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One Year On: Fiscal Stimulus and the Path Ahead

Address to the Australian Business Economists

Sydney

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Thank you for inviting me to speak at what is probably the highest quality regular gathering of economists anywhere in Australia – the Australian Business Economists.

This is a critical time for us to meet; one year to the day since the Government announced that it would guarantee bank deposits and wholesale funding, a year since I saw the fear in the eyes of my international counterparts in a DC meeting of the IMF and World Bank and, in two days' time, a year since we announced the Economic Security Strategy – the first phase of our fiscal stimulus.

As you know, in the year just passed, nearly every major country in the world has experienced a deep recession. Australia has not.

Our resilience is a tribute to the sensible manner with which Australian workers and firms dealt with the crisis, the years of difficult economic reform dating from the early 1980s, and the timely policy interventions from the Government and the Reserve Bank.

One year later, it's an opportune time to take stock of events and assess the benefits of the policy actions that Australia and other countries took. It is the perfect time to evaluate our own stimulus strategy, and to consider where fiscal policy goes from here. These are the two tasks I've set for my speech today.

Global Recession and Australia

Very shortly after the collapse of Lehman Brothers, it became clear that the world's financial system was on the brink of failure. Banks were unwilling to lend to each other at anything other than a massive premium to the cash rate. The prices of many assets had fallen sharply. A dangerous feedback loop had developed, with asset prices and confidence in markets in freefall, credit failing, and confidence in growth and jobs rapidly disappearing.

By October, virtually every advanced economy was either in or about to enter recession – although the hard data would not confirm this until early 2009. Many would go on to experience their deepest and most protracted recession since the Great Depression.

Because Australia is a capital importer, developments in world financial markets have significant implications for our economy. The global financial crisis was just such a development, bringing higher risk premiums, lower asset prices, serious gaps in vital credit markets and a hunkering-down across the global economy that caused a large fall in global trade.

In the week leading up to the decisions we took, we had seen the Australian share market suffer its biggest weekly fall since the 1987 stock market crash. The dollar its biggest fall since the float. And the Reserve take its most aggressive stimulatory action in the inflation targeting era.

As the person ultimately responsible for the conduct of economic policy in Australia, I cannot emphasise enough how deeply we felt the impact of these events. The economic numbers were one thing, but far more troubling was the prospect of a 'lost generation' of workers and businesses. Like many of you here, I remembered the dark days of the early 1990s recession, and the suffering friends and family members went through.

Best-Practice Stimulus

So as a Government we determined to do all we responsibly could to cushion the economy and the labour market from this significant disruption.

The first decision was to tackle directly the threat of a loss of access to global capital markets. We guaranteed deposits in the banking system and offered financial institutions access to a government guarantee for their wholesale funding.

The bank guarantee was an extraordinary policy response made necessary by extraordinary events in international banking and financial markets in October 2008. While we had no bank runs in Australia, pictures of bank panic overseas ran almost nightly on Australian TV news, calls started coming into my office about whether our banking institutions were safe, and people were starting to ask whether what was happening overseas could also happen here.

As governments overseas started providing blanket guarantees to their banks, Australian banks were at risk of being pushed to the back of the funding queue by panic-driven international financial markets, even though our banks are strongly capitalised.

