TE TAI ŌHANGA
THE TREASURY

New challenges for macroeconomic stabilisation policy: The role of fiscal policy

Speech delivered by Caralee McLiesh[1], Secretary to the Treasury

Opening Remarks at the Joint Reserve Bank of New Zealand/Treasury Macroeconomic workshop

22 June 2021

(mihi)

Tēnā koutou katoa. I am delighted to be speaking here today at a joint RBNZ and Treasury Conference. This event continues a long-standing tradition of our collaboration on key macroeconomic issues—from responding to shocks to our stewardship functions.

I would like to start my remarks with a whakataukī: 'Kia whakatōmuri te haere whakamua.' This means 'I walk backwards into the future with my eyes fixed on my past'. This resonates strongly with me and it captures what I want to talk about today: how our existing macroeconomic frameworks can adapt and evolve so that we can navigate the challenges we expect in future.

Our macro frameworks guide decision-making and policy choices for monetary and fiscal policy. That includes decisions about taxes, spending, debt and interest rates. They are critical determinants to the wellbeing of current and future New Zealanders.

While our macroeconomic frameworks have greatly enhanced economic stability in New Zealand over the last 30 years, they have been tested during the unprecedented upheaval of the COVID-19 pandemic, as well as by longer term structural trends in the economy.

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[1] Thank you to Ben Gaukrodger, Isabelle Hermes, Andrew Kennedy and many others in the Treasury for their contributions to this lecture.

In these circumstances it is right to take stock of our approach and ask where changes need to be made. As we do this, we need to learn from the past. That means learning lessons from the pandemic, but also understanding the strengths and weaknesses of our frameworks as we've navigated numerous challenges over the last three decades. It also means keeping our eyes firmly fixed on the fundamental objectives our frameworks have sought, and still seek, to achieve – delivering improvements in living standards for current and future New Zealanders.

In my remarks today I will outline some of the economic challenges that have motivated the Treasury to examine our approach to macroeconomic policy. I will also outline some of the questions we are asking ourselves and issues we are exploring as we progress this work.

I would stress that we are not making policy recommendations. We are keen to engage with you as we build our understanding. In that spirit, next week the Treasury will release for consultation a draft of its combined Long-term Fiscal Statement and Long-term Insights Briefing. A number of the issues I touch on today will be discussed in that paper, and I commend you all to engage with it and provide feedback before a final version is published in September.

A Why examine our macroeconomic frameworks?

For more than 30 years our macroeconomic frameworks have served New Zealand well through clear roles for monetary and fiscal policy, as currently set out in the Reserve Bank of New Zealand Act 1989 (RBNZ Act) and the Public Finance Act 1989 (PFA).[2] These institutional frameworks addressed the economic context at the time, which followed a period of high inflation and debt servicing costs, poor fiscal discipline, lack of transparency over fiscal management, and wider economic underperformance.

In broad terms, the Reserve Bank has had primary responsibility for maintaining a stable macroeconomic environment through the business cycle and controlling inflation. By contrast, fiscal policy has focused on maintaining a sustainable fiscal position, while delivering on the specific policy objectives of the government of the day.[3]

Today, those macroeconomic frameworks face new challenges.

In advanced economies, the decade since the global financial crisis (GFC) was characterised by subdued inflation, falling neutral interest rates and relatively low rates of growth. These macroeconomic trends reflect long-term structural changes in the global economy. For example, globalisation and technological improvements have contributed to weak inflationary pressures with the price of many goods falling. Similarly, falling neutral interest rates reflect factors such as population aging, low productivity growth, and rising inequality, which have influenced global rates of saving and investment.[4]

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2 Reddell (1998) sets out the origins and early development of our monetary policy regime. Janssen (2001) discusses the experience and evolution of New Zealand's fiscal policy framework.

3 This delineation between monetary and fiscal policy was never absolute – for example it was always acknowledged that fiscal policy would be better suited to responding to some types of shocks. Since 2013, the PFA has also required the government's fiscal strategy to have regard to the interaction between monetary and fiscal policy.

4 Lane (2019)

New Zealand has been no exception to these trends. When COVID-19 hit the Reserve Bank’s official cash rate (OCR) was already at an all-time low of 1%. Initial constraints on the ability to introduce negative interest rates meant there was limited capacity for the Reserve Bank to stabilise the economy through deep cuts to the OCR. A 75 basis point reduction in the OCR was supplemented by alternative monetary policy tools, notably Large-Scale Asset Purchases (LSAP) and the Funding for Lending (FLP) programme.

While our use of monetary policy changed, so did our use of fiscal policy, with a pandemic response that was swift and substantial. Overall these interventions, alongside a health response that successfully eliminated COVID-19 in New Zealand, have been effective in supporting the New Zealand economy, which has outperformed our forecasts since the beginning of the pandemic.

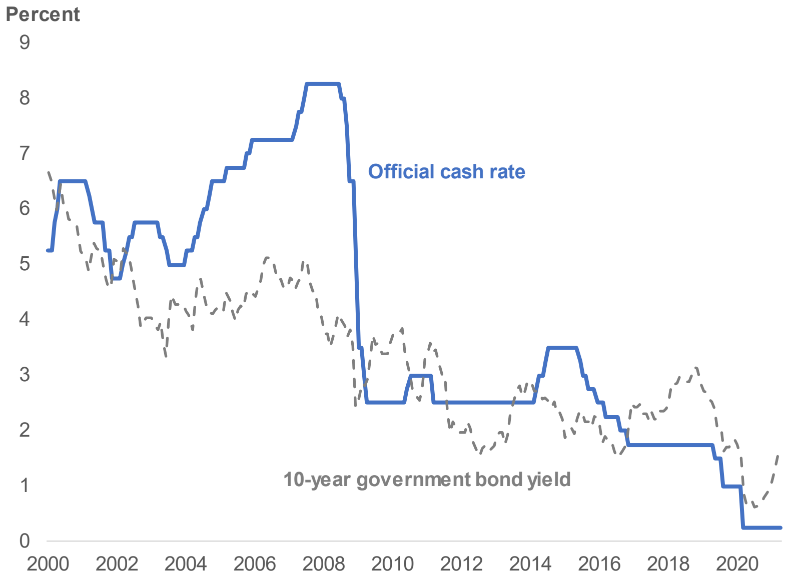
With the initial COVID-19 shock now behind us, although still uncertainty ahead, our attention has turned to the future. Specifically we are asking how monetary and fiscal policy might continue to evolve, taking into account the lessons of the pandemic and the long-term trends that predate it. These questions aren’t unique to New Zealand, and we are learning from experiences in other advanced economies as we develop our thinking.

Two key themes arising from low interest rates are shaping thinking about macroeconomic policy globally and are becoming increasingly relevant in the New Zealand context.[5] At the very outset I will acknowledge that these themes depend critically on assumptions around the future trends of interest rates, over which there is uncertainty. I also want to be clear that my remarks are motivated by long-term trends that have seen interest rates fall, rather than short-term movements in interest rates driven by cyclical variation:

First, as we manage economic cycles in future, it has become more likely that monetary policy choices will be shaped by the effective lower bound on the Official Cash Rate (*figure 1*). We can expect alternative monetary policy tools to become a standard part of the policy toolkit, and there will be an ongoing case for fiscal policy to play a role in short-term stabilisation.

