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The Costs of Covid: Australia's Economic Prospects in a Wounded World

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THE COSTS OF COVID: AUSTRALIA'S ECONOMIC PROSPECTS IN A WOUNDED WORLD

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EXECUTIVE SUMMARY

Australia is emerging from the pandemic sooner and at less economic cost than widely expected, but with higher unemployment and elevated debt. As the pandemic recedes, it is evident that global output and demand will recover slowly and unevenly. Major advanced economies have sharply increased government debt and their central banks have driven interest rates to rock bottom while buying big shares of additional government debt. At the same time, the US–China quarrel has become more intense, and Australia's relationship with China has deteriorated. All these changed circumstances, much amplified and extended from their pre-pandemic appearances, limit Australia's choices.



Image: Getty/JethuynhCan

INTRODUCTION

After infecting more than 23 000 Australians and killing over 420, the coronavirus pandemic in Australia is fading sooner and with less economic damage than expected. While the secondary wave of infection in Victoria is a big setback and there may yet be other regional or local outbreaks, the economic recovery already evident is set to continue. Reckoning total COVID-19 fatalities compared to population at less than one thirtieth of the US or the UK rate, the handling of the crisis by Australian governments, hospitals, health care workers, and public officials has been more successful than in some comparable countries. So too, the economic response has been swift, well targeted, and substantial.

Australia must now continue to recover in a global economy markedly less congenial than it was before the pandemic. Australia's economic policy choices are constrained by the economic policy choices of larger powers, its economic growth trajectory constrained by their degraded growth trajectory, and its international engagement constrained by the increasingly combative relationship between the two biggest national economies — the United States and China. Like many other open economies, Australia has benefited from decades of increasingly liberal global trade and investment. The emerging post-COVID world will likely be less open and less liberal, permitting Australia fewer options and requiring choices that are more difficult.

Even within its own economy, the damage is substantial, and will have lingering effects. The International Monetary Fund (IMF) expects Australia's economy to do much better than most advanced economies. Yet the output loss compared to the outlook before COVID-19 will likely exceed \$160 billion.¹ Measured as Gross Domestic Product (GDP) per head, Australia's average living standards are falling and will take several years to return to the pre-pandemic level. The number of unemployed will soon exceed 1.3 million. With falling revenues and rising spending, the Australian government budget deficit is heading to a new record peacetime high, more than doubling the recent record deficit for the 2019/20 financial year. By the end of this decade Australian government debt as a result of the pandemic may well be more than half a trillion dollars higher than it would otherwise have been.² Business and household debt are also increasing. In a striking expansion of its writ, the Reserve Bank of Australia (RBA) has so far more than doubled its holdings of government and private debt since

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the beginning of the pandemic and asserted control over medium-term government bond rates as well as the overnight or cash rate.³

While Australia has escaped the worst of the economic impact, much of the rest of the world has not. It will take time before business investment plans can be confidently implemented, households become less cautious, foreign students once again enrol in Australian institutions, international tourists return, migration restarts, and overseas travel resumes.

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For all these reasons it will take the rest of this year and most of next to get Australian output and employment back to where they were in December 2019, a time when there were already 700 000 people looking for jobs. Meanwhile, more new entrants will also be looking for employment, along with those laid off from businesses that could not survive the eruption of the pandemic. By July 2020 there were already over a million people unemployed. In its Statement on Monetary Policy, released 7 August 2020, the RBA plausibly forecast unemployment peaking at 10 per cent, or well over 1.3 million people by the end of 2020, and to be not much lower in the middle of the following year.⁴



Queue outside a Centrelink office in Melbourne on April 20, 2020.
Image: Getty/William West

THE ECONOMIC AFTERMATH

As the immediate health emergency becomes more localised and sporadic, it is evident that the pandemic will change the political and economic debate in Australia. Stubbornly high unemployment will now be a central issue in the next election, likely to be in 2022 — the first time unemployment will play such a pivotal role in an Australian election in over a quarter-century. This issue will pose a choice between the rapidity with which increasing government debt can be reined in, the speed at which jobs can be created and unemployment reduced, and the degree to which long-proposed changes to the tax structure and industrial relations can be pressed in the name of pandemic recovery.

While unemployment will be the principal domestic problem, the changing global context will also shape the Australian economy for years to come.

Global output will, for years to come, be lower than it would otherwise have been. On IMF forecasts, the economic contraction in the United States, the whole of the Euro area, the United Kingdom, and Canada will be twice that of Australia.⁵ The impact for Australia of lower global demand and production is mitigated because three-quarters of its goods exports are to East Asia, a region that is growing faster than Europe or the United States and which, in most cases, has handled the pandemic well. While world output will contract nearly 5 per cent in 2020 on IMF forecasts, developing Asian countries will contract by less than 1 per cent. Korea's output will contract somewhat less than Australia's, Japan's somewhat more. China's output, on these forecasts, will actually increase — a projection already supported by its economic growth in the second quarter of 2020.

While Australia's economic integration into East Asia will support its recovery, it also heightens the tension in its foreign relations. The East Asian economy to which Australia sends such a high proportion of its exports is centred on China — by far its biggest player. For most East Asian economies, including Japan, Korea, Taiwan, the ASEAN group, and certainly Australia, China is their largest trading partner.

Because the East Asian economy will perform much better than Europe or North America, Australia's economic integration into the region will likely increase as a result of the pandemic.

Yet at the same time, the period of the pandemic has corresponded with a further deterioration in Australia's engagement with China. This discord could have a far greater impact on Australian security and prosperity than COVID-19. Even without the worsening of Australia–China relations, the larger trade and technology altercation between America and China threatens the global openness of trade and investment upon which Australia's prosperity depends. The pandemic has made this quarrel more intractable, threatening to draw Australia deeper into the dispute, despite the Prime Minister's 2018 insistence that "Australia doesn't have to choose, and we won't choose" sides in the US–China trade and technology war.

...(Australia's) trade is focused on East Asia but financial flows, and sentiment and pricing in its financial markets, are far more influenced by the United States, Europe, and Japan.

The pandemic has also imposed new global constraints on Australia's economic policy options. Its trade is focused on East Asia but financial flows, and sentiment and pricing in its financial markets, are far more influenced by the United States, Europe, and Japan. The United States and the United Kingdom alone account for nearly half of foreign investment in Australia, and well over half of this investment is in liquid securities.⁶ In Europe, North America, and the United Kingdom the COVID-19 impact has been more severe, and the effects will be more protracted. In the decade before the pandemic, the United States, Europe, and Japan accepted rising government debt, very low interest rates, and unprecedented purchases of government debt by their central banks as the only feasible response to slow growth and financial fragility. Responding to the pandemic, interest rates were pushed even lower, government budget deficits and debt have increased even more rapidly, and central banks have bought increasing quantities of their government's bonds. In major advanced economies, the pandemic has locked in a policy combination that had previously been excused as temporary.

Though Australia is exiting the pandemic with lower government debt than many other advanced economies, and though its central bank has acquired less of this debt than have some other advanced economy central banks, Australia cannot escape the consequences of increased government debt elsewhere. Unless it is prepared to accept a dramatic appreciation of the foreign exchange value of the Australian dollar, the RBA must reconcile itself to sustaining very low interest rates for a very long time. It must also resign itself to keeping additional government debt on its balance sheet, and perhaps to buying a good deal more debt to prevent a sharp increase in long-term interest rates and the Australian dollar. Having sensibly ruled out a negative cash rate or a lower ceiling rate on three-year bonds, the RBA's active policy instrument is now the amount of Australian government debt it buys.

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Over the next few years the RBA may well need to reach an understanding with the Australian government on the amount of debt it is willing to buy and hold on its balance sheet. Preventing a widening gap between long-term Australian bond rates and long-term US bond rates, which would put upward pressure on the Australian dollar, will become a serious policy concern.



Reserve Bank of Australia Governor Philip Lowe on 19 March 2020, announcing an official interest rate cut to a record low of 0.25%.

Image: Getty/Brendan Thorne

Unable to either raise or lower short-term interest rates, the RBA is otherwise sidelined. The full weight of managing unemployment inevitably falls on fiscal policy, and therefore on the Australian government. While this represents a formidable fiscal challenge, it is well within Australia's means to manage the interest expense of the additional debt. It would be a mistake to aim for a rapid reduction of deficits at a time of high unemployment and fragile public sentiment. Instead, the Australian government needs to find useful ways to extend deficits created by temporary spending.