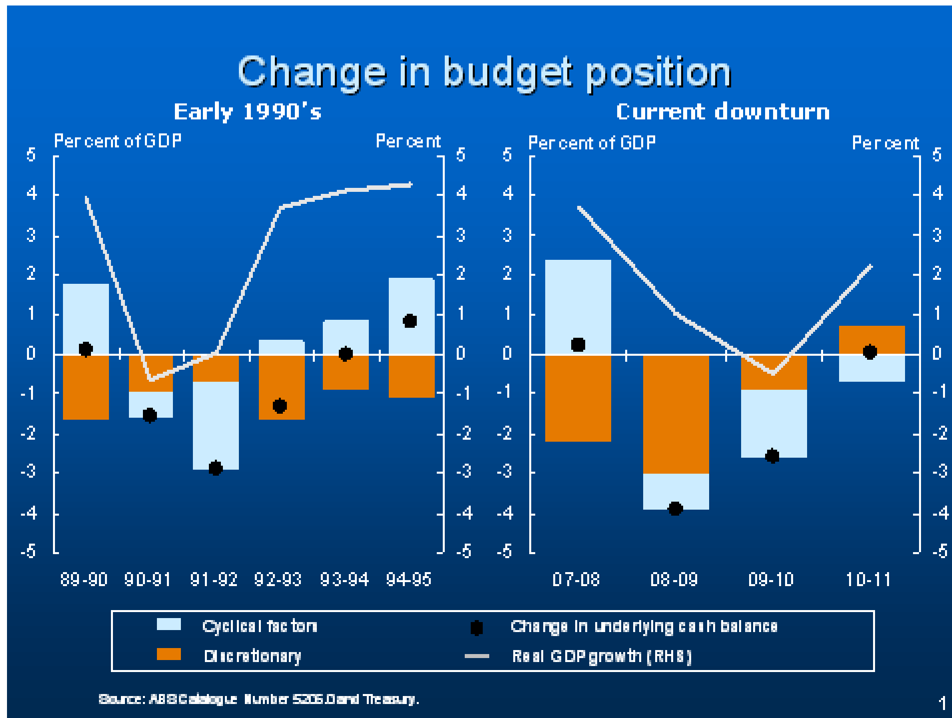
The guarantees tackled the crisis at its root, supporting the availability of credit to the economy, and hence supporting private sector activity. Had we not acted when we did there was a real risk that our own financial system would have experienced a seismic event of its own.

Other decisions to support the operation of our financial system were extremely important, such as our continuing investment in residential mortgage-backed securities, to keep alive the securitisation market and to support competition in our mortgage market.

On the fiscal front, our response came in three stages. First - direct support to households, supporting consumption and housing investment. Second - investment in 'shovel-ready' infrastructure – providing critical and timely support to construction-sensitive industries. And third - investment in critical, long-term economic infrastructure.

The lesson of history is that governments have typically acted too timidly and too late in response to a downturn. We were determined not to repeat those mistakes. We set clear criteria that stimulus be timely, temporary and targeted. And we met them.

Chart One: Change in budget position



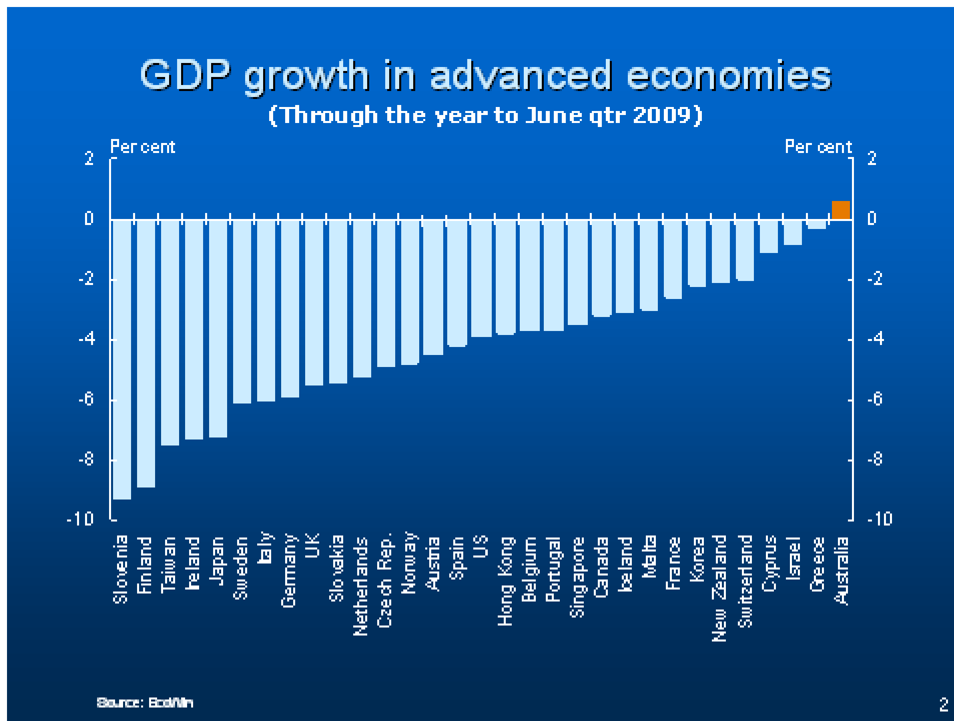
Our stimulus was rolled out immediately and with rapid effect. In fact, our response to this downturn is much better correlated with the economic weakness than Australia's responses to the recessions of the early 1980s and 1990s.

