CEDA Council on Economic Policy
Economic Recovery Series

Macroeconomic policy: avoiding the cliff

Percy Allan and Craig Emerson

July 2020

60
1960-2020
Celebrating 60 years
RESEARCH · MEMBERSHIP · INFLUENCE
>ceda
committee for economic development of australia

CEDA's Council on Economic Policy has prepared a series of papers that each address a different aspect of the economic crisis precipitated by COVID-19. This paper, the first in the Economic Recovery Series, considers the need for new macroeconomic policy to avoid the 'economic cliff' marked by the end of the Federal Government's initial support measures in September.

For policy makers the burning issue is how to prevent the Australian economy suffering a double-dip collapse after existing income and other Federal Government support measures designed to offset the effects of the COVID-19 pandemic expire in late September 2020.

The Federal Treasurer, Josh Frydenberg, will provide an updated economic and fiscal outlook on 23 July, which is expected to outline some features of the government's fiscal strategy ahead of its full budget on 6 October 2020. This paper canvasses the broad fiscal and monetary policy options to avoid an economic cliff at the end of September 2020 and to revive the economy thereafter to limit any ongoing trauma from COVID-19.

Rescue measures

In response to the COVID-19 pandemic, the federal and state governments, through a specially formed National Cabinet, took drastic steps in March 2020 to supress the spread of the virus throughout the community. Passengers arriving from overseas were quarantined for a fortnight, state borders were closed to people movement, schools and other educational institutions were shut, residents were confined to their homes for all but critical requirements, and physical distancing between individuals outside their homes was mandated. Australia overnight moved from being a free to a command society and economy with bipartisan and widespread public support.

Thanks to political leadership and cooperation at both federal and state levels, a fast and competent response by state health authorities, and public compliance and goodwill in accepting social distancing, Australia has not only suppressed viral infections, it has also kept new cases to a small number. Originally, the federal health authority projected that at least 20 per cent of the Australian population would contract COVID-19 (five million people) of whom one per cent might die (50,000 people).[1] By

1 See: https://www.smh.com.au/politics/federal/australia-prepares-for-50-000-to-150-000-coronavirus-deaths-20200316-p54amn.html

the end of June, the total number of cases was fewer than 8,000, with the number of new cases under 100 per day (mainly concentrated in Victoria) and total deaths were just over 100. This is one of the best results per capita of any nation in the world and contrasts sharply with the high infection and death rates in Belgium, Spain, UK, Italy, France, Sweden, Netherlands, Ireland, USA, Mexico, Brazil and Russia.

The remarkable progress in defeating COVID-19 meant state and territory governments in late May were able to begin relaxing restrictions. However, some community-wide rules continued to apply, including a four-square-metre rule, physical distancing, and hygiene and safety requirements for businesses. Australian citizens and residents returning from overseas continue to be quarantined for a fortnight in hotels. The economic impact of the pandemic was a flash crash in March and April.

Treasurer Frydenberg on 3 June 2020 confirmed that Australia was in the midst of its first recession in 29 years following the release of the latest national accounts, saying that "we've just notched up a 0.3 per cent decline in the economy in the March quarter – we're looking at 8.5 per cent (decline) in the June quarter."

To partially offset the economic shock, the government, in a series of announcements in March, committed to a package of income support measures, the most important of which were JobKeeper, JobSeeker and SME support. In addition, the government undertook to guarantee bank loans to SMEs whose cash flow had dried up while its Australian Office of Financial Management offered to invest in structured finance markets used by smaller lenders. Individuals adversely affected by the lockdown were permitted to access a portion of their superannuation savings tax free.

The Reserve Bank of Australia (RBA) came to the rescue with four measures, comprising a cut in the cash rate to 0.25 per cent per annum, an undertaking to buy sufficient government bonds to cap their three year market yield at 0.25 per cent per annum, make three year loans at 0.25 per cent per annum to the banking system on a collateralised basis and pay 0.10 per cent interest on bank exchange settlement balances with the RBA.

The total value of these measures was around $260 billion, largely spread over 2019/20 and 2020/21 financial years. See table below.

Macroeconomic response to the coronavirus, 2019/20- 2023/24 ($ billion)

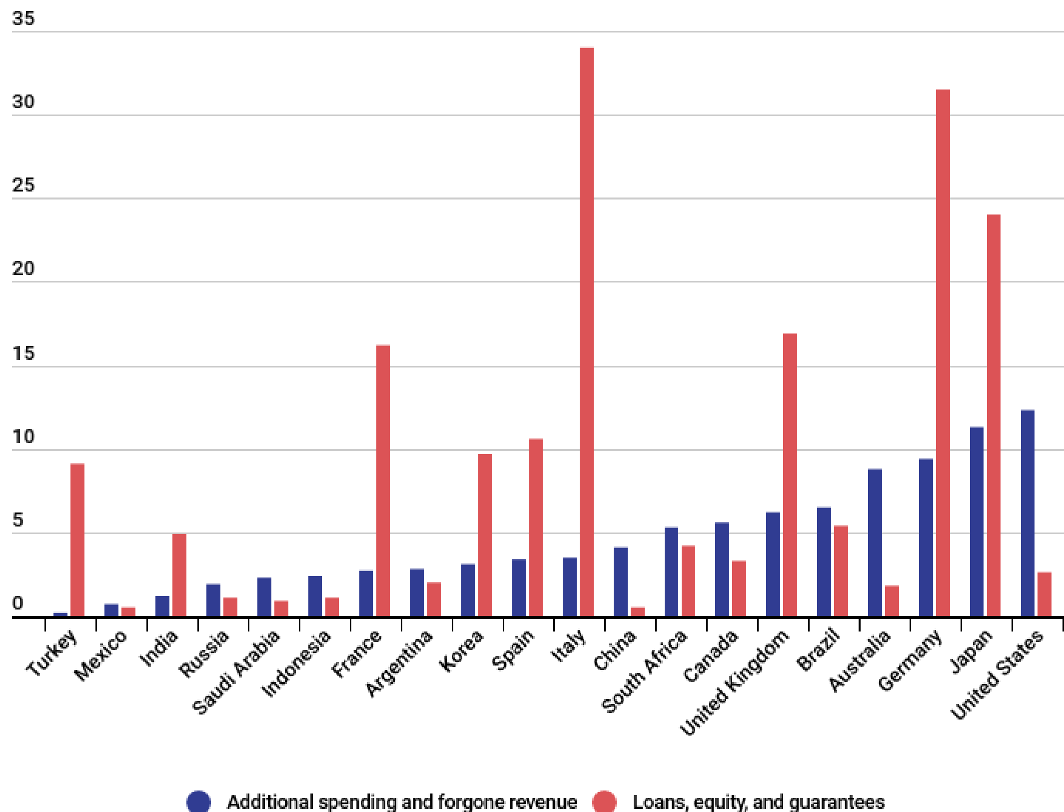
Measure	2019/20	2020/21	2021/22 to 2023/24	Total
JobSeeker Bonus Payments	5.2	8.8	0.1	14.1
Social Security, Veteran, etc. Bonus	4.9	3.9	0	8.8
JobKeeper Payments	20	50	0	70
SME Cash-flow Support	14.9	17	0	31.9
Other Support Measures	0.8	7.3	1.6	9.7
Total Fiscal Support	**45.8**	**87**	**1.7**	**134.5**
SME Bank Loan Guarantees				Up to 20
Structured Finance Market Equity				Up to 15
RBA Support Package				Up to 90
Total Fiscal and Other Support				**259.5**

Source: Australian Government, Economic Response to the Coronavirus, Last updated 25th May 2020 (https://treasury.gov.au/sites/default/files/2020-05/Overview-Economic_Response_to_the_Coronavirus_3.pdf), but also includes under Other Support for 2020/21 the $668 million HomeBuilder package announced on 3 June 2020.

The Federal Government's additional spending and foregone revenue cost relative to GDP was one of the highest amongst advanced economies in the world. But the cost of its loans, equity contributions and financial guarantees relative to GDP was low by comparison. See chart below.

In addition to federal initiatives, banks agreed to defer household mortgage interest and principal repayments until end-September 2020 and several state and local governments and utilities did likewise for land tax instalments, council rates and water, gas and electricity payments. Both commercial and residential landlords were required to grant six months' rent relief or deferrals to tenants in distress. Appendix A lists federal and state support measures announced in March 2020.[2]

2 For an analysis of the fiscal impact of the pandemic on state and territory finances see file:///E:/CIS%20-%20Robert%20Carling,%20State%20Finances%20after%20the%20Pandemic,%20June%202020.pdf



Source: IMF

Most of the fiscal and other support measures will expire after six months, at the end of September 2020. So, although their costs are spread over five financial years (2019/20 to 2023/24), they are largely concentrated in the June and September quarters of 2020.

Post-rescue risk

The concern of many economists is that the abrupt cessation of business, worker and welfare support measures at the end of the first quarter of fiscal year 2020/21 could result in a second economic crash. National income will sharply contract as JobSeeker beneficiaries move back to much lower Newstart allowances, some JobKeeper receipients move to Newstart payments to survive, veteran and aged pensioners lose their bonus payments, and businesses stop receiving government cash-flow assis-

tance and guarantees. In addition, mortgage, land tax, rate, utility and rental payment deferrals or relief are also scheduled to cease at that time.