5 See for example Blanchard (2019) and Furman and Summers (2020).

Figure 1: New Zealand interest rates



Source: RBNZ

Second, low interest rates will substantially lower the costs of government debt. Favourable debt dynamics, resulting from growth rates that exceed the borrowing rate, will allow governments to spend more before fiscal sustainability becomes a concern than would otherwise be the case. This in turn enables fiscal policy to play a more active stabilisation role.

I will now explore both of these themes in more depth, starting with some thoughts on the role of fiscal policy in short-term stabilisation, before considering the implications for debt and fiscal sustainability.

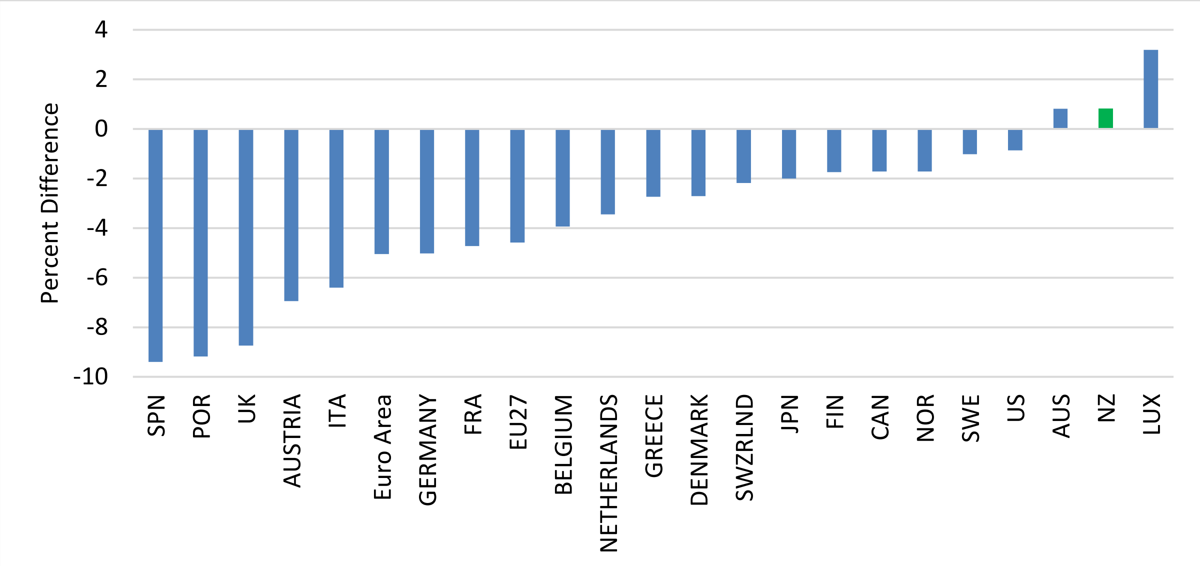
B The role of fiscal policy in stabilisation: early lessons from the pandemic

The COVID-19 pandemic has shown that fiscal policy can play an effective role in macroeconomic stabilisation.

The disruption caused by COVID-19 has been both enormous and unique. The Treasury's latest estimates are that economic activity fell by between 25 and 30 per cent during the height of the lockdown, with wide disparities in how people, places and sectors of the economy were affected.[6]

Some 18 months from the pandemic's onset, New Zealand has experienced one of the strongest economic recoveries in the world. As at March 2021, GDP is at 0.8% above pre-pandemic levels—well above earlier expectations, and most other advanced economies (figure 2).

Figure 2: GDP relative to pre-pandemic levels: Dec 2019 to March 2021



Source: Haver Analytics and Stats NZ

Central to this economic recovery was a successful public health response. Early in the pandemic, Treasury scenarios showed that the costs of an uncontrolled COVID-19 outbreak far exceeded the cost of strict, but short, activity restrictions through the alert level system. New Zealand's COVID-19 elimination strategy resulted in among the fewest COVID-19 community cases and deaths per capita globally. While it led to the sharpest GDP contraction on record—an 11% fall in the June 2020 quarter—the subsequent freedom from restrictions helped deliver one of the fastest bouncebacks in GDP across the OECD.

Alongside the health response, the recovery has been underpinned by a strong and effective economic response—across fiscal, monetary, regulatory, financial, and other economic policy. I am proud of the Treasury's advice and collaboration with our partners in and outside government on the economic response. Like others, we worked at an intense pace and on a scale and level of uncertainty we had not experienced before.

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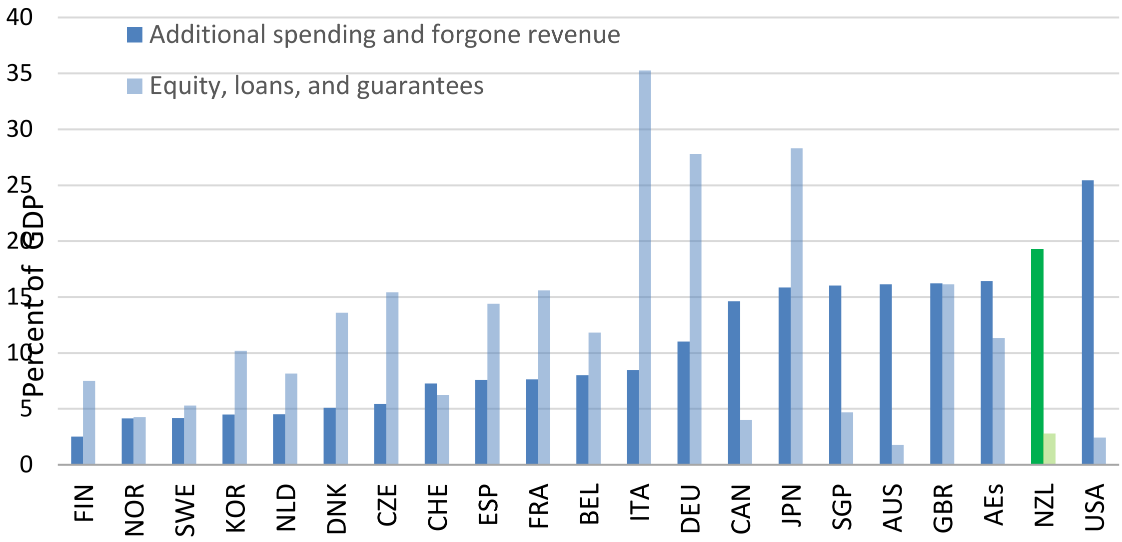
6 The Treasury (2021)

It was clear early on in the pandemic that a swift and strong fiscal response was needed. Given the scale and nature of the shock, a monetary policy response alone would never have been enough. Targeted fiscal measures were necessary to enable a strong public health response, provide direct support to businesses and households to protect jobs and incomes, and support recovery from a large and very uneven downturn.

