Coronavirus threatens global growth

The spread of Coronavirus (COVID-19) infections outside of China over recent weeks has lowered global economic growth expectations. In addition to the tragic human toll, efforts to contain further spread of the virus (e.g. the limiting or banning of travel between certain countries) are expected to disrupt and slow economic activity. Although this disruption may only be in place for a limited period, a sharp drop in production in one period can result in lower levels of economic activity in future periods. The initial drop in production can result in lower income and less capacity to spend and invest in future periods.

The early impact of COVID-19 was experienced in China, where strict travel restrictions and business shutdowns were put in place to limit the spread of the virus. This has resulted in measures of manufacturing and service sector activity falling to historic low levels. Given Australia’s very close economic ties to China, the Australian economy is likely to be significantly impacted by COVID-19, even if the rate of infection here remains low. Tourism and education are two sectors most vulnerable. However, with more than 30% of Australia’s exports sold to China, the impact on the Australian economy is likely to be broad.

Policy makers around the globe are expected to introduce stimulatory measures to help offset some of the economic impact of COVID-19. Measures have already been introduced in China, with China’s Ministry of Finance announcing lower company tax rates. The People’s Bank of China (the central bank) has also lowered prime lending rates in February to encourage borrowing and spending. It is widely anticipated that both fiscal and monetary stimulus will be stepped up in Australia. Australia’s Treasurer, Josh Frydenberg, acknowledged the potential widespread impact of the virus in the following statement made in late February:

“The virus continues to evolve and therefore the impact on the economy continues to escalate, particularly as the travel restrictions remain in place and obviously it’s not just the international students who can’t get to Australia affecting that sector but also, the tourism sector. China is the number one source of international students as well as number one source of international tourists to Australia but we’re also now seeing disruptions to the supply chains with a lot of factories in China being closed and therefore product that they would otherwise sell to Australia which goes into our manufacturing or into our mines or to other, you know, plant and equipment is not coming to Australia as previously planned.”

Q1: Discuss the potential policy responses that could be put in place by the Reserve Bank and the Australian Government to address the economic impact of COVID-19.

Tax rebates show little impact on spending

Although policy makers may put in place measures to stimulate economic activity, the success and timing of any response is far from certain. As interest rates have progressively fallen over recent years, there is some evidence mounting to suggest that monetary policy becomes less effective at stimulating spending once interest rates reach very low levels.

With monetary policy potentially less effective, there have been some calls (including from the Australian Reserve Bank Governor) for fiscal policy to play a greater role in stimulating economic activity. Over recent years in Australia, fiscal policy has not been set in an expansionary mode, with the focus being on budget deficit repair, which has entailed a progressive gradual tightening in policy.

However, in the last Commonwealth Government Budget Statement brought down in April 2019, the introduction of increased tax rebates was expected to have some stimulatory impact. The
rebate (tax offset) of up to $1,080 was receivable upon lodgment of tax returns for last financial year with the bulk of rebates expected to be processed between July and December 2019. This rebate was previously introduced (in the 2018/19 Budget) at the maximum level of $530, with the increase to $1,080 announced last April. The rebate was available to taxpayers earning less than $126,000 per annum and will remain in place each year through to 2021/22.

The targeted nature of the rebates supported the likelihood they would have a stimulatory impact on the economy via an increase in consumption expenditure. With the rebates being restricted to lower and middle income earners, it was expected that the majority of the tax refunds would be spent rather than saved.

Recent data on retail sales (i.e. sales of consumption items and services typically purchased by households), however, fails to demonstrate any significant lift in retail spending growth. Over the year to December 2019, retail sales expanded by 2.7% in nominal pre inflation terms. This was the same rate of annual growth recorded in the year to December 2018. In the 6 months between July and December, when the tax rebates would have had most impact, retail sales rose by just 1.3%.

**Wages growth remains low**

One of the explanations for the slow rate of growth in retail spending is that wages growth has been very subdued. The lack of any significant real wages growth continued into the December quarter last year. Over the 3-month period, the seasonally adjusted Wage Price Index rose by 0.5%, resulting in the annual rate of wages growth remaining steady at 2.2%. (The Wage Price Index measures changes in the price of labour across the Australian economy).