The RBA, the Australian prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) have expressed concern about what will happen after September 2020. Governor of the RBA, Philip Lowe, told a Senate Committee oversighting the Federal Government's response to the COVID-19 crisis that "It's going to be very important to keep the fiscal support going" and that "it would be a mistake to withdraw the fiscal stimulus too quickly".[3]

Wayne Byres, head of APRA, told the same Committee that when mortgage deferrals come to an end in September "There are customers that are clearly not going to be able to pay their loans", that APRA often talks of "the cliff, which is when everything ends in six months' time" and that "there are many difficulties ahead for the financial system – we see this as a long-term challenge, and are approaching it with a long-term perspective."[4] Homeowners have deferred around $250 billion in loans, but an abrupt end to JobKeeper and JobSeeker payments could cause heavy defaults as borrowers struggle to meet their mortgage commitments.

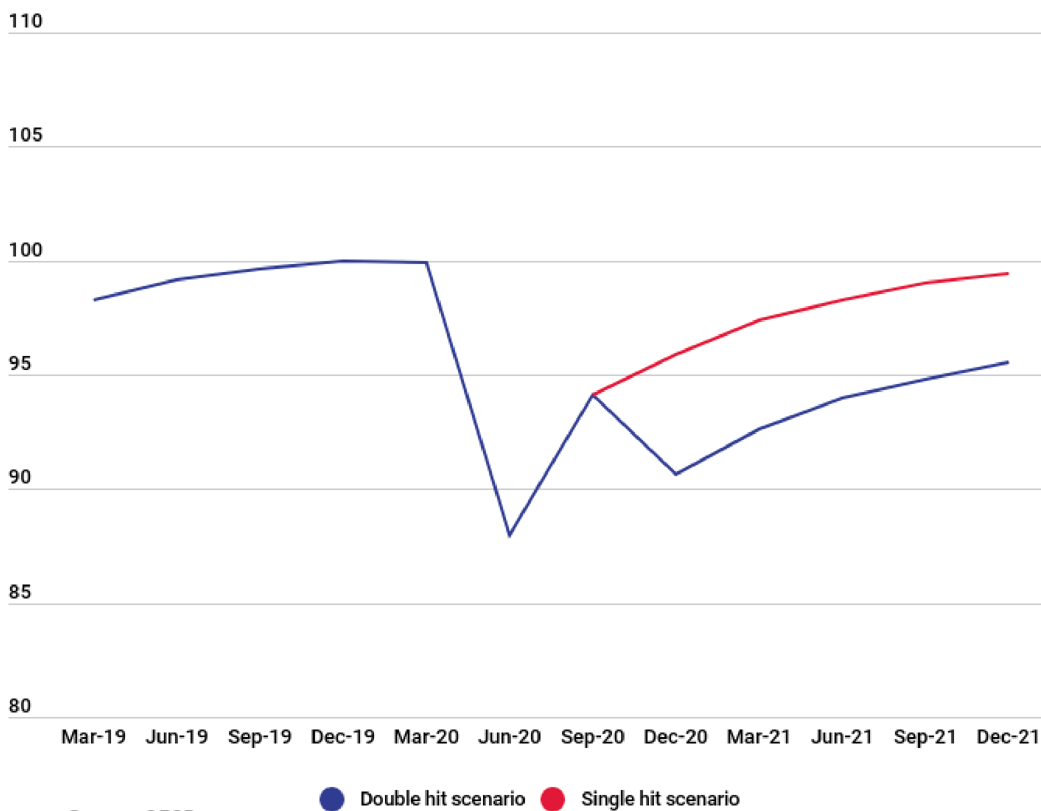
Also, ASIC has disclosed that it is preparing for a spike in payday loans when JobKeeper comes to an end. Payday lenders offer small loans of up to $2,000 and under the law may charge as much as a 20 per cent establishment fee and a four per cent monthly service fee on the amount borrowed.

Economic outlook

Provided the worst of the pandemic is over and there are no further widespread lockdowns, the IMF sees the Australian economy contracting by 4.5 per cent in 2020 and then recovering by 4.0 per cent in 2021. That means it won't restore its former level of production until 2022. Government gross debt increases from 45 per cent of GDP in 2019 to 64.3 per cent by 2021.[5]

3 See https://www.smh.com.au/politics/federal/lowe-can-t-go-lower-morrison-will-have-to-lift-the-bar-20200528-p54xc1.html
4 See https://au.finance.yahoo.com/news/jobkeeper-warning-for-property-market-013144976.html?utm_source=Marketing&utm_medium=EDM&utm_campaign=EDM&utm_term=Finance&ncid=newsletter_edm_ysrigwqmeyw
5 See https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

The latest OECD economic projections for Australia contain two scenarios depicted in the chart below.[6]
The first reflects a V-shaped recovery from the pandemic and the second an elongated W-shaped recession from a possible second outbreak of the contagion. In the single pandemic-hit scenario, real GDP falls by five per cent in 2020 and rebounds by 4.1 per cent in 2021. In round figures, government gross debt jumps from 46 per cent of GDP in 2019 to 58 per cent in 2021.



In the double-hit scenario, real GDP falls by 6.3 per cent in 2020 and rises by only one per cent in 2021, leaving the economy operating at less than 95 per cent capacity as it

6 See Source: https://www.oecd.org/economy/australia-economic-snapshot/

enters 2022. Also government gross debt to GDP reaches around 66 per cent in 2021. This outlook could prove worse if "high household indebtedness results in debt-servicing problems, potentially amplified by a housing market downturn, and derails the recovery. On the other hand, the recovery would be faster if sentiment rapidly rebounds."[7]

On balance the OECD thinks "further stimulus …may be needed once existing measures expire at the end of the third quarter 2020."[8]

Appendix B provides the OECD's forecasts for each scenario in more detail.
The Federal Treasury and the Reserve Bank don't seem to think the economy will bounce back quickly. RBA Governor, Philip Lowe, has warned that without a COVID-19 vaccine, the economic recovery is likely to be "quite slow" as people would be nervous about their health and unwilling to spend.[9]

Treasury Secretary, Steven Kennedy, has said the "demand confidence" of businesses and households would be the key issue that determined whether there is a V- or U-shaped recovery, but it was "very hard to determine" whether consumers would flock back to shops and cafes now restrictions were easing.[10]

The economic contraction means that many businesses won't re-open and others will need to drastically recapitalise and restructure to survive. Virgin Australia, Tigerlily, Aussie Disposals and Sydney's Carriageworks have all gone into administration since the COVID-19 shutdown. Wesfarmers' Target is closing up to 75 stores (and converting the rest to K-Mart stores) [11]and Flight Centre is closing 428 stores.[12] So far, 159 listed companies have withdrawn their financial year 2020 earnings guidance because they can't yet assess the damage to their businesses.

---

7 See https://www.oecd.org/economy/australia-economic-snapshot/
8 Ibid.
9 See https://www.bloomberg.com/news/articles/2020-05-21/rba-s-lowe-urges-banks-to-draw-on-buffers-during-covid-19-crisis and https://www.afr.com/policy/economy/rba-urges-risk-taking-reforms-20200622-p554y1
10 See https://www.theguardian.com/business/2020/may/21/australias-treasury-chief-says-government-should-worry-about-jobs-and-not-rising-debt-during-coronavirus-crisis
11 See https://www.news.com.au/finance/business/retail/target-store-closures-could-be-converted-to-kmarts-list-of-outlets-affected/news-story/939627ff086dee25adae65f40eb65ab9
12 See https://www.thechronicle.com.au/news/flight-centre-closing-428-aussie-stores/3990230/

Employees who find themselves out of work for six months or longer could become so dispirited they drop out of the workforce indefinitely or permanently. That is especially true for older workers. The income and social distress could result in family and individual breakdowns. Many small to medium scale businesses won't have the capital to restart again.

So, what further fiscal measures could be taken to alleviate this household and business hardship and importantly jumpstart the economy to recover quickly from its enforced shutdown? And how could it be funded?

The Federal Budget is not due until 6 October 2020, but the Federal Treasurer's economic and fiscal update on 23 July could point to the broad directions the budget will take. This policy paper is an input into the public discussion on the best way forward, a discussion that others have already contributed to.[13]

Economic impact

The extent of the economic damage done by the lockdown was surmised by the Treasurer in his economic statement on 12 May 2020:[14]

- Household consumption is expected to be around 16 per cent lower.
- Business investment is expected to be around 18 per cent lower with falls concentrated in the nonmining sector.
- Dwelling investment is also expected to be around 18 per cent lower.
- Over the same period, household savings are expected to increase as a result of the restrictions that have been imposed and an understandably cautious approach

13 See in particular the article by Tim Harcourt (https://johnmenadue.com/tim-harcourt-eight-things-we-need-to-do-for-corona-recovery/) and his video (https://newsroom.unsw.edu.au/coronanomics-key-learnings-about-economics-coronavirus)
14 See https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/speeches/ministerial-statement-economy-parliament-house-canberra

by households to discretionary spending.