The orange bars in this slide show the change in the fiscal position after adjusting for the impact of changes in prices and GDP. That is, it shows the part of the change in the Budget that is due to the deliberate actions of government, rather than the automatic stabilisers. It's a simple decomposition, but it shows that the fiscal impulse from policy actions hits the economy much more rapidly, and then withdraws much more quickly in this downturn than the policy response of the early 1990s.

We were acutely conscious of the experience during the 1990s recession, where a rapidly rising unemployment rate was tied to a rapidly declining level of confidence. Once that damaging feedback loop kicks in, it's very difficult to pull back.

The best advice and the best-available soundings – including from some of you in this room – allowed us to get in early. I think it's a big part of the reason policy has been so much more successful this time round – acting before large falls in employment had set in. In other countries, stimulus was applied after big plunges in activity had already occurred, after unemployment was already rising rapidly, and after confidence was already shot.

Chart Two: GDP growth in advanced economies

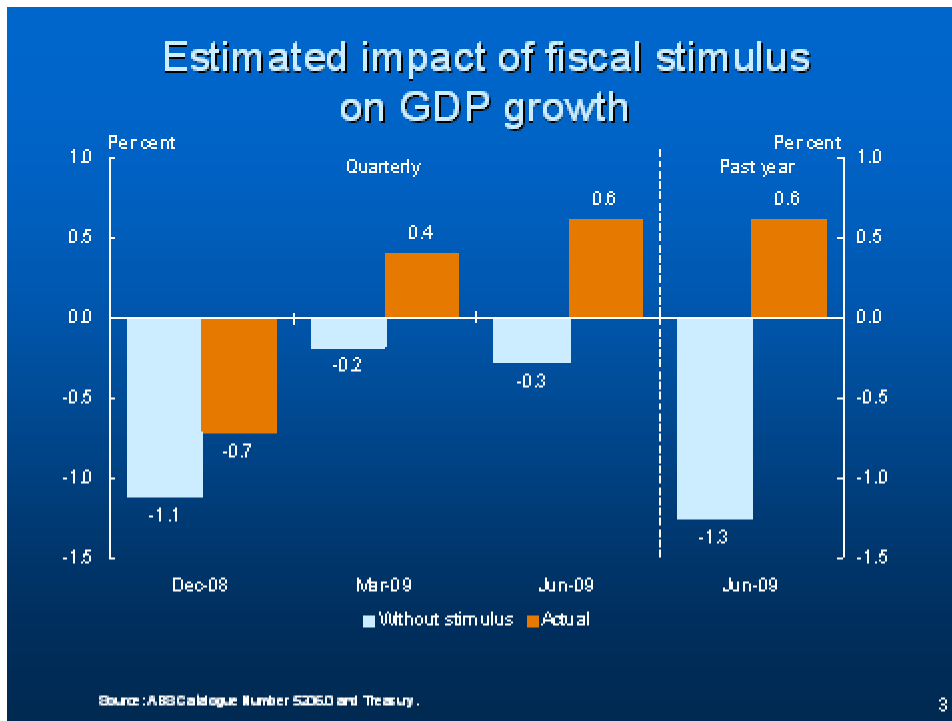


Our actions ensured the Australian economy grew in the year to June – the only one of the world's 33 advanced economies to do so.

It is not true, as offshore commentators sometimes write, that the reason Australia avoided a recession was because of China's growth, but it did help. Our exports overall made a major contribution to GDP growth in the first half of this year, but as you know that contribution was not as big as the contribution of consumption.

