ANZ Research

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Let's get fiscal

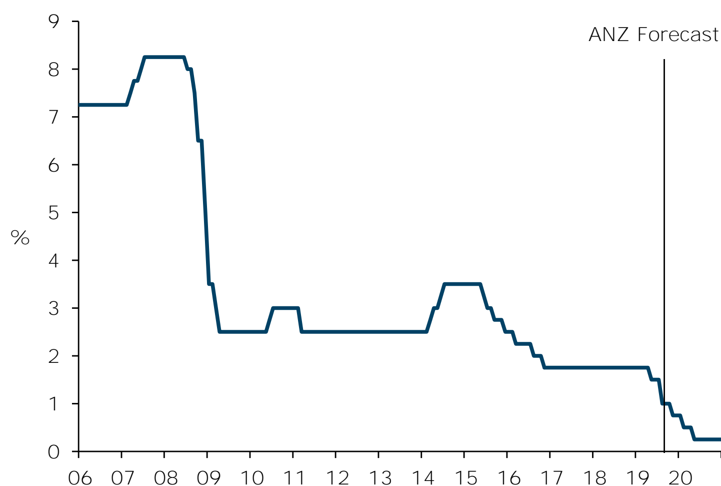
Summary

- Economic momentum continues to slow and inflation pressures are poised to wane, but monetary policy is running out of conventional ammunition.
- Monetary policy is looking for mates, and fiscal policy in New Zealand has room to act. The debate about whether the Government should up the fiscal ante is set to intensify.
- The public may be willing to accept a higher debt ratio in the longer run. But **let's not** forget some of the long-run fiscal challenges such as climate change and an aging population.
- Both global and domestic risks are heightened and if these materialise, data lags mean that **the Government won't know the economy is in recession** until after the fact. The Treasury and Government need to be attentive to the forward-indicators and fiscal policy needs to be ready to act.
- But spending on **infrastructure can't be turned on in a hurry**, so the time to plan is now. Businesses could do with a little more certainty.
- **Ultimately, any stimulus package should have regard for the three T's:** temporary, targeted, and timely. Ticking all three boxes will likely require both more spending and lower revenues.

Fiscal policy in a slowing economy

At this stage no one is forecasting the New Zealand economy to go into recession. But global and domestic economic momentum is softening, and downside risks to the outlook are both numerous and heightened. Our central forecast is for annual growth to slow to a little under 2% by early 2020. Inflation pressures are poised to wane and we expect the RBNZ will cut the OCR to just 0.25% by May next year (figure 1). That means there is no conventional ammunition left to address any unexpected economic bad news such as a sharp commodity price fall or a serious drought.

Figure 1. OCR outlook



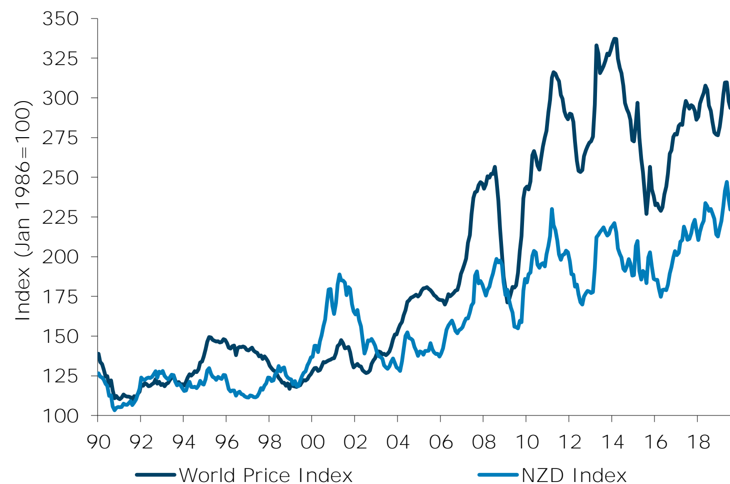
Source: RBNZ, ANZ Research

The truth is, no one knows what's going to trigger the next significant downturn, or when. But contractions do happen, and in a small, open economy like New Zealand, it's typically without much warning. There's certainly no question, the New Zealand economy is vulnerable at the moment.

What happens if the global slowdown gets abruptly real for NZ?