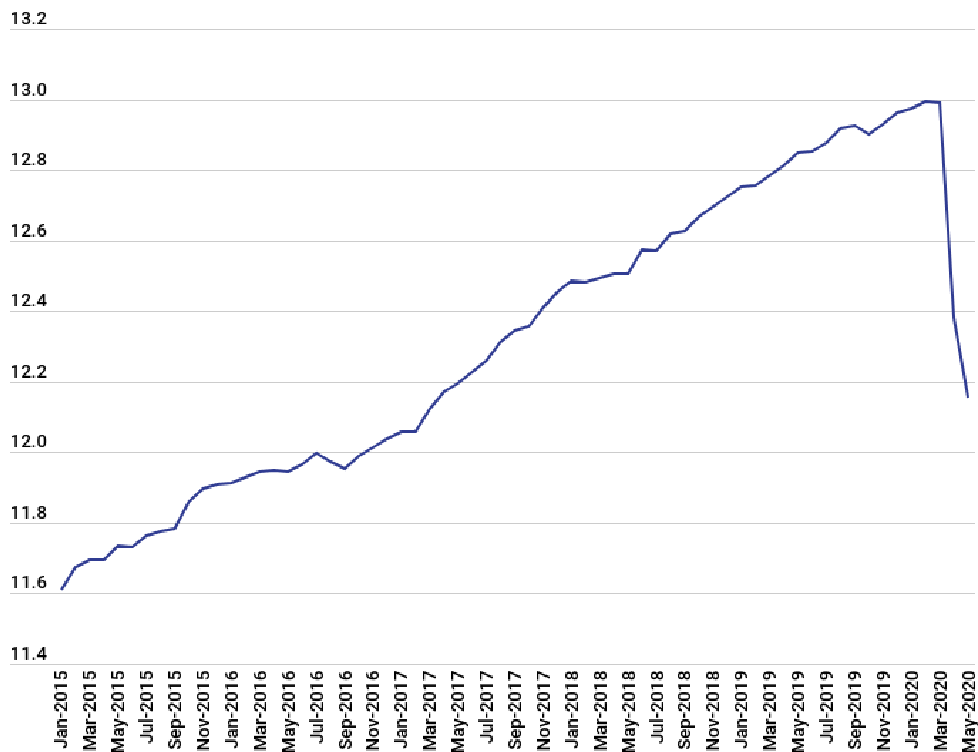
- In March, business and consumer confidence saw the largest declines on record.
- In April, surveys showed that job advertisements halved and activity in the construction, manufacturing and the services sector had their largest ever monthly fall.
- New motor vehicle sales fell by 48 per cent through the year, their largest ever fall.
- House sales fell by 40 per cent.
- Domestic and international air travel is down by more than 97 per cent, with nearly 40,000 passengers moving through Brisbane airport on Easter Sunday last year, compared with just 31 passengers this year.
- Against this backdrop, between 14 March and 18 April the number of jobs decreased by 7.5 per cent and the wages bill paid by businesses decreased by 8.2 per cent.
- During this period, accommodation and food services saw the largest fall in jobs at 33.4 per cent, followed by the arts and recreation sector at 27 per cent.

Also, the Melbourne Institute's ***Tracking the Pulse of the Nation*** survey found that only 32 per cent of workers who had lost hours were receiving the $1500-a-fortnight JobKeeper wage subsidy.[15]

In April and May, 835,100 people lost their jobs. But only just over one in ten of them got classified as unemployed because the Australian Bureau of Statistics' definition of unemployment excludes people on JobKeeper, those not actively looking for work and anyone stood down who was paid for some part of the previous four weeks. When JobKeeper expires in late September, many of its three million beneficiaries will get counted as unemployed.

15 See: https://www.afr.com/politics/federal/public-mood-dips-as-economic-reality-hits-20200603-p54z0p

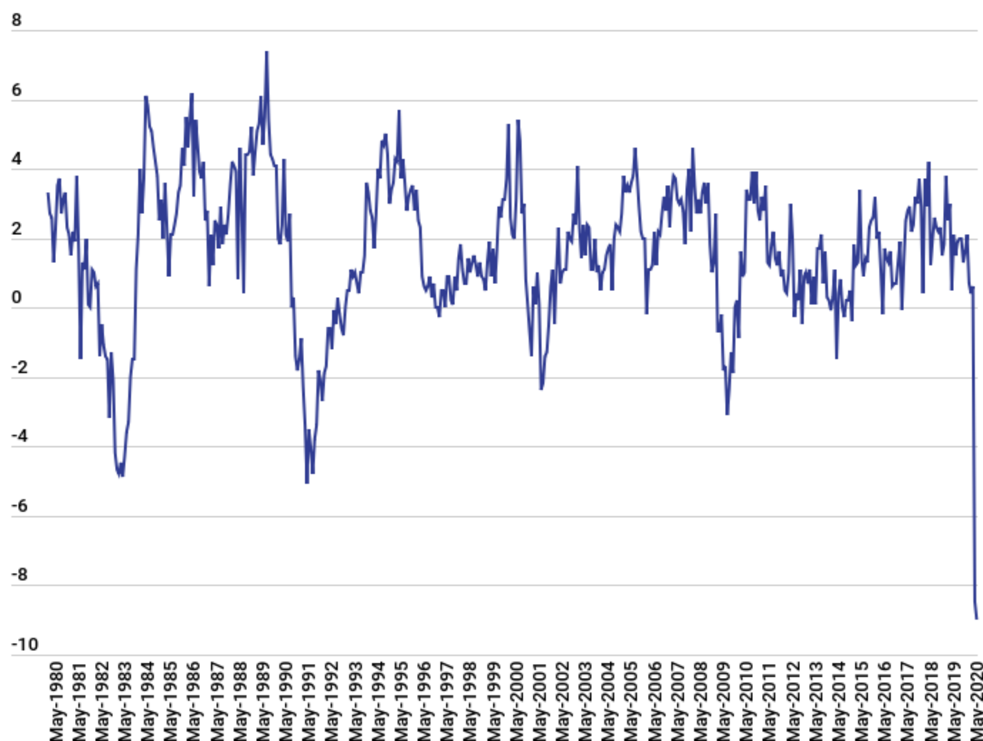
Figure 3: Total employment (millions)



Source: ABS, Catalogue No. 6202.0

In May the ABS reported that over one in five people in the labour force were either unemployed (7.1 per cent) or underemployed (13.1 per cent). This compares with less than one in seven (5.1 per cent unemployed and 8.6 per cent underemployed) in February 2020, before the COVID-19 lockdown started.

Perhaps the best indicator of the pandemic's impact on the labour force was the sharp 9.1 per cent fall in hours worked in May 2020 compared with May 2019. Note in the chart below how much worse that fall was relative to falls in previous slumps (1988, 1991, 2001 and 2009).



Even before the onset of the pandemic, the Australian economy had suffered a prolonged drought, wide-spread bushfires, severe storms and localised flooding. Accordingly GDP grew by just 1.4 per cent in the 12 months to March 2020. ABS chief economist, Bruce Hockman, remarked "This was the slowest through-the-year growth since September 2009, when Australia was in the midst of the global financial crisis, and captures just the beginning of the expected economic effects of COVID-19."[16]

GDP per capita in the March quarter was 0.7 per cent lower than in the preceding December quarter even though the lockdown was not strictly enforced until the last fortnight of March.[17] But for a 1.8 per cent rise in public spending in response to the bushfires and the oncoming COVID-19 pandemic, the March quarter results would have been worse.

Before the pandemic, the retail industry was in trouble with the following companies

16 See https://thenewdaily.com.au/finance/finance-news/2020/06/03/australia-recession-29-years/?utm_source=Adestra&utm_medium=email&utm_campaign=News%20Alert%20-%2020200603

17 See https://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5206.0Main%20Features4Mar%202020?opendocument&tabname=Summary&prodno=5206.0&issue=Mar%202020&num=&view=

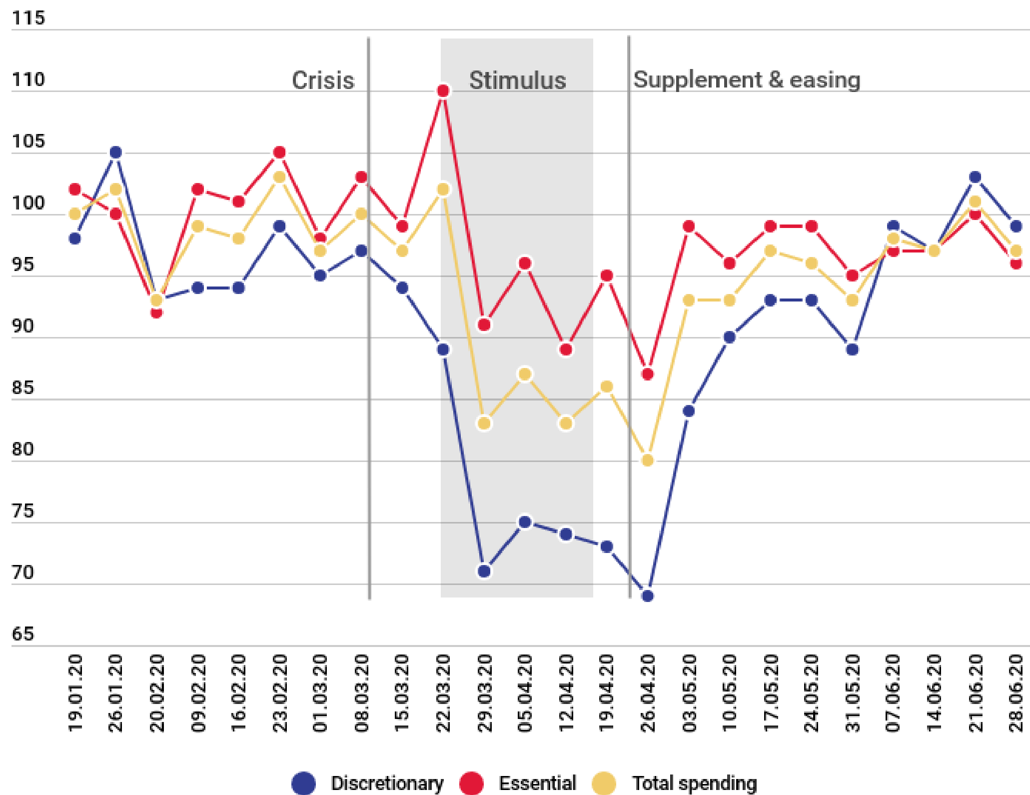
closing shop in late 2019 or early 2020: Jeanswest, Kikki.K, Colette by Colette Hayman, Holden, Curious Planet, McWilliams Wines, Harris Scarfe and Bardot.[18] Falling residential property prices and weak wages growth stymied consumer sentiment.

