# AFTER THE CRISIS: WHAT ARE THE SOCIAL POLICY CHALLENGES?

**Address to the Melbourne Institute & The Australian's 2009 Economic and Social Outlook Conference**


*by*

*Saul Eslake, Program Director – Productivity Growth*
*The Grattan Institute*


5th November 2009

Australia's experience of the global financial crisis has turned out to be remarkably benign, both by comparison with that of most other advanced economies and with what was commonly expected in the early stages of the crisis. As we have been repeatedly reminded, Australia is the only advanced economy to have expanded over the year to the June quarter, and one of only four not to have experienced consecutive quarterly contractions in real GDP. Earlier this week, the Australian Government upgraded its forecasts for economic growth for both the current financial year and for 2010-11; and it is widely expected that the Reserve Bank will do likewise in the *Statement on Monetary Policy* which will be released tomorrow.

Australia's economic resilience through the financial crisis reflects a combination of good luck and good management. It's now clearer than it was this time last year that the financial crisis was primarily a North Atlantic financial crisis, albeit with serious global economic consequences.

As it happened, Australia had comparatively few of the points of vulnerability which afflicted the financial systems of the major North Atlantic economies, and relatively low exposures to the sharp downturns in those North Atlantic economies.

Additionally, the Australian authorities responded in a timely and effective way to the exposures which we did have.

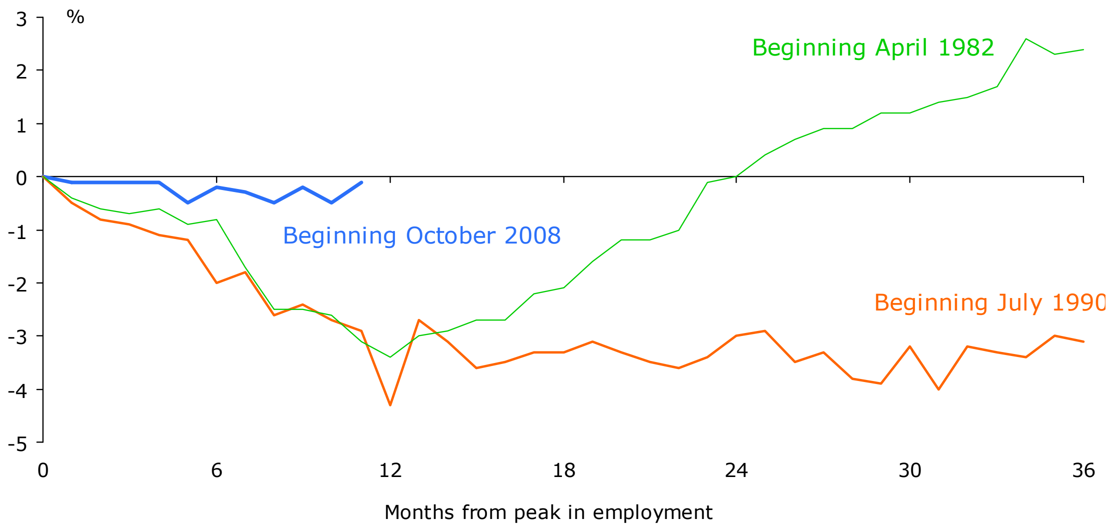
However, in acknowledging our relatively strong performance to date and commending the Government and the Reserve Bank for their contributions to that – as I do – we need to be careful not to lose sight of the fact that the crisis has nonetheless had serious consequences for many Australians; and that, as an inevitable consequence of the way in which fiscal policy has been deployed to mitigate many of the effects of the crisis, we are less well-placed to deal with many long-standing challenges than we thought we would be before the onset of the crisis.

*The impact of the financial crisis on the labour market and unemployment*

The sizeable and timely responses of fiscal and monetary policy to the financial crisis have helped to reduce what otherwise may well have been serious consequences for employment. At its greatest extent, between October last year and June this year, employment fell by a net 59,200 or 0.5% (Chart 1). This is considerably less than the peak-to-trough job losses of 313,200 (or 4.0%) during the recession of the early 1990s, and 229,500 (or 3.5%) in the recession of the early 1980s. And more than four-fifths of the decline in employment during this period has since been reversed.

One of the ways in which the fiscal and monetary policy stimulus has worked – probably more effectively than originally envisaged – has been through its impact on business confidence. Although it's easy to forget now, between October last year and January this year, business confidence fell to levels below those reached during the recession of the early 1990s. Major lay-off announcements increased considerably after September. The stimulus announcements combined with the aggressive reductions in official interest rates appear to have given employers sufficient reason to moderate their expectations of the depth and length of the looming downturn, so that they became more willing to seek alternatives to mass retrenchments (such as reduced working hours) as a means of maintaining the viability of their businesses.