Say New Zealand's commodity prices were to drop by a third – roughly what they did in 2008 (figure 2). But this time, they fail to bounce back aggressively, because China is in no (debt) position to again launch a massive fiscal spend-up as they did following the Global Financial Crisis.

Figure 2. NZ commodity price index (world prices)



Source: ANZ Research

For starters, we'd hope that our first line of defence, the floating (sinking) NZD ducks for cover and secures the perimeter. A sharply weaker currency would soften some of the blow from weaker global demand and support import-competing firms back home – albeit partly by hitting consumers with higher prices for imported goods. But policymakers from other parts of the world will be trying to bring their currency down at the same time. And what we gain in easing via a lower currency we may lose in higher bank funding costs if global markets are in a significant "risk-off" mood.

What about monetary policy? The RBNZ has signalled its willingness to venture into the uncharted territory of unconventional monetary policy if necessary. But there are significant question marks around the practicality and efficacy of such measures, particularly in a New Zealand context:

- A negative OCR might actually be less stimulatory for the economy than a slightly positive one, due to the impact on the functioning of the banking system and credit availability.
- Quantitative easing (as practiced overseas) may face challenges due to the limited assets available to purchase.
- And while some kind of curve-flattening manoeuvres are possible (to lower longer-term interest rates), the curve is flat today, as low-for-longer interest rates are already priced in. So this would likely in practice be done to offset higher risk premia and/or tighter global liquidity pushing up long interest rates – a case of running to stand still rather than adding new stimulus.[1]

So while monetary policy can tinker at the edges, it wouldn't have any game-changers up its sleeve.

[1] See our previous Insight papers 'Prospects for unconventional monetary policy in New Zealand and The OCR limbo: How low can you go?' for further details.

Globally, the debate around current macroeconomic policy frameworks (inflation-targeting central banks in particular) appears to be intensifying as its limitations become clear. Monetary policy partly works because people expect it to work. If households and businesses "lose the faith" then it will be less effective.

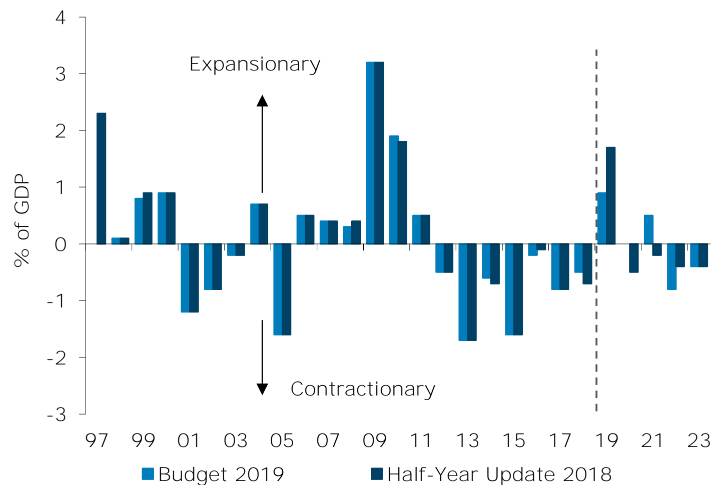
Clearly, fiscal policy needs to be on its game and ready to swing into action to dampen the blow to wellbeing if the economy turns to custard. Indeed, a well thought out and communicated contingency plan could in and of itself go some way towards dampening the blow of a downturn, by limiting the extent to which household and business sentiment deteriorates. Businesses could use a little more certainty.

It's worth noting that because GDP data is published with a three-month lag, chances are that the Government won't know the economy is in recession until after the fact. So it doesn't arrive too late to the party, the Government (and Treasury) need to keep a close eye on the forward-looking indicators such as our Truckometer, the employment and activity components of business surveys, and possibly even benefit expenses.

Fiscal forecasts suggest the boost to growth is past its peak

Current fiscal settings are estimated to be – or at least until very recently, to have been – stimulatory. The Treasury's 2019 Budget Update estimate of the "fiscal impulse" suggests fiscal settings made a material contribution to aggregate demand in the year to June 2019. However, on average, fiscal policy is poised to drag on growth over the next few years (figure 3).[2] Delays in spending may change the profile, but not the theme.