Anecdotal information and preliminary data would suggest the sectors that will be the slowest to recover are those most affected by social distancing requirements, the drop in overseas migrant, tourist and scholar intakes, and exports hurt by Chinese import restrictions.

They include retail, hospitality, arts and entertainment (impacted by social distancing), tourism and education (due to reduced overseas visitors and students), dwelling construction and real estate (caused by a collapse in immigration and rental stress), barley, beef and thermal coal exports to China, and office letting (following a shift to remote working, lift capacity reductions and higher floor space ratios to ensure social distancing). Appendix C shows the likely impact on industrial sectors of COVID-19 prepared by Fitch Ratings., one of the “Big Three” credit rating agencies.

The most heartening news is that weekly tracking of spending using credit data suggests that total consumption has bounced back quickly following the government’s introduction of income support measures in March. See chart below

18 See https://www.abc.net.au/news/2020-05-28/business-collapses-to-accelerate-in-coronavirus-crisis/12293554



Source: Illion & AlphaBeta (part of Accenture)

A director of AlphaBeta, the group that prepared this chart, remarked "This is the most encouraging set of consumer data we've had, showing the economy is bouncing back. But the red flag is how much of the economy is still being supported by consumers who received the stimulus and supplement payments. It is going to be absolutely critical that stimulus measures are tapered and not abruptly ceased to ensure a smooth transition to what the post-September economy will be."[19]

19 See https://www.afr.com/policy/economy/rba-urges-risk-taking-reforms-20200622-p554y1

Macroeconomic strategy

Any early tightening of fiscal or monetary policy during the initial stages after most of the restrictions are lifted would cause the economy to stay in or return to recession. Many countries, especially in Europe, extended the economic harm caused by the Global Financial Meltdown (2008) and the Great Recession (2009) by pursuing austerity measures to return their budgets towards surplus. During the 2009, the global economy shrank by 0.1 per cent.

By comparison, the IMF is forecasting the world economy to shrink by 4.9 per cent in 2020[20], easily the biggest peacetime contraction since the Great Depression. The OECD projects global GDP to shrink between 6.0 per cent and 7.6 per cent in 2020 with unemployment rising to 9.2 per cent to 10.0 per cent from 5.4 per cent in 2019.[21] Governments cut wages and government spending during the Great Depression, deepening and prolonging it. That event inspired the work of John Maynard Keynes, who argued that expansionary fiscal policy was needed to guide economies out of the crisis. Classical economists had argued that, in the long run, economies would naturally return to growth and full employment, to which Keynes replied: "In the long run we're all dead."

In normal circumstances, the price mechanism is powerful in balancing supply and demand, but in an economic slump with rising unemployment, consumers don't open their wallets simply because prices fall. And employers don't expand capacity and rehire staff because the cost of capital (interest rates) is low and that of labour (wages) is negotiable. Both consumers and investors hold back until they see overall demand for goods and services rising in response to increased government spending or rising exports.

During the Global Financial Crisis (2008 to 2009) a household "cash splash" by the Federal Government and high demand for mineral resources by China spared Australia from the global recession. In the 2020 Global Pandemic, Federal Government workplace "income support" has cushioned the downturn, but its legislative basis expires in late September. Also commodity exports might not come to Australia's rescue this

20 See https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
21 See http://www.oecd.org/economic-outlook/june-2020/

time because China's GDP is expected to grow by only by 1.0 per cent in 2020[22] and its trade relations with Australia have recently soured.[23] Nevertheless, iron ore prices have held up well on the expectation that China will ramp up construction to offset its falling exports.[24]

Fiscal policy

Both the IMF and OECD envisage further fiscal stimulus (and hence higher government debt) as governments shift emphasis from rescue and relief aid to recovery and restructuring initiatives.

The IMF says:
"Where economies are reopening, targeted support should be gradually unwound as the recovery gets underway, and policies should provide stimulus to lift demand and ease and incentivise the reallocation of resources away from sectors likely to emerge persistently smaller after the pandemic."[25]

The OECD says:
"Ultra-accommodative monetary policies and higher public debt are necessary and will be accepted as long as economic activity and inflation are depressed, and unemployment is high. However, debt-financed spending should be well targeted to support the most vulnerable and the investment necessary for a transition to a more robust economy."[26]

Further fiscal measures could involve either tax cuts or expenditure increases. Tax cuts could apply to businesses and/or individuals while expenditure boosts could involve recurrent and/or capital programs. All levels of government: federal, state and local, could be instruments for rolling our further fiscal stimulus, though state and local governments have less capacity to act because over 80 per cent of Australian taxes are collected federally.

22 See https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
23 See http://www.futuredirections.org.au/publication/australia-china-trade-dispute-has-australia-become-too-reliant-on-the-chinese-market/
24 See https://markets.businessinsider.com/commodities/iron-ore-price
25 See https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020
26 See https://www.oecd-ilibrary.org/sites/0d1d1e2e-en/index.html?itemId=/content/publication/0d1d1e2e-en

The following is a collection of tax relief measures that have been floated by various interests. Their stated purpose is to increase work or investment incentives, but unless they have a sunset clause or offsetting tax rises, they would widen the government's structural deficit which would add to public debt. Also, tax cuts don't address the fundamental problem: a collapse in aggregate demand for goods and services, which is expected to take two to three years, or more, to recover without further spending stimulus by the government.

1. Bring forward personal income tax cuts worth $14 billion a year which have been legislated for July 2022.
2. Bring forward further personal income tax cuts worth $5.5 billion a year which have been legislated for July 2024.[27]
3. Cut company tax to 25 per cent to bring it closer to the average corporate tax rate in the OECD of 21.4 per cent. [28]
4. Introduce a generous investment allowance to bring forward and increase business investment.[29]
5. Replace the existing corporate profits tax with a cash flow tax, to create an incentive for business investment via an immediate and full tax deduction for capital expenditure.[30]
6. Scrap state property conveyancing duty and replace it with a land tax to make home buying for young people and downsizing for older people more affordable as well as facilitating commercial building turnover.[31] A land tax could also pay for the abolition of stamp duty on property insurance policies.

Set out below is a sample of expenditure stimulus measures proposed by different groups. These are illustrative only because each government portfolio attracts a wish list of spending initiatives too long to cite here.

The first six measures involve operational spending and the last three capital spending. Operational initiatives can often be spent quickly, which helps offset a contracting

27 See https://www.bdo.com.au/en-au/federalbudget2019/individuals/personal-income-tax-cuts
28 See https://www.afr.com/policy/economy/australia-high-corporate-tax-rate-is-becoming-alltooobvious-oecd-report-shows-20190116-h1a3xl
29 See https://www.macrobusiness.com.au/2020/01/preasure-builds-on-scomo-to-introduce-a-generous-investment-allowance/
30 See https://www.afr.com/policy/economy/radical-business-cash-flow-tax-pushed-20200417-p54ku5
31 See https://www.ahuri.edu.au/policy/ahuri-briefs/understanding-stamp-duty-and-land-tax

economy, but unless they have a time limit (like JobKeeper and JobSeeker) or are tapered, they are recurrent in nature and so contribute to outlays permanently for which ongoing revenues need to be found if they are not to be deficit funded.

By contrast, capital spending is on physical projects that have a finite construction period after which spending halts. They, too, add to the fiscal deficit, but only for a limited period, except for their maintenance, which is ongoing. Unless they are shovel ready, small to medium scale works, they may take longer than two to three years to get started and completed which would defeat the purpose of countering the immediate recession.

1. Cash grants to households as was undertaken during the 2008 Global Financial Crisis.
2. Taper the JobKeeper allowance after September and confine it to industries that will be slow to reopen or whose turnover stays depressed (e.g. tourism).
3. Enshrine a permanent increase in JobSeeker, the jobless payment previously known as Newstart.
4. Introduce short-term support measures for the entertainment and hospitality sectors especially for regional areas hard hit by the absence of overseas tourists.[32]
5. Boost funding for Vocational Education and Training while reforming it to better meet student and employer skill needs.[33]
6. Increase funding for the Entrepreneurs Program, Commercial Ready, Cooperative Research Centres and AusTrade's export support programs.
7. Undertake a multi-year public works maintenance, renewal and enhancement program similar to the One Nation infrastructure development program introduced by the Keating government in the aftermath of the 1991/92 recession.[34] This could include a major expansion of social housing units for which the waiting list has grown dramatically.[35]
8. Inject further funds into the Clean Energy Finance Corporation (CEFC) so it can accelerate investment in the electricity transmission network to enable the energy

32 See https://theconversation.com/australias-first-service-sector-recession-will-be-unlike-those-that-have-gone-before-it-137994
33 The Productivity Commission's recent review of the Vocational, Education and Training (VET) sector found it to be *"underperforming, excessively complicated and suffers from ad hoc policy approaches".* It recommended that *"Governments should consider reforms to make (it) a more efficient, competitive market, driven by the informed choices of students and employers, with the flexibility to deliver a broad suite of training options. This goal should be pursued through a new principles-based agreement."* See https://www.pc.gov.au/inquiries/current/skills-workforce-agreement/interim
34 See https://www.voced.edu.au/content/ngv%3A675
35 See https://www.afr.com/politics/federal/calls-for-stimulus-package-to-tackle-social-housing-20200602-p54yku

system to make the shift from coal to renewable energy.[36]

9. Embark on a fast rail project linking the business hubs between Geelong and the Sunshine Coast to form an Eastern Seaboard economic corridor that would rival the 40 biggest mega-regions in the world, as recently flagged by Prime Minister Morrison.[37]

If the objective is a two to three-year fiscal stimulus and not an ongoing one, then tapered income support and small to medium scale public works are the most appropriate measures to employ. On the other hand, to ensure economic recovery is sustainable and self-reinforcing, micro-economic reforms will be needed. This is the topic of a separate paper commissioned by CEDA. The above measures on vocational education and business innovation are relevant to such an agenda.

