TE TAI ŌHANGA
THE TREASURY

New Zealand's economy through the pandemic and choices for fiscal policy

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This morning, I would like to make a few observations on the economy, which has been resilient in part thanks to the strong economic and health response to COVID. But we are now seeing shorter-term issues around capacity and inflation, as well as longer-term issues including a higher debt position. So how do we address these? What are the trade-offs we face across the goals of improving living standards, macroeconomic stability, and fiscal sustainability? With these questions in mind, I'll also outline 3 of the big choices New Zealand faces in fiscal policy:

- Macro-economic stability versus other living standards objectives
- Prudent debt versus prudent investment
- Fiscal versus other government policies

State of the economy

Let's start with the state of the economy.

We are now in year 3 of the pandemic. COVID-19 has caused severe disruption in some sectors and for some businesses and people. But overall, the New Zealand economy has proven resilient to date. Lockdowns caused much spending to be delayed rather than cancelled altogether. This drove unprecedented volatility in quarterly GDP, but the level of overall economic activity is now approaching the pre-COVID trend and is stronger than in many other advanced economies. Government spending and monetary policy have played central roles in this resilience.

[1] I would like to acknowledge with thanks all those involved in compiling this speech. In particular, thank you to Giles Bollinger, Natalie Labuschagne, John Janssen, Bryan McDaniel, Ben Gaukroger, Melanie Craxton, Peter Mawson and Michael Thomson.

Among the remarkable aspects of the COVID-19 downturn is the nature of the supply shocks. Lockdowns shut down both production and consumption in many industries, and subsequent "catch-up production" has not been possible in the same way as catch-up demand. In addition, the availability of workers has been impacted by the border restrictions, and global supply chains have been severely disrupted, constraining businesses' ability to meet demand.

Figure 1 – New Zealand's real production GDP between 2018Q1 and 2021Q4

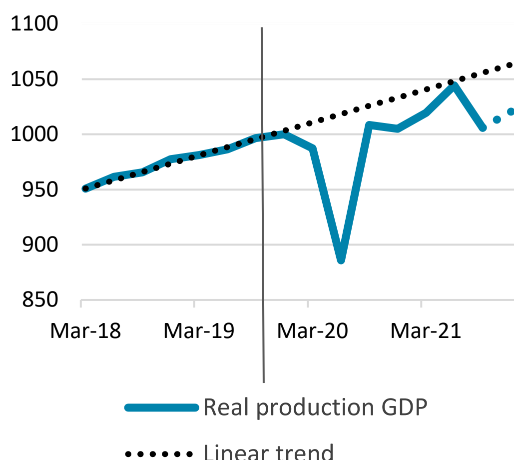
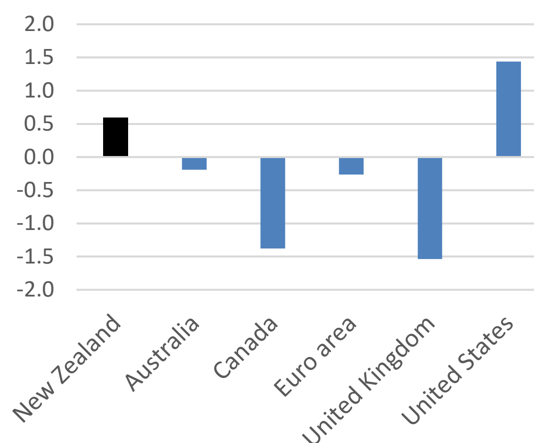