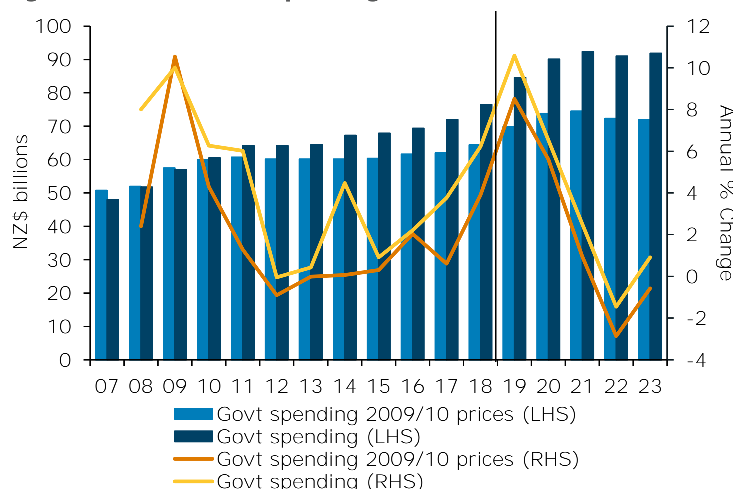
Figure 3. Core Crown fiscal impulse



Source: The Treasury, ANZ Research

[2] See Philip and Janssen 2002, Indicators of Fiscal Impulse for NZ for information about this indicator.

Figure 4. Government spending[3]



Source: The Treasury, ANZ Research

Another way to look at the impact of government spending on GDP is to take the Treasury's forecasts for the main spending categories, deflate them so they're in real terms (we've used our forecast for the GDP deflator), and see how that growth rate compares to our forecast for real GDP growth (or you could also look at the share of GDP). It's rough, but the message is similar: growth in government spending is expected to outpace that of the broader economy for only a little while longer – maybe a year if you assume there will be some typical spending delays. In fact, it appears the peak of the fiscal boost to activity (through the spending side at least) is now in the rear view mirror, with annual growth in real government spending estimated to have hit 9.4% in the year ended June 2019.

But perhaps more worrisome, it appears fiscal settings – even at their stimulatory peak – have been insufficient to prevent the broader economy from slowing. Ultimately, fiscal policy will remain constrained in its ability to stimulate growth beyond next year as long as the Government continues to stick strictly to its self-imposed debt target. This definitely isn't the sustainable contribution to growth which the RBNZ is hoping for.[4]

So how much fiscal headroom is there?

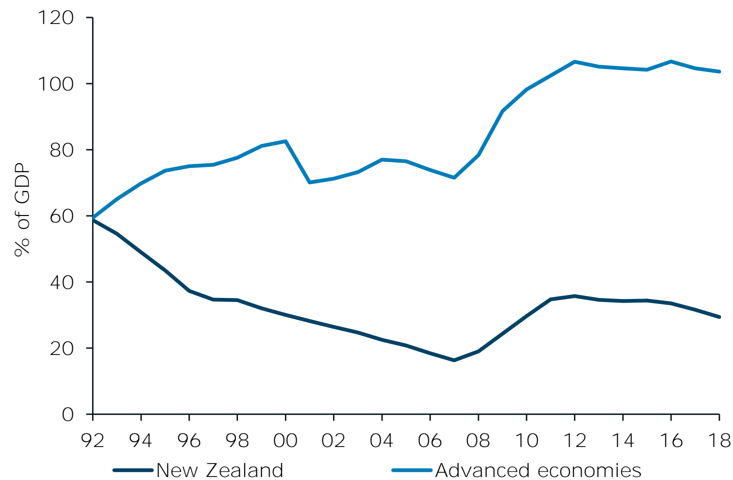
The good news is that the Government's books are in good shape, with ample fiscal firepower should the Government (ultimately the public) become willing and able to use it.

Since the 1990s, the principles of responsible fiscal management in the Public Finance Act have been very (even surprisingly[5]) effective at ensuring governments adopt a fiscal strategy that maintains government debt at "prudent" levels. The Act has achieved this without the use of legislated fiscal targets, rules, and enforceability often seen abroad.

In a nutshell, the Government chooses its own fiscal targets, but these must be consistent with "the principles", and the Treasury reports on whether the Government is on track to meeting their elected targets. As long as the public judges a government by its prudence (this could change, of course), name-and-shame is a powerful motivator. After years of prudent fiscal management, New Zealand Government debt (whether measured in net or gross terms) is low compared to other advanced economies (figure 5).

