Australia's response to the global financial crisis

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Author(s): Infrastructure, Competition and Consumer Division
Presenter: Dr Steven Kennedy
Position: General Manager
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Introduction

It is a pleasure to be here today to discuss the Australian Government's response to the global financial crisis and an honour to follow Professor Stanley Fischer's (Governor of the Bank of Israel) presentation.

The Australian economy has been hit hard by the global recession. However, while experiencing difficult times, the Australian economy is doing better than almost all other advanced economies.

Let me provide one illustration of this relative success.

measures, such as unemployment and the stability of the financial system, Australia is doing better than most other advanced economies.

I think there are three reasons for this: first, the Australian Government's and Reserve Bank of Australia's timely policy responses to the effects of the global financial crisis and global recession; second, that the Australian economy trades substantially with Asia and in particular, China, and the economy is continuing to benefit from Chinese growth in the midst of this highly synchronised global slowdown; third, the Australian banking system has remained in good shape throughout the crisis reflecting sound regulation.

The first reason – the Government's policy responses – is the focus of my talk today.

The structure of the Australian economy

Before I discuss the Australian Government's policy response to the crisis and in particular, the thinking behind some of the specific policy responses, I would like to briefly sketch out the structure of the Australian economy and describe how it was travelling before the global recession hit.

Australia's annual GDP is worth about $1 trillion US at current market exchange rates (somewhat less at PPP exchange rates), and Australia's economy is the 14th largest in the world based on market exchange rates (the 18th largest based on PPP GDP).

There are around 11.4 million people in the labour force and similar to other advanced economies, the predominant activity is services. In fact, more than 65 per cent of the Australian economy is engaged in the delivery of services.

This can surprise Australians and others. People often think of Australia as a predominantly mining and agricultural economy. And while it is true that combined, mining and agriculture make up a relatively large portion of the economy compared with other advanced economies (10 per cent), they are still dwarfed by the service sectors. For example, around 11 per cent of the workforce or 1.2 million people are employed in the retail sector alone, making the retail sector the single largest employer in the Australian economy.

adjust to a rapid increase in demand for its mineral resources from 2003 to 2008, which drove commodity prices to record highs.

While income growth in Australia was strong before the global financial crisis hit because of the surge in commodity prices and associated mining boom, it was also clear in this period that Australia was running up against capacity constraints.

The labour market was tight, despite the strong growth in immigration, with the unemployment rate hitting a 33-year low of 3.9 per cent in February 2008.

Perhaps the clearest signs that the economy had run up against capacity constraints were the steady deterioration in Australia's productivity performance and the rise in inflationary pressures.

It was against this domestic economic context that the new Australian Labor Government delivered its first Budget in May 2008. However, even in early 2008, the global financial crisis was already on the scene, with possible serious flow-on implications for global growth.

Hence, the Government framed a Budget that sought to balance domestic inflation concerns and the need to expand the economy's productivity capacity, with the need to guard against the possibility that there might be a rapid deterioration in global growth. Though I should say that while some of us were aware there was the possibility of a significant deterioration in global conditions, there were few people that anticipated the full ramifications of the global crisis that would ensue.

The Global Financial Crisis and Australia

As for much of the world, the key turning point for the Australian economy was the change that swept through the global economy in mid-September 2008, with the collapse of Lehman Brothers. Of course, it does not all start and end with the collapse of Lehman Brothers, as there were many signs of financial stress before and many factors that contributed to the crisis [see Gruen 2009 for an analysis of the various factors surrounding the global financial crisis].

hand from trips to the US and Europe through 2008, as well as signs of increased difficulties within the Australian economy. In a period when events are moving rapidly, leaders often hear about developments before they have filtered through their bureaucracies.

Following Lehman Brothers' filing for bankruptcy in the week beginning Sunday the 14th of September, the global financial crisis intensified markedly. The provision of credit dried up around the world and business confidence plunged.