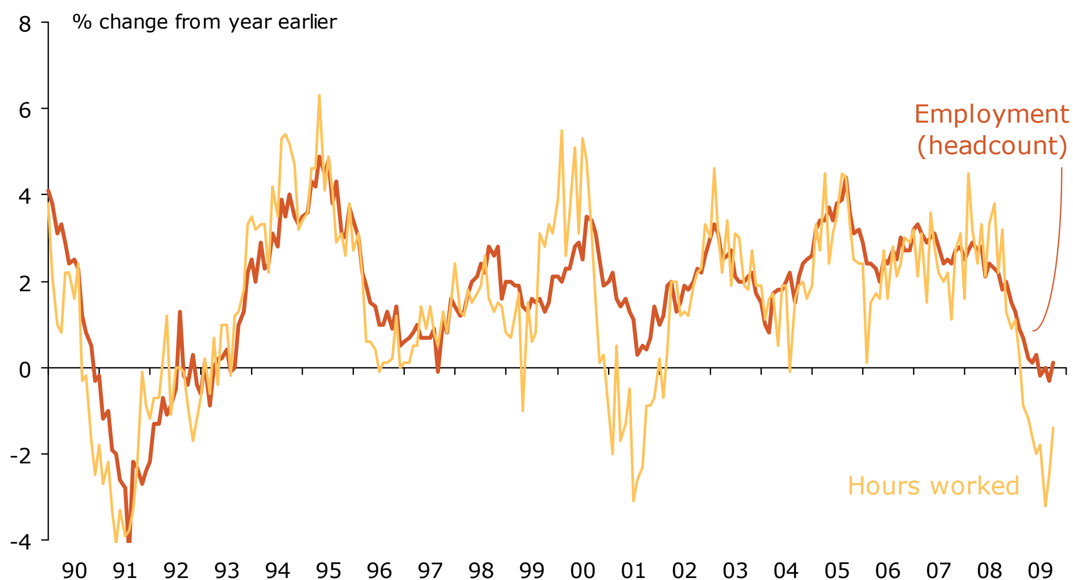
**Chart 1: Cumulative changes in employment from peak**




*Sources:* ABS; Grattan Institute.

Labour market reforms since the early 1990s have given employers greater scope to manage their labour costs in this way (Chart 2). Persistent shortages of skilled (and in some cases unskilled) labour in the years preceding the onset of the crisis may have encouraged many employers to 'hoard' labour once they felt confident that any downturn would be brief and mild. And one would like to think that more enlightened employers had also absorbed research findings indicating that mass sackings at the first indication of a downturn have consequences for morale and productivity among the 'survivors' which often offset the cost savings procured by retrenchments. Indeed, although we didn't know it at the time (because the Statistics Bureau didn't publish data on aggregate hours worked), employers appear to have managed their labour costs in a similar fashion during the brief downturn at the beginning of this decade.

**Chart 2: Employment and aggregate hours worked**

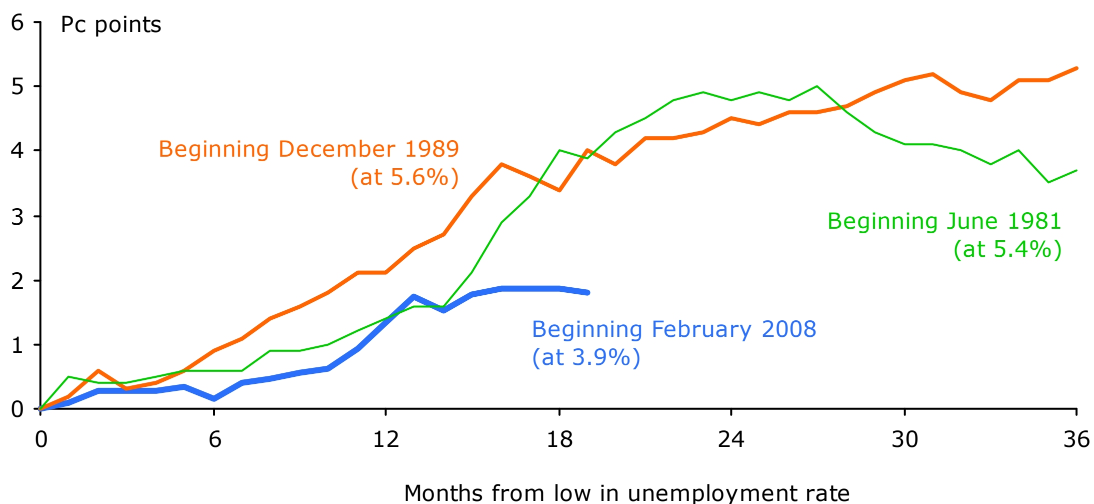



*Source:* ABS.