The policy principles selected by the Australian government to deal with the aftermath of the pandemic depend not only on the economic consequences of the crisis itself, but also on the interpretation of Australia's economic experience prior to the pandemic. Widely regarded as unsatisfactory in recent years, Australia's economic performance was already under intense scrutiny before the emergence of COVID-19. It showed signs, Prime Minister Scott Morrison says, of 'sclerosis'.⁷

The condition of the Australian economy before coronavirus is important because the post-COVID Australian economy is in most respects the same one Australia possessed in January 2020. There is certainly higher unemployment, higher government debt and deficits, the Reserve Bank's balance sheet is bigger, interest rates are lower, and global output growth will be slower. However, the buildings, machines, mines, farms, offices, and transportation are all the same as they were. Technology is unchanged. Australians have the same skills they had previously, the same work routines, the same ambitions and expectations.

Whatever was good and bad about the Australian economy in January 2020 is also good and bad today. The problems presented by the pandemic — unemployment, rising debt levels, low interest rates in advanced economies, and the US–China quarrel — are mostly amplifications of problems that existed prior to the COVID-19 crisis. Yet the experience of the years before did not point to structural problems in the Australian economy, or to persuasive evidence the 29-year run of uninterrupted growth was faltering. In the three or four years prior to the emergence of the novel coronavirus, Australia had experienced weak growth in household consumption and business investment, and unsatisfactorily high unemployment levels. It faces the same problems now, but on a bigger scale.

The manner in which debates about the pre-COVID economy and the post-COVID recovery path are merged will determine policy prescriptions, the political contest, and whether Australia's striking success in containing the virus also extends to mitigating its consequences.

Despite its achievements in containing the health and economic impact of the pandemic, Australia faces several problems in the aftermath. One is the exit strategy from the pandemic. Another is negotiating what will be for many years a more constrained global economy. How quickly and in what stages should the federal government reduce its budget deficit, and the Reserve Bank lift its cap on government bond rates (and buy a smaller share of new government debt)? How ready is business to wean itself off the \$100 billion of emergency payroll and debt support and return to normal commercial decision-making? How rapidly could or should Australia revive its tourism industry, and again invite students from abroad to attend its schools, vocational colleges, and universities? How will the pace of recovery elsewhere constrain Australia's goods exports? How should Australia comport itself in the quarrel between the United States and China?

A SAVAGE BUT SHALLOW SHOCK

The COVID-19 pandemic from which Australia is now emerging was the most abrupt, savage, and frightening economic shock in the lifetime of most Australians. But the jolt was also short and unexpectedly shallow. It produced a deliberate cessation of certain activities, some brought about by government, and others by people's fear of infection. The headlines announcing plunging output, rising unemployment, and plummeting retail sales — indicators that would in other years have portrayed an alarming and sudden economic slump — did not carry the same message in this new environment. These numbers meant government edicts were being observed, that social distancing and partial lockdowns were working, and that policies to suspend activities likely to spread infection were effective.

The big spending response by government, changes to the law to minimise bankruptcies, as well as timely and aggressive financial market support from the Reserve Bank, combined to minimise the financial dislocations and business failures usually revealed in sharp economic downturns.

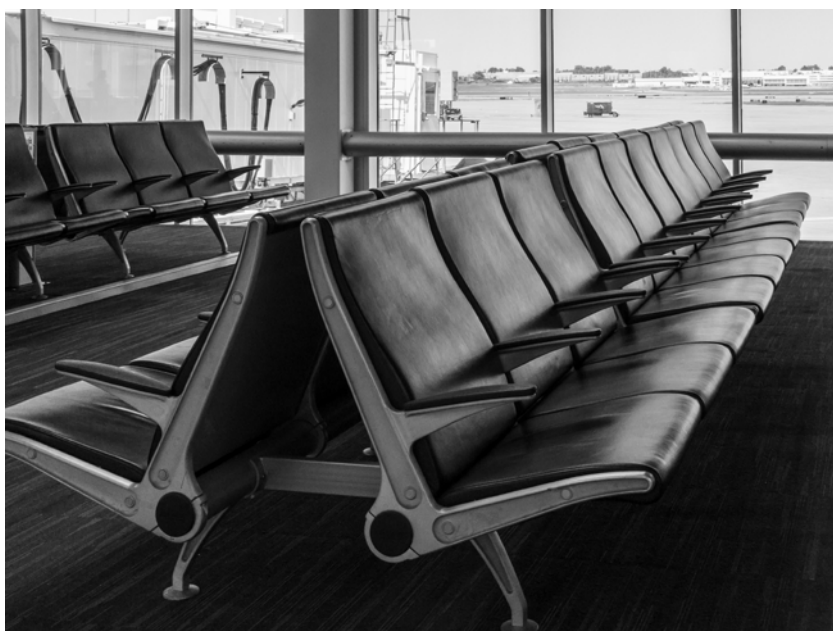
Through the four months of what was widely portrayed as a general economic cessation, a large proportion of Australian employees kept working. New networking technologies permitted most office work to be performed at home. Mining and farming continued. So did much of manufacturing and construction. Electricity, gas, and water utilities employees kept their jobs. Throughout Australia, public servants continued working, often at home. Tradespeople, cleaners, and gardeners more often than not were working. Most health employees remained on the job, busier than ever. Childcare facilities remained open in most places and, where necessary, classroom teaching continued remotely. Media workers struggled to keep up with the demand for news and entertainment.

The economic cessation, such as it was, centred on restaurants, clubs, pubs and accommodation, discretionary retail such as clothing and furniture, local and international travel, sports, entertainment, and the arts. Take-up of the JobKeeper program, which helped businesses retain employees, was far lower than expected because the economic damage was less than expected. All up, most of the Australian workforce remained on the job, either from their usual place of work or from home. As RBA Assistant Governor Luci Ellis noted in a recent

speech, most of the economic downturn took the unusual form of a sudden cessation in household consumption.⁸

While the Australian economy is recovering, many countries — including the United Kingdom, Brazil, much of Europe, and the United States — have suffered far worse damage and face more daunting problems. For Australia, which sells a quarter of its output to other countries, the impact of slower growth elsewhere is mitigated by the high proportion of goods it exports to East Asia, the region that has shown most progress in beating the virus. On the data so far, Australian goods exports have fallen much less than goods imports.⁹ Australia's trade surplus widened during the pandemic, helping support GDP and employment.

While it is true colleges and universities have been hurt by the suspension of foreign student arrivals, the majority of international students living in Australia before the pandemic stayed.¹⁰ Indeed, many of them had little choice. Quarantines will remain necessary, but plans are now being made to permit the resumption of student arrivals.



*More than nine million foreigners, mostly tourists, visited Australia in 2019.
Image; Flickr/Jonathan Cutrer.*

More than nine million foreigners, mostly tourists, visited Australia in 2019. The number arriving since March 2020, when the country's borders closed, is scarcely worth counting. The resumption of mass foreign travel, unimpeded by quarantine, awaits not only the discovery and approval of a COVID-19 vaccine but also its distribution in millions

of doses. In the short term, however, the suspension of normal international passenger travel adds to Australia's recorded GDP. In any one year there are many more Australians visiting abroad than foreigners visiting Australia.¹¹ Australian spending abroad is a minus in the national accounts, foreign spending in Australia a plus. If both inward and outward streams stop, as they have, Australia comes out ahead.

Between March and May 2020, Australia experienced what compared to previous downturns was an astonishingly swift decline in economic activity. Hours worked — the best measure of the immediate employment response — fell by a little more than 9 per cent between March and April.¹² The following month, the additional decline in work hours was less than 1 per cent, suggesting that even then the decline was already bottoming out.¹³ In June, the number of hours worked rose 4 per cent on May, signalling that output and employment were on the way up. Signalling a slowdown in the jobs recovery, July hours worked rose only 1.3 per cent over June. Yet grave as the decline had been, at its worst it was roughly a tenth of economic activity, and only for one month. Even so, the number of hours worked in July 2020 was 5 per cent down on July the previous year, confirming that jobs and production had a way to go to return to pre-pandemic levels. The coronavirus flare-up in Melbourne and the restrictions to combat it will see more weakness in employment and hours worked over the next month or two, but the rebound in employment and hours worked will likely continue in the rest of the economy.¹⁴

Yet grave as the decline had been, at its worst it was roughly a tenth of economic activity, and only for one month.

