Opening statement to the Senate Standing Committee on Economics

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Thank you for giving me the opportunity to make an opening statement.

Since we last appeared before the Committee in June this year, there have been dramatic developments in global financial markets and, largely as a result of those developments, a significant deterioration in the outlook for the world economy. Governments and central banks around the world have acted to counter the effects of these adverse financial market developments. The scope and speed of their actions is unprecedented in our lifetimes.

Here in Australia, the Government has acted to support economic growth directly through its Economic Security Strategy. The Reserve Bank of Australia has also reduced official interest rates by 1¼ percentage points in the past two months. Both the Government and the Reserve Bank have introduced measures to support liquidity and the smooth operation of debt markets and the banking system.

In this environment, I thought it would assist the Committee if I gave a summary of the most important of these financial market developments and outlined Treasury's view of how they will affect our economy. I will also provide you with some background on the processes that we follow in forming our view.

Let me begin by quickly going back to the last set of forecasts that we published. These were in the 2008-09 Budget brought down in May this year. At that time, we forecast GDP growth to be 2¾ per cent in 2008-09, a noticeable slowing from the estimated 3½ per cent growth in 2007-08. If realised, the 2008-09 forecast would be the lowest growth rate since 2000-01. When those forecasts were published, financial market disruption had already been evident for some time, particularly in the United States and Europe, and the world economy was expected to slow.

Since May, we have presented updated forecasts to the Treasurer on two occasions, the first following the release of the March quarter National Accounts in June and the second following the release of the June quarter National Accounts in September.

Let me focus in particular on the most recent update. As is standard practice, the forecasts were finalised following a meeting of the Joint Economic Forecasting Group, known by the inelegant acronym JEFG. JEFG is chaired by Treasury and has representatives from the Reserve Bank of Australia, the Department of the Prime Minister and Cabinet, the Department of Finance and Deregulation and the Australian Bureau of Statistics.

The JEFG report presents Treasury's forecasts, but these forecasts have been informed by discussions with the other agencies.

JEFG met on Friday 19 September, a little over two weeks after the release of the June quarter National Accounts on Wednesday 3 September. The JEFG report and the associated forecasts were sent to the Treasurer in late September. The forecasts covered the 2008-09 and 2009-10 financial years.

Between the Budget and early September, there had been a gradual accumulation of evidence suggesting both that problems in global financial markets were becoming more severe and that the likelihood of a serious economic slowdown in the advanced economies, particularly the United States, was increasing. As a result, our forecasts for economic growth in Australia were also being revised down. As the Prime Minister has told the House of Representatives, the growth forecasts in the September JEFG report had a '2' in front of them. As a point of comparison, in recent years we would have put Australia's potential growth rate at around 3 to 3½ per cent.

In addition to the forecasts themselves, the JEFG Report presented to the Treasurer contained a considerable discussion of the risks to the economic outlook stemming from both the financial market disruption that had already occurred and the possibility that more might occur.

There has been no formal update of Treasury forecasts since the September JEFG report, other than the update we are currently finalising to feed into the Mid-Year Economic and Fiscal Outlook, which will be released within the next few weeks.

I will have more to say about Treasury economic forecasts shortly. But first I want to take you through some of the crucial events that occurred in financial markets and the world economy through September and October.

On Friday 5 September, US payrolls data showed that the US unemployment rate jumped 0.4 percentage points to 6.1 per cent in August, a clear indication of significant further deterioration in the US real economy. On Sunday 7 September, the US Treasury and the Federal Housing Finance Agency took steps that effectively nationalised Fannie Mae and Freddie Mac.

Sunday 14 September marked the beginning of a rollercoaster week for the US. Lehman Brothers, the fourth-largest investment bank in the United States, filed for bankruptcy. While it was not entirely evident at the time, the collapse of Lehman led to a serious intensification of the severity of the financial crisis.

There had been an expectation that a deal would be put together to save Lehman. When that did not happen, there was a significant adverse impact on confidence. Financial markets scrambled to unwind counterparty risk and withdraw credit lines, moving instead to invest in the relative safety of government debt.

As you can see from the first of the two charts that I handed around, the result was a significant and sustained increase in financial market strains, as summarised here by the interest rate premium on 90 day bank bills. I should emphasise that the chart is for Australian data, showing how quickly these financial market shocks can be transmitted across the globe.

Chart 1: Australian inter-bank lending spreads (90-day bank bill to 3-month OIS)

Note: Data as at close 20 October 2008. OIS is overnight indexed swap.
Source: Reuters.

On Monday 15 September, Merrill Lynch entered into an agreement to be acquired by Bank of America. Goldman Sachs and Morgan Stanley successfully applied to the Federal Reserve to become commercial banks, widening their potential sources of funding.