New Zealand's fiscal response to the crisis was one of the largest in the OECD as a percentage of GDP, especially in terms of getting cash to individuals and businesses (figure 3). Government announced a $12.1 billion support package on 17 March 2020, shortly before New Zealand went into its first lockdown, and a further $50 billion was set aside in the COVID-19 Response and Recovery Fund (CRRF) soon after that.[7]

Figure 3: Magnitude of the COVID-19 Fiscal Policy Response by Country (% of GDP)



Source: IMF

The well-accepted objectives for effective fiscal stimulus are that it is timely, temporary and targeted.[8] Overall, New Zealand's fiscal response is meeting these objectives, perhaps better than many may have anticipated.

What do I mean by that? A traditional concern from economists is that fiscal policy is prone to lags, both in the time taken to recognise the need for action and take a decision, and in the time taken for the effect on the economy to become apparent.[9]

The best counter to this is the government's wage subsidy, which was its single largest COVID-19 fiscal measure, with around $14 billion paid out in 2020 supporting nearly 1.8 million jobs (figure 4). The first case of COVID-19 was reported in New Zealand on 28 February 2020. The wage subsidy opened just a few weeks later on 17 March, before the lockdown came into effect on 25 March.[10] By the 26 March, $1 billion of subsidies were already paid to businesses through the wage subsidy and leave schemes. On average,

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7 The measures introduced as part of New Zealand's COVID-19 economic response are summarised on the Treasury's website.

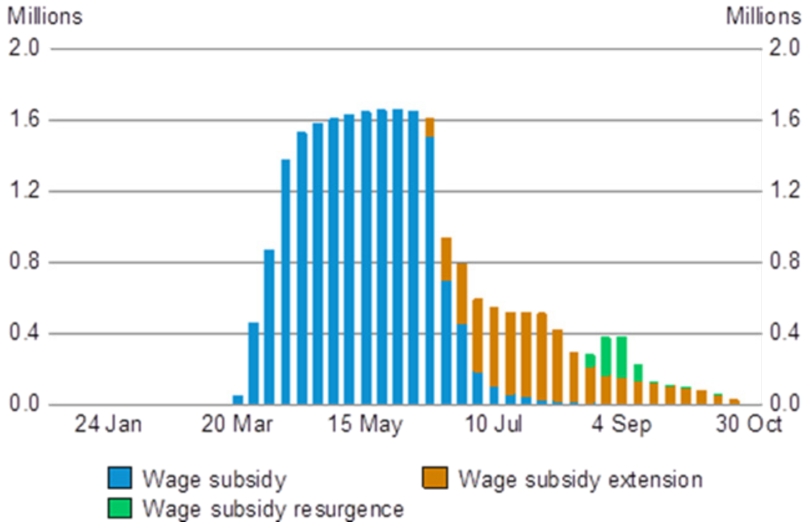
8 Elmendorf and Furman (2008)

9 Blinder (2004)

10 Ministry of Social Development (2020)

wage subsidy payments were made within 3.5 days of receiving an application, and in some cases, a matter of hours.[11] Businesses have told us that the **timely** delivery helped boost confidence, and kept workers in jobs.

Figure 4: Numbers of jobs supported by wage subsidy



Source: Ministry of Social Development

The wage subsidy was designed to provide **temporary** support only. The vast majority of other fiscal supports were temporary, too. This limited the extent to which there was a significant fiscal expansion in permanent spending.

While the wage subsidy has a high profile, it is important not to underplay other elements of the fiscal response, which accounted for more than $40 billion (figure 5). A significant strength of the fiscal policy response was the ability to **target** impacted sectors and populations. This included:

- More than $5 billion for New Zealand's health response, which successfully eliminated COVID-19 in the community.
- A range of business supports, including tax measures, credit programs, and advisory services, as well as support packages for industries most affected, including aviation, tourism, and the arts and cultural sector.
- Direct assistance for more vulnerable groups, including increases in benefits, energy payments, community support through Whānau ora, active labour market programs, employment and expanded education, training and apprentice programs for youth and unemployed.
- Economic recovery measures that also address longstanding challenges, including climate change, housing, and infrastructure.

Another $5.1 billion from the CRRF remains unallocated and available for response to future outbreaks or other needs.

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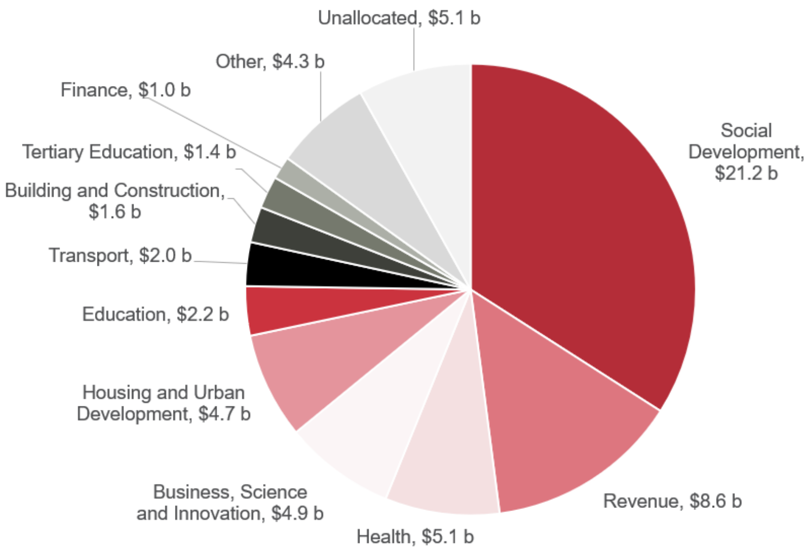
11 Office of the Auditor-General (2021)

Figure 5: COVID-19 Funding Overview by Vote

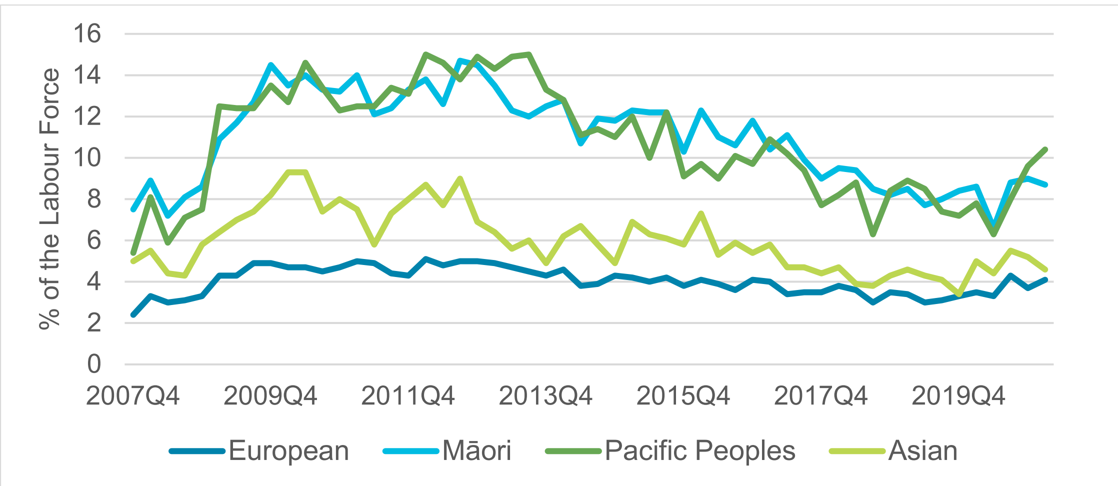


Source: The Treasury

Targeted support has been especially important because of the extreme unevenness of the COVID-19 downturn. Tourism and international education sectors have been particularly hard hit, whereas construction, healthcare, and public administration have grown and are reporting skills shortages in some areas. Existing disparities in employment outcomes were initially exacerbated, with younger people, women, Māori and Pacific people the most disadvantaged.