[3] Includes transfers payments & subsidies; personnel & operating costs; and net purchase of physical assets.
[4] Both the RBNZ's September Statement and this recent speech by Adrian Orr touched on the role of fiscal policy in supporting the economy.
[5] See The Fiscal Responsibility Act 1994: The astonishing success of a weak non-binding policy.

Figure 5. Gross government debt



Source: IMF, ANZ Research

The Government's current fiscal strategy is to reduce net core Crown debt to 20% of GDP by fiscal year 2022, and maintain debt within 15-25% of GDP thereafter. Broadly speaking, this is the self-imposed constraint preventing the Government from spending more or cutting taxes to lean against the wind of a slowing economy right now.

As at the 2019 Budget Update, net core Crown debt was forecast to come in at 20.1% of GDP in the 2018/19 fiscal year, meaning they are sailing pretty close to the wind (the audited Financial Statements for the 2018/19 fiscal year will be published on 8 October). Unless the targets are changed, discretionary fiscal policy has little more to offer.

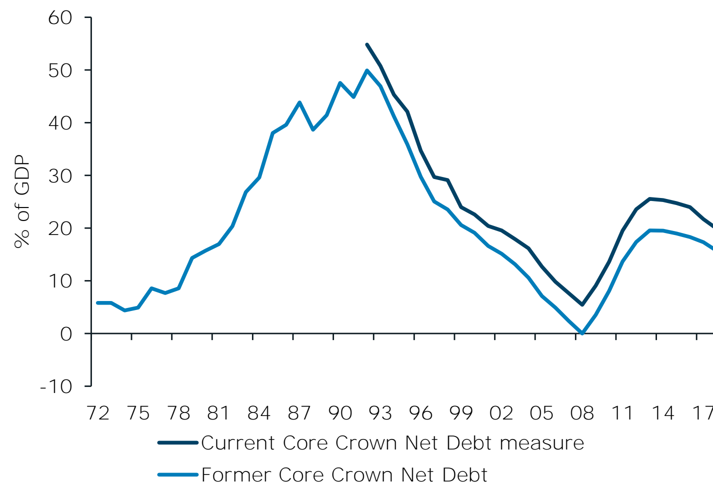
Finding the "prudent" limit

The Government just spending more isn't always a slam-dunk win for the economy. There are constraints to bear in mind:

- International theory and evidence suggests that as government debt increases, fiscal policy becomes less effective at stimulating the economy – households anticipate higher taxes in the future and respond by saving more.
- Increased public sector activity can 'crowd out' private sector activity by competing for resources.
- As with monetary policy, the responses of households and business to a fiscal stimulus package can determine how effective it is at dampening an economic slowdown.

So how high should we go? Figure 6 shows that net core Crown debt was as high as 50% in the 1980s as a result of the "think big" projects.

Figure 6. New Zealand net core Crown debt[6]



Source: NZ Treasury

Recent communications from the Treasury suggest that net core Crown debt above 50-60% of GDP would be the upper limit before the costs of taking on more debt begin to outweigh the benefits.[7]

However, this is not considered a "prudent" level. In a small, open economy that's susceptible to both global economic shocks and natural disasters, it's important to maintain some kind of buffer. The Treasury suggest this buffer should be at least 20% of GDP, noting this is around the extent to which government debt increased in the aftermath of the Global Financial Crisis and Canterbury earthquakes – a double whammy to the Government's books. Another way to think about this buffer is that it allows for automatic stabilisers to effectively deliver stimulus when unemployment rises in the downturn (while simultaneously taking a hit on the revenues side as activity slows).

So, starting at the lower end of the upper limit (50% of GDP) and knocking off the buffer leaves us with a "prudent" limit of around 30% of GDP – a full 10%pts higher than the current point target. In current dollar terms (ignoring fiscal multipliers for now), this implies the Government could increase spending (or reduce taxes) by around $30bn and still tick the fiscal-prudence box. To put that in perspective, the current level of net core Crown debt (excluding NZ Super Fund financial assets and advances) is around $60bn.

