Setting a fiscal strategy under uncertainty

Summary

This note examines three approaches to setting a fiscal strategy under three alternative economic scenarios. The three economic scenarios encompass the preliminary BEFU 2009 forecasts and two alternatives – one with some gain in GDP compared to the preliminary BEFU case, and the other with a large permanent loss of GDP. A permanent loss of real GDP would involve a situation where the economy shifts to lower levels of labour and/or capital utilisation, loses skills from a prolonged period of unemployment, and/or shifts from high productivity activities to lower ones. The three fiscal approaches include a "wait-and-see" option and two options for fiscal consolidation. For each of the nine combinations of fiscal approach and economic scenario we apply a set of criteria that relate to: external financing; impact on aggregate demand; and least regrets considerations. Tracing through the criteria and how they change in shifting across the economic scenarios:

- There is unlikely to be a case for adopting a wait-and-see approach – the first of the two consolidation options applied under the main economic scenario sees gross debt peak at around 45% of GDP (before trending down to 40% by 2023).

- Under a more favourable, but less likely economic scenario, a wait-and-see approach generates on-going deficits with gross debt around 65% of GDP toward the end of the projection horizon.

- The balance of risks across the economic scenarios argues against adopting a wait-and-see approach. There is a possibility that a modest fiscal consolidation may have to be adjusted upward through time.

- Compared to a wait-and-see approach, the first consolidation option will enhance credibility, especially if it includes actions starting in Budget 2009, where these actions start with those that minimise aggregate demand effects. In turn this fiscal approach reduces the risks to external financing and cost of borrowing.

- The degree of contractionary impulse on aggregate demand is subject to the speed and composition of the consolidation.

- It is possible to start with options that begin to consolidate the fiscal position while reducing contractionary effects. Some options can minimise contractionary effects but differ in their fiscal implications. For example, suspending contributions to the NZS Fund reduces the borrowing requirement (and so gross debt) and has little impact on aggregate demand. However, the lower path of gross debt is associated with a reduced path of financial assets so that "net debt with NZS Fund" is unchanged. Relative to a mix of expenses and revenue changes this option could be perceived as a less credible fiscal consolidation. In contrast, reducing contributions to KiwiSaver, ODA or MFAT international costs would likely have limited impact on demand but would also reduce gross debt and all specifications of net debt.

- The second (larger) consolidation option applied under the main economic scenario sees gross debt peak at around 41% of GDP before trending down to about 23% of GDP by 2023. This scenario is consistent with achieving previous goals of partial pre-funding (in terms of the overall net financial asset position) ahead of major demographic change.

- The IMF is forecasting public debt ratios over the next few years to increase by around 30% of GDP in large countries that have been significantly affected by the financial sector crisis (eg, US and UK) and by around 15% of GDP across the smaller Euro countries. Using the *increase* across smaller countries as a benchmark would suggest targeting a debt ratio for New Zealand below 40% of GDP. The nature of stimulus packages and medium-term fiscal plans means that in some countries debt-to-GDP stabilises and even begins to decline. The more structural nature of changes in New Zealand's fiscal balance sees a more sustained increase in the debt ratio.

- The second consolidation option reduces the prospect of having to do more should the economic outlook deteriorate further. It enhances credibility relative to a more modest approach. Subject to the composition of the consolidation, there may be contractionary effects on aggregate demand, especially in the near term. Although contractionary effects are likely to increase as the aggregate demand neutral options are exhausted, monetary policy settings will (all else equal) be easier than otherwise.

On balance this suggests a fiscal consolidation that:

- Is conditional on monitoring the path of the economy (ie, potential shifts between state of the world) and setting milestones for fiscal consolidation.

- Is open to the prospect of using a mix of options across expenses, capital (including NZSF contributions) and revenue. Having a list of options that weighs up the contractionary impact (especially in 2010), longer term growth impact, and contribution to government goals, will provide flexibility to review the speed and extent of consolidation.

- Recognises that starting with some initial decisions now, albeit with conditionality around the future path, is likely to enhance credibility more than announcements and future implementation, even if the latter option involves a larger fiscal consolidation.