Encouragingly, we are now starting to see unemployment rates approaching pre-pandemic levels for many of the most affected groups (figure 6). Unemployment rates appear to have recovered more quickly than was the case after the GFC. Then, it took roughly 10 years to get back to pre-GFC levels for the overall population, while Māori unemployment was just approaching pre-GFC levels as the pandemic hit. Of course, the labour market is not yet fully recovered— in particular, Pacific peoples unemployment remains elevated, as does underutilisation for most groups. And it's important to remember that in returning to pre-pandemic patterns there are existing inequities.

Figure 6: Unemployment rate by ethnicity



Source: Stats NZ

While the fiscal response has supported a strong recovery from the pandemic, we have also learnt more about delivering timely, temporary and targeted stimulus during a crisis. A few reflections:

1. The response underscored the importance of **speedy implementation**, for providing confidence and getting cash to where it was most needed. But there can be a tradeoff with value for money. The wage subsidy scheme was effective precisely because of the speed with which payments were made to businesses – however this meant accepting the risk that some payments would be unnecessary.

2. The speed of response depends critically on **implementation-ready plans**. The remarkably fast rollout of the wages subsidy was possible because it was simple, used existing systems, and built off models from the Canterbury and Kaikoura earthquakes. But we saw lags in other areas, such as infrastructure, highlighting the importance of having a strong pipeline of projects that allows investment to accelerate if required.

3. **Capacity constraints** can limit delivery – and there are limits on how quickly human and capital resources can shift between sectors during a crisis. In the public sector, working across systems was important to help address capacity constraints—for example delivering supports through community organisations, or working with banks on credit support.

4. An **iterative and agile approach** to fiscal policy can help when managing extreme uncertainty. For Treasury this included exercising the flexibility provided in the PFA on advice to setting fiscal targets, working to scenarios, drawing on and communicating high-frequency data, and engaging with businesses in design and ongoing refinement of policies. For future shocks if we have better quality leading indicators it will help us deliver an agile response.[12]

5. Finally, the pandemic has shown how critical it is to **think broadly about living standards** in formulating macroeconomic policy. We've seen that a focus on health outcomes helped hold up GDP and employment. A hallmark of New Zealand's effective response has been strong social capital. The unevenness of the downturn has highlighted the need to understand distributional effects and develop targeted responses. And the fiscal response provided an opportunity to address longstanding challenges to wellbeing while supporting short term stabilisation. That is all consistent with the Treasury's Living Standards Framework for assessing policy, and we have seen the importance of that broader perspective in the pandemic.

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[12] Sahm (2019)

C The role of fiscal policy in short-term stabilisation: beyond the pandemic

Beyond the pandemic, over the last decade there has been a growing view in economics on the need for a more active role for fiscal policy in macroeconomic stabilisation.

Evidence from the period after the GFC has improved our understanding of the benefits arising from fiscal policy, showing that both spending increases and tax cuts can boost output in the short-term. Where monetary policy is at the effective lower bound, fiscal multipliers can be even higher than when monetary policy is not constrained.[13]

It is also widely accepted that fiscal policy may have a comparative advantage in responding to shocks that have large and uneven impacts on particular sectors and regions. Examples include supply shocks, or earthquakes and other natural disasters, which require a targeted response. In contrast, as a broad-based tool, monetary policy is better suited to broad-based disruption such as aggregate demand shocks.[14]

Moreover, there is growing support for the idea that active use of fiscal policy is necessary to maximise employment in the current low interest rate environment.[15] This thinking is underpinned by three inter-linked ideas:[16]

1. That a macro response is necessary to increase aggregate demand to match supply, when private demand is weak.
2. That fiscal policy needs to play a leading role in this, given constraints on monetary policy.
3. There is scope for fiscal policy to take on such a role, given the benefits of low interest rates for fiscal sustainability.

Nevertheless, a number of reservations about the practical constraints to more active fiscal policy remain. I have spoken about implementation lags, a risk of lower value spend, and the challenge of targeting a fiscal stance when the future is uncertain. A critical concern is also how to ensure **symmetry** across the cycle. Fiscal policy is relatively easy to loosen in a downturn, but for political economy reasons it can be difficult to tighten during an upturn, leading to a "deficit bias" and pro-cyclical policy.

I'll turn to mechanisms to address these concerns later.

The first point to highlight, however, is that New Zealand's budget balance has been broadly counter-cyclical in recent decades (figure 7), falling when the output gap is negative and increasing when it is positive. This has been underpinned by both automatic stabilisers and discretionary settings.[17]

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13 Ramey (2019)

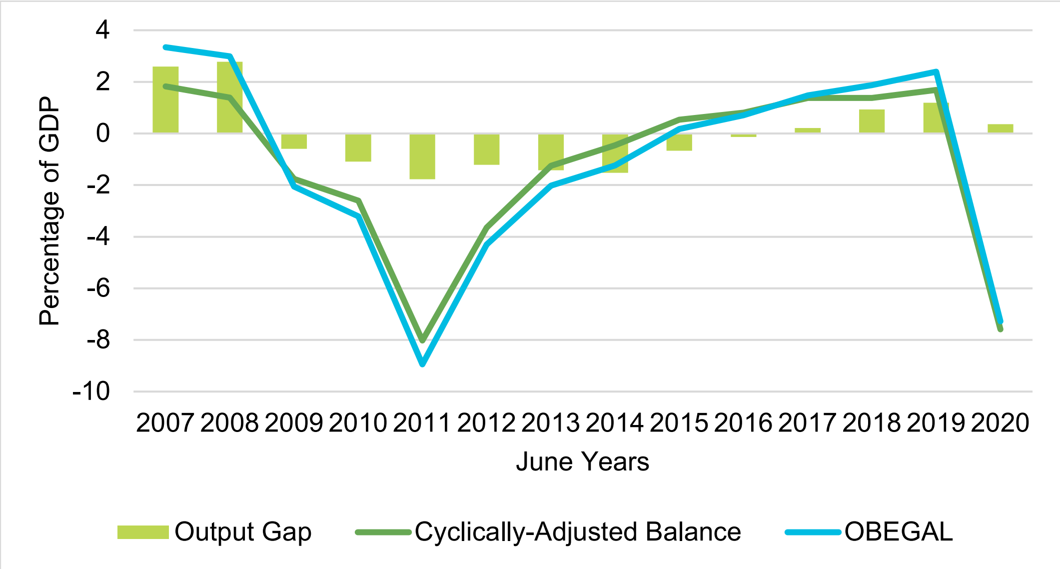
14 Brinca, Duarte and Fario e Castro (2020)

15 Furman and Summers (2020)

16 Blanchard, Felman and Subramanian (2021)

17 Bernstein, Gaukrodger and Parkyn (2021)

Figure 7: Cyclicality of spending in New Zealand



Source: Brook (2013) and the Treasury

D What does a greater role for fiscal policy mean for fiscal sustainability and prudent debt?