At first blush, this seems like a decent factoid to rest an argument on that the Government could be doing a little more. However, as discussed below, there are longer-run fiscal challenges that need to be considered, as well as our need to run a more prudent fiscal position than others. After all, New Zealand runs persistent current account deficits, has a significantly negative net external investment position (although this has improved as a share of GDP over the past 10 years or so), and a very indebted household sector.

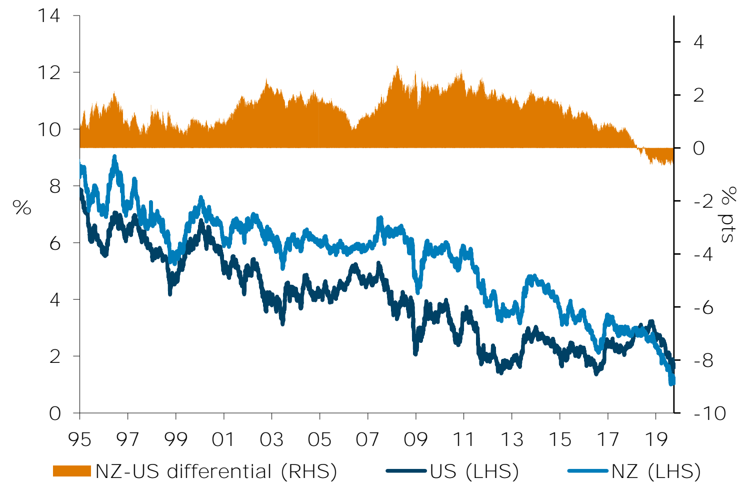
But the Government can borrow so cheaply!

Another popular factoid used by those who want to see a little more from the fiscal side is that the New Zealand Government can borrow incredibly cheaply currently. Thanks to an increasingly desperate global search for yield, the penalty for being a risky borrower has been compressed to such an extent that a small open economy that's susceptible to natural disasters, drought, and global shocks can borrow more cheaply than the US Government. However, the

[6] Advances held by the NZS Fund are excluded in the current measure.
[7] New Zealand's preference to target net core Crown debt often means adjustments need to be made before making international comparisons. There are a number of government debt measures including gross-sovereign-issued debt (around $90bn) and Government Financial Statistics general government net debt (around $40bn) that are often referred to in the literature and/or by rating agencies.

Government probably shouldn't rely on that lasting forever – risk premia could "normalise" right when New Zealand Debt Management is looking to up their bond issuance.

Figure 7. 10-year government bond yields

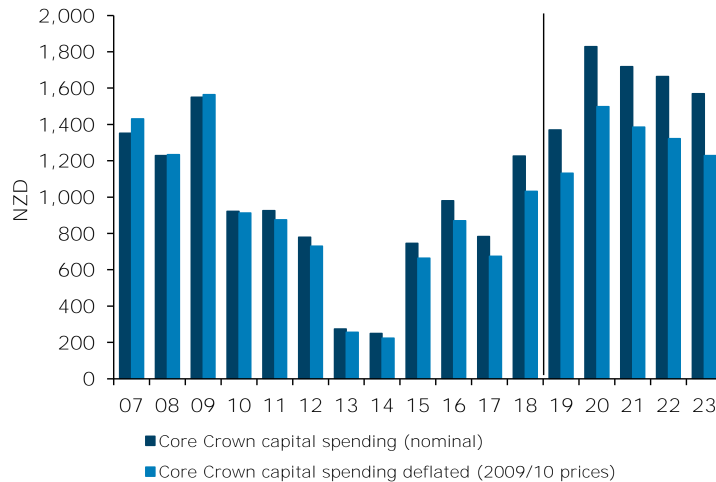


Source: Bloomberg

Also, just because nominal interest rates are low currently doesn't mean the Government should put the investment pedal to the metal on any old project that comes along. These are tax-payer dollars the Government is spending, and it's important to make sure the public get value for money (ie a decent return on their investment). And even if the return justifies the investment, there are other possible constraints to consider.