Figure 2 – Change in real GDP between 2019Q4 and 2021Q3, selected countries



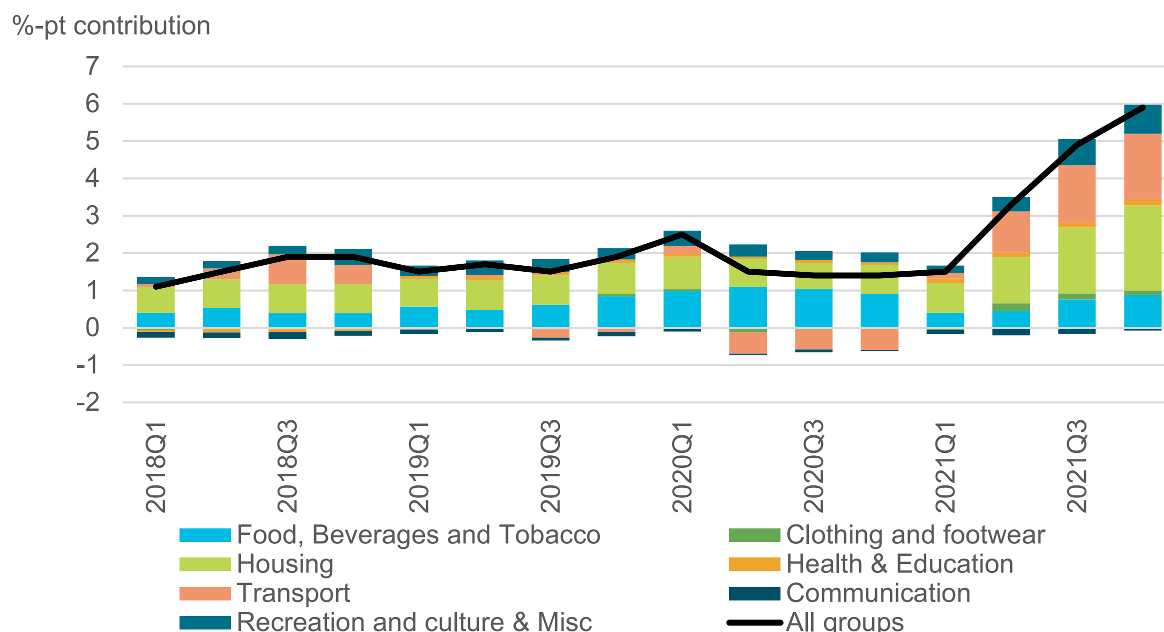
Both the resilience of the economy and the tightness of supply are especially evident in labour markets.

Unemployment and underutilisation are below pre-pandemic levels across all ethnicities, as well as for women and youth—although existing disparities remain. Importantly, participation in the labour force has held up, unlike some other advanced countries. Wage inflation is starting to accelerate and expected to grow.

Border restrictions have contributed to the tight labour market, as industries experiencing skill shortages have been less able to access international workers. But in some cases border restrictions have cushioned the blow to the labour market. For example, while retail trade and accommodation experienced the highest falls in employment in the 2 years to December 21, this was offset by the falls in working holiday visas holders (who comprise 25% of the jobs in accommodation and food services in 2019).

Resilient demand combined with interrupted supply has brought inflationary pressures. Inflation has risen overseas for similar reasons, and global inflation is also impacting New Zealand, with fuel prices the greatest driver of inflation.

Figure 3 – Contributions to Annual CPI inflation



At the onset of COVID-19 central banks in New Zealand and overseas reduced interest rates. This supported consumption and employment, and it also boosted asset prices, exacerbating wealth inequalities between those with and without assets[2]. With inflation on the rise, central banks in New Zealand and overseas have either started lifting interest rates or have signalled they will. This will have a dampening effect on asset prices. In New Zealand we have already seen the housing market start to slow, which we forecast to continue.

We expect inflation to peak in March 2022 and ease over time as supply chains normalise, COVID-19 disruption and border restrictions unwind, and consumer spending moderates in line with monetary policy normalisation and a cooler housing market. As the economy moderates, unemployment may rise slowly from today's record low levels.
While the economy overall has been surprisingly resilient, COVID-19 has driven shifts in the economy's structure, some of which have fuelled inflation as relative prices change. Some businesses have faced far more difficulties than the macro picture would suggest.

- You can see here an expenditure breakdown of economic growth (Figure 4) shows the role that government consumption has played in supporting demand. Residential investment and, to a lesser extent, private consumption, have also grown strongly, supported by rising house prices.

- Imports and exports of services have fallen dramatically, alongside the lack of international travel. Businesses reliant on overseas tourists or students are really struggling.

- New Zealanders have substituted away from services into consuming durable goods – people are buying new cars and kitchens instead of taking overseas holidays.

