The Treasury

COVID-19 Information Release

April 2020

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: COVID-19 scenarios and an initial framework for economic policy responses

Date:	21 February, 2020	**Report No:**	T2020/391
		File Number:	SH-1-6-1-3

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Indicate** your preferred direction fo the Treasury's ongoing scenario and policy analysis on COVID-19	21 February 2020

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Udayan Mukherjee	Senior Analyst, Transitions Regions and Economic Development	39 [redacted]	N/A (mob)	✓
Tim Ng	Deputy Secretary, Chie Economic Advisor		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: COVID-19 scenarios and an initial framework for economic policy responses

Executive Summary

The global spread and economic impact of the COVID-19 outbreak is uncertain. The Treasury, working closely with other agencies, has prepared three stylised scenarios to understand the potential economic impacts that the outbreak may have on New Zealand and the key economic transmission mechanisms.

The current central forecast is for a temporary and short-lived global demand shock. Therefore, we don't recommend that any substantial macroeconomic policy response s required right now.

We acknowledge that there is considerable downside risk, and offer advice in this report about the balance between targeted microeconomic responses and broade fiscal and monetary policy action as the situation develops.

Recommended Action

We recommend that you:

a **note** the three stylised macroeconomic scenarios described in this paper reflect the potential impacts of the COVID-19 outbreak on New Zealand;

b **note** that the Treasury will continue to work closely with other economic agencies and the Ministry of Health to ensure that the public service has an integrated view of the potential economic and public health scena ios;

c **note** that under current forecas s, the Treasury does not consider that substantial macroeconomic policy responses are required to COVID-19, but we acknowledge the need to plan for major downside economic risks;

d **note** the Treasury's advice that any microeconomic policy support at this point should be carefully targeted, but some measures may be useful on a least regrets basis to support acutely affected industries and regions;

e **indicate** if yo want the Treasury to focus on any aspects of the economic impacts as we continue developing forecasts and scenarios;

f **indicate** where you want the Treasury, working with other agencies, to provide you with further advice on particular policy responses the Government may want to consider as the situation develops.

Tim Ng
Deputy Secretary, Chief Economic Advisor

Hon Grant Robertson
Minister of Finance

Treasury Report: COVID-19 scenarios and an initial framework for economic policy responses

Purpose and Next Steps

1. The global spread and economic impact of the COVID-19 virus is uncertain. This report provides you with the Treasury's current advice on how the impact on New Zealand may play out, and what economic policy responses may need to be considered as the situation endures or escalates.

2. The first section presents three hypothetical economic scenarios that are based on our analysis of the key economic transmission channels under different states of the world. The second section explains a framework for thinking about the balance betwee targeted microeconomic responses and broader fiscal and monetary policy action as the situation develops. The third section sets out how we are continuing to update our assessment in the next few weeks.

3. The Treasury will provide you a report containing our full Prelimina y Economic Forecasts early next week, and a report with initial overall fiscal strategy advice on 26 February. Both of these reports will situate the impact of COVID 19 in the broader macroeconomic and fiscal context.

Scenarios for the Economic Impact of COVID-19

4. Earlier this week, we provided you with our initial draft scenarios to understand the potential economic impacts that the COVID-19 outbreak may have on New Zealand (T202/360 refers). This was prepared by the Treasury, working closely with the RBNZ and MBIE, and drew on the three agencies' thinking about the key economic transmission mechanisms.

5. This section presents those three stylised scenarios. These will provide the basis for officials' ongoing advice to Ministers about the Government's overall economic policy response. They will inform the options available to Ministers to respond to a range of possible scenarios.

Three stylised macroeconomic scenarios

Scenario 1: A temporary global demand shock

6. In th s scenario, New Zealand experiences slower growth in the first half of 2020, but the growth rate recovers in the second half of the year. Impacts on specific sectors of the economy are significant, but transitory. Tourism and export education face direct disruption due to border restrictions. Some export goods sectors face a decrease in Chinese demand and logistical disruptions.

7. This is the current baseline economic scenario in the Treasury preliminary Budget Economic and Fiscal Update (BEFU) forecasts, which we will provide to you in full early next week. It is also broadly consistent with the RBNZ's baseline economic forecast contained in last week's Monetary Policy Statement, and the views of other private sector forecasters.

8. This scenario assumes that it is clear within the next few weeks that the spread of the virus is being contained and that activity returns to normal in China thereafter. It also assumes no domestic outbreak of COVID-19, and that New Zealand's short-term

border restrictions do not cause lasting reputational damage to tourist and student demand from the Chinese market.

