AUSTRALIA'S OUTLOOK FOR POLITICS AND GOVERNMENT IN 2009

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According to the conventional wisdom, in his first year of office Kevin Rudd has had the huge misfortune of being hit by a global recession that's likely to drag our economy down, disrupt his many plans and possibly see him thrown out of office after just one term. But that's not the way I see it. I think he's had the great good fortune of having the world economy let him off the hook and greatly improve his chances of being re-elected. He and his ministers must be privately delighted.

Don't blame me, it's the GFC

As I observed in my talk a year ago, this was not a good election to win. Federal governments usually lose office only after they've presided over a recession, but John Howard got tossed out before any recession. As he left office, however, the economy was in its 17th year of expansion and close to full capacity, with the headline inflation rate heading for 5 per cent and the Reserve Bank stepping ever heavier on the interest-rate brakes so as to engineer a period of below-trend growth and rising unemployment. So the chances of a recession during the Rudd Government's first term were high. It would then have had to convince the electorate this was due to the negligence of its predecessors, not any mismanagement of its own. Coming after Peter Costello had spent 11 years reinforcing the public's natural suspicion that Labor isn't good at running economies, this would have been a tall order. Post-war history says no federal government has ever been turfed out after one term, but this time last year I thought Mr Rudd's chance of being the first were quite high.

All this Labor understood full well even before it won the election. That's why it set about from the very start criticising its predecessor's economic management and dramatising the extent to which inflation was blowing out. As we know from the national accounts, tight monetary policy caused the economy to slow to stalling speed in the September quarter without much help from the rest of the world. But that's not the way the public sees it, nor is it the way the Government is encouraging us to see it. The global financial crisis that followed the collapse of Lehman Brothers on September 15 was so scary it's now burnt into the public's brain and the obvious cause of all the nastiness that's to follow. So, as long as the Rudd Government keeps reinforcing that rewriting of history, it's off the hook. Don't blame me, it's the GFC.

All past Australian recessions have occurred as a result of a combination of domestic imbalances and world recession. This one will be no exception. But politicians from the Whitlam government on have always had trouble shifting the blame to overseas factors beyond their control. The punters almost always think local. But that's what different this time. If Mr Rudd can portray himself as just the guy cleaning up the mess after an international conflagration, and doing so with reasonable competence, his chances of re-election are, paradoxically, much enhanced.

Rudd as an economic manager and reformer

Last year I speculated on what Mr Rudd would be like as an economic manager, but this year we've got a lot more evidence to work with. I think the key to understanding him is his boast that he's not ideological. It's true, he's not - which means he doesn't have deeply held convictions about how the world works and how it should work. The closest he comes is that he's a great believer in 'process'. By training and by instinct he's a bureaucrat. Governments' job is to run the country and to do so in an orderly, considered, usually consultative way. That makes him a bureaucratic fixer. A leader's job is to work his way through a list of all the things that are going wrong and need to be put right. Lacking strong views about how the world should work he doesn't have priorities in any genuine sense, he has a to-do list. The fact that he's a control freak also militates against him having genuine priorities.

Mr Rudd keeps saying he's an economic conservative. I think that's true. It's mainly something you say to protect yourself in a Costello-created world obsessed by budget surpluses, but I doubt it will inhibit him all that much in allowing the automatic stabilisers to work and in applying an appropriate degree of fiscal stimulus on the top. When even the most respectable economists are calling on you to spend money, few politicians resist. On a deeper level, I think Mr Rudd is pretty conservative - in all things. He has no great desire to change the world in radical ways. He has no ideology driving him in such a direction and, in any case, radical change would annoy a lot of people and possibly cost him votes. You might think his resolve to do something about climate change doesn't fit with this but, in fact, the great promise of an emissions trading scheme is that it's the way to tackle the problem with least disruption to the status quo.

What being an economic conservative definitely doesn't equate to is being an economic rationalist. Rationalists are ideological and want radical change. Mr Rudd is pro-business, not pro-market. He knows Labor can't occupy government without the at least tacit support of big business and people otherwise inclined to vote Liberal. Having no strong commitment to smaller government or means-tested welfare, he has no burning desire reduce middle-class welfare. Being of bureaucratic inclination he is, almost by definition, an interventionist. If you want a label for him, Michelle Grattan has found the best: he's a pragmatic interventionist.

I don't want to shock you, but Mr Rudd is so lacking in ideology he sees economic rationalists not as people arguing propositions that are either right or wrong, but as just another interest group needing to be squared away somehow. You can see that perfectly in his car plan: the rationalists got continued falls in tariffs; the industry policy advocates got massive government spending. What's your problem? Similarly, with climate change the rationalists get emissions trading and the environmentalists get renewable energy targets.

One of the most disappointing things about the Rudd Government is its obsession with dominating the 24-hour news cycle and its insatiable need for 'announceables'. Utterly contrary to Mr Rudd's commitment to good process, this is a preoccupation that wastes the time of its bureaucratic advisers, perpetually distracts the attention of ministers and gives spin doctors primacy over policy wonks. It makes me think we're getting an antipodean version of Tony Blair and New Labour - superficially intelligent and committed to sensible, middle-of-the-road policy but, actually, preoccupied with re-election and, ultimately, disappointing and disillusioning.

