



Australia and the Great Recession

Chris Barrett

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About the author

Chris Barrett was chief of staff to Treasurer Wayne Swan from 2007 to 2010. Prior to that, he was head of cabinet office in the Victorian Department of Premier and Cabinet and previously served as a senior adviser to Kim Beazley as leader of the Opposition. He started his career at the Boston Consulting Group in Melbourne. Chris has an economics degree and an MA from the University of Melbourne and a Masters in Public Policy from Princeton University. He conducted the research for this paper with the support of a fellowship from the Woodrow Wilson International Center for Scholars in Washington DC between January and April 2011. The original full version of this paper was published in April 2011 on the Center's website at:

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Introduction

Few people with an interest in economics will soon forget the extraordinary events of the global financial crisis (GFC) and what is often termed the “Great Recession” of 2008/09. These were events I experienced professionally as Chief of Staff to Treasurer Wayne Swan between late 2007 and 2010.

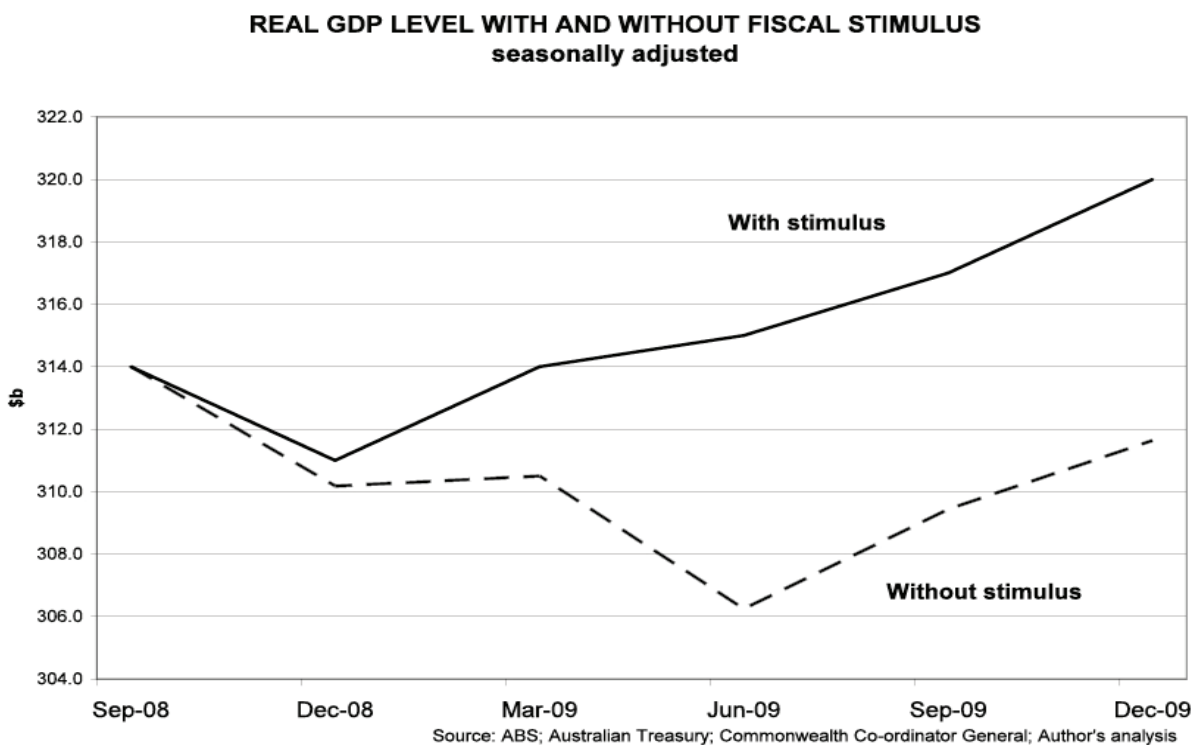
Australia, famously, was virtually alone among International Monetary Fund (IMF) advanced economies in not experiencing a recession during this period, and had the strongest growth of any of these economies in 2009.