With inflation in the year to December at 1.8%, the latest wages data suggests there has been only a modest increase in wages in real, after inflation, terms. This is an unusual situation as wage costs will typically rise at a higher rate above inflation. Improving labour productivity (i.e. the level of output generated by each unit of labour) will normally create capacity for businesses to support real wage growth.

Movements in wages growth will typically reflect changes in the balance of supply and demand for labour. For example, throughout much of the mining boom there was a shortage of labour in the mining sector. This resulted in rising mining sector wages, which peaked at a growth rate of 6.7% per annum in June 2008. In contrast, with the mining boom now ended, annual wage growth rates in the sector are currently in line with the national average at 2.2%. Industries with the highest rate of growth in wages are Health (up 3.2% over the year to December) and Electricity, Gas, Water & Waste Services (up 3.4%). Posting the lowest rate of increase over the past year was the Information, Media and Telecommunications Industry, where an increase of 1.6% was recorded.

As indicated on the chart above, retail sales growth has been relatively muted over recent years. Once inflation (currently 1.8%) and population growth (currently 1.6%) are taken into account, there has been no real growth in retail spending for some time.

**Q2: Describe the recent trends in retail spending by Australian households.**

![Retail Trade (% Change pa)](source: Australian Bureau of Statistics 8501)

![Price and Wage Movements (%pa)](source: Australian Bureau of Statistics 6345 & 6401)
Employment data suggests that there remains some spare capacity in the labour force. As discussed below, although the number of workers employed has increased over the past year, unemployment at 5.3% still remains well above the low of 4.0% reached in 2008. As such, there remains some overall surplus of labour. With this surplus in place, there may be less scope for upward pressure to be placed on wages.

Also providing some evidence that spare capacity remains in the Australian labour force is a comparison with unemployment rates being recorded in various overseas economies. The United States, for example, has a current unemployment rate of 3.5%. Other economies, such as the U.K. and Germany also have materially lower unemployment than Australia with respective rates of 3.8% and 3.1% prevailing.

Technological changes could also be reducing the demand for labour. In some occupation types, new forms of automation are being developed that can replace functions previously carried out by labour. Secondly, a more globalised market for labour could be increasing the ease in which production can be shifted across the globe to the most efficient location; thereby reducing the scope for higher wages to make any individual location a more expensive place to produce.

**Q3: Evaluate whether there is currently spare capacity in the Australian labour market.**

**Q4: Describe two structural changes that could potentially be reducing the scope for real wages growth.**

**Unemployment increases despite employment growth**

Employment growth has continued at a healthy pace in the Australian economy over the past 12 months. In the year to January 2020, the number of workers employed rose by 1.9%. Although this rate of growth is below the peak growth rate of 3.6% recorded in January 2018, it is still marginally above the 10-year average growth rate of 1.8%.

Unemployment will increase when the number of workers employed grows more slowly than the size of the workforce population. Over the past year, the workforce population has increased by 2.2%. As the 1.9% increase in employment has been below the rate of increase in the workforce population, the rate of unemployment has risen. During January, the unemployment rate was 5.3%, up from 5.0% one year earlier.

![Unemployment Rate Chart]

Source: Australian Bureau of Statistics 6202

The 2.2% annual increase in the size of the workforce represents a combination of the change in the adult population size and the change in the “Workforce Participation Rate”. The Workforce Participation Rate refers to the percentage of the adult population that is in the workforce (i.e. either employed or seeking employment). In the year to January, the Workforce Participation Rate has increased from 65.7% to 66.1%. Over the same period, the adult population was estimated to have increased by 1.6%. Hence, the rise in the Workforce Participation Rate has contributed to the rise in unemployment, which has occurred despite employment growing faster than the size of the adult population.