Because there were 700 000 jobseekers even before the pandemic, because there are meanwhile new entrants looking for jobs, and because some big employment industries such as tourism will make a slow comeback, unemployment will increase even as output growth recovers.

In its 23 July Economic and Fiscal Update, Treasury pointed to “noticeable recovery in economic activity” already evident. It expected that the recovery would be underway from the September quarter, after a 7 per cent decline in GDP in the three months ending June 2020, compared to the previous quarter. Over the whole of 2020, Treasury forecast that the economy would contract by 3.75 per cent (compared to the whole of 2019), before growing by 2.5 per cent in 2021. In its 7 August update, which takes into account the setback in Melbourne, the RBA expects GDP to decline by 6 per cent comparing output in the December quarter of 2020 to output in the December quarter of 2019, and then to expand by 5 per cent in the year to the December quarter

of 2021. In this forecast the unemployment rate peaks at 10 per cent of the workforce by the end of 2020, and is still 9 per cent in the middle of 2021.¹⁵

As was already evident in the prime minister's National Press Club speech of 26 May, the government recognises unemployment as the biggest policy and political problem arising from the pandemic.

THE PRE-COVID ECONOMY

Selecting appropriate recovery policies is all the more difficult because the Australian economy was not performing well before the pandemic. It raises the question of how much Australia should focus on 'structural' changes that might remedy an underlying problem in the hope that faster long-term growth will reduce unemployment arising from the pandemic. Determining the scope and severity of that underperformance is an important part of designing the recovery plan.

Struck down by the pandemic, Australia's celebrated record of almost three decades of uninterrupted prosperity probably ended sometime in May 2020. In the 29 years prior, output had doubled, as had household income per head. After starting behind the United States and Japan in 1991, by 2018 Australian per capita income (measured in constant US dollars) exceeded both — and had drawn further ahead of Germany.¹⁶ Despite signs of fading economic success, by 2019 the average Australian commanded almost seven times the wealth of Australians thirty years earlier — though distributed more unequally.

However, by the time coronavirus arrived, the best of Australia's long upswing was over. In the ten years to the end of 2019, the average income of Australians had increased more slowly than in any ten-year period in over half a century.

It was not that things were bad in the opening months of 2020. At 5.2 per cent, the unemployment rate was above the 4 per cent low reached in early 2008, but well below the average of the entire long upswing, and also the average of the last ten years. Measured as average income per head, living standards were higher than ever.

And while the slowdown was undeniable, it was evident that many problems that had troubled Australia in past decades had diminished, or vanished. Australian policymakers had long been concerned about low national savings — one of the reasons the country ran large and persistent deficits with the rest of the world. In 2019, to general amazement, Australia found itself not only with a substantial surplus of exports over imports, but also with a current account surplus. It was the first current account surplus in nearly half a century. At not much less than a quarter of GDP, gross national savings was just below its post-GFC peak, but otherwise higher than it had been for thirty years. Economic problems that had troubled generations of Australians had simply disappeared, unremarked.

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Nor did the economy show convincing symptoms of the 'sclerosis' later discerned by the prime minister.¹⁷ Despite bushfires and floods, employment growth was firm. The number of jobs, the ratio of jobs to population, and the rate of participation in the workforce were all at or near record highs.¹⁸ Output had expanded by over 2 per cent in 2019 — slower than the average of recent years, but very far from a recession. In February 2020, even as reports of a serious epidemic emerged, Australia's share market reached a record high.

It was certainly true that measured in current or 'nominal' dollars, business investment as a share of GDP was back down to where it had been in 1991, when Australia was recovering from a deep recession. True also that productivity growth had slowed, that household debt had reached a new peak of 180 per cent of household disposable income, and that the division of national income had shifted more towards profit and away from wages.

All true — but also misleading. Current dollar business investment in 2019 was indeed the same share of GDP as in 1991. But this was only because the huge increase in export prices in those thirty years had inflated GDP but not investment. Removing inflation from both investment and GDP, business investment as a share of GDP was twice as high in 2019 as it had been in 1991 (Fig. 1A, following page). Excluding mining investment, real (or after-inflation) business investment in 2019 was at a record high (Fig. 1B).

There is no doubt about the rise in household debt, mostly to buy homes. It had indeed reached 180 per cent of household disposable income in 2019 — a formidable number.¹⁹ But while household debt had never been higher, the interest rates paid on it had never been lower,²⁰ so the share of household income paid as interest on household debt was the same as in 2002. High household debt was not the reason for slow consumption growth. For its part, business debt in 2019 was lower compared to GDP than it had been ten years earlier. Australian government debt had risen as a share of GDP, though by 2019 the increase had crested as deficits dwindled.²¹

While the wages share of national income continued to decline (and the profit share to increase; a trend over decades), the decline was not as big as it appeared and probably did not show that owners of capital were appropriating an unfair share of productivity growth.²² Much of the apparent change was due to the increased importance of the mining industry in Australian output in recent years.

Figure 1: Business investment

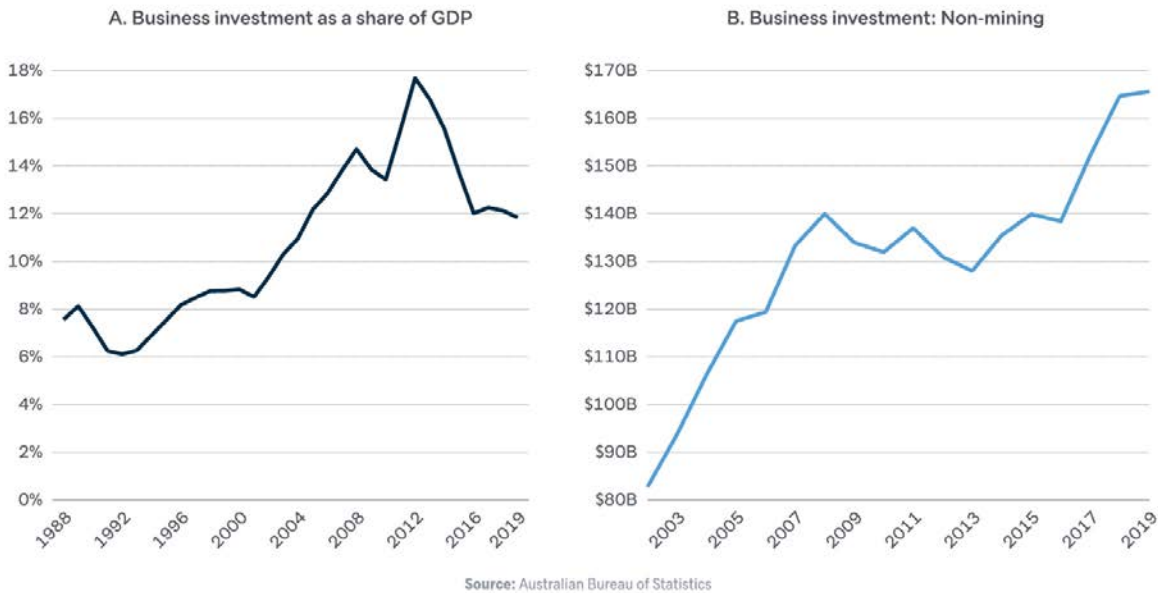
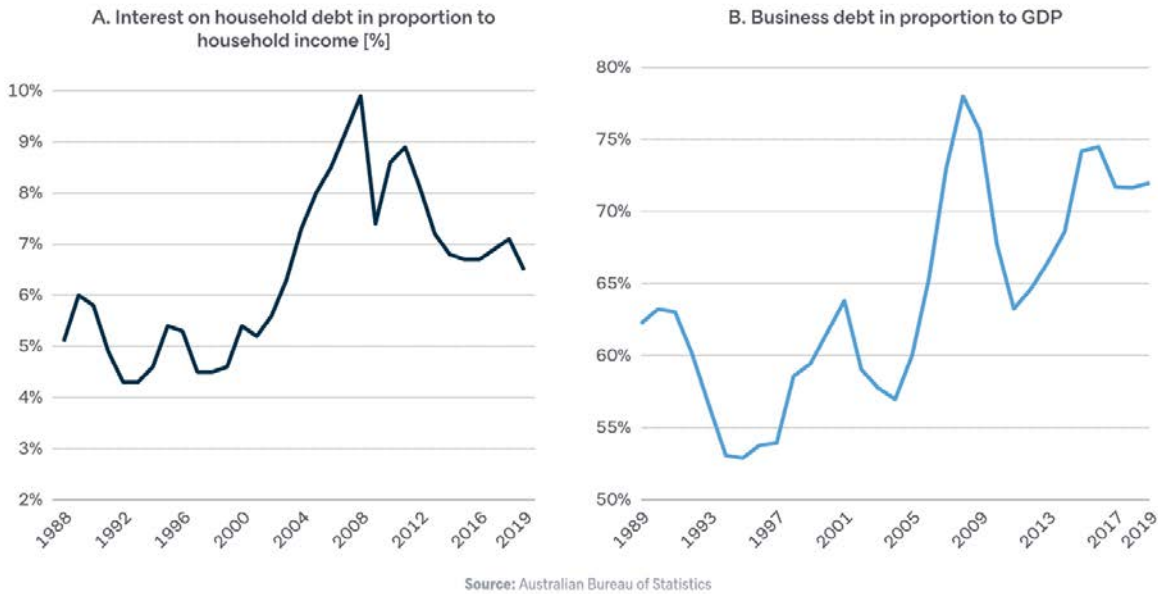


