BUSINESS NZ

PLANNING FORECAST

SEPTEMBER 2020

BusinessNZ

International conditions contribute uncertainty

Executive Summary

The impact of Covid-19 has been laid bare, with the Treasury's recent release of the Pre-election Economic and Fiscal Update (PREFU), along with Statistics NZ's release of official GDP figures for the June quarter, showing the economy tanking, with economic growth down a staggering 12.2 percent.

The GDP figures for the June quarter are not surprising, given that NZ was effectively in various stages of lockdown for almost the entire time.

While it is possible to put a positive spin on the latest PREFU results which were arguably better than expected, this was due in large part to a massive fiscal stimulus (around $50 billion) and accommodating monetary policy settings. But the effect of the lockdowns will last for many more years. Net government debt levels, around 19 percent of GDP at the start of this year, will go to around 50 percent of GDP over the next couple of years.

While NZ's response has been broadly in line with international best practice in terms of managing Covid-19, it seems unsustainable, both domestically and internationally, for the world to remain in various stages of lockdown with borders, beyond goods and some service movements, effectively cut off.

Some hard and politically difficult decisions will need to be made about managing the health effects of Covid-19 while minimising its adverse impact on the economy and people's overall economic and social well-being. Difficult and controversial, but important, issues must be resolved, such as those relating to the overall cost per life saved through various government support programmes and regulatory interventions.

There is still plenty of room to improve regulatory processes, including the impact of decision-making on the broader economy and on business confidence. Rapid, and in some cases, debatable regulatory interventions will not necessarily assist businesses with large sunk costs in making investment decisions. The quality of regulatory decision-making is still NZ's Achilles heel and an area where sizeable improvements should be made.

Notwithstanding, NZ has fared reasonably well by international standards. The Organisation for Economic Cooperation and Development (OECD) shows most developed countries taking a sizeable hit with a significant build-up of debt, making the eyes water when compared with what could be considered highly manageable debt levels in NZ to date.

Official statistical data has yet to show the magnitude of Covid-19's effect on particular sectors, and more broadly, on individuals and households dependent on employment. Responses from businesses so far have varied from effective decimation and closure through to fundamentally little or no change in behaviour.

In this respect, it is important to bear in mind short-term as opposed to long-term effects on households and communities. The short-term impacts have been cushioned to some extent by government initiatives such as wage subsidies and low-interest loans, helping firms stay in business and hopefully come out on the other side. But the fiscal stimulus injection is coming to an end and monetary policy targeted at low or even negative interest rate settings will not stimulate future investment unless businesses can achieve greater certainty. Also, the unintended consequences of such policies need to be clearly understood.

HIGHLIGHTS

NZ's economic growth, after diving in the June quarter (down 12.2 percent) as largely expected, is forecast to improve considerably in the out-years to September 2022 but will take some time to get back to current levels of output. Forecasts of economic growth or other indicators of economic health should be taken with a healthy grain of salt given heightened uncertainty will prevail for some time.

The BusinessNZ Economic Conditions Index, a measure of NZ's major economic indicators, sits at 8 for the September 2020 quarter, up 18 on the previous quarter and up 7 on a year ago. It was inevitable there would be a significant improvement over the September quarter as the economy came out of lock-down, albeit for a limited period before Auckland went into Level 3 lockdown on 12 August and the rest of the country into Level 2.

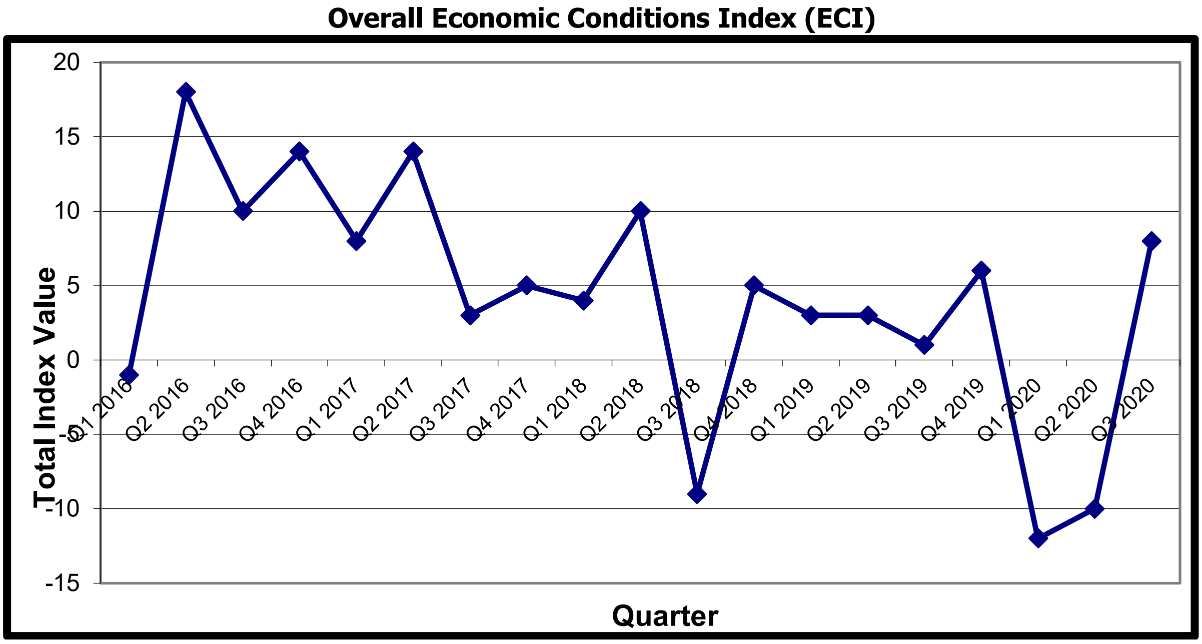
The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the Performance of Services Index (PSI) tanked over March, April and May, before starting on the road to recovery, although both surveys are showing yo-yo effects in line with changes to Covid-19 Alert levels. For August 2020, the PMI sat at 50.7 while the PSI sat at 46.9, hardly surprising given the restriction on social activities associated with Level 2/3 settings.

Despite all the concerns above, the NZ economy remains in relatively good shape compared with many other countries, and some of our key trading partners, such as China, have recovered somewhat - good news for exports, particularly agricultural commodities, where prices are holding up remarkably well.

