COVID-19: The recovery ahead

Assessing the sectoral impact and policy implications for Government spending

New Zealand has managed the COVID-19 outbreak with relative success, in terms of containing infection rates and deaths. This has seen New Zealand move down alert levels over the past few weeks as we achieved zero active cases, with restrictions relaxed but the border closed. However, the impact of the outbreak on the economy is undeniable. The effects have also been uneven across the industries, and this will affect the recovery ahead. We assess the policy implications and key considerations for Government spending as we gear up for this recovery.

We look to have eliminated COVID-19 in New Zealand. Daily new confirmed cases have been either zero or in single digits since 19 April 2020,[1] and this "squashing of the curve" has allowed the Government to relax shutdown restrictions as we achieved zero active cases on 8 June 2020. The move to Alert Level 2 on 14 May saw a reopening of most businesses and resumption of services, including cafes and restaurants, hairdressers, cinemas and gyms. Virtually all restrictions were lifted with the move to Alert Level 1 on 8 June 2020.

Nonetheless, the outbreak has had an undeniable effect on businesses and households. Many firms were seriously damaged. We assess what the different impacts across industries during the lockdown means for the recovery ahead and policy implications.

The outbreak so far – the data

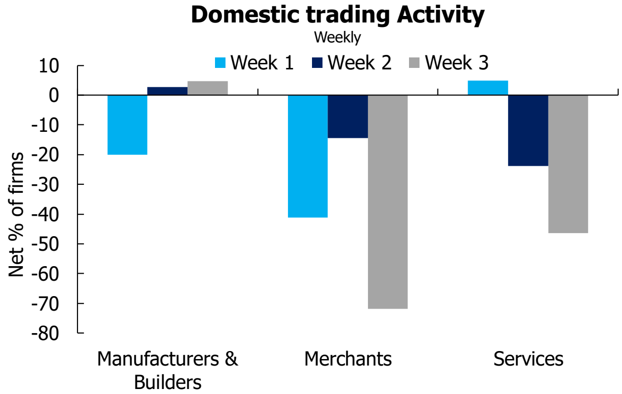
Although the lockdown measures enforced under Alert Level 4[2] on 26 March was one of the strictest in the world, it has been more effective in suppressing and then eliminating COVID-19. In the early stages of the enforcement of Alert Level 4, there was a large degree of uncertainty over how long suppression measures across the different Alert Levels would have to be in place.

The NZIER *Quarterly Survey of Business Opinion* (QSBO) taken just prior to the lockdown in March showed businesses had already grown increasingly pessimistic about the situation as they faced weakening demand. Different sectors were faring differently going into the lockdown.

In the three weeks before Alert Level 4, services sector firms reported a weakening in own trading activity as the weeks progressed. The impact of the enforcement of strict border controls and encouragement of social distancing behaviour was most apparent in reduced demand in tourism and hospitality-related sectors. Retailers also reported a sharp decline in demand in the week before lockdown. In contrast, manufacturers and builders saw an improvement in demand over the weeks leading up to the lockdown.

Figure 1 Retailers and services most affected prior to lockdown

NZIER QSBO by sector, weeks before Alert Level 4



Source: NZIER

To assist in planning around this uncertainty the Treasury on 13 April released a set of scenarios to show the expected outlook for the New Zealand economy given different durations at each Alert Level (Treasury, 2020).

[1] https://www.health.govt.nz/our-work/diseases-and-conditions/covid-19-novel-coronavirus/covid-19-current-situation/covid-19-current-cases#summary

[2] https://covid19.govt.nz/alert-system/covid-19-alert-system/

These stylistic scenarios ranged in severity from one month each spent in Levels 4 and 3 and the remainder in Levels 2 or 1, to six months each spent in Levels 4 and 3.

As the weeks have progressed New Zealand looks increasingly likely to be at the optimistic end of those scenarios. As we moved down the alert levels, more businesses reopened offering a wider range of goods and services.

