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Respond to this virus crisis with genuine incentives

THE AFR VIEW

The lift in annual growth to 2.2 per cent in the December quarter confirms the Reserve Bank's "gentle turning point" for the economy heading into the bushfire and now coronavirus shocks. It at least means the economy had some momentum ahead of what is likely to be an economic contraction in the March quarter and perhaps even the following three months. The task now is to calm the panic, cushion the short-term impact and to push ahead with needed supply-side reforms to help the economy rebound from the shocks. The missing ingredient continues to be business investment. It has fallen now for the past two quarters, and its long-term weakness is the reason Australia's productivity performance has been flat for more than three years.

As *The Australian Financial Review* repeatedly has argued, short-term measures to stimulate demand have largely run their race. The Reserve Bank's 0.25 percentage point cash rate cut on Tuesday – to a record low 0.5 per cent – has mostly sparked a slide in bank share prices after they were strong-armed by the Morrison government to accept a hit to their interest margins, profits and dividend payouts. Overnight, the US Federal Reserve sparked an across-the-board sell-off with a surprise 0.5 per cent rate cut designed to calm market volatility. Even that didn't get Donald Trump off its back.

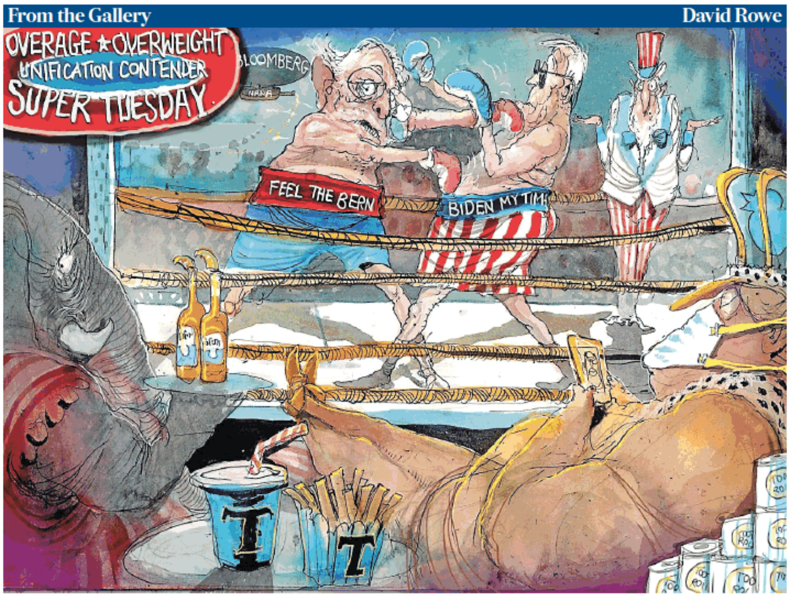
But government can't go over the top with action that panics rather than reassures.

There are similar limits to fiscal policy. The Morrison government can't of course leave the crisis to feed on itself. But nor should it go over the top with stimulus action that panics rather than reassures. Scott Morrison already has slightly turned up the dial in his planned fiscal response from "modest" support to "measured". But it is hard to do something proportionate when it's so unclear how an elusive virus outbreak like this will unfold.

The Prime Minister rightly recalls the good and bad of the Rudd government's large-scale budget response to the global financial crisis. Faced with the seizing up of global capital markets, then-Treasury secretary Ken Henry masterminded a "go hard, go early, and go to households" cash splash to shore up consumer confidence. But that was followed by the infamous pink batts scheme that poured public money into a cottage industry unable to supply the hyper-inflated demand, and then by a school hall building plan which hit the ground after the economy had escaped recession and the Reserve Bank had started to lift interest rates. In the end, the Australian economy was saved by Beijing's domestic fiscal stimulus that reignited demand for Australian iron ore, and the post-GFC leg of the resources investment boom. But by then the Rudd and Gillard governments had used the boom's largesse to embed excessive new spending in the budget which led to more than a decade of supposedly "temporary" budget deficits.

