Fiscal response to the Global Financial Crisis of 2008-09

Ken Henry AC

Date created: February 2020

This paper explores several topics relevant to the extraordinary measures implemented by the Australian Government in response to the global financial crisis of 2008 and 2009 (GFC). The fiscal policy challenge is analysed, against the backdrop of the twenty-year evolution in thinking and practice that preceded it. The effectiveness of individual responses is evaluated. Institutional challenges are discussed. The paper concludes with some reflections on what fiscal agencies might do to be prepared better for future crises.

Table of Contents

1. The proper role of fiscal policy

For most of the second half of the 20th century, Western governments considered themselves responsible for using fiscal policy to support macroeconomic stability. Yet by the end of the century most economists considered that, for the most part, macroeconomic stability could be achieved by an inflation-targeting regime implemented by a credible central bank with operational independence from the government. Monetary policy was king. The use of fiscal policy to achieve short-term macroeconomic stability had been consigned to history.

A history of 'activist' fiscal policy

Australian governments were enthusiastic fiscal activists during the last few decades of the 20th century, pursuing multiple macroeconomic objectives. Government statements announcing expansionary fiscal measures were common in the mid-1970s, early 1980s and early 1990s. In each case, interest in expansionary demand management coincided with rising unemployment. Those instances of 'pump-priming' had been preceded by short-term fiscal contraction designed to control inflation and in most cases followed by concerns with crowding out, and in particular with the need to consolidate the fiscal position in order to make room for private investment.

Few people would argue that macroeconomic outcomes during these decades were greatly assisted by fiscal activism. It could plausibly be argued that several instances of discretionary action were a response to the consequences of earlier action, having the appearance of a fiscal cat chasing its tail.

Textbook arguments against fiscal activism

The application of fiscal policy to short-term counter cyclical targets is subject to considerable recognition lags, implementation lags and transmission (or response) lags.

Recognition lags are inevitable, given the time involved in the compilation of macroeconomic indicators, although these lags have shortened over the past decade with much greater access to digital data. In Australia, the headline GDP statistics for a particular quarter are published in the first week of the third month of the subsequent quarter. A government concerned to avoid two successive quarters of negative GDP growth won't be aware of the first negative figure until it is virtually impossible to do anything to affect the course of the subsequent quarter; a fact that had pronounced implications for the conduct of fiscal policy late in calendar year 2000, following the introduction of the GST (see below).

Whereas a change in the stance of monetary policy can be implemented almost instantaneously, the implementation of a fiscal response will be delayed by the time it takes to design an effective intervention, the time it takes to secure parliamentary passage (if needed) and the time it takes to put in place the administrative apparatus required to implement the intervention. The implementation lags associated with a fiscal intervention can be so large that the intervention has a pro-cyclical impact; a fact illustrated in the fiscal response to the recession of the early 1990s.

In addition, the transmission lags associated with fiscal policy can be highly uncertain.

Then there are matters of effectiveness to be considered. To what extent might a fiscal intervention be thwarted by Ricardian equivalence, the permanent income hypothesis, crowding out of private investment, import leakages or a loss of export competitiveness due to (Mundell-Fleming) real exchange rate effects?

Political economy challenges to the timely use of fiscal policy

While not typically mentioned in undergraduate macroeconomic texts, the ability of a government to formulate and prosecute a case for discretionary fiscal action will be affected by its political strength, the attitude of the media and the economic literacy of the population. These political economy factors feature strongly in the lessons to be drawn from the GFC period.

The 'twin-deficits' and fiscal responsibility

In the mid-to-late 1980s fiscal policy advisers became interested in something called the 'twin-deficits' proposition. According to this proposition, Australia's history of current account deficits, and consequent external indebtedness, owes something to a record of fiscal deficits and the accumulation of public sector debt. The proposition played a key role in building public support for the multi-year fiscal consolidations of the late 1980s and the late 1990s.

The political potency of the 'twin-deficits' proposition ultimately led to bipartisan agreement on the need for fiscal policy to have a medium-term anchor. Treasurer Keating (March 1983 to June 1991) was reluctant to embrace a medium-term framing of fiscal policy beyond the so-called 'trilogy', which operated for a couple of years in the mid 1980s, yet his powerful articulation of the 'twin-deficits' paved the way for the explicit adoption of medium-term fiscal frameworks by his successors. [1]

A medium-term fiscal strategy

The *Charter of Budget Honesty Act 1998* says that '(t)he Government's fiscal policy is to be directed at maintaining the on-going economic prosperity and welfare of the people of Australia'. According to the Charter, pursuit of this objective implies that fiscal policy be 'set in a sustainable medium-term framework'.

The Act sets out a number of 'principles of sound fiscal management'. These are concerned with the management of financial risks; promoting national saving; appropriate counter-cyclical demand management; tax burden stability and

---

[1] Announced in the 1985-86 Budget, the 'trilogy' committed the Hawke Labor Government to not increasing taxes or government spending as a proportion of GDP and reducing the budget deficit in both dollar terms and as a proportion of GDP, in 1985-86 and over the life of the Parliament (in effect, 1985-86 and 1986-87).

predictability, and tax system integrity; and having regard to intergenerational equity.

Successive Australian governments have operationalized the Charter by adopting a formal medium-term strategy of achieving budget balance, or (small) surplus, on average over the economic cycle. This strategy is intended to anchor expectations concerning the through-the-cycle stance of fiscal policy and to deter proponents of new public spending programs.

The Charter also requires that the government publish, at least every five years, projections of the budget balance over a 40-year time horizon. The first Intergenerational Report was published in 2002.

A decade of 'consenting adults'

A fiscal strategy of achieving balance over the cycle (with no distinction being drawn between capital and recurrent spending) means that the general government sector is not, in net flows, making a contribution to the average level of the current account balance. Put another way, the average level of the current account balance is explained by private sector agents acting in their own interests, whether as borrowers, lenders, asset vendors or investors. One school of thought has it that policy makers should assume that these various agents are 'consenting adults', in which case the sign and size of the current account balance should be of no particular policy interest. [2]

In the early years of the 21st century, the general view in the Treasury was conditionally supportive of this proposition, but cautiously so. The reason for the caution is that even if governments need not be concerned about the damage that 'consenting adults' might do to themselves and their counterparts, through the poor choices they make, governments do need to be concerned about consequences for innocent parties. If enough consenting adults get it badly wrong, the macroeconomic consequences could be serious. This is a straightforward instance of something that looks sensible at the 'microeconomic' level having macroeconomic effects with bad microeconomic consequences; which is the essence of the general case for government being interested in macroeconomic stabilisation. An example more familiar to students of introductory economics would be the paradox of thrift.

Ironically, in the decade before the GFC, the country with the largest current account deficit, and therefore most reliant upon external financing, was the United States.[3] Yet almost nobody apart from IMF staff seemed interested in the efficiency of its capital allocation and its ability to continue to attract external capital, perhaps

---

[2] For an articulation of the consenting adults view of the current account, see a number of papers by John Pitchford and Max Corden, in particular, referenced in Gruen and Stevens (2000).

[3] Henry (2003a).

because it was considered to be host (not hostage) to the most highly developed and sophisticated financial centres in the world. [4] [5]

2. LESSONS FROM EARLIER CASE STUDIES

Attachment A reviews a number of fiscal policy case studies from the period prior to the GFC.

The recession of the early 1990s is particularly instructive. It had a significant impact on the development of the Charter of Budget Honesty. In the decade between legislation of the Charter and the GFC there was only one instance of discretionary fiscal action designed to stimulate short-term economic activity. That followed introduction of the GST in mid-2000. There were a number of other incidents, with potentially significant macroeconomic impacts, that motivated unusual government intervention in the early years of the 21st Century. These incidents contain lessons for fiscal policy. Events in other parts of the world between the legislation of the Charter and the GFC also contain lessons for fiscal policy advisers.

Lessons from the recession of the early 1990s

The early 1990s recession contained several lessons for policy practitioners, and especially those in The Treasury.

First, no matter how great the importance of fiscal discipline in establishing policy credibility, it is nothing compared to the loss of credibility associated with a recession.

Second, no matter how stridently economic policy advisers caution against the use of fiscal stimulus measures, at some point a government will find that it has no option but to take action and, when it does, those advisers will find that they have been sidelined.

Third, the implementation lags associated with setting up new institutional arrangements, such as the Development Allowance, and the lags in infrastructure programs are long. Direct payments to households have much shorter implementation lags, though still amounting to several weeks.

Fourth, big swings in unemployment lag GDP by a considerable period, and those who lose their jobs in a recession will find it difficult to secure a new job. Many of those who lost their jobs in the recession of the early 1990s, especially workers aged 55 or more, never worked again. This underlines the importance of acting ‘early and hard’ with any stimulus.

Fifth, political economy factors are very important. The Hawke Government’s handling of the recession was affected by its otherwise admirable determination to stick with its major program of economic reforms, the policy platform that defined it,

---

[4] ibid.
[5] Henry (2012).

no matter the state of the business cycle. It found it very difficult to change policy persona when the circumstances required that it do so. No doubt, leadership tensions throughout 1991 made the task even more difficult.

Lessons from the Asian Financial Crisis

The Asian Financial Crisis contained several lessons for fiscal practitioners.

First, global capital markets can be fickle. If there is a sufficiently large shift in investor perceptions, a long history of strong capital inflows means nothing.

Second, fiscal austerity programs implemented in countries facing a capital account shock will make things worse, at least in the short-term.

Third, the ability to engage in short-term fiscal support depends upon the strength of the public sector balance sheet; it is far easier to preserve, or regain, external support if the public sector balance sheet starts from a position of strength and remains strong.

Lessons from the fiscal stimulus following commencement of the GST

The experience of 2000 illustrates several things of significance to macroeconomic policy practitioners.

First, recognition lags really are a problem.

Second, while the First Home Owners Scheme (FHOS) was chosen because it targeted a sector exhibiting pronounced weakness, it also benefited from relatively short implementation lags; other options were discarded on the basis that they could not reasonably have been expected to have a sufficiently timely impact on economic behaviour.

Third, the dwelling construction cycle can have a pronounced impact on aggregate GDP growth, both directly and because of its strong linkages to other sectors.

Fourth, if the macroeconomic circumstances are considered by a government to be sufficiently alarming, then activist fiscal policy will be employed, notwithstanding the primacy accorded monetary policy nor the force of attachment to medium-term fiscal goals or the aversion to 'debt and deficits'. [6]

Lessons from the collapse of HIH and the response to 9/11

Highly adverse market developments might motivate unusual government interventions designed to restore confidence and avert a pronounced negative macroeconomic impact. These sorts of interventions would not be described as the traditional exercise of fiscal policy, but they have a similar objective.

---

[6] The fact that this particular fiscal stimulus was engineered by a Coalition government is instructive.

3. War games

For some years prior to the GFC the cohort of officials making up the top three levels of the Treasury met approximately monthly to discuss matters of strategic policy significance. In 2004, during a discussion of macroeconomic policy challenges, Martin Parkinson observed that there were very few people in the room who had any first-hand experience of the recession of the early 1990s.[7] We agreed to schedule a workshop to 'war game' policy responses to severe macroeconomic shocks.

The 'war games' provided an opportunity to review the experience of the early 1990s recession and the Howard Government stimulus in 2000. Modelling informed a discussion about the timing and size of a fiscal stimulus that might prove effective in different circumstances.

We discussed the difficulties in rolling out infrastructure projects in response to a crisis. The Howard Government's increase in the FHOS had the advantage of being able to be implemented quickly. On the other hand, it had complicated monetary policy in 2002 and 2003 as house prices accelerated sharply. We investigated the lags in getting cash transfers into the hands of welfare recipients and other household types. And we discussed the utility of temporary investment tax credits.

I came out of those discussions determined that if Australia were to confront a large negative shock during my tenure as Secretary, the Treasury would seek to put itself front and centre in advising the government on an appropriate policy response. The Treasury deputies shared this view. We would not be taking seats in the back row by counselling a government to rely on monetary policy, the exchange rate or the operation of the automatic stabilisers. I carried with me a 'rule of thumb' that if a fiscal stimulus were to be comprised principally of cash payments to households, it would have to be at least one-half of one per cent of GDP, and implemented as soon as practically possible, in order to have a significant impact on aggregate demand. And if it worked, then it might be possible to have a fiscal stimulus, avert a recession and retain a budget surplus.

4. Fiscal policy in Australia in the few years preceding the GFC

By mid-2007, the public sector balance sheet was in good health, with negative net debt (-2.2 per cent of GDP as at 30 June 2007) following a succession of asset sales and budget surpluses (Chart 1). Surpluses were underwritten by fiscal discipline in the late 1990s and strong nominal income growth driven by very high terms-of-trade (Chart 2) and strong employment growth (Chart 5).

---

[7] In 2004, Martin was one of the Treasury Deputy Secretaries. He had spent some time in the Office of the Treasurer in the second half of 1991.

With large personal income tax cuts and increases in family payments having been provided in the 2006 and 2007 Budgets and commodity prices well above historical norms (Chart 3), it was difficult to make an assessment of the structural position of the budget. It is clear, however, that most of the benefit to the budget bottom line from the terms of trade was being recycled to households.

The extent of revenue recycling is evidenced in Table 1. The *projection* for the 2008-09 underlying cash balance presented in the 2005-06 Budget was $9.3 billion (0.9 per cent of GDP). Successive budget documents reveal cumulative parameter revisions between May 2005 and October 2007 totalling $53 billion for the 2008-09 year. $47.9 billion of this (more than 90 per cent) was 'recycled' in tax cuts, increases in family payments and other discretionary measures, leaving a 2007 MYEFO *estimate* of a $14.4 billion surplus (1.2 per cent of GDP). [8]

The economic consequences of this large scale recycling of buoyant revenues included rising official interest rates, a strongly appreciating currency and a 'two-speed' economy. The official cash rate of interest was lifted in 10 steps, from 4.75 per cent at end 2003 to 7.25 per cent by late 2007. The (nominal) trade weighed index of the exchange rate appreciated by about 40 per cent over the same period (Chart 6). And mining's share of Australia's gross value added increased from about 4 ¼ per cent to 10 per cent, crowding out manufacturing activity in particular. Another indicator of the two-speed economy is mining's increasing share of corporate profits (Chart 7). In the lead up to the GFC the Australian economy enjoyed very strong growth, and nominal income growth was even stronger, but the 'two speed economy' had put a lot of businesses outside of mining (and mining-related construction) in a structurally weak position.[9]

Following a review by the Treasury, the Australian Government announced in the 2003-04 Budget that it would continue to issue Treasury Bonds (CGS) sufficient to support a viable Treasury Bond futures market, even though it had no prospective funding need. The decision permitted a bare minimum level of issuance in a handful of tenors, about $5 billion a year. The market exhibited low liquidity, with a high concentration of patient offshore holders.

The Future Fund, which had been established as a debt defeasance vehicle, could not be viewed as a contingent source of budget funding, except to the limited extent that the Fund may wish to hold CGS under its own investment mandate. [10]

---

[8] This implies that the estimate for 2008-09 nominal GDP had been revised up by some 16 per cent over the same period, a consequence of unexpectedly strong terms-of-trade.

[9] This is not to suggest that the fiscal strategy at the time was inappropriate. Nobody at the time knew for certain for how long the terms-of-trade would remain highly elevated. If this were merely a cyclical phenomenon, there would have been an argument for running several years of larger surpluses. But if this was the 'new normal' then a significant structural adjustment was unavoidable. Very probably, the 'two-speed' economy would prove to be a short hand description of a massive structural adjustment to permanently higher terms-of-trade, occurring over many years.

[10] Unlike a number of other sovereign wealth funds, the Future Fund was not designed as an intergenerational wealth fund. It was funded by a succession of *unexpectedly* large budget surpluses.

The heavily indebted Australian household sector (Chart 4) was highly sensitive to interest rates and the state of the labour market (Chart 5).

The Australian stock market had doubled in value in the five years to November 2007. This followed global trends, influenced heavily by a reduction in risk premia similar to the experience of the dot.com bubble a decade earlier. For example, the spread on 5 year B rated United States corporate bond yields to US Treasury bonds fell from around 800 basis points in 2002 to less than 300 basis points in mid 2007, a fall of more than 60 per cent.[11]

While there were numerous instances of infrastructure stress across Australia in the first decade of the 21st century, in part because of strong population growth, there was no national infrastructure program. The Commonwealth had very limited exposure to the infrastructure plans of State and Territory governments, and saw infrastructure as not being within the set of responsibilities of the national government. For their part, sub-national governments had only very immature infrastructure programs at best. In the second half of 2008 there wasn't one significant 'shovel ready' public sector project anywhere in the federation.

5. Systemic issues connected with banking sector liabilities

Late in 2008 the Council of Financial Regulators was still finalising details of the so-called 'Financial Claims Scheme', which was the response of officials to the recommendation of the HIH Royal Commission that the Australian Government consider an explicit bank deposit guarantee scheme, and mid-way through a major piece of work on financial system crisis management.

The 2006 FSAP report from the IMF had highlighted the risk exposure of Australian banks to offshore wholesale funding markets. That exposure had grown with the development of Australia's compulsory superannuation system that had contributed to a diversification of household savings exposure beyond domestic deposit accounts, including portfolio exposure to foreign equities with embedded currency risk. At a national level, Australian households were arbitraging the equity premium in international markets, exposing the country to substantial refinancing risk (Chart 8). When the refinancing risk emerged in 2008-09, Australian superannuation funds rebalanced portfolios in favour of domestic equities (selling foreign equities, on which their capital loses were ameliorated by a substantial $A depreciation). Purchasing Australian bank paper would have gone some way to satisfying the financial system's demand for wholesale debt finance, but fund managers resisted that proposal, considering that equities offered superior long-term returns for members.[12]

---

[11] McDonald (2009).

[12] Henry (2012a).

6. Unusual developments in the global financial system in 2007 and 2008 and Australia's reaction

The global financial crisis was a long time coming. As noted earlier, some economists had long held doubts that the first decade of the 21st century would work out well, if only for the reason that it seemed highly implausible that the most developed country on earth should also be the world's biggest attractor of mobile capital. That didn't sit well with what any economist would have learned in studying development economics. Globally, there appeared to be increasingly concerning saving-investment imbalances. But that's not the same thing as knowing precisely when a crisis will materialise and, more importantly, knowing when, and in what manner, it is time for policy makers in a country like Australia to start taking action.