[2] Analytical Note 21/01: The Wealth Ladder: House Prices and Wealth Inequality in New Zealand. New Zealand Treasury (2021)

- The same switch from services to goods is happening globally, boosting commodity prices. Our key goods exporters are experiencing high prices for their products and the terms of trade are their highest in more than 100 years.

- Consumer spending has shifted from in-person to on-line, and the increase in working from home has changed consumption patterns within cities.

Figure 4 – Expenditure GDP composition
Percentage change – 2021Q2 vs 2019Q4

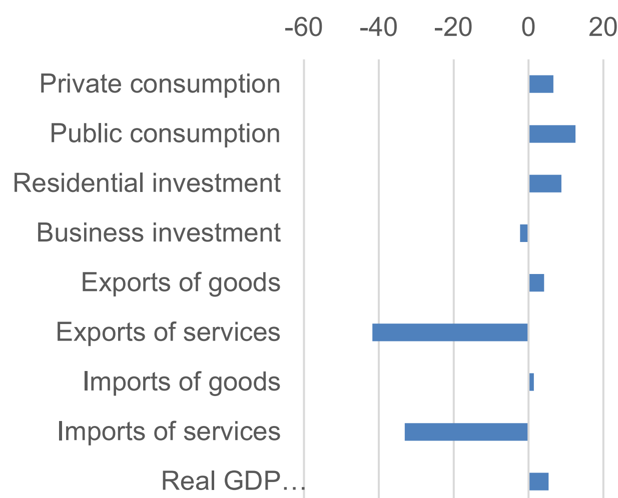
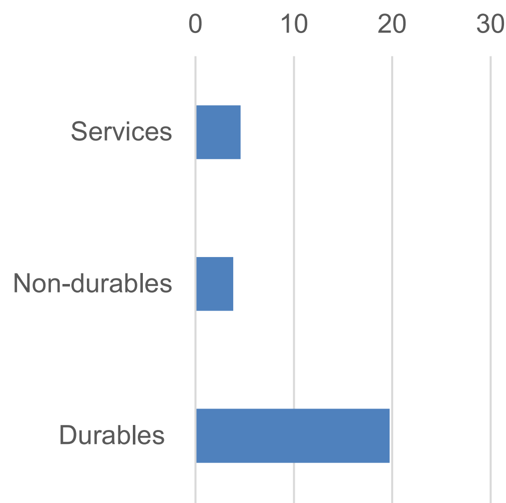


Figure 5 – Household consumption
Percentage change – 2021Q2 vs 2019Q4



Despite the disruption, we do not yet see evidence of widespread scarring to date, with insolvencies at record lows, strong labour market outcomes and stable long-term unemployment. And some longer-term trends have persisted. Increases in the terms of trade—which have contributed to income growth for decades—continued. On the other hand, there is no evidence that the longstanding trend of low productivity growth has changed.

Today we are facing into rising cases of the Omicron variant. Omicron is disrupting both demand and supply through worker absences and individual efforts to avoid illness, rather than via lockdowns. Our analysis suggests Omicron will reduce March quarter GDP by around 1.5 to 2 ppts. However, international experience suggests that Omicron waves peak quickly, and that economic activity rebounds relatively rapidly.

The pandemic has shown us time and again how quickly the outlook can change. On the upside, a lift in savings and stronger household and business balance sheets may support higher consumption and investment. The main uncertainty continues to be COVID-19. The international outlook also presents risks, with tensions in Russia and Ukraine, a growth slowdown in China, and uncertainty around how global asset prices will react to rising interest rates.

New Zealand remains in a strong position to withstand the risks and challenges ahead, with among the most robust economic performance of OECD countries through the pandemic and low levels of government debt relative to peers.

Fiscal policy and choices ahead

Fiscal policy has played a central role in the resilience of the economy through the pandemic to date. The wage subsidy and other economic supports have helped keep people in jobs and businesses running, funding enabled an effective health response, and increases to benefits (and other welfare spend) have supported vulnerable people.

New Zealand had one of the largest and most timely fiscal responses among advanced economies[3]. This was made easier by a strong Crown balance sheet entering into the pandemic, supported by a firm commitment across successive governments to fiscal sustainability.