And although reductions in hours worked, requirements to take unpaid leave and outright salary reductions obviously imply reductions in aggregate income, it seems likely that the broader macro-economic consequences of a given reduction in aggregate labour costs procured through such means are smaller than those of the same reduction in labour costs procured through outright retrenchments. In particular, consumer confidence is likely to be more seriously affected by a rise in unemployment than by an equivalent increase in 'under-employment'; and households whose incomes are adversely affected by a reduction in paid working hours are nonetheless less likely to default on their mortgages than those where an income-earner loses his or her job altogether.

Nonetheless, because employers (in aggregate) effectively stopped creating new jobs – at least until June – in circumstances where growth in the working-age population has remained strong (and indeed actually accelerated slightly), some 218,000 people have become unemployed since February last year, when the unemployment rate bottomed at 3.9%. That's taken the unemployment rate back to 5.8%, where it has remained for the past four months. This is the highest rate since October 2003, and it's the largest increase over any 18-month period, outside of a generally-recognized recession, since monthly labour force statistics began in 1978.

**Chart 3: Cumulative increases in unemployment rate**



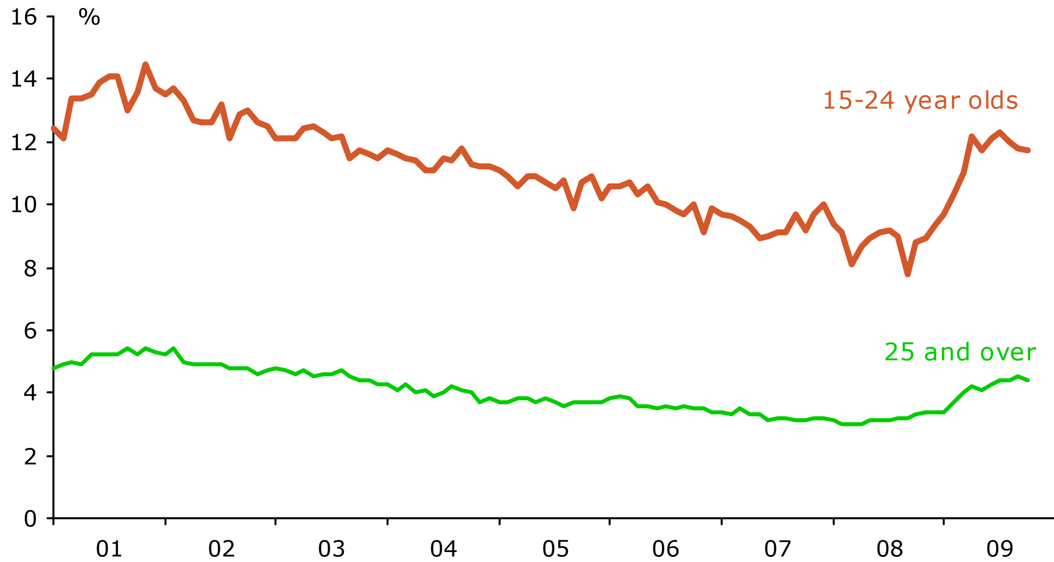

*Sources:* ABS; Grattan Institute.

And even under the more optimistic outlook presented by the Treasury earlier this week in the *Mid-Year Economic and Fiscal Outlook*, unemployment is expected to continue rising to a peak of 6¾% in June next year, implying that an additional 105,000 people will become unemployed by then.

The vast majority of those newly-unemployed would appear to be new entrants to the labour force, either from schools and other educational institutions or recently-arrived migrants.

Thus for example people aged 15-24, who represent about 18% of the labour force, have accounted for 34% of the increase in the number of unemployed since the trough in February last year. The unemployment rate among this group rose from 8.1% at that time to a peak of 12.3% in June, the highest since April 2003, before easing back to 11.7% in September (Chart 4).

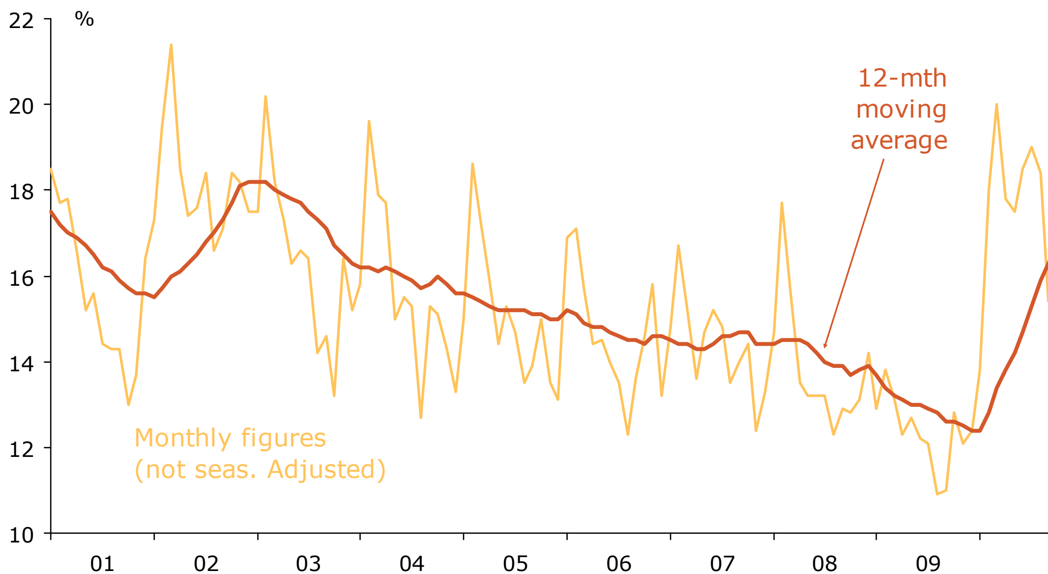
**Chart 4: Unemployment rates among selected age groups**