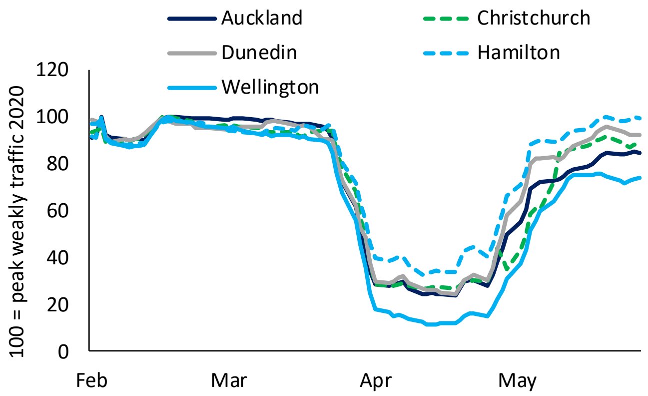
Recent economic indicators provide information on how activity and demand tracked as New Zealand moved through the different alert levels.

Weekly traffic counts of heavy vehicles indicate the level of demand in an economy, as the volume of freight transported around the country tends to increase with demand.

The latest NZTA heavy vehicle traffic count shows a strong rebound in heavy vehicle flows in the wake of the move to Alert Level 3, with transport activity up to around 70% of the high levels prior to the outbreak. It recovered further as New Zealand continued to move down alert levels. In particular, Hamilton's heavy vehicle flow is back to the high levels seen prior to the outbreak in 2020, while Auckland's is back to almost 85% of its highs earlier in the year.

Figure 2 Heavy traffic count rebounds as restrictions relaxed

Heavy vehicles: selected site 5-day average (excl. weekends)



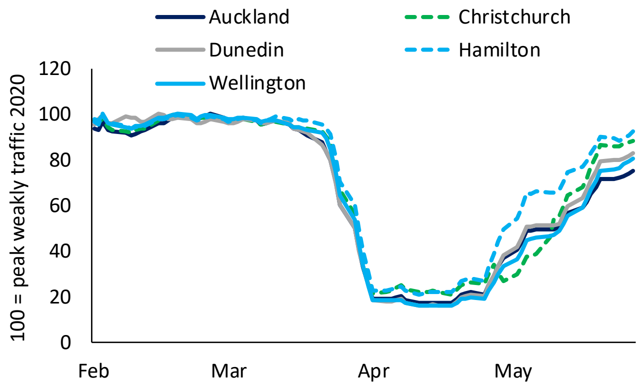
Source: NZTA from Stats NZ, 2020

Light vehicle traffic flows have been slower to recover, with those in Auckland following the move to Alert Level 3 recovering to less than half of the high levels earlier in 2020, and only at 75% at the end of May. Many workers still working from home has meant commuter-related traffic flows remain relatively light.

Given the widespread adaptation, particularly across professional services, to working from home there is potential for light vehicle traffic flows to be permanently lower.

Figure 3 Light traffic count recovery slower

Light vehicles: selected site 5-day average (excl. weekends)



Source: NZTA from Stats NZ, 2020

Unsurprisingly, retail spending fell sharply in April reflecting the mandatory shutdown of non-essential businesses, which was most stores other than supermarkets, and all bars and restaurants. Spending on hospitality and durables thus bore the brunt of the decline. Although there has been a recovery in retail spending as New Zealand moved down alert levels, uncertainty over income prospects will likely weigh on spending over the longer term.

In contrast, besides tourism, the impact of the outbreak on exports has been modest and divergent across the commodities, with the total value of exports since 1 February only $186 million less than the same period last year.[3] This reflects increases in dairy, meat and fruit exports, offset by a decline in forestry, seafood and non-food manufacturing exports.

The divergent changes in demand for the different types of New Zealand goods' exports highlights the uneven effects of COVID-19 on the global economy. People around the world are focusing their spending on necessities such as food, from which New Zealand being a major producer of meat and dairy is benefiting.