While our exports to China are very important to us and are growing rapidly, even so over the first eight months of this year our goods exports to China were only one-fifth of our total goods exports. So though China's continued growth is important and welcome it does not actually explain how we avoided recession.

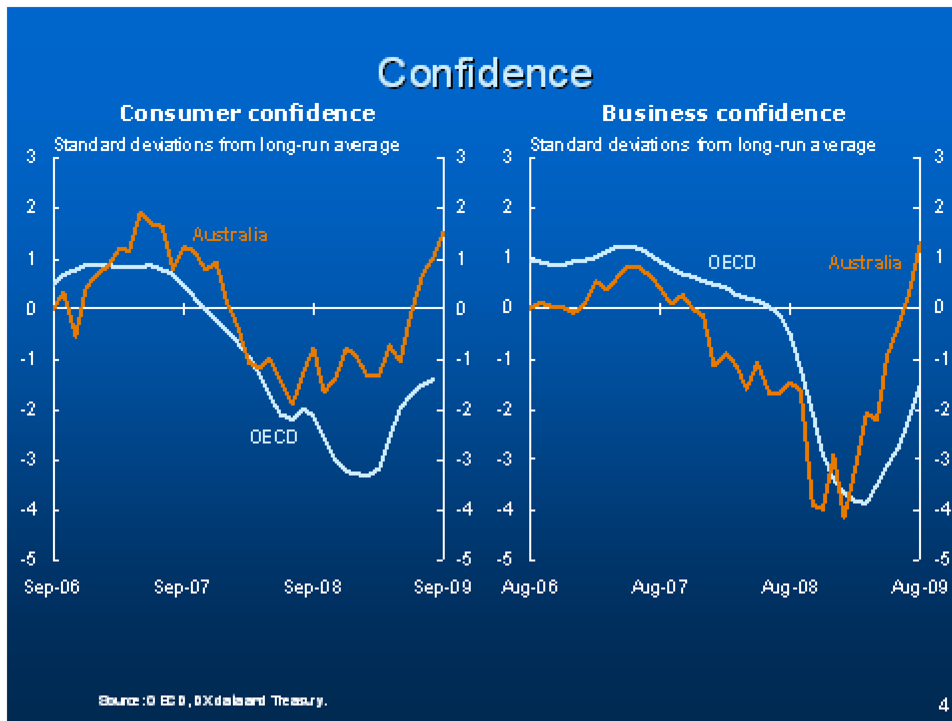
Chart Three: Estimated impact of fiscal stimulus on GDP growth



In this chart, you'll see that on Treasury's estimates, without the fiscal stimulus, the Australian economy would have contracted in not only the December quarter of last year, but also in the March and June quarters of this year. And, our economy would have contracted by 1.3 per cent over the year to June. Instead, with the stimulus, the economy expanded by 0.6 per cent.

Importantly, both business and consumer confidence are recovering strongly. For example, consumer confidence is about 45 per cent higher than pre-stimulus levels – a much stronger rebound than has occurred elsewhere in the developed world.

Chart Four: Confidence



What’s most telling about this chart is that the biggest boost to confidence didn’t come when we announced our stimulus – although that was important. And it didn’t come when families received their stimulus cheques. It came when we received tangible and powerful evidence that our stimulus was working to keep Australia out of recession.

Australians breathed a collective sigh of relief the day we received the GDP outcome for the March quarter, showing Australia had defied global economic gravity. On a personal level, it was one of the most satisfying days I’ve had in this job. It was powerful evidence that we could indeed come through this crisis in better shape than most had feared.

That’s why I have been arguing that the effect of stimulus on confidence is what makes it greater than the sum of its parts. The rapid fiscal and monetary responses kick-started a virtuous cycle of continued spending and investment, leading to higher confidence.

Some people have criticised Australia’s economic stimulus for being larger than that of other countries, particularly given the stronger performance of our economy. To that criticism, I would like to make a couple of points.

The first point is that less stimulus would have meant a deeper downturn in our economy and more jobs lost.

The second is that our economy continues to grow at rates that fall short of what’s required to prevent further rises in unemployment and will continue to operate well below capacity for some time. And hours worked in the economy have fallen substantially – by the equivalent of more than 200,000 full-time jobs. Don’t get me wrong – cutting hours is much better than cutting jobs, but weakness in hours worked remains a potent sign of insufficient aggregate demand in the economy.

