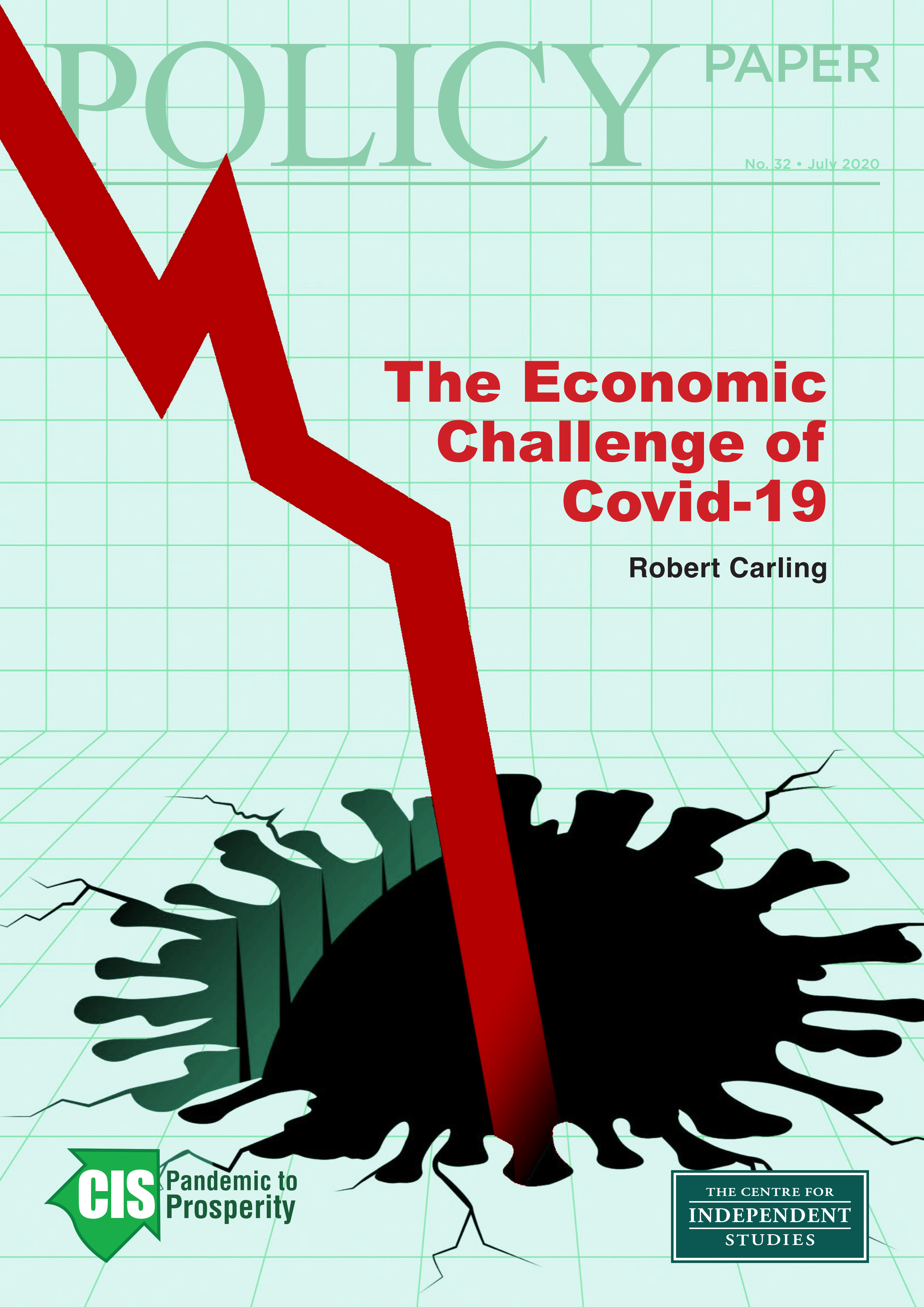


POLICY PAPER

No. 32 • July 2020

The Economic Challenge of Covid-19

Robert Carling

CIS Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

NATIONAL LIBRARY OF AUSTRALIA

A catalogue record for this book is available from the National Library of Australia