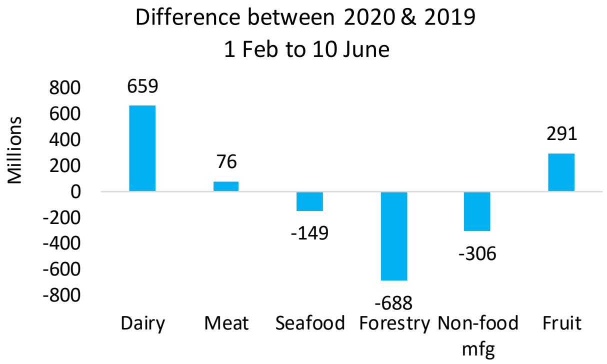
In contrast, New Zealand forestry exports (in values) fell markedly, reflecting the effects of reduced global construction demand.

[3] First of February to 10 June.

The COVID-19 outbreak has shifted priorities in the global economies, and food-based exports will likely continue to fare better than non-food exports over the coming years.

Figure 4 Demand for NZ's main commodity exports varied

Change since beginning of February, relative to same period a year ago



Source: Stats NZ, 2020

There has also been a shift in export markets, with New Zealand exporters selling more to East Asia (excluding China), Japan, and the United States. This is offset by lower exports to China, relative to the same period in 2019.

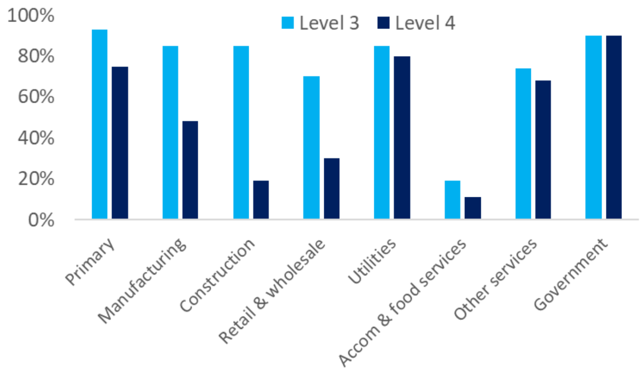
Some have fared better than others

Beyond these economic indicators which show the realised impact of the outbreak to date, the Reserve Bank of New Zealand (RBNZ) has estimated the likely direct impact of each alert level on different industries of the New Zealand economy. The impact is very uneven across the industries, with the RBNZ estimating the accommodation and food services industry would operate at only 11% of its pre-COIVD level under Alert Level 4. In contrast, it was estimated the Government sector would operate at 90% of its pre-COVID level (Stannard et al., 2020). With the move to Alert Level 1 on 8 June, the State Services Commission has advised that public sector workers should return "to their usual place of work as soon as practicable".[4]

Although output in the accommodation and food services industry was estimated to be weak under Alert Level 3, many other industries are estimated to return much closer to their pre-COVID levels. In particular, output in construction is estimated have risen from 19% of its pre-COVID level under Alert Level 4 to 85% under Alert Level 3. Meanwhile, output in the primary industry bounces back from 75% under Alert Level 4 to 93% under Alert Level 3.

Figure 5 GDP by industry during Alert Levels 3 and 4

As % of pre-coronavirus level



Source: Stannard et al., 2020

Where the crunch comes

As New Zealand is now at Alert Level 1 the impact on production across industries will lessen. However, border closures will likely remain in place until a sustainable way to manage the outbreak such as a vaccine is implemented. This will have a persistent effect on the tourism sector.

The effects on the economy extend beyond the imposition of the alert levels. While the shutdown measures themselves will physically constrain activity, beyond this are the shifts in demand that result from changing household and business behaviour.

Border closures and longer lasting precautionary preferences will reduce demand in international education, accommodation and hospitality, while increasing demand in technological services such as online platforms.

Beyond these direct impacts, weaker household income will have a bigger dampening impact on discretionary spending. This means the effects of slowing economic activity will be more pronounced and persistent in some industries.

We assessed the cyclicality of each industry, as measured by the degree to which the industry follows the business cycle (Table 1). The retail sector was the most cyclical industry, followed by accommodation and food services. These results suggest that even beyond the lockdown measures, the weakness in household and business activity manifests itself to a greater degree in the retail, accommodation, and food services industries.

