NEGOTIATING THE DOWNTURN: EMERGING STRONGER

AUSTRALIAN INDUSTRY GROUP

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Thank you for the opportunity to participate in this National Forum.

I have been asked to speak on negotiating the economic downturn and emerging stronger.

Fiscal stimulus: short-term support for the economy

The failure of Lehman Brothers in September 2008 sent shockwaves of uncertainty through financial markets around the world.[1] There was initial uncertainty surrounding which financial firms were safe to lend to, even solvent. The consequence was an almost complete shut down of world debt markets.

Given Australian banks' reliance on wholesale borrowing from offshore, we were not going to be well insulated from these sorts of shockwaves — notwithstanding that aggregate demand growth was still robust, if slowing, and the soundness of bank balance sheets in this country as the first of those shockwaves hit our shores.

The shockwaves had an immediate impact on Australian households as well, with concerns being raised about the security of retail deposits during the latter part of September and in the early days of October.

The Government judged that exceptional measures were required.

The time-limited guarantee of deposits and the price-limited guarantee of wholesale funding have promoted financial system stability; they have reassured Australian depositors and assisted Australian deposit-taking institutions to continue to access funding in domestic and international credit markets.

Back in October last year it was clear also that the financial crisis would have a significant impact on macroeconomic performance — on demand, growth, employment and inflation.

A rapid and large macroeconomic policy response was judged also to be required.

The monetary policy response was indeed rapid and large, with the target cash rate being reduced by 3¾ percentage points over four consecutive meetings from early October 2008 to early February this year. In contrast with the experience of some other countries, the monetary policy transmission mechanism remained highly effective here, with the majority of the cut in the cash rate passed onto households and businesses.

Economic slow downs — especially recessions — are costly: capital lies idle; unemployment increases; there is a loss of skills in the workforce; and living standards fall.

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[1] For a detailed explanation of the events leading up to the economic downturn, see Dr David Gruen's *Opening Statement to the Senate Standing Committee on Economics* on 22 October 2008. The statement is available at http://www.treasury.gov.au/documents/1445/HTML/docshell.asp?URL=Opening_Statement.htm

Economic recessions can also have significant negative impacts on self-esteem and health, and increase the risk of poverty. The costs of recessions are exacerbated if the economy remains below potential for a significant period of time.

Back in October, the Government judged that the size and nature of the global financial crisis were such that it would not be appropriate to leave the policy response to monetary policy alone. A timely fiscal response was also needed to provide support to aggregate demand.

The response was rapid. Lehman Brothers failed on 15 September 2008. The Reserve Bank Board announced a cut in the target cash rate by 100 basis points on 7 October. On 12 October, the Government announced the bank guarantees. Two days later, on 14 October, the Economic Security Strategy — the first phase of stimulus funding — was announced, with delivery scheduled for December.

The impact of the first phase of fiscal stimulus

The first phase of the fiscal stimulus package comprised cash transfers, predominately to low-income households. These types of payments can be targeted and made quickly. Low-income households are usually more adversely affected by weak economic growth and they are also more likely to consume, rather than save, a supplementary transfer payment. Cash transfers to low-income households are therefore likely to support aggregate demand in the short-term.

While assessments of the impact of the stimulus necessarily depend on estimates of the counterfactual, it is reasonable to conclude now that the cash payments did indeed support the economy (Chart 1). Retail trade turnover was showing significant weakness prior to the first stimulus payments, having grown by only 1.8 per cent over the seven months to November last year. Retail sales recorded growth of 5.2 per cent from November 2008 to the end of June 2009. In contrast, the international experience shown here for several advanced economies has been a continuing decline in retail sales. The comparison is particularly stark at the beginning of the crisis. Between November and December 2008, retail sales fell significantly in many countries, while they rose strongly in Australia.

Additional phases of fiscal stimulus

The second phase of the Government's fiscal stimulus, announced in late November through the Council of Australian Governments' reforms, and in mid-December through the Nation Building package, focused on infrastructure projects that could be implemented relatively quickly. The third phase of the Government's fiscal stimulus, announced at the beginning of February 2009, focused on major economic infrastructure projects. These second and third phases have been designed to provide medium-term macroeconomic support, with the infrastructure projects announced in the Budget designed to enhance supply capacity as the economy recovers.