The Economic Challenge of Covid-19

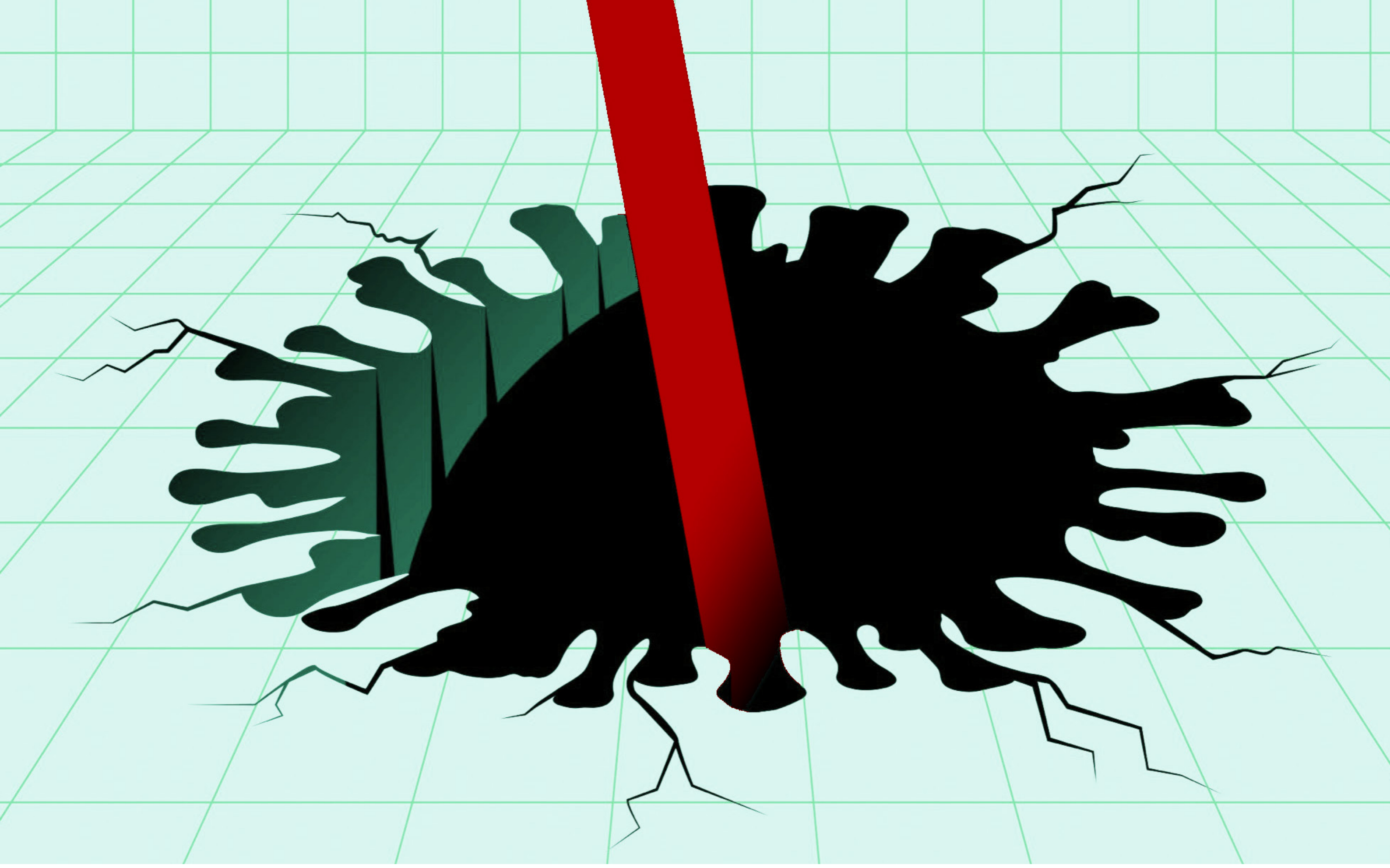
Robert Carling

Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

POLICY Paper 32

Contents



Introduction

This paper provides the broad framework for the papers focused on specific areas of economic policy in the CIS Pandemic to Prosperity series.