Funding measures

Funding any new fiscal measures would need to come from one of three sources: new or increased taxes, asset sales, and increased borrowings or monetisation.

Possible tax options that have circulated for many years include:

1. Introduce carbon and other pollution/waste management taxes.
2. Adopt road user or congestion taxes to replace vehicle registration and transfer duties, petrol excises and luxury car taxes.
3. Adopt a uniform natural resources rent tax in place of varying state mineral royalties.
4. Increase the GST rate to 15 per cent and broaden it to cover more goods and services while compensating the bottom 40 per cent of income earners.
5. Introduce a wealth tax or death duties on deceased estates.
6. Make capital gains taxable at the same rate as personal income.
7. Increase minimum tax on distributions from family trusts to deter income splitting.[38]

36 See https://www.cleanenergycouncil.org.au/news/new-grid-reliability-fund-a-welcome-boost-to-transmission-investment
37 See https://www.theage.com.au/business/the-economy/why-melbourne-sydney-and-brisbane-should-put-an-end-to-old-rivalries-20200522-p54vm7.html
38 See https://www.acoss.org.au/ending-tax-avoidance-evasion-and-money-laundering-through-private-trusts/

8. Scrap dividend imputation in favour of a lower corporate tax rate so as not to discriminate against foreign capital
9. Confine negative gearing to new physical assets (e.g. newly built properties).
10. Leave tax concessions on superannuation contributions and earnings, but not on superannuation income.

Each of these measures has advantages and disadvantages that have been canvased elsewhere.[39] They usually concern the three E's: economic efficiency, ease of administration and equity (income, wealth and intergenerational). It is noteworthy that the government has ruled out tax increases while the economy remains subdued.[40]

Asset sales are now tagged "asset recycling". They normally involve leasing existing government assets (e.g. government buildings, power stations, ports, tollways, freight lines) to private interests for a long tenure (e.g. 50 or 99 years) after which they return to public ownership. They may also involve a public/private partnership where the costs, risks and benefits of the revamped asset are shared between both parties.

The advantage is that the lease payment is usually an upfront lump sum (not dissimilar to the value of an asset sale) that can be used to invest in new public works of a higher social priority (e.g. schools, hospitals and parks). This is where the fiscal stimulus is felt.

A disadvantage is that too often such assets are divested as monopoly businesses (so as to maximise their sales proceeds) which is contrary to the interests of consumers. Another problem is that most government office buildings and publicly owned commercial assets have already been sold thereby limiting the scope for further privatisations.

Increased borrowing involves the issuance of government bonds at market yields. When the bonds mature the government either repays the principal or refinances it by issuing a new bond at the prevailing market yield.

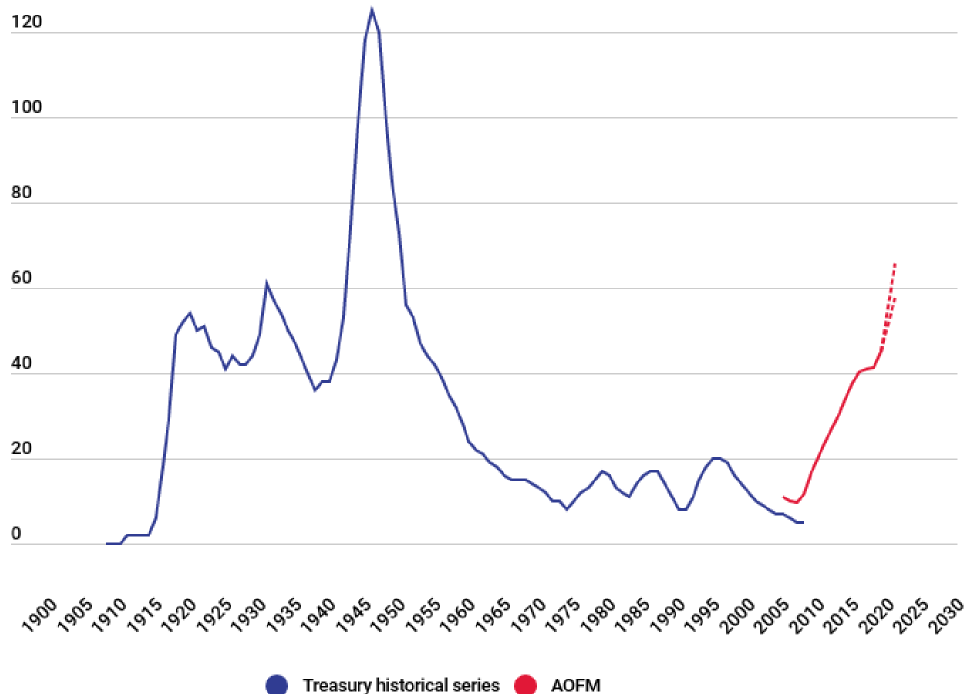
The OECD projects that the government's gross debt/GDP ratio will jump from around 46 per cent to 58-66 per cent between 2019 and 2021 depending on whether the

39 See for example https://cdn.tspace.gov.au/uploads/sites/52/2015/07/Ihlein-Graham.pdf
40 See https://www.afr.com/politics/federal/government-rules-out-new-taxes-on-road-to-recovery-20200417-p54kos

pandemic involves only one or two waves of contagion and lockdown.[41] The IMF forecasts the gross debt/GDP ratio will reach 64.3 per cent by 2021 even if the worst of the pandemic is already over.[42]

The OECD says the government has "ample fiscal space to support the economic recovery as needed". In other words, future economic growth should wear down the debt/GDP ratio as happened in the 20 years following World War II. See chart below.

Figure 6: Australian Government Debt to GDP (%)



Source: Treasury Historical series from https://treasury.gov.au/sites/default/files/2019-03/01_Public_Debt.pdf
AOFM series from https://tradingeconomics.com/australia/government-debt-to-gdp

The contrary view is that the Australian economy after COVID-19 won't enjoy the high immigration and fertility rates, increased workforce participation and productivity rise from a low base that characterised the post-war period, so any debt complacency is misplaced. If government bond yields (presently 0.9 per cent) returned to say three

41 See http://www.oecd.org/economic-outlook/june-2020/
42 See https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

per cent (less than half their average level of seven per cent in the last 50 years) the increased cost of servicing an expanded stock of public debt would warrant higher taxes or reduced public services given the government's firm commitment to balanced budgets outside recessions.

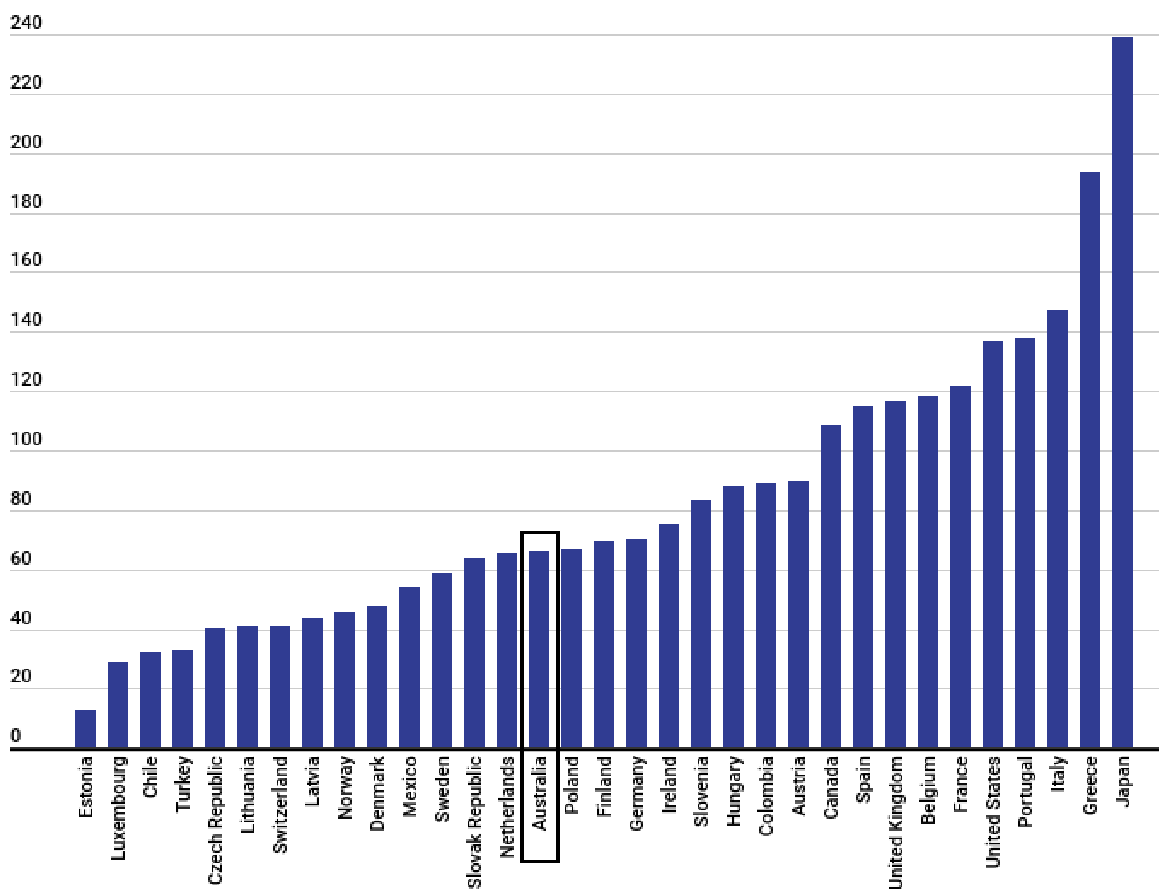
Those who think the federal, state and local government have considerable capacity to borrow more point to Australia's much lower general government debt/GDP ratio that other OECD member countries. See chart below.