The support to real GDP from the stimulus translates into support for employment; that is, lower unemployment than would otherwise have been the case (Chart 2). This chart shows the estimated impact of the stimulus measures on Australia's employment rate over the next two years. While the percentage of working-age (aged fifteen plus) Australians in employment is forecast to fall, the effect of the stimulus is to reduce the extent of this fall, as shown by the upper line. The maximum gap between the two lines represents around 210,000 jobs. Another way of putting this is that the stimulus measures are forecast to reduce the estimated peak unemployment rate by about 1½ percentage points to 8½ per cent.

Emerging stronger: policies that deliver future growth by allowing structural change

The fiscal stimulus is a response to a short-term deficiency in private spending. As important as short-term demand management is at this time, especially in supporting employment, it is not what will drive growth over the medium to long-term.

Over time, private demand will return, the need for fiscal stimulus will abate and the key drivers of economic growth will again be related to population, participation and productivity.

For that reason, it is important that we continue to support policies that embrace openness, flexibility and competition; policies that allow structural change to occur and facilitate the efficient allocation of resources.

Economic downturns often catalyse necessary structural change. These structural changes can be difficult for those affected. Short term fiscal stimulus helps. But its palliative effect is necessarily temporary.

This is why the stimulus measures and guarantees of banking system liabilities have exit strategies.

The Government has a deficit exit strategy to return the budget to surplus by containing growth in real federal government spending once economic growth is above trend and allowing tax receipts to recover naturally as the economy improves. The bank guarantee fees were set at a level designed to provide the basis for a natural price-induced exit, with the expectation that at some point investors will no longer be willing to accept the lower yields on guaranteed paper and banks will therefore no longer seek to insure their debt. Recent non-guaranteed bond issues by the major banks provide promising signs of some normalcy returning to markets.

In discussing structural change and the efficient allocation of resources, I should make mention of the role of tax reform in enhancing Australia's future growth prospects.

As you would be aware, Heather Ridout and I are members of the panel undertaking a review of Australia's tax and transfer system. Reforms to that system will have implications for the way in which Australia emerges from the downturn and, more obviously, for long-term participation and productivity growth.

Two matters among many that the review is considering are how Australia's tax system can be reformed to improve incentives to invest in Australia and to ensure that capital is invested in the most productive way.

Our present tax system produces very different effective tax rates for different types of investments financed in different ways (Chart 3). Consider the following bar chart. The green bars on the right represent the effective company tax rate in Australia on a variety of assets financed through equity where the return on the investment just breaks even with the cost of capital. The purple bars on the left do the same for debt financed investments.

The very different effective tax rates for different assets arise partly because of inherent difficulties in measuring and recognising gains and losses for tax purposes. But differences also arise from deliberate policy choices. Effective tax rates as different as these raise the real prospect of a sub-optimal allocation of resources.

But the chart brings out another issue. As you can see, the effective tax rates for debt financed investments are also much lower than for equity. This reflects the full deduction allowed for nominal interest expenses. Importantly, foreign sourced debt remains tax favoured relative to foreign sourced equity.

One consequence of the overall bias in favour of debt is that it encourages some firms to increase leverage, an outcome that may increase their risk exposure.

And, of course, at an economy-wide level, this bias might be reflected in a relatively high share of debt finance in the capital account of the balance of payments.

It might, therefore, be tempting to conclude that taxation arrangements that favour debt over equity expose the capital account — that is, the financing of the current account excess of domestic investment over domestic saving — to higher risk. But this is far from clear. For an individual firm, debt financing can exacerbate vulnerability in the profit and loss statement when revenue falls, since — unlike dividend payments — the debt servicing costs are essentially unavoidable, short of default. The same is true for the country as a whole, of course. The increased vulnerability of firms would be expected to increase the impact of financial shocks and other sources of macroeconomic instability. But what matters for the stability of the financing of the current account is the reliability of future flows of foreign debt and equity capital combined. And, as the bursting of the 'dot.com' bubble in the United States in 2000-01 illustrated, there should be no assumption that cross-border portfolio equity flows are any less fickle than debt flows.

In my closing remarks I will have more to say about the financing of the current account.

The economic reform task goes beyond tax reform, of course, to include numerous reforms being pursued through the Council of Australian Governments, and many others.