While most expected that the financial crisis would have large real economy effects, I don't think many realised how quickly the financial crisis would affect the real economy. We now know that many businesses responded very quickly to the financial crisis by slashing production and running down inventories. In Australia, in the December quarter 2008, businesses ran down their stocks by $3.4 billion (in real terms), the largest fall on record.

Consumer confidence plummeted along with consumption. Throughout the month of September and into October, the financial crisis spread from the US to Europe, and all around the world economies began to contract.

Australia's first policy responses to the global financial crisis

In Australia, the first significant macroeconomic policy response to the global financial crisis came from the Reserve Bank of Australia (RBA).

On October 7, the RBA Board cut interest rates by 100 basis points.

The minutes of this RBA Board meeting noted:

> 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.

policy.

The Treasurer left for the US on the 8th of October to attend the IMF and World Bank Annual meetings. While events were moving rapidly it was thought important that the Treasurer obtain first-hand experience of the crisis in the US while remaining in daily contact with the Prime Minister and his colleagues back in Australia.

As the weekend of the 11th and 12th of October approached, it became clear that the Government needed to act proactively to cushion the Australian economy from the emerging global crisis.

On Sunday the 12th of October, the Australian Government announced it would guarantee all Australian bank deposits and, for a fee, the wholesale funding of Australia's banks.

This was the first time such actions had been taken in Australia's history.

While the Australian banking system was in good shape — as at mid-October 2008, Australia's four largest banking groups were among only 10 that were rated AA or higher by Standard & Poor's — the Government acted to ensure the stability of the Australian financial system and secure flows of credit to the economy. Because other governments had guaranteed the borrowings of their banks, Australian banks were being put at a competitive disadvantage despite being in better shape than were their international competitors. There were also emerging signs of fragility among Australia's second-tier or smaller banks.

These financial stability measures effectively involved the Government taking on risk to ease consumer and business concerns about the financial sector and more broadly economic conditions. In this highly volatile and risk-averse environment where there was the potential for disorderly and irrational behaviour, it was essential that governments calmed the situation by temporarily taking on private sector risk.

The second aspect of the Government's policy response was fiscal action and it is on this aspect of policy that I will focus the rest of my talk.

The Government and its advisers had been discussing possible fiscal policy responses for some time before the package was announced, and considerable thought had gone into its structure.

The fiscal package was directed at the economy's weak sectors, which at that time were consumption and housing. With housing and consumption representing over 60 per cent of the economy, it was thought important that these weak sectors were supported.

The package also followed the key tenets of good-quality discretionary fiscal policy in that it was timely, targeted and temporary.

The housing aspect of the stimulus package – a time-limited grant to first home buyers – took effect immediately. This was not the first time that grants to first home buyers had been used to stimulate the economy. A similar policy had been effective in bringing forward housing construction activity when the economy had slowed in the early 2000s.

Further, the Government was aware of significant pent-up demand for owner-occupied housing after a period of relatively high interest rates and strong migration. Hence, it knew that if this policy was withdrawn at the right time and in an appropriate way, it could bring forward activity without leading to a substantial collapse in activity when the policy was withdrawn.

The consumption aspects of the stimulus package were also designed to be quick acting, with significant cash bonuses paid to pensioners, carers and seniors, and low-income households within weeks of the announcement.

These are household groups that tend to have relatively high propensities to consume out of income. That is, they tend to spend more out of any additional income they receive than do other groups, thus maximising the economy-wide stimulus effects of the package.

This consumption component of the package had the added advantage of providing much-needed cash assistance to the less well off in the community.

lasting than expected, the Government started planning to bring forward the commencement of large-scale infrastructure projects. A first tranche of these projects worth $4.7 billion was announced in early December.

There were other important developments in late 2008 worth noting.

Through November and December, interest rates were cut aggressively and the global response to the crisis intensified.

Prime Minister Kevin Rudd attended the first G-20 Leaders summit on the 15th of November and spoke of the potential for the financial crisis to affect the real economy and most importantly, unemployment.