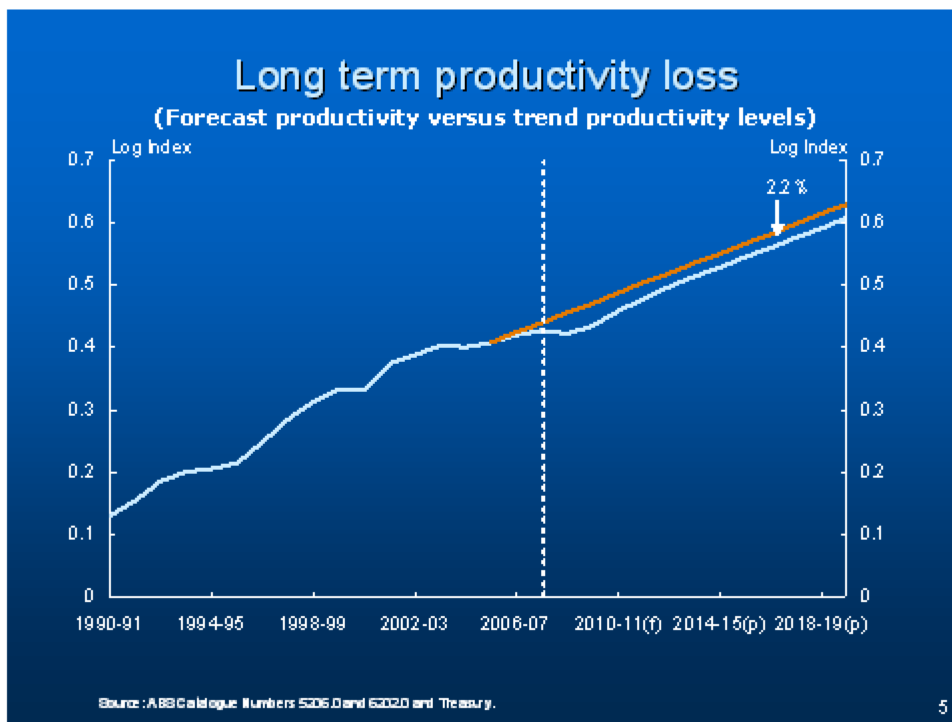
The Government's economic stimulus has been an important part of ameliorating the temporary impacts of the global recession, but it also has important long-term benefits. Temporary spending on infrastructure, for example, bringing lasting economic gains.

Perhaps the most important of these gains is avoiding the creation of a generation of long-term unemployed people. Unemployment doesn't just destroy today's output, it leads to permanent destruction of skills. It drags on an economy for years – to say nothing of the price paid by Australians and their families.

Similarly, economic downturns tear away at the economy's capital stock, either through a degrading of existing capital or a failure to invest in new capital. You have all heard of creative destruction. The bankruptcy of otherwise viable firms during a temporary shock to the economy is not creative, it is just destruction.

Both of the factors that I have mentioned – the erosion of human and physical capital – can lead to a permanent loss of output after economic downturns.

Chart Five: Long-term productivity loss



Given the size of the economic downturn expected at the time, the budget forecasts embodied a permanent loss of output of a little more than 2 per cent of GDP – the result of a permanently lower level of productivity. The success of the economic stimulus and the solid performance of the economy more generally, will mean that the forecasts presented in MYEFO due later this year will embody a smaller permanent output loss than we had estimated at Budget.