Debt has risen dramatically, although the increase is close to the OECD average, and is far less than originally predicted thanks largely to the resilience of the economy.

Figure 6 – Net core Crown debt
Comparing projections

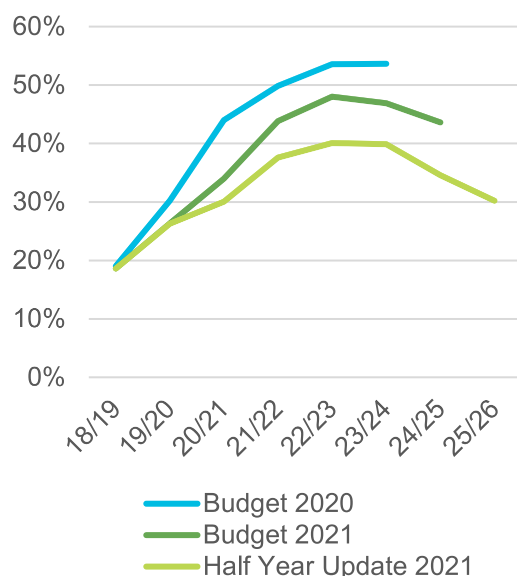
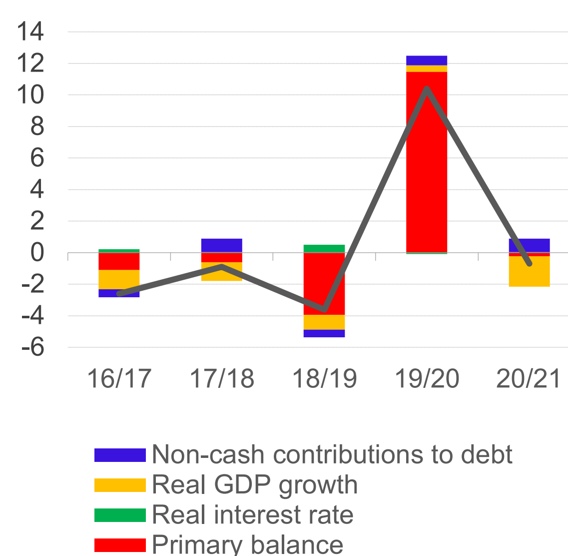


Figure 7 – Contributions to core Crown debt



At the start of the pandemic, Treasury's view was that the choices for fiscal policy were clear. Given the extreme nature of the shock, a swift and strong fiscal response was required. The risks of providing too little support when it was needed far outweighed providing too much support if not needed.

Looking ahead, the choices for fiscal policy entail a more considered balance across the goals of improving living standards, macroeconomic stability, and fiscal sustainability.

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[3] OECD Economic Surveys: New Zealand. OECD (2022), Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic. International Monetary Fund (2021)

As mentioned at the start I'll highlight 3 areas where governments face choices in setting fiscal policy that we believe are particularly relevant for the period ahead (and noting they are not exhaustive). These are the weight placed on:

- Macro-economic stability versus other living standards objectives
- Prudent debt versus prudent investment
- Fiscal versus other government policies

I'll outline briefly the ways in which Treasury aims to surface the trade-offs inherent in these choices in our advice to Ministers, who of course are ultimately responsible for weighing the options and making decisions.

The weight placed on macro-economic stability objectives

The main focus of fiscal policy is raising revenue and allocating spending in a way that lifts living standards. Fiscal policy enables short and long-term investments in schools, hospitals, roads, social and environmental services and essential infrastructure, for example.

Macroeconomic conditions—such as inflation, the state of the labour market, and exchange rates—also matter in setting fiscal policy. But they are only one factor, and need to be balanced against other objectives.

Governments have choices about balancing macro-economic conditions now with shaping long-term wellbeing later.

The main policy tool for managing economic cycles is monetary policy. Fiscal policy has an important supporting role though, particularly through automatic stabilisers that help to make economic cycles less pronounced. As we have seen through the pandemic, fiscal policy can also be very effective in supporting living standards by holding up activity in the face of significant shocks and targeting those most affected.