Figure 2: Comparing household and business debt



Since employment growth accelerated while output growth declined in the six years to 2019, it is evident that the principal cause of slowing growth in real incomes, wages, and output was declining growth in output per hour worked, or labour productivity. If we knew the reasons for this shift, we would already be well on the way to dealing with it, but we do not. As the Productivity Commission sensibly reported in early 2020, the slowdown is concerning but, “Such high-level productivity measures rarely provide guidance to policy makers about specific problems to target.”²³

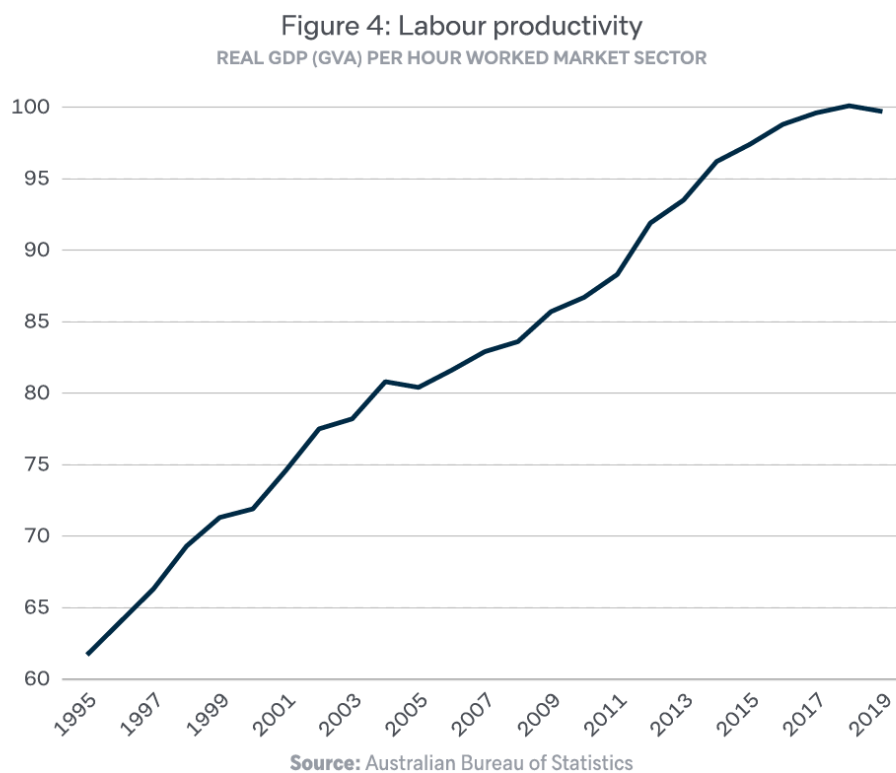
Figure 3: Wages and profit shares of factor income



We do know that the recent slowdown in productivity growth began around 2012/13, that it is apparent in most advanced economies, and that the Australian slowdown is less marked than most.²⁴ We know that it is not uniform across the Australian economy and that some industries such as mining, retail trade, recreation services, and administrative services in the market sector have seen quite strong increases in productivity, while others such as agriculture, construction, and the electricity, gas, and water utilities have not. It is evidently not an economy-wide problem.

The causes of the productivity slowdown are unlikely to include the level or structure of tax in Australia, or the structure of industrial relations, both of which have the same shape today as they did in the decade before the slowdown. Nor does research and development

spending explain slower productivity growth. Though lower as a share of GDP than ten years earlier, research and development spending as a share of GDP in 2019 was nonetheless markedly higher than it had been in most of the first decade of the twenty-first century, when productivity growth was higher.²⁵ There are no doubt improvements we can and should make in these areas, but they are unlikely to contribute much to productivity growth and particularly not in the next couple of years.



Nor was the slowdown in GDP growth in the four or five years before the pandemic startlingly big. The difference in average annual growth between the seven years up to and including 2012 and the seven years up to and including 2019 was a little less than half a percentage point.²⁶ This is well within the range of the usual business cycle fluctuations in output growth in a market economy. Sometimes an increase in demand in one major spending sector in an economy will offset the decline of another, a relay race often observed in Australia's 29-year upswing. Sometimes important categories turn down at the same time, though for different reasons and without suggesting an underlying failure. The simultaneous slowdown in business investment, home building, and

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household consumption over the four years preceding the pandemic was to some extent an unfortunate conjunction rather than an indication of economic sclerosis.

This interpretation of Australia's economic experience suggests that prior to the pandemic, Australia was not encountering a long-run economic problem. Unemployment and underemployment were troubling, but well down on the highs experienced earlier in the upswing, while the labour force participation rate was near a record high. Though business investment overall was flat for the last three years of the upswing, non-mining business investment had risen to a reasonably high share of real GDP compared to previously. Household consumption had fallen a little as a share of GDP, though it had increased as a share of household disposable income. Wages growth was slow, but was close to productivity growth. Inflation was persistently below the RBA's target band, but while that was a problem for the RBA as an institution, it was not of itself a problem for the economy. What is wrong, after all, with low inflation?

Things could have been better, but there was nothing much wrong with the Australian economy in early 2020 that a relatively small upswing in investment and consumption, and a bit more productivity growth, would not have fixed. There are certainly ways to improve performance in many areas of the economy, including industrial relations, federal-state relations, workforce training, and health care funding and delivery. However, none of these reforms will have a significant impact on the major problem now facing Australia.

The Australian economy is slowly returning to the output and employment levels it attained in 2019. How soon it exceeds those levels and how quickly it then continues to grow depends on the skill and boldness of government and Reserve Bank actions, on the return of confidence to investment, on the pace with which the world economy picks up, and on the discovery and distribution of a vaccine or treatment that will permit unimpeded global travel. Since the economy is so far unencumbered by major financial failures, and the economic cessation in Australia brief and with no loss of work skills or capital equipment, we should expect the recovery to continue.

While output growth will continue, unemployment will for a while increase. Australia's last recession ended in the third quarter of 1991, but unemployment continued to rise for another year and did not head downwards until two years after output had begun to grow. The number of people who had been unemployed for more than a year did not begin

to decline until two years after the recession was over. There is a real risk that elevated unemployment numbers created by the circumstances of the pandemic, added to existing unemployment and new workforce entrants looking for jobs, will turn into high and chronic long-term unemployment. That will bring with it decaying work skills and motivation, declining living standards for the jobless, eroding social and family solidarity, and the destruction of life opportunities for a generation of children in jobless families. Mitigating long-term unemployment is expensive, typically requiring case counselling, wage subsidies, and retraining as well as budget support for overall economic demand. Can Australia afford it?

DEBT: SUSTAINABLE, UNAVOIDABLE, AND NECESSARY

Only the shock of Japan's Pacific conquests in 1941 and early 1942 had more financial impact on the Australian government than the COVID-19 crisis. The Australian government expects pandemic support through JobKeeper and other programs, plus the downturn in tax revenues, will create an underlying budget deficit of \$85.8 billion in 2019/20 and \$184.5 billion in 2020/21, equivalent to roughly 14 per cent of 2019 GDP.²⁷ Wage subsidies alone will account for half of the spending support, with the rest going to investment incentives, other household income support, residential construction subsidies, cash flow support to businesses, arts subsidies, and so forth. There will likely be more spending to come as the government responds to rising unemployment.

The annual servicing cost of the additional debt is around \$3 billion, or about 0.5 per cent of Australian government spending.