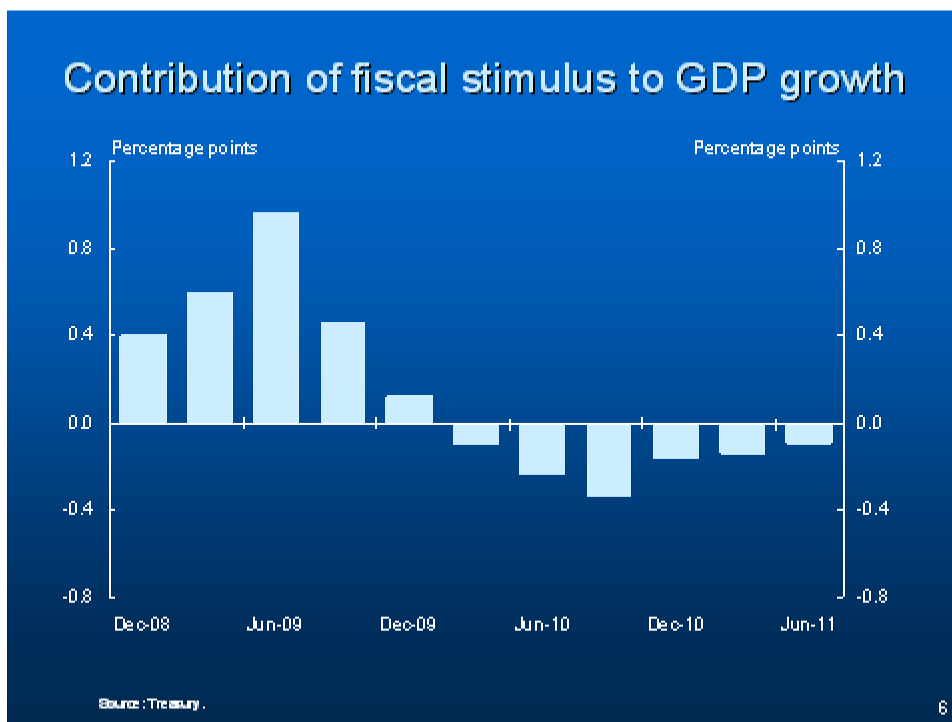
Withdrawal of Stimulus

When I started thinking about this speech a couple of months ago, I envisaged a fairly rigorous defence of the appropriateness of our fiscal stimulus against its critics. It is a sign of the success of the stimulus that the debate has shifted markedly in more recent times. The harshest, most strident critics of stimulus have changed their minds. Having said stimulus would not work, they now say it has worked too well.

A run of encouraging data, including last week's remarkable unemployment figure, and a 25 basis point rise in the cash rate, have now focused attention on the withdrawal of stimulus. And it is the withdrawal of fiscal stimulus, and its interaction with the withdrawal of monetary stimulus, that I want to turn to now.

In this room, you understand our stimulus is designed to reach its maximum impact quickly, before withdrawing gradually as the economy strengthens. But the fact that the stimulus has already peaked, and is already tapering away, is not well understood by the broader community.

Chart Six: Contribution of fiscal stimulus to GDP growth



As you can see in this slide, after stimulus peaked in the June quarter this year, it contributes less to growth in subsequent quarters, and in fact detracts from growth from early next year.

These are important points to consider for those who argue the Government will be crowding out private sector activity in the future. Our call on domestic resources will soon be falling, not rising. Freeing up resources just as the private sector is looking to expand.

Treasury has estimated the fiscal stimulus contributed around 1 percentage point to growth in the June quarter. In the September quarter, its impact on growth is estimated to be less than half that amount. And in the present quarter, fiscal stimulus is expected to have only a marginal impact on growth.

As the stimulus is increasingly withdrawn it makes room for the recovery in private sector activity. This was precisely our intention in designing the package. On current estimates, we expect that to occur from the March quarter of 2010. In fact, the gradual phasing down of fiscal stimulus is expected to subtract from growth in every quarter in 2010.

Calls for stimulus to stop fuelling growth in 2010 are based on a misunderstanding. Presumably what those people really mean is they want it to detract even more from growth next year.

There are many reasons why the withdrawal of stimulus is designed to occur gradually and carefully. The first is because I'm one of many – my G20 counterparts foremost among them – who feel the global recovery is not yet assured. Substantial uncertainties remain, and Australians' jobs are still at risk as a consequence.

The second reason is to prevent any sudden drops in economic activity and unwelcome feedback to consumer and business confidence. To entirely remove the fiscal support from the economy at once, would reduce growth by 2½ per cent in 2010. That would risk stalling growth in our economy before a self-sustaining recovery in private activity has taken hold.

