Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 353

Topic: Unemployment

Hansard Page: Written

Senator EGGLESTON asked:

1. The Budget economic forecasts shown in Budget Paper No 1 Table 1 on page 1-7 and repeated elsewhere show a low in the unemployment rate of 4¾% over the next four years. That is despite at least one year of above trend growth in 2011-12 and roughly trend growth in the other years. The low point in the unemployment rate in recent years was 4.0% seasonally adjusted in February and March 2008. The unemployment rate was at or below 4¾% between July 2006 and December 2008. What has changed in the economy that Treasury no longer believes the recent lows in the unemployment rate can again be attained over the next four years? The difference between an unemployment rate of 4% and an unemployment rate of 4¾% is around 88,000 people given the current labour force of around 11.7 million. What policy steps would be required to reduce the unemployment rate back to where it was in early 2008 and provide jobs for those 88,000 Australians?
2. What does Treasury now consider the Non Accelerating Inflation Rate of Unemployment to be?
3. What are your thoughts on the OECD's Going for Growth study on Australia, released in March, where they said:

   > *A 2006 reform fostered individualisation of labour relations and an independent body was created to set the federal minimum wage, taking into account its employment impact. These measures were partly reversed in 2008 through a reinforcement of the role of awards, raising the risk of increases in minimum labour costs.*

   Are the reversals that the OECD talks about a risk to the performance of Australia's labour market in future economic downturns?

4. Budget forecasts are only as good as the underlying economic assumptions. The recent performance in forecasting key economic parameters has not been good. For example, last year's budget forecast the Australian economy would contract by ½% in 2009-10. This year's Budget tells us the economy will grow by 2%. Last year's Budget said the unemployment rate would peak at 8.5% in 2010-11. This year's Budget tells us the unemployment rate has already peaked – at less than 6% – and is headed to a low of 4.75% in 2011-12. These very significant changes to the underlying forecasts over the space of just one year illustrate that there is a large degree of imprecision in the Budget numbers. Also, these considerably inaccurate forecasts were made *after* the announcement of government stimulus.
   a) Did the government base its strategy of massive fiscal stimulus on faulty Treasury forecasts?

b) As it turned out, was this massive fiscal stimulus actually required? Would a smaller fiscal stimulus have sufficed?
c) Does this mean there is a high degree of uncertainty surrounding the projected Budget surpluses in the last two years of the forward estimates in the 2010-11 Budget?
d) Have you done any work that looks at how ‘projections’ fare compared with actual outcomes later?
e) Given economic forecasts are often so wrong, is it sensible to base extremely expensive policy on them? Or is there some merit in waiting to see what happens?
f) What other parameter changes might have occurred if the fiscal stimulus had been smaller?
g) Would interest rates and the exchange rate have been lower?

5. Would these changes have compensated for a smaller fiscal stimulus?

Answer:

1.

In the 2010-11 Budget, real GDP is forecast to grow above trend in 2011-12 and at around trend in 2012-13. These growth forecasts underpin solid employment growth, which is expected to result in the unemployment rate falling to 4¾ by the end of the 2011-12 – consistent with the forecasts published in the more recent *Economic Statement*, released in July. However, significantly stronger GDP and employment growth than forecast would likely see the unemployment rate fall below 4¾ per cent.

2.

The Non Accelerating Inflation Rate of Unemployment (NAIRU) depends on a range of economic, demographic and institutional factors, including the way inflation expectations are formed, the wage-setting environment, the tax-transfer system, and the education and skills of people in the labour force.

Treasury estimates that the NAIRU in Australia is somewhere around 5 per cent. However, the NAIRU varies over time and cannot be measured directly. While NAIRU estimates are inherently imprecise, this 5 per cent assumption is consistent with the estimates of most economic models.

The first Intergenerational Report in 2002 assumed a NAIRU of 5 per cent, and this assumption was retained in the subsequent 2007 and 2010 IGRs.

3.

In relation to the OECD's reference to the previous Australian Fair Pay Commission as an independent minimum wage setting body that took into account the employment impacts of its decisions, it is important to note that a similar body exists under the new Fair Work system. Under the FW Act, a specialist Minimum Wage Panel within Fair Work Australia (FWA). This Panel is responsible for setting minimum wages for employees in the national workplace relations system. In doing so, FWA must take into account a range of factors including the performance and competitiveness of the national economy, including productivity, business competitiveness and viability, inflation and employment growth.