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 8 for the September 2020 quarter, up 18 on the previous quarter and up 7 on a year ago. This significant improvement needs to be taken in the context of the economy taking a massive 12.2 percent drop in economic growth over the June 2020 quarter as a direct result of the Level 4 lockdown imposed in late March. It was inevitable there would be a significant improvement over the September quarter as the economy came out of lockdown, albeit for a limited period before Auckland went into Level 3 lockdown on 12 August and the rest of the country into Level 2. Auckland was still in Level 2 while the rest of the country was in Level 1 at the time this report was finalised[1]



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 5 for the September 2020 quarter, up 10 on the previous quarter and up 6 on a year ago. Trade flows and prices took a hit over the June quarter and have recovered somewhat since. Supply chains are starting to get back to some semblance of normality although the movement of people into and out of NZ is still very tightly controlled.

Monetary policy/pricing indicators sit at 5 for the September 2020 quarter, up 2 on the previous quarter and the same as a year ago. Interest rates are now at historic lows while pricing intentions remain downbeat. On the other hand, commodity prices, including dairy, are holding up well.

Business/consumer confidence indicators sit at 5 for the September 2020 quarter, up 8 on the previous quarter and up 6 on a year ago. Despite some recent increase, business confidence is still extremely low on the back of continued uncertainty, while consumer confidence remains downbeat on the back of rising unemployment.

Labour market indicators sit at -7 for the September 2020 quarter, down 2 on the previous quarter and down 8 on a year ago. Unemployment is starting to ramp up with increasing numbers enrolling for the Jobseeker benefit as the Government's initiatives, such as wage subsidies and assistance packages, run out. 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, while businesses are having extreme difficulty in securing skilled migrant labour on the back of essentially closed borders.

[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 September quarter 2020 are estimates based on available information to date.

<u>Note</u>: Given the very fluid international and to some extent domestic situation at present, the forecasts below, including with 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 the domestic scene continues to evolve over coming months.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING

1.1 Economic growth (GDP) – Slow hard slog

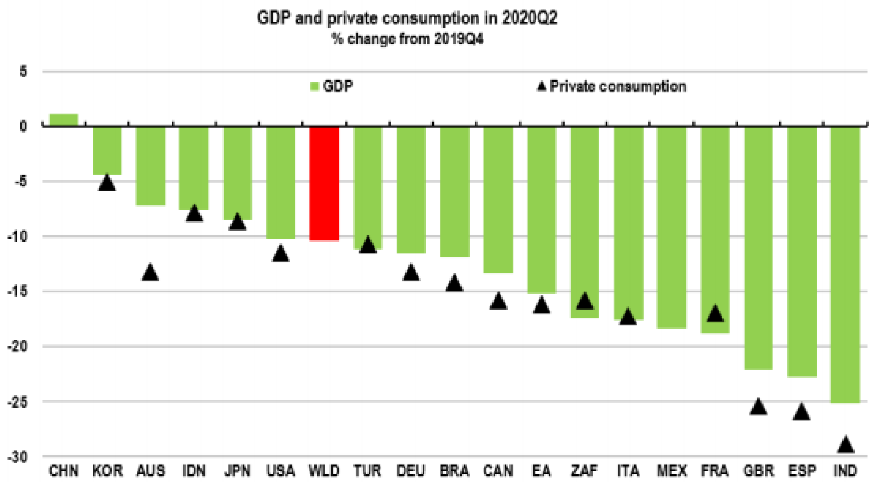
Forecasts out to September 2022 show that economic growth, after taking an early and massive hit, will improve to reach around 3.3 percent in the year ending September 2022 (see below).

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 weekly basis, their forecast scenarios in light of the continuing changes to Covid-19 Alert Levels and the still widespread impact of Covid-19 on international trade.

The latest New Zealand Institute of Economic Research (NZIER) forecasts for economic growth still show a wide-spread divergence of responses in respect to future economic growth, reflecting the large degree of uncertainty over the growth outlook. The most optimistic forecast for the economy is a decline in GDP of 5 percent on average for the year to March 2021, while the most pessimistic is a decline of 11.8 percent.

Internationally, Covid-19 continues to wreak havoc with multiple countries now going through second round effects.

The Organisation for Economic Cooperation and Development (OECD) in its recent OECD Interim Economic Assessment: Coronavirus: Living with Uncertainty (September 2020) found that global output collapsed in the first half of 2020, with declines in economic activity of more than one-fifth in some advanced and emerging-market economies (see Graph below).



Source: OECD

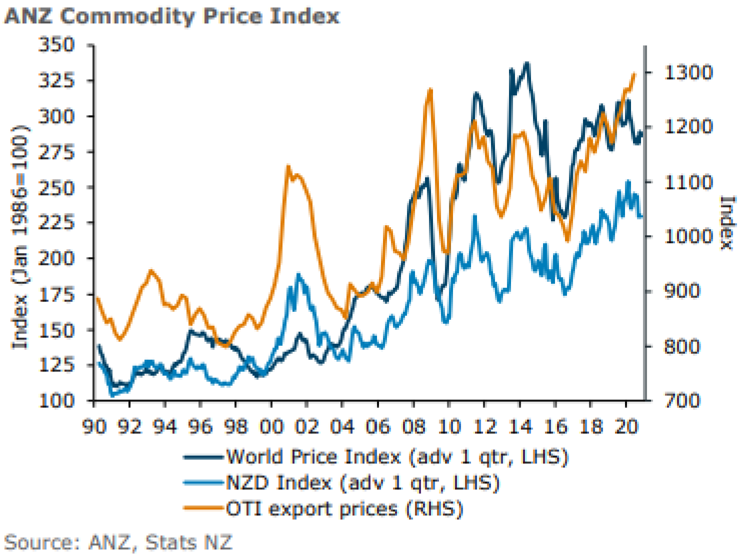
By way of comparison, New Zealand, suffered less severely than many countries with economic growth dropping to around 12 percent in June 2020 compared with the same quarter the previous year.

The OECD went on to say that without the prompt and effective policy support introduced in all economies, the contraction in output would have been substantially higher and that there is a need for fiscal, monetary and structural policy support to be maintained to preserve confidence and limit uncertainty.

Of note, the OECD emphasised the need for enhanced global cooperation to maintain open borders and the free flow of trade, investment and medical equipment to mitigate and suppress the virus in all parts of the world and speed up the economic recovery. Unfortunately, one of the adverse side-effects of the Covid-19 pandemic has been a move not only internationally, but to some extent domestically, to provide greater barriers to the free flow (subject to reasonable constraints) of resources to their most productive uses. Recent and proposed amendments to the Overseas Investment Act 2005 putting greater controls on foreigners investing in NZ are a case in point. While well-intentioned, they may simply make it harder for NZ to obtain capital to rebuild from the devastation caused by Covid-19.

