ECON-19: Inside the Corona Crash
Season 1: Episode 6
Reset

James Whitmore: 2020 has been one of those years, hasn't it? One that will go down in the history books. We're still in the middle of a pandemic that's killed over a million people worldwide, and let's not forget the problems that were already there before 2020 started: climate change, inequality and increasingly fractious international politics. But could this be the year we reset?

I'm James Whitmore and you're listening to ECON-19, a podcast from the University of Melbourne that takes you inside the economics of the coronavirus pandemic. In this episode, I'm talking with professor Ross Garnaut.

Ross is a professor of economics at the University of Melbourne, and he spent his life working on international economics and development. This year, he's been busy developing his plan for Australia's recovery from the pandemic, *Reset: Restoring Australia after the Pandemic Recession.* We called Ross on the road, so please excuse any background noise.

So Ross, to start with, you've been working on this lecture series and you're developing a book. I just wanted to know what was the moment when you though, "This is a really big even. I need to do something big around this"?

Ross Garnaut: It became pretty clear in March, that was before Australia had more than a few cases of COVID. But it was pretty clear that it was going to have a big economic impact on us simply because of the impact it was already having on Northeast Asian countries, Australia's biggest export markets. Biggest trading partners are China, Japan and Korea. These were all affected early by the virus, and it was very clear by March that they were in recession. And that alone was going to have a very big impact on us, a huge effect.

By then, by March, it was starting to spread into Europe. So it was going to have big effect there. But there were, in that earlier stage, not so many signs in the Americas, that came later. But it was clear in the middle of March that this was going to be a very big economic episode.

I recall a conversation I had with the treasurer in his Canberra office on the 5th of March, in which he said he wanted to do everything he could to avoid recession. And I remember saying, "Well, that's a good objective. But I think that's already impossible from what has happened to our trading partners. It could get worse, but it's going to be bad from that alone."

James Whitmore: And of course we did enter a recession. I'm curious to know, how does it compare to previous recessions?

Ross Garnaut: Well, it came up upon us more suddenly. I've put up a chart in the lectures comparing the downward spiral in world trade, type of volume of world trade in the Great Depression of 1929, in the '30s, and then the global financial crisis and this one. In the first few months, you had a bigger contraction of world trade within a few months than you had in either of those earlier episodes.

That didn't keep going like that. After seven or eight months, the global financial crisis of 2008 had caught up, but it was a very sharp, sudden effect. So compared in that way, this one is associated with proportionately a bigger decline in international transactions, partly because a lot of the impact was on movement of people. There were very big restrictions on movement of people to all countries very early on, which really brought to a holt a lot of important services trade. For example, tourism and education, which are very important for us. And tourism in particular, important for a lot of other countries as well. That very large element of world trade just about stopped.

And then recession caused a contraction in demand everywhere. So you had a big fall in most commodity prices. Not quite all, but most. Particularly, a big one, in fossil energy: oil, coal and gas, which are important export over to Australia. So through the international trade impact, it was very big, very sudden. In effect on total output economic activity, first half of this year, saw the biggest decline in such a short period that the world economy has ever seen.

There was a particularly strong stimulatory response from governments, from fiscal policy, budgets, cutting taxes and increasing government expenditure, one of the expenditures being social security payments for people suddenly unemployed, and also a very rapid monetary expansion in every country. But the balance between fiscal expansion, what governments did through budgets and monetary expansion, what reserve banks did through reducing interest rates and expand the money supply, the balance was different this time, partly because interest rates were already so low in most countries, all countries. I said, it wasn't quite as easy as it was in the global financial crisis a dozen years ago to reduce them further, but much more rapid and large fiscal expansion this time.

Australia's increase in expenditure was huge. Amongst the larger, but it was very large in all developed countries. Very large in almost all countries that had the fiscal capacity to support big increases in expenditure. That has been important in stabilizing economies after that very sharp first half fall. At very least, there was this quite sharp reduction in the rate of fall everywhere. In some countries, beginnings of return to growth, the most important economy in which that was the case was China, which would turn to quite strong growth in the September quarter.

So sharper reduction in economic activity, and partly because there was a very strong stimulatory response from governments, much stronger than the great depression and stronger than the global financial crisis, and earlier stabilization. Not a complete stabilization. Still, things are going down in a lot of countries, including important ones in Europe and America, but certainly that very sharp reduction of activity in the first half of the year has stopped.

James Whitmore: It's interesting, you're talking about what governments have been spending. Obviously, in Australia, we have this conversation around how much we can spend, do we need a balanced budget. The budget deficit now is enormous and it's going to be enormous for several years, at least. Is this a problem?

