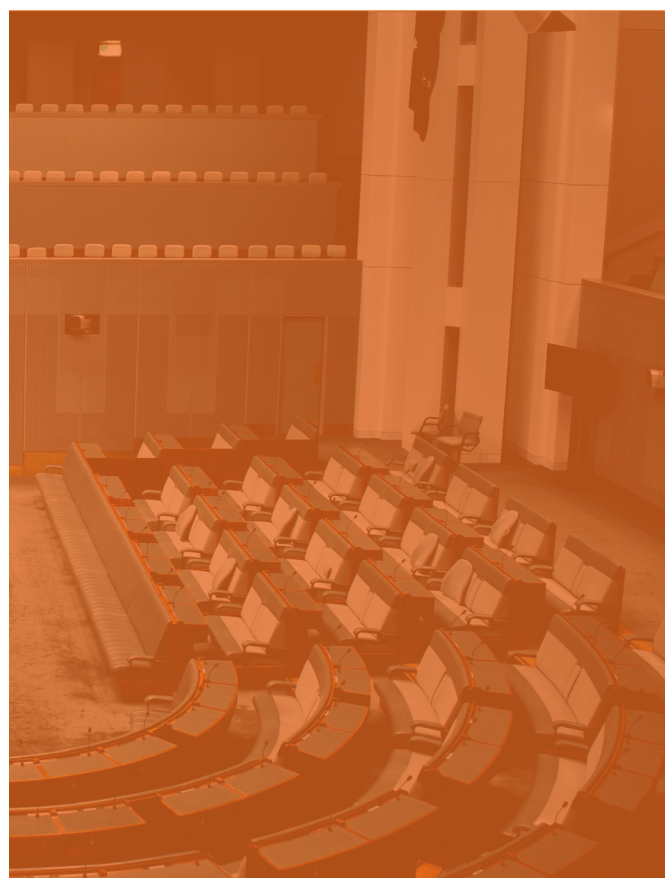


Australia needs a May 2020 economic statement



Greg Smith
April 2020



Australia needs a May 2020 economic statement

This is analysis prepared for CEDA by former senior Federal Treasury official Greg Smith, a member of CEDA's Committee on Economic Policy. It outlines key economic issues that the Australian Government should be addressing, including why there is an urgent need for an economic statement to the nation.

The 2020s have begun with a global medical crisis, arising from the worldwide spread of COVID-19. Following quickly is a global economic crisis leading almost certainly to a very deep depression that will likely have widespread economic, social and political repercussions for years or even decades to come. We can only hope that the horrors of the 1930s are not revisited, although early signs show that this risk is very real.

In responding to the economic crisis, one of the most important immediate tasks is to establish reasonable working assumptions. These assumptions can have a very major effects on the design of policy responses and on their likely future effects. Getting them wrong can result in policies having adverse unintended consequences.

The Australian Government should present an economic statement to Parliament by late May 2020 and Parliament should be given adequate opportunity to scrutinise the statement soon after its delivery.

The statement need not be a full budget, which can wait until later in the year as has already been proposed. Instead it would be a statement of economic and fiscal conditions, preliminary expectations and the current economic strategy, not of measures.

The statement would address a crucial problem: we see extensive daily announcements about the data and policy relating to the COVID-19 crisis but we receive little information about the deep economic crisis and the government's response.

A statement, even if relatively limited, would usefully include some summary measures of economic and fiscal conditions. It will need, much more than usual, to stress high levels of uncertainty. This may require presenting indicative estimates for two or more scenarios for the future course of the pandemic response.



Australia needs a May 2020 economic statement

Given longer term uncertainties, the statement should certainly not present any forward estimates relating to the out-years (whether four years or ten).

It should instead give highly contingent early estimates, or an indicative range of estimates, based on current policy, summarising the economic and fiscal position in 2019-20 (nearing completion) and 2020-21.

These numbers provide vital baselines but they are not the main issue. The main goal of the statement would be to lay out the key working assumptions of government economic and financial policy at the present time and to provide a more integrated and coherent picture of the revised policy framework being pursued.