While the OECD pointed out that a recovery is now underway following the easing of strict confinement measures and the re-opening of businesses, uncertainty remains high and confidence is still very fragile. The good news for NZ though is that the pickup in demand, particularly in China, has helped some commodity prices to remain firm and improve risk appetite in financial markets. This is particularly good news for NZ's agricultural production.

The latest ANZ Commodity Price Index shows that commodity prices have held up remarkably well, as can be seen from the graph below.

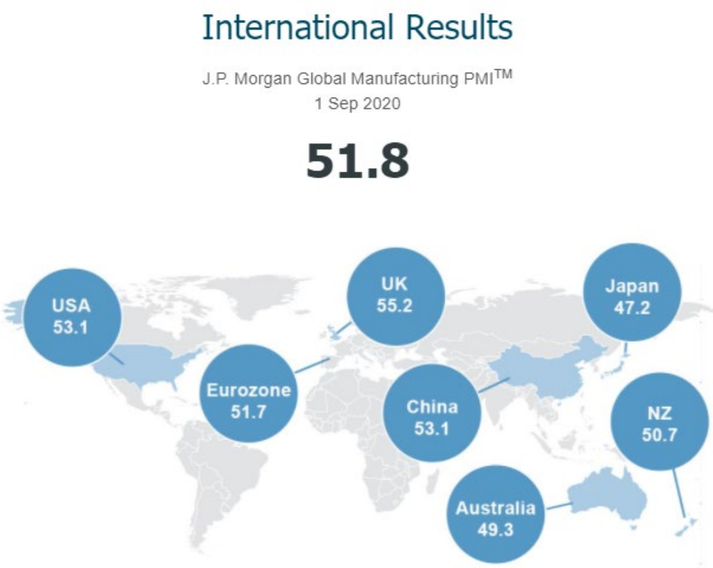


The ANZ World Commodity Price Index eased 0.9 percent in August as lower dairy prices were partially offset by stronger prices for meat and aluminum.

When converted into $NZ, the index fell just 0.2 percent as the NZD weakened by 1.3 percent on a Trade Weighted Index (TWI) basis during August. The NZD strengthened against the USD but weakened against other major currencies.

While there were slight changes in the prices for meat, fibre, horticulture and forestry, the stand-out commodity of the month was aluminum, with prices up 5.6 percent. China, usually a net exporter, has been importing more aluminum as global prices have been cheaper than the prices in their local markets. Obviously, this also reflects the fact the China's manufacturing sector is recovering more quickly than that of other countries.

The latest J.P Morgan Global Manufacturing PMI (Performance of Manufacturing Index) shows the tentative recovery now apparent in several countries after the devastation evident in the initial stages of the global lockdown. Notwithstanding, it is important to understand that given the hammering global manufacturing production took over the first and more importantly, second quarter of 2020, some upswing would be almost inevitable – coming off such a low base.



It is of great significance for NZ that combined, China and Australia account for around 40 percent of its trade. NZ is therefore heavily reliant on the fortunes of both China and Australia. While Australia still has some issues with the spread of Covid-19, particularly in Victoria, it is pleasing that very recent data suggests Victoria's partial lockdown is seeing Covid-19 cases being bought under control. Nonetheless, it seems the idea of a trans-Tasman border remains on the backburner for now and a significant degree of water must flow under the bridge before it becomes a reality.

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 globally and the resultant monetary policy stimulus.

With interest rates close to zero around the globe and the world awash with capital looking for a home, it is not surprising that in many countries, including NZ, stock markets have now regained most, if not all, the short term losses resulting from the onset of Covid-19 in Feb/March.

While the NZX is currently down around 4 percent on its highs (and at the height of Covid-19 in NZ late March was down 27 percent), it is still currently around 6 percent higher than it was a year ago.

NZX50 Index

Source: NZX

Share market 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 buyers are flocking back to equities. Governments around the world have pumped $billions into their respective economies and this has helped to rebuild some semblance of confidence.

Unfortunately for NZ, the fallout from Covid-19 is yet to come. Just about all the key economic indicators - employment growth, unemployment, business confidence and investment – are looking gloomy. Meanwhile, the Government's books have taken a pounding as far as the eye can see.

The recent Treasury release of the Pre-election Economic and Fiscal Update makes for sober reading. Key indicators are generally heading south while debt levels ramp up by the day. While it is possible to put a positive spin on the latest PREFU results in that they are arguably better than expected - due in large part to the massive fiscal stimulus (around $50 billion) and accommodating monetary policy settings - their impact will last for a number of years. Net Government debt levels will go from around 19 percent of GDP at the start of this year to around 50 percent of GDP by 2022. See below for a Summary of the PREFU numbers.

June years	2019 Actual	2020 Forecast[1]	2021 Forecast	2022 Forecast	2023 Forecast	2024 Forecast
Real production GDP (annual average % change)	2.8	-3.1	-0.5	3.6	3.9	4.1
Unemployment rate (June quarter)	4.0	4.0	7.7	7.6	6.6	5.3
CPI inflation (annual % change)	1.7	1.5	1.2	1.2	1.4	1.9
Current account (annual, % of GDP)	-3.4	-2.4	-5.1	-5.2	-4.1	-3.8
Fiscal measures ($billions)						
Core Crown tax revenue	86.5	84.9	84.7	84.3	92.5	98.5
Core Crown expenses	87.0	108.8	119.5	109.9	111.7	116.1
Total Crown operating balance before gains and losses	7.4	-23.4	-31.7	-22.1	-14.2	-12.4
Core Crown residual cash	-0.7	-23.7	-41.0	-28.6	-22.3	-18.9
Net core Crown debt	57.7	83.4	130.2	160.1	182.2	201.1
as a percentage of GDP	*19.0%*	*27.6%*	*43.0%*	*49.9%*	*53.5%*	*55.3%*
Net worth	143.3	115.7	80.4	60.6	50.9	43.5

Source: The Treasury PREFU

The Government's debt level has increased massively over a short space of time but by international standards it still sits below just about that of all other developed countries.

The International Monetary Fund (IMF) suggests that Australia's government debt is around 57 percent of GDP, Europe's is sitting at over 100 percent and the United States' at around 140 percent. At the far end of the spectrum is Japan, which has consistently had government debt of more than 200 percent for many years.

While many argue that serviceability of debt is not a problem with interest rates so low, increasing government (and household) debt can become an issue.

As a small, open economy, with a number of potential risks, it is desirable for NZ to have relatively low levels of debt to deal with potential issues such as the current global pandemic, earthquakes etc. which have come our way over recent times and which have required very significant fiscal policy responses.