Ross Garnaut: Well, it's a problem but one that we have to have. It's absolutely necessary to do that, or we won't restore growth in the economy, or we won't even stop things going down. So we have to do it. It would be a mistake not to do it. It will be a mistake to do less of it. It will be a mistake to stop doing it too early, be a mistake to stop doing it until we've got genuine full employment, which is a lot lower unemployment than we had in the period before the crisis.

But that's not to say that it's cost to us. Do we have to repay it, or the future generations have to repay it? Well, that depends on economic circumstances in future. If to get to full employment we find that we need to continue to have budget deficits, then it may be good economic policy not to repay that debt for a very long time. On the other hand, if we find that as we come towards full employment, people's tendency to invest is as great or greater than their tendency to save in the private sector, then we will have to hold back that debt and reserve bank will have to sell into the private sector the securities that it accumulated to finance government debt during this period of expansion.

How much of a challenge it is for the future depends a bit on economic conditions that are hard to predict in the future. But there is a cost, and it would be best to get back to full employment as quickly as possible so that we can slow the growth of debt as early as possible.

James Whitmore: So your lecture series and your book are called Reset. Why is this the moment to change the way we do things?

Ross Garnaut: Well, I spent one of the lectures and one of the chapters in the book explaining that we couldn't go back to what we had immediately before the pandemic, but we wouldn't want to go back there even if we could. The years between the resources boom on the onset of the pandemic early this year was a pretty bad period for economic conditions in Australia, a pretty bad period for the standard of living of ordinary Australians.

Per capita, our output in that eight years, seven years or so, grew more slowly in Australia than in other developed countries. It grew significantly more slowly, output per person, in Australia than in the average of developed countries, much more slowly in the United States. More slowly even than in Japan, and we're used to thinking of Japan as a poorly performing economy. But our output per person and our productivity grew more slowly than that in Japan. That was reflected in stagnant living conditions.

Even worse for ordinary people, ordinary workers than that stagnation suggests because it was a period of wide distribution of wealth and income. So the people in the median over the income distribution and below, many of them didn't quite maintain living standards. It's quite unusual in modern day economic development to have such a prohibitive income stagnation. So there are reasons why we don't want to go back there even if we could. But we can't go back there anyway because a number of things will be harder.

James Whitmore: You've mentioned productivity, which is something that economists always talk about it. Can you just tell us what is it and why is it so important to economies?

Ross Garnaut: Well, Paul Krugman, a Nobel Laureate amongst economists, who puts a lot of things in an engaging way, writes a very interesting column for the New York times. He once said that, "In the long run productivity isn't everything, but it's almost everything." Productivity is how much output you get from a given quantity of capital and labour. If you can produce more output with the same amount of capital and labour, then you've got much more income to distribute across the community.

It's different from producing more output by working harder, which may or may not make you better off overall. It's different from producing more output by putting more capital into it, because you've got to divert resources from consumption of doing something else to make it available as capital expenditure. So, if you like, it's another form of free lunch. And over the long term, it's the main determinant of living standards. Countries with high average productivity are likely to have higher average standards of living. Countries with low productivity are going to be countries with relatively poor populations.

James Whitmore: So these are... is unequal impact on different groups of people. To what extent do they reflect inequities that are already present in Australia's economy?

Ross Garnaut: I think, to a considerable extent. People who had established wealth have not been much effected by this, because they have more comfortable house from which to keep working on and they have reserves of wealth, more likely to have permanent incomes. If they are still in employment, jobs that they could keep getting paid for even though office is closed, or if they were living off asset income. That was not severely disrupted. There was an early fall in the share market but that's mostly been recovered, early fall in housing prices, but that's stabilized.

And those falls were a tiny proportion of the huge increases in wealth that accumulated during the period of falling interest rates from the turn of the century until the eve of the pandemic recession, that people who had some assets at the beginning of that long period of falling interest rates, if they hadn't consumed them unusually, went from being modestly wealthy to very wealthy over that period, or from being very wealthy to fabulously wealthy. So the different experiences of different parts of the community were extreme.

James Whitmore: What are some of the ways that we can improve the equity in Australia's economy?

Ross Garnaut: In the lectures and in the book, I suggest two major reforms. One in corporate tax and one in integration of the personal social security system. On the former, it's not any question of equity, it's a question of efficiency. We'll get better economic performance if we do it. But as soon as we move from the standard corporate income tax to a tax on cash flow, which has the effect of shifting the incidents of corporate taxation away from those who are investing and innovating, and place the hard burden on those who are not doing any of those things, they're just earning rents from historical assets.

And in the personal income tax and social security area, I suggest that now is a good time to go to, what are sometimes called a basic income guarantee for an earlier generation of economists, or as more commonly called a negative income tax, where nearly all Australians, all except those who are well above average means, receive a basic payment into their bank account over a fortnight, whether employed or not. And they keep getting that whether or not they're earning income. And I think we would find that a very reassuring source of income security, favourable to incentives for labour force participation, especially for people on low incomes.