The key statement information would be about that framework, not budget-type measures or estimates. It would of necessity be no more than an interim statement, recognising that the government must remain flexible and adaptive as this economic crisis unfolds, and that risks and uncertainties are greater than usual.

Several core areas of the economic policy framework urgently need to be addressed and expectations clarified in the public interest.

While the rush of events and announcements to date has of necessity taken all priority, we are now rapidly shifting into a situation where our economy and society needs a clearer sense of expectations, policy direction and understanding of goals.

Without this, uncertainty and misunderstanding could itself start to add to the costs we are bearing and delay recovery.

Speculation and fear of future developments is more likely to further damage confidence if the government does not set out its thinking in a timely and integrated way. Seven months or more is too long to wait for even a first instalment.

There no doubt will be different views about what specifically should be addressed, but the following are likely to be among the main matters needing attention.

Analysis of the crisis

The economic profile of this crisis differs markedly from that of the Global Financial Crisis and most previous crises, which derived mainly from failures in one or more financial markets. Because it is based on a physical disaster and has required the government to limit people movement and associated production, this crisis involves both supply disruption and demand collapse.

It is likely that over time the geometry of the crisis will change, perhaps with growing second round effects, and with substantial asymmetries in experience across the world.

In the near term, the crisis could increasingly manifest in risk of financial instability for which we need clear policy readiness. In the medium term, we should expect ongoing disruption to the global economy, particularly in emerging markets. Australia must be prepared to define its policies for, and within, a coordinated international response strategy.

Difficult and uncertain though it is, we need to have some analysis of the possible course of economic events and the types of economic policy response required at different stages. This may need to include some significant new variables. In particular, constraints on the movement of people, which could continue for some years, may in turn change the course of Australia's growth pattern and industry structure. In recent times, Australia's growth has been heavily based on high short- and long-term immigration, which may now be impossible.

Fiscal and monetary policy framework and assumptions

Prior to this crisis, Australia had continuing but weakening economic growth, a persistent unemployment rate above five per cent, and disappointingly high levels of underemployment. Orthodox monetary policy had been adjusted to the maximum feasible stimulatory extent, with interest rates reduced to historically low levels. Fiscal policy on the other hand aimed to shift from deficit to surplus, with longer term promises of future tax cuts and public expenditure constraint.



Australia needs a May 2020 economic statement

We are now moving to a dramatically different situation, with public revenue collapsing, expenditure soaring and GDP falling. All the former fiscal ratios must now be set aside. With nominal interest rates at bottom, the Reserve Bank has commenced a new era of quantitative easing, rapidly expanding its balance sheet and the money base.

Apart from describing the framework and assumptions behind these immediate developments, an economic statement now should address the critical question of contingent future pathways. There is a very strong case for modifying the medium term fiscal policy framework based on the notion of balance over the cycle. We need a more realistic formulation in the new environment.

Critically, we need to make clear that the crisis response will not, and need not, be followed by a period of austerity economics.

Future fiscal and monetary policy must be directed at economic recovery and growth, and full employment (see also item five below). Old idealised notions of target government revenue, expenditure and debt ratios need to be entirely subordinated to rational macroeconomic policy objectives focused on growth toward full employment.

Financing public spending

Many in the community are understandably concerned about how the change in public spending will be financed and what the implications of that could be for them, such as for their retirement savings and incomes, future access to bank credit, house prices and affordability.

Financial market participants also need a clear understanding of the strategy for funding public spending and the consequences across all sectors of the financial system.

Indications to date are that the government will dramatically increase its debt issuance through existing channels. There is some uncertainty about the relative role of Commonwealth and state debt at this time. At the same time, the Reserve Bank will substantially increase its holdings of government debt through secondary market purchases under a quantitative easing program.



Australia needs a May 2020 economic statement

Through a huge deficit, banks will see a large influx of funds. At present, it appears that they will be expected to invest much of these funds in very low yield assets – a combination of Reserve Bank deposits through quantitative easing and very low interest rate government debt instruments.