The PREFU forecasts the unemployment rate to peak at 7.7 percent next year, below the double-digit figures once projected, but worse than at any period since 1998. Economic growth is predicted to drop by 3.1 percent this year, and by a further 0.5 percent next year, with a subsequent return to growth in 2022.

It is key, when looking at the PREFU, to understand the potential broad outcomes associated with different scenarios. The main forecasts project no more than about four weeks at Covid-19 alert levels 2 and 3 after this quarter, that border restrictions will end at the start of 2022, and that some limited increase in visitor entry will be permitted from mid-2021. If these outcomes do not eventuate, the potential for risk could be on the downside.

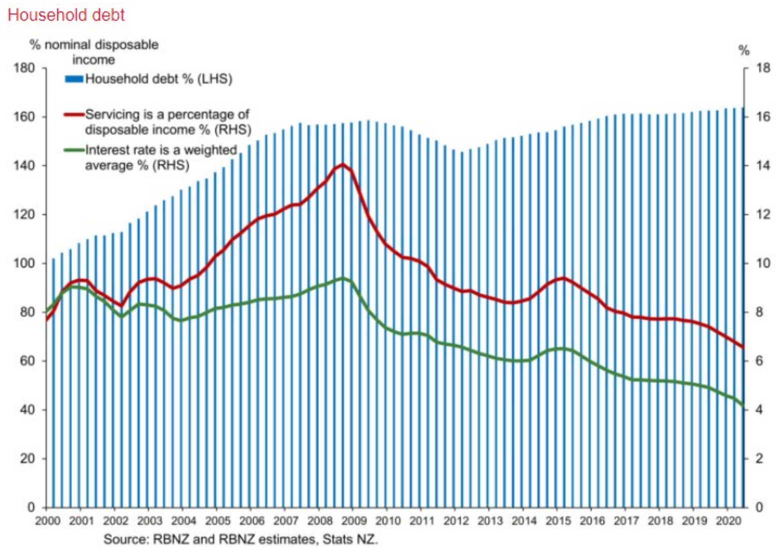
While NZ's response has been broadly in line with so-called international best practice in terms of managing Covid-19, it is arguably unsustainable, both domestically and internationally, for the world to remain in various stages of lockdown with border flows beyond goods and some services, effectively cut off.

Closed borders for long periods of time have huge implications for employment levels in NZ, although it is equally acknowledged that inefficient and ineffective border processes have the potential for greater community transmission.

Some hard and politically difficult decisions will need to be made between managing health effects while minimising adverse impacts on the economy and people's economic and social well-being. This will involve a controversial but necessary discussion of issues such as the valuation of life. Intervention generally comes at a cost and trade-offs will be needed to determine where the best return from resources can be found.

In this respect, it is important to bear in mind the short-term as opposed to long-term effects on households and communities. The short-term impacts have been cushioned to some extent by government initiatives such as wage subsidies and low interest loans hopefully helping businesses over the short-term to come out on the other side. The difficulty is that the fiscal stimulus injection is coming to an end while monetary policy targeted at low or even negative interest rate settings will not stimulate future investment without greater certainty for business. Also, the unintended consequences of such policies need to be clearly understood.

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 well over two decades, as shown by the graph below.



In relation to agricultural debt and the relatively large percentages of farm debt related to dairy (although commodity prices are still at satisfactory levels, given current circumstances), there is the potential for recent government interventions - to regulate water quality and restrict land-use changes, for example - to add to the banks' nervousness about lending further to this sector.

While many forecasters initially thought Covid-19 would impact adversely on housing prices, over the short-term, there has been little real effect – in fact, prices have gone up, something which in normal circumstances would defy logic. However, we are not in normal times.

Several factors are currently driving up house prices, but the question remains will this effect last?

Factors acting to positively drive up prices include:

- Restrictions on lending temporally removed e.g. Loan-to-Value ratios (LFR).
- Mortgage interest rates (particularly fixed) at the lowest level they have been for 50 years.
- Low returns from bank deposit rates encouraging households and investors to look at alternatives for potentially higher returns e.g. shares and property.
- NZers returning from overseas who may be looking for a home for their capital.
- Large fiscal support measures from government (including the availability of low interest loans).

On the flip side, there are reasons to be cautious:

- The impact of the biggest Government fiscal stimulus and support for households and businesses is still flowing through the system. Once the stimulus ends, will some businesses be able to continue and will many of their employees still be employed? (Some surveys have suggested that around 200,000 employees expect the chance of their job being disestablished in the next couple of years is very high).
- NZ's borders are effectively closed with net migration currently flowing at a trickle. There is no certainty that the borders will reopen as fast as Treasury's PREFU predicts.
- The development of vaccines to deal effectively with Covid-19 (without unintended side effects) still seems some way off.
- The impact of rising unemployment has yet to filter through into mortgagee sales with the Reserve Bank suggesting that under dire circumstances where unemployment increases well into double figures, the impact on house price falls could be very traumatic.
- The Government's recent firming up of controls on landlords that may encourage some to exit the market as things get all "too hard" to manage.
- The number of people taking mortgage holidays. This is concerning as it will come back to bite them down the track as a result of accumulating interest costs. Reality will bite when repayment must be made or alternatively, assets sold to reduce liabilities. There is no free lunch here.
- A house is largely a redundant asset unless it can be rented out to tenants and/or there are significant capital gains to be made due to special location or other desirable factors.
- And finally, the big issue of uncertainty which can be either a positive or negative in respect to people's decision-making.

At this stage in the recovery process there are both strong arguments for supporting continued house price growth and equally strong arguments for supporting an easing of prices over the next couple of years.

One perhaps unintended consequence of having historically low interest rates and plentiful capital looking for a home is that the gap between the "haves" and "have nots" will likely increase as asset prices are forced up. This is unfortunate for those who want to obtain a first home and get on the housing ladder.