Early signs of an emerging financial crisis became evident in 2007, in the form of highly elevated inter-bank lending rates (the rates banks charge one another for short-term loans). Comparing inter-bank rates with official rates provides a measure of perceptions of counterparty credit risk in the banking system. In the second half of 2007, the LIBOR-OIS spread, which historically had often been no more than one basis point, jumped into the range of 100 to 150 basis points, then rose to more than 400 basis points late in 2008.

A good overview of the proximate causes of the crisis, and several other early warnings, is contained in Gruen (2009, Sydney Institute).

Northern Rock

On 17 February 2008 Northern Rock, the fifth largest bank in the United Kingdom at the time, was nationalized. It had experienced a bank run on 14 September 2007, the first run on a UK bank since 1866. It was rescued by liquidity support from the Bank of England. Governor Mervyn King had been considered a reluctant savior. Reasons for his reluctance, having mainly to do with concerns of moral hazard, are set out in King (2007).

29 February 2008

Shortly after arriving at my office on 29 February 2008 I received a call requesting that I accompany Prime Minister Rudd and Treasurer Swan on a flight that morning to Gladstone. I was not provided with any other information. Once the plane had levelled out, the Prime Minister asked me: 'What's the worst thing that can happen?' Clarifying that he was referring to the possible consequences for Australia of emerging global financial volatility, I replied that the worst thing that could happen would be that the world overnight stopped funding our current account deficit. If that were to happen, it would most likely show up first in Australian banks being denied access to offshore wholesale funding. If bank balance sheets had to shrink, the reduction in lending would have a significantly adverse macroeconomic impact, most likely resulting in a deep recession.

I explained that the exchange rate would collapse, but even very large currency depreciation would be insufficient to prevent a recession. With the official cash rate at 7.25 per cent, monetary policy had a lot of spare capacity, but a cut in short-term interest rates wouldn't help with the financing of the current account. To avert a macroeconomic and financial crisis, highly unusual government intervention would be required, including fiscal stimulus. We discussed a range of possible measures, including sovereign guarantees and the possible issuance of Commonwealth Government Securities to fill funding gaps. I noted that if we were in a world in which nobody wanted to hold bank paper there was no guarantee that anybody would want to hold sovereign paper either, but our bonds would be more attractive than virtually every other financial asset trading on global markets, given the strength of the Commonwealth balance sheet and Australia's strong fiscal position. We discussed other funding measures that might be considered as a 'last resort' in the event that global markets were to freeze for an extended period.[13]

On this flight we also discussed the possible need for the government to support particular pieces of the financial system, depending upon how a crisis might play out.

Bear Stearns

On 16 March 2008 the United States Federal Reserve brokered the purchase, by JP Morgan Chase, of Bear Stearns, for a heavily discounted price of $US 2 per share; its shares had been $US 170 at the beginning of 2007. JP Morgan Chase's market capitalization increased by $US 14 billion the following day.

Spring 2008 IMF meetings

I accompanied Treasurer Wayne Swan to the spring meetings of the International Monetary and Financial Committee (IMFC) of the IMF on 11, 12 April 2008. Prior to the IMFC meetings, we took the opportunity to meet with United States regulators in Washington (including Federal Reserve Chairman Ben Bernanke and senior people in the SEC) and senior executives of large financial institutions in New York. In those meetings, the principal topics of conversation were the continuing uncertainties concerning the quality of bank balance sheets; the evolving shape of financial sector regulation and other unusual market interventions, including the handling of Bear Stearns; likely macroeconomic impacts of financial sector volatility; and implications for the stance of monetary and fiscal policies. These topics also featured strongly in IMFC discussions.

The Communique of the IMFC, released on 12 April 2008, noted that 'the Committee met at a time of unusual uncertainties surrounding global economic and financial market prospects. [14] It stresses that the challenges facing the world economy are of a global nature, requiring strong action and close cooperation among the membership.'

[13] In the event, none of these 'last resort' measures was required.
[14] IMF (2008a).

In respect of market interventions, the IMFC 'welcomes the actions taken by the central banks of the advanced economies to provide liquidity support to ease strains in interbank markets, and calls for continued vigilance to deal with the financial turmoil. Further prompt actions by large financial institutions to disclose losses and repair balance sheets by raising capital when needed and mobilizing medium-term funding will contribute to restoring confidence.'

And in respect of monetary and fiscal policy settings, the IMFC concluded that 'in the advanced economies, monetary policy should continue to aim at medium-term price stability, while responding flexibly to signs of a more pronounced and prolonged economic downturn. Fiscal policy can also play a useful counter-cyclical role. In the United States, temporary fiscal easing will help to counter downside risks to growth. Other advanced economies have also experienced financial turbulence and their growth rates have declined; when consistent with medium-term fiscal objectives, automatic stabilizers should be allowed full play.'

At this stage (April 2008) the IMF was not recommending strong fiscal stimulus. The mindset of Fund staff was still attaching primacy to dealing with global imbalances.

While there is no need to provide a detailed account of the meetings Treasurer Swan and I had in Washington and New York prior to the IMFC meetings, a few recollections are worth reporting.

We were struck that every senior US official with whom we met was in uncharted territory. All were dealing with unprecedented levels of uncertainty and anxiety. We were told that in respect of Bear Stearns, action had to be taken because of its 'octopus-like' connectedness to the rest of the financial system; it was considered to be 'systemically important'.[15] This was especially significant, because, at that time, the US Federal Reserve, unlike the RBA, had no explicit mandate for systemic stability. And yet, it felt compelled to act. At the same time, though, it was evident that officials were very uncomfortable with what had been done, including because of concerns about moral hazard. I recall saying to Treasurer Swan as we left one of the meetings that 'you wouldn't want to be the next US investment bank to get into trouble; they are going to let it go'. This was five months before the collapse of Lehman Brothers.

In New York in the second week of April 2008, financial sector executives were struggling to come to terms with the dimension of the risk to the financial system posed by so-called 'toxic assets'. At a roundtable with executives from several leading financial institutions, one executive suggested that the level of uncertainty was so great that counterparties might simply stop dealing with one another, at any price. Asked what would be required to manage that risk, he suggested that the US Government might have to underwrite all mortgages. I was shocked. Treasurer Swan

[15] This was the expression used by a very senior US official in one of our meetings in Washington.

appeared shocked also. Our United States based interlocutors were not. Were they panicking, or did they have a much better sense of what was coming?

The Strategic Priorities and Budget Committee (SPBC) of Cabinet

The SPBC, chaired by the Prime Minister, with the Deputy Prime Minister, Treasurer and Finance Minister as members, was constituted late in 2007 to guide the development of the 2008 Budget strategy and to deal, at a high level, with other strategic policy matters. Meetings were attended by senior officials of the Department of the Prime Minister and Cabinet, the Treasury and the Department of Finance. On occasion, other Ministers were co-opted for the discussion of particular topics. As the months went by, SPBC discussions became increasingly more detailed.

The role played by public servants in the deliberations of the SPBC was unusual. From the outset of the crisis (long before the collapse of Lehmann's), Prime Minister Rudd made clear publicly that he was taking the advice of the country's most senior public servants with responsibility for economic and financial matters. In addition to those leading departments of state, this included the Governor of the Reserve Bank and the Chairman of APRA.

The Treasury found itself closer to the spotlight than in normal circumstances. Some officials were uncomfortable with the Prime Minister's stating publicly that he was acting on their advice. Some in the media were critical of the apparent closeness of the relationship between the Government and its departmental advisers.

A number of commentators argued that the Treasury was being politicised. It's hard to know whether they really believed this, since these commentators were consistently highly critical of just about everything the Rudd Government did. Obviously, if it were generally accepted that the Treasury had in fact been 'politicised', then the Prime Minister would derive little benefit from publicising that he was acting on its advice. Thus, encouraging the perception of a politicised Treasury would weaken the Prime Minister's credibility. .

Observations

At a time of international economic and financial crisis, senior government ministers will want the advice of the Treasury, given its overall responsibility for economic and financial policy, its leadership of Australia's engagement with the IMF, World Bank, OECD and the G20, and the fact that the Secretary to the Treasury sits on both the Reserve Bank Board and the Council of Financial Regulators.

It is important that the government of the day have access to an apolitical body of expert advisers whom they can trust to have no motive other than the national interest. The Australian Public Service (APS) uniquely plays this role. Especially in a time of crisis the APS is duty bound to advise the government what course of action it considers to be in the national interest. That advice should in no way be considered tainted by the government's making it public.

7. How the collapse of Lehman Brothers and the bailout of AIG changed Treasury's world

By the time Lehman's collapsed, Australian officials understood that the principal macroeconomic risk exposures for the Australian economy were concentrated in three areas: funding risk associated with the capital account, especially through the role being played by major bank intermediation; funding and liquidity risk in various 'lower-tier' financial intermediaries and in businesses reliant upon short-term debt; and commodity price and trade volume exposure to China. Officials also appreciated that the Chinese economy was very exposed to the strength of demand in the United States and Europe.

The collapse of Lehman's, a decade after the Asian financial crisis, demonstrated again that 'consenting adults' can change their minds rapidly and with serious consequences. If Lehman's couldn't rely upon private sector funding, including inter-bank credit lines, then why should we be confident that Australia's banks would continue to be able to rely upon access to offshore wholesale funding markets? Some in official circles took the view that we had little to worry about because, in a more turbulent world, our banks would appear relatively attractive debtors. Others worried that wholesale funding lines might simply dry-up, with no entity in any country having secure access to credit. This was a concern I had raised with Prime Minister Rudd and Treasurer Swan on our flight to Gladstone back in February.

8. International reaction

G7 and IMF

Early in October 2008, the IMF published revised quarterly forecasts for growth in 2009 and 2010. For 2009, global growth was revised down from 4 per cent to 3 per cent, and for 2010 from 4 ½ per cent to 4 ¼ per cent. Subsequent downward revisions were much larger (see below), but it was already clear that we were likely to be dealing with a negative shock from offshore.

As finance ministers from IMF member countries were gathering in Washington for the IMF-World Bank annual meetings in the second week of October 2008, the IMF staff was developing a recommendation for urgent coordinated action to address financial sector fragilities, including various measures to shore up financial sector balance sheets, and fiscal stimulus by countries with the capacity to do so.

Meeting on Friday 10 October in Washington, the International Monetary and Financial Committee (IMFC) of the Board of Governors of the IMF endorsed a five-point action plan that had signed off by the G7 the previous day:[16]

> "Take decisive action and use all available tools to support systemically important financial institutions and prevent their failure.
>
> Take all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding.
>
> Ensure that our banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses.
>
> Ensure that our respective national deposit insurance and guarantee programs are robust and consistent so that our retail depositors will continue to have confidence in the safety of their deposits.
>
> Take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets. Accurate valuation and transparent disclosure of assets and consistent implementation of high quality accounting standards are necessary.

In its communiqué issued following the meeting, the IMFC added that:

> The Committee emphasizes that macroeconomic policies in the advanced economies need to provide essential stimulus in the face of the risk of a pronounced economic downturn, as confidence in the financial system is restored.[17] Given the decline in commodity prices from their recent peaks and the expected slowing activity in many countries, policymakers should consider the most appropriate policy actions depending on national conditions.

In his remarks to the Board of Governors of the IMF on Monday 13 October, the Managing Director, Dominique Strauss-Kahn said that:

> Action in the financial markets is essential, but it is not sufficient.[18] We also need to deploy all of the instruments of modern macroeconomic policy to limit the damage to the real economy.
>
> For the advanced economies, this means using fiscal policy when they can. The most obvious use of fiscal policy is precisely to ease pressures where they are greatest: in the financial and housing sectors. But governments that can afford it should also be ready to undertake a broader fiscal stimulus.

[16] IMF (2008a).
[17] ibid.
[18] IMF (2008b).

In the six months since the Spring meetings, the mindset of Fund staff had adjusted considerably. Dealing with global imbalances now had to play second fiddle to keeping the global economy and the global financial system functioning.

G20

Australia had been an active participant in international meetings convened following the Asian financial crisis a decade earlier. We had observed our Asian partners being lectured by the major developed countries about the need to enhance economic and financial governance, transparency and financial system resilience. Yet, initially, the most important forum for those discussions was the G7, which didn't include any of the crisis-affected economies, and excluded the major Asian economies of China and India. Eventually, due in no small part to the efforts of the North American members of the G7, a larger and more representative grouping emerged in the form of the G20. This new grouping provided a forum for discussions among finance ministers and central bank governors of 19 systemically important economies, together with the Governor of the ECB and heads of the IMF and World Bank.

From its inception in 2000 there had been talk of elevating the G20 to a heads of government forum, but there had been no sufficiently compelling reason to do so, prior to the GFC. Following the collapse of Lehmann's and bail-out of the AIG, Australia, through Prime Minister Rudd, pressed for the G20 to become the pre-eminent multilateral forum for crisis discussions by leaders.

The first G20 Leaders Summit was held on 15 November 2008. In addressing that summit, Prime Minister Rudd spoke of the potential for the financial crisis to affect the real economy, drawing attention especially to the consequences for unemployment.[19]

Early unilateral action

As noted earlier, prior to the collapse of Lehman's, northern hemisphere governments had intervened on a number of occasions to inject capital or otherwise shore-up various distressed financial institutions. These sorts of interventions continued right through the northern summer.

But when it came to Lehman's, on 15 September 2008, the US Federal Reserve stayed its hand. There was no rescue forthcoming on this occasion.

Yet something had to be done, given Lehman's size and the complex financial inter-dependencies among financial institutions. Bears Stern had been rescued because it was considered systemically important, with 'octopus-like tentacles' right through the financial system. This was also true of Lehman's. Its collapse would impair assets in countless other places. So, on 18 September, just three days after Lehman's collapse, the United States Treasury announced details of a proposed $US

[19] Kennedy (2009).

700 billion issuance of Treasury securities, to finance the purchase of 'toxic assets' from troubled US banks. The proposal required Congressional approval. Legislation was submitted to Congress on 21 September. On 29 September the House of Representatives rejected the proposal. Market reaction was severe, with the S&P 500 index falling by about 9 per cent. Congress eventually passed an amended version of the package on 3 October, creating the Troubled Asset Relief Program (TARP). The package included an increase in the cap on guaranteed retail deposits, from $100,000 to $250,000.

Lehman's collapse sparked considerable speculation over the quality of Australian bank balance sheets. Macquarie Bank was mentioned by a number of commentators. As a precaution against potentially destabilizing speculative activity, on 19 September the Australian Securities Exchange banned naked short sales not otherwise allowed under the Corporations Act. ASIC followed on 21 September with a ban on short selling.

The day following the collapse of Lehman's, we received word that the large global insurer American Insurance Group (AIG) was in trouble. AIG was involved in the provision of insurance to many Australian banks. The Treasury briefed the Prime Minister to call senior US officials to stress the importance, from an Australian financial system perspective, of AIG's being kept afloat. AIG was bailed out, by the United States Federal Reserve, with an injection of US$85 billion. The US government took 79.9 per cent of the company. Its share price had fallen by 95 per cent in 18 months.

A further consequence of the emergent crisis was the evaporation of mortgage securitization markets. Securitised mortgage lending had grown rapidly in Australia in the several years prior to the crisis, adding competition and volume to the Australian mortgage market. The Government considered that there was a public policy case for keeping securitized lending markets open for a period, hoping that they would thaw quickly. Accordingly, on 26 September 2008, the Australian Government announced that the AOFM would spend $4 billion buying prime or AAA-rated residential mortgage backed securities. The amount was later increased to $8 billion.

By the end of September, several governments, especially in Europe, had become concerned about possible 'runs' on retail banks. On 2 October the Greek government removed the pre-existing cap on deposit guarantees. On 4 October the Irish government announced that it would guarantee all deposits (US$575bn) in six Irish banks. The German government followed suit a day later, Denmark and Sweden announcing new or expanded guarantees on 6 October, and the European Union on 7 October. On 7 October the Bank of England extended the existing GBP£50 billion Special Liquidity Scheme to GBP£200bn, and set aside an additional GBP£250bn under a debt guarantee scheme.

Monetary authorities moved quickly to adjust policy. The Reserve Bank of Australia was the first to make a large move, on 7 October cutting the official cash rate by 100 basis points to 6 per cent.[20] The following day, The Bank of Canada, the Bank of England, the European Central Bank, the Federal Reserve, Sveriges Riksbank and the Swiss National Bank announced a co-ordinated reduction in interest rates.

9. Initial Australian action to supplement monetary loosening

For Australia, the emerging global crisis posed two inter-related sources of risk. The first was a negative macroeconomic shock, transmitted principally through exports, and business and consumer confidence. The second was the risk of a financial sector crisis, caused either by domestic financial institutions losing access to wholesale funding or a loss of confidence in the safety of the banking system, and in non-bank financial intermediaries, possibly leading to a ‘run’ on deposits and attempts to liquidate investments in various other deposit-like instruments. There was the consequent risk that some financial institutions might become illiquid, even insolvent, and that various sectors of the economy, especially those reliant upon non-bank finance, would lose access to credit.

As noted earlier, the Council of Financial Regulators (CoFR) was still progressing its work on the HIH Royal Commission recommendation concerning bank guarantees. It had concluded that, especially given the depositor preference provisions of the Banking Act, there was no general case for deposit guarantees in Australia.[21] However, given the time likely to be taken in liquidating a failed financial institution, the Council had concluded that there was a public policy case for developing a facility that permitted ‘early access’ to at least a proportion of a depositor’s funds. The draft Financial Claims Scheme (FCS) proposed that early access be limited to $20,000 per bank customer.

