THE ECONOMICS OF THE PANDEMIC

Analysis by Senior Researcher Julian Wood | 06.04.2020

SUMMARY

The economic shock from the Covid19 pandemic response is likely to be large and ongoing. Economic activity could well decline by 10 percent or more in the first quarter with a negative effects continuing for some time. The economy is likely to take over one and half years to fully adjust, or, if negative shocks persist, even longer. There is likely to be an overall decline in private consumption and business investment in the medium term (with strong negative wealth effects (from both lower income but also an adjustment in asset prices). This includes lower returns on business activity. The Government sector (both here and overseas) will expand as a result of increased benefits and subsidies. It is likely that Government debt levels will balloon and we'll see greater pressure on financial markets and liquidity. The impact on net exports is hard to predict but is likely to suffer from both demand and supply shocks. For exporters these shocks might be somewhat offset by the impact on the NZ dollar.

Regions heavily reliant on tourism or international education will be particularly hard hit. Aggregate unemployment could grow to 15 percent and be even higher in local labour markets (raw numbers of unemployed could well go out beyond 200,000). Until we have a vaccine, large parts of the domestic economy are likely to remain stalled (Accommodation, Hospitality, International students/Education). Firms and exporters that are part of supply chains or rely on overseas supply chains will be particularly exposed. Private lending institutions will become increasingly vulnerable.

The severity of this ongoing shock will depend on:

- the Government's ability to support demand, manage financial instability and overall trust in the financial system and or the public support for the public health response;
- the economic health of our trading partners (I would expect most of our trading partners to also experience a negative economic hit. Most will expand their Government sector but this will not offset the losses. There are also risks that trade barriers (tariffs, border protection, bureaucracy, and freight costs) will rise;
- the banking system's health and the availability of liquidity (particularly risky here are non-clearing parts of the financial system like private lending institutions);
- individual liquidity (which unfortunately is overstretched with high household debt levels while we enter a period of falling income and overall wealth); and
- the value of the New Zealand dollar (which I would expect to experience downward pressure and remain low for a significant period.

The transition period will also require significant resources of both capital and labour to be moved from areas of decline to those that expand or experience labour shortages. This will come with all the associated costs of retraining, lost production, mobility issues for people not living where the job vacancies are, and the need for people to revise their own expectations in regards to pay and conditions of work. The economy will take time to adjust to the new normal and many people will simply be worse off. The path to the new economic normal may well reshape how we think about the way society should be structured and leave a heavy debt burden for future generations to repay.

THE GOOD NEWS

The simulation modelling based so far shows that the COVID-19 infection curve can be bent and the human cost of lives lost as the hospital system becomes overwhelmed can be avoided by harsh mitigation measures.

THE BAD NEWS

The simulation modelling also show that when these mitigation measures are relaxed (in the absence of a vaccine) the viral beast roars back to life. The medical system once again ends up being overwhelmed and there is a high death rate. We effectively moved the infection curve out time wise and potentially enabled the health care system to level up. Based on these simulations, I would be projecting that as long as the Government can afford to continue with its current policy choices, we are likely to bounce in between levels 3 and 4 until a vaccine is produced. Best estimates so far put that at 18 months or longer. The best mitigation strategies so far appear to be closing of borders to unnecessary travel of people and social distancing. The bad news here is that this is not a four week event, but probably a rolling series of negative shocks spaced out over time in different locations over the country. This is unless different choices are made or forced upon us all.

THE MAYBE GOOD NEWS

If the four week isolation goes well, and we close our borders as well as internal borders so inter-regional travel is removed and put strict quarantine measures in place so anyone coming from overseas doesn't become a vector for infection, then perhaps life can go on with most of the country operating at Level 3 or even 2. This of course is with the caveat that the economic world we wake up to will be very different. Domestically this would effectively shutter the tourism and related sectors of the economy. Internationally as our trading partners face a downturn as well, many other parts of the New Zealand economy will face less demand for their products or face difficulty in accessing key parts of their supply chain.

