The impact of Covid-19 on government finances

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by

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Thankyou Liz for the introduction, and to Medicines Australia for inviting me to be part of this panel discussion.

I'm talking to you today from my home which is on the traditional lands of the Muwinina people, so let me also acknowledge the *palawa* people of *lutruwita*, and pay my respects to their elders, past, present and emerging.

Australia is now in its first recession in more than 28 years – at least according to the most commonly-used definition of two or more consecutive quarters of 'negative growth' in real GDP, a definition which I've often previously described as a bit silly, but that's just my opinion and obviously not one that's shared by other economists, journalist and politicians.

The current recession isn't as bad as we initially feared it might be.

In its May Statement on Monetary Policy, the Reserve Bank forecast that real GDP would contract by "around 10% over the first half of 2020", that total hours worked would decline by "around 20%", and that the unemployment rate would "rise to around 10% in the June quarter". As it turned out, real GDP declined by 7.2% over the first half of this year; total hours worked dropped, at their greatest extent (between March and May) by 10.4% (and have since recouped about half that decline); and the (published) unemployment rate peaked at 7.5% in May and average 7.0% for the June quarter as a whole[1].

Reflecting this, overnight the OECD revised upwards (that is, made less negative) its previous forecast, issued in June, that Australia's economy would contract by 5.0% in 2020 as a whole, compared with 2019: it now thinks that the contraction will be "only" 4.1%.

Nor has our recession been as bad as that experienced in most other countries. For example earlier this morning New Zealand reported that its economy shrank by 12.2% in the June quarter.

Of the 67 economies which have so far reported their June quarter GDP numbers, 55 have experienced bigger declines in real GDP between the June quarter last year and the June quarter of this year than the 6.3% which Australia did. Tiny Macau's economy contracted by 49.7% over this period – reflecting the fact that tourism (much of it gambling-related) accounts for over 72% of its GDP. But India's economy shrank by 23% over this period, Spain's and the UK's by 22%, France's by 19% and Italy's by 17%.

[1] A broader measure of unemployment, including people working zero hours but nonetheless classified as 'employed' because they remained on their employers' payrolls, and people who had lost or been stood down from their jobs but had 'dropped out' of the labour force rather than actively searching for work (and hence were not counted as 'unemployed'), peaked at 14.9% in April and averaged 13.4% for the June quarter as a whole. But that isn't what the RBA was forecasting.

Despite all of that, the current recession is still likely to be Australia's worst since the Great Depression of the 1930s, as measured by the magnitude of the decline in real GDP (if not by the rise in unemployment).

And the path out of the economic hole which we are now in is likely to be slower than the path into it was. I've never been a believer in a 'V-shaped' recovery: although I have also struggled to think of any other letter, in the Latin alphabet or any others with which I'm even vaguely familiar, which neatly characterizes the scenario ahead.

Other forecasters are now coming around to a similar view. Again, this is captured by the updated forecasts which the OECD issued overnight, in which they revised *down* their expectation for Australia's economic growth rate next year from 4.1% to 2.5%.

As people living in Victoria - The Police State, as I've sometimes characterized it[2] – can attest, the trajectory of the 'path out' of the economic hole we're currently in depends *crucially* on our success (or lack of it) in controlling the virus, and in what we have to do to be successful in controlling the virus – particularly until a vaccine becomes widely available, is proven to be effective, and a sufficient number of Australians have been willing to take it.

What does this mean for the fiscal environment, which is the topic for this discussion?

In a way that might seem a bit perverse for anyone who's been brought up on the notion that governments have to "live within their means", and that in tough times everyone has to "tighten their belts", the fiscal environment is actually *less constrained* today than it has been at almost any time in living memory.

In the Government's most recent *[Economic and Fiscal Update](#)*, presented by the Treasurer in July,

- *government spending* was expected to increase from 24.9% of GDP in the 2019-20 fiscal year, just gone, to 33.8% of GDP in the current 2020-21 fiscal year, the highest percentage since 1945-46;
- the '*underlying' cash deficit* was forecast to widen from 4.3% of GDP in 2019-20 (remember this was originally meant to have been a small surplus) to 9.7% of GDP in 2020-21, the largest since 1943-44; and
- *net government debt*, which stood at $374bn (19.2% of GDP) at 30th June 2019, was forecast to rise to $677bn (35.7% of GDP) by 30th June 2021.

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[2] Based on the enthusiasm which successive Victorian Governments (of both political complexions) have long displayed for using the police as a branch of the State Revenue Office – a penchant which carried over into the first lockdowns during which the Victorian Government raised $90 per 100,000 people by way of fines (and bragged about it), compared with the average for all states and territories of $38.30, and with only $15.90 per 100,000 people in New South Wales, which had a very similar 'risk profile' to Victoria as one of the two principal points of entry into Australia for foreign visitors and returning Australians, at a time when overseas transmission was the main source of infections.

All of these forecasts will, I expect, be revised upwards even further in the delayed Budget which the Treasurer will deliver on 6th October.

