Economic Policy and the Novel Coronavirus

Introductory remarks to the Epidemic Response Committee

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Thank you.

Four months ago on 13 January no one in New Zealand had much conception of the havoc the coronavirus was about to wreak. That was the day the very first case outside the People's Republic was reported and still 10 days until the extreme responses were adopted in Wuhan. Locally, not even the rock lobster industry was yet in focus.

Unfortunately, two months later - 13 March – our economic officials and ministers still appeared to be reluctant to recognise the magnitude of what was about to break in full force on New Zealand. A day or two earlier the Governor of the Reserve Bank had given a speech and press conference which minimised the issue, and when the Bank finally cut the OCR a few days later - weeks late - he was still reluctant to concede that a recession was upon us. The government had been mostly focused on the disruption to our exports to China, and that sort of thinking was still shaping the economic package announced a few days later. In time, they were all simply overtaken by events they weren't ready for.

That is all water under the bridge now. In the end, the modified wage subsidy scheme ended up serving (mostly) as a more-generous income support scheme, and if some portion was poorly targeted at least it was disbursed quickly. Whether it will save many jobs and firms, only time will tell.

Where do we stand now? We will have undergone the sharpest deepest economic slump ever. GDP in the so-called Level 4 was probably 40 per cent below normal and is probably still 30 per cent or so below normal. June quarter GDP could be 25-30 per cent lower than it was late last year[1]. In the 2008/09 recession, by contrast, GDP fell by 3 per cent. GDP often appears as rather abstract, but lost GDP - lost activity - will translate into lost jobs. You can see that in, for example, the reported unemployment rates for April of around 15 per cent in the US and Canada.

As the restrictions continue to wound back there will be some further rebound in economic activity. But even if - as some suggest - 95 per cent or more of people/firms are lawfully able to work, we should not suppose for a moment that economic activity will quickly snap back to 95 per cent of normal. Hotels in Rotorua may have been free to open, but they are unlikely to have many customers.

[1] https://croakingcassandra.com/2020/05/08/the-macro-outlook/

And even if there is little or no Covid in New Zealand, that isn't so abroad. There is a savage deepening global recession unfolding. Even at home, people are going to be poorer, and will be cautious, nervous, and uncertain. It isn't like a normal recession that results from things that happened previously: this virus still stalks the earth, and even vaccine optimists talk in terms of another 12-18 months of that.

On current policies, even if we get back to so-called Level 1, even if trans-Tasman travel is freed-up later in the year, GDP could still be 10 per cent less than normal.

Left to themselves, economies would heal themselves…but very slowly. Active macroeconomic policy has a crucial role to play – not picking winners, not planning for this sector or that, but getting in place the broad-based support for demand (stuff only governments can do) and then leaving it to the energy of the private sector to generate the new activity and jobs.

Monetary policy typically takes the lead - it can deployed most quickly, it operates pervasively, it doesn't cost the Crown money, it influences voluntary private choices, and it works without ministers deciding who or what is favoured.

But monetary policy is doing almost nothing. Real interest rates have barely changed since the start of the year. The Bank will tell you they are purchasing lots of government bonds. That is nice, but almost irrelevant to New Zealand now. In past serious recessions - 2008/09 or 1991 - real interest rate have fallen very sharply, and the exchange rate has fallen a long way too. Right now our exchange rate is only about 5 per cent below where it was late last year. 25 per cent would be more normal. In New Zealand we a "deeply negative" OCR – of the sort former IMF chief economist Ken Rogoff called for last week - to get retail interest rates down much nearer zero. Right now, we are in the weird situation where the government is lending at zero interest to businesses that can't get funds elsewhere, while the existing stock of borrowers are still paying materially positive interest rates.

Is fiscal policy an alternative? It has a place - including letting the "automatic stabilisers" work - but it is no realistic substitute for monetary policy. Fiscal measures could help provide some certainty, buy some time and offer some support. But it isn't going to grow sales abroad, and if anything heavy reliance on fiscal policy will skew the economy inwards and reinforce what has been a persistently overvalued exchange rate. And letting monetary policy sit on the sidelines - and either doing little else, or emphasising fiscal policy - means that our older citizens (with more bank deposits than most) keep earning reasonable returns, while our younger people - hardest hit by the downturn, and the future taxpayers – are stuck with the sorts of real interest rates that made sense last year, but not this year.

We'll eventually recover: much bigger disasters - the World Wars - didn't put us on a permanently lower path of GDP. But remember how poor our previous performance was: decades of relative decline, with really poor productivity growth and no success at all in growing foreign trade as a share of GDP.

So looking forward we need macro policies that put us aggressively on a path back to full employment, but they need to be working hand in glove with an approach to broader economic policy that looks outward, not inward[2]; that looks to provide a favourable climate for business investment and productivity growth - the only secure foundation for high incomes. And we need hardnosed prioritisation of what new spending the government does do, recognising that for now we are poorer.

Finally, in 2008/09 we threw a lot at the economy, responding to a recession that also wasn't homegrown. The OCR was cut by 575 basis points and a lot of fiscal stimulus was in the works. But it still took until 2017 - ten years – for the unemployment rate to fall back even to 4.5 per cent. This is a much much bigger economic disruption. We must do what it takes to prevent any repetition, and all the scarring of individual lives that such persistent unemployment would entail. Doing so will have to involve both fiscal and monetary policy. But there isn't limitless fiscal capacity, and at present monetary policy is largely spinning its wheels, doing little that makes much difference where it counts. That can't be allowed to continue.

[2] For more on this, see my recent Policy Brief https://www.canterbury.ac.nz/media/documents/oexp-arts/research-centres/ssanse/Rebuilding-New-Zealands-shattered-economy-in-a-post-COVID-world.pdf