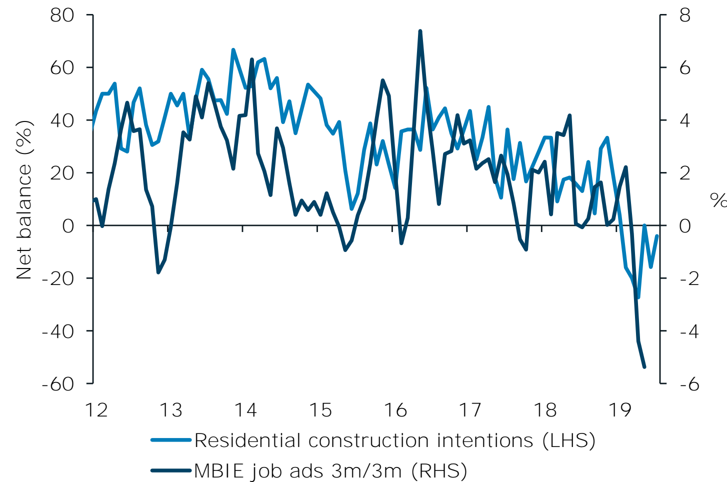
- The public needs to step back and ask how big it wants the Government to be as a share of the economy. Leaning against a slowing economy is one thing, but unless that additional growth in spending is unwound later, the Government could end up significantly larger. And that could carry with it inefficacies and crowding out of private sector activity. This can be mitigated by ensuring that any lift in spending is temporary or that putting more money into the private sector's hands is a meaningful part of the fiscal mix.
- Political constraints exist too. The Government's unlikely to plan a big spend up if it thinks it will cost them at the next election. Public opinion may lean towards austerity if automatic stabilisers have already put the debt to GDP ratio on an upwards trajectory. But it's fair to say that hasn't been the international experience of recent years. Voting-public opinion will also determine where any additional spending is allocated, and this might not always be an efficient use of tax payer dollars (eg fees-free tertiary education and interest-free student loans). So be careful what you wish for; if Governments are given licence to spend more, they might not spend it well.
- Even if the Government (and public) were in favour, there are questions around whether and how fast it could actually deliver the type of spending the economy is crying out for, or whether capacity constraints will ruin the party. KiwiBuild is case in point; outside of social housing the Government has been able to do very little in terms of adding to the housing stock at a time when the private sector is already throwing everything it's got at it. And on the infrastructure side, the Government is already playing catch-up after years of capital underspending (figure 8) that's left the nation's infrastructure creaking under the weight of a growing population, and such spending tends to have substantial lead-in times. However, in a marked downturn, some of these capacity pressures are likely to ease. In fact, forward-looking construction indicators, and general employment indicators for that matter, suggest capacity could be about to free up – quickly (figure 9).

Figure 8. Nominal and real capital spend per person



Source: The Treasury, ANZ Research

Figure 9. MBIE job ads, ANZBO construction sector activity



Source: Stats NZ, MBIE

- It's also worth noting some of the long-run challenges facing the Government's books, which highlight the need for any stimulus package to consider fiscal sustainability. These challenges include both the fiscal implications of an aging population and climate change. The impact of an aging population on interest rates is ambiguous, but there's no denying that healthcare and superannuation costs are poised to rise while the income tax base shrinks. According to the Treasury's "what if" scenario, health and superannuation spending combined could lift from 11% of GDP in 2015 to 17.6% by 2060.[8] A 'two birds, one stone' approach could see more spending on hospitals, more future-proof transport links, incentivising investment in greener technologies (though this might have a large imported component, mitigating the stimulus), and/or providing a little more resource to businesses for whom recent policy changes are keeping them up at night – particularly farmers.

All up, there appears to be a fair amount of room for a bit more spending, but the focus should really be on quality spending that actually stands a chance of getting done. But the supply side matters too. The Government is already attempting to address supply-side constraints in housing development – not easy, but success would boost economic activity without a meaningful lift in government spending. But one thing's for sure, looking into the options now will

[8] See the Treasury's 2016 Statement on the Long-Term Fiscal Position for further detail.

make it a lot easier for the Government to swing into action if the call to arms evolves from monetary policy needing friends to hit its inflation target to supporting the economy through a meaningful downturn.

Options for discretionary fiscal stimulus

The Government has two basic options available when it comes to stimulating economic activity: increase spending or put more money in people's (or businesses) pockets through tax cuts or transfers. They are likely to transmit through the broader economy differently and the cyclical position of the economy is going to matter.