Legislated depositor preference is not common. Many countries choose, instead, to have explicit deposit protection (sovereign guarantee or insurance) schemes. Under these schemes, the value of deposits protected varies, but is not limited to a figure as small as $20,000. Of course, these amounts are not comparable with what was being proposed under the CoFR’s FCS, a scheme designed to complement legislated depositor preference with limited early access to funds. But the distinction proved beyond the comprehension of most Australian commentators, especially following the then Leader of the Opposition’s address to the Queensland Liberal National Party on 10 October 2008:

> Recently the Government announced with our support a scheme to provide a guarantee of deposits in authorised deposit taking institutions up to $20,000.[22]
>
> While deposit insurance is common place in other countries (and becoming more so), Australia has not seen any need for it given the priority the Banking

[20] It had been cut by 25 basis points at the September meeting.

[21] Under the Banking Act at the time, depositors were preferred creditors, meaning that they stood ‘first in line’ in the event of a bank failing.

[22] Turnbull (2008).

> Act gives depositors over other creditors and the sound prudential management of our banking system.
>
> ………
>
> This deposit guarantee scheme has been a long time in the making and indeed we proposed to introduce one ourselves last year but felt if we had done so in the wake of the sub-prime crisis it may worsen rather than bolster confidence in institutions.
>
> However, in the light of the current global economic crisis, the Coalition considers that the proposed \$20 000 cap per person is less than adequate and, moreover, out of line with similar schemes in the rest of the world. Accordingly, the …. Coalition recommends … that the cap in the proposed scheme be increased to at least \$100 000 to allow Australians, including small businesses, additional assurance in these difficult times.

Earlier that week officials had been made aware of anecdotal material that pointed to a need for government action. First, large cash withdrawals of retail deposits were being made from some of the nation's major banks. Second, Armaguard had doubled the number of trucks on the road transporting currency. And third, Note Printing Australia was operating at full capacity printing \$100 notes. None of these things, on its own, might have constituted sufficient evidence of an emergent loss of confidence in the banking system but, taken together, they could not be ignored.

Retail deposits were not the only bank liabilities that were at risk. When the IMF team undertaking the 2006 FSAP reported their draft conclusions to the Council of Financial Regulators at the end of their on-site review, there was some discussion of the Australian banks' heavy reliance on off-shore wholesale borrowings. Given the relatively high quality of banking supervision and bank assets in Australia, we wondered whether anything short of a collapse of the global financial system could put at risk continued access to those wholesale markets. Such an event was barely imaginable. Yet, in the early days of October 2008 it looked like the barely imaginable was happening; the global financial system appeared to be on the brink of collapse. Wholesale funding markets had frozen. The balance sheets of the Australian banks appeared to be at risk of a rapid contraction.

Of course, there was no certainty that wholesale funding markets would remain closed for an extended period; perhaps they would re-open after a month or two. And there was also an argument that in a world of elevated perceptions of counterparty credit risk, Australian borrowers (our banks) should look relatively attractive. Money has to go somewhere. Why should it not find security in Australia?

Wherever the right balance of these arguments lay, all official advisers were agreed that it made sense to take out some insurance. The strength of the government balance sheet meant that this could be done effectively, and at very little economic cost.

10. Weekend of 11, 12 October 2008

The SPBC had met in Brisbane on Tuesday 7 October as the RBA was meeting in Sydney. David Gruen took my seat at the RBA board table. The Brisbane meeting discussed several dimensions of the crisis, including the possible need for fiscal stimulus.

The SPBC met again on Saturday 11 October. Prime Minister Rudd chaired the meeting. Deputy Prime Minister Gillard and Minister Tanner were in the Cabinet room. Treasurer Swan, who was in Washington in order to attend a G20 Finance Ministers meeting and subsequent IMF meetings, joined by telephone. Ministers were joined by ministerial staff and officials from The Departments of the Prime Minister and Cabinet, The Treasury and Finance.

The case for action

By the time the SPBC convened in the Cabinet room in Canberra on the morning of 11 October 2008, ministers and officials were convinced that the highly unusual developments in the financial markets of the northern hemisphere posed a very substantial risk to the Australian economy and financial system. The negative shock to the Australian economy could be the worst since the Great Depression, especially if wholesale funding markets were to remain frozen for an extended period.

In preparing for the meeting in the Treasury we came to the view that there was a strong case for an immediate fiscal stimulus of at least one-half of one per cent of GDP. Ideally, this would be delivered with sufficient speed to boost household spending before Christmas. In consultation with the RBA, we had also come to the view that wholesale funding guarantees would probably have to be announced at some time the following week, and that there was a significant risk that the Government might also have to announce a guarantee of retail deposits at some time to avert a run on a bank.

The meeting commenced with a discussion of the deteriorating international environment. The Prime Minister then asked me what The Treasury would advise. I reminded ministers that the RBA had, just a few days earlier, cut the official cash rate by 100 basis points and advised that further cuts were certain. The RBA would move aggressively. I also noted that the exchange rate had already depreciated, and further depreciation was likely. In addition, some measure of fiscal support would be forthcoming through the operation of the automatic stabilisers. Nevertheless, there was a strong case for an immediate discretionary fiscal stimulus to support monetary policy. The questions we needed to address were the form, shape, size and timing of the stimulus.

Everybody in the room that Saturday was determined that we not have a repeat of the early 1990s recession.

Deputy Prime Minister Gillard recalled that most of the older male workers who lost jobs in that recession never worked again, with devastating economic and social consequences. Attachment B describes the behaviour of labour utilisation from 1978, with charts illustrating the negative impact on male workers, especially, of the recessions of the early 1980s and 1990s. All of those meeting in the Cabinet Room that Saturday morning were agreed that we had to do what we could to ensure that these terrible employment shocks, with generational consequence, did not happen again.

On that Saturday we also had a detailed, though still preliminary, discussion of the emerging case for various bank guarantees. We were aware that four of the ten banks in the world at that time rated AA by Standard and Poor's were Australian. But would that credit rating save them?

It was agreed that we would reconvene the following day to determine the shape of a fiscal stimulus package and to continue the discussion of bank guarantees.

Bank guarantees

Very early Sunday morning I was woken by a phone call from my mother in Taree. She wanted to know whether she should go down to the bank (NAB) first thing Monday morning and withdraw the balance of her account. She told me that 'that's what everybody up here is saying we should do'. When I asked her why people in Taree thought things were that bad, she referred to media reports of Mr Turnbull's comments about the lack of deposit guarantees. His comments implied that bank deposits were not safe.

When the Prime Minister arrived in the Cabinet room later that morning, I took him aside and informed him of the phone call I had had from my mother. He agreed that he would need to make an announcement that afternoon. We had to act quickly to avert a possible run on retail deposits.

That afternoon, the Government announced a guarantee of bank deposits of up to $1million per customer per bank. Fee-based guarantees were also made available to APRA regulated banks in respect of wholesale sources of funding and large deposits.

Reaction to the guarantees

For the most part, reaction to the Government's announcement was supportive. But there was also strong criticism from some quarters.

The RBA led the design of the various guarantees, with assistance from The Treasury and APRA. Design details took some time to be bedded down. One minor design issue was the subject of an email to me from Governor Stevens. A highly distorted rendering of the contents of this email found its way onto the front page of *The Australian* newspaper, in a manner that seemed to me designed to undermine confidence in the Government's implementation of the wholesale guarantees.

Another line of criticism was that the guarantees were distorting markets. That was their purpose, of course.

The first fiscal stimulus package

The first fiscal stimulus package, the *Economic Security Strategy*, was announced on 14 October 2008. It was close to one per cent of GDP in magnitude.

The SPBC agreed that their task had three dimensions: first, to deliver sufficient fiscal stimulus to ameliorate the short-term impact of the prospective downturn; second, to demonstrate a firm commitment to the medium-term fiscal strategy; and third, to ensure that any decisions with adverse consequences for the long-term budget position were offset fully over the 40 year IGR time-frame. In this and subsequent discussions, senior ministers had three sets of tables and charts in front of them recording the impact of their decisions in each of those three timeframes. These tables and charts framed decision-making.

Couching discussions of packages in terms of their short, medium and long-term fiscal impacts exerted considerable discipline. But it did complicate the public presentation of what the Government was doing and why.[23]

In ameliorating the short-term impact of the emerging crisis, ministers accepted that the package should be guided by three principles: 'Go early, go hard and go to households'. This needs some explanation.

Ministers were encouraged to think of the macroeconomic challenge through the various elements of aggregate demand for Australian output. If aggregate demand is not sustained, output will weaken, workers will be laid off and business investment plans will be scaled back, further weakening aggregate demand. As workers are laid off, household incomes will fall and household consumption demand will contract, adding to the fall in aggregate demand. Household consumption of Australian produced goods and services and business purchases of Australian made fixed capital (plant and equipment) are two of the components of aggregate demand. Both are heavily influenced by confidence; consumer's confident of employment security and businesses confident of the strength of future demand for the things that they produce. Construction activity, residential and non-residential, is another source of aggregate demand. Then there are exports, vulnerable to any weakness in growth among our major trading partners, especially China. Finally, there is the direct government purchase of Australian made goods and services.

The emerging crisis posed a direct risk to the strength of exports. That component of aggregate demand would be hit first and, whilst the impact would be ameliorated somewhat by the $A depreciation, there is nothing fiscal policy could do to prevent it. Household consumption, business investment and construction were highly vulnerable to negative confidence affects. Household consumption might be supported by cash payments of various sorts. The effectiveness of such payments is

[23] See Henry (2009, ABE).

subject to two principal sources of 'leakage': first, some amount might be saved rather than spent on domestic goods and services; and second, some amount might be spent on imports. Perhaps the second of these doesn't matter so much if it keeps people employed in the labour-intensive retail sector.[24] Measures to support business investment are also subject to 'leakage' into imports. Because of these risks of leakage, there is an obvious theoretical attraction to initiatives that increase government direct purchases of Australian-made goods and services or boost construction activity. The latter has especially attractive direct consequences for employment.

Notwithstanding the risk of leakage, the first stimulus package was comprised overwhelmingly of cash payments to households and measures to support residential construction. Household consumption and residential construction make up more than 60 per cent of GDP.

The $10.4 billion package comprised $8.7 billion in cash bonuses to pensioners and low-income families, a time-limited grant to first home owners costed at $1.5 billion, a temporary investment allowance to encourage businesses to bring forward capital expenditure; and $187 million for new training places.

There was much discussion of the possibility of this first package including an increase in direct government purchases of goods and services, with considerable interest in infrastructure spending. In principle, an infrastructure-focussed stimulus delivers a 'double benefit'; a short-term stimulus to aggregate demand followed by a longer-term lift in the supply capacity of the economy. But there are two obvious challenges. First, the Commonwealth has not historically played the major role in pubic infrastructure provision. And second, there are long lags in project selection and implementation. At any point in time there are few, if any, 'shovel-ready' projects available. On this occasion, there was none.

Work would continue on identifying suitable projects for a subsequent public expenditure package. It was agreed that this first package should be delivered as soon as possible. Despite the risk of 'leakage' into household saving or imports, that meant concentrating on cash payments to households.

Taking action as early as possible, and thereby demonstrating that the Government both understood the nature of the emerging crisis, and was prepared to act pre-emptively to avert it, should at least do something to shore up consumer and business confidence.

Reaction to the first fiscal stimulus

Much of the commentary on the fiscal stimulus package was negative: By going so 'early', the Government was undermining business and consumer confidence; its speedy action implied that things were much worse than those in the community

[24] Internet shopping wasn't as prevalent then as now.

had been imagining. [25] [26] By going so 'hard', the government was evincing panic.[27] And by going 'to households' rather than spending the money directly, the Government was simply pushing up household saving, with no increase in aggregate demand.

Critics of the stimulus package, including members of parliament, quickly became exponents of various academic cautions on the macroeconomic effectiveness of an increase in government spending: the permanent income hypothesis, which implies that temporary boosts to 'income' don't affect consumption; Ricardian equivalence, which implies that private agents increase saving to pay future tax increases necessitated by higher government spending; and the Mundell-Fleming model, which implies that in a small open economy (facing a perfectly elastic global supply of capital), an increase in government spending will be fully 'crowded out' by a currency appreciation-induced fall in exports.[28] Several commentators also argued that it would be better to allow a recession to 'clean out' the weaker performing businesses, some referring to a process of 'creative destruction', even citing Joseph Schumpeter (ironically).[29]

These technical, academic arguments were repeated upon the announcement of subsequent stimulus packages. Time and time again I was reminded of the value of economic literacy, and the costs of its having been so quickly and completely eroded through the years of complacency preceding the GFC.

There was also concern expressed about the impact on the Budget surplus of a discretionary loosening of fiscal policy. Some considered that the Government would quickly lose whatever economic credibility it might have were it to do anything to jeopardise the surplus. Others considered that preserving a budget surplus was fundamental to supporting business and consumer confidence.

---

[25] There has been considerable rewriting of history, with some critics now saying that they were supportive of this first package, but consider subsequent packages to have been 'over-kill'. My memory is different.

[26] I recall one commentator saying that the Government 'should wait until it sees the white of its eyes'. I presume the point was that it was only once you got that close to the monster would you be able to assess what it would take to kill it. The problem is that if you wait that long it will be too late to deploy whatever might be required. Others argued that the fiscal response should be 'proportionate', calibrated in some way to the precise size of the need. I am not aware of any case in history of the successful implementation of such a fiscal policy.

[27] The Opposition was aware that Treasury officials had gone into the October weekend meeting with a proposed stimulus of one-half of one per cent of GDP.

[28] I was astounded when this argument was trotted out. In normal circumstances, the Mundell-Fleming model provides useful insights for Australian macroeconomic policy practitioners. But these were not normal circumstances. The elasticity of foreign capital inflows had probably never been smaller at any time in the 25 years since the $A had been floated and capital controls abolished; interest rates were falling at all points across the yield curve; and the $A was depreciating strongly. None of these facts sits at all comfortably with the M-F model's behavioural equations and comparative statics.

[29] This was ironic because Schumpeter, like Karl Marx, considered economic crises and business failure to be inherent features of capitalism that would ultimately lead to its being replaced by some form of socialism. The 'cleansing' does not strengthen, but rather subverts. Keynes' motive, on the other hand, was to have government take short-term action that would sustain the capitalist model. Indeed, this is the point of macroeconomic policy.

11. Daily monitoring

From early October 2008 through until end January 2009, the Prime Minister received daily status reports, prepared overnight, on economic and financial developments, both domestic and global. The typical early morning brief, usually of between two and five pages in length, had the following structure:

ECONOMIC UPDATE
Australia
International

UPDATE ON APRA-REGULATED FINANCIAL INSTITUTIONS

UPDATE ON NON APRA-REGULATED FINANCIAL INSTITUTIONS

INTERNATIONAL FINANCIAL DEVELOPMENTS
Equity markets
Money markets
Government actions
Other news

From early December 2008, two new sections were added: central bank actions/commentary; and government/IMF assistance.

The overnight briefs were supplemented by daily 'liquidity reports' from the Treasury.

Both reports were discussed with the Prime Minister in early morning meetings. Sometimes other ministers were in attendance.

By the second week of November, officials were participating in numerous task forces focussed on particular aspects of the evolving financial crisis, with the following membership:

- Domestic finance (Treasury and the Council of Financial Regulators)
- ADIs (banks, building societies and credit unions) (Treasury)
- Managed investments (cash management trusts, mortgage trusts, property trusts) (Treasury)
- Superannuation (Treasury)
- International finance (Treasury; plus a cross-government Taskforce comprised of PMC (Chair), Treasury, DFAT, ONA and RBA)
- Domestic economic (Treasury; plus a cross-government taskforce comprised of Treasury (Chair), PMC and Finance)
- International economic (Treasury; plus the pre-existing International Economic Policy Group, established following the Asian Financial Crisis, comprised of PMC (Chair), Treasury, DFAT, ONA and RBA)

These task forces fed into, and responded to action requests emerging from, the early morning briefings.

The following extracts from early morning briefing documents illustrate the sort of work officials were progressing as the crisis unfolded.

22.10.08	The UK Financial Times reported that some European governments are struggling to sell bonds because of the vast financial pledges they have made in bailing out banks.
24.10.08	GMAC Financial Services, a source of finance for Holden and Subaru dealer networks, told dealers on 23 October that it was quitting its Australian operations from end 2008. Options to extend ADI guarantees. Examples include corporate bonds, debentures, cash management trusts, annuities, shares, superannuation, residential investment properties etc. All offer the potential for higher return but have a corresponding higher degree of risk. 'If any of these investments were brought into the guarantee, there would be a rush into these products at the expense of ADIs who would experience a run on deposits from depositors who wanted to take advantage of the higher potential yield offered by the non-APRA regulated products but keep the benefit of the government guarantee….We strongly advise against rushing into any decision to extend the guarantee…..'. 'This issue is highly complex and even apparently small decisions can have major, unforeseen effects on the stability of the financial system.'
28.10.08	Colonial First State follows competitors, including AXA and Perpetual, in freezing redemptions from mortgage funds. Treasury has commenced a review of the insurance and re-insurance industries to explore risks associated with the GFC.
31.10.08	APRA has had discussions with credit unions and other smaller financial institutions concerning the probable impact of the fee-based guarantees commencing on 28 November.

3.11.08	Unlisted property trusts are experiencing funding problems. Redemption requests from retail investors are not being accepted. Finance companies are facing severe funding pressure. Regional areas might be disproportionately affected. AOFM advises that State government borrowing authorities are worried about the impact of the wholesale funding guarantee on the semi-government bond market. ASIC announces that it will assist investors suffering financial hardship because of the freezing of mortgage funds.
5.11.08	Treasury and APRA have had discussions concerning the possibility of finance companies becoming (APRA regulated) ADIs so as to qualify for the guarantee arrangements. Liquidity problems with Ford Credit have emerged. Allco Finance enters voluntary administration.
18.11.08	IMF First Deputy Managing Director John Lipsky says that IMF studies had determined that a global fiscal stimulus of 2 per cent of GDP is warranted. It 'would be more effective if it were implemented in key trading partner countries more or less simultaneously'.
25.11.08	Treasurer Swan has communicated his expectation that CoFR members will be monitoring closely developments in the financial system as the fee-paying guarantees are implemented from 28 November.
28.11.08	Officials have had discussions with the banks, car financiers and the MTAA to secure early agreement on the establishment of a SPV to fund wholesale car finance.
4.12.08	Bendigo and Adelaide Bank has reported a loss of retail deposits from depositors who have requested a guarantee but insisted on the BBB rated bank absorbing the 80 basis points fee differential over a AA rated bank.
15.12.08	EU leaders have endorsed an EU-wide stimulus plan of around Euro 200 billion.
8.01.09	IMF First Deputy Managing Director John Lipsky says advanced economies as a group are in recession and he expects this will persist well into 2009. President-elect Barack Obama and US Congress leaders are trying to craft a fiscal stimulus package, expected to cost between US$675 and US$775 billion. US Treasury unveils US$6 billion package to assist GMAC, the financial arm of General Motors.
13.01.09	Storm Financial enters voluntary administration. Germany manages to sell only two-thirds of its planned debt issuance last week.
19.01.09	IMF Managing Director Dominique Strauss-Kahn calls for additional stimulus of 2% of GDP and says that countries with strong fiscal positions, like Australia, should do more.
20.01.09	NBER confirms that the US economy slipped into recession in December 2007.