Crisis is an overused word, but it comfortably fits the current predicament of the Australian economy — and to an even greater extent, the global economy. As the World Bank recently declared, "Covid-19 is the most adverse peacetime shock to the global economy in a century."[1]

This crisis has come about rapidly; entirely as a result of the Covid-19 pandemic and government policy responses to control it, both here and abroad. Even before being struck by these events, the Australian economy was under-performing and in need of reinvigoration. Although aggregate economic activity as measured by Gross Domestic Product (GDP) was still growing, growth was below the long-term trend and barely positive in per capita terms, continuing a long record of post-Global Financial Crisis stagnation in living standards. It can therefore be said that the Covid-19 torpedo found a slow-moving economic target.

The current slump in perspective

The deep slump that developed rapidly after about mid-March 2020 is a recession unlike any other known in modern times, in that it was essentially ordered by drastic government-imposed restrictions on business operations and the freedom of people to move about — all for the purpose of slowing the spread of Covid-19. The shock has been to both aggregate demand and aggregate supply; although the supply shock is much greater in some sectors — such as tourism and hospitality — than others. The need for restrictions and the trade-off between public health and economic considerations have been the subject of fierce debate, and will no doubt continue to be for years to come.[2] However, the reality to be dealt with now is that the restrictions were imposed, the economic consequences have been severe, and policy has had to both soften the economic blow and chart a path out of the abyss.

The data available as at end-June suggest the slump — while deeper than anything seen since the 1930s

— may not be as drastic as first feared and probably hit bottom in May. The way out has begun with an earlier easing of restrictions than envisaged under the six-month economic hibernation plan hatched by the national cabinet in March. However, there are still restrictions in place that would have been unthinkable just a few months ago. And enormous economic damage has been done and will continue to be done, not to mention the damage to the social fabric. Indeed, the bigger concern is not the short-term damage in the past three months and the next three, but the long-lasting damage that sees the economic and social cost mount over years.

The flow of economic data in early 2020 continued pointing — as it had for some years — to mediocre growth in real GDP, minimal growth in per capita incomes, and weakness in business investment, research and development, productivity growth and real wages. Economic policy was focused on achieving a budget surplus but was doing much less to address structural weaknesses and reinvigorate investment and productivity.

The economic shock of the pandemic came too late in the March quarter to have a major impact in that quarter, but it was enough to produce a small 0.3 per cent contraction. A much larger shrinkage is expected in the June quarter. Although this will not be confirmed until that quarter's national accounts are released in early September, a severe decline is already apparent in partial indicators such as retail sales, business investment expectations, employment and unemployment (see box below).

With the easing of restrictions, a rebound is expected to be apparent in the September quarter GDP outcome. However, there is a great deal of uncertainty about the strength and staying power of the rebound; not only because of fears of a renewed upsurge in Covid-19 cases, but also the uncertainties about the dynamics of an economic recovery from a slump of an unprecedented nature. In contrast to early talk from the government of an economic 'snap-back' to pre-existing conditions, what looks increasingly likely in a business-as-usual policy scenario is, at best, a longer, slower and more uneven recovery that will see real GDP remain below its previous growth path – and unemployment above its pre-crisis level – for years to come. This is why business as usual is unacceptable. As highlighted by the dismal labour market indicators in the box above, the top priority needs to be job creation and re-creation.

Australian labour market indicators as at end-June 2020[3]

- Total employment fell by 6.4 per cent from March to May and unemployment rose from 5.2 to 7.1 per cent. However, these figures substantially understate the deterioration because of an exodus from the labour force, the JobKeeper program and underemployment.
- Total hours worked fell by 10.2 per cent from March to May.
- Labour force participation fell from 65.9 per cent in March to 62.9 per cent in May.
- If not for this exodus from the labour force, unemployment would have been 11.3 per cent in May.
- The underemployment rate jumped from 8.8 per cent in March to 13.1 per cent in May. Combined with unemployment, this means the labour underutilisation rate was a record 20.2 per cent in May.
- Job vacancies shrank by 43 per cent from February to May.
- There are about 3.5 million people temporarily sheltered in the work force, doing little or no work but not classified as unemployed, in the JobKeeper scheme.
- In April, 23.8 per cent of all workers and potential workers were either without any job or working part-time in a job providing fewer hours than preferred.

A long road to recovery

There are several reasons for a long recovery period — and why a full recovery (in the sense of restoring the pre-existing long-term trend growth path) may never be achieved unless economic policy faces up to structural weaknesses.

