Opening statement to the Economics Legislation Committee
Dr Steven Kennedy PSM
Secretary to the Australian Treasury
16 February 2022

Over the summer the Omicron wave impacted the health and welfare of the community and disrupted economic activity.

The most significant economic impact stemmed from increased absenteeism. Many businesses found it difficult to maintain their full operations because of high levels of staff absences.

In MYEFO we recognised that the pandemic would continue to create headwinds for the recovery, and we laid out scenarios that reflected this uncertainty. However, we did not foresee the extent of the Omicron wave nor the extent of the disruption to supply chains.

Nonetheless, while the disruption caused by Omicron has been significant, its overall economic impact is likely to be less than was foreshadowed in the downside scenario.

This is because we have also learnt that the underlying economy is stronger than we had recognised.

These recent developments reflect a pattern that has emerged following the first wave of the pandemic: the challenging health outlook has persisted, while the economy has proved more resilient.

This likely reflects both policies being more effective than expected and a more rapid adjustment by the community to the tribulations of COVID.

Living with the pandemic

With widespread community transmission of the virus in most parts of Australia, the community is now familiar with the challenges of living in this new phase of the pandemic.

During January many businesses faced acute staff absences because of the high number of workers infected and many others required to isolate as close contacts. In a range of industries, reports of staff shortages as high as 30-40 per cent were widespread in our liaison with business.

This created a challenging business environment in industries such as food manufacturing, transport and logistics, and retail that led to some temporary shortages of goods. Other high social contact sectors, like restaurants and entertainment, also saw activity significantly impacted.

In January, Treasury undertook analysis of the potential impact of the outbreak on staff absences for National Cabinet. We used infection scenarios provided by the Doherty Institute for the NSW Omicron outbreak. This analysis suggested that up to 10 per cent of state workforces could be absent due to COVID illness or the need to self-isolate at the peak of state Omicron outbreaks.[1]

Self-isolating rules for close contacts working in essential industries have subsequently been relaxed, case numbers have fallen and we have observed labour pressures lessening in these industries.

Notwithstanding the significant impact on labour supply, our current assessment is that the negative impact on aggregate spending has been relatively muted. Spending declined in January relative to a strong December but remains above levels experienced in previous lockdowns.

The latest labour market data indicate that late last year, demand for labour was robust, pushing the unemployment rate down sharply to its lowest level in 13 years.

We do not expect the Omicron wave to have a large negative impact on employment. It is more likely to have a relatively larger impact on the number of hours worked across the economy, rather than employment.

Globally the Omicron wave is having a major impact on health systems and is interrupting economic activity. However, as for Australia, the impact on economic activity is expected to be relatively muted and short lived compared with earlier waves of the virus. The IMF recently revised down its expectations for growth this year but continues to forecast solid global growth of 4.4 per cent.

Forecasting the path of the pandemic is difficult. Cases have moderated from the peak in January, but the Chief Medical Officer has indicated that future surges in community transmission are likely, potentially another wave of Omicron in winter and the ongoing emergence of new variants.

Treasury continues to work closely with the Department of Health and the Doherty Institute to incorporate health scenarios into our assessment of the economic outlook.

Uncertainty surrounding the health outlook will be with us for some time. Business and the community could be dealing with an extended period of intermittent disruptions and higher absences.

That said, the community can be confident that Australia is in a strong position to manage future waves.

[1] This is an indicative estimate of the magnitude of worker absences, averaged across all industries, at the peak of a significant wave. This estimate was based on a range of assumptions around testing, close contact rules and isolating behaviour.

Challenges in macroeconomic policy

I'd now like to turn to some of the challenges facing macroeconomic policy.

Usually, monetary policy is the primary tool with which to manage economic cycles and fiscal policy focuses on growth and budget sustainability, while being complementary to monetary policy primarily through automatic stabilisers.

Fiscal policy plays a more active role in the face of significant shocks, but the circumstances surrounding the response to COVID is something different again.

The relative primacy of monetary policy in responding to the COVID shock has been entirely reversed due to the nature of the shock and interest rates being near the zero lower bound.