At present, the combination of withdrawal of social security, if you start to earn more than a rather modest amount of income and income tax, a combination of those two things gives you very high effective tax on extra income that you earn. You just have a steady moderate level of taxation from the first dollar of income. You'd effectively keep your basic income and add to that what you earned less a moderate income tax rate. I think that would be a comprehensive way to improve income security, remove the stigma of unemployment benefits that's there at the moment, remove unhelpful, wasteful requirements of proof that you're searching for enough jobs even when there's no jobs there, and increase incentives for labour force participation and therefore strengthen the economy as we recover from this pandemic recession. There are the two reforms I put a lot of emphasis on.

Recently, with the Melbourne economic forum, some of my colleagues are here and colleagues at Victoria University gave other suggestions. Peter Dawkins, once the director of the Melbourne Institute, now Vice-Chancellor of Victoria University, put a strong case that amongst our recovery policies should be a very strong emphasis on education, including early age education, preschool education, and training. That should be a very important part of the big emphasis on economic expansion in the post-pandemic period. I think he's got a good point there. So do those three things and we would've made a good start.

James Whitmore: It's worth mentioning here that we spoke to Ross directly before the US election, so his suggestions here are based on what he thought would happen.

And something else that's on your pandemic recovery wishlist is something that you've been working on for a very long time since you did the climate change reports for the government under Kevin Rudd and Julia Gillard, is making low carbon energy a focus of the recovery. Why should this be central to our recovery from the pandemic?

Ross Garnaut: Well, it's a bit of good luck, really. Wasn't anything there in nature that said that this would be helpful at this time. There was no economic law that said that making the adjustments we have to make to get the emissions at about... economy for climate change reasons was going to be helpful to the economy. But the way things turned out, it could, A, be very helpful and, B, be the only thing that is helpful enough.

I told the story of the chain in the economic role of climate change mitigation in my book, Superpower, which came out from another series of lectures I gave this time a year before, in 2019. In that book, I compared this situation facing us with climate change now, which it existed around in my first report. My first report was commissioned by all the governments of Australia. Initially, the six state governments and the two territories and the Commonwealth joined it, so all the sovereign governments. The Federation were part of the exercise.

And I gave that report to the Prime Minister and the Premier's chief ministers in September 2008, after a year and a few months, a year and a half of very careful work. One of the things that I did was, with a lot of excellent help from very good government and university economic modelist, was to do a very detailed exercise on how the Australian economy would evolve through the rest of the century, with and without Australia playing its full part in a global climate change mitigation.

It turned out that the costs of the world failing on climate change were very much greater than the cost of playing our part in a global effort to stop climate change or to hold it at reasonable levels or moderate levels. Nevertheless, the early costs were considerable. And for a couple of decades, my modelling showed that income's growth would not be as strong as it otherwise would be. And there was a measurable and significant sacrifice of incomes to play our full part in a global financial effort.

Well, what's changed since that work? Well, one thing's changed rather radically. And that is, as it's turned out, the costs of the zero emissions technologies in electricity, the technologies that give you solar power, wind power, are better in industry. The costs of electrification of transport using zero emissions electricity, also pathways to zero emissions industry. The costs have turned out to be very much lower than I anticipated in my modelling a dozen years ago.

I tried to take into account all the work that was going on to reduce the costs of those zero emissions technologies. My team and I consulted closely with people working on the pure research at universities, but also applied research and technology, also making equipment and using it, not only in Australia but in China, Japan, Korea, United States, Britain, Germany. My assumptions about the likely rate of production of costs of zero emissions technologies were based on all of that, but they greatly underestimated the reductions that have actually happened.

For example, with solar energy, after my consultations I wrote into all of the assumptions of the modelling and an expectation of a fall in costs through technological improvement of a few percent per annum. Well, in practice, in the first decade after the report came out, cost fell by 85%. So that's much more rapid than anticipated. And so the costs of making the adjustment are very much lower than anticipated. In fact, in some areas, including the shift to zero emissions electricity using solar, and wind, and storage, and demand management, the cost of new technologies are already lower than new build old technologies. So we'll actually do better economically using new technologies.

In Australia's case, the advantages are even greater because we've got a greater, relative abundance of solar and wind resources than any other country. Also, a relative abundance of capacity to capture carbon in our landscape in soils and trees, and therefore a capacity to produce biomass for zero emissions industry. So all of these advantages mean that as the world as a whole goes to zero emissions, as we must if we're going to ever stop increasing temperature, Australia will have a competitive advantage in industries that use a lot of energy. We should be the lowest cost country in the world.