Since the Commonwealth had only just returned to balance, all of the additional spending and revenue shortfalls will appear as deficits. After adjusting for some cash items not included in the underlying cash balance (such as students loans and NBN costs), the headline cash deficit is expected to be \$94 billion in 2019/20 and \$209 billion in 2020/21. That \$303 billion, or around 15 per cent of GDP, is the additional amount the Commonwealth needs to borrow to meet the deficits of 2019/20 and 2020/21. It will increase Commonwealth net debt, given as \$373 billion in 2018/19, by 80 per cent.²⁸

It is a daunting number, but well within Australia's capacity to sustain. At today's interest rates and assuming the debt is funded by ten-year Australian government bonds, the annual servicing cost of the additional debt is around \$3 billion, or about 0.5 per cent of Australian government spending.

To the extent the RBA buys Australian government bonds, the cost to the taxpayer will be less, at least for some years to come. The government owns the central bank, which remits back to the government as its profit much of the bond interest paid by the government. The RBA buys the bonds with money it creates.²⁹

By mid-July 2020 the RBA had more than doubled its holdings of Australian dollar investments compared to the level in late February — an increase of \$126 billion.³⁰ Most of that increase is in Australian

government bonds held either as outright purchases, or as security for loans to banks and other big financial intermediaries.³¹ The increase in the RBA's holding of Australian dollar investments through to mid-July was roughly equal to the additional issuance of Australian dollar instruments by the government over the period, and markedly higher than the government's headline budget deficit for 2019/20. At \$50 billion from March to May the RBA's outright purchases of Australian government bonds were alone equal to not much less than the two-thirds of the additional bond issuance in the financial year 2019/20.³²

The RBA is committed to sustaining a ceiling interest rate of a quarter of a percentage point on three-year government bonds. Their price is closely related to the price of longer term bonds. As more bonds are issued (and the Australian government needs to borrow more than twice as much in 2020/21 as it borrowed in 2019/20), the price of bonds will tend to fall and the interest rate paid on them will tend to rise. To sustain that ceiling, the RBA will probably find itself buying more bonds. Given the trajectory to date, it would not be surprising if the RBA ends up buying bonds equivalent to half of the additional Australian government debt issued since February 2020. That would come close to halving the interest rate cost to the Australian government (and the taxpayer) of the additional debt required to respond to the pandemic.³³

Though the speed of its increase is unprecedented in peacetime, the rise in Australia's additional debt level is well below that expected in some other advanced economies. In April, the IMF forecast that general government net debt in Australia would rise by over 11 per cent of GDP in 2020, reflecting the size of fiscal support announced that month.³⁴ The IMF expected debt so defined would rise another 5 per cent of GDP in 2021. Big as those forecast increases are, they are comparable to those elsewhere, or smaller. United States debt was expected to increase by a formidable 23 per cent of GDP in 2020, France by 17 per cent, Canada by 15 per cent, Italy by 20 per cent, and Japan by 15 per cent.

Australian government gross debt compared to GDP remains well below that of many other advanced economies.³⁵ At an expected 35 per cent of GDP in 2020 (as measured by the IMF, for comparability), it would be slightly more than a third of the expected average of 94 per cent among advanced economies, less than a third of the United States', the average of the G7 (which is puffed up by Japan's 169 per cent), and less than half the average of the Euro area.

Though the speed of its increase is unprecedented in peacetime, the rise in Australia's additional debt level is well below that expected in some other advanced economies.

Australian government deficits will certainly continue beyond the next two or three years, largely due to the lingering impact of high unemployment on spending and of lower employment and wage growth on tax revenues. Even so, on Parliamentary Budget Office calculations, net Australian government debt at the end of this decade may be under \$600 billion. On today's interest rates, the annual interest cost then would be around \$6 billion, or around one-sixth of 1 per cent of nominal GDP in 2029/30. By that year, again using PBO calculations, the budget would be in a small surplus and total Australian government debt would have been falling as a share of GDP for several years.³⁶

The PBO baseline scenario assumes pandemic support spending ends in 2021/22. It will more likely be phased out gradually, adding another couple of hundred billion to Commonwealth debt. On present low government bond interest rates, however, even an additional debt of one trillion dollars by 2029/30 would have an annual interest cost equivalent to less than a third of 1 per cent of GDP, and not much more than 1 per cent of Australian government spending.

The RBA's role in the economy, not long ago confined to pursuing inflation and employment targets, has radically changed.

But that also underlines the sensitivity of the fiscal outlook to the government bond rate. Before the pandemic, the Australian government was paying an average of 2.9 per cent on its debt, or three times the current rate.³⁷ To expect interest on government bonds to remain at or below 1 per cent for a decade assumes that bond holders are willing to indefinitely accept a return below the likely inflation rate — possible but not probable.

The RBA's decision about the amount of Australian government debt it is willing to buy and hold will thus be crucial, because that decision will affect both the rate itself and the net burden of interest payments in the Australian government budget — as well as the foreign exchange value of the Australian dollar. Already the RBA is coordinating with Treasury in its response to the pandemic. Already it has purchased outright (though indirectly) much more than half of the additional bond issuance for 2019/20, and holds as security on cash lending a great deal more.

The RBA's role in the economy, not long ago confined to pursuing inflation and employment targets, has radically changed. A sensible way forward would be a pact or understanding between the RBA and the Australian government in which the RBA undertakes to buy half of additional government debt, and the Australian government undertakes to work towards a return to surplus within a decade. Whether implicit or explicit, whether for half the additional debt or for

a greater or smaller share, this is now the likely direction of the relationship between the fiscal and monetary arms of economic policy. Always close, they have become inseparable.

For now, the real budget problem is not the size of deficits, not the sustainability of debt, nor its additional cost. It is that the additional spending was explicitly temporary. The JobSeeker program has been extended, but only until March 2021 and with reduced payments. If the JobKeeper program is not extended again, or an equivalent amount is not spent on alternative job support or job creation programs, government spending will drop abruptly by something over 5 per cent of GDP in 2021. This at a time when the economy will be fragile, with hesitant business and consumer spending, unemployment still over one million, and an election expected within a year. That is not a serious policy option.

MONETARY POLICY: AUSTRALIA BOUND BY GIANTS

Just as the Australian government has little choice but to continue for some time with the expansionary fiscal stance it adopted in response to the pandemic, so too the RBA has little choice but to continue its expansionary monetary stance. In the RBA's case, it has already and explicitly undertaken to do so.

Because of low rates maintained by the European Central Bank, the US Federal Reserve, and the Bank of Japan, the RBA must also maintain low rates unless it is prepared to accept a substantial appreciation of the Australian dollar.



US Federal Reserve Chair Jerome Powell and Treasury Secretary Steve Mnuchin during the House Committee on Financial Services hearing on the Treasury and Reserve pandemic response, 30 June, 2020. Image: Getty/Pool.

This has become evident in recent months. The RBA has since March successfully maintained a 0.25 per cent ceiling on the three-year bond rate. In January, that rate was 0.75 per cent, or three times higher. The ten-year bond rate, however, has decreased much less than the three-year rate. Since March, the US ten-year Treasury bond rate has fallen below Australia's. So too for the New Zealand and Canadian government ten-year bond rates. At the same time, and not unconnected, the Australian dollar has been appreciating against both

the US dollar and the trade-weighted index, suggesting the offshore buyers find Australian bond interest rates comparatively attractive. Australia will likely be growing faster than the United States, Europe, and Japan over the next few years, as it has for most of the last two decades. It has recently moved into a persistent trade surplus with the rest of the world. Both trends will also support upward pressure on the Australian dollar. Mild now, the Australian dollar appreciation could gain speed and become a problem for Australia's export returns if the bond rate spread between Australia and the US continues to widen. Given that the short-term rate controlled by the RBA is already at rock bottom, its only remaining tool to manage bond rates and the Australian dollar is the amount of Australian bonds it buys.

There are also good domestic reasons to sustain rock-bottom interest rates.

Like governments, households, too, currently have increased debt. To sustain consumption while incomes were falling, households ran down savings, and borrowed. Where households could not meet their mortgage commitments, the payments were deferred, but added to the debt. The banks announced that by late May, 700 000 households had requested relief on their mortgage payments. By early August payments on a total of \$274 billion in household and small business loans had been deferred. At the same time, households were encouraged to draw down their retirement nest eggs to finance daily expenses.