At the beginning of 2008, there were five US investment banks. By the middle of September, there were none.

On Tuesday 16 September, data released showed US housing starts falling a further 6.2 per cent in August. The same day, one of the world's largest insurers, American International Group, effectively collapsed. AIG entered into agreements with the Federal Reserve and New York state authorities that would allow it to sell its assets in the most orderly manner possible.

On Wednesday 17 September, Primary Reserve became only the second mutual fund in US history to 'break the buck' — that is, to have its net asset value fall below US$1 per dollar invested — after it wrote off US$785 million on Lehman Brothers debt. BNY Institutional Cash Reserves also saw its net asset value fall below US$1 per dollar invested and Putnam Investments liquidated its Prime Money Market Fund. With net

asset values falling below US$1 per dollar invested for some of these usually very safe funds, investors began to redeem their money, triggering the distressed sale of securities and causing severe market dislocation.

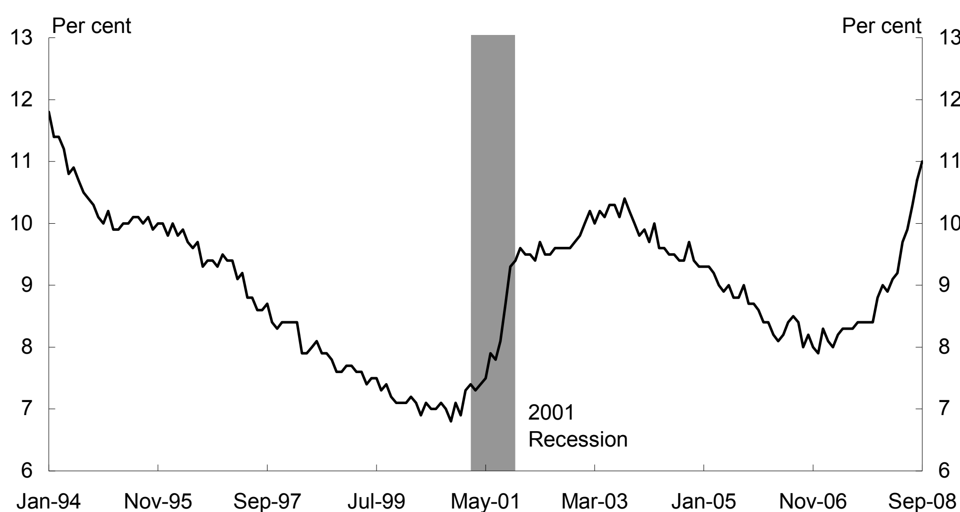
On Thursday 18 September, the Federal Reserve significantly expanded its swap operations with other central banks and, on Friday 19 September, the US Treasury submitted legislation for Congress to approve the US$700 billion Troubled Asset Relief Program. On Thursday 25 September, Washington Mutual collapsed in the biggest US bank failure in history.

On Monday 29 September, the focus shifted to Europe, with the collapse of three institutions: Fortis, a Belgian financial group; Bradford and Bingley, the UK's largest lender to landlords; and Glitnir Bank, Iceland's third largest lender. The German Government extended emergency support to Hypo Real Estate, Germany's second-largest commercial property lender. On Tuesday, the governments of Belgium, France and Luxembourg combined with existing shareholders to inject €6.4 billion of new capital into financial services group Dexia.

On Friday 3 October, the Emergency Stabilization Act of 2008 — a modified version of the Troubled Asset Relief Program — was eventually passed by Congress. The package provided US$700 billion for the Treasury to purchase assets, with US$250 billion available immediately.

Data released the same day showed US non-farm payroll employment falling by 159,000 in September, although the unemployment rate remained at 6.1 per cent. What was more troubling, however, were the recent outcomes for a broader measure of underemployment in the US. This broader measure includes both the unemployed and those who want to work longer hours but are unable to find such work. It is shown in the second chart that I have circulated to you.

Chart 2: US Underemployment



Source: US Bureau of Labor Statistics.

This broader measure of US underemployment is not one we would normally look at. It came to our attention because Paul Krugman posted it on his *New York Times* blog. As the chart shows, US underemployment in September 2008 was already higher than at any time during, or after, the 2001 recession, and was continuing to rise rapidly. And this was happening before the mid-September intensification of the financial crisis had had time to have any material impact on the US real economy.

It seemed that the US economy was weakening at a disturbing pace, and that the recent intensification of the financial crisis was only going to make matters worse.

Also on Friday 3 October, we participated in a phone hook-up with other G-20 countries. During that call, an official from the International Monetary Fund advised that, even at that late stage, the IMF was further reducing its forecasts for world economic growth in 2009 to be published on Wednesday of the following week. The IMF forecasts had already been reduced a couple of times from their initial estimates. In total, from July to October, the IMF reduced its forecast for advanced economy growth in 2009 from 1.4 per cent to 0.5 per cent, with much of this downward revision occurring in the weeks before the forecasts were finalised.