That said, an excessive short-term stabilisation focus for discretionary fiscal policy could lead to frequent changes in spending and tax programs, which could in turn impose microeconomic costs. Moreover, given the various lags inherent in discretionary fiscal policy outside of emergency spending, there is also a real risk that attempts at stabilisation actually end up exacerbating the economic cycle.

Fiscal policy can of course contribute to inflation—for any given level of activity, fiscal stimulus will add to demand and that puts pressure on prices. A few important points of clarification:

- First, demand is boosted by fiscal stimulus not just spending. For example, if revenues are rising at the same pace as expenses, we would not expect the same effect on demand.
- Second, the extent of any effect of stimulus on inflation will depend on the nature and timing of spending.
- Finally, we need to consider the supply side of the economy. If an increase in demand were accompanied by an increase in supply, we would expect growth not inflation.

What does this mean for fiscal policy today? While the extent of fiscal stimulus has been very large, the Treasury's Half-Yearly Economic and Fiscal Update shows a fiscal tightening from June this year, with a return to surplus by 2024 and a negative fiscal impulse from next year onwards.[4] This reflects the wind down of temporary-by-design COVID spending, and solid revenue growth—offset by significant allowances to achieve government's budget objectives, which include tackling climate change and health reform.

Economic supports are still available but are more targeted and aimed at avoiding scarring rather than broader support for demand provided earlier in the pandemic. (recognising that government can't fill all shortfalls).

The net effect is that fiscal policy is dampening pressure on inflation in the coming years. While the Treasury is forecasting inflation to remain above the Reserve Bank's target range throughout 2022 and 2023, fiscal policy is not the main factor driving this.

Of course there are options about the speed and extent of fiscal tightening. Interactions with monetary policy are relevant to the choices. Any government spending is expected to add to demand relative to not spending and will require a greater monetary policy response than otherwise. Fiscal multipliers are higher when rates are low. With interest rates close to their effective lower bound, fiscal policy may support monetary policy in normalising and enable additional headroom for future downturns—noting also effects on asset prices, and the potential for real higher exchange rates if New Zealand out of step with other advanced economies.

Ultimately the balance of these macroeconomic and microeconomic objectives are choices for the Government of the day. Our role at Treasury is to help inform those decisions by making clear the trade-offs

The weight placed on prudent debt versus prudent investment

The concept of prudent debt was introduced in New Zealand's legislation through the Fiscal Responsibility Act (FRA) 1994[5]—as part of a series of public finance reforms that are internationally renowned as a benchmark for promoting fiscal discipline and performance.

The authors did not define "prudent," instead giving governments the flexibility to interpret the principles of responsible fiscal management in the economic context of the time. There is no magic number for optimal debt; as Treasury advised back in 1994, it varies according to circumstances[6].

The Treasury's view is that today's level and trajectory of debt is prudent and consistent with the principles of responsible fiscal management enshrined in legislation. The fiscal framework is enduring, but context has changed.

[4] The total fiscal impulse estimates the total impact of Government support on aggregate demand from one year to the next, including the impacts of discretionary fiscal policy, automatic stabilisers, and finance costs. The methodology is outlined on the New Zealand Treasury website.

[5] Later incorporated into the Public Finance Act.