9. Businesses and workers in some industries and regions will face acute challenges in this scenario, even if the broader macroeconomy recovers quickly as forecast.

<u>Scenario 2: A longer lasting domestic incomes shock</u>

10. In this scenario, New Zealand experiences a longer period of slower growth throughout 2020. Prolonged uncertainty about the worldwide spread and containment of the virus causes deeper impacts on directly exposed sectors and broader indirect impacts across the economy.

11. Ongoing travel restrictions and more cautious traveller behaviour curtail activity in the tourism and export education sectors, including from reduced demand beyond the Chinese market. This effect occurs even if New Zealand lifts its own temporary border restrictions. Domestically, consumer and business confidence declines, and businesses may start to delay hiring or investment decisions. This will lead to reduced incomes for firms and households and second round effects through domestic supply chains.

12. In this scenario, the New Zealand dollar is likely to depreciate further and provide some support to the export sector, reflecting a general global flight to safer financial assets. Short-term interest rates may also be cut by the RBNZ, and this would provide some support to firms and households.

13. A major uncertainty in this scenario is whether there is a moderate outbreak of the virus in New Zealand. If this occurs, the appropriate public health response could impose additional disruptions that would add to the economic impacts described above.

<u>Scenario 3: A global recession</u>

14. In this scenario, New Zealand is likely to experience a recession during 2020. It would involve a more severe global pandemic where the Chinese economy slows considerably, and there is an outbreak of the virus beyond mainland China.

15. The domestic economy would face broad-based disruption through international trade and financial channels. If the Chinese economy slows considerably, this may cause significant global financial market volatility, affecting global capital markets and funding conditions. Many of New Zealand's other major trading partners would face a serious slowdown, such as Australia and many countries in Asia.

16. If there is a global pandemic, it becomes more likely that there will be a moderate or severe outbreak of the virus in New Zealand. This will have serious direct public health effects. But it will also contribute to further economic impacts if production supply chains or labour supply is disrupted through substantial domestic quarantine measures and significant worker absence.

17. For avoidance of doubt, this scenario is not the current expectation. But characterising this worst-case scenario is helpful to consider how economic policy may need to be prepared for this eventuality.

Further development of these scenarios

18. The Treasury is working with other agencies to add more depth to our analysis of these scenarios, to better understand the concentrated effects on particular regions and sectors.

19. The Ministry of Health is leading analysis to understand epidemiological scenarios around the potential spread of COVID-19. These will include hypothetical estimates around the impact and severity of the virus if there was an outbreak in New Zealand. This analysis will then inform the likely public health policy options that may be required in light of those scenarios.

20. The Treasury is working closely with the Ministry of Health to bring our economic analysis together with its epidemiological analysis to provide an integrated view of the scenarios as quickly as possible.

Framework for Economic Policy Responses

21. This section sets out the Treasury's initial framework to think about the right balance between targeted microeconomic responses and broader fiscal and monetary policy action as the situation develops. Table 1 below develops this analysis.

22. Our current expectation is that the macroeconomic impact of COVID-19 on New Zealand will be measurable, but temporary. Right now, fiscal and monetary policy is supportive of growth, and this should continue.

23. Further microeconomic intervention is worth considering, but it isn't certain that it is required at this stage. Early action may set a precedent for active Government support that is not sustainable if it has to be extended across the economy. So any interventions should be targeted and temporary at this stage (or easily reversible).

24. We acknowledge that the situation is developing quickly and officials have incomplete information. It is prudent to plan for the downside risks to help prepare more detailed policy responses that could be implemented if the situation deteriorates. This is especially true when those require long lead time for design and implementation.

25. In this context, if Cabinet is of the view that further microeconomic intervention is warranted, then some of the business support proposals being developed by the Minister of Economic Development may be a good least-regrets option. The Treasury considers that expanding these services is likely to deliver some value, even on our best-case scenario, and getting them in place early will be protective on the other scenarios. Nevertheless, we do not think it is necessary to proceed with a decision on these initiatives on Monday.

26. A longer lasting domestic incomes shock (as in Scenario 2) presents the most ambiguity for economic policymaking. Incoming data and analysis will not be timely, and there will be judgement required on when to take precautionary microeconomic policy action. Monetary policy would as usual be the preferred macroeconomic stabilisation tool in response to weakening aggregate demand. Planning a fiscal stimulus should rise in priority so it can be deployed if needed.

27. If it becomes clearer that the global economy is tipping into recession (as in Scenario 3), the economic policy choices for New Zealand become less ambiguous. In that event, we would recommend fiscal stimulus beyond what automatic stabilisers provide, particularly given the domestic and global context of limited conventional monetary policy space. There would be choices around the design of such a stimulus.