Not long after the October stimulus package, the Australian Government had begun planning for the possibility that the unemployment rate might rise dramatically should the economy slow.

In the recessions of the early 1980s and 1990s, the unemployment rate rose quickly. After peaking at over 10 per cent, the unemployment rate took around 10 years to fall below 6 per cent after the 1990s recession and around 6 years after the 1980s recession [see Kennedy 2007 for a discussion of unemployment in Australia].

Given that the likelihood of recession was increasing, the Government wanted to be ready to respond with policies to support the work force that went beyond support for aggregate demand.

In late 2008, another important factor was working in Australia's favour and that was a depreciating Australian dollar.

The floating of the Australian dollar in 1983 has turned out to be one of the most important economic reforms in Australia's history. It has worked as an effective automatic stabiliser, curtailing demand in the good times and supporting in bad.

The global recession becomes worse than previously thought

Through December 2008 and January 2009, it became clear that global conditions were much worse than initially envisaged. By late January, it was also becoming clear that the global economy had experienced a very weak December quarter.

Something that wasn't clear in January was just how synchronised the global downturn would be. Around 75 per cent of countries are now expected to contract in 2009 – a remarkable outcome and one that has not been seen for over 50 years.

As has been noted by the IMF, financial crises and global recessions with high degrees of synchronisation are associated with long and deep recessions and weak recoveries.

Australia's second stimulus package

By mid-January, it was clear to the Government that further discretionary fiscal policy would be required to support the Australian economy. In late January, the Strategic Policy Budget Committee ministers finalised a package that work had effectively begun on not long after the delivery of the first package.

On February the 3rd, the Australian Government announced a $42 billion stimulus package titled the Nation Building and Jobs Plan.

In constructing this second
stimulus package, it was clear that further support for consumption would be required. Despite the considerable planning that had gone into constructing a fast-acting infrastructure program, further consumption measures would still support the economy more quickly than even a fast-acting infrastructure package.

packages have been vigorously debated in Australia.

There is now strong evidence that these aspects of the stimulus package provided substantial support to the economy. In the month of April 2009, Australian retail trade turnover was 4.8 per cent above its pre-stimulus level. In contrast, in Japan, the US, Canada and Germany where stimulus packages were not targeted at consumption in this period, retail trade was 2 to 3 per cent lower over the same period.

And off the back of GDP growth in the March quarter, consumer confidence has rebounded after hitting long-term lows, to be now 22 per cent above its October level.

However, perhaps the strongest evidence of the positive effects of consumption-based stimulus measures is the empirical analysis that has been undertaken in the US.

Often when people see consumption fall or saving rise in a period in which the Government has provided additional income through tax rebates or welfare bonus payments, they are inclined to conclude the stimulus was ineffective. Of course, to conclude that the policy was ineffective we need to know what the world would have been without the policy, something we don't know when just examining aggregate (consumption) data.

Analysis that explores a world without stimulus versus one with stimulus, has been undertaken in the United States by Broda and Parker (2008) and Johnson, Parker and Souleles (2006). They use individual-level household data to show that tax rebates or bonus payments are effective in stimulating consumption, especially among low-income groups.

The US Congressional Budget Office (2009) has lent its support to this style of careful empirical analysis, regarding it as the most valuable in gauging the effectiveness of consumption measures.

While the consumption aspects of the second major stimulus package were important, because the global recession was expected to be deep and long, infrastructure spending played the central role.

In fact, 70 per cent of the Government's second stimulus package was comprised of infrastructure spending; but the key reason, as I noted earlier, for also including support for consumption was the speed with which it would provide support to the economy.

The infrastructure component of the stimulus package

Australian governments have attempted to use infrastructure spending to support the economy in the past. Unfortunately, the experience has not been wholly successful, with much of the infrastructure spending and activity not getting started until the economy was already recovering.