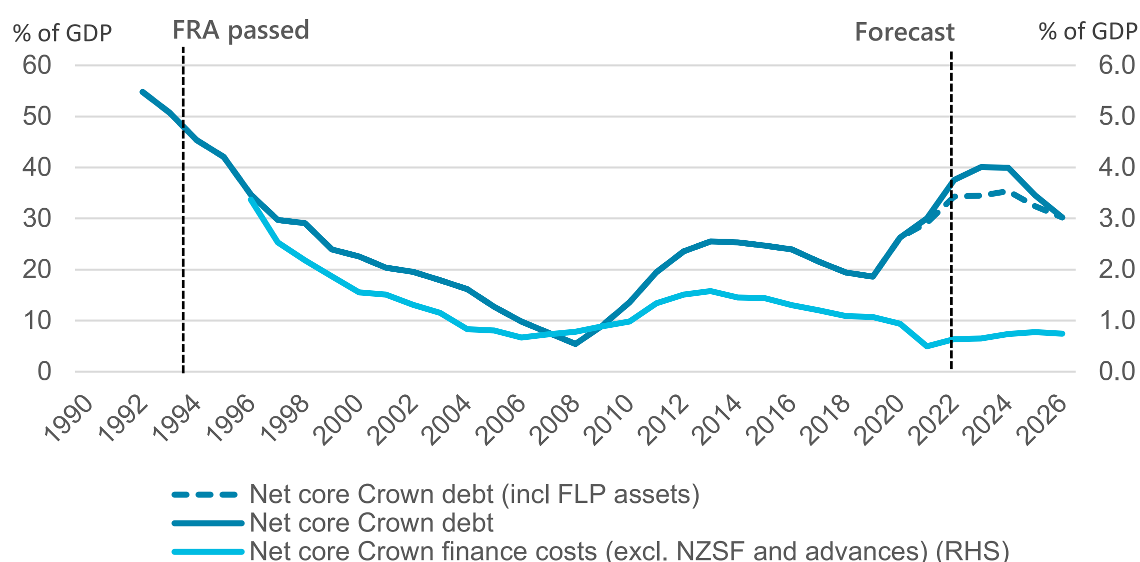
[6] In advice to the Minister of Finance in December 1993, Treasury stated that "There is no particular level of net public debt that unequivocally can be considered as "prudent" in all circumstance and at all times".

We examine three main factors in determining prudent debt: sustainability, market access, and welfare—or wellbeing—effects.

Net core Crown debt reached its peak of 55% of GDP in 1992, shortly before the FRA was passed and a long-term objective of net debt at 20 to 30% of GDP was established.[7] At that time:

- the Crown's liabilities exceeded its assets (negative net worth), financial assets accounted for only 3.8% GDP in 1994
- New Zealand sovereign debt rated at AA-
- Foreign currency debt comprised 43% of issuance
- and interest rates averaged 8.4%, over the 1992 year.

Figure 8 – Net core Crown debt and finance costs



Today, as Treasury advises on post-pandemic debt targets, debt servicing sustainability and market access considerations are completely different. Thanks in good part to the strong fiscal institutions embedded through public finance reforms, net worth to GDP is among the top quartile of OECD economies, with core Crown assets accounting for 32.5% of GDP. New Zealand's credit rating is within the top 20 globally, and New Zealand was the first sovereign to be upgraded by S&P in the pandemic. Less than 2% of debt is foreign currency denominated. And interest rates are 2.7% on 10-year bonds, with finance costs under 1% of GDP despite a large increase in debt.

The decline in debt costs reflects a longer-term trend of falling neutral interest rates (or the rate that neither stimulates nor constrains the economy). The result is that interest rates are lower than growth rates, a condition that reduces the welfare costs of debt[8] and creates more fiscal headroom.

[7] Working Paper 01/25 - New Zealand's Fiscal Policy Framework: Experience and Evolution. New Zealand Treasury (2001)

[8] See Blanchard for a description of how r<g conditions forces a reconsideration of welfare costs of debt. Fiscal Policy Under Low Interest Rates - a draft for open review. MIT Press (2021)

We cannot be certain that these favourable debt dynamics will continue indefinitely. In the near term, rates are expected to rise as monetary policy normalises. But falling neutral rates is a global trend. It reflects strong savings and weak investment, driven by long term factors such as population aging, low productivity growth and rising inequality—offset by increases in public debt. While not unanimous, the general consensus is that these long-term forces are unlikely to reverse, and neutral interest rates will remain low.[9]

An important point I'd like to stress is that prudent debt is also inextricably linked to the concept of prudent investment, which captures the welfare or wellbeing effects of spending. While lower debt targets can enhance short-term fiscal sustainability, set too low they risk inefficient cuts in public investment or increases in taxation that reduce overall wellbeing. Conversely, debt limits set too high impose costs on future generations and lead to wasteful spend.