This performance merits examination for what it can tell us about the contribution policy decisions made to this outperformance. I have looked at the most extensively debated of those policy interventions: the fiscal stimulus packages announced in October 2008 and February 2009. It is timely to look back on the latest data and analysis to draw some conclusions about the impact of fiscal stimulus during this period, and ask two questions: (1) did fiscal stimulus prevent an Australian recession?, and if so, (2) why did it do so in Australia when it didn't in other countries?

Would Australia have experienced a recession without fiscal stimulus?

To answer the first question, Chart 1 derives a “no fiscal stimulus” GDP path by subtracting the estimated impact of stimulus from the actual GDP path observed in the economy during the crisis period. The impact of stimulus has been calculated by allocated spending as closely as possible to when stimulus funds were actually spent (not budgeted or allocated) gleaned from the reports of the Commonwealth Coordinator-General, and applying fiscal multipliers consistent with the work of the IMF and OECD, and with the results of a micro study of Australia’s cash payments in 2009 and similar past studies in the US.

Chart 1



This chart shows the level of GDP and the estimated impact of stimulus. We can deduce the GDP growth impact from the slope of the different lines. They show a slightly deeper downturn in the December quarter 2008 (-1.2% versus actual -0.9%), basically no growth in the March 2009 quarter (0.1% versus actual 0.9%), and then a second and much larger fall in the June quarter of 2009 (-1.4% versus actual +0.4%). This tells us something very important. Ever since Australia’s growth surprised on the upside through the crisis, there has been a current of opinion that fiscal stimulus was not required after all, and that looser monetary policy, a lower exchange rate and China’s stimulus were sufficient for Australia to avoid recession. All of these factors are of course present in the “without stimulus” path of GDP above.



My analysis suggests Australia would have suffered two large negative quarters of growth without fiscal stimulus. In fact, the figure for the 2009 June quarter of a 1.4 per cent fall in GDP compares to the worst negative quarter of the early 1990s recession (-1.3% in March 1991).

As noted above, this analysis has been done using fiscal multipliers supported both by empirical evidence and international bodies such as the OECD and IMF.

But since fiscal multipliers themselves are a matter of academic dispute, I performed another version of the analysis looking at the amounts that were spent by government and the final path of GDP, and deriving from these variables the multipliers for which stimulus was (or was not) decisive in Australia's avoiding recession.

From September 2008 to December 2009 there was a cumulative \$7 billion (accounting for negative and positive growth) added to GDP, yet the stimulus entering the economy during this period was \$40 billion. We would have to believe the weighted multiplier for this spending was below 0.18 for fiscal stimulus not to have been decisive in maintaining positive growth over these five quarters.

This is implausibly low in the company of estimated Australian multipliers of 0.7 from the OECD and 1 from the IMF. This comparison doesn't surprise – the idea that four-fifths of a total stimulus of \$40 billion would not make its way through into economic activity stretches credulity in all but the most extreme circumstances, and in fact, the extreme global economic circumstances in this case suggest higher fiscal multipliers, not lower ones.

Further, the analysis here has asked whether fiscal stimulus made the difference between positive and negative growth. That is important for the technical debate about whether there would have been an Australian recession without fiscal stimulus, but of course the intent of policymakers should never be to get growth as close to zero as possible.

If fiscal stimulus was overdone, as many critics argue, it is incumbent on those critics to explain why growth of just 1.7% between September 2008 and December 2009 is too high and should have been lower. Such an explanation should also take account of the fact that unemployment rose by 1.1 percentage points over this period.



What explains Australia's success?

I now move on to the second question above, namely which factors explain the success of fiscal stimulus in Australia compared to other countries.

In my view, there are three elements that explain the better outcome for fiscal policy in Australia's case:

1. The first is a better policy response to the crisis itself.
2. The second is a better starting position.
3. The third is good fortune, independent of any Australian action.

Let me deal with elements (2) and (3) and move on to a longer examination of element (1).