One reason is that some restrictions on business activity and human interaction remain in place and — in the case of activities like overseas arrivals and departures — will continue for some time ... perhaps a long time. With these restrictions in place, it is impossible to get back to a 100% economy. Even 95%, if we could reach that, would leave a high level of unemployment and underutilisation of economic resources in general. This is what the government calls the 'Covid-safe economy'.

The second reason is that even if all restrictions were removed tomorrow, the shock to the economic system since March has been so profound that it will have long-lasting effects. This is the phenomenon economists call hysteresis, which refers to the relationship between cause and effect and the persistence of the effects long after the causal factors have disappeared. Hysteresis is most often cited in explaining the slowness of unemployment to fall back after a typically rapid recession-induced increase — after the 1991 recession in Australia, for example, it took eight years for unemployment to drop back to its pre-recession level — but it applies to the dynamics of economic recovery more generally (see Box 2).

As Martin Wolf of the *Financial Times* put it succinctly: "Low levels of capacity use deter investment and leave a legacy of obsolete capacity. Expectations of weak future growth discourage investment and so become self-fulfilling. Long periods of unemployment cause loss of skills and may permanently deter workers from seeking jobs. Countless companies will disappear forever."[4]

Why the road to recovery will be long

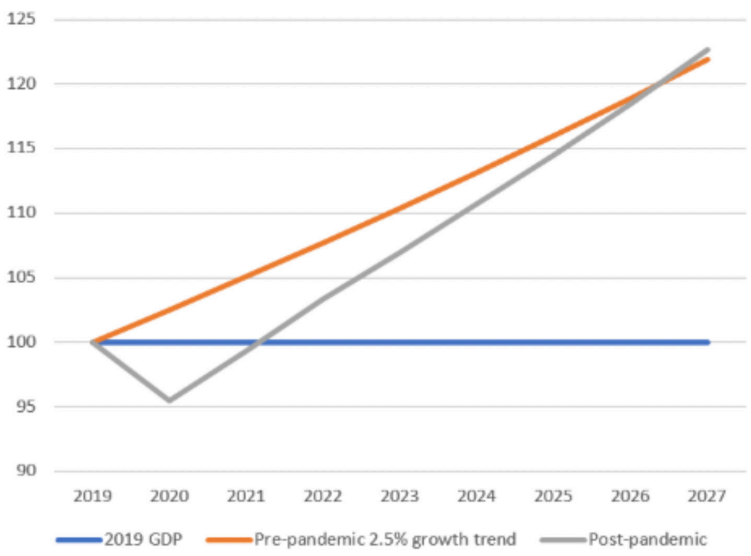
- The erosion of workers' 'employability' due to loss of skills during long spells of unemployment and the lack of familiarity with the job search process on the part of those with marginal attachment to the labour force. This is often referred to as 'scarring' of the labour market.
- Employers' reluctance to rebuild their work forces in circumstances of heightened uncertainty about the business outlook.
- The disruption of education and training due to the substitution of remote learning for structured in-school learning during the lockdown may do long-lasting harm to the human capital of the current cohort of students.[5]
- The permanent closure of a proportion of businesses that is normal in any recession will be reinforced in the current episode as many businesses that had to close down due to government-imposed restrictions will struggle to regain their footing and some will never re-open. It will take time for new businesses to open in their place. Even before the pandemic, the rate of new business formation in Australia was abnormally low.
- Business and consumer confidence has taken a severe hit and will take time to recover.
- Business investment — already at a 25-year low before the pandemic — will contract further, reducing the economy's future capital stock and productivity. A plunge in investment to new lows was confirmed by a recent ABS survey of private new capital expenditure.
- The lockdown may produce permanent structural and behavioural changes — such as more working and shopping from home — which will be painful for the economy to adjust to, even if the eventual result is greater efficiency.
- The population growth rate will be reduced by a large reduction in immigration. If the lower growth rate is sustained, there will be a difficult adjustment by some sectors geared to population growth, such as home building.
- One legacy of the crisis will be much higher levels of public and private (especially business) debt, which will act as a brake on economic growth.
- The whole world is in the same or worse economic predicament as Australia; the global environment is inhospitable to a recovery and may become more so if there are short-sighted policy reactions in other countries — such as a permanent shift away from market economics and international trade. Australia is reliant on world markets and cannot achieve a full recovery unless its trading partners and foreign investors recover too. Being an island continent helps deal with a pandemic, but we are not an island in the economic sense.

