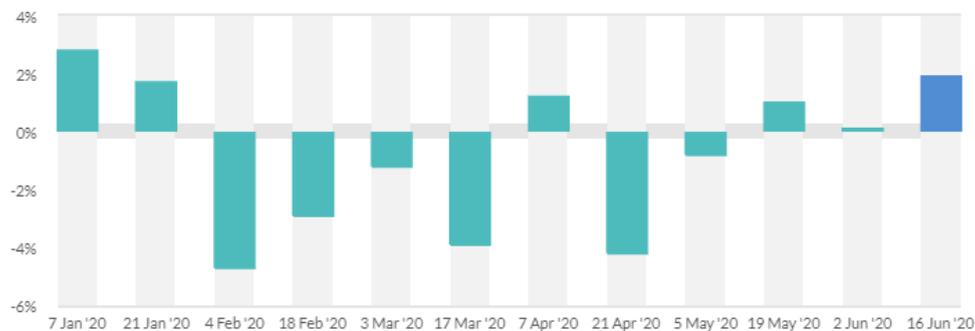
On the other hand, industrial activity might ramp up again in light of the potential for greater manufacturing to be brought home to NZ, partly as a result of moves to buy locally and minimise the risks associated with international supply chains.

The agricultural sector has soldiered through Covid-19 pretty well despite facing some upwinds from previous production losses as a result of drought conditions earlier this year and the fact that winter feed is in short supply with little likelihood of any respite given colder conditions now preventing significant grass growth. The potential impact of the Government's moves to restrict land-use changes in the effort to improve water quality and biodiversity, and the impact of the coronavirus on demand and supply in international markets will also provide pain for the sector.

Despite some likely softening in international dairy product prices, the milk payout for the upcoming season (2020/21) might fall only a little further to around \$6/kg, still not bad by historical standards. Also reduced interest rates, and banks willing to support businesses (it is in no one's interest to see them go to the wall) could provide some relief to farmers, already saddled by high levels of debt.

The Global Dairy Trade (GDT) has shown some slippage as expected as the coronavirus pandemic rolls on although recent GDT prices have shown little real change (see below).

Change in GDT Price Index



Source: GDT

In summary, all the above factors are likely to impact on asset prices over time. Already, dairy land sales are down and some in the agricultural sector say it is almost impossible to sell dairy land, at least without a heavy discount, compared with in the recent past.

Other sectors, e.g. fishing, forestry, export education, tourism, air transport, and increasingly, the retail/accommodation sectors, are taking a pounding as border restrictions and general fear means travel plans go on hold. The Government's recent fiscal stimulus package is targeted at trying to ensure as many affected businesses as possible get through without having to lay-off staff or closedown completely.

As for consumer confidence, the worst has yet to come as job layoffs and reduced income streams start to bite.

But it is still relatively early days, and things are likely to get worse over the coming weeks as general economic concerns become more personalised and individuals and households are increasingly affected.

Retail and electronic sales have bounced back somewhat, as mentioned earlier, and an increased use of online shopping is likely as households look to alternative mechanisms for accessing goods and services.

1.4 Labour market – from high to low

Today's labour market will likely be significantly different this time next year. Some commentators suggest the unemployment rate could more than double from 4.2% in March 2020 to around 8.6% by June 2021 before starting to decline again thereafter (see below).

On the other hand, while job ads have continued to slow, this slowing down was occurring even before Covid-19 became a major issue in March.

Many sectors will face significant short-term job losses as border closures impact severely on certain sectors. As a result, unemployment is expected to rise significantly despite government efforts to cushion the blow through wage subsidies and initiatives targeted at keeping businesses afloat.