Going into the crisis, household debt was already equal to 180 per cent of household disposable income, mainly due to Australians' preference for owning their homes, and the high price of those homes. Coming out of the crisis, household debt is likely somewhat higher, while household financial assets are likely somewhat lower. Household incomes on average will also be lower, with the loss falling mostly on the newly unemployed or underemployed. After RBA rate cuts, household mortgage interest payments fell in March 2020 to less than one-fifteenth of household disposable income — the lowest share since the late twentieth century.³⁸ That share may rise a little given the likely rise in debt and fall in household disposable income since, though not by much. The sustainability of the budgets of many households depends on interest rates remaining at the lowest level they have ever been. Any small increase in the RBA policy rate would have a significant effect.

Business debt in Australia as a share of GDP moderated after the GFC. During the COVID-19 crisis, many strong businesses prudently drew on

lines of credit or issued new debt to ensure they would have enough cash. Some weaker businesses were obliged to negotiate with their banks to postpone debt repayments. With the share market tumbling but long-term interest rates low for quality borrowers, there was an incentive to borrow rather than issue new shares at a price well under their long-term value. The result is that businesses are now likely to come out of the crisis with somewhat higher debt but at somewhat lower cost than before the pandemic.

Like households and the Australian government budget, corporations are now more sensitive to the decisions of the RBA. This imposes a constraint on raising interest rates, perhaps for quite a while.

What the government and the central bank have switched on, they will not easily be able to switch off. The Australian government needs to sustain demand through spending, while the RBA needs to assist by keeping rates low — and both need to maintain this stance for long enough to bring unemployment down substantially.

CHINA: THE DECOUPLING FANTASY

Pressed in November 2018 about the emerging US–China trade and technology conflict, Prime Minister Scott Morrison told reporters in Singapore that Australia did not have to choose between the two, and would not choose. He repeated the policy in his October 2019 Lowy Lecture. "Even during an era of great power competition, Australia does not have to choose between the United States and China," he said, adding that, for Australia, China is a comprehensive strategic partner and "the strategic importance of our relationship is clear".

The truth is that Australia chose long ago, and is locked into its choices. It chose its region, including its largest member, China, as the economic community to which it inescapably belongs. It also long ago chose the United States as a defence ally to support Australia's territorial independence and freedom of action.

There is a good deal of tension between these two choices, but no possibility that either will change. Like many other enduring foreign policy problems, it cannot be resolved. It must instead be managed. However, it can only be managed if the Australian government has a clear and united understanding of Australia's interests, and competent people to execute policies consistent with that understanding.

Australia's trade with East Asia has been growing faster than its GDP or its trade overall for many decades. In just the last thirty years — a time of uninterrupted prosperity for Australia — the share of Australian goods exports sold in East Asia and the Pacific increased from a little over half to more than three-quarters.³⁹ During the same period, exports rose from one-seventh to over one-fifth of Australian GDP.⁴⁰ More than one-sixth of Australia's total income or GDP arises from its exports to East Asia. Half of Australian exports to the region are directly to China. In the last three decades, Australian goods exports to the United States fell from over a tenth of total Australian goods exports to one-twenty-fifth. Australian goods exports to China now amount to ten times those to the United States.

Australia is meshed with China's economy not only because China is the market for more than a third of Australian exports, but also because it is the major trading partner for Australia's other markets in East Asia. Thirty years ago, more than a third of Australian goods exports went to Japan, Korea, and Taiwan — the economies adjacent to China (and the

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models for its development as an export manufacturer). As China's economy rapidly expanded, it became more integrated with its neighbours, and Australia's exports to China rose. Today, East Asia and the Pacific form a regional economic community that in terms of trade and investment between its members is only a little less integrated than the European Economic Community, and very much more integrated than the North American economic community.⁴¹ Australia is part of it. The increasing importance of value chains within these regional economic communities continues to drive integration.⁴²

Already selling all it can to Japan and Korea, Australia would not find new markets for iron ore and coal to replace even a part of what it now sells to China. Nor could it easily replace exports of wine, meat, dairy products, and manufactures to China. The largest share of foreign tourists are from China, as is the largest share of foreign students. Without trade with China, Australia's living standards would be lower, its economy smaller, and its capacity to pay for military defence reduced. It is difficult to imagine plausible circumstances in which an Australian government would voluntarily cut exports to China. Australia cannot and will not decouple from China's economy any more than Japan, Korea, Taiwan, or Southeast Asia can, wish to, or will.

On the contrary, the economic relationship between Australia and China will likely deepen in coming decades as the incomes of hundreds of millions of Chinese consumers reach advanced economy levels. This will be driven by the demand for a more varied and expensive diet, for better health care services, for competitive funds management, for tourism, for English language tertiary education, for sports and entertainment, and for offshore assets. Australia is well placed to compete in all these markets. Japan, Korea, Taiwan, and Singapore too will become more integrated in a regional economy with China at its core. Australia's stance towards the US-China competition must therefore be informed by a recognition that what injures China's prosperity also injures Australia's prosperity. Economic 'decoupling' of China from North America or Europe is not in Australia's interests.

Nor will Australia decouple from its security arrangements with America. The United States will remain the primary source of advanced military technology for Australia. It will also remain the primary source of security intelligence. And no hostile power can entirely discount the possibility that the United States would come to Australia's military assistance if required. The security arrangements Australia has with America are therefore sufficiently valuable that no Australian

government would voluntarily deprecate them, let alone relinquish them.

The tension between these two pillars of Australia's engagement with the world will continue for decades to come. The centrality of these relationships makes it all the more important for Australia to conduct them carefully and cleverly, always guided by a notion of Australia's long-term interests. China's growing role on the world stage, its authoritarian government, its suppression of internal dissent, its territorial claims and defence build-up in the South China Sea, together with the deterioration of the relationship between the United States and China, make this tension increasingly difficult to manage. Thus far, the cleverness Australia increasingly needs is not evident in its handling of relations with China.

In 2012, the Australian government decided, on the basis of security reports, to ban Chinese telecommunications equipment maker Huawei from selling its products to the broadband provider, NBN. It subsequently banned Huawei from participating in building Australia's nascent 5G network. Whether or not that was the only option depends on the content of the security reports, so far undisclosed. What was certainly unnecessary, however, was that Australia would then send officials to urge India to adopt the same ban, while also openly urging the United Kingdom and Europe to follow suit.⁴³

Similarly, while it was fine for Australia to support an independent inquiry into the origins and spread of the coronavirus, it was hardly ideal for the Foreign Minister Marise Payne to announce the proposal offhandedly in a television interview. This came four days after she had publicised a conversation with the US Secretary of State Mike Pompeo that included among its subjects the coronavirus and China, and which followed weeks of insistence by US senators and administration officials that China be condemned for its delayed response to the new virus.⁴⁴

These mistakes of conduct are avoidable and contribute to the deterioration of Australia's relationship with China. The Foreign Minister was on firmer ground with her late July Washington declaration that Australia's relationship with China "is important, and we have no intention of injuring it, but nor do we intend to do things that are contrary to our interests".⁴⁵

Refusing to take sides in the trade and technology competition between China and the United States is Australia's declared policy. It was wisely adopted — but not deftly implemented.

CONCLUSION

Australia is emerging from the pandemic sooner and at less economic cost than expected, but with higher unemployment and elevated debt. Businesses and households are more uncertain than usual, though the recovery is already underway and will likely gain momentum over coming months.

As the pandemic recedes, it is evident that global output and demand will not recover the levels of 2019 for some time. Major advanced economies have sharply increased government debt and their central banks have driven interest rates to rock bottom while buying big shares of additional government debt. At the same time, the US–China quarrel has become more intense, and Australia's relationship with China has deteriorated. All these changed circumstances, much amplified and extended from their pre-pandemic appearances, limit Australia's choices.

The task of Prime Minister Scott Morrison and his government is to manage the pandemic's consequences. The domestic political contest will not be based on what has happened, but on what will happen, and specifically on where unemployment is likely to be in two or three years' time. It is already apparent that both the prime minister and his opponent, Opposition Leader Anthony Albanese, are well aware of the likely direction of the political debate. Each is determined to dominate it.

If containing unemployment is the policy objective it would be unwise for the Australian government to commit itself to a rapid reduction in deficits. The government can cut its deficit only if its tax revenue increases faster than its spending, subtracting from total demand in the economy. If the government is to subtract from total demand, it needs to be confident that rising private sector demand alone will be sufficient to grow the economy at a rate necessary to prevent an accumulation of long-term unemployment. Planned reductions in the deficit should be slow and modest. The better the private sector recovery, the faster deficits can be reduced.

