Opening statement to the Economics Legislation Committee
Dr Steven Kennedy PSM
Secretary to the Australian Treasury
27 October 2021

Over the past few months, we have seen the world adjusting to living with the Delta strain of COVID.

The emerging story is similar across many countries. There is variation in the number of cases, and in many circumstances opening up is leading to caseloads increasing. What does seem to be clear is that countries with high vaccination rates are experiencing lower rates of hospitalisation and deaths.

The pandemic has impacted many countries severely with deaths per million in Canada, the UK and the USA, respectively 12, 32 and 35 times the rate we have experienced here in Australia.

It remains a significant achievement of all Australian governments that the health and economic impacts of COVID have been much less than in most other countries.

Here in Australia, NSW, Victoria and the ACT have been adjusting to living with COVID and other states and territories will soon follow.

The modelling for National Cabinet by the Doherty Institute shows that high vaccination rates are the key to managing the virus in the future, allowing us to open up and avoid costly lockdowns.

Our economic success hinges on our success in managing the virus and its impact on health systems. And this, in turn, hinges on the combination of high vaccination rates and effective COVID treatments.

Progress on vaccination is positive. Australia’s vaccine rollout has continued at a strong pace, with almost 2 million doses administered each week for the past 9 weeks, putting Australia on track to have one of the highest vaccination rates in the world.

It is particularly encouraging that over 90 per cent of the population aged over 16 in NSW, Victoria and the ACT have now had their first dose.

There have been significant improvements in COVID treatments over the past 12 months, with a number of treatments approved and more under evaluation. Many of these treatments have been shown to substantially reduce the risk of hospitalisation or death, particularly if they are administered very soon after someone is infected.

Treasury worked closely with the Doherty Institute to provide integrated health and economic advice to inform the development of the National Plan that is guiding Australian governments.

Recent outcomes and forecasts

While we can look forward to better economic outcomes as vaccination rates rise and the economy opens up, the recent lockdowns will affect growth and employment in the short term.

In early August, almost two-thirds of the population was in lockdown.

These outbreaks and associated lockdowns have disrupted the strong economic recovery that was underway.

From July to September this year, employment fell by 2.2 per cent.

Business and consumer confidence has also declined owing to heightened uncertainty but remains much higher than the record lows reached in 2020.

Treasury currently expects economic activity to contract by around 3 per cent in the September quarter, a smaller hit to activity than the record 7 per cent fall in the June quarter 2020.

However, should GDP fall by 3 per cent in the September quarter that would be the second largest fall in the history of the series. Somewhat surprisingly there is little commentary about the significance of this potential contraction in activity. Our assessment is that this mostly reflects the effectiveness of past and current fiscal interventions.

As restrictions continue to ease, economic activity and the labour market are expected to recover quickly, as it did in late 2020 and early 2021. As a result, we are expecting the transition away from emergency household and business support to proceed smoothly.

Outside of COVID, Treasury continues to monitor a range of other risks.

The International Monetary Fund's (IMF) latest report has slightly downgraded its growth forecast for this year to 5.9 per cent as a result of worsening pandemic outcomes and supply disruptions. While the growth outlook for 2022 remains unchanged, the IMF note that risks to growth are tilted to the downside and there is some uncertainty around the outlook for global inflation.

In China, there are signs the economy could slow more than anticipated. Headwinds have emerged on several fronts, including in the property sector and as a result of recent power shortages. We have already seen some collateral effects of this in Australia through a reduction in the iron ore price from its recent highs.

In the run up to COP26 there has been heightened discussion of the risks to growth and financial stability from climate change. The Treasurer outlined some of these in a recent speech where he discussed the increasing requirements on companies to assess and report on their climate risks being imposed by large institutional investors, capital markets and regulators.

The Government’s recently announced commitment to net zero emissions by 2050 is an important step forward. It will provide confidence to domestic and international investors allowing them to manage climate risks more effectively. As part of the modelling undertaken by the Department of Industry, Science, Energy and Resources, Treasury provided advice on these issues.

Advanced and emerging economies have experienced an increase in inflation this year. While major central banks continue to view recent inflation pressures as mostly transitory, driven by supply chain disruptions and commodity price volatility, they have acknowledged that these pressures are likely to persist for longer than first anticipated.

To date, measures of inflation expectations remain well anchored, and most ‘core’ measures of inflation – which remove energy prices and other volatile components – are consistent with central bank inflation targets.