Forecasts: Real GDP percent Growth

	Years Ending		
	Sep 20	Sep 21	Sep 22
Highest	-2.9	4.2	4.3
Average	-3.6	1.6	3.3
Lowest	-4.0	-0.9	1.1

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Monetary Policy – loosening continues

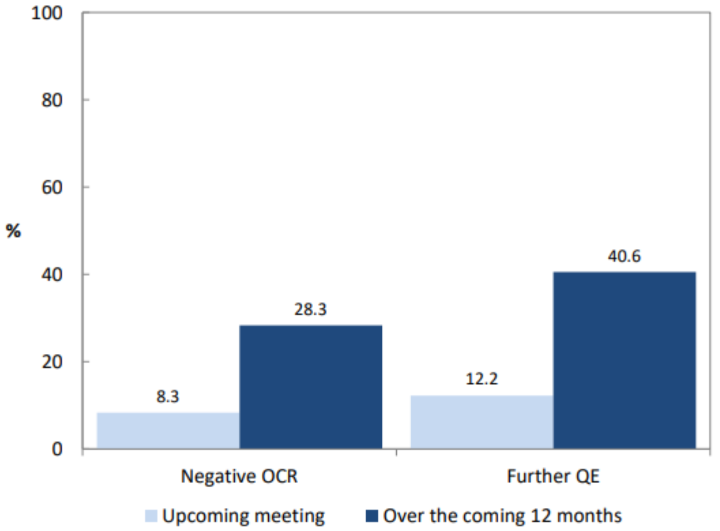
Over the last six months the Reserve Bank has made significant changes to monetary policy settings to ensure the NZ financial system remains in a solid position to weather both the significant economic impact of Covid-19 and to support NZ's recovery. Taking the slasher to the Official Cash Rate (OCR), 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. Quantitative easing is now a significant part of the Reserve Bank's weaponry in its attempt to keep interest rates at historic lows.

The question still remains as to whether the Reserve Bank will drop the OCR further to zero (or below) although there are conflicting opinions as to the merit of such a decision, including amongst members of the New Zealand Institute of Research's (NZIER) Shadow Board.

The NZIER is continuing to seek its Shadow Board's view on whether the OCR should be negative and if the Reserve Bank should expand its quantitative easing programme.

Fewer board members see further quantitative easing as appropriate over the coming year given the Reserve Bank expanded its Large-Scale Asset Purchases (LSAP) programme up to $100 million at the August meeting.

Figure 1 Fewer *Shadow Board* members think further QE is required
(% strength of policy preference on what the RBNZ should do for each monetary policy tool)



Source: NZIER *Monetary Policy Shadow Board*

The Reserve Bank continues to indicate in its most recent review that it is actively preparing to introduce a negative OCR and a Funding for Lending programme if required. Nonetheless, some Shadow Board members continue to highlight their scepticism about the effectiveness of a negative OCR in stimulating the economy.

Interest Rates – lower still

As expected, the earlier move by the Reserve Bank to lower the OCR has flowed through into reduced mortgage costs for households and businesses. The possibility is for fixed rate mortgages to reduce even further if the Reserve Bank lowers the OCR into negative territory next year, as several commentators are predicting. As a result, the 90-day bill rate is forecast to fall and go into negative territory by September next year (see below).

Interest rates have certainly declined but 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 ever been), 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.

Interest payments from bank deposits are often used to supplement income for those in their later years but current low interest rates mean many people will now have to eat into capital or try less conventional policies, such as reverse mortgages, to supplement income flows. There has often been an aversion by many elderly people to enter into reverse mortgages, despite such mortgages allowing money to be freed up, particularly for asset rich but income poor households.

Low interest rates can also 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 more than fully-funded to a situation where current assets are considered to be falling well short of what is needed to deliver on future liabilities. What government has effectively done will likely see employers (in respect to work accidents), earners (in respect to non-work accidents) and motorists (in respect to Motor Vehicle Accidents) facing a significant increase in levies, or a permanent change in ACC's funding policy will be required.

Low interest rates may also encourage greater premium-smoothing over ACC accounts to allow for potential interest rate fluctuations, although smoothing premiums also comes with its own set of problems, including less transparency in sending signals about the actual cost of accident claims over particular periods.

Forecasts: Interest Rates (90-day bills)

	Years ending		
	Sep 20	Sep 21	Sep 22
Highest	0.3	0.0	0.0
Average	0.3	-0.3	-0.2
Lowest	0.3	-0.5	-0.5

Source: ASB, BNZ, Kiwibank and Westpac

The NZ dollar – steady does it

The NZ dollar fell earlier this year as the Reserve Bank unleashed a substantial amount of stimulus on the economy in the form of quantitative easing, also indicating the potential for the OCR to head into negative territory next year. However, in general, the NZ dollar has strengthened against the US dollar over the last six months, while dropping against the Australian dollar, although this has changed of late.

Picking where the NZ dollar might go is fraught with uncertainty given current international circumstances, with the relatively wide difference in forecasts outlined below. Nevertheless, on average, the TWI is generally forecast to remain relatively stable out to September 2022.

NZ is likely to be protected from any wild swings in the dollar due to our transparent and open monetary policy framework and, to date, sound fiscal policy settings.

Forecasts: Exchange Rates

	AUD (cents)		
	Sep 20	Sep 21	Sep 22
Highest	0.92	0.95	0.92
Average	0.91	0.89	0.89
Lowest	0.90	0.85	0.86

	USD (cents)		
	Sep 20	Sep 21	Sep 22
Highest	0.67	0.69	0.72
Average	0.67	0.67	0.69
Lowest	0.66	0.63	0.66

	TWI		
	Sep 20	Sep 21	Sep 22
Highest	72.5	71.6	73.8
Average	71.3	70.1	71.3
Lowest	69.6	67.5	67.7

Source: ASB, BNZ, Kiwibank and Westpac

Inflation – downside risks

Inflation as measured by the Consumers' Price Index is likely to remain within the Reserve Bank's target band of 1-3 percent out to September 2022, although there is a risk it might breach the downside limit of 1 percent over the short-term (see below).

NZIER consensus expectations indicate some uncertainty over the inflation outlook, although on average, annual inflation is expected to ease over the coming year to trough at 0.4 percent for the year to March 2021.

Beyond that, the expectation is for annual inflation to pick up briefly but generally track around the bottom of the Reserve Bank's target band.

This suggest Covid-19 is expected to have a longer and more persistent effect on consumer and household confidence despite the massive fiscal stimulus packages government has introduced over the past 6 months.

But it is not all doom and gloom in respect to inflation expectations, with world commodity prices holding up reasonably well as outlined earlier and housing prices not falling to the extent many had expected – yet.

Forecasts: Percent Change in Inflation (CPI)

	Years Ending		
	Sep 20	Sep 21	Sep 22
Highest	1.8	1.1	1.6
Average	1.5	0.8	1.4
Lowest	1.3	0.3	1.1

Source: ASB, BNZ, Kiwibank and Westpac

1.2 Business activity and confidence – generally down but a mixed bag across sectors

Recent surveys of business activity confidence make for sober reading although here, too, it is not all doom and gloom with some sectors including agriculture proving relatively resilient, while others, such as tourism and hospitality, continue to face a highly uncertain future with border closures and internal lockdowns weighing heavily on their ability to open up for business. While tourism regions such as Queenstown and Rotorua have held out for increased domestic tourism, the major providers of high-end tourism generally reside with overseas tourists. As a result, prices and hence profit margins, have been severely squeezed in regions heavily reliant on overseas tourism as a major component of their economic well-being.