Mr Rudd is a timid leader, one anxious to avoid offending many voters and lacking the courage of his convictions - manly because he doesn't have many. The Government seems far more worried by what the Opposition will say about things than it needs to be. So Malcolm Turnbull will carry on about a budget deficit - so what? Labor is so obsessed by its unjustified reputation as a bad economic manager that it fails to see all the advantages of incumbency it possesses. Governments monopolise the microphone. When it comes to budgets, what the Treasurer says drowns out what anyone else says (including yours truly).

Rudd Government's first year

Mr Rudd's first year had some high spots - the ratification of Kyoto, the apology to the Stolen Generation - and quite a few low ones, such as all the nonsense about petrol and grocery price watches. The $6.2 billion car plan and Mr Rudd's statements about not wanting to be the leader of a country that doesn't make things was disappointing. It's noteworthy that the global financial crisis was used to help justify the car plan, a sign that we can expect more exercises in the New Protectionism, all in the name of protecting jobs. How can protecting jobs be bad?

Labor's first budget purported to involve a significant tightening of fiscal policy so as to reduce the pressure on monetary policy and interest rates, but didn't. We were told to expect tough spending cuts but they were few and far between, with their place taken by increases in the taxes on alcopops, luxury cars and petrol condensate. With storm clouds gathering internationally, the Government took a punt that a tightening of fiscal policy wouldn't be needed and its bet paid off. Even so, a once-in-a-government chance to spring clean government spending with political impunity was lost. We were told the Government hadn't had enough time to properly review spending programs and that a proper review would be implemented in next year's budget, but I'll believe that when I see it.

Despite the lone campaign being conducted by an Australian newspaper, Labor's replacement of Work Choices with its own Fair Work was almost completely consistent with its election commitment. It was a reasonably even-handed exercise, to which the main employer groups took little exception, unless you believe that fairness is an irrelevant consideration in industrial relations and that efforts to stamp out collective bargaining are in the best interests of all sides. Remember that Work Choices had already been heavily modified by John Howard with his late insertion of a 'fairness test'. As an example of Labor's moderation, note that the guidelines devised for the Fair Pay Commission's setting of minimum wages were little changed when handed over to Fair Work Australia.

Mr Rudd and his ministers have put much effort into achieving productivity improvement through co-operative federalism and revitalisation of the COAG process. About 90 special purpose payments have been reduced to five broad categories and 'national partnership payments' introduced as an incentive for the states to achieve certain targets. But progress has been slow and how much actual improvement is achieved remains to be seen.

Generally speaking the Government did well with its 'decisive' response to the global financial crisis in late September and October. Its one significant error was that, when it finally produced details of its guarantee of bank deposits, it didn't pull back sufficiently so as to reduce flow-on problems for other institutions.

Policy prospects for 2009

Next week the Government will publish its white paper on its Carbon Pollution Reduction Scheme, including its target for reduction in emissions by 2020. I fear we'll see a demonstration of Mr Rudd's lack of courage and lack of conviction. We'll be off to a very slow start - with a reduction of maybe only 10 per cent by 2020 and a fixed or tightly capped carbon price - plus a lot more concessions to polluters than are warranted.

Next year's budget will be an important one, no doubt with a lot more fiscal stimulus. We know it will contain increased payments to single pensioners combined with, we must hope, reform of the interface between tax and transfers. We know Ken Henry's root and branch tax review has also been called on for advice about superannuation arrangements - though not about the tax-free status of payments to the over-60s. The budget will incorporate already-announced spending on infrastructure projects. Note that spending from the nation-building funds will add to the budget deficit but not to the borrowing requirement. The budget will contain the second round of tax cuts promised in the election campaign - which, though already included in the forward estimates, will add to the fiscal stimulus. The thing to note here, however, is that as they stand, those cuts deliver little to low and middle income-earners, and so will have to be supplemented by additional cuts that aren't in the forward estimates.

Speaking of the tax review, it's supposed to report late next year, but I have a feeling it won't figure largely in the government's pre-election figuring, except to the extent that, as with transfer payments and with super, it's called on for special advice on a specific issue. Next year will be some sort of moment of truth for the Rudd Government as the many inquiries it has commissioned report and recommend action. The Government has been running a line that says: terribly sorry, we assumed we'd have a big budget surplus to play with, but now the GFC has robbed us of that we'll have to be much more selective in what we can agree to. I find this a curious argument. If we were still running big surpluses that would mean we were still close to full capacity and so the Government shouldn't be spending big. On the other hand, in my experience periods of recession and deficit are times when governments spend freely and become less discriminating, not more. So perhaps this line is the Government's way of belatedly admitting that, in commissioning so many inquiries, it bit off a lot more than it could chew.

My summary judgement on the Rudd Government's performance to date: good but far from great.