Now, as it turns out, the pandemic has been associated with an acceleration of the global commitment to moving to zero emission. United Kingdom will host the next United Nations conference on climate change. It will be held in Glasgow next year. It was to be held in December this year, 2020, but COVID caused the postponement. Well, Britain has a commitment to a zero net emissions by 2050, and it's going to use its hosting of the conference to push and pull other countries to make... not only make similar commitments, but to do things to get there. In this, it's following what the French President did who played such a role in the Paris agreement in December of 2015.

Just a month and a half ago, in an address electronically to the general assembly of the United Nations, the Chinese President, Xi Jinping made a commitment for China to a zero net emissions by 2060. Well, that is a very big step. China accounts now for about 28% of global emissions. It produces half the world's coal. It produces half the world's steel which is still made primarily from coal. Uses more than half the world's cement, which is very emission intensive. It nearly produces and uses nearly half of the world's nitrogenous fertilizers which produce a huge amount of emission.

So for China to go to zero emissions is a very big step. Of course, the world as a whole can't deal with this problem unless China does, but China's now announced just in September, 2020, it announced it's going to do so. Since then, Japan and Korea have formally committed themselves to zero net emissions by 2050. Europe had already done so.

In the United States, President Trump had always said that climate science wasn't to be taken seriously, just like medical science wasn't. So he tried to get America out of the international agreement made in Paris. But if he loses the election next week, as the polls and the betting markets say he's likely to do, then the new president will commit the United States to zero net emissions by 2050 to zero emissions in electricity and energy by 2035.

So the world is moving quite strongly in that direction. All of our biggest trading partners are heading quite strongly in that direction. And so we're going to be quite quickly in a world, in which... If Australia invests in energy using industries, and the energy is zero emissions energy, could be a very strong demand for products. Australia is going to become the natural place to process Australian minerals for export to other countries committed to zero net emissions.

And with that, so there'd be very large opportunity for us to get a lot of the business investment in the trade exposed industries that we need for full employment with a reasonable amount of debt. But we can get a lot of that investment and a lot of that growth in income from the transition, accelerating the transition to zero emissions energy.

If you look at other things, there aren't so many rich opportunities in other spheres. A lot of the traditional energy mining will not be the source of major new investments. There's been some talk of a gas wide recovery, but it's hard to see where the external demand's going to be for that or, for that matter, where the Australian competitiveness is going to be. I think it's unrealistic to think that will make much of a contribution.

A lot of our old manufacturing was wiped out by the lack of competitiveness, cheering the China resources boom. That's not going to come back. But there will be very strong economic reasons to expand the zero emissions industries, including metals processing but a lot of others, as the world moves towards a zero emissions economy. So we're fortunate that change in the economic context of the movement to zero emissions coincides with the need for high levels of investment to get us to full employment with a reasonable amount of debt.

James Whitmore: It gives me great hope to hear you say that, because it really felt like it could've gone either way on climate change during the pandemic. So that's really great to hear. So I'm just curious, as we look to recover, what is the big risk for our recovery?

Ross Garnaut: I think the biggest risk is that we won't change enough and that we'll slip back into dog days. For example, the treasurer said the priority will be increases in employment. The reduction of unemployment until unemployment falls below 6%, and then they will start reducing deficit. Well, we don't have full employment at 6%. I said in the lectures and I say in the book that you only know you're at full employment when wages start to rise in the marketplace. That hasn't happened. We were nowhere near that in Australia before the pandemic. Even America, which got down to three and a half percent unemployment, wasn't experiencing strong inflation in the labour market. So it's a very big risk that...

First of all, the monetary policy won't go far enough in matching the easy conditions of the rest of the world, and so exchange rate will stay too high. And secondly, that our expansion of fiscal policy will end too soon. And thirdly, that we will let the history of debilitating debate on climate change get in the road of taking advantage of the immense economic opportunity that lies before us in that area. Suppose, fourthly, that we don't undertake reforms that could raise productivity and give us rising living standards when we return to full employment. And fifthly, merely underpinning all the rest.

If there's a danger that we won't recognize it, that we're not going to get productivity raising reforms won't get accepted, so new ways of doing things either can underpin rising incomes. Unless and until there's widespread acceptance in the Australian community that the benefits of economic growth are being shared equitably, so that equitable income distribution and policies to generate that become an integral part of an economic program to achieve full employment and rising incomes.

James Whitmore: Pandemic recession is one of the most sudden shocks to the global economy we've seen in over a century. But if we are clever, we can recover from it more prosperous and more sustainable than before.

Thanks to our guest, Professor Ross Garnaut. You'll be able to read more about Ross's work and his pandemic recovery plan in his book that will be out in the new year.

Subscribe to ECON-19 for new episodes. For more insights on the economics of the coronavirus, head to our website, fbe.unimelb.edu.au/econ-19.

ECON-19 is recorded on Wurundjeri land. The podcast is produced by Seth Robinson and me, James Whitmore. The theme music comes from Premium Beat.