The Treasury

Budget 2020 Information Release

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[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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TE TAI ŌHANGA
THE TREASURY

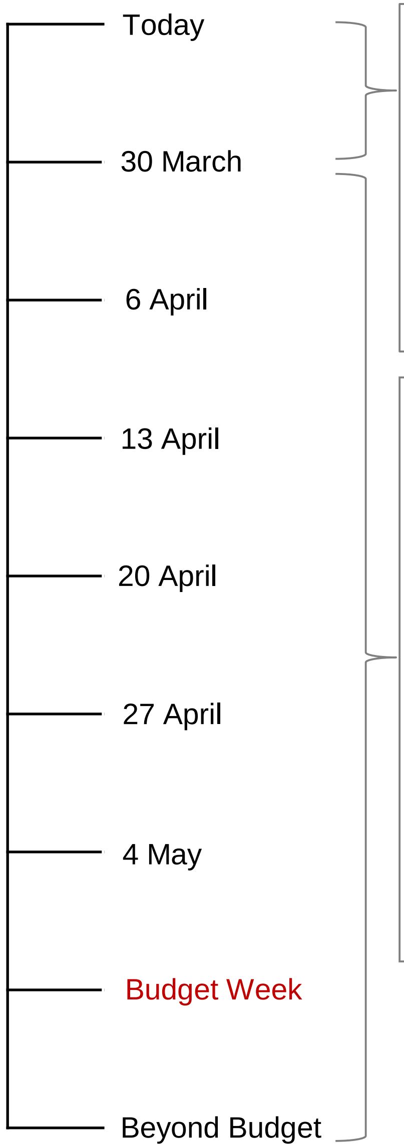
COVID-19: next steps on macroeconomic advice

23 March, 2020

Key points

- New Zealand is at the early stages of an **unprecedented economic shock**
  - Your Phase 1 response has bought some time
  - Even so, a second fiscal response could be needed very soon
  - Further fiscal responses will be needed, as well as longer term reforms
- **Government needs to share the cost** of the crisis across time and people
  - Use fiscal policy aggressively in the short-run, making use of our fiscal headroom
  - Review the position and our policy response if debt is forecast to rise to around 50% of GDP
  - Depending on the severity of the shock and the duration of our response, in the long-run everything might need to be on the table
- For now, **fiscal policy is the main tool to stabilise the economy**; but the response will need to be broader than fiscal, with monetary, regulatory and financial support
- To manage the fiscal risks, we need an exit strategy from stimulus by **ensuring that all new spending is temporary**
- **Fiscal policy decisions need to be more regular and agile.** We should move to a model of fiscal policy decisions on a 6 to 12 week cycle, like monetary policy

Immediate decisions and future focus



Some key fiscal strategy decisions will need to be made over the next week:

- Size of one-off Budget 2020 package
- Size of Budget 2020 allowances
- Signalled allowances for Budgets 2021 to 2023
- Developing a process for future decision points

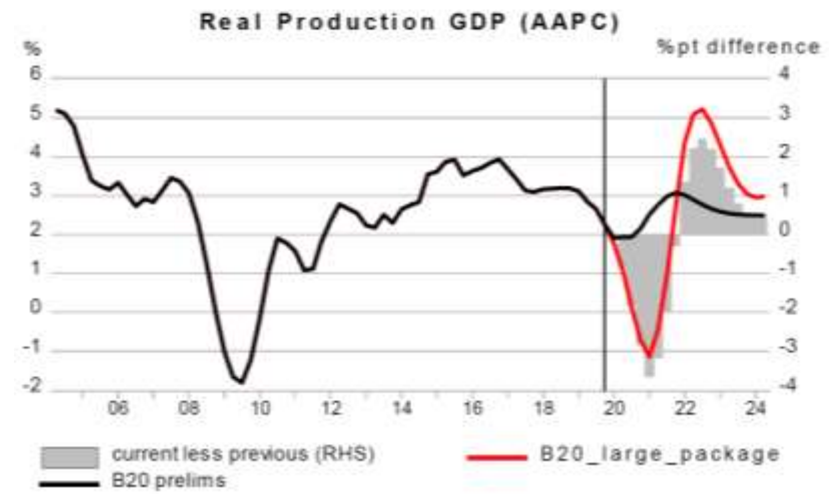
There is also a raft of big questions to answer over longer timeframes:

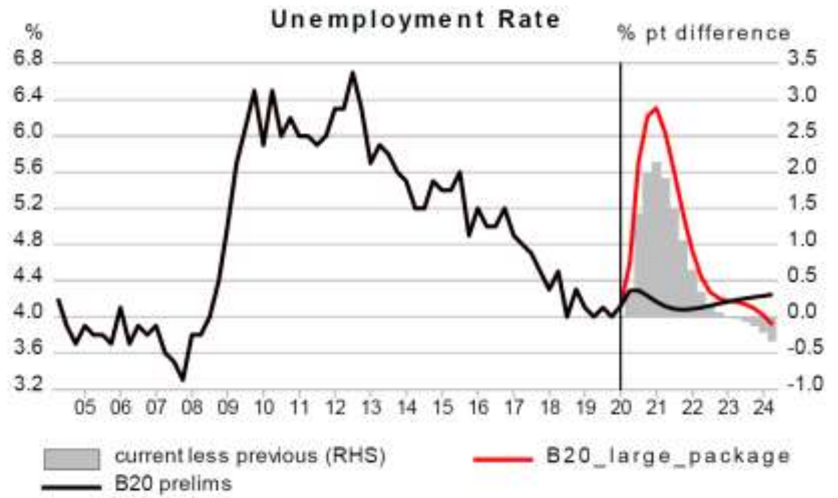
- How much do we try and lean against the shock? How much risk should the government take on?
- Which policy options should form part of phase 2? How do you want to design them?
- When do you launch a recovery phase? How big should it be? How do you deliver it?
- How far can net debt increase in the short term? What is a prudent level in the long-term?
- How quickly do we want to try and return to surplus?
- How do we rethink our macroeconomic frameworks?
- How do we use the recovery to drive economic transformation?

The economic & fiscal context has deteriorated

- These charts show economic forecasts as modelled on Tuesday 17 March, including the Phase 1 package.
- The Phase 1 package helps the economic outlook, but won't offset the entire shock.
- This forecast assumes a V-shaped shock, with a sharp decline, followed by sharp recovery
- **This is now looking to be a very optimistic scenario.** The shock is increasingly likely to be U-shaped, with a longer trough and slower recovery.
- Partial fiscal modelling – including decisions made to date, but not including the full fiscal impacts of increased welfare payments – suggests net debt rising to around 30% of GDP in the next 3 years, and an OBEGAL deficit of around 2% of GDP in the next year.
- **These fiscal estimates are also highly optimistic, and you should be prepared for net debt to rise substantially higher.**

We are still intending to finalise our BEFU economic forecasts on March 30.





The big picture: macroeconomic policy over the next 3 years

Containment period	Post-containment recovery	Sustaining the recovery	Medium term
Until late 2020 or 2021	*Through 2021/2022*	*2022*	*2023 and beyond*
Focus on **fighting the virus** and **cushioning the impact.** Households and firms run down savings. Support households and firms weather income shock of containment, and support public health response.	**Large temporary fiscal stimulus** could help to generate quick recovery in demand when containment measures ease. Initially weak demand. Consumption and investment low, under high uncertainty.	**Maintain economic support** to sustain momentum. Growth promoting fiscal policies, deferring immediate fiscal consolidation. RBNZ develops capacity for further unconventional monetary policy tools.	**Fiscal consolidation** may be needed to stabilise debt and restore surplus. Choices on the long-run level of debt and speed of consolidation given economic factors and size of stimulus required in preceding periods.

This period will require **iterative and frequent fiscal policy decisions** in response to a high degree of uncertainty over progression of the virus, the public health response, the timing of the recovery and the effectiveness of policies.

Timings are highly uncertain, and will depend on the progression of the virus, the depth of the shock, the public health response and macroeconomic context

A longer containment period will impose higher fiscal costs, but there is ample space to respond

- **We should use fiscal policy aggressively in the short term** - assuming the fiscal response is temporary, debt can be stabilized and OBEGAL returned to surplus under most scenarios (short of long-term structural deterioration in the economy).
- **Net debt should be forecast to rise to around 50% of GDP before we review debt levels** and consider restraining the fiscal policy response.

	Current policies (12 weeks)	12 week extension	24 week extension	36 week extension
End of containment	June 2020	September 2020	November 2020	February 2021
Rough cost of continuing current policies*	$6 billion	$12 billion	$18 billion	$24 billion
Indicative Phase 2 package	-	$5 billion	$10 billion	$15 billion
Total direct fiscal cost of containment support	$6 billion	$17 billion	$28 billion	$39 billion
Direct fiscal cost as a % of current GDP	2%	5%	9%	12%

The figures above only show the direct fiscal cost of spending to support the economy through a long period of containment – the cost in lost output, tax revenue and higher welfare expenditure will make the fiscal impact far greater than shown above.

*Wage subsidies, sick leave, public health response & higher Winter Energy Payment. The current cost of $5.9 billion for these measures is rolled forward for each 12 week window; the actual fiscal impact will be different, but this is used as a proxy at this stage.