The effect of these factors is that although real GDP and employment will increase from their June quarter levels, they may take years to return to pre-crisis (December quarter 2019) levels. Whether, if at all, they return to — or even exceed — the pre-crisis growth path will depend on economic policy to overcome structural obstacles to growth.

The pre-crisis level of GDP might be restored by, for example, the end of 2021, but the true measure of loss is the opportunity cost that also takes account of the fact that the pre-crisis growth path would have taken real GDP to a level 5 to 6 per cent higher by the end of 2021. Thus, there would still be a 5 to 6 per cent shortfall relative to pre-crisis conditions, which would take several more years of above-trend growth to make up. In per capita terms — more relevant to living standards — the shortfall will be even larger, depending on population growth.

Estimations such as this show why the Prime Minister and the Treasury Secretary have recently spoken of a full recovery taking at least five years and requiring a step-up in annual growth to 3.75% — compared with a 2.5% average in the past five years. The following chart depicts a stylised recovery path (not a forecast) that would restore GDP to its pre-pandemic trend level by 2026, starting with the latest IMF forecasts for 2020 and 2021 and then assuming 4 per cent growth in 2022 and 3.5 per cent a year thereafter. This comes with the caveat that reality is never so smooth, and the Australian economy has not performed that well over a six-year period since 2004. That's not to say it can't do so again, but a lot would have to go right for it to happen. Adopting the right economic policies gives us the best chance; without them we are entirely dependent on good luck. Even with a recovery as depicted in the chart, the total GDP shortfall from trend over six years would be $500 billion, or a quarter of 2019 GDP.

Illustrative Post-pandemic Recovery Path
(Real GDP as index numbers; 2019 = 100)



Economic framework: markets or the state?

The road map for sustained economic recovery described in this paper works within an economic system of free markets, globalism and moderation in taxation and regulation accompanied by a safety net of social benefits. The pandemic was not caused by the economic system, nor does it alter the fact that the 'capitalist' or 'free market' system has proven through history to be the best in delivering widespread improvement in living standards and reductions in the incidence of poverty. Indeed, if pandemics are to happen, then strong economies, strong public finances and high standards of living provide the best platform for dealing with them.

The Australian economy and the global economy have not performed up to expectations since the Global Financial Crisis, but those who rushed to conclude the free market system is to blame need to recognise that it has been handicapped by regulation and poor economic management, and that globalism has been reined in since its pre-GFC heyday. The picture often painted of unrestrained laissez faire capitalism and unfettered globalisation is a fiction.

The state has been in the vanguard of the response to the Covid-19 pandemic with greatly increased levels of public expenditure and extreme intervention. Some of this was inevitable, but the course of events we have seen doesn't mean that bigger government and more government intervention are the correct prescriptions for all time. As The Economist put it recently:

> "But the current expansion of the state does not represent a philosophical conversion to the case for revolution. It is a pragmatic response to a unique set of problems: a combination of Keynesian demand management to boost the economy, time-limited intervention to prevent industries from collapsing and a basic income for workers who are temporarily laid off."[6]

These observations should be kept in mind when calls for revolutionary change are heard in responses to the pandemic. In part, this is just opportunism from those who have long called for the overthrow of free markets and globalism – and the responses to them should be as critical as ever. But the pandemic, in its unique way, has fostered new thinking about safety, security, robust public health systems, self-sufficiency and a stronger state.

It may well be that lessons learned from this crisis will lead to better and faster ways of responding to future such outbreaks, stockpiling of personal protective equipment and investment in domestic capacity to produce certain key items of equipment. The parallel in the aftermath of the last global crisis — the Global Financial Crisis of 2008-09 — was action by many countries in an internationally coordinated fashion to make their financial systems more secure through increased minimum bank capital requirements and the like.

However, it is a very long leap from measures of that kind to fundamental changes to the economic system; such as repudiation of globalism or adoption of a universal basic income. We should never lose sight of the improvement in the human condition that the current system — broadly defined as capitalism and globalism — has delivered, and the failure of alternative systems both in theory and in practice. The pandemic has not changed that story.