If the deficit is to be reduced gradually rather than abruptly, the Morrison government will need to add spending. Most of the big increase in spending for the financial years 2019/20 and 2020/21 automatically falls away as people return to work. The government thus has an opportunity to fund a bigger infrastructure program, adding to

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economic capacity and removing obstacles to productivity growth. It also has the opportunity to fund private sector investment through more generous depreciation allowances for new private investment. To minimise long-term unemployment it will need to invest in case counselling, job subsidies, and retraining — all expensive, though not as expensive in the long run as large-scale and long-term unemployment.

It is also essential that the RBA keeps interest rates very low. It is already committed to this path for the overnight cash rate, and more ambiguously to the three-year bond rate. It should also continue to support bank lending. If the rate on ten-year bonds continues to increase over the three-year rate, and the spread between Australian and US bond rates continues to widen, the RBA may find it needs to buy more bonds to slow a damaging appreciation of the Australian dollar against other currencies. A formal or informal understanding with the Australian government on the amount of government bonds it is willing to hold on its balance sheet would be useful. We can be reasonably confident the RBA will continue to do its utmost. Unlike the Australian government, it has declared it will maintain expansionary policies as long as necessary.

How will the Morrison government find its way through these issues? In a fragile and uncertain economy, austerity is disfavoured. The government may well bring forward personal income tax cuts already legislated, though it cannot now afford to make additional considerable and permanent tax cuts. To deal with high unemployment there are now no good alternatives to fiscal support, extending well beyond 2021. The Morrison government has so far been unforthcoming on the extent to which it is prepared to moderate the abrupt decline in government stimulus currently built into program design. The pandemic ending, the economic recovery underway, Australia now faces the bigger challenge of dealing with the consequences.

NOTES

- ¹ Using the RBA's 7 August forecast of a year-on-year decline of 6 per cent in 2020 GDP, and assuming GDP might otherwise have grown 2 per cent over the period;
<https://www.rba.gov.au/publications/smp/2020/aug/pdf/statement-on-monetary-policy-2020-08.pdf>. See also Treasury's 23 July forecast of a year-average 3.75 per cent decline in output over 2020, Australian Treasury, *Economic and Fiscal Update: July 2020*, 23 July 2020, 18, <https://budget.gov.au/2020-efu/downloads/JEFU2020.pdf>.
- ² Author calculations based on Parliamentary Budget Office *Medium-Term Fiscal Projection Scenarios*, 5 June 2020, https://www.aph.gov.au/-/media/05_About_Parliament/54_Parliamentary_Depts/548_Parliamentary_Budget_Office/Reports/Research_reports/Post_COVID-19_medium-term_fiscal_scenarios/Medium-term_fiscal_projection_scenarios_-_impact_of_COVID-19_pandemic_and_response_pdf.pdf?la=en&hash=A299FEF44C29A285E25FCE4FE1DA58E7A959C4F2.
- ³ Reserve Bank of Australia, *Liabilities and Assets, Weekly*, 22 July 2020, <https://www.rba.gov.au/statistics/frequency/stmt-liabilities-assets.html>.
- ⁴ RBA op.cit. See also Australian Treasury, *Economic and Fiscal Update: July 2020*, <https://budget.gov.au/2020-efu/downloads/JEFU2020.pdf>.
- ⁵ International Monetary Fund, *World Economic Outlook Update, June 2020: A Crisis like No Other, An Uncertain Recovery*, June 2020, <https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUupdateJune2020>.
- ⁶ Australian Bureau of Statistics, *ABS 5352.0 – International Investment Position, Australia, Supplementary Statistics, 2019*, [https://www.abs.gov.au/ausstats/abs@.nsf/mf/5352.0#:~:text=The%20level%20of%20foreign%20investment,for%20%2024285.8b%20\(7%25\)](https://www.abs.gov.au/ausstats/abs@.nsf/mf/5352.0#:~:text=The%20level%20of%20foreign%20investment,for%20%2024285.8b%20(7%25)).
- ⁷ Simon Benson, "Scott Morrison's Post-Pandemic Powerplay", *The Australian*, 18 May 2020, <https://www.theaustralian.com.au/nation/morrison-pushes-for-new-order/news-story/152d2adb2d8e26e5f46d84ab9e4fb2ee>.
- ⁸ Assistant Governor Luci Ellis, "The Economic Outlook", Reserve Bank of Australia, Australian Business Economists Lunchtime Briefing, 7 August 2020, <https://www.rba.gov.au/speeches/2020/sp-ag-2020-08-07.html>.
- ⁹ Australian Bureau of Statistics, *5368.0 – International Trade in Goods and Services, Australia, June 2020*, <https://www.abs.gov.au/ausstats/abs@.nsf/mf/5368.0?OpenDocument>.
- ¹⁰ The study reports that more than 20 000 fewer students were living in inner Melbourne and inner and southern Sydney due to travel bans. The report estimates the total number of international students in Australia at 600 000. See Peter Hurley, *International Students Vital to Coronavirus Recovery*, Mitchell Institute, Victoria University, June 2020,

<https://www.vu.edu.au/sites/default/files/issues-brief-international-students-covid.pdf>.

- 11 Using ABS data on short-term visitor arrivals and short-term visitor arrivals departures, the gap is about 20 per cent. See Australian Bureau of Statistics, *ABS 3401.0 – Overseas Arrivals and Departures, Australia, May 2020*, <https://www.abs.gov.au/ausstats/abs@.nsf/mf/3401.0>.
- 12 Australian Bureau of Statistics, *6202.0 – Labour Force, Australia, Apr 2020*, 14 May 2020, <https://www.abs.gov.au/ausstats/abs@.nsf/lookup/6202.0Media%20Release1Apr%202020#:~:text=6202.0%20%2D%20Labour%20Force%2C%20Australia%2C%20Apr%202020&text=Seasonally%20adjusted%20employment%20fell%20by,labour%20market%20indicators%20in%20April.&text=Total%20hours%20worked%20fell%20by,cent%20between%20March%20and%20April>.
- 13 Australian Bureau of Statistics, *ABS 6202.0 – Labour Force, Australia, Apr 2020, Insight into Hours Worked*, <https://www.abs.gov.au/ausstats/abs@.nsf/Previousproducts/6202.0Main%20Features10Apr%202020?opendocument&tabname=Summary&prodno=6202.0&issue=Apr%202020&num=&view=>.
- 14 Assistant Governor Luci Ellis, “The Economic Outlook”, Reserve Bank of Australia, Australian Business Economists Lunchtime Briefing, 7 August 2020, <https://www.rba.gov.au/speeches/2020/sp-ag-2020-08-07.html>.
- 15 Reserve Bank of Australia, *Statement on Monetary Policy, August 2020*, <https://www.rba.gov.au/publications/smp/2020/aug/>.
- 16 World Bank, *GDP Per Capita (Constant 2010 US\$) – Australia, Germany, Japan, United States*, <https://data.worldbank.org/indicator/NY.GDP.PCAP.KD?locations=AU-DE-JP-US>.
- 17 Simon Benson, “Scott Morrison’s Post-Pandemic Powerplay”, *The Australian*, 18 May 2020, <https://www.theaustralian.com.au/nation/morrison-pushes-for-new-order/news-story/152d2adb2d8e26e5f46d84ab9e4fb2ee>.
- 18 See Australian Bureau of Statistics, *ABS 6202.0 – Labour Force, Australia, June 2020*, <https://www.abs.gov.au/ausstats/abs@.nsf/7d12b0f6763c78caca257061001cc588/a8e6e58c3550090eca2582ce00152250!OpenDocument>; and *ABS 6354.0 – Job Vacancies, Australia, May 2020*, <https://www.abs.gov.au/ausstats/abs@.nsf/mf/6354.0>.
- 19 Reserve Bank of Australia, *Household Sector – Household Wealth and Liabilities*, 8 July 2020, <https://www.rba.gov.au/chart-pack/household-sector.html>.
- 20 While household debt had reached 187 per cent of household disposable income by March 2020, the required interest payment on that debt was 8 per cent of disposable income — well below the peak of 13.3 per cent reached in 2008. This amount was no higher than the share of interest in disposable income reached 18 years earlier, when

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household debt to disposable income was not quite two-thirds of the share it had reached by the end of 2020.