[4] https://ssc.govt.nz/resources/covid-19-alert-level-1/

Many of the non-food manufacturing sectors, as well as construction, are also highly cyclical. This suggests the weakness in economic activity will also be more pronounced and persistent in these sectors.

At the other end of the scale, the public sector-centric industries such as local and central government, education and healthcare have minimal cyclicality. The production of essential goods and services such as utilities and agriculture also appear to be resilient to the business cycle in terms of output.

This information provides a good indication of how growth will likely be distributed as the New Zealand economy recovers over the coming years. The uncertainty over income prospects among households and businesses will likely weigh on the more cyclical industries such as retail, hospitality and construction.

Pivoting towards a recovery

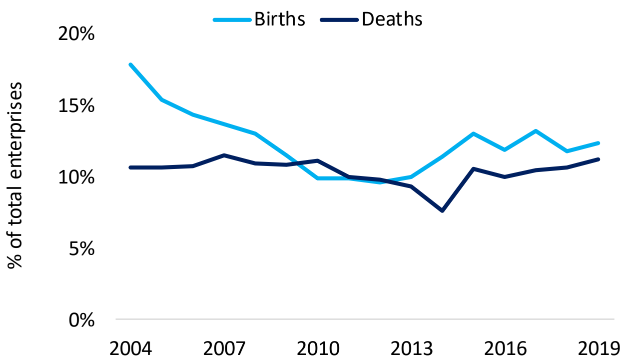
While a shutdown of the economy was required to contain the COVID-19 outbreak, the disruption to cashflow and revenue has had a devastating impact on many businesses. It will take some time for data to reveal the true extent of business failures in the wake of the lockdown.

However, it is important to assess the viability of businesses over the coming months in the context of how businesses normally fare when it comes to starting up and failing.

Stats NZ's business demography data shows that business turnover has been trending mildly higher in recent years, with the birth of new businesses running at 12.3% of total enterprises in the 2019 year – up from 11.4% in 2014. Over the same period, business failures trended up from 7.6% to 11.2%.

Figure 6 Business turnover trending higher in the years prior to COVID-19

Firm start-ups and failures as a % of total enterprises



Source: Stats NZ, 2020

The extremely low interest rate environment is likely to have encouraged business turnover in recent years. Low interest rates make it easier for business owners to take risks and start up new businesses. However, this relative ease in accessing finance to start-up businesses also means more competition. Increased competition will put more pressure on firms' revenue, which increases the chances of business failures. However, low interest rates can allow poor performing firms to stay in business, which may offset some of this turnover.

The recent high-profile restructuring of organisations including The Warehouse Group and Max Fashions has highlighted the challenges faced by chain stores of conventional bricks and mortar shops presented by internet sales, with the shock of the lockdown crystallising closures. After restrictions are lifted around the world, businesses will have to be even more adaptable than before to the rapidly changing conditions. The COVID-19 outbreak will have increased risks, but also presented opportunities.

Border restrictions will likely see increased domestic tourism, as New Zealanders unable to travel overseas instead explore their own country. This will mean tourism offerings will need to be adapted for the domestic market.

Besides the shift in demand, both domestically and abroad, towards spending on necessities such as food, changes in the way people work will also drive a change in demand.

The lockdown has forced the workforce, where possible, to work from home. This has increased demand for technology and home office supplies. Meanwhile, working from home has seen demand for food and beverage services pushed out from the CBD to the suburbs. Although people are now being encouraged to return to the office as New Zealand is at Alert Level 1, the increased focus on flexibility in working hours and conditions means that some aspects of working from home are likely to remain for many businesses, particularly in professional services, even as the economy transitions to a new 'normal'.

Businesses that can pivot to the new opportunities presented by the changing conditions will be much more effective in navigating the recovery over the coming years.