12. SECOND FISCAL STIMULUS PACKAGE

In December 2008 the Government announced a $4.7 billion *Nation Building Package*, including new infrastructure spending of $3 billion over three years, focused on TAFE, university and rail.

13. DETERIORATING INTERNATIONAL CONDITIONS

Having downgraded its world growth forecasts for 2009 by 1 percentage point in October 2008, the IMF cut the forecast by a further 2 ½ percentage points, to only ½ per cent in January 2009. Then in April 2009, as the Australian Budget was being finalised, the IMF published a negative growth forecast for the world, estimating that global GDP in 2009 would be 1 ¼ per cent lower than in 2008. For the advanced economies, a contraction in GDP of 3 ¾ per cent was forecast for 2009, as against forecast growth of 1 ½ per cent published a year earlier. The forecast for 2010 growth in the advanced economies had been cut from 2 ¾ per cent to zero. Thus, in April 2008 the IMF had forecast that 2010 GDP in the advanced economies would be 4 ¼ per cent higher than in 2008, but 12 months later was forecasting that it would be 3 ¾ per cent lower, a turnaround of 8 per cent of advanced economy GDP.

Policy advisers in Canberra, who were following the evolution of IMF assessments closely, were in no doubt that they were confronting a massive negative shock to the Australian economy. None of us thought it likely that an Australian recession could be avoided. But we had to do what we could to ensure it was as mild as possible.

14. THIRD FISCAL STIMULUS PACKAGE

Structure of the package

On 3 February 2009 the Australian Government announced a $42 billion *Nation Building and Jobs Plan*. About 70 per cent of this stimulus package was comprised of infrastructure spending: $14.7 billion on school infrastructure; $6.6 billion on social and defence housing; $3.9 billion on energy efficiency measures (mainly insulating the ceilings of existing homes); and $890 million on road, rail and small-scale community infrastructure projects. The package also included a business investment tax break (an increase from 10 per cent to 30 per cent in the temporary business investment allowance), costed at $2.7 billion.[30]

The school buildings program was designed for speedy delivery and wide geographic coverage. Buildings were approved to standard specifications, across 9,500 sites.

The February package was supplemented quickly with a jobs package aimed at younger workers. As Kennedy (2009) notes, around 40 per cent of the unemployed are aged less than 25. And these are the natural entrants to the labour market. Thus, in a period of economic weakness, in which the rate of job creation falls, young

[30] Kennedy (2009).

people are disproportionately affected. This is the mirror of the disproportionate impact on older workers who miss out on jobs in the subsequent recovery.

The Government struck an agreement with the States to guarantee a training place to all unemployed people aged less than 25 years. The jobs package was expected to provide training opportunities to around 135,000 people, costing $1.5 billion. It was intended to enhance the job readiness of young unemployed people and prevent skill atrophy.

Further infrastructure measures were announced in the 2009-10 Budget. The third phase in the Government's infrastructure program was brought forward and an additional $22 billion of large-scale infrastructure was announced. As noted earlier, work on identifying suitable infrastructure spending had been initiated in October 2008 as the first stimulus package was being finalised.

This spending on long-term infrastructure was designed to increase the productive capacity of the economy and provide sustained medium-term macroeconomic support.[31]

Development of this third fiscal stimulus package, the most important, was complicated by political concerns about the potency of the 'debt and deficits' attack on the Keating Labor Government of the early 1990s. By the time of the GFC, Coalition members of Parliament and most media commentators seemed to have forgotten the emergency fiscal stimulus implemented by the Howard Government in 2000, which had pushed the budget into deficit. The October 2008 package posed no threat to the ability of the Rudd Government to claim that it was preserving the surplus. But, with a weakening economy forcing large parameter revisions, a substantial discretionary stimulus would put the surplus at risk. These concerns featured strongly on the morning of a critical SPBC meeting in Brisbane. Over lunch senior Treasury officials agreed that when the meeting resumed in the afternoon I should inform the Prime Minister that it was the considered advice of the Treasury that he take sufficiently strong action to push the budget into deficit in the national interest.

Reaction to the second and third stimulus packages

The political and media reaction to the second and third stimulus packages was overwhelmingly negative. As the packages were being implemented, through the course of 2009, much of the negative commentary focussed on the school buildings and home insulation packages.

Critics argued that the school building package was being 'rorted', especially in NSW. The home insulation scheme attracted considerable criticism, because of the deaths of four people engaged in installation. It is a tragic irony that one of the reasons for the Government's choosing this measure was that it would provide jobs for workers with relatively modest skills. The Government had been assured by industry that a

[31] ibid.

one-day training course was all that would be required before people could begin working under supervision.[32]

Observations

The risks posed to Australian living standards by the global financial crisis should have been enough to motivate agreement on concerted action in the national interest. One might have expected less partisan mischief from the political opposition and elements of the media. Instead, just about everything was contested. The Government's response to the crisis provided an opportunity for obstructionism and the re-running of ideological debates that should have been consigned to the dustbin of history decades earlier.

Some of those critical of the Government would have preferred that Australia sustain a deep recession and a financial system crisis. Their objective was merely political; to buttress the myth that Labor governments are poor economic managers.

15. Assessment of Economic Impact

Did the fiscal stimulus packages work?

The Australian economy grew by 0.6 per cent through the year to the June Quarter 2009. No other advanced economy grew at all during this period.

The first fiscal stimulus package (the *Economic Security Strategy*), announced in October 2008, was broadly successful.

Retail trade grew by 3.8 per cent in the month of December 2008, and March 2009 data revealed that retail trade remained 4.5 per cent above its pre-stimulus level of November 2008. These results compare to falls in retail turnover in other parts of the world. In countries such as the United States, Japan, Canada and Germany, retail turnover fell by 2 to 3 per cent over the same period.[33] Following introduction of the First Home Owners Boost in October 2008, the number of loans to owner-occupiers rose for six consecutive months through to March 2009, after having fallen in each of the eight months prior to its introduction.[34]

The *Nation Building Package* ($3 billion over three years), announced in December 2008, containing a minor increase in infrastructure spending, largely in 2009-10, had a countercyclical profile. A comprehensive COAG reform package announced at about the same time had a 'U-shaped' profile, with substantial amounts budgeted for out-years in which stimulus was not needed.[35]

[32] ibid.
[33] Henry (2009) ABE
[34] ibid.
[35] It was not designed to provide a fiscal stimulus; rather, to reform Commonwealth-State relations across several dimensions.

The $42 billion *Nation Building and Jobs Plan*, announced on 3 February 2009, contained multiple elements. It is reasonable to conclude that the $14.7 billion (2008-09 to 2010-11) Building the Education Revolution program did have a positive impact on employment and the general level of economic activity, but the publicity surrounding its implementation probably damaged confidence in the Government's policy capability and may therefore have negatively impacted confidence at the margin.

Relative to other stimulus measures, the $3.9 billion (2008-09 to 2011-12) Home Insulation Program suffered from long implementation lags and high political risks. But it provided employment opportunities for many people who would otherwise have been without work.

Rodgers and Hambur (2018) conclude that the temporary tax break for business investment had a significant impact. The authors find that GDP growth would have been significantly lower in 2009 in the absence of the tax break. The tax break increased the investment of companies, despite the operation of Australia's full dividend imputation system, suggesting that its effectiveness arose, at least in part, from a relaxation of a binding financing constraint.

Taken together, the various stimulus measures are estimated to have contributed 1 percentage point to growth in 2008-09 and 1½ percentage points to growth in 2009-10. Absent the fiscal stimulus, GDP would have contracted by about 1 per cent in 2008-09 and a further 2 per cent in 2009-10 (Treasury, 2009; Gruen, 2009).

As noted earlier, the Government and its advisers were motivated to avoid a repeat of the labour market impacts of earlier recessions. I recall confiding to David Gruen, as conditions were deteriorating, that if we emerged from the crisis with the unemployment rate having remained below 7 per cent, then we should be judged to have done very well. As Chart 5 shows, the unemployment rate peaked below 6 per cent. And the negative impact on the workforce participation rate, due to the so-called 'discouraged worker effect', was also quite small. As shown in Attachment B, the male employment ratio, which combines impacts on the unemployment rate and the participation rate, fell by about 3 per cent but was almost fully restored within 2 years of the collapse of Lehman's. Average hours worked by male employees fell by a similar proportion, and recovered as quickly.

Female labour utilization performed much better than male rates during the GFC. Between September 2008 and September 2009, the employment ratio of females fell by only one per cent, and was close to fully restored to its pre-crisis level within a further 12 months. Average hours worked by female employees did fall, but only by about 20 minutes a week between September 2008 and September 2009.

Taking males and females together, labour utilization rates exhibited far less volatility in the GFC than in the recessions of the early 1980s and 1990s. As chart B3 in Attachment B illustrates, the fall in labour utilization (as measured by the reduction in hours worked per person of working age) during the GFC, while sharp, was no more pronounced than following the introduction of the GST in 2000. That is quite an achievement.

It is worth considering why the fall in the employment ratio was so small on this occasion. The fall in Australia was noticeably smaller than in the United States, Canada and the United Kingdom. Prior to the GFC, the United States had always had a stronger employment ratio than Australia, but the United States employment ratio fell by much more in the GFC and has remained below the Australian level ever since, even with an unemployment rate well below 4 per cent.

I think it reasonable to conclude that the outcome in Australia's case owes much to Australian business having confidence in the government's handling of the crisis. Australian employers, outside of the mining industry, were confident that the negative shock to aggregate demand would be small and short-lived, and wanted to hold onto workers they would need in the imminent economic expansion. [36] This conclusion is supported by the fact that, compared to the recessions of the early 1980s and early 1990s, relatively more of the labour market adjustment came through a reduction in average hours of work. Of course, a deregulated labour market made that sort of adjustment considerably easier on this occasion.

A word of caution, however: Whilst I am confident that timely and strong fiscal action averted a repeat of the recessions of the early 1980s and early 1990s, two points should be made. First, the slowdown in growth was still quite pronounced, with more than 100,000 Australian workers losing their jobs. Second, there has been only one year since the crisis in which the Australian economy has recorded growth at the rates experienced pre-GFC. Post-GFC, growth has been disappointing, with weak business investment (so weak, and for so long, that the Australian economy is now experiencing capital-shallowing), weak productivity growth, falling average hours of work, and weak wages growth.[37] It is worth asking whether this period of weakness is a hangover from the GFC, or has another explanation.

Was the external environment helpful?

There were few helpful external factors operating in the period from September 2008 through to June 2009. Growth in our major trading partners collapsed from 5 ½ per cent in 2007 to -3 per cent by early 2009 and -2 per cent by June 2009. In 2008, GDP fell by 8 per cent in Japan, 6 per cent in the Euro Area and about 3 ½ per cent in the United States.[38]

Aside from liquidity issues affecting the financial system, the principal other source of negative external shock to the Australian economy was China, which experienced a particularly sharp downturn (Chart 9). For four years from late 2003, very strong

---

[36] Mining, being heavily exposed to industrial production outside of Australia, especially China, shed labour rapidly late in 2008 and into the early months of 2009.

[37] That is, the capital-labour ratio is falling. This is a highly unusual thing, normally seen only during recessions, and not always even then. Capital deepening (an increasing capital-labour ratio) is usually the principal source of labour productivity growth.

[38] These are 'through-the-year' growth rates to the first readings in 2009.

Chinese growth was the major contributor to unprecedented demand for Australian commodity exports and export prices. Over that four-year period, China had become our second most important trading partner, after Japan. At end 2003 we exported less to China than to the United States. By end 2007 we exported twice as much to China.

Australia's trade exposure to China meant that we were especially vulnerable to the strength of its economy, particularly the strength of industrial production. With Chinese growth collapsing through 2007 and 2008, Australian exports were hit hard. In the December quarter 2008 the volume of Australia's exports fell by 1.3 per cent. They then grew by 3.0 per cent through the first half of 2009, but export prices fell by almost 10 per cent in the March quarter 2009 and a further 15.8 per cent in the June quarter 2009 (the largest ever quarterly decline). (Treasury, 2009) Commodity prices had already fallen by a third through 2008, $US spot prices for iron ore and coking coal falling by 70 per cent. With Chinese demand weakening rapidly, the Australian mining industry cut its workforce by an extraordinary 15 per cent in the six months to May 2009 (Chart 10).

China's fiscal stimulus program, announced on 9 November 2008, ultimately contributed to a turnaround in global commodity prices from the beginning of 2010, but was too late to save the Australian economy, and every other economy, from recession in 2008-09.

Did monetary policy help?

Both the 425 basis point cut in the official cash rate over several months (see RBA paper) and the more than 20 per cent depreciation of the $A in TWI terms (Chart 6) would have helped to cushion the external shock. It is possible that both the interest rate cut and currency depreciation would have been larger in the absence of the fiscal stimulus package (consistent with the Mundel-Fleming small open economy (M-F) model), but economic conditions would also have been considerably weaker. That is, the extreme conditions assumed in the M-F model, including a perfectly elastic supply of external capital, were not present late in 2008.

The importance of flexible labour markets

Labour market flexibility probably helped cushion the negative shock. Relative to earlier recessions, more of the labour market adjustment came in the form of reduced average working hours, and somewhat less in lay-offs, limiting the negative feedback into aggregate demand and debt servicing.

The role played by other market interventions

An unusual program of timely market interventions played a critical role in avoiding a deep and sustained economic downturn, including through their contribution to business and consumer confidence. These measures included:

- Sovereign guarantees of the principal liabilities of the core banking system. It is possibly the case that offshore wholesale borrowings by the major Australian banks would have been interrupted for only a couple of months, even in the absence of government guarantees. But nobody knew that for certain at the time, and borrowing costs would have been higher without sovereign guarantees. At the very least, the guarantees might be viewed as a cheap form of insurance.

- A Commonwealth guarantee of state and territory borrowing (announced 25 March 2009).
- Arranging the merger of BankWest with the CBA.
- A loan forbearance program developed by the Government with the banks.
- RBA and government support of the RMBS market.
- Enhanced regulation of short-selling.
- Government guarantee of part of the funding of a SPV established to provide wholesale financing for motor vehicle dealerships, following the announcements by GE Money Motor Solutions and GMAC that they were withdrawing from the Australian market.

Myths that can be exposed

(Myth i) China and the mining industry saved Australia from recession

This is the most enduring myth, for reasons that are difficult to understand.

Neither China, nor the Australian mining industry, saved the Australian economy from recession during the GFC.

The GFC constituted a negative shock to aggregate demand for Australian product, with negative consequences for employment. In order to identify those things that saved the economy from recession we should look for things that boosted aggregate demand or employment; that is, to things that went in the opposite direction to the negative shock. But China and the Australian mining industry reinforced the negative shock.

As note earlier, China suffered a severe downturn, with GDP growth slowing from 15 per cent in early 2007 to only about 7 per cent two years later (Chart 9). While growing at annual rates of about 20 per cent through 2006 and the early months of 2007, Chinese production of crude steel grew at about half that rate into mid-2008 and then collapsed, falling by 15 per cent through the year to September 2008. From October to November 2008, Australia's merchandise exports to China fell by almost one third. [39]

Employment in the Australian mining had doubled over the five years to November 2008. Then, as noted earlier, as a consequence of the collapse in China's production of crude steel, mining industry employment fell by 15 per cent in the six months to May 2009 (Chart 10). Had every industry shed labour at the same rate, the Australian unemployment rate would have exceeded 19 per cent.

[39] For more on the China myth, see Barrett (2011).

The shapes of the relevant lines in Charts 9 and 10 are more or less the opposite of what would be required to support this myth. The truth is that, far from saving Australia from recession, the collapse in China's demand for Australian resources and the shedding of labour by the mining industry were among the principal negative factors for which the fiscal stimulus was compensating during 2008-09.

(Myth ii) Australia's early response damaged confidence

The Government's proactive identification of the risks to the economy, and early action, did not damage business or consumer confidence, instead acting to support confidence. The Westpac-Melbourne Institute Index of Consumer Sentiment recorded that consumer confidence had risen back above its long-run average by mid-2009. Gruen (2009) notes that 'the cumulative rise over the four months to September 2009 was the largest four-month rise in the thirty-five year history of the series.' Consumer confidence in the OECD as a whole was still significantly below its long-run average as 2009 came to a close. As Gruen (2009) observes, the sharp improvement in consumer confidence in Australia probably had a lot to do with confirmation, in the first week of June 2009, with publication of the March Quarter 2009 GDP figure, that Australia had avoided a technical recession.[40]

(Myth iii) 'Rorts' damaged macroeconomic effectiveness

So-called 'rorts' in the implementation of the BER school buildings program did not compromise the macroeconomic effectiveness of that measure, though they probably did damage public perceptions of the Government's economic policy capability. The macroeconomic effectiveness of the measure was compromised by the political difficulty of terminating the building program once the economic need for stimulus had passed.