The rise in unemployment over the past year is consistent with a period of reasonably sluggish economic growth. Employment is generally considered to be a "lagging" indicator of economic growth. That is, movements in employment will follow movements in the rate of economic growth. This is because firms often delay making decisions to change employment levels until they perceive that changing economic conditions have a degree of permanency. High costs (e.g. training costs) associated with either increasing or reducing employment are an important factor in creating this "lag".

Although being a “lagging” indicator, unemployment trends can also influence the direction of future economic growth. For example, rising unemployment can create a negative feedback loop or “vicious cycle”
whereby consumption spending declines as a result of unemployment. The fall in spending can then lead to lower economic growth and further unemployment. It is this threat of a “vicious cycle” that adds to the importance policy makers place on the goal of avoiding high rates of unemployment.

Q5: Define the term “participation rate”.

Q6: Outline why unemployment is considered to be a “lagging” indicator of economic growth.

**Australia’s trade position**

Although domestic demand growth in the Australian economy has been sluggish, the contribution to growth from exports has been strong. The Australian economy has continued to benefit from its trading partners experiencing a higher rate of economic growth than the global average, particularly in the Asian region.

Over the year to December 2019, receipts from exports out of Australia increased by 8.3%. This compares with a rise of 6.9% in expenditure on imports. The strong growth in exports can be attributed to both increasing volumes and improved prices for some of Australia’s key exports.

With approximately two-thirds of Australia’s export value being commodity related, changes in commodity prices can significantly influence income from international trade. As commodities represent only a small proportion of Australia’s imports, average export prices have increased relative to average import prices over the past year. The ratio of the price index of exports to imports is known as the “Terms of Trade”. Movements in this ratio over time are shown on the chart below.

The chart shows that for much of the decade leading up to 2012, Australia’s Terms of Trade steadily improved. This upward trend reflected rising commodity prices as well as very limited growth in the price of imports. The increasing dominance of China as a cheap manufacturer over this period was a key contributor to the lack of growth in import prices. After declining between 2012 and 2016, the Terms of Trade has increased again over the past three years. All else being equal, a higher Australian Terms of Trade increases the nominal income produced within the Australian economy.

At least partially offsetting the impact of any lowering of commodity prices is a lower level of the Australian dollar. As is often the case, the recent period of weaker growth in demand for commodities has coincided with a fall in the value of the $A. Against the $US, the $A has dropped from U.S. 70.1 cents at the end of December to U.S. 65.2 cents at the end of February. The lower $A makes Australian exports more competitive on world markets and thereby assists Australian exporters offset some of the impact of lower commodity prices on $A receipts from trade.

Q7: Define the term “Terms of Trade”.

Q8: Describe the relationship between the Terms of Trade and the size of the Commonwealth Government’s budget deficit.

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<tr>
<th>Stats on Australia</th>
<th>Latest</th>
<th>Previous Year</th>
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<tr>
<td>Economic Growth</td>
<td>1.7% (Year to Sep)</td>
<td>2.5%</td>
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<tr>
<td>Inflation</td>
<td>1.8% (Year to Dec)</td>
<td>1.8%</td>
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<tr>
<td>Unemployment</td>
<td>5.3% (Jan)</td>
<td>5.0%</td>
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<tr>
<td>Employment Growth</td>
<td>1.9% (Year to Jan)</td>
<td>2.1%</td>
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<tr>
<td>Wage Price Index</td>
<td>2.2% (Year to Dec)</td>
<td>2.3%</td>
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<tr>
<td>Exchange Rate (TWI)</td>
<td>57.0 (28th Feb)</td>
<td>60.7</td>
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<tr>
<td>Cash Interest Rate</td>
<td>0.75% (February)</td>
<td>1.50%</td>
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<td>Current Account Surplus</td>
<td>$4.3 bn (Yr to Sep)</td>
<td>-$48.4 bn</td>
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<tr>
<td>Current Acct (% GDP)</td>
<td>0.2% (Year to Sep)</td>
<td>-2.6%</td>
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<tr>
<td>Foreign Debt (% GDP)</td>
<td>58.9% (End Sep)</td>
<td>57.2%</td>
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Source: Australian Bureau of Statistics 5206 & Reserve Bank