In terms of a better starting position, as the crisis hit Australia had a number of advantages, chiefly:

- Good regulation that had avoided financial collapses in Australia;
- A flexible exchange rate that could help absorb a large external shock;
- A flexible labour market that allowed working hours to absorb much of what would otherwise have been job losses;
- A strong fiscal position that allowed a substantial fiscal response; and
- An independent central bank that rapidly cut interest rates and made other policy accommodations.

This is an impressive legacy of more than two decades of economic reform, but it's a legacy shared by two very similar economies – Canada and New Zealand. Yet Canada's economy shrank by 3.3% between December 2008 and June 2009, and New Zealand's by 3.8% between March 2008 and March 2009. Both countries' experiences strongly suggest that the quite unusual combination of structural economic advantages Australia enjoyed on the eve of the crisis were not decisive on their own for Australia's outperformance.

Secondly, there was the role of good luck, chiefly the Chinese announcement in November 2008 of \$US600 billion in fiscal stimulus (and large expansion of bank lending) which very substantially benefited the Australian economy.

This raises an intriguing question: could Australia have benefited by "free-riding" on the Chinese stimulus, and should we have done so, given the Chinese package was announced before our second stimulus package?

This was a question we did grapple with at the time, but which decision-makers ultimately rejected for two specific reasons. Firstly (and it is very easy to forget this from today's vantage point) there was widespread skepticism within government and more generally at just how much real stimulus there was in the Chinese announcement. Secondly, Australia faced some very specific weaknesses in domestic sectors (especially in construction) that would not be assisted by the Chinese stimulus, and would likely add significantly to unemployment.

The analysis of the impact of stimulus detailed in Chart 1 above provides a good sense of where "free-riding" on the Chinese response would have left Australian growth, namely in a recession, albeit a shallower one than would have been the case without China's stimulus. Regrettably, Chinese stimulus was not sufficient to fill the Australian output gap.



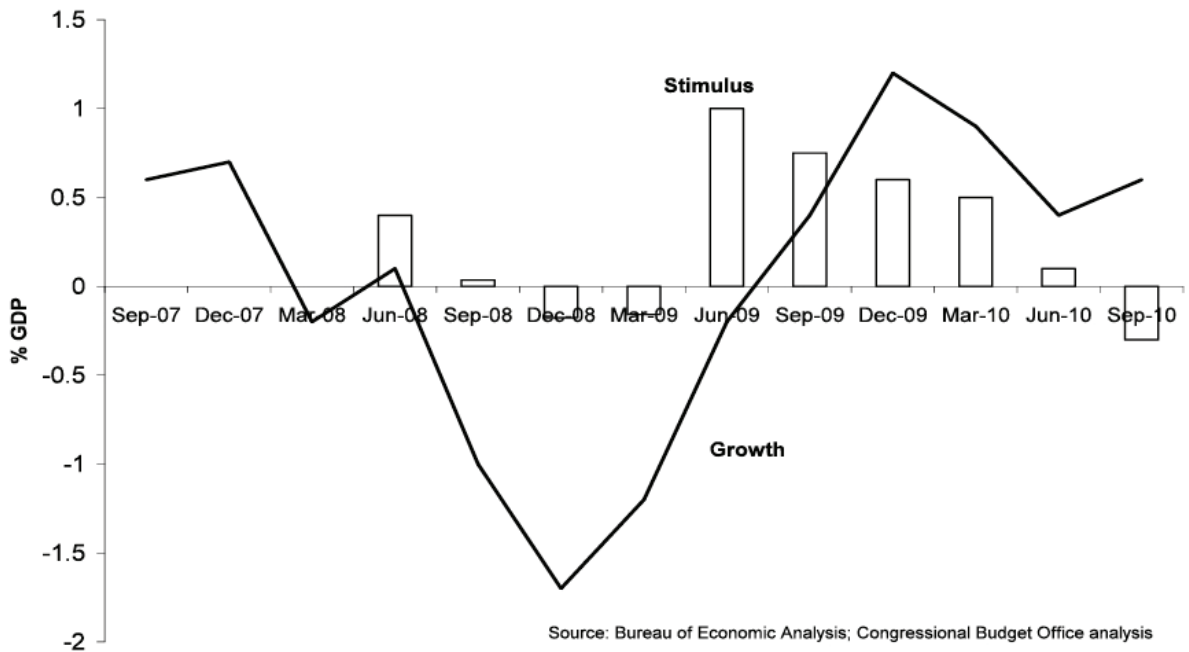
Finally, then, there is the question of what was distinctive about the Australian response.