(Myth iv) The fiscal stimulus is responsible for the growth in government debt

The GFC fiscal stimulus package did not cause the deterioration in the Commonwealth net debt position from -$24.3 billion (-2.2 per cent of GDP) as at 30 June 2007 to $342 billion (18.5 per cent of GDP) as at 30 June 2018. Ignoring public debt interest, the total budgetary cost of all stimulus measures summed to about $90 billion (Table 2). As at 30 June 2012, by which time the stimulus measures had concluded, net debt stood at $153.4 billion. Thus, the stimulus measures explain about half of the deterioration in net debt to 30 June 2012, and about one-quarter of the deterioration to 30 June 2018.

[40] The December Quarter 2008 recorded negative GDP growth.

16. WHAT HAVE WE LEARNED ABOUT FISCAL POLICY?[41]

Given the role played by the twin-deficits proposition in the development of Australia's medium-term fiscal framework, it is worth considering what the GFC has taught us about the consenting adults proposition.

In the aftermath of the Asian Financial Crisis of 1997-98, attention focussed on the quality and transparency of policy settings in the crisis-affected economies. The *presumption* was that their current accounts had proved unsustainable because of internal deficiencies. There was an *assumption* that countries with high quality regulatory systems and strong financial institutions could run current account deficits sustainably. This assumption motivated the IMF's FSAP, referred to earlier.

We now know that the assumption is false.

No country can take for granted the financing of its current account position. What appears to be a more or less perfectly elastic supply of funds from abroad can, in the blink of an eye, become perfectly inelastic. Consenting adults can be fickle.

***Lesson 1**: A country with world's best regulatory settings and financial institutions can still suffer a current account crisis because of events in distant places that cause global financial markets to seize. Even so, creditworthiness remains important.*

The crisis may be an extreme form of contagion, where all borrowers are considered infected with unacceptable credit risk, or it could be that there is no lender confident of having a balance sheet to support lending to anybody.

The GFC also serves as a reminder that what looks like arbitrage is not always market stabilising. It could be just the sort of micro speculation (on currencies and financial asset prices) that eventually produces macroeconomic instability. Moreover, what looks like a broader sharing of risk might actually be the transmission of contagion.

Of course, on this occasion, the early action to extend a government guarantee to the principal liabilities of approved deposit-taking institutions was sufficient to ensure on orderly, uninterrupted, financing of the current account deficit. It is impossible to know whether such action would prove sufficient in every case of contagion affecting global market perceptions of private sector borrowers in Australia.

***Lesson 2**: It is possible to design and implement an effective fiscal policy stimulus, notwithstanding recognition, decision and implementation lags. But it is far from easy to do so.*

Many analysts globally have suggested that it might be useful to explore means of redesigning fiscal arrangements in ways that increase the potency of the automatic stabilisers. Any such enquiry would have to bear in mind that fiscal policy is

[41] This section draws from Henry (2012b).

concerned with a great deal more than macroeconomic stability. Care would have to be taken not to compromise the social benefits of reliable service delivery and equitable income redistribution. Australia's heavy reliance on means testing in the delivery of transfer payments, and relatively progressive income tax system, already provide a relatively high degree of automatic stabilisation, though there would be benefit in shortening the lags in the responsiveness of these systems to changes in employment circumstance.

Lesson 3*: While monetary policy experts continue to debate the merits of focussing on asset prices instead of, or in addition to, consumer prices, the GFC experience illustrates powerfully that fiscal policy, not monetary policy, will play the major role in addressing the messes generated by asset price volatility.*

The GFC experience also raises interesting questions about the need for fiscal policy to complement monetary policy in some circumstances. Given our institutional arrangements, of an independent, non-political, monetary policy agency and a political fiscal policy, monetary policy is likely to be more effective than fiscal policy in taking the edge off unsustainably strong growth. That might involve explicit guarantees, the acquisition of various pieces of the financial system infrastructure (an activity that goes beyond normal concepts of fiscal policy) and fiscal stimulus. It obviously makes sense that any such action be implemented pre-emptively, rather than cleaning up after the fact. But how do fiscal policy practitioners know that they are forestalling a macroeconomic crisis and not simply having government underwrite private risk-taking? This poses a big challenge for practitioners of fiscal policy post-GFC.

The resurrection of fiscal policy as the primary instrument for dealing with large macroeconomic shocks is a significant departure from the way we had been thinking about policy assignment pre-GFC.

Thus, while there remains good reason for fiscal policy to have a medium-term anchor, with a transparent connection to net public debt, in this world of very large cross-border flows of financial capital, and the risk of financial sector volatility, fiscal policy will – from time to time – be called on to do a great deal more than respond passively to macroeconomic developments through the operation of the automatic stabilisers.

Importantly, fiscal policy will be able to play those roles only if it has the capacity to do so. That capacity rests on public sector balance sheet sustainability and, influenced heavily by that consideration, government fiscal policies retaining credibility with financial markets.

Lesson 4*: The quality of the relationship between key senior officials, especially the Secretary to the Treasury and the Governor of the Reserve Bank of Australia, is important. It is particularly important that officials be able to communicate openly but with absolute confidentiality assured.*

Fiscal policy needs to be coordinated with monetary policy. Regular contact between the Secretary to the Treasury and the Governor of the Reserve Bank of Australia is assured by virtue of the former being a member of the Board of the Reserve Bank and also a member of the Council of Financial Regulators, the Governor chairing both bodies. But at times more frequent communication will be essential. It is obviously very important that such communication can be had with absolute confidence as to its confidentiality. For me, this stands out as a strong feature of the GFC period.

17. OTHER LESSONS FOR THE FUTURE

Investment in economic literacy and developing a credible narrative

***Lesson 5**: The economic literacy of the general population is important.*

Taking action in advance of a crisis (proactive) is always going to be controversial, the more so if the population is incapable of imagining the counterfactual. Climate change mitigation policy provides another instance.

***Lesson 6**: Having a credible, compelling narrative is important.*

There is a low, and declining, level of public trust in politicians. Moreover, whatever a politician says will spark a political argument, even in a crisis. There is simply no chance of bi-partisanship. That being the case, and even if it is not, it is worth reflecting on the appropriate role to be played by unelected officials in the public square, especially the RBA Governor, the APRA Chairman and the Treasury Secretary. It is also worth considering what media (social or traditional) would be most effective for communicating the narrative.

***Lesson 7**: It is important to know the distributional implications of every intervention.*

Australian commentators have a preoccupation with the distributional consequences of everything government does. It is much better to have done the distributional analysis prior to the policy announcement than be scrambling to respond to some other person's analysis in the heat of debate.

Institutional capability

A minister with responsibility for any portfolio should be able to have confidence that public servants are undertaking contingency planning, to guard against a future crisis. This is more easily said than done. The Treasury had 'war gamed' some crises and had, to some extent, curated a living memory of previous crises. But every crisis has unique elements. And there are obvious limits to the extent of operational planning that can be done ex ante.

In the case of financial crises, the Council of Financial Regulators will have the key role to play. It has developed detailed protocols to deal with various forms of financial crises.

***Lesson 8**: It is not sensible to seek to develop an operational manual to guide the development of the full set of fiscal interventions that may be required at some future time. Rather, it would make sense to focus on core institutional capability, investing in human capital that is capable of assured crisis management, whatever the scenario.*

***Lesson 9**: Treasury officials must be sufficiently expert to discuss academic propositions in an authoritative manner.*

Whenever unusual policy measures are taken, the Government will be criticised by its political opponents and their media supporters. This is more likely to be the case if the Government is Labor. The experience of the GFC demonstrates that academics will join the debate, often with unhelpful propositions. It is a fact of life that in Australia, the line between policy analysis and political posturing is wafer thin, and frequently crossed. Senior Treasury officials can expect to find themselves ambushed by arcane propositions in parliamentary enquiries and other public appearances. The public won't have confidence in highly unusual economic and financial policy initiatives if Treasury officials aren't able to deal effectively with critical commentary.

***Lesson 10**: Advisers must possess maturity, commercial nous, judgement and have the courage to 'speak truth to power'; to speak up when the national interest demands it and to counsel against 'populist' interventions that would do more harm than good.*

Unusual policy measures will also have 'unintended consequences' and create market distortions of various sorts. In designing the bank guarantees, our key objective was to protect the core of the Australian financial system. But, of course, protecting the core means that those institutions and activities outside of the core are disadvantaged. On this occasion, there were many calls for assistance to address the disadvantage suffered by those beyond the perimeter. That will always be the case. A government under pressure to save everything needs wise counsel.

***Lesson 11**: Whilst 'institutional memory' is important, hearing from those with lived experience is even more important.*

Clearly, it is important that relationships between public servants and ministers be based on trust and respect. Ministers are more likely to have confidence in advisers whom have lived through a previous crisis.

***Lesson 12**: Central agencies must have sufficient institutional capacity and flexibility to be able to lead the creation, ab initio, of new pieces of institutional architecture in very short time.*

It is very unlikely that Commonwealth agencies will always have the institutional architecture in-house to deliver every market intervention that might be required. This has implications for the design of interventions. For example, it might mean that some interventions are better delivered by State or local government agencies. In other cases, there may be a need to 'stand up' new institutions virtually overnight, as there had been following the collapse of HIH and the 11 September terror attacks in the United States in 2001. In the GFC, the Treasury and other Commonwealth officials confronted the probable need to stand up new entities to deal with various gaps in markets.

Confidence

In a financial crisis, it is important that community confidence in the banking system be restored as quickly as possible. In dealing with a large negative shock to the real economy it is equally important that business and consumer confidence be fostered. This poses a challenge for those designing a fiscal stimulus. The big question is 'how much is enough?' Some critics argued that the announcement of the third stimulus package damaged confidence. The evidence does not support this argument. To the contrary, Australia's early and strong fiscal action appears to have given the community confidence that the Government was on top of things.

Lesson 13*: In responding to a crisis, it is important to act early and to err on the side of doing too much rather than too little.*

When the negative macroeconomic shock emanates from a financial system crisis, protecting confidence requires more than traditional macroeconomic stimulus. Confidence in the financial system itself has to be managed. This requires attention to financial system soundness at a micro level of detail. Even in normal times, the failure of one financial institution can have contagion effects, through inter-linked balance sheets; the liability of one institution being an asset of another. But in 2008-09, the risk was that contagion would spread through business and consumer confidence: if one entity were to fail, what would stop all entities from failing? At the height of the crisis, all ADIs, of whatever size, were considered systemically important.

Design issues

In designing a fiscal stimulus package, thought has to be given to both timing and coverage.

Lesson 14*: It will generally be the case that, apart from transfer payments to households, a fiscal stimulus should focus especially on jobs for the unskilled, tradespeople, and on creating or supporting jobs in the regions.*

Lesson 15*: The profile of budgetary costs due to a temporary stimulus has somehow to be made to fit with the medium-term fiscal strategy.*

Exit strategies are important because the stimulus should be 'temporary'. In Australia's case, the *Charter of Budget Honesty Act* mandates that the Government's fiscal strategy 'specify fiscal policy actions taken or to be taken by the Government that are temporary in nature, adopted for the purpose of moderating cyclical fluctuations in economic activity, *and indicate the process for their reversal* (emphasis added).' There is a risk that this discipline infects advisers with undue caution. Even if it doesn't, the communications challenge (developing the narrative) is substantial. The public reaction to the narrative of the 2009-10 Budget, especially by intelligent and seasoned commentators, illustrates the challenge.[42] But it is a challenge that has to be met.

Institutional and other challenges

It is difficult to double the size of the Commonwealth bond market in 18 months.

One intervention might compromise the effectiveness of another. For example, the guarantees of bank deposits gave investors an alternative to subscribing to sub-AAA RMBS, which complicated the AOFM's support of that market. Similarly, on intervention may force another. For example, the guarantee of wholesale borrowings by the banks ultimately forced the offer of a guarantee to State government debt raisings.

Lesson 16*: There are limited options for getting money out the door quickly. Somebody in Treasury has to know whom to call, 24/7.*

The legislated cap on debt was an obstacle. Who even knew it existed? This is an instance of a general set of lessons concerning policy coordination, clarity of accountabilities and trusted relationships among public servants across government.

Policy advisers need to keep in mind that the government may consider it necessary that other policy projects proceed in parallel. In this instance, responding to the GFC had to be managed in parallel with the work on the CPRS, the health and hospital reform package and other matters on the COAG agenda (including a complete overhaul of federal financial relations), the National Broadband Network and tax reform. David Tune's paper argues, persuasively, that there is a case for the government reassessing (all of) its policy priorities when it finds itself dealing with a macroeconomic crisis.

The Commonwealth does not have a general constitutional power to give cash to everybody. High Court decisions in 2009 and 2014 clarify the limits on the Commonwealth's power to spend public money. Unless there is a power conferred by statute, the Commonwealth's ability to spend will be governed by a limited number of exceptions inherent in the notion of executive power.[43]

It is likely that the recognition lags have been reduced over the past decade with vast amounts of real time data available via digital platforms. Even so, it remains the case that an anecdote might still be the best 'early warning' policy advisers will get.

---

[42] Ross Gittins said that it was 'the most puzzling, back-to-front budget I can remember'. In his column the day after the Budget, Ross explained the communications challenge: 'It's as though we're planning the clean-up after the cyclone, even before the cyclone's hit'.

[43] See Chordia et al (2015).

How to be better prepared next time

***Lesson 17**: There has to be a mechanism for central agencies to bring in earlier both line agencies and State colleagues.*

The States have a lot of things on which they can spend money quickly, the Commonwealth less so. There may never be a set of 'shovel-ready' infrastructure projects, but repair and maintenance of existing infrastructure is something on which the States could ramp up spending quickly.

And there may be other options that could be developed in cooperation with State and territory governments. Reflecting on the fate of tax reform in the years following the GFC, there has to be a case for designing reform packages that could be implemented quickly should a fiscal stimulus be considered warranted. For example, the implementation of the land tax replacement of property stamp duties is difficult because of its temporary shock to State and territory budget revenues. In a macroeconomic crisis, this short-term budgetary hit could be absorbed by the Commonwealth, funding a short-term stimulus to the property market and, at the same time, buying much needed long-term tax reform. There would be many other such options.

Several financing matters are worthy of further reflection. How important was the budget balance and negative net debt starting point? Would it be useful to have a war chest of liquid assets and not have to rely on new debt issuance? Are there any assets more liquid than freshly minted $A government bonds? Would you want to be offloading US Treasuries in an Australian funding crisis? Would it be politically feasible to build such a war chest? With near-zero public sector interest rates, what does debt sustainability now mean?

18. POSTSCRIPT CONCERNING COVID-19

This paper was finalized just prior to the WHO's declaration of the COVID-19 pandemic (11 March 2020). While the nature of the pandemic serves to underscore that every crisis will be different in important respects, and while it is too early to be making an assessment of the quality of the various fiscal measures deployed on this most recent occasion, the pandemic does provide an opportunity to reflect on the relevance of the lessons drawn together in this paper.

Obviously, the macroeconomic shocks have very different origins. The GFC was precipitated by fear of a specific form of financial system contagion; financial institutions were fearful of dealing with one another lest they infect their balance sheets with worthless assets. As this paper argues, the Australian Government played a useful role on that occasion in boosting household spending power and supporting both consumer and producer confidence. The present economic crisis is a consequence of a public health crisis. Australian governments have prohibited various activities because of the risk of human transmission of a highly infectious disease.

The mandated closure of entire industries compromises the operation of fiscal multipliers. Multipliers are also being compromised by complex global supply chains capable of triggering random supply shocks. So the effectiveness of fiscal stimulus measures is even more uncertain than usual in the present crisis. Even so, a fiscal stimulus would still be expected to boost aggregate demand and support economic activity to some extent. But unconventional fiscal measures are also required.

With that background, it would be worth considering which of the lessons from the GFC seem especially relevant on this occasion and which should be modified.

Clearly, the present crisis has important implications for how we might think about debt and deficits. Concern about those two things drove many of the prescriptions of the *Charter of Budget Honesty*, including those relating to the development of a medium-term fiscal strategy. In developing responses to the GFC, we were careful to respect the fiscal guardrails of budget balance (or small surplus) on average over the cycle, anchored by a medium-term target of zero net general government sector debt. And we faced heavy criticism from some quarters for pushing the budget into deficit. Yet, more than a decade after the collapse of Lehman's, the budget remained in deficit, with substantial and growing net public debt. In the period between the GFC and the COVID-19 pandemic there was a failure to deliver on the requirements of the Charter of Budget Honesty.

Given the fiscal starting point, it would have been absurd to impose the restrictions of the Charter on policy making in respect of the COVID-19 pandemic. And this crisis may well warrant ongoing fiscal support for several years. Yet, without some credible medium-term guardrails and widely accepted anchor, the quality of fiscal policy could very easily degrade even further. As a pragmatic matter, it may be an appropriate time now to separate the budget into its recurrent and capital components and formulate an anchor in terms of net worth rather than net debt. A medium-term strategy of balance on average over the cycle makes sense for the recurrent budget, but not for its capital component.

If a separation of recurrent and capital budgeting is to be pursued there would be considerable merit in developing a national public sector balance sheet, with the Commonwealth government taking a lead role in the development of a medium to long-term national infrastructure strategy. On the recurrent side of the budget, there would also be merit in a rationalization of spending roles and responsibilities as between the Commonwealth and the States and, of course, national tax reform. All of these looked sensible before the COVID pandemic. They look essential now; that is, if fiscal policy is to retain credibility.

In respect of the lessons summarised in this paper, I would say that all continue to have relevance. As the present crisis has unfolded, I have been reminded, frequently, of Lesson 13. Speed and magnitude are important. Time and time again, we have witnessed governments around the world deferring tough measures, declaring that they are reacting to the pandemic with 'proportionate' responses, calibrated to need. This is the same language used by some of those who criticised the speed and magnitude of the Rudd Government's fiscal response to the GFC. On both occasions, the human cost of waiting has been terrible. It is difficult to avoid the conclusion that crises are best met with speed and overwhelming force.

Of course, a government direction to cease, even if only for a time, any activity upon which people depend for income will have an economic cost. Like illness, economic costs cause human suffering.

Many otherwise highly lucrative activities are outlawed by government because of the risks they pose to human health; the production and distribution of illicit drugs are obvious instances. In most of these cases we wouldn't see a case for compensation. But in the case of a pandemic, where governments also outlaw certain activities because of the risks they pose to human health, there is a clear case for compensating those most adversely impacted. This is how governments should address what many have described as the 'balancing of lives and livelihoods'; that is, through compensating those whose livelihoods have been impacted.