In addition, the aim of the award modernisation process which was undertaken by the Australian Industrial Relations Commission was to rationalise and streamline existing awards and other industrial instruments in order to make it easier for employees, employers and their representatives to understand their obligations and entitlements. Through this process, the AIRC reduced 3,715 state and federal instruments, many of which were complex and lengthy, to just 122 modern awards. These awards commenced on 1 January 2010 and include transitional provisions to phase in changes in wages, loadings and penalties over a five-year period. When combined with the model flexibility clauses referred to above, this is expected to contribute to greater labour market flexibility.

4.

a)

The 2009-10 Budget forecasts were prepared in the context of the worst synchronised downturn since the Great Depression and represented our best judgement as to the effects of these external events on the Australian economy given the available information.

Along with the bleak outlook for the world economy, partial indicators for domestic economic activity were very weak and the latest National Accounts had shown that quarterly GDP had contracted for the first time since 2000. The IMF, OECD and many market economists were forecasting an even larger contraction in Australia over 2009 compared with Budget.

As events turned out, the economy performed significantly better than expected – although it did experience a significant slowdown. Annual growth in GDP slowed to 2.1 per cent in 2008 and 1.3 per cent in 2009 – well below trend. The fall in the terms of trade also resulted in the weakest through the year growth in nominal GDP since the 1960s.

b)

A number of factors contributed to Australia's better performance during the recent global economic downturn. These include the timely and substantial fiscal and monetary stimulus, the strength of the Australian financial system, as well as Australia's close links to Asia, where growth was supported by China's large stimulus.

Australia, alongside China and Korea, enacted large and timely fiscal stimulus. The actual multipliers for fiscal stimulus measures in these countries turned out to be larger than expected.

– This partly results from the favourable feedback loop generated by the timely and substantial macroeconomic policy actions. In other words, policy stimulus-both monetary and fiscal- was large and quick enough to convince businesses and consumers that the slowdown would be relatively mild. This led consumers and businesses to continue spending and to maintain staff. Such economic behaviours, in turn, helped the economic slowdown to be relatively mild.

The multipliers underpinning Treasury's estimates of the effects of the fiscal stimulus on the economy are at the conservative end of the range suggested by the OECD and IMF.

– Treasury assumed that 70 per cent of the cash transfers would be spent over the horizon of the forecasts, with the remainder saved. For government investment spending, the spending propensity was assumed to be one.

– The OECD suggests multipliers for cash transfers for Australia of between 0.7 and 0.8 by the second year. For infrastructure spending, the comparable numbers are between 1.1 and 1.3, while the IMF estimates multipliers of between 0.5 and 1.8 for infrastructure spending across the G-20 economies (Table 1).

Table 1 – OECD and IMF estimates of fiscal multipliers

	OECD - Australia		IMF - G20
	Year 1	Year 2	
Cash transfers to households	0.4	0.7 to 0.8	
Government consumption	0.6	0.7 to 1.0	
Infrastructure	0.9	1.1 to 1.3	0.5 to 1.8

– The decision to use relatively conservative fiscal multipliers was made at a time of remarkable volatility and uncertainty in the global economy, amidst significant falls in business and consumer confidence and extreme risk aversion in financial markets.

In the absence of the fiscal stimulus, it is estimated that the Australian economy would have contracted by 0.7 per cent in 2009, rather than growing by 1.2 per cent.

In light of recent recovery in the domestic economy, stimulus measures are being withdrawn as initially designed. The withdrawal of stimulus is estimated to subtract around 1 percentage point from GDP growth over 2010.

c)

Please see Budget Paper No. 1 2010-11, Statement 8, p.8-7 and the Sensitivity Analysis in Statement 3, pp.3-24 to 3-28.

d)

The projections are based on key assumptions, including those relating to trend GDP growth, that have been shown to hold over the long term.

e)

To be most successful in limiting the severity of the downturn, the macroeconomic policy response had to be quick. The timely implementation of the stimulus ensured that it was effective in bolstering consumer and business confidence, supporting the economy at a time when it was needed the most.

Indeed, Treasury estimates suggest that had it not been for the timely implementation of the fiscal stimulus, the economy would have experienced a recession, declining by 0.7 per cent over 2009.

f)

The fiscal stimulus is estimated to have contributed about 2 percentage points to real GDP growth in 2009. A smaller stimulus would have contributed less to GDP growth, which in turn would have had adverse consequences for key parameters such as the unemployment rate and wages growth.

g)

The Reserve Bank of Australia sets interest rates in order to achieve its medium-term inflation target. A number of factors impact on the Australian dollar at any point in time. The fundamental drivers of the Australian dollar include the outlook for the terms of trade (and therefore the health of the world economy) and interest rate differentials.

5.

As outlined in the answer to 4(f), if the fiscal stimulus was to have been smaller, growth would have been lower and unemployment higher.