On Monday 13 October, European nations agreed to a package of measures to support the financial system, including the guarantee of interbank loans and the purchase of equity in banks. Later that week, the United States announced a plan to stand by all key financial institutions by purchasing equity from financial institutions and guaranteeing all senior unsecured debt issued by eligible financial institutions, as well as guaranteeing non-interest bearing transaction deposit accounts. Measures similar in nature to these had also been announced by a number of other countries.

Throughout these events, financial markets were extremely volatile, with swings in share market indices and exchange rates of 5 per cent or more on a number of days. In Australia, from mid-September to mid-October, the ASX200 fell from above 5,000 points to around 4,000 points, and the Australian dollar fell from above 80 to below 70 US cents.

Let me, at this point, return to the issue of forecasts.

In principle, it is possible to put together a set of economic forecasts in half an hour and I imagine there are people who do just that. All you need do is jot down a couple of growth numbers and come up with a plausible story to justify them. But forecasts like these add little to our understanding of the world.

A coherent and useful set of forecasts requires a more careful specification of the assumptions you are using — for interest rates, for exchange rates, for share prices, for commodity prices, etc — and a clear analysis of the mechanisms by which you think these factors might affect the economy. The narrative around the forecasts comes out of this analysis. You also need to be clear about what you don't know, and about the nature of the major risks to the outlook.

In Treasury's case, preparing a set of economic forecasts in this way from a standing start would take us about a week; longer if we consulted extensively with our colleagues in other economic departments and agencies.

In the current situation — that is, if we were to have updated our forecasts in late September or early October — we would not have been working from a standing start. We already had a prepared set of forecasts in mid-September. We could have locked ourselves in a room with our September forecasts and the new information that had accumulated since they were finalised and spent two or three days coming up with a coherent set of new forecasts.

Had we done so, however, it is clear that international events were moving so rapidly that, when we emerged from that hypothetical room after a couple of days, we would have wanted to rip the forecasts up and start again.

We did not think that this was a particularly useful exercise. You can, I suspect, appreciate the difficulties of putting together a coherent set of forecasts in a period of such extraordinary volatility.

What we did think would be useful was to carefully track developments in financial markets and the world economy and to analyse their implications for Australia. We were constantly updating the Treasurer and his staff, and through them the

Government, on events as they unfolded and their likely implications for the Australian economy.

In such circumstances, the central forecast of what might happen to the economy is probably less valuable than a careful assessment of the balance of risks. And, for the most part, the accumulating evidence was suggesting that the balance of risks around our September forecasts for Australian economic growth were shifting decisively to the downside.

In situations like this, macroeconomic policy must be ready to respond quickly and substantively to developments as they occur.

On this point, let me quote from the minutes of the October monetary policy meeting of the Reserve Bank Board that were published by the Reserve Bank yesterday: 'The paper prepared for the Board recommended a large reduction in the cash rate, of at least 50 basis points, with the amount to be subject to review in light of any events occurring between the preparation of the paper and the time of the meeting. In the event, the recommendation put to the Board at the meeting was for a reduction of 100 basis points, to 6.0 per cent.'

This is an example of the speed with which the risks around the outlook were changing. As the Governor said in his statement following the meeting, '… the Board judged that a material change to the balance of risks surrounding the outlook had occurred, requiring a significantly less restrictive stance of monetary policy'.

The same 'material change to the balance of risks surrounding the outlook' was also central to the decision about whether or not to introduce a short-term fiscal stimulus package. When confronted with such a decision, the right question to ask is: what is the policy of 'least regret'?

And when deciding on the policy of 'least regret', it is important to remember the extremely unusual circumstances that have confronted the Australian economy over recent weeks. It is rare to get such a strong signal over such a short time period — I am referring to the three weeks following the collapse of Lehman Brothers — that the outlook for the world economy has deteriorated so significantly. The shock is unusual in terms of both its size and the speed of its transmission through the world economy. Furthermore, even before the recent intensification of the global financial crisis became evident, the Australian economy was growing at a below-trend pace and was expected to slow further.

In these circumstances, the Government decided that the 'least regret' policy was to introduce a significant short-term fiscal stimulus package to support economic activity at the end of 2008 and into early 2009. The stimulus is specifically targeted at household consumption and dwelling investment, areas of spending that recent data confirm as being particularly weak.

It is rare for macroeconomic policy to be called upon to move so quickly. When that happens, it is because big and potentially destructive forces are at play in the economy.

I am sure that Committee members will have many questions for us and we are happy to take them now.