Table 1 Estimated cyclicality of industries

Alpha and beta of each industry to business cycle

Highly cyclical

Industry	Magnitude of the effect	Likelihood industry follows the business cycle
Retail trade	1.3	77%
Accom & food services	1.6	68%
Non-metallic mineral mfg	2.9	67%
Construction	3.2	67%
Transport & equipment mfg	2.4	61%
Printing	1.6	56%
Other services	1.3	45%
Rental & real estate	1.0	44%
Metal product mfg	2.2	43%
Arts & recreation	1.4	40%
Prof, scientific & technical	1.0	38%
Furniture & other mfg	1.8	37%
Admin & support	1.6	36%
Transport, postal & warehousing	1.1	33%
Food beverage & tobacco mfg	1.2	33%
Financial & insurance	0.9	33%
Wood & paper mfg	1.2	32%
Textile & clothing mfg	1.1	22%
ICT	0.8	22%
Wholesale trade	0.9	19%
Forestry & logging	- 1.2	17%
Petroleum & Chemical mfg	0.5	7%
Mining	- 1.4	7%
Primary support	0.6	5%
Central government	0.3	2%
Utlities	0.1	1%
Health care & social assistance	0.1	1%
Education	- 0.1	1%
Agriculture	0.2	0%
Local Government	0.1	0%

Non cyclical

Source: NZIER

Key considerations for spending decisions

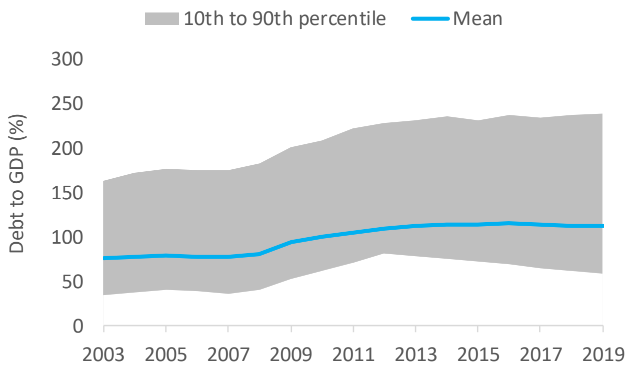
Government is starting off in a favourable position – low debt levels means even with the additional $50 billion in stimulus (in addition to the $12 billion already announced in the initial package), New Zealand Government debt as a proportion of the economy will remain low relative to other developed economies.

Before the outbreak of COVID-19, New Zealand's government debt was at 30% of GDP, which was much lower than 113% debt to GDP ratio of the G7 + Spain. With New Zealand forecast to continue to have a debt to GDP ratio of under 100% (gross debt is forecast to be 58.5% of GDP by 2024). Even with the increased Government spending, there is still breathing room if the global economy gets worse.

However, it is extremely important to assess the costs and benefits of any new Government spending – there is no free lunch. Poor spending decisions mean there is less funding available for higher value projects. Substantial Government investment also has the potential to crowd out private sector investment, thus reducing long-term prosperity. Undisciplined spending is likely to prolong New Zealand's recovery.

Figure 7 Debt to GDP ratio G7 + Spain

Mean ratio compared to 10th and 90th percentile



Source: IMF

We suggest that the government looks to spending on high quality infrastructure and worker training as areas with long-term benefits, as this spending focuses on building sustainable capability. Given the reduction in private sector investment as a result of the uncertainty in the wake of the COVID-19 outbreak, there should be extra capacity in the construction sector which can be taken up by increased infrastructure spending by the Government. It is a great opportunity to replace ageing water, transport and waste infrastructure. In the current low interest rate environment, the cost of borrowing to invest is much lower.

Tourism is unlikely to come back anytime soon, so rather than allow firms to hold on to workers in the hope demand will return it is more important to re-train workers to meet growth in other industries.

Short-term fixes such as grants and tax breaks targeted at specific groups will likely create incentives for businesses to find ways to meet the criteria to access the funds, with the potential for the effects to wear off once the payments stop.

A key challenge with large scale infrastructure investment is the lag time it takes for the project to get started. Although the Government has asked for a list of 'shovel-ready' projects to accelerate over the coming years, it will still take time for the construction to get started. Managing the lags in activity will be important in supporting a sustainable recovery for the coming year.

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