Air NZ has come to the party by offering significant low fares and an increased number of flights over the current school holiday period. But while some Queenstown hospitality operators report they are holding out for a successful school holidays spend-up, a couple of weeks is small-fry when operators are so dependent on international tourists for their livelihood. Continued border closures are going to be the death of some tourism regions unless the Government is prepared to look at innovative and relatively cost-effective ways of getting more people into NZ. Closed borders are not a successful strategy beyond the very short-term.

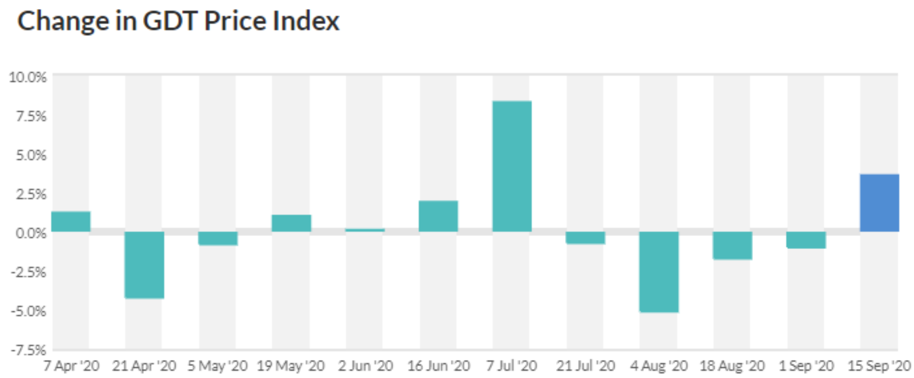
Probably the best indicator of how specific sectors are faring is the June quarter GDP. Although now 3 months old, this provides a useful overview of which sectors are being hit hardest.

On the positive side of the ledger, primary production experienced the smallest decline, with agriculture showing a very small drop for the quarter. On the other side, some big hitters faced a considerable downturn e.g. transport, retail and accommodation, and construction faced big drops in output, not surprising given that the June quarter coincided with a significant period where NZ was in Level 4 lockdown.

While the agricultural sector outlook is still reasonably positive, particularly in respect to international commodity prices, it still faces some headwinds, particularly in terms of greater environmental obligations and regulations which have received mixed responses from those likely to be affected. To its credit, the Government is said to be willing to look at specific instances where recent water quality standard obligations may be unreasonable and to show some flexibility in its approach.

Despite some likely softening in international dairy product prices, Fonterra has recently announced the final milk payout for the season 2019/20 season as a healthy $7.14 but with a reduced payout for the 2020/21 season. Fonterra's current forecast milk price ranges from $5.90-$6.90 - still not bad by historical standards.

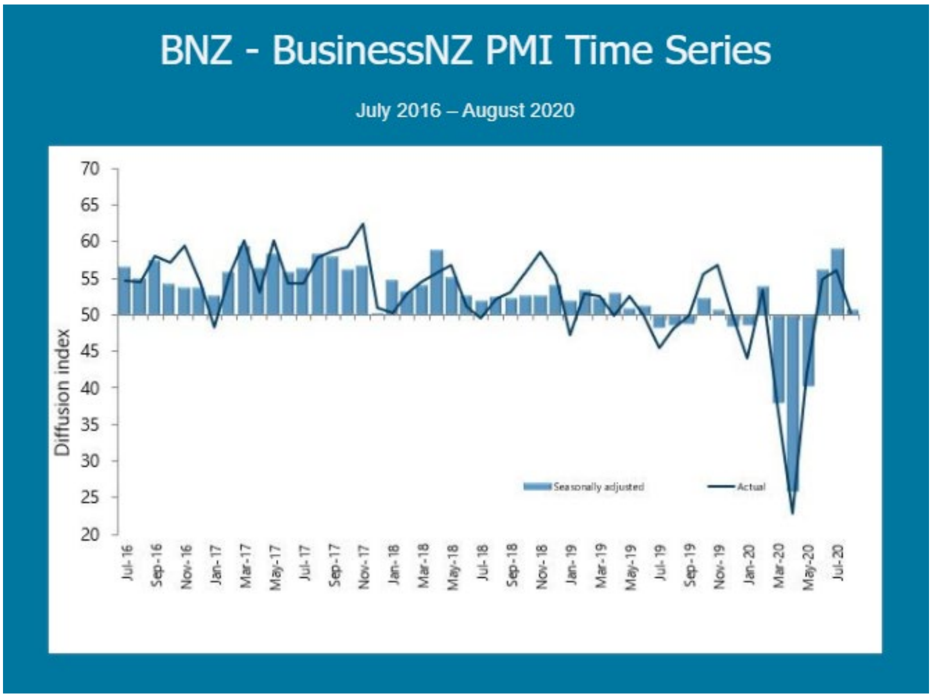
The Global Dairy Trade (GDT) has shown some slippage, to be expected as the pandemic rolls on, although the most recent trade on 15 September 2020 showed some improvement (see below).



Source: GDT

The manufacturing and services sectors are showing some signs of recovery after the depths reached in March, April and May, coinciding with a period when NZ was in Level 4 lockdown. However, it needs to be emphasised it was inevitable that improvements would be evident as NZ came out of lockdown and consequently recent results need to be put in context and are clearly not results that provide for overwhelming future confidence.

The seasonally adjusted BNZ – BusinessNZ Performance of Manufacturing Index (PMI) for August 2020 was 50.7 (a PMI reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining). This was down 8.3 points from July, and the lowest result since May. The Auckland lockdown has obviously had a strong influence on the latest results.