A useful framework for thinking about this is through the standard (and still highly relevant) critique of Keynesian demand management, namely that it is plagued by lags in recognition, decision and implementation that make it ineffective at anything other than inflating the next boom.

Let me demonstrate the timing issue: I have charted below the growth figures for both the United States and Australia during the global financial crisis (the solid black lines), and then overlaid the estimated impact of stimulus (columns) from the Congressional Budget Office in the US case and from the Treasury Department in the Australian case.

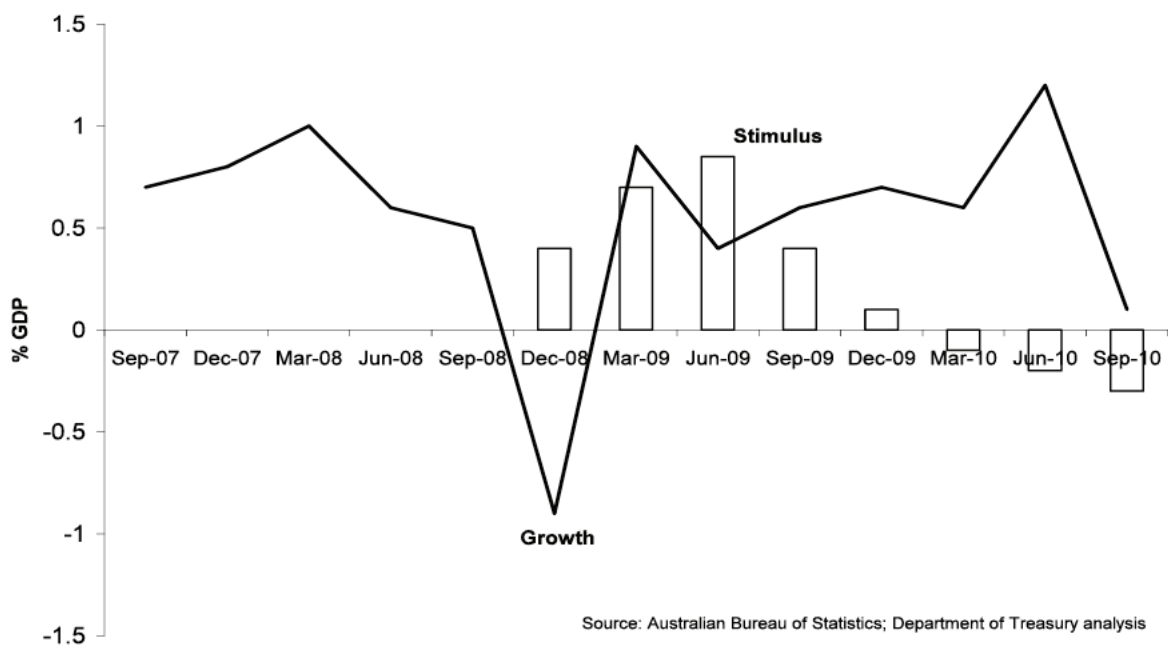
Charts 2 and 3

UNITED STATES GROWTH AND STIMULUS





AUSTRALIAN GROWTH AND STIMULUS



The very significant lag in fiscal action is immediately apparent in the US case. The National Bureau of Economic Research (NBER) – the body tasked with dating recessions in the US – now concludes the US recession began in December 2007. And yet the chart makes it clear that a sustained fiscal response sufficient to support economic growth did not take effect until the June quarter of 2009. All told, there was more than a year between the US economy’s entry into recession and the passage of a substantial and sustained fiscal stimulus.