Figure 7: Australian 10 Year Bond Yield (%)

Source: RBA

Fiscal conservatives argue that global government debt/GDP is already worryingly high and this year will far exceed the World War II peak[43] so is not a valid benchmark. See next chart.

Figure 8: General government debt, 2018 (% of GDP)



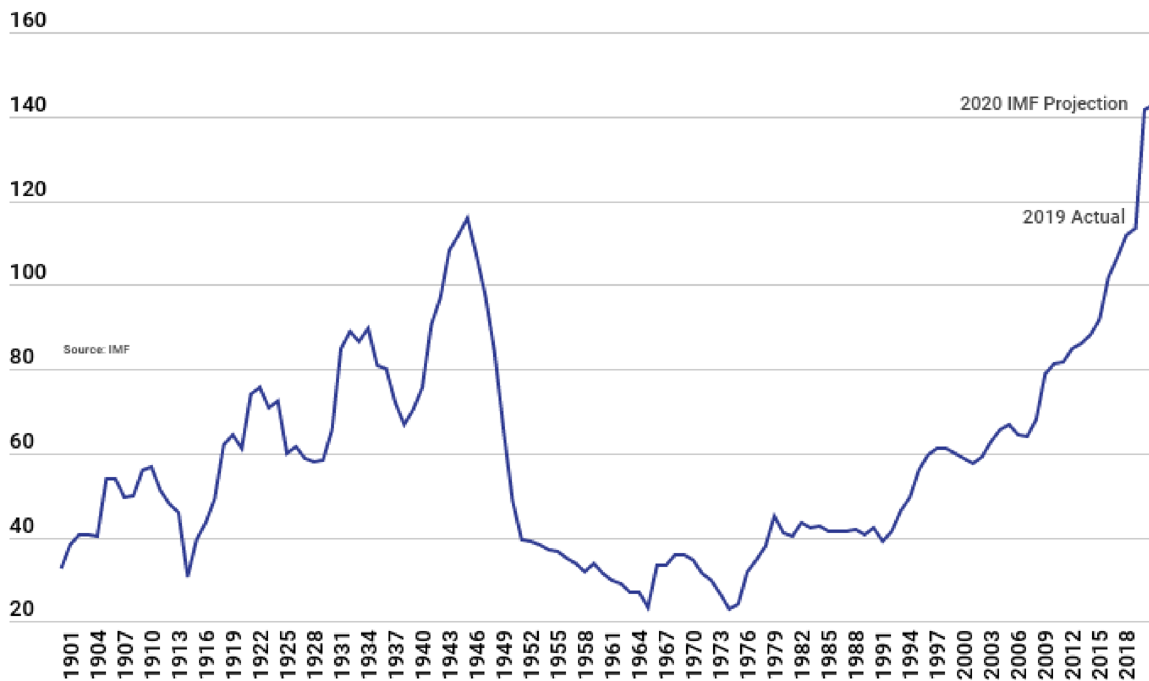
Source: OECD

Deloitte's Chris Richardson (who monitors fiscal policy very closely) estimates the Federal Government's combined deficits between 2019/20 and 2022/23 will total $300 billion (after subtracting the JobKeeper costing error of $60 billion).[44] That would lift Federal Government gross debt (at face value) from $542 billion in June 2019 to $842 billion by June 2023. And that is before any extra fiscal stimulus in the coming Federal Budget.

43 The latest IMF ***Word Economic Outlook Update***, June 2020, projects general government gross debt of advanced economies to increase from 105.2per cent of GDP in 2019 to 132.3per cent of GDP in 2021. See Table 1 of https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

44 See https://www2.deloitte.com/au/en/pages/media-releases/articles/budget-monitor.html

Figure 9: Gross Debt for advanced G20 economies (% of GDP)



Given that Australia has one of the largest household debts to GDP of any OECD country there is a risk that if the Federal Government's debt blew out further it would lose its triple-A credit rating, which is already on "negative credit watch" by two of the three big rating agencies. If that happened, Australia could be vulnerable if another 2008/09 type global financial meltdown occurred since its dollar is not a reserve currency like the US Dollar, Euro, Yen and British Pound.

Fiscal liberals retort that Australia may have no choice, but to take that risk if it wants to avoid a double-dip recession after employee, business and welfare support measures expire by end September 2020.

Monetary policy

Having cut the cash rate to 0.25 per cent on 20 March 2020, the Reserve Bank announced it had reached the lower bound of interest rates and was resorting to what is known as unconventional monetary policy. It adopted a form of quantitative easing

(QE) that had been practiced for a decade by the central banks of the US, the EU, Britain and Japan in response to the Global Financial Crisis. QE involves a country's central bank buying government bonds being held by the private sector, typically commercial banks, insurance companies and pension funds as well as foreign governments. Corporate bonds, mortgage-backed securities (and in Japan's case company shares) could also be included in the central bank purchases.

The objective of bond purchases by overseas central banks was to inject more cash into the economy to help stimulate it. However, by relying on private financial institutions as middlemen in getting cash into the economy, QE resulted in much of the central banks' extra liquidity going into housing finance, forcing up property prices and into corporate share buybacks to goose their market prices, increasing the returns to existing shareholders including senior management and board members. Relatively little went into new, productive investment.

Faced with a recession, the Reserve Bank announced a form of QE that did not specify a particular quantity of bond buying but instead was to be whatever amount was needed to reduce the three-year Treasury bond rate to 0.25 per cent and keep it there. This has been so successful the Reserve Bank has stopped buying bonds with the result that most of the fiscal stimulus is being funded by private lenders.[45] Also, the RBA low-interest loans to banks have so far amounted to only $6 billion.[46] Hence the RBA's support package looks like falling well short of its commitment of up to $90 billion.

Since October 2018 Australia's money supply (M3) has been increasing at a much slower rate than in most other OECD countries because the RBA adopted a form of QE only in March 2020 and by May 2020 had ceased buying government and corporate bonds altogether. Its reluctance to respond to the recession by creating additional money and reducing interest rates further may explain the 21 per cent rise in the Australian dollar from a low of US$0.57 on 19 March 2020 to $0.69 on 24 June 2020.

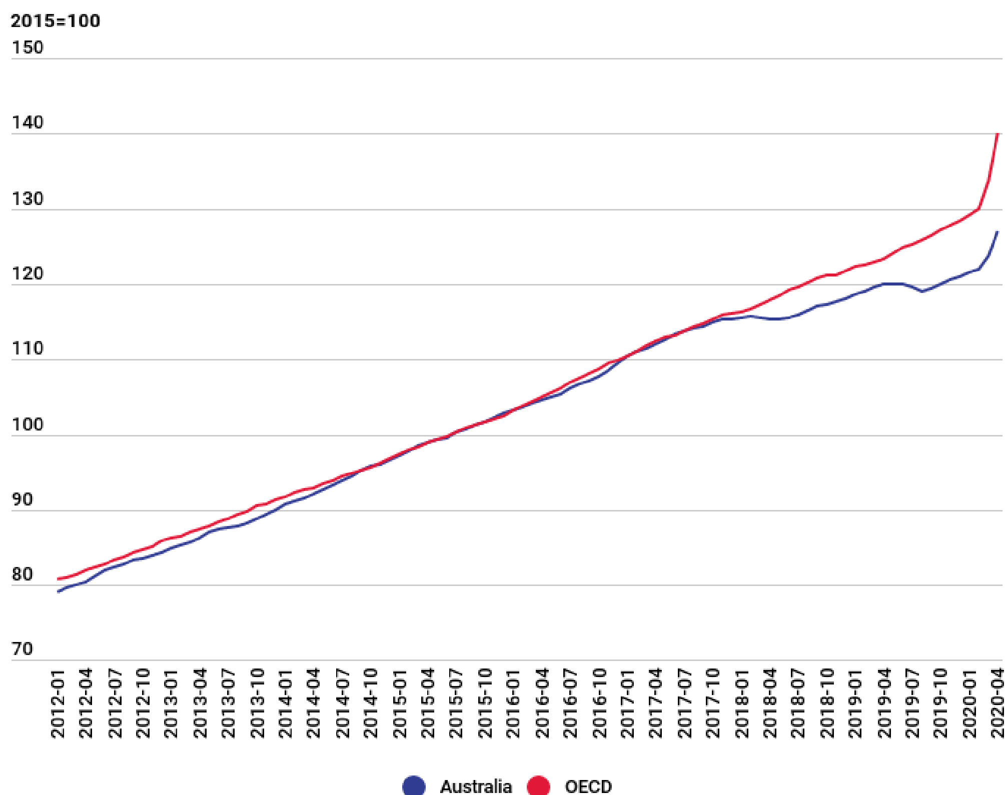
Another possibility is that it reflected a jump in iron ore prices since the Australian dollar is perceived as a commodity currency. In any event, its appreciation is hurting Australia's international cost competitiveness.

45 John Kehoe, RBA relaxes emergency mode but still on watch, AFR print edition, 4th June 2020
46 Ibid.

An alternative form of QE would be for the RBA to deliberately fund the government's deficit by buying government bonds (either directly from the office of Financial Management or indirectly through the private secondary bond market) and holding them indefinitely on its books. Any profits on these holdings would be returned to its owner (the Federal Government) in the form of dividend payments thereby neutralising the cost to the government of the debt.

