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Senate Select Committee on COVID-19 Opening Statement

Thursday 30 July 2020

Thank you for the opportunity to provide an update to the Committee following the release of the Government's Economic and Fiscal Update.

When I appeared in front of this committee three months ago, I noted that "We have never seen an economic shock of this speed, magnitude and shape, reflecting that this is both a significant supply and demand shock."

This remains the case.

I also said that "The final shape of this shock remains hard to predict because it depends on how the virus' transmission unfolds in the face of efforts to suppress it – both in Australia and overseas. Over time, the uncertainty around the progression of the virus will diminish and more economic activity will return."

This also remains the case and underpins our advice to government on responses to the economic consequences of the pandemic.

This shock is far from over.

This is obvious to Australians living in Victoria.

We are learning more about the management of COVID-19 but there remains considerable uncertainty about the progression of the virus and its full impact on the economy.

The management of the pandemic from a health perspective will continue to underpin economic recovery and the effectiveness of economic policy responses.

We can see this in our data, with falls in travel and public activities typically preceding government decisions to increase restrictions.

Confidence is an essential ingredient to economic recovery.

Confidence firstly in the management of the spread and treatment of COVID-19.

Confidence in the governments and public institutions that decide and implement responses and policy.

And then confidence in our economic future.

Today I will draw on the Economic and Fiscal Update to describe the evolution of the economic shock to date and our forecasts, explain how we see the policy response unfolding, and provide some reflections on macroeconomic and fiscal frameworks.

Forecasts

The Australian economy is expected to have fallen by 7 per cent in the June quarter, the sharpest quarterly fall on record.

Business investment is expected to contract by 19 per cent in the quarter, with the falls concentrated in the non-mining sector.

Household consumption is expected to have fallen around 12 per cent in the quarter. Consumption of services such as accommodation, food services and transport were particularly hard hit.

As a result of the lower spending and restrictions on specific industries, severe job losses occurred in the June quarter. For the quarter as a whole, employment fell by 5.5 per cent, alongside a record fall in participation in the labour market.

The largest falls from March to April occurred in accommodation and food services; transport, postal and warehousing; retail trade; and arts and recreational services industries.

While normally we would look to quarterly measures of economic activity and labour market outcomes, this shock is moving so fast that there are significant differences between months within a quarter.

Observing the evolution of what we have termed the effective unemployment rate, provides a useful insight into the progression of economic effects to date.

The effective unemployment rate is a measure of unemployment that includes the unemployed, those that have recently withdrawn from the labour force and those still connected to their employer but working zero hours.

In April, around 600,000 people lost employment, with only around 120,000 of those actually being counted as unemployed and the remaining 500,000 not counted as in the labour force. In addition, around 700,000 people were counted as employed but were working zero hours for economic reasons. Bringing these changes together the effective unemployment rate was close to 15 per cent in April.

By May, this number had begun to decline as people started to work again, even as the number of people technically counted as unemployed increased, the effective rate had fallen to around 14 per cent.

By June, as health restrictions began to ease, the effective unemployment rate had fallen to around 11 per cent, with employment increasing and fewer people working zero hours.

While the Australian economy has begun to recover from the severe effects of the containment restrictions in April and early May, the road to recovery will be long and unpredictable. Economic activity and employment will likely remain below pre-COVID levels for at least the next 12 months.

This reflects assumptions about continuing restrictions to contain outbreaks of the virus which keep sentiment below average, as well as the dislocation expected from the substantial loss of business and household income.

In financial-year terms, following a fall of ¼ per cent in 2019-20, the Australian economy is forecast to fall by a further 2½ per cent in 2020-21.

The pick-up in activity is more evident in calendar years - we are forecasting GDP to decline by 3¾ per cent in 2020, before increasing by 2½ per cent in 2021.

Household consumption is forecast to fall by 1¼ per cent in 2020-21, reflecting the impacts of containment measures, with significant declines in incomes, wealth and consumer confidence.

Dwelling investment is forecast to fall by 16 per cent in 2020-21 because of reduced demand, cancellations and delays in residential projects, health restrictions on construction sites and some supply-chain disruptions.

Non-mining business investment is forecast to fall sharply driven by a sharp decline in machinery and equipment investment, as firms seek to preserve cash.

However, mining investment is expected to grow for the first time in seven years, largely driven by the need to sustain productive capacity and to maintain large capital stocks accumulated over the investment boom.

Net exports are forecast to fall by only a little, with large falls in international tourism and education exports offset by less international travel by Australians.

The unemployment rate is forecast to remain elevated, and by mid-2021 is expected to be 8¾ per cent.

As a result of significant spare capacity in the labour market and the economy more broadly, wage and price pressures are expected to be subdued.