The sustainable way out of this induced recession is to strengthen the system of markets and open trade and investment by strengthening the incentives for enterprise, innovation and job creation and remove regulatory obstacles. Increasing government intervention, strangling markets and enlarging the welfare state would only make the current crisis worse and ensure prolonged stagnation.

The task for economic policy

Covid-19 business, border and social restrictions created the recession and the nature and scale of the task for economic policy will continue to depend on those restrictions as long as any of them remain in place. The extent to which they remain necessary to suppress the virus is debatable; but it is clear they are suppressing both aggregate demand and supply, and that the economy cannot return to normal as long as they remain in place. Attempting to eradicate the virus would impose unbearable economic and social costs and we must find low-cost ways to live with the virus rather than remaining constrained while waiting for a vaccine that may take years to arrive, if ever.

Bearing in mind that both aggregate demand and aggregate supply (or potential GDP) have taken a hit and need to recover, the task facing economic policy can be broken down into two parts:

- Providing temporary support to aggregate demand through fiscal and monetary policy. However, a very large stimulus is already in place and the issue is not how to add to it or extend it indefinitely but how and when to withdraw it. There are limits to the effectiveness of Keynesian fiscal stimulus and the longer it continues the less positive effect and the greater the longer term negative consequences it has, such as those resulting from the accumulation of public debt.[7]
- Reinvigorating aggregate supply (potential GDP, or productive capacity) through structural policies that will boost labour force participation and employment in the short-term and productivity growth in the longer term. This action is needed to overcome the damage to potential GDP and associated employment caused by the crisis and the economic shut-down. It should go further, however, and aim to boost the anaemic productivity growth that was holding the economy back even before this crisis. Taken far enough, such reforms can lead to stronger and more sustained economic growth than the pre-crisis trend.

The distinction between boosting aggregate demand and productive capacity is somewhat artificial. The two are never completely independent. For example, focusing on productive capacity does not mean aggregate demand is left to languish, as some of the measures to boost supply will also boost demand. This is the case, for example, with policies that succeed in boosting investment and with reductions in tax rates that give households and businesses better incentive for the long-term but also more capacity to spend in the short-term.

Consistent with a switch to the economic fundamentals, the government's emergency fiscal measures — such as JobKeeper — elevated social benefits, and industry assistance of various kinds need to be phased out over the next few months as originally intended. Apart from general concerns about fiscal stimulus outlasting its welcome, some of the emergency measures are having the perverse effect of making welfare dependency more rewarding than a return to work. It is vital that the distortion of incentives not become permanent and that the temporary extra spending not become built into the ongoing government expenditure base and thereby increase future taxes and borrowings.

To the extent further fiscal measures are needed after the emergency measures are removed, they should take a form consistent with the reform agenda to encourage creation of lasting, productive jobs and longer term productivity growth.

The role of fiscal stimulus and the limits to debt

The long history of Keynesian demand management teaches us that in judicious amounts and types, and with deft timing, fiscal stimulus can reduce the magnitude of a downturn and buttress a recovery. However, while automatic stabilisers make a useful contribution, these conditions are rarely met in practice in the case of discretionary stimulus. Typically stimulus money is poorly spent and the timing is wrong. Nor, with reference to the current unique circumstances, can fiscal stimulus substitute for the hibernation of sections of the economy under government dictate.

As for the longer term, as Reserve Bank Governor Philip Lowe recently said:

> "Unless we change something, we're going to have a world of lower growth in Australia. And if that's the world we're in, we can't just resolve that problem by continuing to borrow. Borrow to build the bridge (to recovery), but we can't borrow to address a slower growth world. What we can do is reform …"[8]

What fiscal stimulus undoubtedly does is add to government borrowing, and if large enough it can destabilise the public finances for years to come. In any economic policy deliberations from here on, the elephant in the room is public debt; which in gross terms for the Commonwealth and states combined is likely to rise from its recent level of about 42 per cent of GDP to the high 50s or 60 per cent within the next two years largely as a consequence of the Covid-19 crisis.[9]

However, this does not mean that fiscal policy should hasten to pay down debt, which taken literally means there would need to be large budget surpluses and/or large privatisations. Surpluses are not a realistic prospect for the foreseeable future, and the few sizeable privatisation opportunities available (mostly to state governments) would not make a large impression on the national debt and should be driven primarily by micro-economic efficiency considerations.