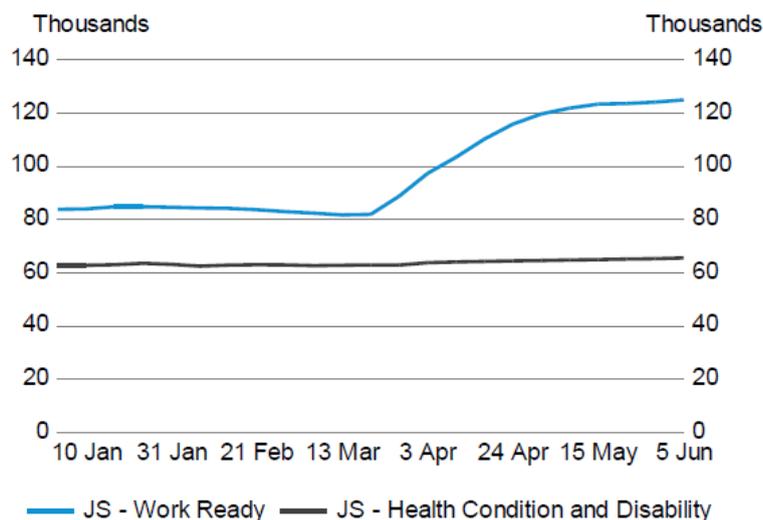
Tourism activity has taken a massive hit as international tourism effectively dried up overnight and the hospitality sector is now really feeling the pinch as, despite NZ moving to level 1, people have changed their social activity habits and many major sporting and cultural events have either been cancelled or put on hold for an extended period. On the positive side, it was great to see the recent domestic rugby competition get up and running and close to sell-out crowds enjoying our professional players back on the field.

Tourist towns (e.g. Queenstown and Rotorua) will be badly affected as Covid-19 is not a normal cyclical slow-down where businesses have some ability to adjust. Covid-19 has effectively blind-sided many businesses and the fallout in terms of house prices and rental accommodation is already showing itself in key tourism hotspots such as Queenstown. Reports of rental accommodation costs being halved and many houses being untenanted are now the norm.

Many businesses have already encouraged staff to work from home where practicable, increasingly observable from the reduced traffic on both roads and public transport. Central city businesses dependent on foot traffic are being severely affected and are likely to continue to be despite NZ now firmly back in level 1.

While numbers enrolling for the Job Seeker benefit have not been as high as initial enrolments would have suggested, it is important to understand that the wage subsidy scheme the Government introduced in March and subsequently extended will not last forever and there is at least anecdotal support for the notion that a number of employees are simply being kept on the pay-roll until the wage subsidy runs out. That there is much more pain to come on the job front will become increasingly evident over the next quarter as businesses face renewed pressure to restructure and reduce costs in order to survive. As can be seen from the graph below, the number of Work Ready Job Seekers has risen by over 40,000 (or around 50%) since Level 4 lock-down.

Job Seeker Support



Source: MSD

According to the latest Westpac-McDermott-Miller Employment Confidence Index, Employment Confidence fell 12.9 points in the June quarter to 87.3 – its lowest level since 2004.

The potential for relatively large-scale inward migration of ex-pats, particularly from Australia, could also significantly increase benefit numbers of coming months, given they are not entitled to social welfare support in Australia.

Migration policy continues to provide a headache for both policy makers and those caught up as migrants. The speed with which the lockdown was introduced meant many migrant workers had little time to get flights back home or secure accommodation and temporary financial support.

It is important that policy makers understand the contribution migrant employees make to the NZ economy and to specific sectors. Now is not the time to put up the shutters on skilled migration, as the NZ economy depends on the skills provided by a diverse and flexible migrant workforce that cannot, in many cases, be simply replaced by NZ citizens made redundant from their current employment. Now is not the time to throw the baby out with the bath water.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Jun 20	Jun 21	Jun 22
Highest	7.0	9.9	7.5
Average	6.3	8.6	6.8
Lowest	5.7	6.8	6.3

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – on hold

Forecasts below show labour cost increases are predicted to drift lower out to June 2022 (see below).

Recent increases up until the March 2020 reflect significant and continuing rises in the minimum wage, while settlements in the public sector (health, education, and police) put some upward pressure on labour costs overall.

Notwithstanding the above, the game has changed over recent weeks with significant labour-shedding likely, particularly in sectors most adversely affected by the continuing spread of the coronavirus. e.g. tourism, hospitality, and transport, particularly airlines. Labour costs are likely to remain flat, with minimal increases expected over the coming year.

Forecasts: Labour cost index percentage change (wages and salaries)

	Years Ending		
	Jun 20	Jun 21	Jun 22
Highest	2.3	1.3	1.9
Average	2.1	1.2	1.5
Lowest	2.0	1.0	0.9

Source: ASB, BNZ, Kiwibank and Westpac