The post-containment recovery package will need to be large, but the total size is uncertain

- The size of the post-containment recovery package will depend on the
  - magnitude and duration of the disruption from the COVID-19 shock, and
  - the composition and effectiveness of the recovery package
- Our March 17 forecasts suggested a large, temporary shock to the economy. The output gap reaches a c. 4% of GDP and unemployment peaks at 6.3% - though this picture may worsen substantially.
- Assuming this gap persists throughout the containment period, a recovery package will be needed to support the economy when containment is lifted. **This is likely to be in the range of $10 to $20 billion,** in addition to the costs of supporting the economy through a period of containment.

Recovery package required to eliminate output gap after a period of containment

Output gap trough (% of GDP)	Stimulus required to return output gap to between 0% and -1% of GDP
-4	$9 – $12bn
-5	$12 – $15bn
-6	$15 – $18bn

Figures assume a cumulative fiscal multiplier of 1 across the forecast period. If using taxes and transfers, a multiplier of 0.5 might be more appropriate implying double the level of spending.

- However, entirely eliminating the negative impact of COVID-19 on economic growth through fiscal policy is likely not feasible given the disruption to supply and the labour market, and any necessary reallocation of resources in the economy.
- The effectiveness of fiscal policy in stimulating economic activity is uncertain – likely to be higher in the context of constrained monetary policy, but lower in the context of the supply effects of COVID-19.

Four principles for fiscal policy through the containment period (and beyond)

1. **New spending must be temporary or time limited** – permanent spending risks creating an unsustainable medium-term trajectory and deepening the future consolidation required.

2. **Continue to use fiscal policy aggressively** to get through the containment and initial recovery phases, shifting focus to fiscal consolidation once the shock has passed.

3. **Maintain health spending and the automatic stabilisers** to minimise the level of disruption and take the edge of the shock, but bear in mind the economic costs of public health measures.

4. **Be iterative –** take regular fiscal decisions on response packages that allows us to calibrate our response over time.

Short-term recommendations & workstreams

Short-term decision	Recommendation
Size of one-off Budget 2020 package	Set aside a **contingency of $5bn-$10bn for time-limited spending** to cover the next 6-12 week phase of the response, but knowing that more is likely to follow.
Size of Budget 2020 allowances	[33]
Signalled allowances for Budgets 2021 to 2023	Allowances for Budgets 21-23 should include **low permanent allowances at HYEFU levels** but with large time-limited components to indicate scale of recovery package.
Developing a process for future decision points	Set up a process to allow regular fiscal policy decisions with **decision points every 6 to 12 weeks**.

We can provide further advice on any of the above points over the next week.

We are also progressing several short-term workstreams:

- Updating scenarios and forecasts
- Addressing firms' financing constraints
- Strengthening the Reserve Bank's tools for unconventional monetary policy
- Assessing the policy options for a prolonged containment phase; the initial post-containment recovery phase; and the medium to long term economic transition. Some of these [33] require work commencing now to enable implementation.

Questions for discussion

- What decisions do you want Cabinet to take on 30 March?
- Are you comfortable moving to a regular 6 to 12 week cycle for decision-making?
- Do you agree with an expansionary fiscal approach during the containment and initial recovery phase?
- What work-streams should we prioritise in the short-term? Medium-term?
- Are there any crucial issues that we have overlooked?

Annex – Background

How high should debt be allowed to rise?

- Typically, a prudent level of debt is one which entails a low risk of debt reaching unsustainably high levels. This requires an on-balance judgment that depends on the Government's risk tolerance.
- In 2019, Treasury analysis suggested a *conservative* upper limit for prudent net core Crown debt is around 30% of GDP, based on likely **adverse wellbeing consequences from public debt between 50 and 60% of GDP,** and a safety buffer of 20 to 30% of GDP.
- **Now is the right time to use that safety buffer in full.**
- If debt rose to 50% of GDP, **it is unlikely market access would be affected**, and New Zealand's debt position would still be more favourable than many developed economies.
- However, that would be **an appropriate point to review how much further it would be prudent to allow debt to rise**, based on:
  - the condition of global credit markets in the light of COVID-19;
  - the trade-off between the costs to society of higher debt to compared to the benefits of a continued comprehensive fiscal response to COVID-19;
  - our debt relative to other economies; and
  - the level of debt we wish to achieve in the long-term.

You will need to consider these judgements in the Fiscal Strategy Report for Budget 2020, including how (or if) you intend to demonstrate consistency with the principles of responsible fiscal management. We will provide advice on this in the coming weeks.