Compensation for the impact on livelihoods of government action taken to protect public health is not the same thing as a fiscal stimulus. But it is every bit as important. Fiscal conservatives will worry that too much is being spent. Concerns about the cost of compensation might influence attitudes about the extent of restrictions that should be imposed to protect public health. During the GFC fiscal conservatives expressed concern that too much was being spent in fiscal stimulus. Yet those countries that spent less initially ended up not only with considerably worse economic and social outcomes but, ultimately, a larger fiscal cost also. On this occasion, evidence is mounting that both the loss of life and the budgetary cost of compensation will generally be higher the weaker the public health measures, and the longer for which their implementation is put off.

19. Tables and Charts Referenced in Text

Table 1: Evolution of the 2008-09 budget balance

		($ billion)	(% GDP)
2005-06 Budget projection (May 2005)		**9.3**	**0.9**
Cumulative revisions to 2007 MYEFO			
Parameter and other	53.0		
Cumulative impact of discretionary policy decisions			
Personal income tax	-25.3		
Other	-22.6		
Total	-47.9	5.1	
2007 MYEFO estimate (October 2007)		**14.4**	**1.2**

Source: Australian Government, various budget papers.

Table 2: Stimulus packages

	2008-09	2009-10	2010-11	2011-12	Total
Transfers	**20.44**	**4.22**	**1.78**	**1.59**	**28.03**
Major fiscal stimulus packages					
ESS package (cons.)	9.55	0.65	0.07		10.27
Nation Building and Jobs Plan (cons.)	10.49	1.72			12.21
2009-10 Budget Measures					
2009-10 Budget net pension spend*	0.39	1.86	1.71	1.59	5.55
Investment	**4.52**	**21.93**	**17.27**	**4.91**	**48.63**
Major fiscal stimulus packages					

ESS package (inv.)	0.12	0.07			0.19
Dec. Nation Building package	0.88	1.95	0.39	-0.19	3.03
Nation Building and Jobs Plan (inv.)	2.04	16.19	10.03	1.67	29.93
2009-10 Budget Measures					
2009-10 Budget infrastructure (inv.)	1.48	3.72	6.85	3.43	15.48
COAG reforms (transfers)	**3.50**	**1.78**	**2.23**	**3.57**	**11.08**
Total	**28.46**	**27.93**	**21.27**	**10.07**	**87.73**

Source: Treasury (2009)