Analysis

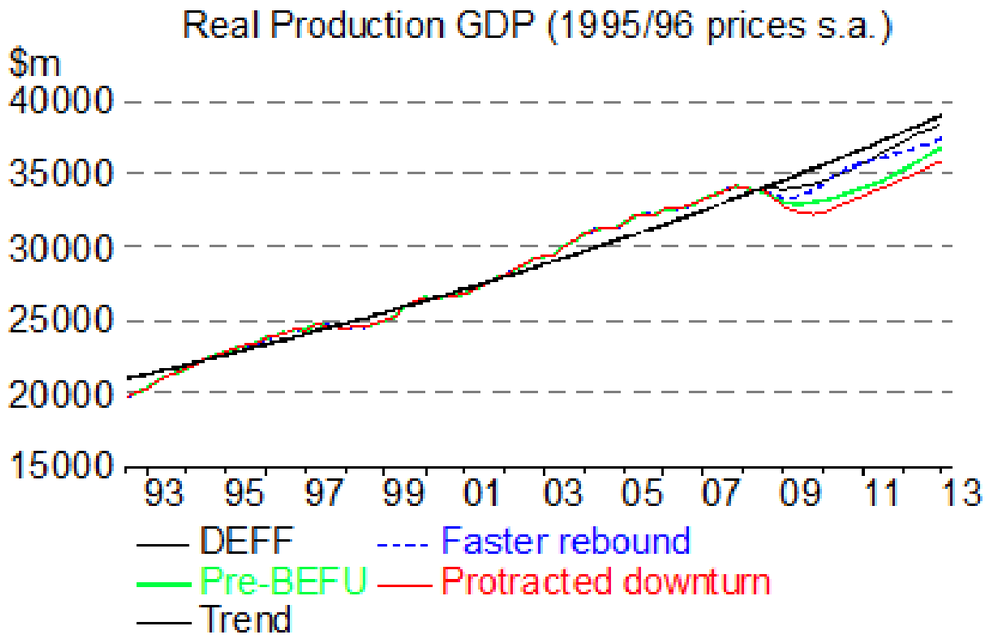
The main uncertainty we have been focussing on is the level of GDP over the forecasts and beyond. The path of GDP in the forecasts is a subset of the uncertainties driving various scenarios (eg, the path of trading partner growth, terms-of-trade, access to credit etc…). The path of GDP over the medium-term is more about fundamental drivers of growth (eg, labour force and productivity).

Forecast rounds since the 2008 BEFU have been revising down real GDP growth so that the real GDP loss looks increasingly permanent. A permanent loss of real GDP would involve a situation where the economy shifts to a lower level of labour and/or capital utilisation, loses skills from a prolonged period of unemployment and/or shifts from high productivity activities to lower ones. A long-lasting loss of GDP and the associated opening up of large output gaps is a theme in the IMFs current forecasts.

Importantly, it is the path of nominal GDP and so tax revenue that affects the fiscal position. This is particularly the case under the existing Fiscal Management Approach, where downward revisions to inflation forecasts are not fed through to changes in nominal spending (ie, thereby creating increases in forecast real spending). To varying degrees, fiscal consolidation on the spending side represents a response to this asymmetry.

Given the high degree of uncertainty regarding the path of the economy we have developed three economic scenarios and three discretionary fiscal policy responses. This leads to nine combinations (see attached table) that help set out the policy challenges and the robustness of alternative policy responses. Each cell includes the results of a medium-term fiscal projection determined by the relevant economic scenario with different approaches about what is fiscally "fixed" or "adjusted". These economic scenarios are selected to help work through the fiscal strategy choices. They do not necessarily reflect the scenarios that will appear in the BEFU.

The chart below sets out the real GDP path from the main scenario of the December Economic and Fiscal Forecasts (DEFF) and the three alternative economic scenarios. The first economic scenario features a less pronounced recession with a faster rebound, but still with a lower level of real GDP and loss of nominal GDP relative to DEFF. This scenario is closer the Reserve Banks March Monetary Policy Statement. The second scenario is the *preliminary* BEFU 2009 macroeconomic forecast. The third scenario features a more protracted downturn with a substantive loss in real and nominal GDP. The "Faster rebound" and "Protracted downturn" scenarios are generated using Treasury's macroeconomic model.



The table below sets out the main features of each of the three scenarios across the forecast horizon.

	Faster rebound	**Preliminary BEFU**	**Protracted downturn**
Real GDP relative to DEFF main (in 2013)	-3%	-4.6%	-7%
Nominal GDP relative to DEFF main (over 2009 to 2013)	-$13b	-$54b	-$98b
Quarters of recession (from December 2007)	5	7	8
First quarter of growth	June 2009	December 2009	March 2010
Quarters to return to December 2007 real GDP	9	14	16

The associated fiscal forecasts for the preliminary BEFU scenario are preliminary fiscal forecasts. The fiscal tracks for the "Faster rebound" and "Protracted downturn" scenarios are generated via ready-reckoners.

In the Baseline "wait-and-see" row of the attached table, the absence of a fiscal response (beyond the reduction in the operating allowance for Budget 2009 to $1.45b) means that debt is a residual outcome. For the other two fiscal responses a fiscal consolidation is applied to reach a particular debt ratio in 2023. The cells do not incorporate any feedback from the fiscal response to the economic situation and tax revenue. The fiscal responses are modelled as changes in spending baselines and operating allowances. Given that the operating allowance is a net concept a particular consolidation can be achieved through a mix of larger baseline changes and higher gross new allowance spending. In addition, although it may be possible to run low operating allowances for a period, a build-up of operating pressures might suggest adjusting the size of the allowance in-conjunction with baseline savings.