In Australia, the economy never entered recession, but did experience a very sharp downturn in the December quarter of 2008. Initial stimulus (cash payments) was paid out in that same quarter (albeit only at the very end) and a further and more substantial one (the Nation-Building and Jobs Plan, or NBJP) was passed in February 2009. Fiscal stimulus for all intents and purposes arrived at the same time as the downturn, and stayed long enough to see it off.

There are many reasons for the speedier and more effective Australian response, and many of them have to do with Australia’s good luck (or America’s bad luck) depending on how one looks at it. Australia did not have the issue of national elections and a change of administration in the middle of our crisis response. Nor were our decision-makers overwhelmed by the difficulties of our financial sector – they had time to focus on the real economy effects.

But Australia’s response was not just faster than in the US. It was faster than any number of countries without the US’s problems. So what are some of the factors that explain Australia’s speedier and more effective response?

There were in my view five elements of Australia’s response that worked to reduce the lags inherent in fiscal stimulus, and which I discuss briefly in the remaining space.



1. Early Warning

To begin with, Australian policymakers recognised the coming recession more quickly, because they were intensely engaged with international economic developments long before the collapse of Lehman Brothers in September 2008. From my perspective, the Treasurer's trip to the United States for the IMF/World Bank spring meetings on the weekend of April 12 to 13, 2008 was decisive. It seemed everyone he had met in Washington and in New York was telling the same story, and I heard most of them from the Treasurer and colleagues calling home during the trip. They were all summed up by the comment that most lodged in the Treasurer's mind, when Tim Stewart, a former Australian Treasury official and senior manager with Fortress Investment Group told him that Bear Sterns was not the end of the crisis, it wasn't even the beginning of the end, it was just the beginning.

As a consequence, a number of planned budget cuts were shelved as the government took out some insurance against the crisis that, it turned out, was just five short months away.

If the April meetings were part of the early warning, the Treasurer's presence over the weekend of October 11 and 12, 2008 in Washington could not have been more important for the decisions Government was about to make on the crisis response. It was this schedule of IMF/World Bank fall meetings (and the emergency G20 Finance Ministers' meeting) from which the Treasurer called in to the Sunday morning deliberations of the Strategic Priorities and Budget Committee (SPBC) in Canberra on the fiscal stimulus and bank guarantee packages. It was an accident of timing and circumstance, but to have a senior Minister dial in from the epicentre of the crisis to such a decisive meeting was a remarkable example of real-time policy intelligence that served Australia very well during the crisis.

2. (a) Preparatory Work - Financial Sector

Once Ministers are convinced of the need to act, there is a separate and just as difficult question of what action to take. This is where some decisions the Treasurer took in the first half of 2008 were important in preventing the crisis more severely affecting Australian markets.

The first was the announcement on 20 May 2008 that the government would increase the amount of Commonwealth Government Securities (CGS) on issue.

He couldn't say so at the time, but a major factor in the Treasurer's consideration of this measure was potential future credit and bond market disruptions. Increasing CGS on issue was important to maintain liquidity and assist pricing in the bond and futures markets. He made less of an issue publicly of a much more important move the same day, which was to expand the investment powers of the Australian Office of Financial Management (AOFM). What he specifically had in mind was the potential need for government to be able to purchase Residential Mortgage Backed Securities (RMBS) should it become necessary to intervene to re-open that market (which by then had been shut since late 2007). This was subsequently realised when the Treasurer announced just such an intervention on 26 September 2008 – just 11 days after the Lehman's collapse.



Even more important was the Treasurer's decision, announced on 2 June 2008 but in the works for most of that year, to introduce a Financial Claims Scheme (FCS). The recommendation for such a scheme – to provide timely access to depositors' funds in the event of a financial institution's failure and also to strengthen regulators' powers to deal with a failed institution – had been around since 2003, but was controversial within the industry.