That failure of counter-cyclical fiscal policy means that, unlike in 2008, there is no fiscal surplus to cushion the blow from a genuine exogenous shock. The Morrison government may now have to sacrifice the prize of a first surplus a decade after Labor's rot set in – having claimed the political win prematurely last year – in order to deal with the new contagion. The Prime Minister wants measures that specifically protect jobs and small business cash flow, and promote investment. He also says they must be targeted, and "scalable". Aside from some support for the most stricken sectors like travel, that strongly suggests structural, supply-side measures to encourage businesses to invest such as the investment allowance that is already planned for the May budget. It's already a second-best alternative to a company tax cut that was promised in 2016, but which the Coalition couldn't deliver. A clear statement on incentive is now urgently needed. The problem is not reluctant demand – which has all the easy money it could ever want – it's reluctance to invest with drags like uncompetitive tax, red tape and labour inflexibility. The Morrison government isn't immune to the politicisation of handouts: look at the farmers propped up for years on marginal land, or the cynical sports rorts scandal. That can't be part of the plan. Genuine incentives to work, hire and invest are the best response.

From the Gallery David Rowe



The RBA mangles its messaging

Managing expectations

By sending the wrong signals on the economy and on housing, the RBA may now have exposed heavily indebted households to a bigger coronavirus hit.

Gabriele Gratton

How this week's interest rate decision unfolded is revealing of the way the Reserve Bank of Australia has been interacting with the market and with the policy debate. Instead of proactively managing expectations, the RBA allowed virus-shocked market sentiment to determine monetary policy.

In reality, on Monday, as the RBA board members pondered the pros and cons of a 25 basis point cut in official interest rates, financial markets chose for them. By the end of the trading day, futures markets had fully priced in the cut. That is, financial markets behaved as if the cut was going to happen with 100 per cent probability. That probability had been only 18 per cent on Friday night.

Such a turn of events de facto forced the hand of the RBA. If it did not cut rates, then the whole market would have had to suddenly revise its position, potentially causing further and much greater damage to the Australian sharemarket. Whether they were convinced or not of the cut, the RBA board, at the Tuesday meeting, had no real choice any more.

With the markets so exposed, whether a rate cut would in the medium term keep unemployment from rising or not became of secondary importance, as well as debates about how much of the coronavirus shock is a supply-side or demand-side problem. Rather than lighting the path forward, the board seems to react, perhaps too late, to the events.

There is no reason why attempting to stimulate the economy has to also feed the property bubble.

This is in stark contrast to the US Federal Reserve. On Friday, Fed chairman Jerome Powell sent a clear message to the American economy: "The fundamentals of the US economy remain strong … the coronavirus poses evolving risks … we are closely monitoring … and will use our tools and act as appropriate to support the economy." That in turns explains the US markets' reaction to the 50 basis point cut on Tuesday night: if 50 basis points is appropriate, then the evolving risks must be quite substantial.

But the further worrying significance of the latest interest rate cut lies in how it interacts with the Australian bigger failure of economic governance: the over-reliance on only ultra loose monetary policy to stimulate the economy which, by fuelling the housing bubble, has left Australia's heavily indebted households precariously perched if the worst-case coronavirus shock eventuates.

Managing expectations, in particular about inflation, is a key part of a central bank's tool kit. In June last year, the RBA implemented its first rate cut in three years, signalling that future cuts would have followed as appropriate to reduce unemployment and stimulate price and wage inflation.

But with Australian productivity staggering, the extra liquidity only fed the housing and debt bubble rather than increasing productive investments. And since no new investments mean nothing is happening to unemployment and wages, investors and home buyers could safely bet more cuts would come, making housing an even more inviting option.

Now the RBA is facing the possibility of reaching its self-imposed floor of 0.25 per cent much sooner than expected, and potentially much sooner than the end of the coronavirus crisis. That could expose the Australian economy and its giant private debt to a disastrous crash.

This did not have to happen. There is no reason why attempting to stimulate the economy has to also feed the property bubble. On the contrary, macro-prudential regulations like the ones APRA lifted between December and July last year could help funnel additional liquidity to more productive investments, while slowing down the property bubble.

The federal government also has options: it can reduce the fiscal advantages given to property investments and at the same time stimulate demand directly. For example, through much-needed infrastructural investments, or a serious plan to minimise the social cost of the inevitable move out of coal mining.

But, I fear, that would have required a new way of managing expectations. It would have required the RBA to send a clear message to APRA and to the government: rate cuts alone will not solve the problem. On the contrary, they may cause a bigger problem if a bigger shock arrives. We will stimulate the economy if you help keeping property prices below the bubble threshold.

Is it too late? Hopefully, the virus epidemic will peak soon and won't affect Australia directly, though this seems less likely now than a week ago. Last year we lost an opportunity, exposing ourselves to global shocks like this one. Fasten your seatbelts.

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