For example, unconventional monetary policy on its own would have had little impact in the face of lockdowns. Instead, it was most effective through its support of fiscal policy.

This is not to underplay the importance of bond purchases for example. There is little doubt they have lowered longer-term yields and the exchange rate, providing important support to the economy.

Nonetheless, such impacts are likely much less than the effects of $337 billion in direct spending from the Australian Government. Further, it is likely that fiscal multipliers have been larger than normal during this period. Evidence from the literature suggests that in deep recessions and when monetary policy is constrained by the zero lower bound this is the case.[2]

This unusual episode of macroeconomic policy is now coming to an end.

The fiscal policy impulse is receding reflecting the temporary and targeted nature of the policy response.

After two very strong years of growth in Commonwealth payments, in MYEFO payments in 2021-22 and 2022-23 were forecast to fall by 6.3 and 4.8 per cent in real terms.

As a share of GDP, Commonwealth payments are estimated to fall across each of the Budget and forward estimate years, from 31.6 per cent in 2020-21 to 26.5 per cent in 2024-25.

And monetary policy is beginning to normalise with no additional unconventional monetary policy being applied and bond purchases coming to an end. Moreover, in other countries, interest rates have begun to rise slowly from very low levels.

---

[2] See for example Ramey, V. 2019. "Ten years after the financial crisis: What have we learned from the Renaissance in fiscal research?" *Journal of Economic Perspectives*, 33(2): 89-114.

Despite these early steps towards normalisation, macroeconomic policy settings are still far from usual. Interest rates are still close to zero and expected to remain historically low for some time.

It will not be until we see interest rates rise back toward more usual levels that the risks associated with very low interest rates abate.

In these circumstances, it is important that the withdrawal of fiscal policy support is tapered, as it currently is, to ensure that monetary policy has an opportunity to normalise.

However, there is an even more compelling reason for fiscal support to sensibly taper and that is the opportunity to achieve full employment.

The unemployment rate averaged 4.7 per cent in the December quarter rather than the 5¼ per cent forecast at MYEFO, as workers returned to employment more quickly than expected after Delta lockdowns.

Surprisingly, the unemployment rate fell to 4.2 per cent in the month of December, the lowest rate since August 2008.

We have seen dramatic falls in youth unemployment, an especially welcome sign after some years of underperformance in this area. The young always bear the brunt of an underperforming labour market.

The underemployment rate has decreased to the lowest level since 2008, alongside a steady increase in average hours worked, indicating a genuine reduction in the labour market's spare capacity.

Measures of long-term unemployment have fallen to around 16 per cent below pre-pandemic levels.

Other countries have seen significant falls in their unemployment rate, but few have also experienced an increase in labour supply from the working age population to the extent we have in Australia.

More people were in employment as a proportion of the working age population than at any time in Australia's history in December, and the employment to population ratio is now higher than any major advanced economy.

Not only has the supply of labour been responsive to the strong demand, but dynamism in the labour market has increased.

Workers have been switching jobs at increased rates. This is assisting the economy to adjust to shifting demand patterns because of the pandemic and is facilitating productivity improvements by matching workers with the right jobs.

This will support stronger growth in earnings.

A tight labour market will mean firms will have to compete harder for labour by increasing wages and improving conditions. Firms will need to focus on lifting productivity. For example, by changing business practices to encourage greater employee engagement and increasing investment in training to upskill and reskill new and existing employees.

The reopening of our international borders will provide some additional supply following the collapse in immigration of the past two years. This will assist in easing the tightness in those industries such as hospitality that are more reliant on working holiday makers and migrant workers. However, the recovery in population growth will also support demand so the broad-based tightness in the labour market is likely to persist.

The improving outlook for business investment is adding to the potential for future increases in productivity. If our expectations for non-mining business investment are realised across the next two financial years, non-mining investment would rise to its highest share of the economy since 2011.

Our assessment is that the role of fiscal and monetary policy, and policy more broadly, has been instrumental in supporting Australia's strong outcomes.

