Prosperity, Preparedness, Providence: Why Fiscal Policy and Management Matter

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Good afternoon everyone. I am delighted to welcome you to the launch of He Tirohanga Mokopuna, the Treasury's Statement on the Long-Term Fiscal Position. This is the fourth such Statement we've prepared. The Public Finance Act requires the Treasury to produce a Long-Term Fiscal Statement at least every four years. As with previous Statements, He Tirohanga Mokopuna covers the next 40 years and more; it includes projections of government revenue, spending and debt, and analysis of the factors that will drive these in the decades ahead.

Before we get into a presentation on the content of the Statement, I'd like to talk about the broader context in which it sits by exploring a few questions. Namely, what is fiscal policy, and why do we concern ourselves with it? What is responsible fiscal management, and how do we implement it? What's the interaction between fiscal and monetary policy? What lessons have we learned about good fiscal policy and fiscal management? And how can we help New Zealand's long-term fiscal position in the short to medium term?

I'll start with a basic one: what does the word "fiscal" mean? Fiscal refers to public finances, including revenues, expenditure, and the broader Crown balance sheet. And I emphasise the word "public". New Zealanders have entrusted their publicly-elected representatives and their public servants with the responsibility to manage public revenues, expenditure and debt for the public good. And not just for the good of today's public, but also for future generations of New Zealanders.

The choices that governments make about public spending, tax and the balance between them – its fiscal policy in other words – are, needless to say, very important. These choices are one of the most direct levers a government has to influence economic and social outcomes. Not surprising really, considering the many billions of dollars covered by these choices year after year.

Governments impact the level and composition of activity in the economy by spending more or less than they receive in revenue. For example, looser fiscal policy – where governments increase spending or reduce taxes – stimulates demand. In a downturn, this may be appropriate. However, when the economy is already operating at or near capacity, stimulating demand tends to push up inflation, interest rates and the exchange rate.

A key objective of economic policy is to promote macroeconomic stability. Generally, countries that maintain relatively stable macroeconomic variables such as inflation, unemployment, interest rates, exchange rates, the balance of payments and fiscal aggregates tend to display higher long-term growth rates. Policies and systems that assist in dampening down the volatility of economic cycles are important because they allow individuals, businesses and the Government to plan more effectively for the future, increase investment, and help to raise productivity. The prime stabilisation tool we have at our disposal is monetary policy.

You can see from this that the way fiscal policy interacts with monetary policy can have a big effect on economic stability. If a government makes large changes to its spending or tax from year to year, affecting supply and demand pressures, that adds to the burden put on monetary policy. Poorly-judged fiscal policy decisions can cause shocks to the economy and make the peaks and troughs of economic cycles more precipitous than they otherwise would be. Conversely, good fiscal policy and management can help to smooth out these cycles. This is recognised in the principles of responsible fiscal management in the Public Finance Act: to have regard to the predictability and stability of tax rates and the interaction between fiscal policy and monetary policy, alongside, among other things having regard to the likely impact of fiscal strategy on present and future generations.

One area of the sharpest lessons from the global financial crisis is the critical role of better coordination of fiscal, monetary, financial and broader macroeconomic policies in order for each of those policies to be implemented effectively when one of them faces constraints. As I said a couple of weeks ago, New Zealand was one of the countries that coordinated fiscal and monetary policy effectively over the course of the GFC.

There has been an international debate on whether there's a need for a greater use of fiscal policy to stimulate the economy in a number of countries. That may be appropriate in some countries but I do not believe that fiscal stimulus is required in New Zealand. It's important that we do not import policies and paradigms from overseas without considering our own domestic context.

In general, the hurdle for fiscal stimulus should be high. As I just mentioned, monetary policy is the primary stabilisation tool, and if monetary policy is not constrained it is likely that the stimulatory effects of any fiscal expansion would be largely offset by higher interest and exchange rates than otherwise.

The Treasury's Budget forecast was for economic growth over the next few years, rising inflation and rising interest rates. Under these circumstances fiscal stimulus would be counter-balanced by tighter monetary policy.

However, we should be ready to provide greater fiscal support should monetary policy be constrained or hit the effective zero lower bound, which could happen if New Zealand was struck by a large shock.

Shocks aren't a rare thing; natural, domestic and international shocks hit the New Zealand economy regularly. There were the oil shocks of the Seventies and 2002; the global share market crash of 1987 and the global financial crisis of 2008/9; the Asian financial crisis in 1997/98; destructive earthquakes in 2010, 2011, and of course just last week; and significant droughts in 1973, 1992, 1998, 2008 and 2013. We have to make sure our fiscal position is resilient enough to deal with such shocks.

One of the most important ways we can get ourselves ready is by beginning to reduce net debt and rebuild our fiscal buffer. Reducing net debt doesn't exactly capture the public's imagination in the same way that new spending does; you may notice that whenever the Crown accounts show a surplus there's also a surplus of ideas about how to spend it. But a focus on reducing debt still matters, especially in the good times.