Such a strategy has been effectively followed by the world's four largest central banks which have accumulated US$23 trillion in financial assets, most of which represent sovereign debt.[47] None of these central banks have run down their debt securities and whenever the US Fed has attempted to do so it has been forced to reverse course so as not to destabilise financial markets and economic growth.[48]

Figure 10: Broad money (M3)



Source: OECD

47 See https://www.yardeni.com/pub/peacockfedecbassets.pdf

48 In America the Federal Reserve in 2013 backed off an intended exit from its quantitative easing (QE) program after it caused a "taper tantrum" in financial markets. Again in October 2019 the Federal Reserve abandoned "quantitative tightening" (i.e. selling bonds instead of buying them) under pressure from the President and a slowing economy. See (a) https://inflationdata.com/articles/quantitative-tightening/ (b) ahttps://www.bloomberg.com/news/articles/2019-08-01/fed-move-ends-the-short-era-of-global-quantitative-tightening and (c) https://finance.yahoo.com/news/quantitative-tightening-211917762.html

This approach involves permanent money creation, colloquially called "digital money printing"[49]and as such would not leave the government with increased debt servicing and repayment obligations. A recent Newspoll found that the second biggest concern after catching COVID-19 was the blowout in government debt.[50] Citizens probably fear that higher debt spells higher taxes and austerity cuts in future given the government's past commitment to achieving a budget surplus.[51]

The Parliamentary Budget Office has estimated that "the impact of COVID-19 may result in Commonwealth Government net debt in 2029/30 being between 11 and 18 per cent of GDP (i.e. $379 billion to $620 billion) higher than it would have been otherwise"[52]

Monetising say $250 billion of such increased net debt would permanently boost the stock of Australia's money supply (M3) by about 11 per cent. That would be modest compared with the 95 per cent increase in the money supply in the last thirteen years, an average compound rate of growth of 5.3 per cent per annum. A $250 billion fiscal package would be equivalent to around 12 per cent of nominal GDP which would provide a strong boost to the economy without leaving taxpayers with an unaffordable bill.

In more normal circumstances the main risk associated with such unconventional action that effectively combines fiscal and monetary policy is inflation. But for several years the global economy has been operating in a deflationary world, or one of secular stagnation, where aggregate savings have exceeded the demand for productive investment. That's why other central banks are comfortable doing it.

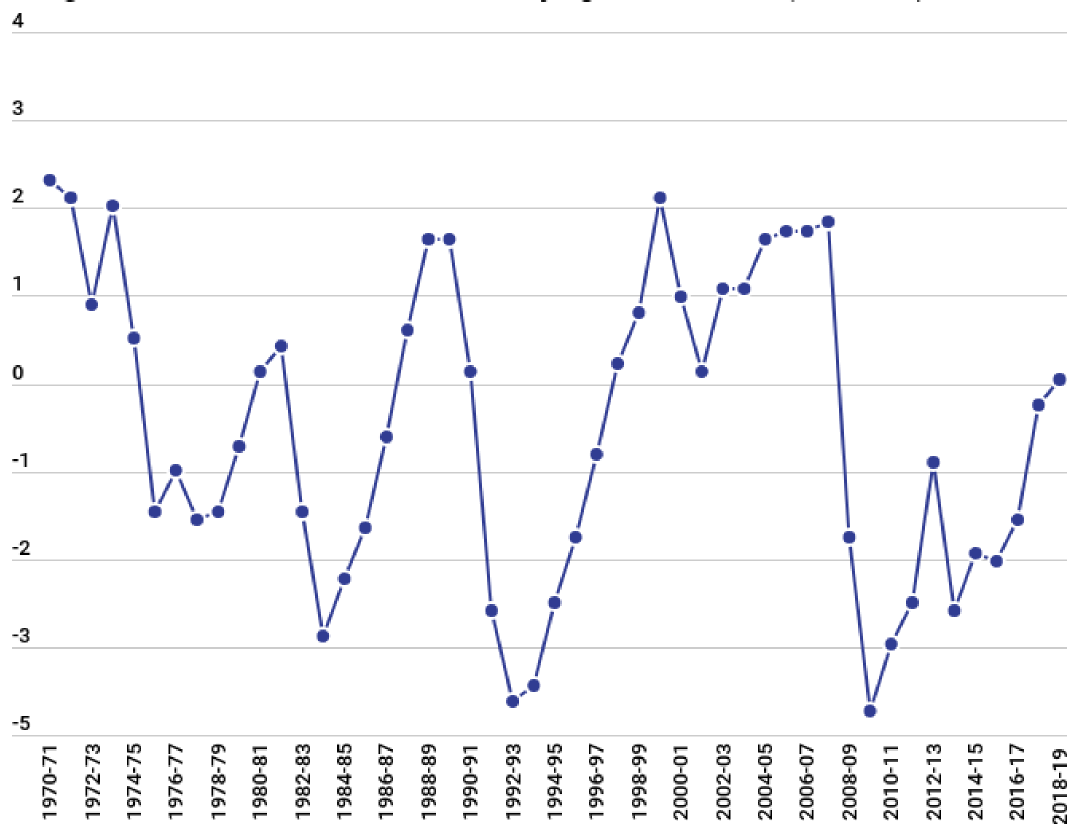
Australia like other democracies has a fully independent central bank. Its twin tasks are to keep unemployment low while achieving inflation in the two to three per cent range. If, through the deployment of unconventional monetary policy to fund an expansionary fiscal policy, price inflation rose to and significantly above the three per

49 See https://cointelegraph.com/news/fed-chair-we-have-the-ability-to-create-money-digitally
50 See https://theconversation.com/morrison-sees-massive-ratings-surge-in-newspoll-over-coronavirus-crisis-trump-also-improves-135693
51 See https://www.afr.com/policy/economy/federal-budget-2019-the-long-journey-back-to-surplus-20190401-h1d1ru
52 Source: ***Medium-term fiscal projection scenarios: impact of COVID-19 pandemic and response***, Parliamentary Budget Office, 5th June 2020, page 1

cent upper bound of the RBA's target range, the Bank could partially or completely withdraw its direct financing of government spending to signal that fiscal stimulus should end. Sceptics say that creating free money for government spending might be difficult to stop once the economy recovered. That's why it's important any moves on QE be done by the RBA and not left to political discretion.

Monetary hawks also argue that as long as the Federal Government after 2022/23 runs balanced budgets then its debt should be manageable if nominal economic growth returned to five per cent per annum (2.5 per cent real growth and 2.5 per cent inflation). The doves dispute this, arguing that for the past 50 years the Federal Government on average has run an annual deficit of over one per cent of GDP. See chart below.

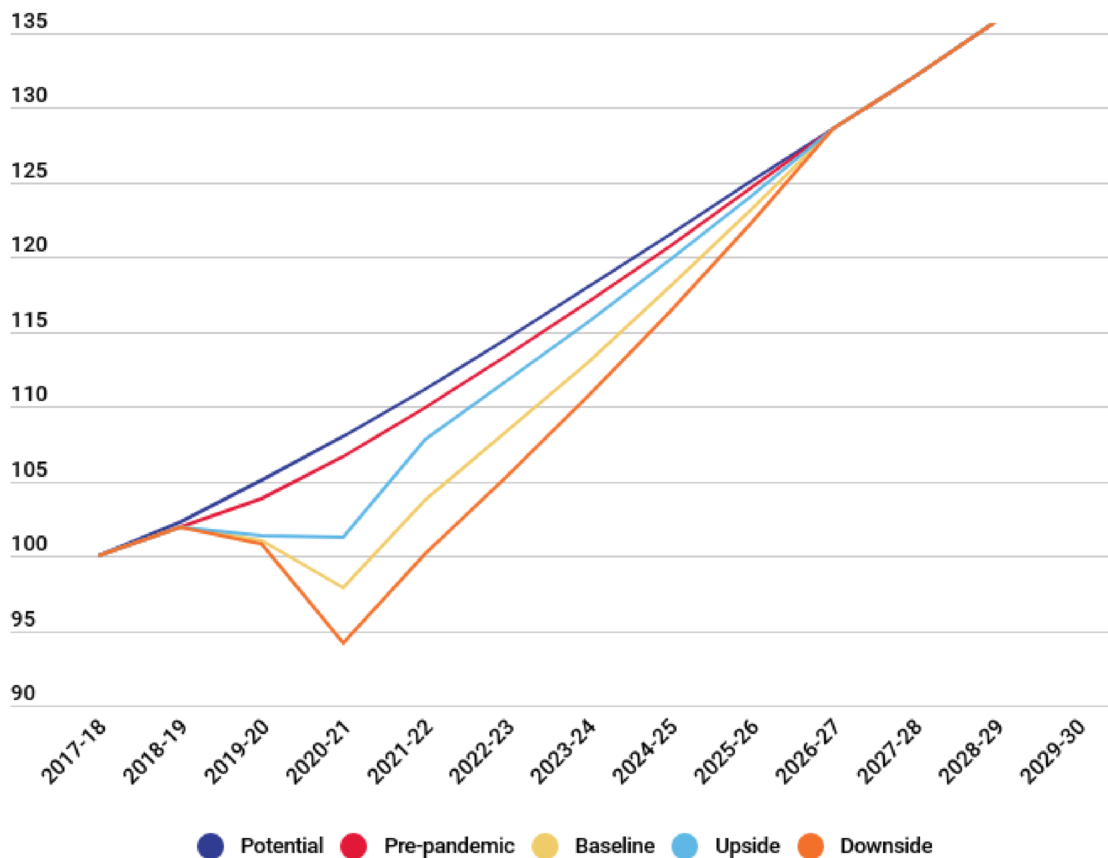
Figure 11: Federal Government underlying cash balance (% of GDP)



Source: Federal Budget Papers

If this pattern continued in future the Federal Government's gross debt (at face value) would expand by about $20 billion a year (at 2019/20 prices).