However, if supply side shocks persist and lead to a rise in inflation expectations or shocks begin to have second round effects on broader prices, particularly wages, then central banks overseas are likely to bring forward the normalisation of monetary policy.

Here in Australia, domestic inflation and inflation expectations remain moderate and the Reserve Bank has noted that inflation is not expected to be consistently within their inflation target band until around 2024.

In relation to the Australian housing market, we have recently seen some risks emerging in residential mortgage lending, in the form of an increase in the share of heavily indebted borrowers and leverage in the household sector more broadly.

In response, the Australian Prudential Regulation Authority (APRA) recently raised the home loan serviceability buffer from 2.5 percentage points to 3.0 percentage points. This move was supported by the Council of Financial Regulators, of which we are a member.

This is a prudent step to manage emerging risks. As noted by APRA, the banking system remains well capitalised and lending standards overall are sound, but they are continuing to monitor the situation closely.

We will continue to monitor these global and domestic risks ahead of revising our forecasts in the upcoming MYEFO.

Policy response

Over the course of the pandemic, the Government has worked with state and territory governments to provide direct assistance to households and businesses as well as broader macroeconomic stimulus to mitigate the impact of the lockdowns and support a strong recovery.

The direct household and business measures have been replacing lost income and helping to strengthen household and business balance sheets.

In relation to the most recent lockdowns, Treasury projects that the federal and state governments provided around $20 billion in direct economic assistance to businesses and households in the September quarter of 2021.

Data from August suggests that the COVID-19 Disaster Payment is flowing mostly to younger workers, with 57 per cent of payments going to those under 35. It is also supporting workers on lower incomes, with 58 per cent of payments going to those in the bottom 40 per cent of the income distribution.

In conjunction with previous assistance, household and non-financial business deposits are almost $330 billion higher compared to the end of 2019. Household cash savings having increased by $185 billion and business cash holdings having increased by $145 billion by the end of August 2021.

The run up in household and business balance sheets provides resilience and will continue to support activity throughout the recovery.

The overall fiscal policy response has been developed in the context of unique macroeconomic circumstances. In particular, the novel aspects of the economic shock and the presence of unusually low global and domestic interest rates.

The pandemic has been a shock to both the supply and demand side of the economy. The supply side shock stems from the health measures designed to limit the spread of the virus, which restricts the supply of labour and other goods and services and economic activity more broadly.

This, in turn, results in a loss of income and a decline in confidence, creating a demand shock.

Monetary policy has provided important support during the pandemic, despite the cash rate reaching its lower bound.

We have seen the Reserve Bank undertake interventions outside usual practices, such as purchasing national and sub-national debt in the secondary markets which the Bank has committed to continue at a rate of $4 billion per week until at least mid-February 2022.

By mid-February, the RBA balance sheet will have expanded to around $650 billion or around one-third the size of GDP. While not an unusual position when compared with other countries, it will be a first in Australia’s history for the Central Bank to hold this amount of Government debt.

While monetary policy has been important to the recovery, there is little doubt that given the nature of shock and constrained position of monetary policy, more weight has been on fiscal policy to support the economy.

Outside of wars, it is hard to see a period in Australia’s history when the requirements of fiscal policy to avert economic harm have been higher.

Moreover, it remains the case that while interest rates are close to zero, fiscal policy is not only more effective than usual, it remains the primary tool to manage negative economic shocks.

Fiscal sustainability

Recent budget outcomes have shown an improvement reflecting the better-than-expected health and economic outcomes prior to the latest lockdowns. With the economic recovery likely to quickly re-establish itself once lockdowns are eased, growth and fiscal outcomes could again surprise on the upside. It will be important that such improvements are used to pay down debt where possible.

As outlined in the Government's fiscal strategy, once the recovery is secured, the second phase of the fiscal strategy will focus on growing the economy to stabilise and reduce debt as a share of the economy over the medium term.

The 2021 Intergenerational Report shows an outlook that has been altered by the COVID-19 pandemic.

Australia's population is projected to grow at a slower rate, with the old-age dependency ratio, (the ratio of working-age people to those over 65), projected to continue falling. The ratio has already fallen from 6½ to 4 since the early 1980s, and it is projected to fall to a little above 3 by the end of the decade. The decline between 2010 and 2030 is largely due to the baby boomer generation reaching age 65.

The lower long-term population projections highlight the potential longer-term impacts of the COVID-19 pandemic.