There is some evidence that investment has been below prudent levels:

- Te Waihanga – the New Zealand Infrastructure Commission – have estimated: a historical infrastructure gap of $104 billion and a future infrastructure gap is $106 billion assuming current public investment trends continue over the next 30 years.[10]
- For many years, New Zealand's capital intensity (covering both public and private investment) has been below the OECD average and one of the drivers of poor productivity performance.[11]

Higher rates of both private and public investment are likely to be critical to achieving objectives around New Zealand's long-standing challenges such as housing, climate change and productivity. The two are closely related: there is international evidence that additional public investment can catalyse private investment. Increased certainty about the path of public investment can also allow industries like construction to plan and prepare for higher levels of activity.

At a macroeconomic level, higher public investment is likely to be supportive for economic growth. In 2018, the IMF estimated that long-term, real GDP would be as much as 0.8 percent higher from closing New Zealand's infrastructure gap. This represents a long-term fiscal multiplier of around 2.7—a finding supported by recent Treasury work.[12]

Striking the right balance between prudent debt and investment depends critically on the rigour and enforcement of public investment disciplines. The more credible the investment framework and better the ability to identify value-for-money proposals, the less need there is for blunt and restrictive debt targets. Without these disciplines, there is a risk that looser debt targets could lead to wasteful spend.

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[9] Background Paper for the 2021 Statement on the Long-term Fiscal Position: Long-term projections of the New Zealand Government's interest rate. New Zealand Treasury (2021)

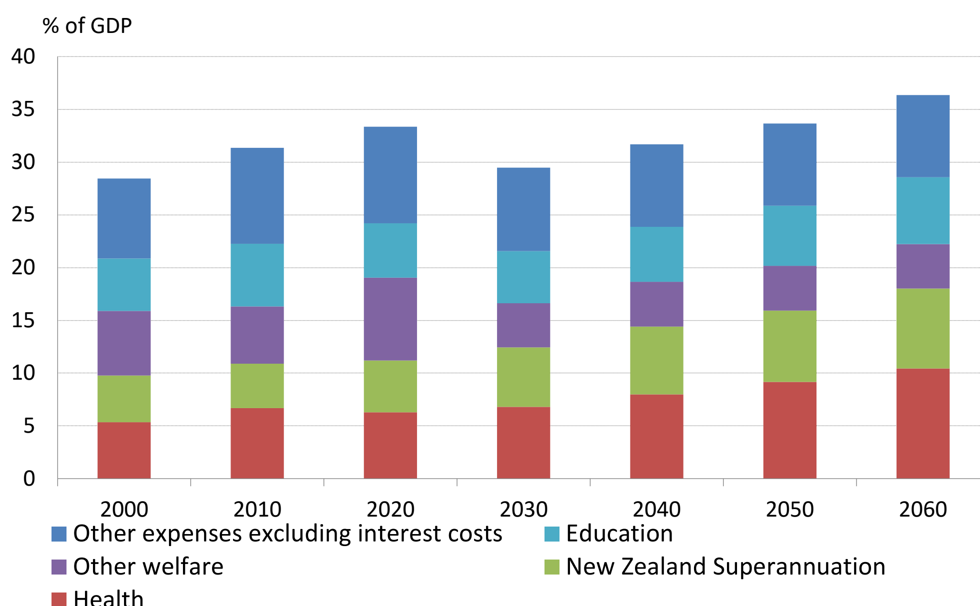
[10] New Zealand's infrastructure challenge – Quantifying the gap and path to close it. Sense Partners (2021)

[11] New Zealand firms: Reaching for the frontier. Final report. New Zealand Productivity Commission (2021)

[12] Selected Issues Papers. International Monetary Fund (2018), Working paper (WP 21/02) – The Macroeconomic Effects of Government Spending Shocks in New Zealand. New Zealand Treasury (2021)

Choices on prudent debt and investment also require close attention to rules on operating spending. The Treasury's Long Term Fiscal Statement shows that if historical trends continue, the greatest risks to debt sustainability are from rising New Zealand Superannuation costs and health expenditure. Ensuring that operating expenses are covered by operating revenues helps to ensure intergenerational equity. It means the current generation pays for its own consumption, and debt can be used for investments that also provide returns to future generations.