New Zealand entered the pandemic with a strong balance sheet, reflecting a long bi-partisan history of fiscal discipline, as embedded in our existing macro frameworks and our political culture.

The Government's fiscal strategy has focused on securing our economic recovery while maintaining fiscal sustainability in the long term.

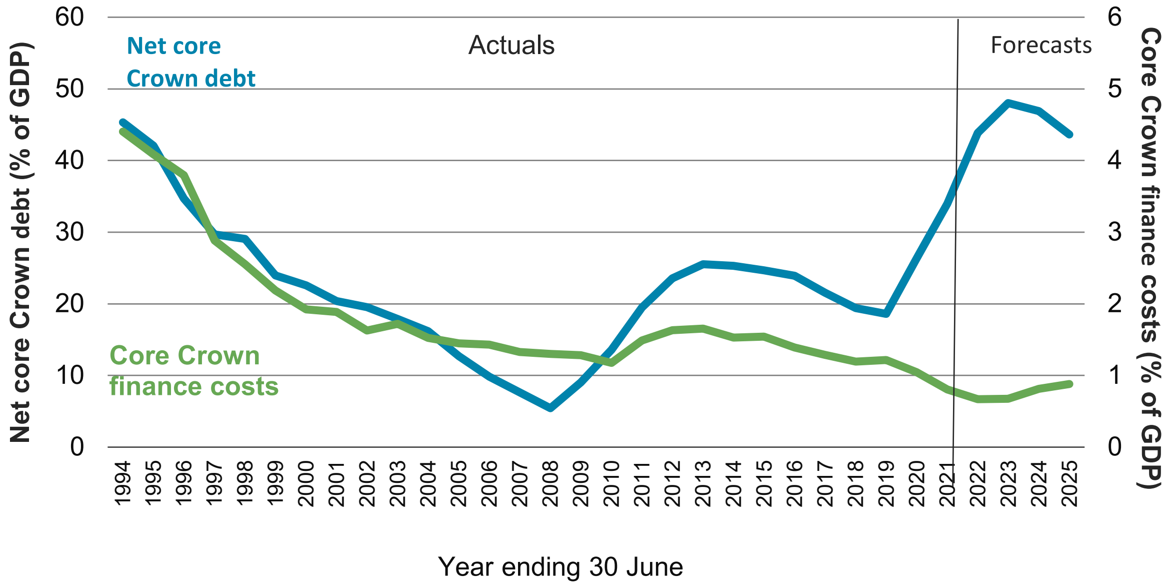
The COVID-19 response was critical to the recovery, but led to large increases in public debt. Net debt is now forecast to peak at 48% of GDP in 2022/23[18] compared to the pre-pandemic forecast peak of 21.5% of GDP in 2021/22.[19]

Despite the increase in debt over the past year, the Treasury considers our current debt level and the trajectory of net debt over the forecast period to be both prudent and consistent with the principles of responsible fiscal management in the PFA. In part, this is because even as debt levels rose, interest rates fell, meaning that debt servicing costs are actually lower now than they were before COVID (figure 8).

[18] The Treasury, Budget Economic and Fiscal Update 2021. This figure includes impact of FLP.

[19] The Treasury, Half Year Economic and Fiscal Update 2019

Figure 8: Net debt and Finance Cost since 1992



Source: The Treasury

Our view is also that there are high marginal benefits to wellbeing for spending to offset the worst aspects of the crisis and avoid long term economic scarring. With limited space for conventional monetary easing and ongoing uncertainty, consolidating too early could also have significant risks to long-term living standards. The IMF has warned about premature consolidation as a risk to our economic recovery.[20] If the economy ultimately responds better than expected, automatic stabilisers will be triggered and monetary policy could be adjusted.

So how does the Treasury interpret prudent debt? Critically, the Public Finance Act allows significant flexibility in this question, recognising that 'prudent' debt levels will vary over time and according to context. Historically, there have been considerable changes in the government's debt targets, which reflect the context and value judgments of the time (figure 9).

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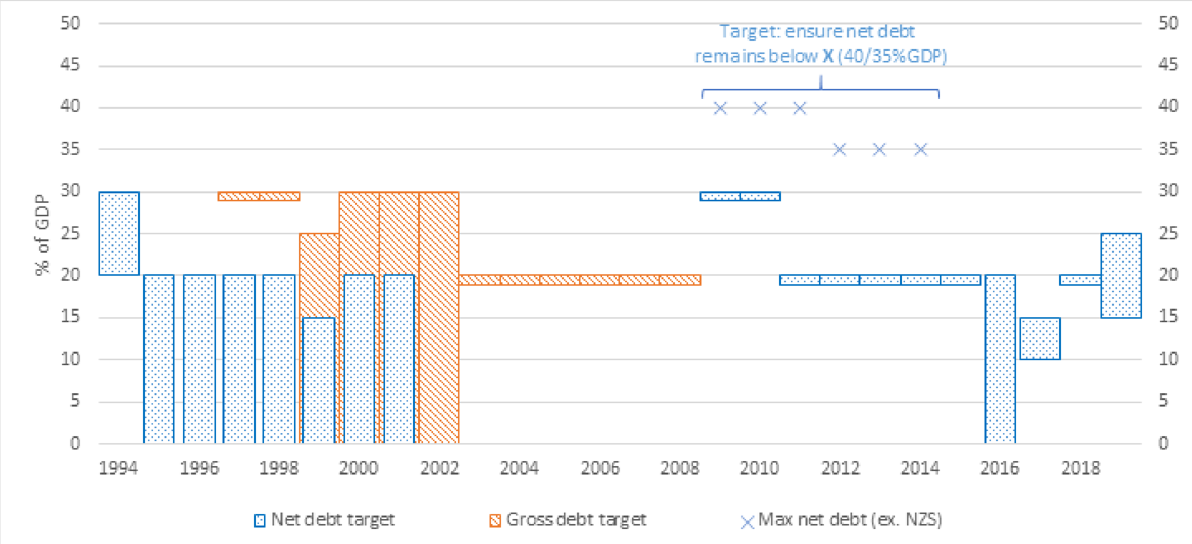
[20] IMF (2021)