As noted by the OECD, countries that introduced job retention schemes seem to have had more positive labour market responses to COVID than others. In Australia's case, the JobKeeper program in conjunction with the JobSeeker enhancements, appear to have been especially successful in preserving employment while supporting incomes and encouraging rapid recovery.

Both temporary supports were appropriately withdrawn as they were no longer required as confidence in adapting to the pandemic increased, labour markets tightened, and substantial income support accumulated on household and business balance sheets.

I have previously noted that following a recession the NAIRU (the level of unemployment below which inflation would be expected to accelerate) typically drifts up because of labour market scarring, ultimately constraining the ability for the economy to grow strongly out of the recession.

At this stage, there is no evidence of any labour market scarring and the debate has shifted to how low the unemployment rate can fall and be maintained, without generating rising inflationary pressures.

Our experience in the years prior to COVID and recent developments suggest the NAIRU could be lower than our historical estimates. This suggests a degree of caution is required in framing fiscal and monetary policy, particularly given the large error bounds associated with technical estimates of the NAIRU.

To put this another way, overestimating the NAIRU could see policy tighten prematurely and prevent Australia from attaining the goal of full employment.

A further consideration is the likely non-linear relationship between wages (or inflation) and unemployment. That is, there may be little trade-off between wages and unemployment until we hit an inflection point at which point wages growth increases more rapidly with further falls in unemployment.

This suggests we should approach low levels of unemployment steadily but it certainly does not outweigh the argument for persistently testing these boundaries.

At full employment, and if we can achieve productivity growth of 1.5 per cent, then nominal wages can grow at 4 per cent and put no pressure on inflation.

However, on the other hand, if productivity is only 0.5 per cent, then wages can only grow at 3 per cent before they begin to put pressure on inflation.

This again illustrates the importance of achieving strong productivity growth for our long-term prosperity.

Risks to the outlook

Before I conclude I would like to mention a few of the other macroeconomic risks that we are continuing to monitor and assess.

Most notably, there remains a high level of uncertainty surrounding the ongoing impacts of COVID on the economic outlook.

As I noted earlier, our most recent assessment is that the economic impacts are continuing to diminish, even in the face of new waves of infection and some health measures.

However, the effects of COVID on inflation, often characterised as a combination of increased demand for goods and supply side shocks, are still passing through the economy. Fortunately, these impacts have been much less pronounced in Australia than in other countries. Nevertheless, the impacts have been felt and headline inflation is currently at an 11-year high.

Geostrategic risks are also increasing. This is leading to shifts in global trading patterns and supply chains, as countries seek to build additional economic resilience. There is also a heightened risk of sudden economic disruption, as illustrated by current events in Eastern Europe, which may bear down on global markets and investor confidence.

There are also ongoing and rising risks from climate change and the transition to a lower carbon economy. There is not sufficient time here today to speak to this important issue in detail, but Australia will need to continue to adapt and build resilience to the physical impacts of climate change.

Finally, as a result of the response to COVID many countries have significantly higher levels of public debt that will need to be addressed in the coming years.

Concluding comments

As the pandemic ebbs and begins to become endemic, health responses will still be required. Vaccination and treatments will remain crucial to reducing the economic impacts. And there will always be an ongoing need to protect the most vulnerable, especially as the focus shifts away from transmission.

Remarkably, at the same time, Australia may be given an important opportunity – the opportunity to achieve and sustain full employment.

These circumstances, with the right policy settings, could entail an unemployment rate with a 3 in front of it or at the very least settling in the low 4s, rising productivity back towards 1.5 per cent per year, inflation settling in the middle of the band and nominal wages growing at 4 per cent.

This would be an outcome consistent with the maximum opportunity being afforded to all Australians to enjoy prosperity and the benefits that flow from a highly engaged and well remunerated workforce.

Australia has not been this close to this opportunity since 2008 and before that prior to the shocks of the 1970s.

While nothing is assured, let us hope we can seize this opportunity in the period ahead, and reward younger generations for the significant impost they have taken on through the Budget in protecting all Australians from the impacts of COVID.