Clarity is needed about the expectations in these matters and about the policy goals the government is pursuing. Again, this clarity needs to address not only near term developments but also the likely policy strategy to be pursued in the medium term, when the immediate crisis and its conditions have passed.

We are moving into an environment where fiscal and monetary policies are greatly amplified and must be closely coordinated and, perhaps even of necessity, operationally more integrated. We should arguably consider different funding approaches, such as direct purchases of some public debt by the central bank, and/or the issue of different types of instruments. The statement could give an assessment of expected costs and benefits of whichever approaches are contemplated.

Federal-state finances

The states have been at the forefront of much of the COVID-19 response. This has required very considerable health and other spending. In addition they have sought to supplement Commonwealth assistance programs in areas where they see gaps. At the same time, they likely face a sharp contraction in their own account revenues and in the pool of GST revenues.

In the distant past, the Loan Council mechanism would have provided for the control and coordination of state borrowing programs. There is a case for ensuring that the Commonwealth rather than the states take on its shoulders the overwhelming bulk of the fiscal consequences of the crisis. The Commonwealth has the financial and other powers to best perform macroeconomic functions in Australia, and to access finance on the best terms.

A strategic statement on federal-state finances (even if subject to future negotiation) is increasingly urgent to ensure that the best overall outcomes are pursued.

Other medium term strategies

While the focus to date rightly has been on securing a 'bridge' for people and businesses to a post-COVID-19 future, the evidence is now overwhelming that the future on the other side will be very different from the recent past.

The government has already given indications that it is thinking about these issues. An Economic Statement would be a useful place to put at least some of this thinking into the context of a future economic policy framework. Although much further development will be needed, some early indications of policy directions could be valuable for building confidence.

For example Australia, like many other countries, is learning lessons about strategic supply risk. We may need to consider urgently tasking a national supply commission or like body to advise government on the full scope of future requirements and the means to best achieve them.

Australia is also learning lessons about pandemic risk. It is known that multiple influenza, coronavirus and other threats are widely harboured in certain animal species. Regrettably there is a risk that the SARS2 corona-virus could well undergo mutations at any time now that it is globally widespread in human populations. We need to think again about the best design for our health system and arrangements, including federal and public-private arrangements, in this environment.

We should also be better prepared for implementing broader response strategies. Global economic and social conditions are also likely to change for the long term (and several key constraints had already built up before this crisis).

Australia's international trade and other economic strategies may require considerable adaptation.

To the extent that past growth industries will not recover, or recover quickly, the economy will need to achieve rapid innovation and structural change to secure a sustainable growth recovery. That too, requires a strong and deep agenda of policy reform.

Maintaining strategic policy flexibility

As noted above, the statement must at all points stress the need for policy to remain flexible and adaptive to possible future changes in circumstances. Much is unknown and will remain unknown in advance of actual events.

Current pandemic response strategies come with uncertain prospects, and the possibility that follow-up responses of some kind may need to extend for long periods cannot be ruled out. New developments, perhaps favourable (such as medical breakthroughs) or unfavourable (such as virus mutations or financial crises), will demand new or changed policies.

But these things are always possible. They do not mean that economic policy making and political discussion of them should come to an end in the meantime, forever deferred until some mythical point when all is clear. That point never comes. The emerging response to economic crisis needs a timely flow of information and policy disclosure in much the same way that the medical crisis does.

Governments have continually stressed that COVID-19 responses will continue to change as events unfold. The same approach can and must be taken to economic matters. Moreover, it often can be useful to provide indications of how policy is cast to manage these uncertainties, and what might be expected or feasible under realistic scenarios.

The views expressed in this paper are those of the author alone in a personal capacity. Greg Smith no longer works in any official capacity or represents the views of any public or private entity. He is a former senior Commonwealth Treasury official, where his past roles included Executive Director of Budget Group and Revenue Group (prior to 2004). He was also formerly a member of the 'Henry' Tax Review panel (2008-09) and a member and chairperson of the Commonwealth Grants Commission (2006-March 2020).