Figure 9: Fiscal targets over time



Source: The Treasury

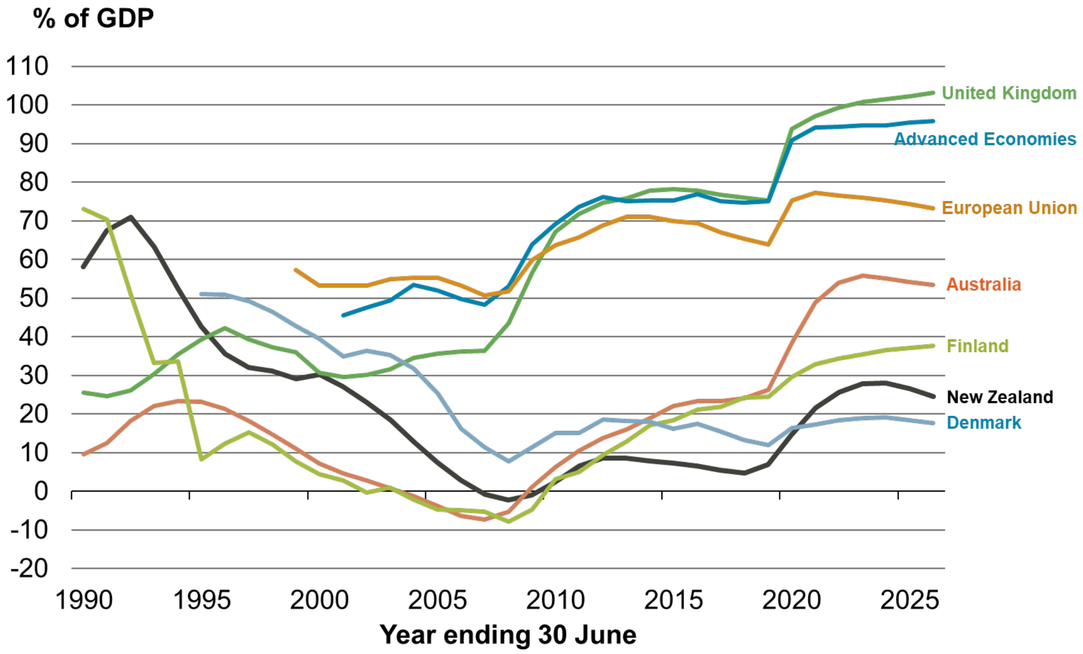
The Treasury's starting point in assessing prudent debt is to consider the upper limit for debt, which depends on a set of factors and value judgements:

- **Whether debt remains sustainable**: This considers the trajectory of debt and the risk that it reaches a level above which the government may default. Future interest rates and GDP growth rates are important considerations to assess this, alongside pressures on the underlying structural balance.

- **Whether we have the ability to access debt markets**: This refers to the level of debt beyond which creditors may no longer be willing to lend on reasonable terms. Credibility in our frameworks and institutions is a critical factor here, as is the level of private debt in New Zealand and our risk relative to other borrowers—noting that net debt remains low relative to other countries (figure 10).

- **Whether debt is welfare-enhancing**: This requires weighing up the costs of higher debt against the benefits of new spending and needs to take an intergenerational perspective. When debt servicing costs are low, or quality of investment high, it is increasingly likely that the benefits of investing to maximise outcomes for current and future generations outweigh the costs.

Figure 10: IMF general government net debt[21]



Source: IMF

In 2019, we considered an upper debt level of around 50 to 60% of GDP to be appropriate.[22] But there is no one fixed number; upper limits of debt depend on the context.

At present, the risks associated with market access and debt sustainability are very low. Market access is likely maintained with debt far in excess of 50 to 60% of GDP, and low interest rates mean debt sustainability is not currently a concern at those levels either. Like all advanced countries, New Zealand has long term fiscal pressures—from population aging, rising health expenses and community expectations, and climate change—that need to be managed. But these are not new.

Prudent fiscal management is broader than limits on debt, however. Indeed, while fiscal discipline is always important, it is also important not to have an excessive focus on debt levels as an end objective in and of themselves. The greater challenge for fiscal management is determining the level of debt and spending over time that maximises wellbeing.

The general rule of thumb is that debt should fund spending where, across generations, the benefits in wellbeing exceed the costs of that spending. The ‘right' level of spending therefore depends critically on the value of spending initiatives – where initiatives can deliver high value for money, the appropriate level of debt will be higher. And with debt servicing costs at historically low levels, there is greater headroom for high-quality investments that raise living standards across generations.

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[21] The IMF’s general government net debt definition is different to the net core Crown debt measure that the Treasury produces. The difference reflects variations in accounting frameworks, entity coverage, and the financial assets included within the respective net debt measures. For example, the IMF measure includes the financial asset portfolios held by ACC and the NZ Superannuation Fund. This produces a relatively lower net debt figure. The financial assets coverage attributes a large portion of the difference between the two measures.

[22] Makhlouf (2019)

The Treasury's Living Standards Framework helps us to assess these trade-offs. It can help identify value-for-money investments that might be overlooked with a narrow focus on debt limits, for example high quality spending to tackle longstanding challenges like productivity, climate change and inequality, which bring benefits to future as well as current generations. As we think about investment, we need to recognise that public investment crowding out private is a potential cost, but needs to be balanced against potential benefits as well.

It is also important to recognise the implications of low interest rates beyond the *level* of debt. With interest rates expected to be below growth rates for a considerable period, it is technically possible for debt as a percentage of GDP to fall, even with a structural budget deficit. This is a fundamentally different dynamic to what we were experiencing when the principles of responsible fiscal management were created, and highlights the importance of having a flexible framework that allows practice to evolve in line with conditions.

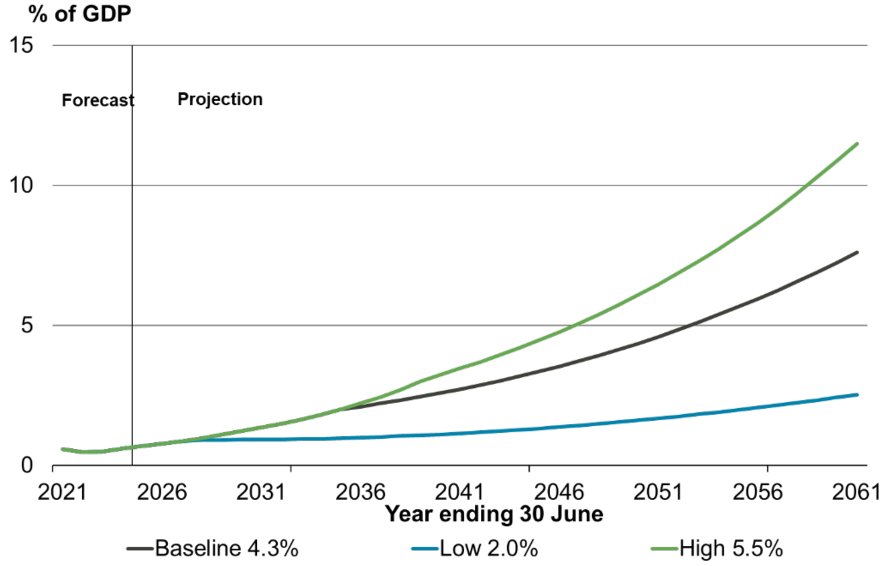
Our thinking about debt levels also needs to factor in risks and uncertainty. New Zealand is a small open economy that is susceptible to economic shocks and natural disasters. This means it remains prudent to keep a fiscal buffer that enables us to respond in times of crisis.

In addition, there is uncertainty over future trends in key variables, such as interest rates. The Treasury debt forecasts assume that interest rates rise, consistent with market expectations. While factors influencing the long term decline in interest rates—such as changing demographics, globalisation, technology, inequality—are unlikely to quickly change, we cannot discount the possibility that favourable debt dynamics will reverse.