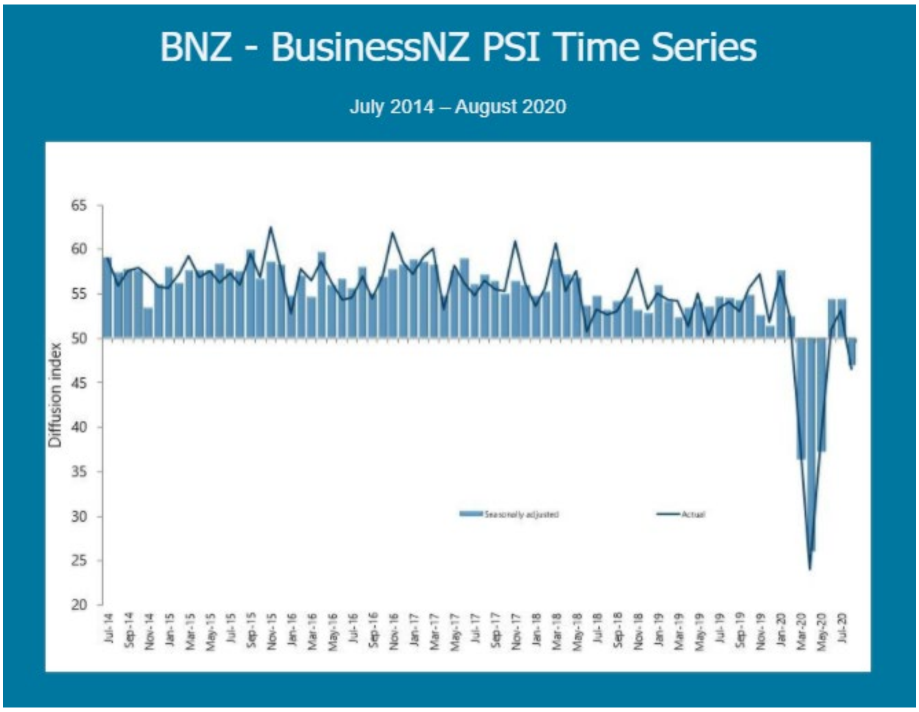
After two months of playing catch-up, the Level 3 lockdown placed on NZ's largest population centre and economic region ensured the sector would experience another hit. While results in other parts of the country allowed the national result to keep its head above water, the latest results show how fragile and short the recovery might be.

The key indices of new orders (54.0) and production (51.1) remained positive but employment (49.0) stayed in contraction for the sixth consecutive month.

Notwithstanding the above, an outcome above the 50 breakeven mark - indicating a modicum of growth occurred in the month – is arguably a commendable result given more than a third of the country moved into Level 3 for over half the month.

Meanwhile, activity in NZ's services sector dropped off in August, after showing some recovery in the previous two months, according to the BNZ-BusinessNZ Performance of Services Index (PSI).

The PSI for August was 46.9, which was down 7.5 points from July (A PSI reading above 50.0 indicates that the service sector is generally expanding; below 50.0 that it is declining). Unlike its sister survey for the manufacturing sector, the PSI returned to negative territory on the back of the Level 3 lockdown in the Auckland region.



The lockdown was felt throughout the country, as no region managed to show expansion during August. Barring a further outbreak in a major region, we would hope the sector gets well and truly back into expansion for the last quarter of 2020.

Notwithstanding the above, the ANZ New Zealand Business Outlook (Preliminary data for September 2020) suggests that firms have largely looked through the re-emergence of Covid-19 in the community.

While many activity indicators are at their highest level since February, they are still in the cellar compared with pre-Covid-19 days.

Business confidence lifted 16 points to -26 percent, while businesses' own activity lifted 8 points to -10 percent – still not great readings.

ANZ New Zealand Business Outlook – Preliminary data for September 2020

Source: ANZ

As for consumer confidence, the worst has yet to come with job layoffs and reduced income streams about to bite as wage subsides and other support measures come to their end of life.

It is still relatively early days. Things are likely to get worse over the coming months as general economic concerns become more personalised and individuals and households are increasingly affected.

Rising unemployment and reduced employment opportunities will have a dampening effect on wages, while broader levels of income flows will also likely constrain household budgets over the medium term.

1.4 Labour market – further pain to come

The fall-out associated with Covid-19 and hard lockdowns, including border closures, has yet to manifest itself in official unemployment figures. In the grand scheme of things, the Household Labour Force Survey (HLFS) for the June quarter was an outlier, seeing official unemployment (as measured by the HLFS) actually falling to 4.0 percent despite NZ being effectively in various stages of lockdown throughout this period.

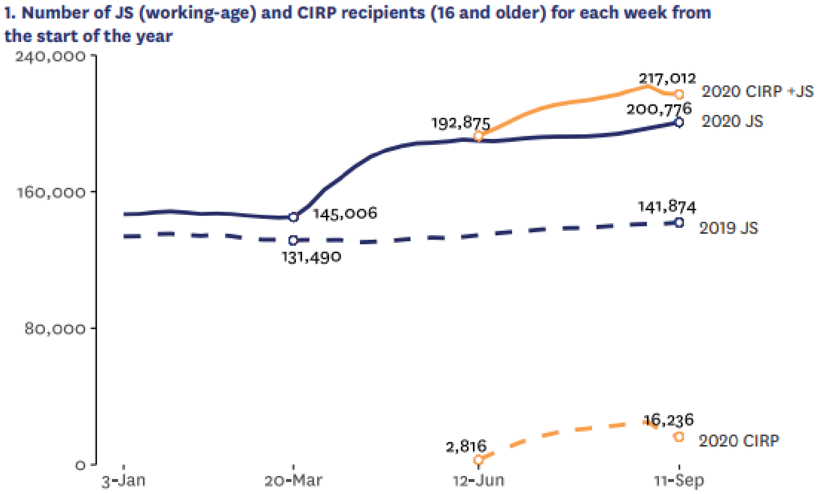
Without getting into the technical detail, essentially the number of people considered to be ready and available for work was substantially reduced during the lockdown phase. This provided for some interesting headlines but - although technically correct - a misleading picture for many people who just look at the headline figures.

Forecasts (see below) show the real impacts have yet to be reflected in official figures, with official unemployment likely to double from around 4 percent at the start of the year to peak at around 7.5 percent by this time next year.

The Government correctly and rapidly tried to ensure employees could remain attached to a business operation to the extent possible during earlier lockdowns by providing wage subsidies and other assistance measures to businesses directly, e.g. low interest loans. This has not been without cost with around $14 billion flowing through to keep employees working in the hope of ensuring businesses could get up and running as soon as possible after the various stages of lockdown - the appropriate response at the time.

However, the impact of wage subsidies, while positive for ensuring staff retention over the short-term, is now wearing off as the subsidies come to an end. Businesses must now make the hard decision whether to try to continue as normal, restructure their operations and provide different offerings to customers in order to survive, or close, either temporarily or permanently.