THE BIG TRADE-OFF (AND WHERE THE PRESSURE IS GOING TO COME FROM)

Effectively, by going into isolation we are trying to save lives and stop the medical system from being overwhelmed by explicitly trading off economic and social activity. At the moment this an explicit trade off and one that has created a very deep and still deepening negative economic shock. The social costs will also be high (but others are better placed to discuss social effects).

The range of economic forecasts I have seen put this negative event in company with the likes of the Great Depression or even greater. Estimates range between 10-17 percent contraction in a quarter, which if prolonged will compound. Estimates of 200,000 people being unemployed are not entirely ungrounded or perhaps even large enough. Financial systems are being stretched and the Reserve Bank is providing liquidity to the banking system but also helping the Government inject money into the economy by purchasing government bonds. I would expect smaller and non-clearing private lending institutions to be particularly exposed to liquidity risk.

At the same time the Government is spending a lot of money, in a whole lot of ways, in an attempt to offset the economic impacts. Unfortunately, this event is not just a financial issue, or even a lack of spending issue. It's also an enforced lack of economic activity issue turning into a global recession.

Reponses by the Government will balloon government debt out past 30 percent of GDP quickly. All this if there are not significant policy shifts. One saving grace so far is that if this debt is held by the Reserve Bank, in New Zealand currency and not on-sold, there is potential for the impacts of this debt on future generations to be minimised.

Some economists are expecting there to be a healthy bounce back in economic activity fairly quickly. For some firms there hasn't been a slow down at all, some will re-enter and have a catch up phase, but for many this is just the start of a significant transition period. I think as long as border restrictions remain and we are making the choice to try and flatten the curve we are in for a prolonged need to shutter economic activity, especially for some. Certainly regions could be on different isolation regimes if we see re-infection in different places.

Having said that, there will be economic winners throughout this period and new jobs will still be created. It some senses it is a transition to a new economic normal with lower consumption and production for a period. This will impact negatively on a wide range of people and businesses and the longer the crisis goes on, the more pressure there will be to make a different trade off in regards to life versus economic activity.

POTENTIAL FOR A NEW NORMAL

It is highly likely that borders remaining closed to human crossing will become the new normal, potentially with quarantine measures remaining in place for travellers. This will have massive demand implications for sectors and industries of the economy like Tourism, Accommodation and Food services, and the Arts not to mention the Education sector (although this will depend on distance learning opportunities as well as overseas travel with quarantine measures for students). Different regions will feel the economic shock in different ways with regions or towns that rely on tourism or overseas students likely to particularly struggle.

Similarly, until we know how our trading partners fare, regions heavily reliant on export sales can only hope that demand for our exports remains high. Having China coming out of lockdown will help, but only if borders remain open to trade and the demand for New Zealand's relatively high priced food and commodities remains high. If the Chinese, American or European economies tank (and I think there is a significant risk that they will at least struggle), overseas consumers might choose cheaper alternatives or their governments may tighten import restrictions—all of which will have a negative impact on exports, and incomes.

A technical closing of the border will also flow into labour supply issues in industries like Agricultural, Forestry and Fishing (which includes horticulture and viticulture etc) but also the Construction Industry and Administrative and Support Services (this later being a way of supplying contract labour to construction and hospitals etc), all of which were previously over-reliant on immigration for their labour supply. One potential source of workers (beside displaced domestic workers) may well be New Zealanders living in Australia (or overseas) who lose their jobs and have limited access to foreign government support. A proportion may decide to return to New Zealand to either access government assistance or take up work opportunities.

Moving out then, expect there to be focus on matching people who have lost work or their businesses into new roles and opportunities. This will come with all the associated problems of retraining, lost production, people not living where the job vacancies are, and the need for people to revise their own expectations in regards to pay and conditions of work.