The Treasurer had a different take on this. He believed such a scheme was too important to leave in the bottom drawer, and instability in global markets made it prudent to act quickly. The legislation was introduced on October 15 2008 in the flurry of activity following the bank guarantees announcement, but this obscures a point that those outside government readily underestimate: had the Treasurer not given the go-ahead for this months earlier, the complex legal drafting would not have been completed and refined for introduction of legislation.

2. (b) Preparatory Work - Fiscal Policy

A further factor is that the bureaucracy was rapidly able to provide advice to government on precisely which fiscal policies to implement. This was assisted by some forward planning for potential crisis undertaken by the Treasury in 2004. The papers from this exercise have since been released to me and others under Freedom of Information. The most interesting one war-games a series of possible responses to a slowing economy. The fingerprints of this work show up in a few places in the government's eventual crisis response:

Firstly, the paper is eloquent about the need to move quickly as the economy begins to turn and to be mindful of the slow reaction time in past crises. This was hardly a lesson those in Treasury in the early 1990s had need of learning, and yet it was doubtless very useful for younger officials – which in this case would be anyone under about 45!

Secondly, there is a critical (and essentially counter-intuitive) insight about the different speeds at which monetary and fiscal policy can take effect:

Changes in monetary policy have an impact on economic growth that is spread roughly evenly over about two years after the change ... The impact of fiscal policy can be considerably quicker. Some fiscal policy actions can influence activity from the point of announcement, before they are implemented.

Thirdly, the paper on balance comes down in favour of one-off benefit payments to low income households, and government consumption and investment expenditure, as opposed to tax cuts.

It's easy to say much of this was stating the obvious, but that underestimates how contested this view is – witness the academics who still to this day dispute that fiscal policy can be successful. It also misunderstands how governments make decisions: given the controversial nature of the advice and the very compressed timeframe in which decisions were being made, it was vital that these policy responses had been thought through and debated at official level to make them as robust as possible in the time available.



3. Implementation Architecture

Once decisions were made, smooth and rapid implementation was vital. We were fortunate to have an established architecture for rapidly making payments to benefit recipients but no such system existed for infrastructure investments. A big part of the explanation for the speed with which infrastructure stimulus dollars were transferred to the states and territories and spent in a timely manner lies in the COAG meeting held just two days after the announcement of the Nation-Building and Jobs Plan specifically to agree an implementation architecture for the plan.

This initiative itself arose from the Prime Minister's concern that the stimulus (a) might be diluted in its impact by process delays at the state level; and (b) might be in part offset by state cutbacks at the same time as the federal government was increasing spending.

The Department of Prime Minister and Cabinet devised a management, reporting and monitoring structure to roll out the key stimulus initiatives, in particular, the school building and social housing programs. Coordinators-General were established for each state and territory, and each of the major stimulus programs. These in turn reported to a federal Coordinator-General. Timelines for delivery and even standard designs were explicitly stipulated, and progress regularly monitored. Crucially, "maintenance of effort" clauses were inserted into the agreement with the states to prevent them taking their own money out as the commonwealth money was being paid in.

All this architecture was wrapped up in a comprehensive agreement signed by all the state leaders and released publicly. In this way, the Prime Minister ensured state leaders had politically "bought in" to the timely rollout of stimulus.

4. Corporate Memory

A further two factors worked to shorten fiscal lags across the board. The first was a strong corporate memory of the last Australian recession among policymakers. Focusing specifically on Treasury, for example, the Department is well known in Canberra for being one that people serve for long periods of their career. The Executive Board, as the chief decision-making body of the Department has an average tenure in excess of 20 years. For the purposes of management during the economic crisis, it had one distinct advantage: most of the senior people advising the Treasurer had been in Treasury (and in one case, the Reserve Bank of Australia) at the time of the last recession – almost 20 years earlier. One executive director put it to me this way:

I was in Treasury during the last recession. Our forecasting group was following the economy down. We never had the right picture of the recession. We were always too late. It was a sobering experience for all involved.

This was no small matter. It meant that the new government had a view through the windscreen of the gathering global recession, not a view through the rearview mirror of what we had already hit.