*Sources:* ABS; Grattan Institute.

The unemployment rate among 15-19 year olds not attending full-time education (mainly school leavers), which is not available in seasonally adjusted terms, typically peaks in January or February: it did so in February this year at 20.0%, the highest for eight years, and well above last year's seasonal peak of 13.8% (Chart 5). As of September the unemployment rate among this group was still at 17.0%, the highest figure for this month since 2001.

**Chart 5: Unemployment among 15-19 year-olds not in full-time education**



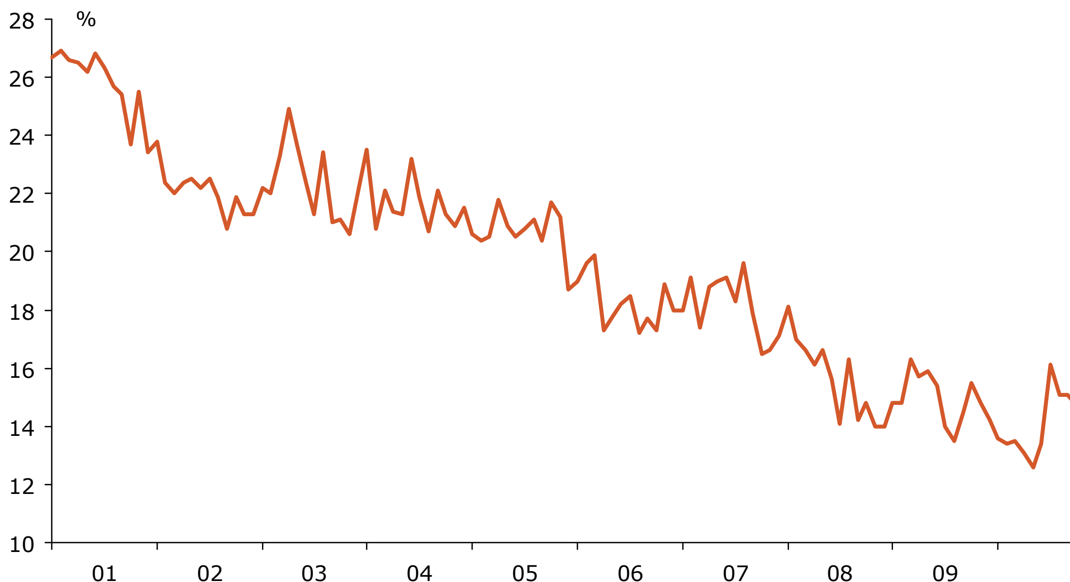

*Sources:* ABS; Grattan Institute.

Unfortunately, labour force statistics disaggregated by birthplace are only available triennially, so it is not possible to confirm directly that recently-arrived migrants figure disproportionately among those who have become unemployed since the onset of the financial crisis. However I would suggest that is a reasonable inference.

It also seems reasonable to assume that, since much of the reduction in labour demand has been absorbed through reductions in hours worked rather than in head-count, much of the increase in demand for labour, as and when the cycle turns, will initially be met through increasing working hours rather than through new hiring.

It therefore follows that those who have become unemployed since the onset of the financial crisis may be unemployed for some time. And this is a serious concern because we know that the longer someone remains unemployed, the more difficult it becomes for him and her to become employed, because of the atrophying of skills and because of adverse employer perceptions. We also know that the 'non-inflation accelerating rate of unemployment' is higher, other things being equal, the larger the proportion of those out of work have been jobless for a long period of time: that is, long-term unemployment detracts from potential GDP growth. To date, there is no conclusive evidence that long-term unemployment has begun to trend higher. The proportion of those unemployed who have been out of work for more than 12 months continued to decline, from 16.3% in February 2008 when the unemployment rate bottomed, to a low of 12.6% in April this year, presumably as a result of the large number of people becoming newly unemployed (Chart 6). The April figure was the lowest since this series commenced in 1986. It subsequently rose to 16.1% in June, before edging down to 14.7% in September. However this series will bear close watching over the next year or so to see whether one of the more lasting legacies of the financial crisis is a significant increase in long-term unemployment.