And, may I say, *this is as it should be*.

Now, I've long been what some people call a 'fiscal conservative'. I wrote most of the first half of the Kennett Government's Audit Commission Report in 1992-93, and oversaw the writing of the second half – not that I ever got any thanks or acknowledgement from the Victorian Liberal Party for that piece of work. And I've generally supported the current Federal Government's (and its two predecessors') objective of returning the budget to surplus.

But, as the great economist John Maynard Keynes is supposed to have said, "when the facts change, I change my mind"[3].

And 'the facts' about the condition of the Australian economy have rarely, if ever, changed by as much, as quickly, as they have over the past six months.'

Every reputable authority – including such erstwhile bastions of economic orthodoxy as the IMF and the OECD, as well as our own Reserve Bank – has been urging governments, including our own, to use their budgets to support households and businesses through the shutdowns required to beat the virus, and then to underpin the economic recovery which needs to follow, especially in circumstances where the scope for monetary policy to play the 'lead role' which it typically has in promoting recovery from recessions over the past 40 years or so is much more limited.

There is absolutely *no need* to fret about the size of the deficits which the Commonwealth government, and the governments of the states and territories, are running at the moment and will be running over the next few years: nor about the levels of debt which they will accumulate in order to finance those deficits:

- the Australian Office of Financial Management, which is responsible for undertaking the borrowings required to finance the Commonwealth's deficits, has had no difficulty at all in meeting that task: on the contrary, for every dollar it has borrowed since 31st March, it could have borrowed another $3.57 at interest rates averaging just 3 basis points (0.03 of a percentage point) more than the rates it has committed to pay on the bonds it has issued;
- and because the interest rates which it has to pay on the debt it issues are so low, the most recent *Economic and Fiscal Update* forecasts that the Commonwealth will actually be spending *less* (as a proportion of GDP) on interest payments in the current financial year than it did in any financial year between 2013-14 and 2018-19 (when the level of debt was much lower than it will be this year).

[3] although there is some doubt about whether he did actually ever say it.

Nor should we be worrying unduly about "paying back" this debt.

Governments are not households: and the simple analogies which politicians often draw between household budgets and government budgets are false and illusory.

There has not been *one year* since Federation in 1901 when the Commonwealth Government has not had some gross debt on issue: and from 1901 until 1963 that gross debt was higher, as a percentage of GDP, than it will be in June next year. There have only been eight years since 1970-71 (which is as far back as the data goes) in which the Commonwealth has not had some *net* debt.

There has not been one year since 1776 in which the Federal Government of the United States has not had some debt outstanding. Nor according to the Bank of England has there been a year since 1693 (when the Bank was founded) when Britain (or since 1801 the United Kingdom) has not had some public debt.

None of this should be seen as a licence for fiscal irresponsibility or recklessness.

Every dollar of money borrowed to fund either additional spending or tax cuts should be used either to fight the virus and contain its spread, to support households and businesses in coping with the restrictions that governments have imposed in order to fight the virus and contain its spread, or to lay the foundations for a sustainable and equitable economic recovery once the fight against the virus has been won.

In the months immediately ahead will need to re-focus the measures put in place in the early stages of the recession, which were intended to help businesses and households survive a period during which their revenues and incomes have been savaged by the restrictions required to prevent the spread of Covid-19, towards measures which will help to nurture a sustainable economic recovery, taking account of the lasting changes wrought by the virus, and moving us back to full employment.

In so doing it will be crucially important, as the OECD advises in its updated Economic Outlook, to avoid "trapping resources in non-productive zombie firms and jobs" and policies which "reduce the prospects for job switching to more productive and higher-paid positions" – risks to which, the OECD says, "young people are particularly exposed".

That is one of the reasons why I continue to urge that policy should move away from preferencing *small* businesses, simply because they are small and for no other reason, and instead start encouraging *new* businesses.

There will of course come a day when it will be necessary to put the budget on a sure path back to surplus, and thus to start repaying some of the debt which the government will be racking up between now and then.

But that day *will not come* before we have been able to declare 'mission accomplished' with respect to Covid-19; before the economy is on a sustainable recovery path; or before we are demonstrably and unequivocally on the path back to full employment.

As the OECD warned overnight, "premature withdrawal of fiscal support in 2021 would stifle growth, as occurred in the aftermath of the global financial crisis in many countries" – or indeed as Franklin Delano Roosevelt did in 1936, when he tightened fiscal policy prematurely and put the 'great' back into the Great Depression (again), from which it didn't emerge until the launch of the massive fiscal stimulus program better known to history as World War II.

Jorge Agustín Nicolás Ruiz de Santayana y Borrá, better known to English speakers as George Santayana, once said – although the saying is more commonly remembered as a result of Winston Churchill quoting it in a speech to the House of Commons in 1948 – "those who fail to learn from history are condemned to repeat it".

Let us hope that none of us, in Australia or anywhere else, will be condemned to repeat this history of previous economic policy failures.