Nor should we discount the memories of the early 1990s recession among the politicians themselves. The early 1990s recession was a searing experience for Labor politicians (and many of their staff). We all remembered not only how slow fiscal stimulus was to arrive in the early 1990s (after the recession had passed) but also the very patchy record of labour market programs introduced after the recession to try and reduce unemployment. They were by most experts' agreement expensive, slow to work, and left too many long term unemployed, some of whom never worked again. There was a deep attraction in getting ahead of the deteriorating economy to prevent unemployment from soaring in the first place.

5. Policy Responsiveness of New Administrations

Many of these individual elements may not have been as decisive were it not for a final, and I think critical, factor: we were a new administration.

A new government necessarily assembles facts and questions assumptions differently from an established one. I have no doubt it was much to the frustration of a number of our official advisers, but the Prime Minister and his Ministers were obsessive about getting briefing and analysis on a wide range of economic developments.

This went to the critical question of how long the recognition lag was before decision-makers realised something would need to be done. But it also had a powerful effect on the time it took to consider options and make a decision.

The consequence of so much concentrated senior attention to developments in the economic indicators was that views had aligned sufficiently by that October 2008 weekend for decisions to be made relatively quickly. It wasn't the case that decisions were made without thinking, or that large differences of opinion were glossed over. Rather, long and intensive engagement with the subject matter had brought opinions close enough together for agreement to be reached relatively quickly.



Conclusion

Australia has been called the “miracle” economy since well before this most recent crisis. While the performance has certainly been remarkable, the label is unhelpful. It suggests our strong economic performance is the product of chance alone; it excludes the important role good economic management has played in the last 20 years of Australian economic success. Former British Prime Minister Gordon Brown used to talk about banishing “boom and bust” economics in Britain. This was and remains the dearest goal of economic policymakers around the world. Brown’s emphasis was on monetary and fiscal rules to provide a stable policy framework. This wasn’t wrong, but it also wasn’t enough. Better regulation was an obvious blindspot, but so was a practical plan for intervening in times of crisis – how to judge your chances of success, and what to do if you decide to act.

The general pre-crisis consensus in macroeconomics was that discretionary fiscal policy was ineffective for managing economic growth. It was thought better to leave aggregate demand management to monetary policy, which acted more speedily and was more able to operate with greater symmetry through the economic cycle.

I think we learn something different from Australia’s most recent experience, and the conclusion for discretionary fiscal policy more broadly is one of bounded optimism. On the one hand, we should remember the unusual circumstances of success in this instance of fiscal policymaking. It is rare to have a country with such propitious starting circumstances as Australia; some advance warning of a serious downturn; and an ability to act quickly enough to make a difference.

But all of these propitious factors are themselves amenable to policy action. Countries can – and should – choose to build strong economic fundamentals such as sound financial regulation and a strong fiscal position. Countries can build the systems and linkages that give them better advance warning of looming crises. And countries can be prepared to act on the fiscal front when it is justified by the economic circumstances and when the odds of success are sufficiently high, accounting for the risks of intervention.

In particular, governments must have fiscal stimulus packages fully-formed in their top drawers. The Australian government had elements of such a package ready, but still much of it had to be purpose-built at the time. Immediate cash payments are a simple enough thing to design, but in a sustained downturn, cash payments have to pass the baton to investment projects. These take time to scope and plan, and time is the one thing policymakers never have when crises hit. There must be a conscious effort to have viable and beneficial projects ready beforehand. In the good times, they can be part of a queue of projects to be steadily worked through as fiscal circumstances allow. But they must be constantly replenished to be ready in case of crisis. Even if they are never built, they sit there as an insurance policy against recession and mass unemployment.

A blanket denial of the potential effectiveness of fiscal policy deprives policymakers of options at the precise times they are most in need of them. It is important that the story of Australia’s fiscal policy success during this crisis is understood for what it can tell us about the conditions under which such interventions can be successful in future – and when they can’t – and that policy advisers and policymakers continuously seek to learn the lessons to be ready for future crises.