**Chart 6: Per cent of total unemployed out of work for one year or more**




*Sources:* ABS; Grattan Institute.

One other aspect of the impact of the financial crisis on the labour market is its regional dimension. There are a number of regions where the increase in unemployment since the onset of the financial crisis has been considerably greater than for Australia as a whole – in particular, Far North Queensland, where the unemployment rate leaped by 7.3 percentage points, to 12.3%, between the September quarters of last year and this; and also South Eastern metropolitan Melbourne and South Eastern metropolitan Perth, where unemployment has risen by 4.7 and 4.5 percentage points, respectively, to 8.7% and 7.3%, respectively, over the past year (Chart 7).

**Chart 7: Unemployment rates in selected regions**

| Region | September quarter 2009 | Change from year earlier (pc pts) |
|---|---|---|
| Far North Queensland | 12.3 | 7.3 |
| South-eastern Melbourne | 8.7 | 4.7 |
| South-east Perth | 7.3 | 4.5 |
| Inner Sydney | 6.1 | 3.7 |
| Sydney Northern Beaches | 5.2 | 3.3 |
| North-western Melbourne | 7.7 | 3.3 |
| Sunshine Coast | 6.5 | 3.3 |
| Inner western Sydney | 5.8 | 3.0 |
| Northern Perth | 5.1 | 2.9 |
| Eastern Perth | 4.9 | 2.6 |
| | | |
| **Australia** | **5.8** | **1.5** |

*Sources:* ABS, Grattan Institute.

Four other regions have experienced increases in unemployment of more than three percentage points over the past year – Inner Sydney, Sydney's Northern Beaches, North Western Melbourne, and the Sunshine Coast; all of these except Northern Beaches have unemployment rates above the national average. Unemployment has also risen by more than the national average in a number of other regions where unemployment was already well above the national average – including Fairfield-Liverpool, Outer and Central Western Sydney, and Queensland's Wide Bay-Burnett region.

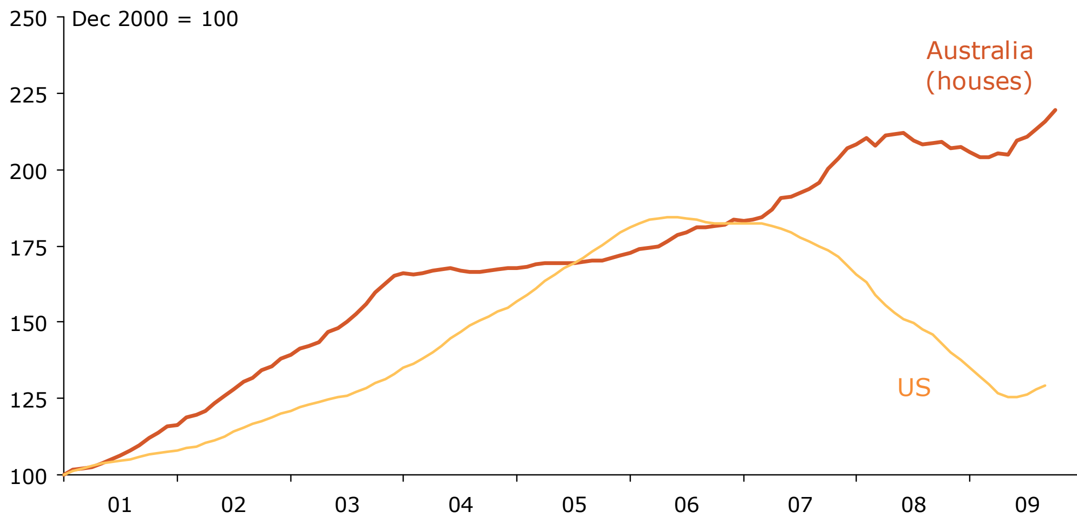
Regional concentration of unemployment may be exacerbated by the pattern of economic growth which seems to be emerging in the aftermath of the financial crisis, with the resumption of the resources boom pushing up the Australian dollar, adding to the pressure on other trade-exposed sectors such as manufacturing, agriculture, tourism and education. Some of the just-mentioned regions (for example Far North Queensland, the Sunshine Coast, South East and North West Melbourne and Fairfield-Liverpool) would seem to reflect these kind of pressures.

A number of the programs implemented by the Australian Government since the onset of the financial crisis are explicitly directed towards these developments in the labour market, including the Compacts with Young Australians and Retrenched Workers, and with Local Communities for regions experiencing the sharpest increases in unemployment, as well as more general assistance for training and skills development. These are programs which will almost certainly need to be continued even after the Government has begun to wind back other components of its fiscal stimulus.