However, the public debt burden can be managed: first, by returning budgets to balance whenever economic conditions make that feasible, so that budget operations cease adding to debt year after year; and second, through economic growth, which will lighten the burden of a given dollar value of debt provided economic growth is at a faster rate than the interest rate paid on the debt. At current very low interest rates — and even at somewhat higher rates — this condition should be easily met once an economic recovery gets under way and if it is a long-lasting recovery sustained by economic reforms. However, if interest rates were to spike sharply for whatever reason — such as an upsurge in inflation — reducing the debt burden would suddenly become a more pressing issue.

It was essentially economic growth over many years rather than budget surpluses that reduced the burden of very high public debt after World War II, although the process was aided by policies of financial repression that kept interest rates artificially low and created captive holders of government debt. Financial repression is neither feasible nor to be recommended in the global economy of today.

Another school of thought derides concerns about high levels of public debt as unwarranted 'austerity' and believes the true limits to debt accumulation to be much higher than previously assessed. This attitude of benign neglect to public debt draws on the experiences of countries such as Japan — which has built public debt up to over 200 per cent of GDP over many years and shows no sign of stopping — and numerous other advanced economies which have gone above 100 per cent of GDP and also show no sign of stopping, including the United States.

Some developed countries with high public debt burdens, such as Greece and Italy, have already demonstrated there are indeed limits to debt. Others like Japan may appear to have gotten away with fiscal profligacy so far, but their economic growth has already suffered. For others, the day of reckoning is still coming. The international experience should not give comfort to advocates of Keynesian fiscal stimulus in large and repeated doses. In any case, Australia has its own circumstances which don't necessarily accommodate a level of debt that other countries might be able to carry without economic dislocation resulting.

Key elements of economic reform

As Gary Banks, the former Chairman of the Productivity Commission, has put it recently, "The reforms that are most needed right now are ones that can support job creation in the short-term, while simultaneously contributing to higher productivity growth in the longer term".[10] Banks went on to identify as reform priorities the regulatory impediments to innovation — not only technology adoption but enabling investment and enterprise adjustment generally — and features of the industrial relations system that impede business adjustment and job creation. Firms must be able to adjust to the permanent or long-lasting changes in their markets wrought by the pandemic.

These are the priorities, but numerous reports by and for governments over many years have identified a larger number of targets for economic reform. These are illustrated by the list in the box below.

The reform agenda

- Tax and transfer policies to reduce the disincentive to saving, investment, innovation, entrepreneurship and job creation. As explained by Bennett, Makin and Potter,[11] company income tax has a crucial part to play here.
- Reviews of government expenditure programs to reduce wasteful, ineffective and low priority spending, thereby curbing the growth of government expenditure and providing extra fiscal headroom for lower taxes and bringing forward the return to balanced budgets — as explained by Makin.[12]
- Changes to federal-state financial relations that respect the basic principles of federalism.
- Reforms to education and training to reverse the slide in school outcomes and address shortages in technical skills.[13]
- Building an enterprise bargaining system as the cornerstone of the industrial relations system with a simplified award system limited to the role of a backstop.[14] Enterprise bargaining needs to be capable of delivering job creation in the short-term along with higher productivity over time.
- An energy policy that makes possible low cost and high reliability.
- Open trade and foreign investment policies, reduced protection and leveraging Australia's international influence to resist global protectionist tendencies and promote multilateral trade liberalisation.
- Productivity-enhancing infrastructure. This does not necessarily mean more government spending on infrastructure — much of which is already taking place at the state level — but more careful selection of projects according to cost/benefit criteria and more participation by the private sector.
- Streamlined governmental project approval processes so that investors are not left waiting interminably for the go-ahead.
- Deregulation — but too often this is promulgated as a generalisation rather than a list of specific actions.[15]

None of the above will be easy to achieve. When people say 'don't let a good crisis go to waste', they mean that a crisis atmosphere can make it easier for governments to make policy reforms that were needed anyway, even before the crisis. But there is no guarantee a crisis will lead to positive reform — it can just as easily result in further policy deterioration.

Crisis or no crisis, achieving sufficient support to secure particular reforms still requires government and other stakeholders to make a compelling case.