Figure 9 – Long-term Fiscal Statement projections of Core Crown primary expenditure to GDP



The Treasury is currently examining how fiscal indicators can set the right incentives for both prudent debt and investment. For example in measures of net debt the treatment of:

- monetary policy expansion could have the perverse effect of encouraging contractionary fiscal policy
- financial assets can affect choices between paying down debt or offsetting New Zealand Superannuation or other liabilities, and
- crown entities could affect incentives to fund activity through those entities over general government.

What is clear is that there is no one perfect fiscal target. For example, net debt targets alone will not adequately set incentives to manage current expenses within current revenues. Ignoring net worth may create a bias against investment[13]. Debt servicing ratios can better capture the costs of the stock of debt, although have potentially high sensitivity to unpredictable movements in interest rates, and sensitivity to the structure of government's debt. Any targets need to be considered alongside a more comprehensive suite of fiscal performance measures that are embedded in our broader fiscal framework.

[13] Why Public Assets are Key to Debt Sustainability: A Moral Goal. Ball et al. (2021), Mapping the Unknown. International Monetary Fund (2022)

The weight placed on fiscal versus other government policies

Government has a wide set of tools available—fiscal, regulatory, social policies—and careful consideration is needed on which tool to use when. I touched briefly on some interactions of monetary and fiscal policy earlier. More broadly, in setting fiscal policy we always need to check whether alternatives can achieve the policy objective more effectively. In many instances, and particularly where affordability and macro-economic concerns are high, non-fiscal levers can provide more attractive options for achieving the government's objectives.

New Zealand's climate policy response provides an example of assessing how fiscal and other policy tools can be leveraged alongside one another.

Achieving New Zealand's climate targets will require meaningful action from all levels of government, businesses and households and involve profound structural shifts across all parts of the economy.

Global climate change represents what has been termed the greatest market failure that the world has ever seen—those who emit greenhouse gases have not paid for the full costs of emissions. Correcting this through price signals on emissions is our first-best solution and one that we stand strongly behind.

There are, however, reasons why emissions pricing cannot be the only tool in our climate policy toolbox. While emissions pricing corrects for one key failure, there are more to be addressed, such as imperfect information, asymmetric information and consumer behaviour. In addition, at present the Emissions Trading Scheme, our core emissions pricing instrument in New Zealand, does not cover all sectors and businesses in our economy.

Given this, pricing mechanisms are necessary, but not enough. Complementary regulatory and other non-spending measures, alongside value-for-money spending measures, are needed to achieve our emissions goals at minimum cost.

Moreover, complementary measures may be used to support equity in the climate transition, or achieve other social goals.

However, careful design is required to ensure complimentary measures work with, not against, the ETS. For example, public funding for abatement that would have occurred through price mechanisms simply allows other emissions, that could have been abated at lower cost, to continue.

Ultimately, our choice of how to use these levers comes down to assessing a number of trade-offs and requires consideration of efficiency, equity and broader distributional concerns from economic, social, cultural and environmental perspectives. The Treasury's living standards framework helps us to assess these trade-offs.

Understanding these types of policy interactions and trade-offs will help us to sharpen our response to other complex challenges we face. Lifting productivity, for example, is a longstanding challenge for New Zealand that is central to raising living standards. Productivity is influenced by a vast range of measures, including innovation policy, competition policy, regulatory and other measures to enable and reduce barriers to investment, education and health policy to build human capital, as well as fiscal policies such as tax settings or infrastructure spend. Governments face choices on where to focus their policy efforts.

In closing, while the economy has proven resilient to date, COVID-19 response policies have at times involved tough trade-offs. As we continue to navigate the pandemic and look ahead to recovery, choices and trade-offs for fiscal policy will persist. They require a considered balance across the goals of improving living standards, macroeconomic stability, and fiscal sustainability.

We do not know what the next shock will be, but we must evaluate lessons from the pandemic response to help us navigate the inevitable shocks and changes ahead.

We also seek to understand the effects of economic policy on not just the fiscal and traditional economic measures as discussed today, but broader measures of living standards.

Later this year Treasury will release the first Wellbeing report, a new stewardship requirement under the Public Finance Act that asks us to examine the state, trends and underlying drivers of wellbeing in New Zealand. We look forward to engaging with academics and others in the economics profession on this work.