It comes down to the importance of long-term fiscal sustainability. The Statement we are releasing today makes it clear that sustainable government finances are a precondition to improving long-term living standards. They reduce the risks associated with economic, social or environmental shocks; they provide current and future generations with the opportunities to participate in society by allowing governments to provide essential services and infrastructure, and they give certainty in the future for individuals and governments to plan.

New Zealand has relatively healthy operating balances and low levels of debt. The importance of having sustainable finances has been highlighted over the past decade where countries around the world have faced significant economic challenges with diminishing fiscal space. This reinforces to me that we should make good use of our current strength to prepare for more challenging times in the future.

As we have set out in the latest and in previous Statements, fiscal pressures are projected to build over the next 40 years. Population ageing is projected to apply pressures through slower revenue growth resulting from lower participation, as well as increased expenses primarily through New Zealand Superannuation and healthcare.

The Public Finance Act requires that governments aim, on average over time, to ensure that they fund current expenses such as those of the health, welfare and justice systems out of current revenue without needing to borrow. Good fiscal management would dictate that keeping on top of net debt has to be part of meeting that requirement.

This doesn't mean that all borrowing is bad. In fact borrowing for capital investments in assets such as bridges, roads and buildings can be desirable. For example, if we borrow for investments that improve economic growth and achieve a financial rate of return that's higher than the cost of borrowing, that makes us better off. And if we use debt to pay for long-lasting assets that serve social needs, like prisons or hospitals, that helps spread the cost of those assets across the generations that benefit from them.

Regardless of what the borrowing is used for, when public debt levels get too high it exposes a country to higher risks. For example, economic shocks will often lead to lower tax revenue but higher spending on unemployment benefits and the like, and thus often result in the government needing to borrow more. But if we are already carrying a high level of debt, our ability to borrow more might be restricted. Even in the absence of shocks, a high level of public debt might make lenders start to doubt a country's ability to repay its debt, leading to higher interest rates.

At the extreme, a government that runs an imprudent fiscal strategy exposes its people to serious risks. For example, New Zealand's public debt rose to high levels during the 1980s and early 1990s, with net core Crown debt reaching over 55 percent of GDP in 1992. Over this period New Zealand's sovereign credit rating was downgraded twice.

By contrast, at the beginning of the global financial crisis New Zealand had particularly low net debt, at about 5 percent of GDP. This is forecast to peak at 25 percent of GDP before gradually reducing. Because net debt was low at the start of the financial crisis it allowed the Government to avoid having to make the difficult trade-offs between maintaining access to international markets at affordable rates and having to cut valuable public services.

That's a great lesson on fiscal policy and management from the recent past. Looking at the present and the near future, we need to be awake to even more opportunities to help New Zealand's fiscal position over the long term.

One of those opportunities is for policy advisers and decision-makers to keep learning what they can. The Treasury took this opportunity on board three years ago when it commissioned an independent external review into the quality of its fiscal policy advice. We wanted to see how well we were performing, learn what we could from other countries, and see what we had to do to maintain our position at the forefront of fiscal policy management and advice.

The report came back with practical steps for us to consider as we aim to improve our processes, the usefulness of our analysis, and the quality of our advice. These included ways that we might strengthen our modelling and empirical estimation of the macro-economic and distributional effects of fiscal policies, means to sharpen our analysis and advice around managing fiscal risks, and how we might go about enriching the information-base that we use to assess and manage expenditure programmes and the Crown balance sheet. We've been progressing a number of the recommendations from the report.

Another important approach the Treasury can take in the short to medium term to help New Zealand's fiscal position in the long term is by adhering to the fundamentals of what we're ultimately here to do. The Treasury sees its job as improving the living standards of New Zealanders, helping people live better lives, now and into the future. And we do this by putting our Living Standards Framework at the heart of our advice.

The Living Standards Framework identifies that the things that need to be in place to promote wellbeing are the capital stocks which collectively comprise our 'economic capital' or 'comprehensive wealth': human capital, natural capital, social capital, and financial and physical capital.

The aim is to grow these capital stocks by focusing public policy on governing and investing, on behalf of people today and into the future, towards:

- enhancing resilience to systemic risks;
- sustaining social cohesion;
- increasing the growth potential of the economy;
- improving equity across society and generations; and
- ensuring sustainability of wellbeing as people go about their daily business of living and improving their lives.

When we use the Living Standards Framework to consider fiscal policy, it shows the links between economic and social outcomes. Income is affected by economic growth, the employment and skills of our workforce, and the way tax is used to raise revenue but also as a lever to correct externalities, for example through the Emissions Trading Scheme. Spending is considered in terms of how it enhances social inclusion, the importance of money being used efficiently and effectively, and how we can use the investment approach to achieve a sustainable improvement in our collective wellbeing. And of course I've already covered the importance of managing net debt.

So the Living Standards Framework is helping us strengthen our fiscal policy advice and fiscal management role, the choices about how we raise revenue, how we spend it, how we can achieve value for money, and how we can make the best contribution to government objectives.

Finally, governments today and in the future have choices that will determine what our long-term fiscal position will be. The Long-Term Fiscal Statement being published today sets out a range of those choices that can be made to help manage the fiscal pressures we know are coming over the next few decades. Choices made now or postponed until the future can make the difference between overcoming fiscal pressures or being overcome by them.