²¹ Australian Treasury, *Mid-Year Economic and Fiscal Outlook 2019–20*, Table E4, 323, https://budget.gov.au/2019-20/content/myefo/download/MYEFO_2019-20.pdf.

²² As RBA economist Gianna La Cava pointed out in March 2019, some of the income attributed to profit is the rental value imputed to owner-occupied homes. When that is put aside, the labour share rises, though the decline in its share is still evident. The profit share also includes income to small and micro businesses, the owners of which often apportion as profit what is actually attributable to their own labour. However, the big influence is the mining sector. Most of the factor income in mining is attributable to profit, whereas in the economy as a whole more than half is attributable to wages. Mining is highly capital intensive, and its high profit share is the payment for that capital. When mining surges as a share of GDP, as it has in recent years, so too the profit shares surges. See Gianni La Cava, “The Labour and Capital Shares of Income in Australia”, Reserve Bank of Australia Bulletin — March 2019, 21 March 2019, <https://www.rba.gov.au/publications/bulletin/2019/mar/the-labour-and-capital-shares-of-income-in-australia.html>.

²³ Productivity Commission, *PC Productivity Insights — Recent Productivity Trends*, No 1/2020, February 2020, 5, <https://www.pc.gov.au/research/ongoing/productivity-insights/recent-productivity-trends/productivity-insights-2020-productivity-trends.pdf>.

²⁴ Ibid, 15.

²⁵ Organization for Economic Cooperation and Development (OECD), *Gross Domestic Spending on R&D*, 2020, <https://data.oecd.org/rd/gross-domestic-spending-on-r-d.htm>.

²⁶ It accumulated to 20 per cent for the earlier period and 17 per cent for the more recent period. It averaged 2.4 per cent for the seven years to and including 2019, and 2.95 per cent for the seven years to 2012.

²⁷ Australian Treasury, *Economic and Fiscal Update*, <https://budget.gov.au/2020-efu/downloads/JEFU2020.pdf>.

²⁸ Australian Government, *Statement 10: Historical Australian Data*, Table 4: Australian Government General Government Sector Net Debt and Net Interest Payments, https://budget.gov.au/2019-20/content/bp1/download/bp1_bs10.pdf.

²⁹ It is true the Australian government pays banks for holding the money it creates. The rate it pays, however, is now only one-tenth of 1 per cent, or less than one-sixth of the rate paid by the government on new ten-year bonds (and can anyway be met by additional created money).

³⁰ Reserve Bank of Australia, *Liabilities and Assets — Summary*, <https://www.rba.gov.au/statistics/tables/xls/a01whist-summary.xls>.

³¹ RBA governor Philip Lowe said in July the RBA had bought, to that point, an additional \$50 billion in Commonwealth debt since it had targeted a

0.25 per cent ceiling on the three-year bonds. See Reserve Bank of Australia, *Statement by Philip Lowe, Governor: Monetary Policy Decision*, 7 July 2020, <https://www.rba.gov.au/media-releases/2020/mr-20-17.html>. That appears to be around two-thirds of the additional issuance of Commonwealth bonds by the Australian Office of Financial Management (AOFM) over the period, by market value. All up, the RBA had added \$126 billion in Australian dollar investments by mid-July. This is substantially more than the \$94 billion headline cash deficit for the Commonwealth in the year ended 30 June 2020, which the AOFM would need to fund from additional issuance. Not all of the RBA's additional holding of Australian dollar investments consists of Australian government bonds, but most does. In terms of its impact on bond pricing, I cannot see much difference between an outright purchase of a bond, and holding a bond as a security for a loan (a 'repo'). In the first case, the RBA buys a bond, in the second it rents a bond. Either way, the bond is taken off the market.

- 32 Australian Office of Financial Management (AOFM), *Data Hub — Portfolio Aggregates*, <https://www.aofm.gov.au/data-hub>. The RBA does not buy bonds directly from the government but from other holders. Whether they are bought directly or indirectly makes no difference to the price or interest rate impact of RBA purchases of bonds.
- 33 Perhaps in the future the RBA will sell off its inventory of bonds, and destroy the money it created to buy them, slimming its balance sheet. Perhaps — but that would be associated with rising interest rates and a rising Australian dollar, a combination neither the Bank nor the Commonwealth government would welcome in the foreseeable future. The US Federal Reserve announced an intention to sell down (or 'taper') its inventory of bonds in 2013 and again in 2017. In both cases the market responded with a 'taper tantrum' in which bond rates spiked. The Fed soon abandoned the program.
- 34 International Monetary Fund, *Fiscal Monitor — April 2020*, <https://www.imf.org/en/Publications/FM/Issues/2020/04/06/fiscal-monitor-april-2020>.
- 35 Shane Wright, "Economic Outlook Worsening, Global Debt to Surpass WWII Levels: IMF", *Sydney Morning Herald*, 24 June 2020; <https://www.smh.com.au/politics/federal/economic-outlook-worsening-global-debt-to-surpass-wwii-levels-imf-20200624-p555mc.html>.
- 36 Author calculations based on the baseline scenario in Parliamentary Budget Office *Medium-Term Fiscal Projection Scenarios*, 5 June 2020, https://www.aph.gov.au/-/media/05_About_Parliament/54_Parliamentary_Depts/548_Parliamentary_Budget_Office/Reports/Research_reports/Post_COVID-19_medium-term_fiscal_scenarios/Medium-term_fiscal_projection_scenarios_-_impact_of_COVID-19_pandemic_and_response.pdf?la=en&hash=A299FEF44C29A285E25FCE4FE1DA58E7A959C4F2.

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- ³⁷ Australian Treasury, *Mid-Year Economic and Fiscal Outlook 2019–20*, Table E5, 324, https://budget.gov.au/2019-20/content/myefo/download/MYEFO_2019-20.pdf.
- ³⁸ Reserve Bank of Australia, *E2 Household Finances — Selected Ratios*, <https://www.rba.gov.au/statistics/tables/xls/e02hist.xls?v=2020-08-05-11-23-26>.
- ³⁹ The increase was from 57 per cent to 76 per cent. See World Integrated Trade Solution (WITS), *Trade Summary Database*, World Bank, <https://wits.worldbank.org/#>.
- ⁴⁰ In real or after-inflation terms, exports increased from 14 per cent of GDP in 1991 to 22 per cent in 2019. In current prices, from 15 per cent to 25 per cent of current dollar GDP. See Australian Bureau of Statistics, *ABS 5206.0 — Australian National Accounts: National Income, Expenditure and Product, March 2020*, <https://www.abs.gov.au/ausstats/abs@.nsf/mf/5206.0?opendocument&ref=HPKI>.
- ⁴¹ The interregional trade share was 57.5 per cent in 2018, the latest estimate. The Asian Development Bank's 'Asia' includes South Asia and Central Asia as well as East Asia and the Pacific. See Asian Development Bank, *Asian Economic Integration Report 2019/2020: Demographic Change, Productivity, and the Role of Technology*, November 2019, <https://www.adb.org/sites/default/files/publication/536691/aeir-2019-2020.pdf>.
- ⁴² Ibid.
- ⁴³ Jennifer Duke and David Wroe, "Australian Government, Spy Chiefs Secretly Urge UK to Ban Huawei", *Sydney Morning Herald*, 4 June 2019, <https://www.smh.com.au/business/companies/huawei-20190603-p51tur.html>; and "Australian Cyber Officials Warned India Against Using Huawei: Newspaper", Reuters, 10 September 2019, <https://www.reuters.com/article/us-australia-cyber-india/australian-cyber-officials-warned-india-against-using-huawei-newspapers-idUSKCN1VU2JU>.
- ⁴⁴ US Department of State, "Secretary Michael R. Pompeo at a Press Availability with Secretary of Defense Mark Esper, Australia Foreign Minister Marise Payne, and Australian Defence Minister Linda Reynolds, Washington DC, 28 July 2020, <https://www.state.gov/secretary-michael-r-pompeo-at-a-press-availability-with-secretary-of-defense-mark-esper-australian-foreign-minister-marise-payne-and-australian-defence-minister-linda-reynolds/>.
- ⁴⁵ John Power, "Must Australia Choose between Trade with China and Siding with US on Hong Kong, South China Sea?", *South China Morning Post*, 30 July 2020, <https://www.scmp.com/week-asia/politics/article/3095236/must-australia-choose-between-trade-china-and-siding-us-hong>.

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