*The financial crisis and housing*

Another important social issue which has been affected by the financial crisis is that of housing affordability. The United States has, in effect, solved the housing affordability problem it had prior to the onset of the crisis. From the perspective of would-be buyers, American housing is now more affordable than at any time since at least the early 1970s (provided you can get a mortgage); while for renters the vacancy rate is the highest it has been since at least the early 1960s.

**Chart 8: US and Australian house prices**




*Sources:* S&P (Case-Shiller index), Residex, Grattan Institute.

Needless to say, of course, this 'solution' to the problem of housing affordability has come at a considerable cost!

By contrast, housing affordability remains as a significant issue in Australia, for both would-be buyers and for renters.

Australia has not experienced a sharp decline in house prices similar to that which has occurred in the United States, Britain, Spain and a number of other countries. Depending on which series one uses, Australian house prices did ease modestly in 2008 and/or the early part of 2009; but more recently, Australian house prices have recovered to levels above their pre-crisis peaks.

In fact, there was never likely to be a significant fall in housing prices in Australia, notwithstanding some well-publicized forecasts to the contrary which have since proved somewhat embarrassing to their authors.

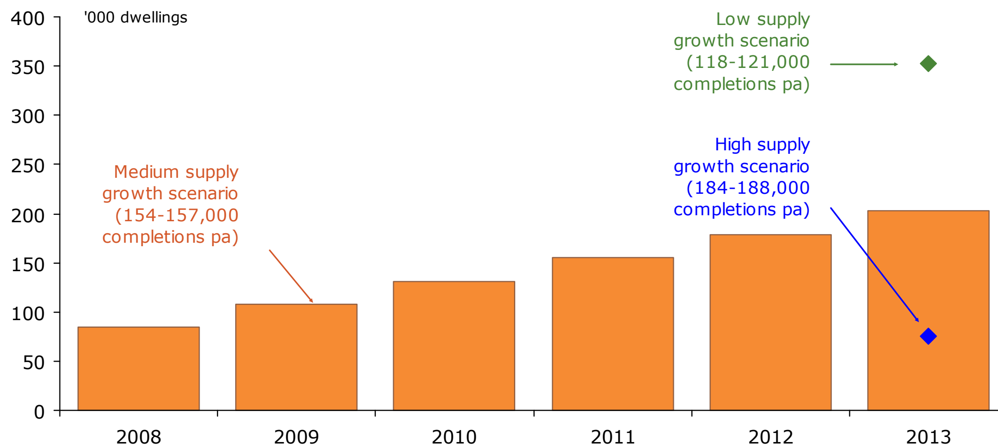
There are two reasons for that.

First, very few Australian home-buyers took out mortgages at relatively low points in the interest rate cycle which they could no longer afford to service as interest rates began rising. That's partly because the Reserve Bank of Australia was one of the few advanced economy central banks not to have made the mistake of leaving interest rates too low for too long after the milder-than-expected downturns at the beginning of this decade; and partly because 'sub-prime' (or 'non-conforming', as it was more commonly called here) lending and other forms of degraded mortgage lending never caught on in Australia to the same extent as in other countries.

Hence there has not been a large number of forced or distressed sellers, obliged to accept whatever price they can get for their dwellings, putting sustained downward pressure on residential property prices as there has been in the US and, to a lesser extent, some European countries. Nor, of course, has unemployment risen by enough to precipitate significant distressed selling.

Second, unlike the United States, where the pre-crisis housing 'bubble' saw the quantity, as well as the price, of housing reach unsustainable levels, here in Australia we have for more than a decade been building fewer new dwellings than have been required to keep pace with the increase in the number of households requiring accommodation. That's why there is a shortage of housing estimated by the National Housing Supply Council (of which I'm a member) to be of the order of 85,000 dwellings – an estimate which is well below those made (using different methodologies) by private sector analysts such as BIS-Shrapnel, ANZ and Westpac. It's also why the rental vacancy rate remains below 2% in Australia, compared with over 10% in the United States.

**Chart 9: Australia's housing shortage**




*Note:* Estimates of housing shortage as at June 2008 based on numbers of homeless 'sleeping rough' or with relatives and friends, marginal caravan park residents and number of dwellings required to lift rental vacancy rates to 3%. Projections based on medium-term underlying demand scenario which assumes annual growth in the number of households of 152-156,000 per annum.