Just as all of the monetary policy stimulus won't be withdrawn overnight, nor should the fiscal stimulus be withdrawn sharply or prematurely either. Both are being withdrawn gradually as the economy recovers, working together during the recovery as they did during the downturn.

Looking Forward

Just as we were alert to developments as the global economy deteriorated, so too are we diligently monitoring this tentative recovery.

As I have said consistently and for some time, our fiscal settings are always subject to review, and we will always ensure they remain suited to changing economic circumstances as we come through this global recession.

We are constantly assessing the impact of our stimulus, to ensure it is providing support where the economy most needs it. And we will always be vigilant when it comes to any emerging capacity constraints or other impediments to the successful delivery of infrastructure projects.

While the stimulus is an important part of our fiscal strategy, it's only one part. It's the total fiscal picture that matters when it comes to the impact of government on domestic demand.

Since the end of last year, both the automatic stabilisers and discretionary stimulus spending have moved the budget position in a way that has contributed to economic growth. Our fiscal strategy ensures that as the economy recovers these effects will shift into reverse. That is, as revenues recover and stimulus is withdrawn – the budget position will improve and fiscal policy will subtract from economic growth.

We have made two clear commitments that ensure any improvement in economic conditions means an improvement in our budget position: first, we will offset all new spending; and second, we are banking any improvement in revenue naturally associated with a stronger

recovery. This ensures that the operation of the automatic stabilisers will be allowed to improve the budget position as the economy strengthens in concert with the withdrawal of fiscal stimulus.

I should caution here that it will take time for tax revenue to recover, even with an improved economic outlook. The structure of our tax system means that there can be considerable lags between strengthening activity and increases in revenue from company and capital gains taxes, in particular.

We are also committed to holding real spending growth to 2 per cent a year once the economy is growing above trend. This means our fiscal stance will also be tightening through both automatic and discretionary means.

And I think the response from international credit rating agencies and investors generally, demonstrates their confidence in the Government's ability to deliver on those fiscal commitments.

Conclusion

It is fair to say that the Australian economy has proven its resilience in the face of massive, synchronised recessions in almost all of the world's major economies. The economy is performing better than we had expected at the time of the Budget in May, with implications for the Mid Year Economic and Fiscal Outlook to be released later this year.

Nevertheless, significant challenges and risks remain. As I mentioned, we still expect the economy will operate below capacity for a while yet and for the unemployment rate to continue to rise. The full effects of the fall in Australia's terms of trade are also still being felt, and this will continue to weigh on domestic incomes. Private business investment and company profitability are still expected to decline. And the global economy and global financial markets remain in a more fragile state than they were prior to this crisis. A sustained global recovery is no sure thing.

It is possible the economy could continue to surprise on the upside. We judge that the clear and transparent fiscal strategy I have talked about today continues to be appropriate. But, as I have noted on many occasions, we are monitoring developments closely and we are quite prepared to adjust fiscal policy settings should circumstances warrant it.

We have laid out our plans for supporting the economy during the downturn, and for returning the Budget to surplus during the recovery. Our much-needed investments in nation-building infrastructure are helping to ensure the next generation of prosperity is built on sturdier foundations than the last, as will our efforts in critical areas like climate change, health, and tax.

It was not luck that saw Australia avoid recession. In Australia, as the Prime Minister has said, we make our own luck. We made our luck with a quarter century of economic reform. We made our luck by having vigilant regulators, by a swift central bank response to the liquidity problems which arose early in the crisis, and the boldness of its rate cuts from the second half of last year.

We made our own luck by the vigour and comprehensiveness with which the Australian Government responded to the dramatic magnification of the crisis following the collapse of Lehman, and we made our luck by the confidence and restraint with which our people kept their heads in what were quite frightening economic circumstances.

Australians are rightly proud of our country's performance during the toughest global conditions in three-quarters of a century. There is quite a story to tell, and they're right to be proud of it. But in many ways the story of what we do in the next year to set Australia up for the future is as important as the remarkable story of the year just passed.

As the story-tellers and analysts and commentators and translators of national economic life, your role has probably never been more important.

So I thank you again for having me here today and I look forward to the discussion.