Our forthcoming Long-Term Fiscal Statement and Insights Briefing explores this risk and shows that changes in the interest rate can have a significant impact on debt outcomes (Figure 11). For example, a 350 basis point increase in interest rates can increase debt by about 87 percent of GDP by 2061, an increase of about two-thirds. While the difference doesn't fundamentally change the trajectory of debt over the next 40 years, debt servicing costs in 2061 vary from 12 percent of GDP in the case of a 5.5 percent interest rate, to only 2.5 percent of GDP if interest rates were 2 percent.[23]

[23] Treasury's Long-Term Fiscal Statement and Insights Briefing projects the fiscal position over the next 40 years assuming that expenditure and revenue follow historical trends. The alternative scenarios presented here apply different assumptions about long-run interest rates to this projection. It should be noted that the basis for these scenarios, which assumes no adjustment, is unlikely to play out. However, it usefully illustrates the magnitude of fiscal adjustment governments may need to manage if historical trends persist.

Figure 11: Core Crown debt finance costs as a % of GDP under different interest rate scenarios



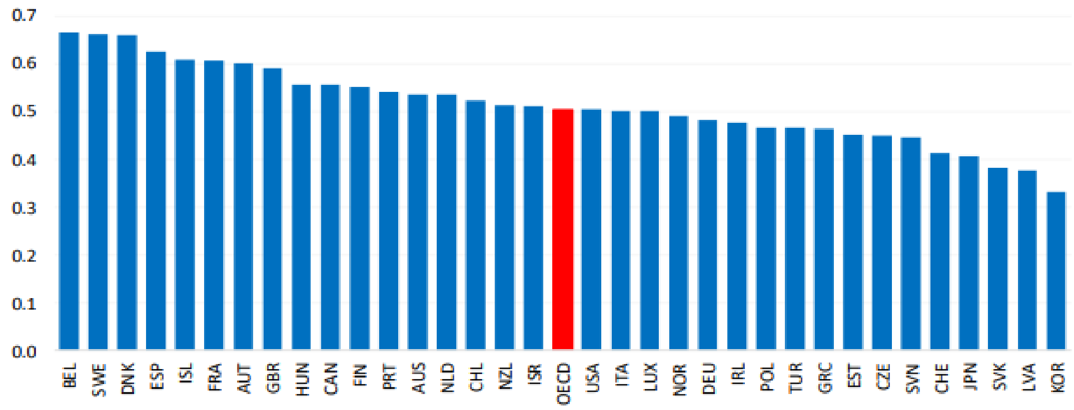
Source: The Treasury's Long-term Fiscal Model

E Towards more effective fiscal policy in short term stabilisation

If fiscal policy is to play a greater role in stabilisation, there are choices about how that is achieved. These choices will have implications for the size and structure of government. There are three broad options for how fiscal policy can act as a stabiliser: through automatic-stabilisers, semi-automatic stabilisers or discretionary policy changes.

Automatic stabilisers act to dampen the effects of economic cycles by automatically adjusting taxes and welfare payments in line with economic activity. New Zealand's automatic stabilisers are slightly above the OECD average in terms of how responsive the budget balance is to changes in output (figure 12).

Figure 12: Effectiveness of automatic stabilisers (budget balance semi-elasticity)



Note: The semi-elasticity indicates the cyclical component of the budget balance (i.e. the difference between the structural cyclically-adjusted budget balance and the unadjusted balance – as per cent of GDP) when the output gap is equal 1% of potential GDP – see the main text.
Source: Price, R., T. Dang and J. Botev (2015), "Adjusting fiscal balances for the business cycle: New tax and expenditure elasticity estimates for OECD countries", *OECD Economics Department Working Papers*, No. 1275.

Key benefits of automatic stabilisers include that they reduce implementation lags and lean against asymmetric incentives such as a deficit bias, by adjusting automatically according to the economic cycle.[24] For example, one likely benefit of a social insurance scheme, as is currently under policy consideration, would be to strengthen the automatic stabilisers.

New Zealand's COVID-19 response has demonstrated the impact of discretionary fiscal policy. Discretionary policy has the advantage of being calibrated to address the circumstances. However, as I discussed earlier, discretionary policy also poses a number of challenges such as implementation lags and deficit bias.

More recently, there has been significant academic interest in semi-automatic stabilisers which could be triggered once the output growth rate declines or the unemployment rate increases.[25] In New Zealand, the COVID-19 business support payments could be considered an example, as they get triggered with higher COVID-19 alert levels.

The right balance between these fiscal tools may depend on the frequency with which they are used. If frequent fiscal policy interventions are required to manage the economic cycle, then the administrative and implementation costs associated with discretionary interventions could become high. In this case, automatic or semi-automatic stabilisers may be more appropriate. A key strength of both automatic and semi-automatic stabilisers is also that they are not contingent on us being able to forecast the future.

Value for money

Regardless of the tool, fiscal policy will be more effective by ensuring we get value for money from government spending.

Higher quality spend can support fiscal sustainability, by achieving more for less and dampening pressure on expense growth.

Improving value-for-money can be seen somewhat like maximising the 'fiscal multiplier'—aiming for the greatest benefit from a given level of spend. Of course not all welfare or wellbeing is captured by GDP, so we need to think broadly about the outcomes achieved by spending. The Treasury's Living Standards Framework prompts this broader and more rigorous view. As I have said before, there is no dichotomy between the Living Standards Framework and traditional economics. In many ways the Living Standards Framework is classic welfare economics, and cost-benefit analysis done thoroughly and thoughtfully.

Ensuring value for money means greater attention to budget and investment frameworks—measures like strengthened systems for long-term service and asset planning, cost-benefit analysis and use of the Living Standards Framework, non-financial and financial performance monitoring through implementation, and ex-post evaluation that links back to budget decisions.

More broadly, Treasury is examining opportunities to modernise the public finance system. This includes a greater focus on strategic planning and wellbeing outcomes, improved collaboration across agencies to achieve those outcomes, further emphasis on base not just incremental spending, and a stronger medium-term focus. These changes aren't just about our budget systems, they are also about making fiscal policy more effective.

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24 Deficit bias is the tendency of governments to allow deficit and public debt levels to increase.

25 Sahm (2019)

F Policy interaction and coherence

A low interest environment and stronger role for fiscal policy has also meant new interactions between fiscal and monetary policy. I want to be clear, this is not about the independence of monetary policy: independent monetary policy is a cornerstone of strong economic institutions in New Zealand, and this is critical to maintain. At the same time, we need to understand policy interactions, and ensure a coherent policy stance. I'll highlight three areas of focus:

The first is the impact of alternative monetary policy on the Crown's balance sheet. During COVID-19, as part of its monetary policy mandate the RBNZ purchased nearly as many government bonds from the market as the Treasury issued into the market. This helped lower interest rates across the economy and resulted in lower government funding costs.