*Sources:* National Housing Supply Council *State of Supply Report 2008.*

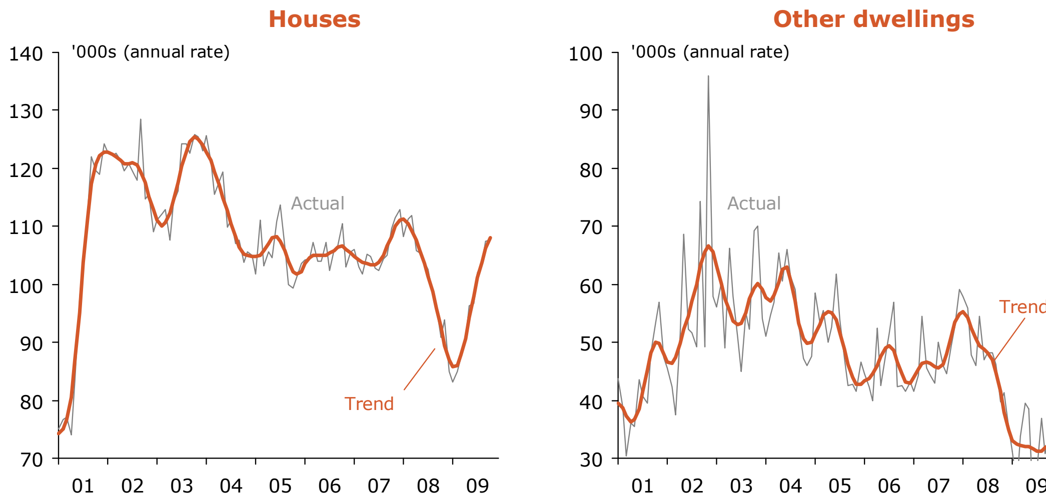
Hence, provided that the mortgage finance remained readily available – as it has – it was always difficult to figure out how prices could fall in a market where demand exceeded supply by such a wide margin.

One lingering effect of the financial crisis which is likely to exacerbate the housing shortage for some time yet to come is the difficulty which proponents of multi-unit housing developments are continuing to encounter in gaining access to finance. The debt securities market remains for all intents and purposes closed to property developers, and financial intermediaries have become more conservative in their lending for large-scale residential (as well as commercial) property development, partly of their own volition as well as at APRA's insistence.

As a result, although a recovery in construction of new detached dwellings appears to be firmly under way, approvals for new multi-unit housing remain at historically low levels (Chart 10). And yet this is the type of housing of which we need considerably greater supply, not only to address affordability concerns but also on environmental sustainability and traffic congestion criteria.

Hence, now that mortgage rates are also rising, housing affordability is likely to re-emerge as an important economic, social and political issue. My concern is that governments will again seek to respond to concerns about housing affordability with policies that make the problem worse rather than solving it.

### Chart 10: Residential building approvals by type of dwelling




*Sources:* ABS, Grattan Institute.

That is, they will emphasize policies which ostensibly seek to improve housing affordability by putting cash into the hands of would-be home buyers, through cash grants, stamp duty concessions and the like. The problem is that, in a market characterized by an excess of demand rather than supply, this cash ends up in the pockets of vendors whilst doing nothing either to improve housing affordability, increase home ownership rates or increase the supply of housing.

It's actually quite staggering to think that, notwithstanding the billions of dollars which governments have handed over to would-be home buyers through such schemes, combined with the substantial decline in average mortgage rates since the early 1990s, the home ownership rate is actually lower than it was in 1961. (Chart 11). Indeed, over the past decade, home ownership rates have actually declined in every age bracket except for the over 65s; and the only reason that the overall home ownership rate hasn't declined significantly is the increase in the proportion of the population aged over 45, for whom home ownership rates are typically much higher than for those in younger age groups.

### Chart 11: Home ownership rates by age group

| Age range | 1961 | 1971 | 1976 | 1981 | 1986 | 1991 | 1996 | 2001 | 2006 |
|---|---|---|---|---|---|---|---|---|---|
| 25-29 | 54 | 50 | 54 | 53 | 51 | 48 | 44 | 43 | 43 |
| 30-34 | 64 | 63 | 67 | 68 | 65 | 63 | 59 | 57 | 57 |
| 35-39 | 71 | 69 | 72 | 74 | 72 | 71 | 67 | 66 | 65 |
| 40-44 | 73 | 72 | 74 | 76 | 76 | 77 | 73 | 72 | 71 |
| 45-49 | 75 | 75 | 75 | 78 | 78 | 80 | 78 | 76 | 75 |
| 50-54 | 76 | 77 | 77 | 79 | 80 | 82 | 80 | 80 | 78 |
| 55-59 | 78 | 78 | 78 | 81 | 81 | 83 | 82 | 82 | 81 |
| 60-64 | 79 | 79 | 78 | 81 | 83 | 84 | 83 | 83 | 82 |
| 65+ | 81 | 80 | 75 | 78 | 80 | 84 | 82 | 82 | 82 |
| | | | | | | | | | |
| **Total** | **72** | **69** | **68** | **70** | **70** | **72** | **69** | **70** | **70** |

*Source:* Judy Yates, Hal Kendig & Ben Phillips, *Sustaining Fair Shares: the Australian Housing System and Intergenerational Sustainability,* Australian Housing and Urban Research Institute Final Report No. 111, February 2008.