As in the past, most such reforms will be about getting relative price signals right; especially to correct for externalities, both positive and negative. And to get the benefit of these reforms, we will need to allow the economy to reallocate resources — labour and capital — consistent with those better relative prices.

The task is to ensure not only that the Australian economy is delivering strong growth in living standards in the present global environment, but also that it is as well placed as it can be to meet the challenges of the future. There are some challenges we can prepare for, like the ageing of the population and climate change, but there will be others that are presently unforseen. And we cannot predict exactly which firms or industries will be the drivers of future growth.

On other occasions in meeting with this group I have spoken about the re-emergence of China and India and the implications for the structure of the Australian economy of what will very probably turn out to be a structurally higher level of our terms of trade.

China and India are only in the early stages of catching up with the living standards of the developed world (Chart 4), and this process could have a very long way to run. That catch-up presents substantial opportunities for our economy.

To get a sense of China's importance to Australia, consider the proportion of Australian export income attributable to China (Chart 5). This rose to almost 15 per cent in 2008 from less than 5 per cent a decade ago. While China's growth and demand for resources have been impacted by the global downturn, it nevertheless seems likely that the Chinese economy will continue to play a key role in shaping Australia's economic prospects for some time to come.

Though our terms of trade have been negatively affected by the global downturn (Chart 6), they remain well above their longer-run average. Indeed, based on the Budget forecasts, in 2012-13 the terms of trade are expected to be around 35 per cent above their 50-year average prior to the recent terms of trade boom. This represents a profound break with the pattern of earlier decades. And it is a shift that will continue to be reflected in structural change in the Australian economy in the next expansion phase.

Earlier, I referred to the balance between debt and equity flows in the financing of the current account. In my closing remarks I want to say something about a related matter that is getting some attention in analytical circles at the moment. This is the question of whether, in the post-crisis expansion, industrialised countries will enjoy the same level of access to capital that they enjoyed in the earlier part of this decade. The general consensus is that they will not. That consensus implies that, as a whole, industrialised countries will find it more expensive to finance current account deficits; that is to say, their businesses will face a higher cost of capital, implying a lower level of investment and growth. According to this emerging consensus, the next growth phase might not be as favourable for the industrialised world.

Supposing this consensus is right, what might be its implications for Australia? The first point to note is that it is quite probable that future capital flows will, indeed, be 'better balanced' as between the developed and developing world; the 15 year trend of capital from the developing world financing an ever-widening United States current account deficit certainly lacked balance. Secondly, that better balance may well be reflected in slower growth for the advanced economies taken as a whole. Third, the better balance may also be reflected in somewhat faster growth for the developing world. Fourth, the durability of that faster growth in the developing world might turn out to be dependent upon further progress in several economies on governance standards and regulatory reforms, and on their ability to realign their economic structures in favour of domestic sources of growth with less reliance on exports. And fifth, it is not at all clear that, in this rebalancing of global capital flows, the impact on the Australian economy will be characteristic of the advanced economies; that is, it seems quite likely — to me at least — that the Australian economy might attract an even greater share of global capital flows, and quite possibly even larger capital flows in aggregate.

This fifth observation might surprise you. My thinking is simply that, in a world that pays more attention to fundamentals than herd-driven investor psychology, the Australian economy will be seen as possessing the best of the qualities — of governance and flexibility — of the developed world while also offering an abundance of real investment opportunities usually found only in the developing world. That is to say, the Australian economy may be seen as offering the best of both worlds.

It follows from what I have just said that I do not think it likely that, relative to earlier growth periods, the future expansion of the Australian economy will be constrained by a reduced capacity to attract foreign capital.

Nevertheless, like the Asian Financial Crisis a decade earlier, the Global Financial Crisis is a timely reminder of a lesson learned the hard way in Australia in the 1980s — that no country, developed or developing, can take for granted a stable inflow of cheap foreign capital.

Our response to the turbulence on capital markets that we experienced in the 1980s was to embark on an essentially continuous program of microeconomic reform, supported by the development of robust, credible medium-term frameworks for both monetary and fiscal policies. That response served us well as we weathered the fallout of the Asian Financial Crisis, and it has meant that we have been well-placed to deal with the considerably larger challenges of the past year or so. But, as many people have noted, the task of economic reform is ongoing; and it must continue.