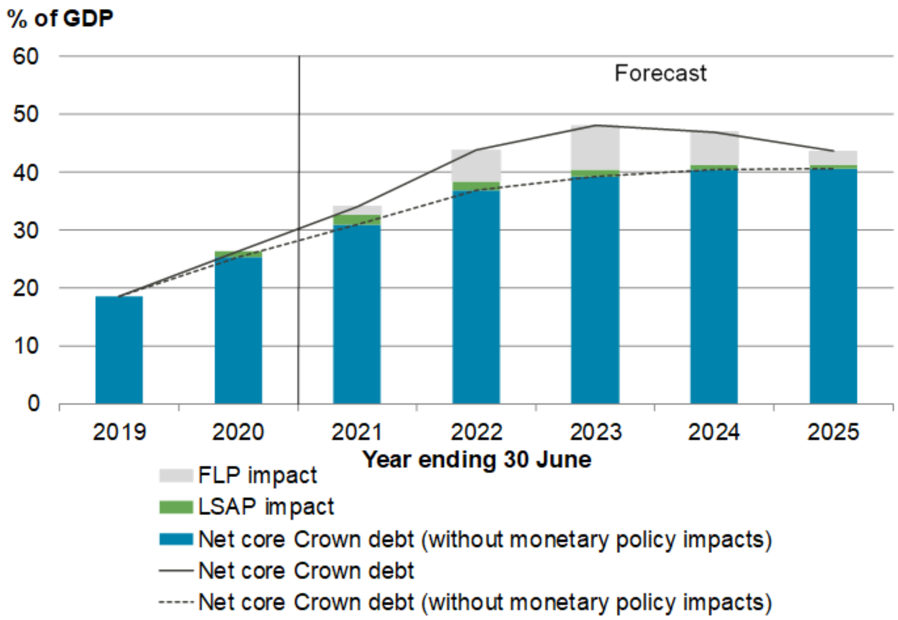
Because the RBNZ is consolidated into the Crown's balance sheet, the LSAPs alongside the funding for lending programme have increased net core crown debt. Moreover, the LSAPs have changed the composition of net debt, with a greater share now held as settlement cash (figure 13 and 14). We are now reviewing our fiscal indicators—Treasury is of the view we need to avoid the perverse effect of alternative monetary policies encouraging a fiscal tightening. We have also worked closely with the RBNZ on indemnities and other mechanisms to enable independent decisions on AMP, while ensuring transparency on Crown balance sheet impacts and risk appetite.

The second point to highlight is that an increased use of discretionary fiscal policy could have cyclical implications for monetary policy. As explained earlier, a key challenge in using fiscal policy as a stabilisation tool is asymmetry—it is generally easier to loosen than tighten fiscal policy. While expansionary fiscal policy can take the pressure off monetary policy during a downturn, it can also increase inflationary pressures during periods of economic recovery and growth, with consequences for interest rates, the exchange rate and exports.

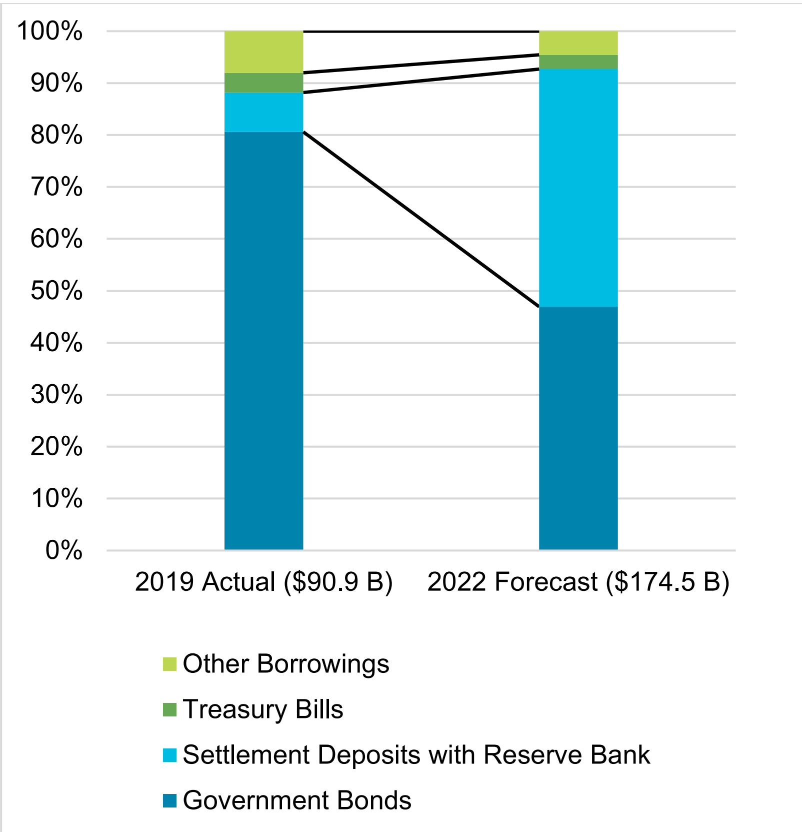
Thirdly, the pandemic has raised the profile of the distributional impacts of monetary policy, particularly as they relate to house prices. These distributional impacts are complex. Lower interest rates increase employment, benefit borrowers and asset holders, and reduce returns to savers. The net effect on total wealth and income inequality is an empirical question we cannot yet fully assess. What we do know is that monetary policy is a broad tool that is not well suited to managing distributional impacts—this is the domain of other policies including fiscal, regulatory and social policy. But greater transparency and communication—**without** transferring accountability to the RBNZ—can help. Recent changes to the monetary policy remit aim to improve policy coherence in this way, and we continue to coordinate with the RBNZ on these and related matters.

In sum the Treasury and RBNZ have a strong and effective relationship. We have long had institutional arrangements and mechanisms to support coordination, while respecting each others mandates. Our changing context has meant these mechanisms are evolving and strengthening.

Figures 13 and 14: Impact of alternative monetary policy tools on the level and composition of net core Crown debt



Source: The Treasury



Source: The Treasury

G Closing remarks

I want to conclude my remarks today with an explicit acknowledgement of both the strength of New Zealand's macroeconomic frameworks, and the need to evolve and interpret them to account for the current economic challenges we face.

For this reason, the Treasury has recently started a work programme to ask: what do the structural changes in our economic environment mean for our approach to macroeconomic management?

Clearly, our understanding of the response to the pandemic, and big economic trends that I've discussed today mean we need to examine topics like the role of fiscal policy in macro stabilisation, our approach to fiscal management, increasing the quality of spend and wellbeing benefits from fiscal policy, and the coordination of monetary and fiscal policy.

Our first step is to ask questions, outline the issues and build knowledge. As I outlined at the start of this speech, our intention as we do that is to learn from the past – both in terms of the great strengths in our existing system that have meant we have been well-placed to respond to economic shocks, and also how to build on these strengths as we adapt to our new context. Doing so will help us in our goal of lifting living standards for all New Zealanders.

Speaking to New Zealand's expert community, as gathered here today, marks an important step in our engagement on these topics. Hopefully today's remarks serve to spark some interest and some debate, and again, I encourage you all to be active participants in our imminent consultation on the combined Long-term Fiscal Statement and Long-term Insights Briefing.

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