The list is long and it would be unrealistic to expect every element of such a comprehensive reform program to be put in place quickly. Indeed, seeking to move on too many reform policies at once can reduce the chances of success with any of them. This is why the identification of priorities — as above — is so important; action on these should be taken in the remaining months of 2020.

With the right selection of reforms, early results should be expected. The mere demonstration of clear intent by governments to embrace such an agenda would be a fillip to business confidence and investment. But the policies themselves can also produce quick results in job creation, investment and new business formation.

It is also the case that some reforms would take time to be fully implemented and take more time for the full benefits to investment and productivity to accumulate. But this is just what the economy needs — fuel for a multi-year performance uplift, not a short-term sugar-hit that soon fades, leaving underlying weaknesses to reassert themselves. Short-term results aside, a comprehensive reform agenda offers the best prospects for a sustained recovery that lifts the economy back to potential in the medium term and enhances that potential in the longer term.

Conclusion

Even before the pandemic struck, the Australian economy was under-performing its potential and in need of reinvigoration. Policy changes that were previously desirable have now been rendered crucial by the pandemic. The shock to the economic system since March has been so profound that it will have long-lasting effects. Recovery will inevitably be measured in years, but the right policies can speed it up. This involves transitioning from fiscal stimulus and increased government borrowing to structural reforms that will support job creation in the short-term while simultaneously contributing to higher productivity growth in the longer term.

Endnotes

1 World Bank, Global Economic Prospects.

2 Terrence O'Brien and Robert Carling, *Policies against Covid-19: Reflections on the way in and the way out*, CIS Occasional Paper, forthcoming.

3 Data from Labour Force, Australia, May 2020, ABS cat no 6202.0; except the last point, which is an estimate by Mark Wooden as reported in Australian Financial Review, 23 June 2020.

4 Martin Wolf, Financial Times, 10 June 2020.

5 Blaise Joseph, Pain without gain: Why School Closures are Bad Policy, CIS Policy Paper 28, May 2020.

6 Bagehot column, The Economist, 4 April 2020.

7 Tony Makin, A Fiscal Vaccine for Covid-19, CIS Policy Paper 30, June 2020.

8 Remarks during Australian National University Crawford Leadership Forum, as reported in Australian Financial Review, 23 June 2020.

9 Robert Carling, State Finances after the Pandemic, CIS Policy Paper 29, May 2020.

10 Gary Banks, 'A job-killing IR system has to go', Australian Financial Review, 4 May 2020.

11 Jeff Bennett, Michael Potter and Tony Makin, *Lower Company Tax to Resuscitate the Economy*, CIS Policy Paper 31, 6 July 2020.

12 Tony Makin, as above.

13 Blaise Joseph, Overcoming the Odds: A study of Australia's top-performing disadvantaged schools, CIS Research Report 39, March 2019; and Getting the most out of Gonski 2.0: The evidence base for school investments, CIS Research Report 31, October 2017.

14 Judith Sloan, CIS Policy Paper, forthcoming.

15 Gene Tunney, CIS Policy Paper, forthcoming.

About the Author

Robert Carling

Robert Carling is a Senior Fellow at the Centre for Independent Studies, an independent public policy research and educational institute based in Sydney. He undertakes research into a wide range of public finance issues and regularly comments in the media on taxation and other budget issues. Before joining the CIS, he was a senior official with the New South Wales Treasury and before that, with the Commonwealth Treasury.

Acknowledgement

I am grateful to Gary Banks for comments on a draft of this paper, while remaining responsible for the views expressed and any errors.

Related Works

Jeff Bennett, Michael Potter and Tony Makin, *Lower Company Tax to Resuscitate the Economy* (CIS Policy Paper 31, July 2020)

Tony Makin, *A Fiscal Vaccine for COVID-19* (CIS Policy Paper 30, June 2020)

THE CENTRE FOR INDEPENDENT STUDIES

POLICY Paper 32 (PP32) • ISSN: 2209-2447 • ISBN: 978-1-925744-57-6

Published July 2020 by the Centre for Independent Studies Limited. Views expressed are those of the authors and do not necessarily reflect the views of the Centre's staff, advisors, directors or officers.

This publication is available from the Centre for Independent Studies. Visit **cis.org.au**

Level 1, 131 Macquarie St, Sydney NSW 2000 • **phone:** 02 9438 4377 • **email:** cis@cis.org.au