Numbers enrolling for the Job Seeker benefit have continued to increase and there will be more to come since the Government's wage subsidy scheme, introduced in March and subsequently extended, will not last forever. There is at least anecdotal support for the notion that many employees were simply 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 year as businesses face renewed pressure to restructure and reduce costs to survive. As can be seen from the graph below, the number of Job Seekers (and CIRP) has risen by over 70,000 (or around 50%) since NZ went into Level 4 lockdown in late March.



Source: MSD

Many sectors will face significant short-term job losses as border closures impact on them severely.

Tourism activity has taken a massive hit with international tourism effectively drying up overnight and the hospitality sector is now really feeling the pinch as NZ has yo-yoed out of various levels. 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 again, off again is currently the name of the game.

Tourist towns (e.g. Queenstown and Rotorua) have been 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. Encouraging domestic tourism and increased movement during school holidays is no substitute for international tourists, who often have much deeper pockets.

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. Net migration has effectively reduced to a trickle, affecting the ability of many seasonal operations, dependent on foreign sourced labour, to operate as effectively and efficiently as in the past. Flow-on effects for other businesses down the supply chain – e.g. transport, port operations and the like, will likely be very real.

There is a strong case for greater investment in effective border protection measures allowing greater numbers of people to come into NZ and quarantine for appropriate periods of time before being released into the community.

This would make NZ a desirable place for individuals to come to given our relatively Covid-free environment.

At least 4 distinct groups could fall into this category.

- Kiwis returning from overseas
- International students
- Skilled migrants
- Overseas people willing and able to reside in NZ while working remotely for overseas companies.

All these groups would add to the demand for goods and services and provide a very useful boost to consumption for very little cost to the NZ taxpayer, provided group members paid for their managed isolation and any appropriate bond that might be required to ensure they did not become a burden on the taxpayer.

It is important for policy makers to 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. These cannot, in many, if not most, cases, be simply replaced by NZ citizens made redundant from their current employment.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Sep 20	Sep 21	Sep 22
Highest	6.5	8.1	6.7
Average	6.4	7.5	6.1
Lowest	6.2	6.6	5.6

Source: ASB, BNZ, Kiwibank and Westpac

Labour Costs – on hold

Forecasts below show labour cost increases predicted to drift lower over the near term (see below).

Increases last year and earlier this year reflected to some extent 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 massively over recent months with significant labour-shedding, particularly in sectors most adversely affected by border closures such as tourism and hospitality, and associated industry sectors such as transport. As a result, labour costs are likely to remain flat, with minimal increases expected over the coming year.

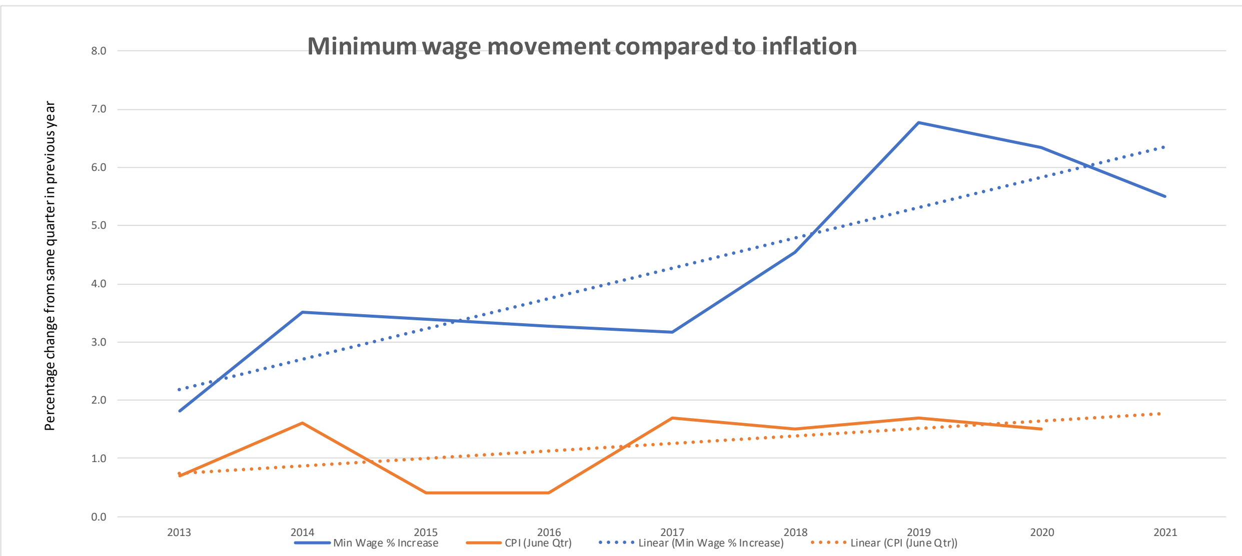
it is somewhat concerning that the Government continues to contemplate increasing the minimum wage at a time when thousands of jobs are being disestablished and businesses are struggling to keep their heads above water. Increasing the minimum wage further does not take into consideration the plight of, particularly small, businesses already hard hit by this year's $1.20 per hour increase at the beginning of lockdown.

Currently at 59 percent of the average wage, NZ's minimum wage is already the highest in the developed world.

Some International Comparisons

Minimum Wage by Country	**Against Average Wage**	**Against Median Wage**
NZ	59%	70%
Australia	54%	54%
UK	46%	55%
Canada	45%	51%
Germany	43%	48%
US	22%	32%

The minimum wage, and wages set as a consequence of movements in the minimum wage, are most often associated with hourly paid work. Such jobs also correlate most strongly with the manufacturing, produce, retail, hospitality, services and tourism sectors, the very jobs that will be the backbone of economic recovery from Covid-19.



Source: StatsNZ, BusinessNZ

In 2016, the average annual wage was around $56,600 ($27.13/hr) and the median wage, $48,180 ($23.10)[1]. The present minimum wage of $18.90 is equivalent to an annual wage of $39,425. Currently the minimum wage is at 70% of the median wage. In setting the minimum wage so close to the median wage the Government is in fact arbitrarily, both directly and indirectly, setting the wages of nearly half of all wage and salary earners.

This effectively drives costs higher without recognising underlying inflation or underlying labour market conditions.

Paradoxically, the benefits of a significant increase in lower wages will not be fully realised by employees since many in this earnings bracket also receive Working for Families and other government assistance which abates as wages rise.

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

	Years Ending		
	Sep 20	Sep 21	Sep 22
Highest	1.8	1.3	2.0
Average	1.6	1.2	1.6
Lowest	1.4	1.1	0.9

Source: ASB, BNZ, Kiwibank and Westpac

[1] Source: Statistics NZ. Rounded up figures based on a 40-hour week.