In generating the medium-term fiscal projections, some changes to the Fiscal Strategy Model (FSM) have been made relative to the December version to reflect the uncertainty around the depth and length of the downturn. The changes focus on adjusting labour force participation rates (upward) and the unemployment rate (downward) as these are two variables that do not seem to be at long-run values at the end of the forecasts. Adjustments have also been made to corporate tax-to-GDP and other tax-to-GDP in the projection period. At this stage we have not changed medium-term assumptions for population growth and labour productivity growth. The fiscal projections assume fiscal drag *does not* operate over the projection period. A separate note covers the preliminary FSM assumptions.

Each cell in the table reports the peak and end-of-projection period ratios for gross debt. (Since the assumed fiscal consolidations do not involve changes to NZSF contributions we do not report a wider net debt measure.) In each cell we also assess the fiscal and economic outcomes against the following criteria:

1. Response of rating agencies, access to external finance and cost of borrowing.

2. Impact of fiscal consolidation on aggregate demand:

   - Negative via contractionary effects (which as discussed above is influenced by the particular options selected in the consolidation)
   - Positive via confidence effects and higher credit rating and access to finance than otherwise
   - The speed and timing of consolidation, together with its composition, will interact with the state of the economy (ie, spare capacity), confidence, market perceptions and interest rates in determining the effects on GDP. Although expansionary effects of a fiscal contraction *might* occur if avoidance of a significant fiscal deterioration had positive effects on confidence, investor sentiment and interest rates, at least in the short-term we would expect a contractionary impact on aggregate demand. The latter is what forecasting approaches would tend to capture

3. Least regrets of each response:

   - What if the economic outlook is worse and fiscal plans need to be changed?
   - What if the economic outlook improves and so the consolidation is more than needed?

	ECONOMIC SCENARIO		
FISCAL RESPONSE	**Faster rebound**	**Preliminary BEFU**	**Protracted downturn**
Baseline (Wait-and-see) Operating allowance of $1.45b for Budget 2009	Gross debt around 65% in 2023 and starting to stabilise Large financing requirement and ratings downgrade likely Low fiscal contraction on aggregate demand Debt stabilising but large deviation from previous fiscal strategy of prefunding	Gross debt around 85% in 2023 and trending up Significant financing requirement and ratings downgrade almost certain Low fiscal contraction on aggregate demand but negatives from more difficult access to financing and/or potentially higher cost of borrowing Debt stabilising but significant deviation from previous fiscal strategy of prefunding	Gross debt around 125% in 2023 and trending up Unsustainable financing requirements and substantial ratings downgrade Low contraction on aggregate demand more than offset by reduced access to financing and higher cost of borrowing Very difficult to correct fiscal position
Consolidation 1 Baseline savings of $1.5b in each of the 3 years, from 2010/11 to 2012/13 (ie, $4.5b or 2.5% of 2008 GDP); operating allowance at $1.25b from 2010/11, growing with inflation	Gross debt peaks at around 37% and reaches 31% by 2023 Financing requirement manageable and reduced chance of ratings downgrade More flexibility to delay contraction if economy weakens for a period A return to previous fiscal strategy of prefunding looks plausible over medium-term	Gross debt peaks at around 45% and reaches 40% by 2023 Financing requirement large but below Baseline Less scope to delay contraction if economy weakens but higher offset from credibility gains and access to funds Large deviation from previous fiscal strategy of prefunding	Gross debt around 88% in 2023 and trending up Significant financing requirement and ratings downgrade almost certain Contraction on aggregate demand offset by reduced access to financing and higher cost of borrowing Difficult to correct fiscal position
Consolidation 2 Baseline savings of $2.0b in each of the 3 years, from 2010/11 to 2012/13 (ie, $6.0b or 3.4% of 2008 GDP); operating allowances at $1.0b from 2010/11, growing with inflation	Gross debt peaks at 33% and reaches 11% by 2023 No pressure on financing requirements with small possibility of ratings upgrade in medium-term if this track was realised Higher risk that poorly timed and structured contraction affects aggregate demand Considerable overachievement relative to previous fiscal strategy of prefunding	Gross debt peaks at 41% and reaches 23% by 2023 Financing requirement manageable and reduced chance of ratings downgrade More flexibility to delay contraction if economy weakens for a period Consistent with previous fiscal strategy of pre-funding over the medium-term	Gross debt peaks at around 66% and reaches 65% in 2023 Significant financing requirement and ratings downgrade almost certain Less flexibility to delay contraction Debt stabilising but large deviation from previous fiscal strategy of prefunding