Observations on monetary policy

Towards the end of the monetary policy tightening cycle that ran for six years, the Reserve Bank developed a clear and simple modus operandi in which it waited for the quarterly CPI release, revised its inflation forecast on the basis of the new information and then adjusted the stance of policy if necessary at the board meeting about two weeks later. It aligned its quarterly statements on monetary policy so they followed the board meeting after the CPI release and they preceded its six monthly appearances before the parliamentary committee. This simple MO had many advantages for the Reserve, but also for the markets. Particularly because the Reserve moved in steps of 25 basis points, predicting the size and timing of rate rises became child's play.

But in these comments last year I observed that this MO would not be suitable in times when you needed to move fast, nor during an easing cycle. I noted that this MO would last only as long as it suited the Reserve. Well, that's one thing I got right. As soon as the Reserve began its easing cycle in September the old, predictable way of doing things disappeared. When you're cutting interest rates there's never any political resistance - from the government or the lobby groups - so you don't have to worry about carrying the public with you. And, just as the old saying says the dollar goes up by the stairs and down by the lift, so you need to ease a lot faster than you tightened. I think this is because the effect of rate rises isn't linear. When business and consumers are in an optimistic mood, you can keep tightening time after time and not have much effect on demand. But then one day you give it one more turn and suddenly the mood switches to pessimism and caution. The economy begins slowing rapidly and you need to cut quickly to avoid a hard landing.

When the world is hit by a global financial crisis of almost unprecedented scariness, and when it becomes clear that almost all the major economies are already in recession, then the need to achieve a rapid change in the stance of policy is clear. When interest rates are a long way from neutral - in either direction - you probably shouldn't stay there for long, and you need to act quickly if you discover the stance is no longer appropriate. On this occasion, the Reserve moved the stance from quite restrictive to clearly expansionary in just three moves spread over two months. In that time it cut the cash rate by a remarkable 40 per cent.

In the process, however, the Reserve's signalling to the market went awry and a lot of market participants and business economists were caught out. So let's try to explain what happened. We now know that, at both the October and November board meetings, the rate cut that was recommended in the board papers was increased at the meeting itself. Some people have wondered whether surprising the market by cutting more than expected was a ploy intended to increase the favourable impact of the move. It wasn't. The explanation was simply that, in the short period between the recommendation and the meeting, more worrying information arrived to cause the governor to decide that an even greater cut was warranted.

Some people were led astray by a speech Ric Battellino gave in which he observed that the big inflation task could limit the Reserve's room for manoeuvre on monetary policy. This hardly seemed to fit with the move less than a week later to cut by 75 points. So how was it explained? Well, Ric is an independent thinker, he has strong and non-conformist views which, as a member of the board in his own right, he's not afraid to express. There's no danger of group think while Ric's around. He expressed his view but, in the end, it didn't prevail.

It's clear Glenn Stevens regards the threat to our economy from the global recession as very great and decided to get rates down to the right level as quickly as possible. But while the Reserve does <u>not</u> see it as its job to provide the markets and business economists with an everlasting one-way bet, it also knows that if it goes on surprising people it will lose some goodwill. I think we'll find that, when the minutes of the December meeting are published, the cut of 100 points was what had been recommended in the board papers.

Remember, too, that in response to the market's urging, the Reserve puts out a lot more material than it used to - a statement after every board meeting, even when there's no change; minutes of board meetings, and Mr Stevens giving a lot more speeches than Ian Macfarlane did. But the more material the Reserve puts out, the greater the scope for misunderstandings.

Looking to next year, there are a few things we can say. I'm sure the board will meet in January if that proves necessary, but the normal gap until early February provides a welcome opportunity for the Reserve to sit back and take stock. It has made a very large change in a short time, taking the cash rate down to its previous low. To some extent it's got ahead of the data, relying heavily on 'liaison' (regular and systematic consultations with key firms and industry groups), anecdote and intuition. It has assumed that what's been happening abroad will have a big effect on us, but it will now need to see the hard data confirming this.

The world recession looks like being significantly more severe than we've experienced before. If so, there's little doubt we'll be pushed into recession as well. It's already apparent that our economy is softer than was forecast as recently as the November SoMP. We now know the first quarter has made a contribution of just 0.1 per cent to the forecast of GDP growth over the year to June 09 of 1.5 per cent. Similarly, the first quarter has made a contribution of minus 0.3 per cent to a forecast for non-farm growth of 1 per cent.

So it's clear that, even though the cash rate is already as far from normal/neutral on the downside as we've seen, the Reserve has further to go next year. But if you thought it likely on present indications to go no further than the low 3s, just one more cut of 100 points would see it done. This suggests the Reserve will soon have to level out, making smaller cuts of 50 points or even 25.

The Reserve will respond to developments as they occur. But there are two things to remember about next year. First, the cuts to date have had an expectation of more bad news to come factored in. So when the expected bad news actually arrives, you need to respond only to the extent that it's worse than you originally allowed for. That is, you have to avoid double counting. Second, because the Reserve has acted with such alacrity, we're reaching a point where things continue getting worse, but it doesn't respond because it's already done all it considers appropriate. This is an inevitable consequence of the pre-emptive approach to monetary policy, but that won't make the appearance of inaction any easier to accept by the public - and maybe even some business economists.