Chart 1: Public sector net debt

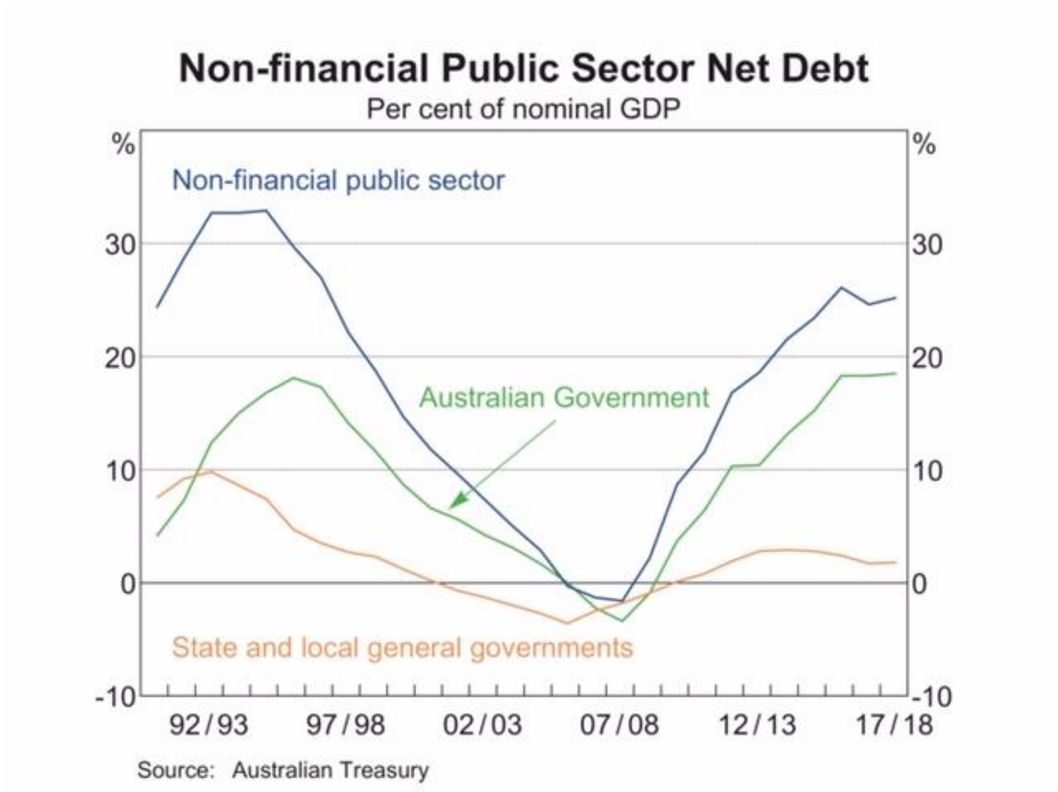


Chart 2: Terms of trade

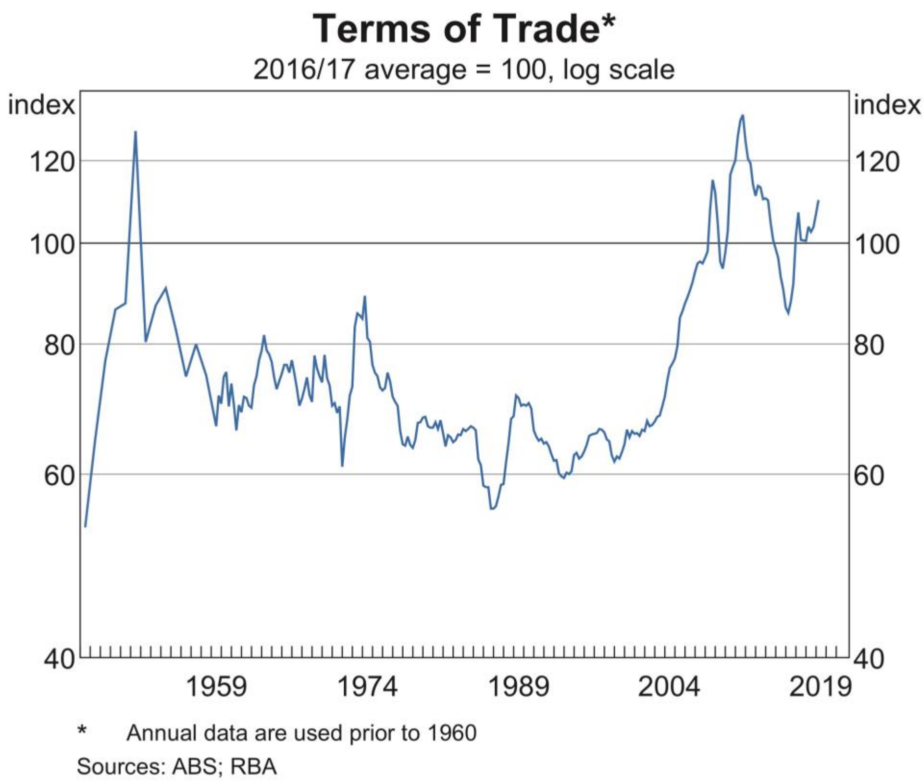


Chart 3: Commodity prices

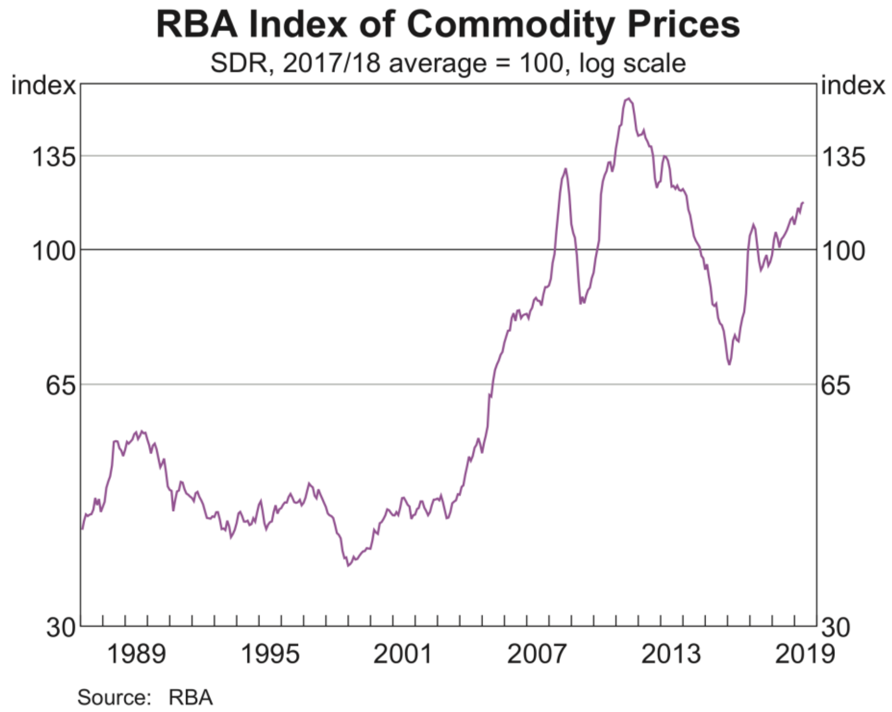


Chart 4: Household debt

Chart 5: Labour market

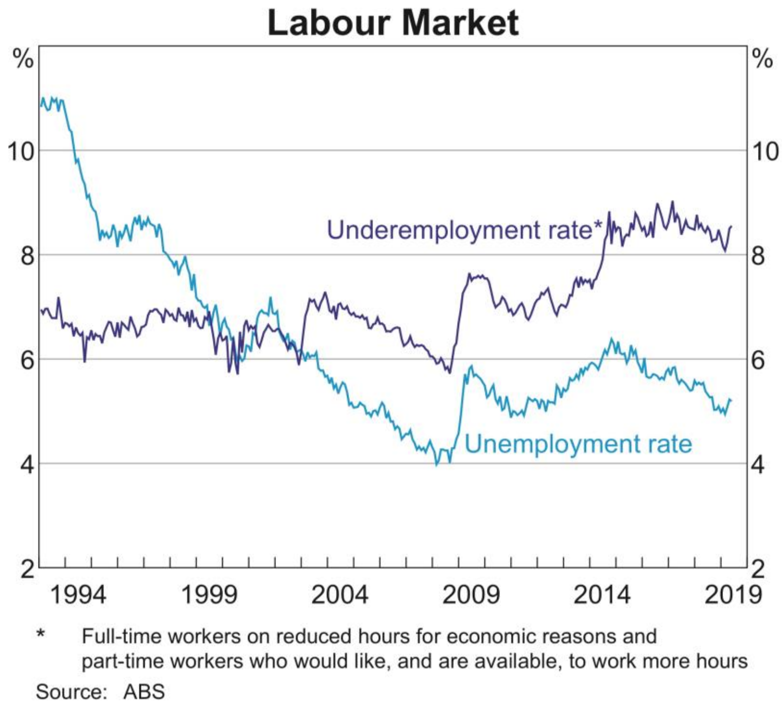


Chart 6: Trade weighted index of exchange rates

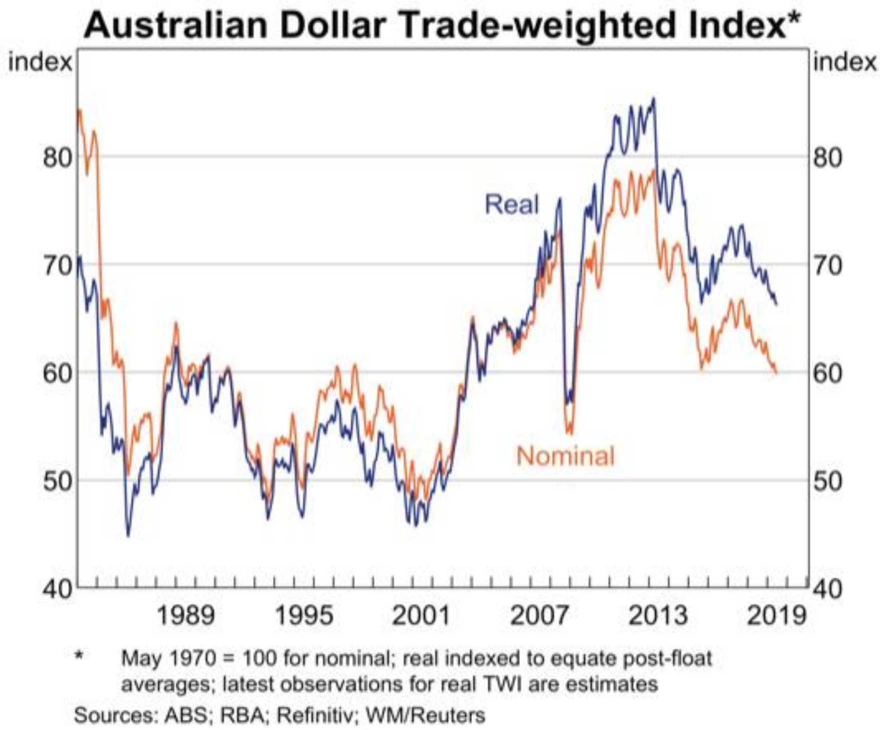


Chart 7: Mining profits vs the rest

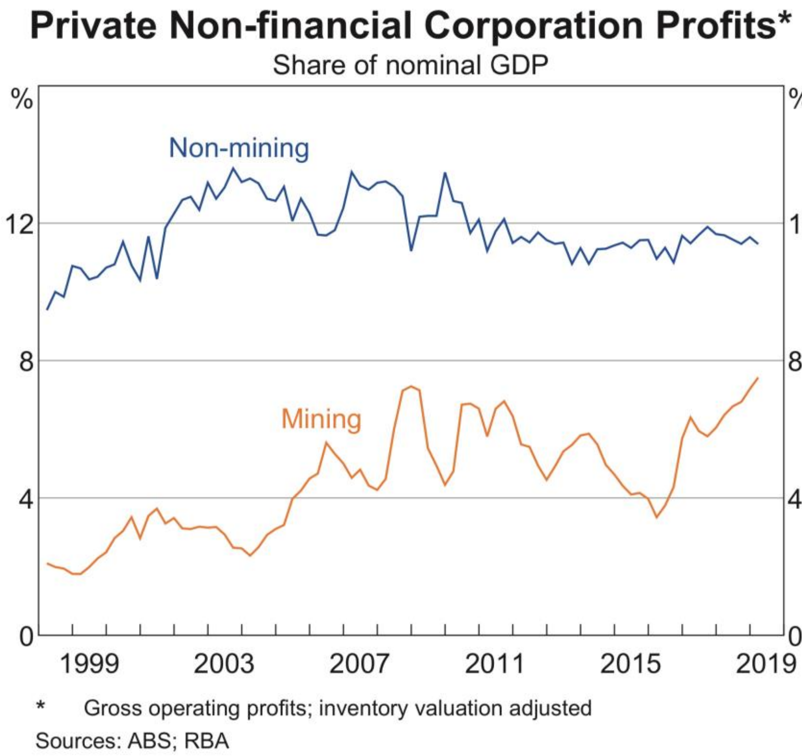


Chart 8: Capital account

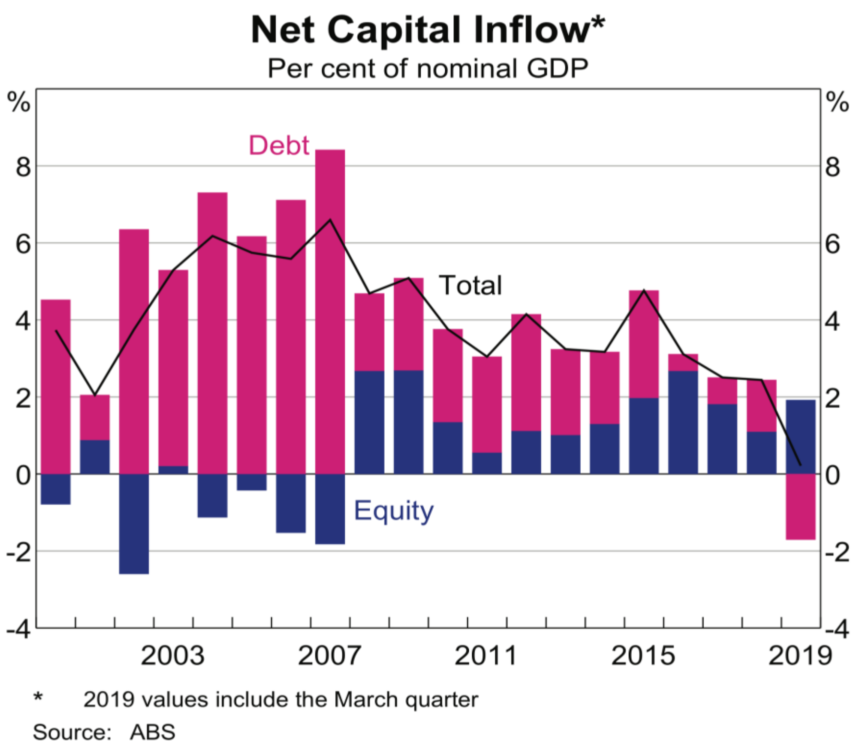


Chart 9: Growth in China and India

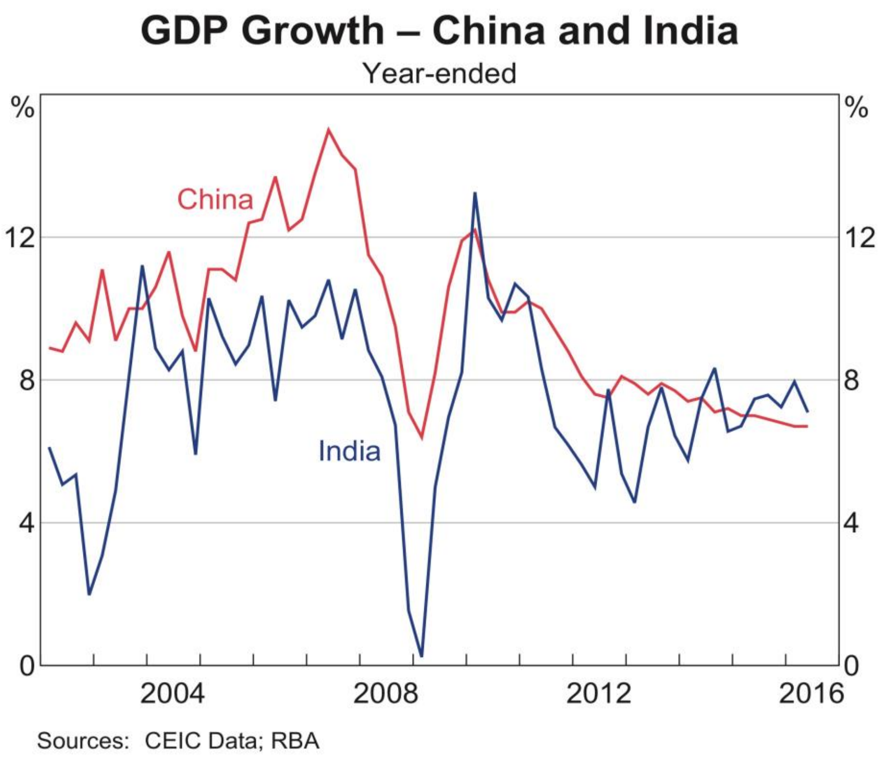
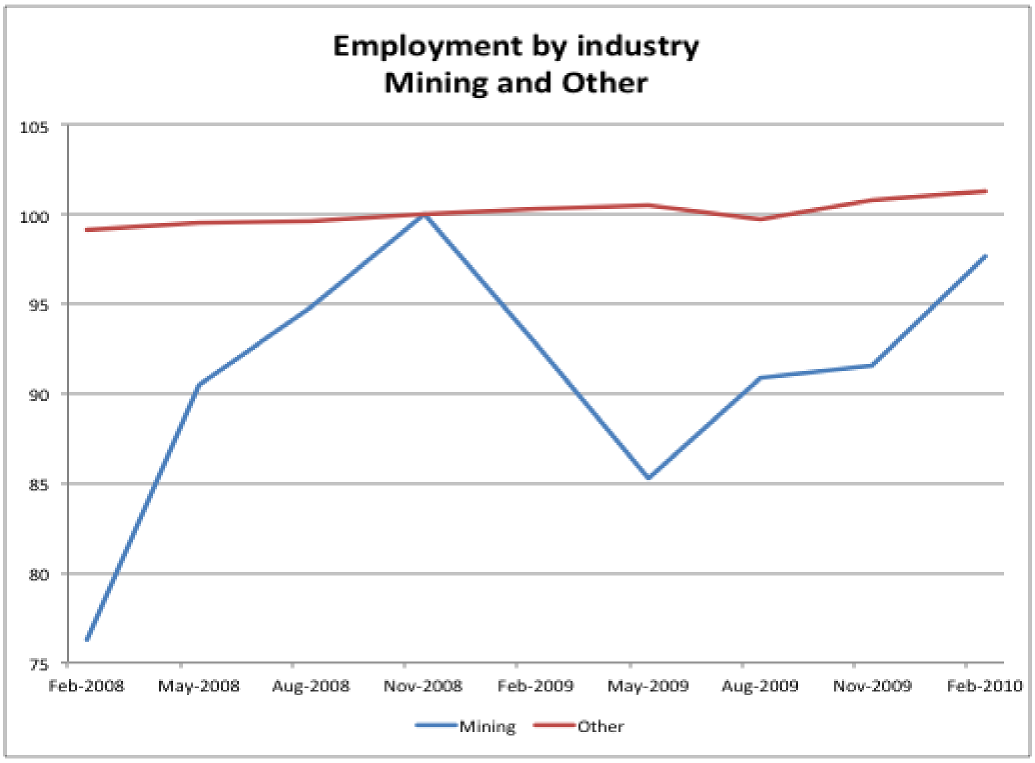


Chart 10: Mining employment vs the rest (Index; Nov 2008 = 100)



20. ATTACHMENT A: CASE STUDIES

The recession of the early 1990s

I was a senior policy adviser in the office of then Treasurer Paul Keating when, at 11.30 am on 29 November 1990, the National Accounts reported GDP growth of -1.6 per cent for the September Quarter.[44] The June Quarter had recorded growth of -0.9 per cent. Australia had entered a technical recession.

The Treasury cautioned against a fiscal stimulus, arguing that the so-called 'automatic stabilisers' should be allowed to operate. Because the government had to do something, if only for political reasons, The Treasury had more or less sidelined itself, leaving others to design various policy interventions. But that didn't happen immediately.

Cabinet records subsequently made public reveal that the Minister of Finance, Ralph Willis, 'counselled Cabinet in February 1991 that "we must not fritter our reputation away now" by relaxing controls over outlays, even amid a "significant deterioration" in activity across the economy'.[45] That same month, the Government decided to cut the Research and Development tax concession from 150 per cent to 125 per cent.[46] Then in March 1991 the Hawke Government launched a major economic statement on national competitiveness. This 'made no concessions to economic uncertainty in up-grading commitments to the next round of tariff cuts, projected to fall from a general level of 10–15 per cent to 5 per cent by 1996'.[47]

The 1991-92 Budget, delivered by Treasurer John Kerin in August 1991, reported an estimated budget deficit of $4.7 billion, following surpluses of $1.9 billion (0.5 per cent of GDP) in 1990-91 and $8 billion (2.2 per cent of GDP) in 1989-90.[48] The Budget emphasised that this deterioration in the budget balance was not due to discretionary action: 'the swing into deficit has arisen primarily from the slowdown in economic activity that has increased budget outlays – especially outlays on unemployment benefits – and reduced revenue … policy decisions taken since the 1990-91 Budget have reduced outlays by a net $50 million.'[49] 'New policy costing $1917 million has been offset by savings of $1967 million.'[50] 'Higher outlays on unemployment benefits account for 2.1 percentage points of the 2.6 per cent growth in real outlays in 1991-92.'[51]

---

[44] ABS: 5206.0, September Quarter 1990, 29 November 1990.
[45] Brown (1991).
[46] ibid.
[47] ibid.
[48] John Kerin had replaced Paul Keating as Treasurer following Keating's unsuccessful challenge in June 1991 against Prime Minister Bob Hawke for leadership of the ALP.
[49] Australian Government (1991), p. 1-1.
[50] ibid., p.3-3.
[51] ibid., p.2-44.

The 1991-92 Budget was based on year average GDP growth rates of -0.9 per cent in 1990-91 and a forecast of 1½ per cent in 1991-92. The final outcomes for these years, published by the ABS, are -0.4 per cent and 0.8 per cent.[52]

Unemployment emerged as the principal policy concern. Having been as low as 5.8 per cent in December 1989, the unemployment rate climbed to 10.5 per cent by December 1991 and 11.2 per cent in December 1992. It remained above 10 per cent until April 1994 and didn't get back to 5.8 per cent until September 2003.[53]

On 26 February 1992, 15 months after confirming that the Australian economy was in recession, Prime Minister Paul Keating released the *One Nation* statement, a package of measures designed to 'bring back jobs and prosperity'. [54] [55] The statement was a broad ranging articulation of the policy priorities of the Keating Government. And it contained a number of fiscal stimulus measures, including:

- one-off payments to those eligible for Family Allowance, paid on 2 April 1992;
- a reduction in the rate of wholesale sales tax applying to motor vehicles from 27 February 1992;
- various infrastructure programs (rail, road, aviation, 'Building Better Cities', restoration of heritage buildings, upgrading educational infrastructure), estimated to cost the budget $874 million in 1992-93 and $375 million in 1993-94;
- accelerated depreciation rates for plant, equipment and certain infrastructure;
- new depreciation provisions for buildings used to provide 'short-term traveller accommodation' and tourist plant;
- a Development Allowance at the rate of 10 per cent for certain large scale investments;
- concessionally taxed Pooled Development Funds (PDFs), to provide patient equity capital to certain companies;
- an Australian Technology Group;
- increased outlays on a restructured vocational education and training system;
- support for apprentices and trainees;
- greater funding for various labour market programs; and
- personal income tax cuts to take effect from July 1994 and January 1996.[56]

Whilst many of these measures had to be implemented by the Treasury portfolio, including the Development Allowance and PDFs, The Treasury was a reluctant party to their development, having previously counselled against fiscal stimulus. The

[52] ABS: 5204.0.40.002, 1996-97, published 27 May 1998.
[53] ABS: 6202.0, Table 12.
[54] Paul Keating became Prime Minister in December 1991.
[55] Keating (1992), p.3.
[56] Interestingly, the tax cuts were designed to ensure that 'the great majority of full-time wage and salary earners' face a marginal tax rate no higher than 30 per cent. This policy objective was subsequently embraced by the Howard Government (in its 2007-08 Budget), and by the Morrison Government (in the tax package taken to the 2019 election, subsequently legislated in July 2019).

Prime Minister's Office and the Department of the Prime Minister and Cabinet had stepped into the role of chief economic policy adviser.

The *One Nation* statement also contained several structural measures designed to address medium-term priorities, including:

- proposed amendments to the *Industrial Relations Act 1988* to ensure 'greater emphasis on workplace bargaining';
- a set of competition policy reforms, in aviation, electricity and the finance sector; and
- proposals to 'legislate for progressive increases in the prescribed standard of employment-related superannuation'.[57]

The fiscal stimulus measures proved 'too little, too late', with the first measures being implemented two years after the economy had begun slowing sharply. Indeed, several of the measures, especially the infrastructure programs, new depreciation provisions and the Development Allowance, had a pro-cyclical impact, adding to strong underlying growth in the subsequent recovery.[58]

Lessons

The early 1990s recession contained several lessons for policy practitioners, and especially those in The Treasury.

First, no matter how great the importance of fiscal discipline in establishing policy credibility, it is nothing compared to the loss of credibility associated with a recession.

Second, no matter how stridently economic policy advisers caution against the use of fiscal stimulus measures, at some point a government will find that it has no option and, when it does, those advisers will find that they have been sidelined.

Third, the implementation lags associated with setting up new institutional arrangements, such as the Development Allowance, and the lags in infrastructure programs are long. Direct payments to households have much shorter implementation lags, though still amounting to several weeks.

Fourth, big swings in unemployment lag GDP by a considerable period, and those who lose their jobs in a recession will find it difficult to secure a new job. Many of

[57] The Superannuation Guarantee Levy had been announced in the 1991-92 Budget, to take effect from 1 July 1992. Its architect was Paul Keating, even though he was a backbencher at the time. The design of the scheme was based on an address delivered by Paul Keating to the Australian Graduate School of Management on 25 July 1991; Keating (1991). In that address, Keating set out the framework for what he labeled a 'comprehensive National Retirement Income Scheme', proposing that by the year 2000 superannuation contributions for all employees be12 per cent of wage and salary income, imposed by way of an avoidable, non-deductible, levy.

[58] It can be argued that because the output gap was still substantial, with the unemployment rate well above its 1989 level, some continuing support of aggregate demand was appropriate.

those who lost their jobs in the recession of the early 1990s, especially workers aged 55 or more, never worked again. This underlines the importance of acting 'early and hard' with any stimulus.

Fifth, political economy factors are very important. The Hawke Government's handling of the recession was affected by its otherwise admirable determination to stick with its major program of economic reforms, the policy platform that defined it, no matter the state of the business cycle. It found it very difficult to change policy persona when the circumstances required that it do so. No doubt, leadership tensions throughout 1991 made the task even more difficult.

The Asian Financial Crisis

There is no need to detail the circumstances that led to the Asian financial crisis is 1997-98. But the response to it set up several pieces of institutional infrastructure that came into play during the GFC.

The Asian Financial Crisis stimulated deep introspection among those who saw themselves responsible for the 'international financial architecture'. Several matters of consensus arrived at in that period had a serious reality check in the subsequent global crisis. The principal international forum for these discussions was a long way from Asia, in the G-7. There was also a lot of discussion around the table of the IMF. But in that forum also, Asia found itself underrepresented, with quota shares disproportionately low relative to GDP shares.[59] Asian economies had stronger voices in the so-called 'Four Markets', chaired by Japan, the 'Six Markets', which added China and the United States, and the Manila Framework Group established in November 1997 to discuss approaches to regional surveillance and crisis management.[60] APEC Finance Ministers also hosted several discussions on responses to the crisis. A global forum that brought the right voices to the table emerged with the creation of the G-20, established initially as a forum for finance ministers and central bank governors two years later.

An additional piece of financial architecture developed in 1999 by the IMF in response to the crisis was the Financial Sector Assessment Program (FSAP). This program assesses member countries' financial sector resilience and the quality of domestic regulatory and supervisory arrangements.

Ironically, by late 2008 the United States was one of only a few member countries not to have participated in the FSAP program. And that wasn't because everybody held a sanguine view of the quality of policy making in the United States, nor of the risks to global financial stability posed by its large current account deficit position

[59] Henry (2003a).
[60] Japan, Australia, Hong Kong and Singapore.

and consequent reliance upon external funding.[61] For example, in delivering the Sir Leslie Melville Lecture at the ANU in July 2003, I drew attention to the fact of the United States 'attracting more capital than the whole of the developing world … given the size of the United States' current account deficit, this is likely to be the case for many years'. I went on to note that '(a)s far as the immediate to medium-term prospects for international financial stability are concerned there is at least as much riding on the quality of United States economic policy as there is the macroeconomic and structural policies of the emerging markets.' I observed that 'the Fund has done little to convince the United States (or anyone else for that matter) of the risks associated with its singular current account position. These failures could have serious implications for international financial stability.' Of course, were all that capital being directed to activities with high (risk-adjusted) returns, rather than poorly regulated housing lending, and had United States financial institutions been as well regulated as was generally assumed, the United States current account deficit might have proved sustainable through 2008-09.

Lessons

The Asian Financial Crisis contained several lessons for fiscal practitioners.

First, global capital markets can be fickle. If there is a sufficiently large shift in investor perceptions, a long history of strong capital inflows means nothing.

Second, fiscal austerity programs implemented in countries facing a capital account shock will make things worse, at least in the short-term.

Third, the ability to engage in short-term fiscal support depends upon the strength of the public sector balance sheet; it is far easier to preserve, or regain, external support if the public sector balance sheet starts from a position of strength and remains strong.

Fiscal policy challenges associated with the turn-of-the-century tax reform package

At the October 1998 federal election, the Howard Government secured electoral support for an ambitious tax reform package that had, as its centre-piece, a new 10 per cent tax on goods and services (GST), replacing a complex and inefficient set of pre-existing indirect taxes. The net consumer price impact of the set of indirect tax changes taking effect on 1 July 2000 was estimated to be 1.9 per cent.[62] The reform package contained an elaborate set of compensatory measures, including personal income tax cuts and increases to various pensions and allowances, including a restructuring of family payments. The Treasury calculated that these various

[61] See, for example, Henry (2003a). I wrote a couple of technical notes on the risk, for internal circulation in The Treasury, in September 2002. One was titled 'why the crunch cometh'.

[62] Senate amendments reduced the scope of the GST and its CPI impact.

measures 'over-compensated' for the one-off consumer price impact by about one-half of one per cent of GDP ongoing. But relative price shifts were far larger than the average price impact. For example, motor vehicles would face a 10 per cent effective retail sales tax in place of a wholesale sales tax at the rate of 22 per cent. And building materials, which had been exempt from wholesale sales tax, became subject to indirect tax for the first time.

Treasury officials considered that the impact on the cost of building materials would quickly be capitalised into existing house prices. But first-time house purchasers would face a higher cost, with no wealth compensation. In recognition of the issue, the Howard Government announced a First Home Owners' Scheme (FHOS), administered by the States and Territories, the recipients of GST revenue. Under the scheme, first-time purchasers of new or existing houses were entitled to a one-off cash grant of $7,000.

In policy circles, there was a lot of debate about the macroeconomic impact of the tax reform package. The Reserve Bank considered that the impact would be stimulatory, and there was a risk that the intended one-off price impact might feed into inflationary expectations in an unhelpful manner. This was one of the factors responsible for the RBA's lifting the official overnight cash rate by 150 basis points over the first half of 2000, from 4.75 per cent to 6.25 per cent. Predicting the macroeconomic impact of the package was made especially difficult by significant relative price changes. In the early months of 2000, there was a substantial bring forward of construction activity, apparently motivated to avoid the new tax. Building construction in the March and June Quarters of 2000 was 15.6 per cent and 24.2 per cent higher than for the same quarters a year earlier. Demand was so strong that the average cost of dwelling construction in the September Quarter 2000 was 16.4 per cent higher than a year earlier.[63] With that much bring forward of activity, there was a risk that the second half of 2000 might experience relatively weak domestic demand, notwithstanding the FHOS and the various elements of 'over-compensation' contained in the package.

In the event, while the September Quarter 2000 National Accounts recorded positive GDP growth (seasonally adjusted) of 0.6 per cent relative to the June Quarter and 4.2 per cent through the year, private dwelling construction fell by 21.5 per cent relative to the June Quarter 2000 level. The December Quarter 2000 National Accounts revealed a further fall in private dwelling construction of 15.4 per cent relative to the September quarter and real GDP growth of -0.6 per cent.[64] The December Quarter figures were published at 11.30 am on Wednesday 7 March 2001, just three weeks short of the end of the subsequent (March 2001) quarter. A second successive quarter of negative GDP growth, whilst unlikely, would be interpreted as official designation of a recession, an intolerable policy and political outcome.

---

[63] ABS: 5206.0, Table 4.

[64] Seasonally adjusted chain volume measure. ABS: 5206.0. Published 7 March 2001. The figure has subsequently been revised to -0.4 per cent.