The Federal Parliamentary Budget Office has done fiscal scenario projections for the impact of COVID-19 and the government's existing response to it. It uses the Reserve Bank of Australia's economic scenario forecasts (baseline, upside and downside).[53] See Appendix D. Below are charts depicting the RBA's real GDP scenarios and the PBO's federal government cash deficit and net debt scenarios between 2019/20 and 2029/30. The PBO scenarios reflect the impact of COVID-19 only and are shown as a deviation from the Treasurer's Mid-Year Economic and Fiscal Outlook (MYEFO) baseline, and so are not equivalent to budget forecasts.[54]



53 See https://www.aph.gov.au/about_parliament/parliamentary_departments/parliamentary_budget_office
54 See The Treasury, 2019-20 Mid-Year Economic and Fiscal Outlook, December 2019 at https://budget.gov.au/2019-20/content/myefo/download/MYEFO_2019-20.pdf

Figure 13: Underlying cash balance ($b)

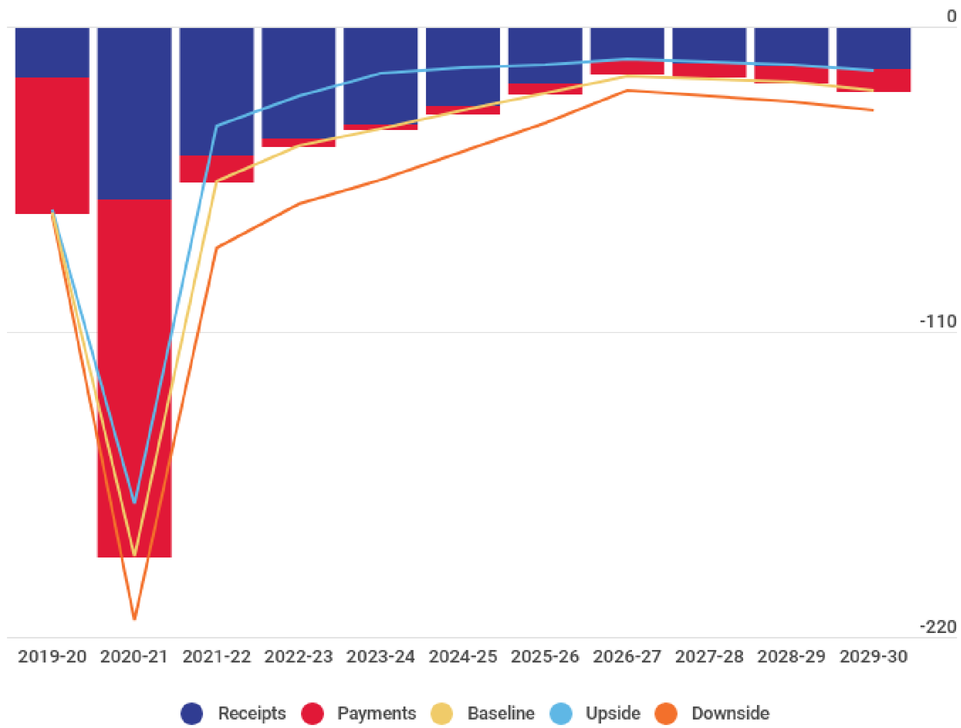
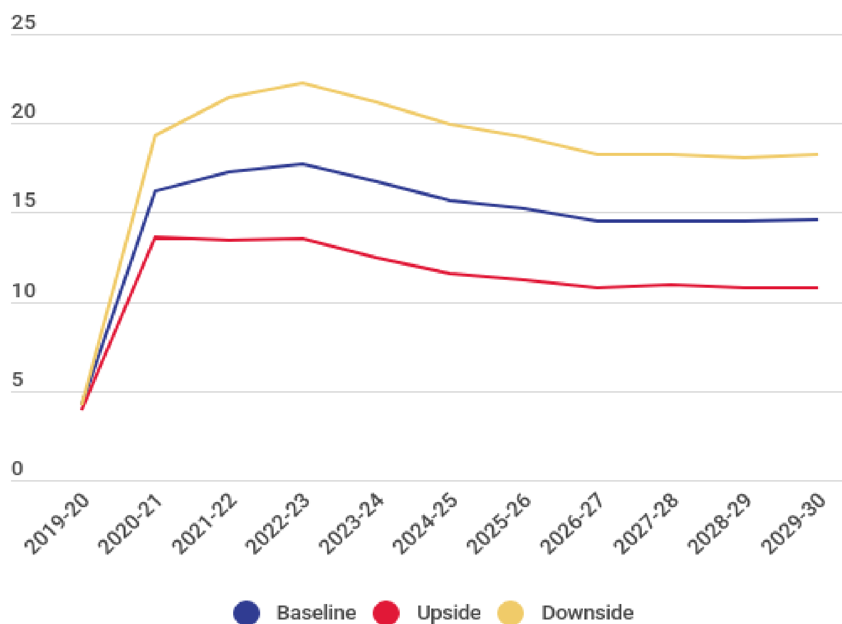


Figure 14: Impact on the level of net debt (% of GDP)



Source: RBA and PBO.

What these charts show is that without any further fiscal measures post-September 2020, the Federal Government's net debt/GDP ratio by 2029/30 would still be 11 per cent to 18 per cent higher than without the pandemic. That represents an additional net debt of between $379 billion and $620 billion on the MYEFO estimate of $392 billion for 2019/20 (before the pandemic struck).

If the Federal Government's forthcoming October budget introduced a further fiscal stimulus package worth say $150 billion the PBO's projections of the net debt blowout by 2029/30 would be between $529 billion and $770 billion.[55]The net debt/GDP ratio would then be about 15 per cent to 22 per cent higher than without the pandemic.

Monetary doves argue that the cost burden of servicing such extra debt could be ameliorated by monetising most of that stemming from the existing fiscal package (to provide income support during the lockdown) and any new fiscal package (to kick-start economic growth).[56]

As discussed above that could mean the RBA financing say $250 billion of total fiscal stimulus by buying new issues of government bonds and holding them indefinitely unless price inflation increased above the Bank's three per cent upper limit. Monetary hawks as stated earlier see this as a dangerous precedent notwithstanding other central banks following such a path for the past decade.[57]

They argue the US, Eurozone, Japan and Britain can digitally print "reserve currencies", but Australia does not have that luxury. Doves think Australia has no alternative if it wants to avoid an excessive and unaffordable debt overhang.[58]

Conclusion

There is a serious risk that the Australian economy will relapse into deep recession once most of the existing fiscal relief measures expire at the end of September 2020.

55 These estimates do not take account of the interest payments on the extra debt that would marginally increase the government's annual cash deficit thereby adding to the debt.
56 See https://www.afr.com/policy/economy/central-banks-must-print-money-for-nation-rebuilding-20200415-p54jz9 and https://nymag.com/intelligencer/2020/05/were-paying-for-coronavirus-stimulus-by-printing-money.html
57 See https://www.firstlinks.com.au/magic-money-printing-faces-reality-inflation
58 See https://www.smh.com.au/national/the-free-ride-we-can-t-afford-to-spurn-how-the-rba-can-jump-start-our-economy-20200519-p54uju.html

To avoid that fate, the Federal Government should adopt another large round of fiscal stimulus. Possible measures include:

- Extend, but gradually taper and better target its JobSeeker allowance especially for industries heavily reliant on immigration and foreign tourism and student intakes;
- Set future unemployment benefits at a midway point between the old Newstart rate and the new JobSeeker rate;
- Embark on a nationwide program of small to medium scale works in both urban and regional areas supervised by state, territory and local governments; and
- Reform funding for vocational education training programs to ensure they better train and equip young Australians to meet the present and future skill needs of employers.
- Provide a two to three year extra grant for the Entrepreneurs Program, Commercial Ready, Cooperative Research Centres and AusTrade's export support programs.

Of these measures only the second would add to the government's structural deficit beyond 2022/23. This recovery package could be limited to $150 billion up to 2022/23. Along with the existing rescue package (also worth about $150 billion) the total $300 billion boost to the economy would be equivalent to about 15 per cent of GDP spread over four years (2019/20 – 2022/23). That should ensure the economy does not fall off a cliff at the end of September 2020 when income support measures expire.

To minimise the cost of this $300 billion fiscal stimulus the RBA could be requested to buy most of the government bonds issued to fund it and to hold them indefinitely unless the CPI significantly overshot the Bank's three per cent inflation ceiling. That would replicate what the world's major central banks have been doing for a decade or longer.[59]

If the RBA funded $250 billion of the combined $300 billion of rescue and recovery measures that would increase the broad money supply (M3) by about 11 per cent. It would assure taxpayers and beneficiaries of government services and transfer payments that such measures should not create an excessive debt-servicing burden that would later require swinging tax hikes and/or welfare cuts.

59 See https://nymag.com/intelligencer/2020/05/were-paying-for-coronavirus-stimulus-by-printing-money.html

Percy Allan is a visiting professor at the UTS Institute of Public Policy and Governance and a former Secretary, NSW Treasury. Craig Emerson writes on Australian politics and was an economic adviser to Bob Hawke and a minister in the Gillard government. Both are members of the CEDA Council on Economic Policy and were requested to prepare this paper for the Council's Economic Recovery Series. The authors are grateful for helpful comments on an earlier draft by other members of the CCEP (Greg Smith, Tim Harcourt, Beth Webster and Jenny Gordon), but take full responsibility for the final content.