The Treasury considers that any fiscal stimulus package should be timely, targeted, and temporary. In other words, it needs to support economic activity when it's needed most, be effective at supporting activity with minimal "leakage" (eg not just used to pay down debt or boost imports), and it shouldn't create a permanent shift away from sustainable fiscal settings – ie lift debt so high that future Governments are less able to respond to a downturn.

Unfortunately, there's no such thing as a perfect stimulus package. If capacity constraints and lengthy planning times didn't exist, then spending on infrastructure (to address Auckland's and Wellington's transport woes, for example) would be a great start. In time, this kind of spending can pay for itself, with future economic activity higher than otherwise as resources (people and materials) flow more efficiently. But alas, while capacity pressures are likely to wane in a marked downturn, it can still take years for large-scale projects to go from planning to doing, so the stimulus could arrive a bit late to the party – not exactly passing the "timely" test.

Possibly the fastest delivery would be a boost to household incomes. Options include:

- Lifting transfer payments to households;
- Cutting income tax rates (or making tax bracket adjustments);
- Reducing the GST rate (disinflationary, though, so perhaps not the best option as far as helping out the Reserve Bank);
- Lifting the Government's wage bill by increasing headcount and/or lifting wage rates for nurses, teachers, police etc.

Not all of these options pass the "temporary" test. For example, lifting Government wage rates or hiring more teachers would be politically impossible to unwind, meaning inflation and population growth would have to do it – and that could take a while.

Households' propensity to spend an income bump will determine the economic impact. There's no denying that at 164.4% of disposable income, household debt is high. If households are feeling concerned about their future income prospects, they might just funnel a large chunk of that income bump into paying down debt. And recent survey data suggest that's exactly what households on average are currently thinking. However, lower-income households are most likely to spend an extra dollar of income, and boosting these households' incomes is consistent with the current Government's overriding vision.

But let's not forget about businesses. Lowering the business tax rate could also help businesses get though a downturn. But again, it could prove difficult to tick the "temporary" box. Working directly with the private sector to "get stuff done" is also an option. PPPs are a vehicle the Government could use to help fill the pipeline of work for the private sector, and if done well can lead to great outcomes. Indeed, with business sentiment in the doldrums (and even the RBNZ acknowledging policy uncertainty is contributing to this), a bit of extra certainty wouldn't go amiss for the construction sector at least.

The Treasury and RBNZ have done a fair amount of work over the years estimating the effects of fiscal policy. Some of this suggests a relatively low fiscal multiplier of just 0.26 from higher Government spending – that is, an increase in spending equivalent to 1% of GDP pushes GDP just 0.26% higher.[9] Further, it's likely that the near-term bump to activity could come at a cost – higher long-term interest rates (probably not too much of a problem right now, but that doesn't mean it won't be one day) and lower medium-term growth than otherwise.

More recent analysis suggests the type of stimulus matters for not only the overall impact, but the persistence of it.[10] Here, a stimulus delivered via the tax revenue channel (a tax cut or similar) carried the biggest bang for its buck, with an estimated multiplier of 1.29, followed by public consumption (0.82), transfers (0.76) and public investment (-0.59). Even the authors acknowledge the puzzling nature of that last result. Maybe it's the traffic congestion from all that construction! Certainly feels like it in Auckland CBD as the City Rail Link is being built. More seriously, the battle for resources is probably at play here, indicating that timing is important.

Bringing it all together

- Leaning against the wind of a slowing economy isn't a bad idea, and the Government's current debt target over-achieves on "prudence".
- But the debate should also have regard for capacity constraints, the return to tax-payers, long-run fiscal challenges, and how big you want the Government to be when all is said and done.
- While the choice of what to spend more on (or tax less) is, quite appropriately, a political one, having some kind of plan in place would be wise. Recessions are never forecast well in advance. An extensive wish list of ready-to-roll "just in case" projects might be a stretch, but allocating more resources to the challenge would be prudent.
- Delivering a discretionary fiscal stimulus in a timely manner is always a challenge.
- Ultimately, any stimulus package will need have regard for the three T's: temporary, targeted, and timely. And ticking all three boxes will likely require a multi-pronged approach.

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[9] See Parkyn and Vehbi 2013, The Effects of Fiscal Policy in New Zealand: Evidence from a VAR Model with Debt Constraints.

[10] See Hamer-Adams and Wong 2018, Quantifying Fiscal Multipliers in New Zealand: the Evidence from SVAR Models.

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