The participation rate is projected to decline due to the ageing population, but by less than in previous Intergenerational Reports. The projections assume that the labour productivity growth rate converges to 1.5 per cent per year – consistent with the 30-year historical average to 2018-19. However, achieving this rate will require a significant improvement over recent performance, where Australia has seen a slowdown in productivity growth broadly in line with global trends.

Taking together a slower growing and ageing population, lower participation, and a return to long term average productivity, the Australian economy is projected to grow at a slower pace over the next 40 years than it has over the past 40 years.

However, from a GDP per person perspective the difference is small, 1.5 per cent compared with 1.6 per cent. Projected growth in GDP per person is almost entirely driven by the productivity assumption.

The projections contained in the Intergenerational Report are for the most part simple extrapolations of past trends, and they don't capture events such as terms of trade cycles that have had significant impacts over the past couple of decades.

Nevertheless, they provide some insights into the long-term sustainability of government spending. In this context, past reports have played a role in shaping government spending by laying out long-term fiscal challenges.

The latest trajectory for the underlying cash balance begins with a period of improvement before deteriorating in the second half of the projection period, similar to previous Intergenerational Reports.

The longer-term deterioration reflects growth in spending, mainly on health, aged care and interest payments outpacing growth in incomes, while the increase in tax receipts is constrained by the tax-to-GDP cap.

Total government spending as a share of the economy is projected to fall from a pandemic induced high, before gradually increasing as a share of GDP over the next 40 years.

Health, aged care and the NDIS are projected to be the fastest growing areas of spending over the next 40 years, reflecting pressures from both the ageing of the population and non-demographic factors such as technology, changing consumer preferences, and rising incomes.

Health spending is projected to rise as a share of GDP from 4.1 per cent to 6.2 per cent over the next 40 years. Aged Care expenditure is projected to rise from 1.2 per cent to 2.1 per cent over the same period.

Total government spending on the NDIS has increased considerably since the 2015 Intergenerational Report, with projected spending at the end of the decade when the scheme is expected to be at maturity, increasing from 1.1 per cent of GDP to 1.5 per cent of GDP.

Since the release of the 2021 Intergenerational Report, projections from the NDIA Scheme Actuary show that the scheme is expected to grow at an even higher rate than envisaged, driven by increased participant costs and an increased number of participants.

Governments will need to manage spending pressures arising in these areas by improving the efficiency of service delivery and ensuring support is well targeted.

JobKeeper Insights

I'd like to conclude with a few comments on the recently released Treasury analysis of the first six months of the JobKeeper program.

JobKeeper provided significant fiscal support at a time of unprecedented uncertainty. Designed as health restrictions were being implemented to control the spread of COVID-19, it brought confidence and certainty to both businesses and their employees. It stabilised the economy and, over the following few months, positioned Australia for recovery.

JobKeeper was well targeted. It went to small and medium businesses, highly productive but financially fragile firms and those heavily affected by health restrictions. JobKeeper businesses faced higher rates of job shedding and worse employment outcomes than businesses that were not eligible for JobKeeper.

Even in JobKeeper businesses that did not face the expected decline in turnover, job separations increased by 60 per cent at the start of the crisis, compared to almost no increase in non-JobKeeper businesses. The number of jobs at these businesses also declined sharply and remained below the level for non-JobKeeper businesses at the end of September 2020.

JobKeeper worked effectively with other programs such as JobSeeker. The combination of JobKeeper and JobSeeker saw incomes rise for people in the lowest income quintiles whilst there was little to no contribution to the incomes of those in the higher income quintiles. Labour and welfare income, for those in the lowest quintile increased by over 20 per cent on average in the June and September quarter 2020, relative to March 2020. The same measure of income was broadly unchanged for those on middle and higher incomes.

The targeting of support to those in lower income quintiles is likely to have led to more support for aggregate demand in the recovery period than if assistance had flowed more evenly across income levels.

A central consideration in designing JobKeeper and fiscal support more broadly was ensuring the overall level of support was sufficient to provide a credible offset to the large economic shock that was unfolding. If it had been designed differently, for example if it was more tightly targeted or shorter in duration, this would have affected macroeconomic outcomes and the course of the recovery.

Importantly, we have largely averted the COVID demand shock and the associated long-term labour market scarring.

The JobKeeper program was not unlike programs introduced in other countries and, as a proportion of the economy, similar in size.

Thank you for the opportunity to provide this opening statement.