The July Update contains considerable detail on the assumptions so we could be transparent about the basis for our forecasts and the risks to the outlook in these unusual times. We also provided information that indicated the impact of variations to key assumptions.

Policy response

Turning now to the policy response.

We see the Government's fiscal response moving through three phases.

The first phase has focused on providing income support to people and businesses, especially in light of the loss of income that comes from the withdrawal from economic activity due to COVID-19.

In other words, the response focused on the supply element of the shock.

The two most significant mechanisms to deliver income support have been JobKeeper and JobSeeker, although they have been substantially supplemented by payments to welfare recipients and cash payments to SMEs linked to their payrolls.

An important additional element of JobSeeker and JobKeeper, is that they act as automatic stabilisers, that is, they flex in response in the size of the shock.

Given the uncertainty that emerged in late March and remains with us, this automatic element is important and a deliberate design feature of JobKeeper, and one of the reasons for the enhanced JobSeeker.

Naturally, this also means the costs of these programs can be significantly more or less than anticipated given the capacity for the effects of COVID-19 to swing substantially.

Not all of this income transfer will be spent immediately by businesses and households.

For example, we are likely to see the household saving ratio rise to around 20 per cent in the June quarter reflecting both precautionary behaviour and forced savings.

This transfer of money from the public balance sheet to the private balance sheet will support activity not only in the quarter it is provided but also over future quarters.

The second phase will see income supports maintained but increasingly targeted, while switching fiscal support to encouraging economic activity and employment, and taking the opportunity to reform where it arises.

The focus of policy here is switching more to responding to the demand element of the shock.

Elements of the second phase that have already been put in place include tax measures to encourage business investment, subsidies to support housing investment and direct public expenditure on infrastructure.

Reform elements include industrial relations reforms associated with JobKeeper, and training reforms through the National Skills Commission and the JobTrainer Fund.

The timing of the third phase of Government support will depend on the shape of the COVID-19 shock.

In this phase it will be necessary to increasingly focus on the functioning of labour and product markets, and responding to accelerated structural change.

Clearly, support for demand will still be required to lock in a declining unemployment rate.

The extent of this support is hard to predict.

It will depend, in part, on how long businesses and consumers remain precautionary as a result of ongoing health concerns and general uncertainty around the outlook.

It will also depend on the extent of restructuring and structural change that occurs throughout our economy.

As we move into this phase and start to emerge from the crisis, there will be both a need for, and more opportunities to pursue, economic reform.

This is necessary in order to lift our growth potential and help the economy adapt more quickly and at lower cost to the new environment we face.

Taking opportunities when and where circumstances present is one of the most powerful ways to achieve reform.

I would see the successful manner in which governments around Australia have approached the challenges of COVID-19 as fitting very much into this mould.

Sustained and successful reform periods have common features.

These include an unwavering commitment to public value for spending, the application of markets to delivering outcomes, the use of evidence in understanding and responding to the challenges, the effective engagement of people and businesses, a fair and reasonable approach to structural change, successfully sharing the gains of growth, an understanding that the national interest is not always achieved through balancing sectional interests, and high-quality governance.

Macroeconomic policy and fiscal frameworks

In the July Update it was noted that interest rates were cut by 425 basis points in response to the GFC.

As outlined in the Treasurer's National Press Club speech on 24 July, the stimulatory effect of a cut in interest rates of this size today equates to about $100 billion in fiscal stimulus over a 12 month period.

While actions taken by the RBA are assisting the economy, they are not providing anywhere near the amount of support that they have in the past.

This is not just the experience here in Australia, this is happening in many developed countries.

I suspect that these new circumstances are going to be with us for some time and they have direct implications for monetary and fiscal policy.

From a monetary policy perspective, we have seen central banks undertaking more interventions outside their historical conventions, such as standing ready to directly purchase national and sub-national debt and buying considerable amounts of private debt.

Phil Lowe outlined very effectively the RBA Board's position on these developments, their implications for central banks and their relevance to Australia in his recent speech on 21 July.

From a fiscal perspective, this means more is going to be expected of governments and fiscal policy in managing economic cycles.

Interestingly fiscal policy will be more powerful in these settings. It is highly likely that fiscal multipliers are larger when interest rates are near zero and are expected to remain there for the foreseeable future.

In other words, the usual crowding out features of fiscal policy are much less pronounced.

Fortunately, Australia is in a very good position to provide appropriate policy responses as it has done to date.

This is not an invitation to spend in an untrammelled fashion. The intersection of the quantity of the fiscal policy response, be it through tax measures or spending, and the quality of that spending or tax measures will determine our future success.

And, at an appropriate time moving back toward a balanced budget will be essential to driving quality decisions.

Thank you for the opportunity to provide this opening statement.