Ongoing Monitoring and Assessment of the Situation

28. The Treasury's preliminary BEFU forecasts will include a measureable impact from COVID-19, consistent with Scenario 1 described above. We will provide these forecasts to you early next week.

29. There is still a lot of uncertainty globally about what will happen next. This relates to all of: when the spread of infections will peak, how deep the economic shock to China will be, how quick the recovery will be, and how much spill-over there will be to the rest of the world. We will continue to monitor all data and analyses on these topics and adjust our assumptions and forecasts accordingly.

30. We are constructing a downside scenario to our preliminary forecasts, which will explore the effects of a more prolonged outbreak. This is a proxy for scenario two described above. In this analysis, we explore the implications of visitor arrivals including students, falling to around 70% of normal in the June quarter before subsequently recovering, and weaker demand for New Zealand's exports. Conditions return to normal towards the end of the year.

31. The first signs of the impact of COVID-19 on New Zealand are likely t be reflected in consumer and business confidence indices released at the end of ebruary and in early March, and commodity price indices in early March. O ficial data on February trade will be available in mid-March, while February travel da a w ll be released in mid-April.

32. Other administrative data that may provide signals is being explored. This may be more timely than official data as a leading indicat r, bu will also be more noisy. This includes visitor arrivals data (which we should get this eek from Tourism NZ) and weekly immigration border data (starting next week Tue day on a weekly basis).

33. In addition, the Treasury is attending weekly meetings at the Ministry for Primary Industries, where we receive qualitat ve evidence on the challenges exporters and importers are facing with regard to market access. The Treasury's regular business visits around the country as par of its forecasting round will provide further insights.

34. We will draw on the network of Treasury staff posted overseas in Singapore and at the International Monetary Fund to get updates on the emerging global impact of COVID-19. We are also monitoring high-frequency data from China – ranging from coal consumption to a r pollution levels and traffic jams – in addition to commodity price data, to assess th extent of the economic impact on China.

<u>Table 1: An initial framework for economic policy responses to COVID-19 scenario</u>

	Microeconomic Policy	Monetary Policy	Fiscal Policy
A temporary global demand shock	A range of operational measures are already being implemented by agencies to support acutely affected firms and regions. Existing income support policy is also supporting employees. Further measures should not create a precedent that the Government will provide ongoing support for sectors that are overly exposed to international shocks. This could bring considerable fiscal risk and create the wrong economic incentives for firms in the future.	Monetary policy is currently expansionary, which will support the economy through 2020. The Reserve Bank is monitoring the economic impacts to inform future Official Cash Rate (OCR) decisions. The next OCR decisions are on 25 March and 13 May. The exchange rate has already depreciated, which will provide some support to exporters.	The current stance of fiscal policy is expansionary, which will support the economy through 2020. No specific further fiscal policy response is recommended. Budget 2020 decisions can maintain an expansionary fiscal stance, and allow the automatic fiscal stabilisers (taxes and transfers) to provide ongoing support to the economy.
A longer lasting domestic incomes shock	Further targeted measures may be justified to support firms to absorb an extended disruption and/or for households to maintain labour market attachment. As far as possible, these interventions should be designed in a way that is aligned with the Government's economic strategy. Officials will work to identify what options may be best to ramp up if the uncertainty persists. Broader microeconomic policy responses will have larger fiscal costs.	An easing of monetary policy settings would be a likely first step in this scenario. While interest rates are low, there remains some scope to lower them further. Monetary policy is the preferred macroeconomic stabilisation tool. This reflects shorter lags relative to fiscal policy, and that monetary policy can be adjusted more quickly should the situation change again. Further exchange rate depreciation would be expected.	A further loosening in the fiscal stance should be considered. If it is clear that the shock is longer lasting, then planning should accelerate for a discretionary fiscal package that could be deployed if a recession became more likely. Support from automatic fiscal stabilisers (taxes and transfers) would continue, and increase in line with the severity of the shock.
A global recession	Sectoral policy interventions will most likely no longer be adequate to respond to the scale of economic impact on New Zealand.	A stronger conventional monetary policy response would be expected. In addition, the use of unconventional monetary policy tools may be needed to support the economy and the financial system.	As low interest rates provide limited scope for a conventional monetary policy response, a large-scale fiscal stimulus would be required in this scenario. The best response would likely be a temporary tax and/or transfer package rather than an increase in capital spending. This reflects shorter lead times and wider coverage for tax and welfare changes, and sectoral capacity constraints given recent increases in capital spending.