The Howard Government responded quickly, on 9 March 2001 announcing a doubling of the FHOS for new dwellings, relating to contracts entered into from that date until 31 December 2001. Following consultation with State and Territory governments, Treasurer Costello announced on 23 March 2001 final details of the time limited $14,000 grant, including that 'Recipients of the grant must begin to build within 16 weeks of signing a contract. The contract must also specify a completion date within twelve months of the date of building commencement. These requirements will help ensure that the $14,000 grant provides a targeted, short-term stimulus to the building sector.' In the subsequent 2001-02 Budget, the estimated cost of the initiative was put at $150 million.[65]

The March Quarter 2001 real GDP growth figure, published at 11.30 am on Wednesday 6 June 2001, was 1.1 per cent.[66] Investment in the construction of new dwellings increased by 0.8 per cent, seasonally adjusted, on the December 2000 level. Whether by good luck or astute macroeconomic management, Australia appeared to have avoided a 'technical' recession, for the moment.

The 2001-02 Budget, announced on 22 May 2001, reflected continued caution concerning the economic outlook and a preparedness to assist with ongoing fiscal stimulus. The Government noted that '(in) the present situation of a temporary slowdown in economic growth, an easing in the fiscal position is appropriate as it helps to support demand growth in the economy. The Government has provided a moderate stimulus in the 2001-02 Budget through targeted tax reductions, discretionary spending and by allowing the Budget to respond to the temporary slowdown in economic growth (through the operation of the 'automatic stabilisers' which reduce tax revenues and increase expenditure). This is an appropriate policy response to recent economic developments.'[67]

One measure of the Howard Government's preparedness to use fiscal policy for short-term macroeconomic stimulus is that the Commonwealth budget for 2001-02 recorded a deficit of $1.3 billion, 0.2 per cent of GDP, despite the Government's emphasis on the need to build strong surpluses to deal with the 'debt and deficits' record of their predecessors and political opponents, a consequence of the recession of the early 1990s.[68]

[65] Australian Government (2001a), p. 1-28.
[66] ABS: 5206.0, 6 June 2001. Figure subsequently revised to 1.0 per cent.
[67] Australian Government (2001a), pp. 1-9, 1-10.
[68] Australian Government (2001b).

Lessons

The experience of 2000 illustrates several things of significance to macroeconomic policy practitioners.

First, recognition lags really are a problem.

Second, while the FHOS was chosen because it targeted a sector exhibiting pronounced weakness, it also benefited from relatively short implementation lags; other options were discarded on the basis that they could not reasonably have been expected to have a sufficiently timely impact on economic behaviour.

Third, the dwelling construction cycle can have a pronounced impact on aggregate GDP growth, both directly and because of its strong linkages to other sectors.

Fourth, if the macroeconomic circumstances are considered by a government to be sufficiently alarming, then activist fiscal policy will be employed, notwithstanding the primacy accorded monetary policy nor the force of attachment to medium-term fiscal goals or the aversion to 'debt and deficits'.

Other unusual incidents

On 15 March 2001, Australia's largest general insurance company, HIH Insurance Ltd, received approval from the Supreme Court of NSW to enter into provisional liquidation. Two months later (15 May), on the advice of the Treasury, Prime Minister Howard and Joe Hockey, Minister for Financial Services and Regulation, announced a $500 million package of assistance to people in hardship as a consequence of the collapse. On 17 May, Mr Hockey announced the formation of HIH Claims Support Pty Ltd (HCS) to administer the Government support package.

One of the consequences of the attack on the World Trade Centre and other buildings in the United States on 11 September 2001 is that insurance for commercial buildings virtually dried up. Commercial construction stalled. In response, the Treasury developed the Australian Reinsurance Pool Corporation to administer a new terrorism reinsurance scheme. This scheme provides primary insurers with reinsurance covering commercial properties damaged by a declared terrorism incident.

Lessons

Highly adverse market developments might motivate unusual government interventions designed to restore confidence and avert a pronounced negative macroeconomic impact. These sorts of interventions would not be described as the traditional exercise of fiscal policy, but they have a similar objective.

21. ATTACHMENT B: LABOUR UTILIZATION

Chart B1 presents monthly labour utilisation date for Australian males from September 1978 (index = 100) through to September 2008. Over that 30 year period, the data have been influenced both by cyclical and demographic developments. The latter would have been boosting rates of workforce participation through immigration and the ageing of relatively young baby boomers, both of which would have acted to increase the numbers of males of *prime* working age (25 to 65) as a proportion of all males of working age (15-plus).

The blue line in Chart B1 presents the employment ratio. This is the product of the participation rate and one minus the unemployment rate. It shows the proportion of males aged 15-plus who have a job. The green line shows average hours worked per male employee. And the red line shows the product of the blue and green lines: average hours worked per male aged 15-plus. This is a good aggregate measure of male labour utilisation.

In early October 2008 we were focussed on the history summarised in the blue line in Chart B1.[69]

In the recession of the early 1980s the male employment ratio fell by 7 per cent. By the time the 1990s recession hit, it had only clawed back half that loss. Then it collapsed, to be 13 per cent below its level in September 1978 (6 percentage points below its level in the early 1980s recession). 16 years later, in September 2008, the proportion of working age males who actually has a job was barely above its level in the recession of the early 1980s, despite favourable demographic tailwinds and decades of strong economic growth.

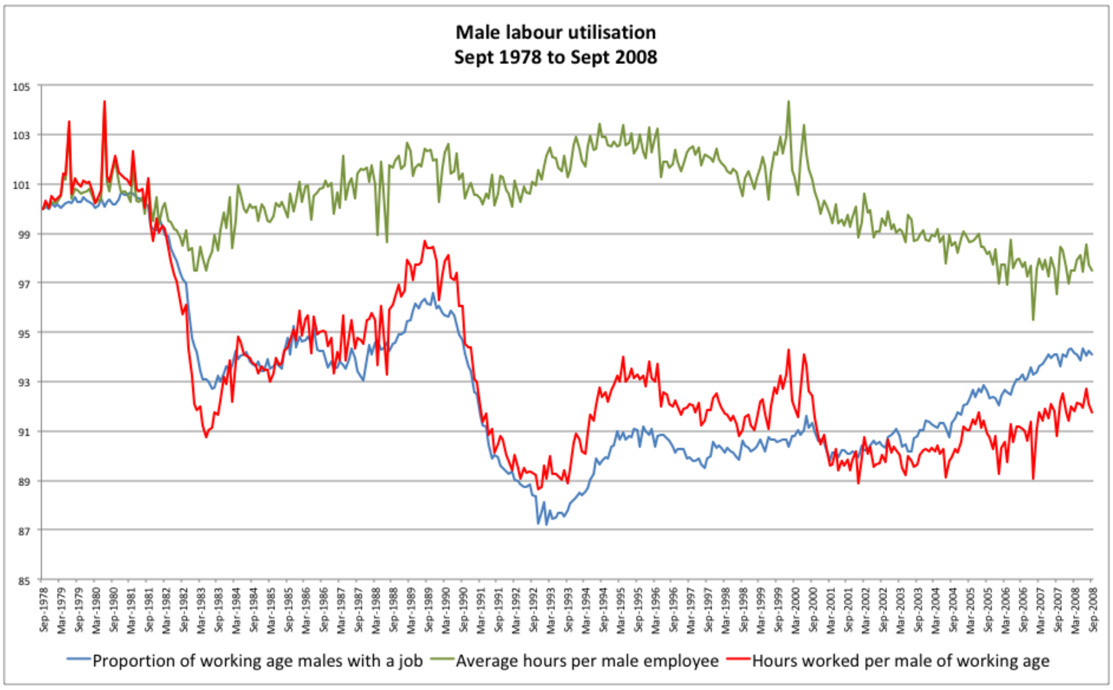
It's worth considering, also, the impact of average hours of work. Male workers have traditionally worked full-time jobs, with cyclical developments affecting over-time hours. The chart shows that average hours worked by male employees demonstrated little trend until this century, when casualization began to have an impact. The negative trend of casualization has acted to offset, to some degree, the positive impact of demography, at least up to September 2008. Two intergenerational reports (2002 and 2007) had projected that the demographic trend was also about to become a negative for the employment ratio.

Thus, as we were meeting in the Cabinet room on the morning of 11 October 2008, considering the case for a fiscal stimulus, we had in mind that male workers had been hard hit by the recessions of the early 1980s and 1990s, they had been losing hours of work during the first several years of the 21st century due to casualization, and were about to experience a pronounced fall in workforce participation because of ageing. These developments had implications for macroeconomic performance and, of even more importance, for the living standards of Australian families.

[69] Not literally, since we didn't have this chart in front of us. But we were aware of its shape.

Female labour force participation rates had not been as badly impacted by earlier recessions, experiencing about half the fall in the male participation rate in the early 1990s. Even so, on that occasion the female participation rate didn't recover its pre-recession level for five years, despite a strong structural trend increase in women wanting to work. The recession of the early 1990s had denied hundreds of thousands of Australian women the chance to enter the labour market for many years. It is very likely that many were discouraged from ever entering the labour market because of the events of the early 1990s.

Chart B1: Male rates of labour utilization, Sept 1978 (index = 100) to Sept 2008

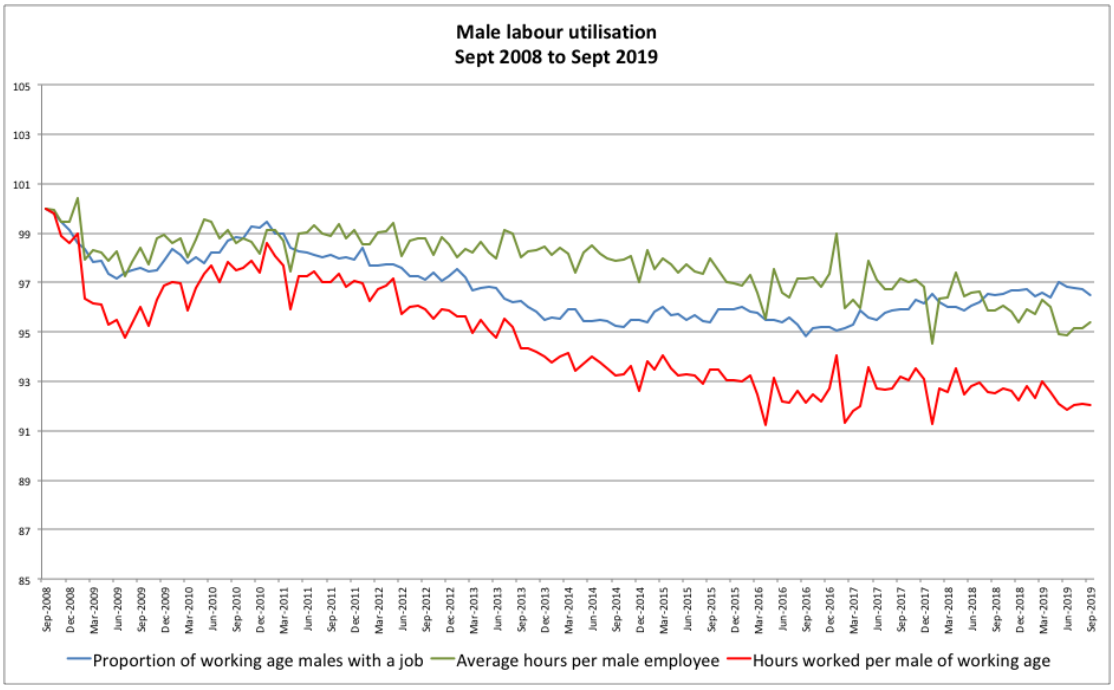


Source: ABS 6202.0

Chart B2 extends Chart B1 for 11 years, from September 2008 (index = 100) through to September 2019. The behaviour of the male employment ratio appears starkly different from earlier slowdowns. Having fallen by about 3 per cent, the ratio was almost fully restored within 2 years of the collapse of Lehman's. Average hours worked by male employees fell by a similar proportion, and recovered as quickly. Since late 2010 the male employment ratio has been influenced strongly by demographic trends. Average hours worked by male employees have exhibited trend decline through the whole post-crisis period, offsetting recent cyclical strength in the male participation rate.

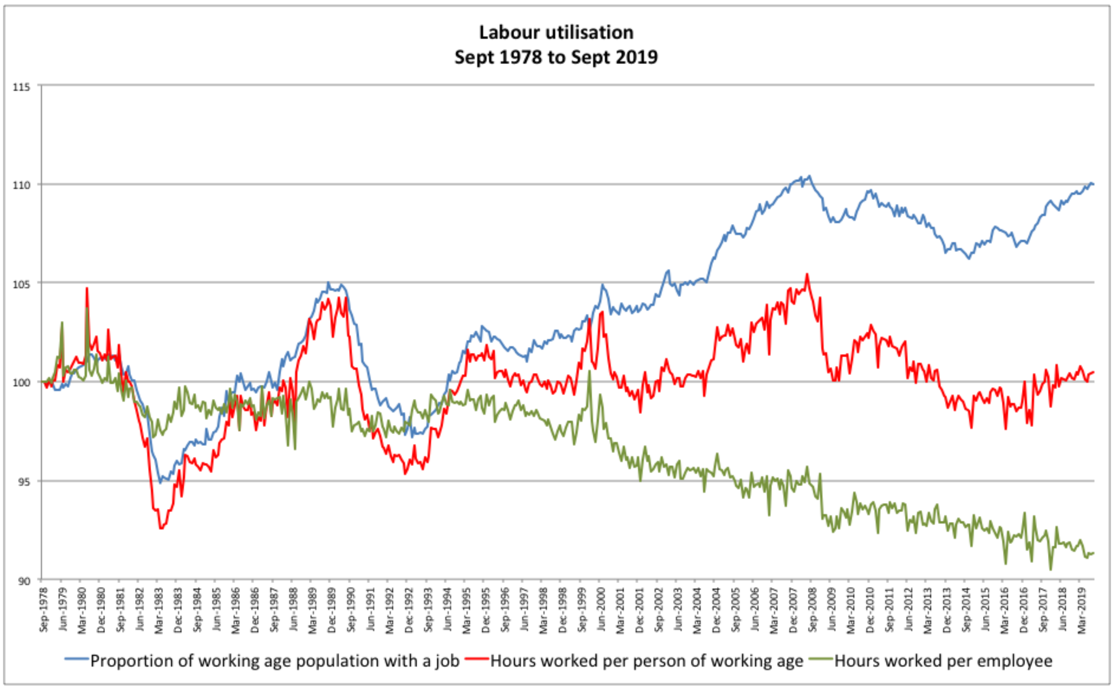
Chart B3 presents labour utilization rates for the total working age population; that is, for males and females combined.

Chart B2: Male rates of labour utilization Sept 2008 (index = 100) to Sept 2019



Source: ABS 6202.0

Chart B3: Total rates of labour utilization, Sept 1978 (index = 100) to Sept 2019



Source: ABS 6202.0

22. References

Australian Government (1991), *Budget Statements 1991-92*, AGPS, Canberra 1991.

Australian Government (2001a), *2001-02 Budget Paper No.1, Budget Strategy and Outlook 2001-02*, May 2001.

Australian Government (2001b), *Final Budget Outcome, 2001-02*, September 2001.

Barrett, C. (2011), 'Australia and the Great Recession', Woodrow Wilson International Center for Scholars, April 2011.

Brown, N. (1991), *Background to the 1990 and 1991 Cabinet records*, National Archives of Australia, available at http://www.naa.gov.au/collection/explore/cabinet/by-year/1990-91/background.aspx; accessed 6 July 2019.

Chordia, S., Lynch, A. and Williams, G. (2015), 'Commonwealth executive power and spending after Williams [No 2]', Case Note, University of Melbourne Law School, available at law.untimely.edu.au.

Gruen, D. and Stevens, G. (2000), 'Australian macroeconomic performance and policies in the 1990s', *RBA Conference 2000*.

Gruen, D. (2009), 'The Return of Fiscal Policy', *Address to the Annual Forecasting Conference*, Australian Business Economists, 8 December 2009.

International Monetary Fund (2008a), Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, April 12, 2008.

International Monetary Fund (2008b), Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund, October 11, 2008.

International Monetary Fund (2008c), Remarks by Dominique Strauss-Kahn, Chairman of the Executive Board and Managing Director of the International Monetary Fund, to the Board of Governors of the IMF at the Joint Annual Discussion, *2008 Annual Meetings of the International Monetary Fund and the World Bank Group*, Washington DC, October 13, 2008.

Keating, P.J. (1991), 'A Retirement Incomes Policy', *Address to the Australian Graduate School of Management*, 25 July 1991.

Keating, P.J. (1992), *One Nation*, AGPS, Canberra, 26 February 1992.

Henry (2003a), 'Australia and the International Financial Architecture – 60 Years On', *Sir Leslie Melville Lecture*, Australian National University, 16 July 2003.

Henry (2003b), 'Fiscal Policy in Australia', *Address to the Australian Conference of Economists Business Symposium*, Canberra, 2 October 2003.

Henry (2012a), 'Should the super industry invest more in fixed interest?' *Address to the ASFA Investment Interchange*, Sydney, 16 March 2012.

Henry (2012b), Lecture in Honour of Emeritus Professor John Nevile, University of New South Wales, 10 October 2012. Edited version reprinted as 'Macroeconomic Policy Challenges in the Asian Century', *The Economic and Labour Relations Review*, Volume 24 Issue 2, June 2013.

King (2007), Speech delivered to the Northern Ireland Chamber of Commerce and Industry, Belfast, 9 October 2007. Available online at www.bankofengland.co.uk/publications/Pages/speeches/default.aspx.

McDonald and Morling (2011), 'The Australian economy and the global downturn – Part 1: Reasons for resilience,' *Economic Roundup*, September 2011 edition.

Rodgers and Hambur (2018), 'The GFC investment tax break', *RBA Discussion Paper – RDP 2018-07*.

Treasury (2009), *Treasury Briefing Paper for the Senate Inquiry into the Economic Stimulus Package*, The Treasury, Canberra.

Turnbull (2008), *Address to Queensland Liberal National Party*, 10 October 2008, accessed at www.australianpolitics.com.