The reason these industries have been using a lot of temporary workers from overseas is that these jobs often require a lot physically and/or are not as rewarding financially as previous alternatives. The good news for employers is that a lot of the alternative employment opportunities will have dried up and so finding willing workers should be easier. The not so good news (depending on whether you are paying the wage or spending the wages) is that the minimum wage increase has gone ahead.

There are also financial risks and especially risks to asset prices (namely, stock, land, and house prices). This will all come down to people's liquidity and a banking and lending system all arranged around an economic world that might not exist again for some time. Key here will be enabling financial arrangements to be shifted to reflect the new normal and the extent to which quantitative easing (if financed by printing money) is used. Alongside this the non-clearing part of the finance system will be particularly exposed to liquidity issues and I would expect there to be more failures in this sector.

In regards to the housing market I would expect the supply of rentals to increase as AirBnB homes re-enter the rental market. Landlords will find it difficult to raise rents because of increased supply, a lower demand as people co-house and migration slows, and an increase in supply of marginal rental houses coming up for sale. Overall, I would be leaning toward a correction in house prices, subject to how the Government makes use of quantitative easing. Once again the longer the new normal of lockdown or rolling lockdowns goes on for, the more pressure there will be to revert back to the old normal no matter the human cost life wise.

THE BOUNCE BACK

This is potentially the most uncertain part of the discussion. In my opinion, unfortunately macro-economic outcomes do not just bounce back to previous growth trajectories. There will be a significant change in the growth path going forward for many people with some being better off but many worse off. I would expect there to be a significant amount of lost economic activity and a transition period from the new normal to more of the old normal over time. Once again I think this is an 18 month to 2 year journey at the very least and for some there will be no recovery. Supply chains will be re-examined with a focus on local resilience and some sectors of the economy might take a long time to recover.

CAN'T THE GOVERNMENT JUST BRING FORWARD SOME INFRASTRUCTURE SPEND TO RESTART THE ECONOMY?

Unfortunately not. There are three levels of government fiscal assistance, the first is the tax and benefit system, these operate like automatic stabilisers and are being used heavily at the current time. Benefits have been increased, and wage subsidies given. I would expect there to be a range of mid-term options here as we move out of isolation and these tools are repurposed to help people and businesses retool towards opportunities and labour shortages.

The second stage is to activate shovel-ready projects. The operation of the PGF has shown that even these can take months to activate, and longer for the full employment and growth effects to kick in, usually in the 12 to 18 month timeframe.

The third level of assistance is longer term infrastructure projects. These are not ready to go and need to progress through planning stages before even getting to shovel ready status. The expected time frame for impacts from these types of interventions are usually 2 years plus.

NEXT STEPS OUTLINED BY THE MINISTER OF FINANCE

The following are a range of immediate policy options the Minister of Finance discussed with the Select Committee on the 1st of April:

1. Further support for SME's, with a rent and then utilities package to deal with pressure points for SME's;
2. Network with significant large firms, position to keep them operating;
3. Insolvency law update;
4. RMA review and how it works;
5. Scenario modelling future of wage subsidy scheme, etc, precarious work.

In the medium term the Government also appears focused on regional development and infrastructure spending to assist with industry and regional recovery. Included here are options around housing and employment, and looking at how to address the education, arts, and sports sectors. Included here were comments around the role of the union movement. There was also mention of the $100 million redeployment fund and the role that this will take. There is little public information about this fund currently available.

MOVING BEYOND JUST THE ECONOMICS

In the longer term, the Minster of Finance in his briefing yesterday also signalled his desire to look at Macro-economic settings and approach. The Minister quickly sketched a number of areas he would be looking into including:

a. What should we make and do here?
b. What role institutions will have?
c. What role the state will have in society
d. How do we encourage trade?
e. How do financial systems cope?

This is moving beyond an economic reset and rebuild into what I would describe as a re-shape of the economy and society going forward. Maxim Institute will be keeping a close eye on these reshaping movements.

We welcome feedback on this analysis, and dialogue on the unfolding economic implications of Covid19 over the next few months. Please get in touch with us at mail@maxim.org.nz with your thoughts and questions.