Although it is possible to defend the trebling of the First Home Owner Grant for first-time buyers of new housing as part of the Government's fiscal stimulus package as a way of stimulating new housing supply, the doubling of the grant for purchasers of existing homes was a complete waste of money, given that (as noted earlier), house prices were not likely to fall significantly in this country anyway (and it mightn't in any case have been an entirely Bad Thing if they did).

To be fair, in its 'Nation Building and Jobs Plan' unveiled in February, the Government provided up to $6 billion for the construction of around 20,000 new public and community housing dwellings to be 'largely completed' by December 2010. Unfortunately, in August, $750mn of this funding was re-allocated to the program of new primary school buildings, which would not qualify as one of the 'higher-quality' fiscal policy decisions taken over the past year.

The Government also has another excellent scheme aimed at increasing the supply of affordable housing, in the form of the National Rental Affordability Scheme introduced in the 2008-09 Budget, which provided $623 million over four years by way of incentives for investors to build up to 50,000 dwellings for rent at least 20% below market rents. This scheme could have been expanded as part of the Government's fiscal stimulus measures – but it wasn't.

It's good to see that the Government is now winding back the additional First Home Owner Grants provided last October, and in addition imposing ceilings on the value of properties eligible for the grants. Ideally, however, the Government should abolish them altogether for purchases of existing dwellings – since they were originally introduced as 'compensation' for the introduction of the GST, yet no GST is payable on purchases of established dwellings – and redirect the funds towards programs which increase the supply of housing, rather than ones which inflate the demand for it.

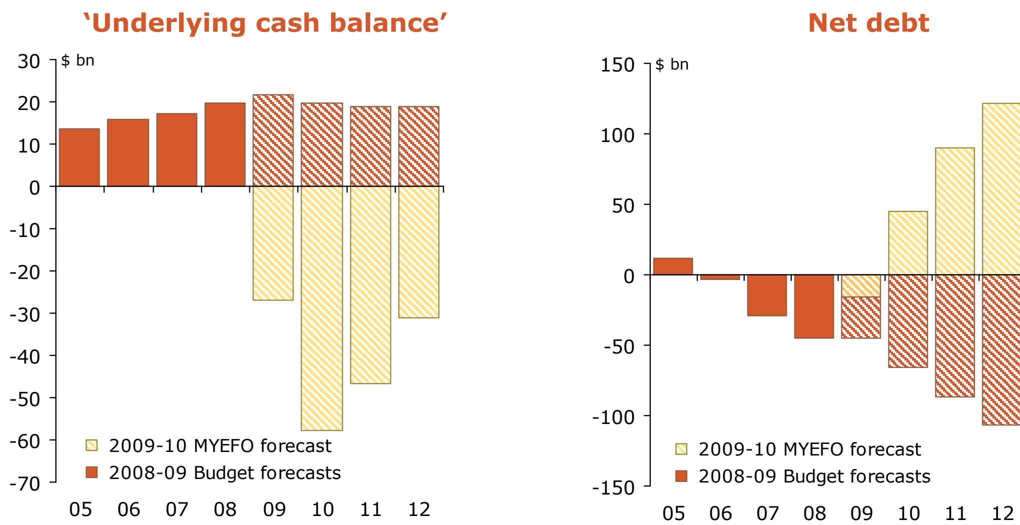
*The financial crisis and the Government's fiscal position*

One other very important consequence of the financial crisis which I want to mention in concluding is that it has left the Government in far less strong a position to tackle many of the issues which it identified prior to and immediately after assuming office. I make that observation from the standpoint of one who has, for the most part, supported the way in which the Government has responded to the financial crisis, and in particular its willingness to take the Budget into deficit and to incur debt in order to ameliorate the effects of the crisis.

Nonetheless, the fact remains that, whereas prior to the onset of the crisis the Government anticipated accumulating cash surpluses totalling $79.2bn over the four years to 2011-12 and having net financial assets of $107bn at the end of that period, it now expects to have incurred deficits totalling $163.2bn over that period and to have net debt of $122bn at the end of it (Chart 12).

This inevitably means that the Government faces less palatable choices in pursuing reforms and dealing with problems than it envisaged in its first year in office. Decisions to spend more in particular areas will need to be paid for by cutting spending elsewhere or by consciously raising revenue. It won't be as easy to 'pay off' potential losers from reforms such as those likely to be recommended by the Henry Tax Review. Additional infrastructure spending may needed to be funded by debt, rather than from special funds established out of past budget surpluses.

**Chart 12: Australian Government budget projections pre- and post-crisis**




*Sources:* 2008-09 *Budget Paper No. 1*, 2009-10 *Mid-Year Economic & Fiscal Outlook*.

This is not necessarily an entirely Bad Thing. But it does mean that the Government will have to think more carefully about choices and trade-offs than would have been the case had the financial crisis not occurred. Perhaps that will result in greater discipline over the choices which the Government does make: and, of course, that would be a Good Thing.