The Government and its advisers had absorbed this lesson and set about designing an infrastructure component of the stimulus package focused on quick-starting mid-scale infrastructure.

The package had the following elements: $14.7 billion to be spent on school infrastructure, $6.6 billion on social and defence housing, $3.9 billion on energy efficiency measures (most of which will go to insulating the ceilings of existing homes), and $890 million on road, rail and small-scale community infrastructure projects. There was also an additional $2.7 billion for private business investment through a business investment tax break.

The largest component of the infrastructure package, the school-based infrastructure spending, has a number of elements that both enable speedy construction and maximise the impact of the stimulus across Australia.

These include the immediate availability of (school) land upon which to construct new buildings, hence no planning delays. The school buildings that are being constructed by States have standard design features. That is, schools choose from standard designs rather than developing their own designs, to speed up construction.

Finally, in addition to the support to local labour markets across the country, school infrastructure projects have a low import content, thus the domestic impact of this stimulus is maximised.

Once the package has been fully implemented, over 9,500 schools in Australia will either have a new multi-purpose centre, library or assembly hall or they will have substantially refurbished existing facilities. Therefore, while the school-based infrastructure was designed with stimulus benefits in mind, it will also provide a positive lasting legacy for the education sector.

One of the defining aspects of economic slowdowns and rising unemployment is their harsher impact on the less skilled. One of the aims of the Government's energy efficiency ceiling insulation policy is to provide support to less skilled labour.

Industry informed Government that typically a one-day training course was required before people could begin working on insulating the ceilings of homes under supervision. This part of the package therefore would not only lower energy-related costs for Australians by providing free insulation for over 2 million homes, it would also provide employment opportunities for predominantly less skilled workers.

In designing the ceiling insulation policy, the Government also considered whether 'standard' rebates for ceiling insulation would be effective in an economic downturn. Even when generous rebates are offered to households during economic weakness, the take-up is often low, because concerns about future employment prospects reduce people's tendency to spend even when they are given the opportunity to claim monies back.

To counter this effect, the Government simplified the process for households obtaining a rebate for insulating their ceilings. Rather than having to arrange for the installation of ceiling insulation and then claiming a rebate for the costs, households are able to arrange installation from a registered installer and the installer then claims the costs of installation (up to $1,600) back from the Government. The household is never out of pocket.

The other infrastructure components of the February stimulus package – the investments in social housing and transport infrastructure – were also designed to be quick acting.

understood that the effects of the global recession on the Australian economy could not be completely resisted. In particular, the unemployment rate, which had already begun to rise, was expected to rise further.

The past two recessions in Australia provided a number of important policy lessons, not only for the shape of stimulus packages, but al
so the design of policies to support the unemployed.[4]

In recessions, many people lose their jobs. But it is also true that the labour market's capacity to absorb new entrants is impaired. That is, around one-third of the rise in unemployment might be due to a lower level of employment while around two-thirds is due to too few jobs being generated to absorb an ever increasing labour force. Moreover, many of these new entrants to the labour market tend to be younger people.

In the early 80s and 90s recessions, a large proportion of the unemployed were aged under 25 years. This is not surprising given that those aged under 25 years typically make up around 40 per cent of the unemployed and, when unemployment rises, the number of unemployed for different age groups tends to rise proportionately.

This knowledge led the Government to quickly follow its February stimulus package with a jobs package aimed at younger persons. The Federal Government struck an agreement with the States, who are primarily responsible for delivering secondary and technical education in Australia, to guarantee a training place to all unemployed people aged under 25 years.

The Government anticipates the compact with young Australians will provide up to 135,000 people with higher qualifications. This $1.5 billion package is designed to promote a more skilled workforce in preparation for the return of normal demand conditions in the labour market; in particular, to increase the job readiness of unemployed persons and prevent skill atrophy, thus enabling the domestic economy to grow more quickly when the global economy recovers.

The 2009-10 Budget

additional $22 billion for large-scale infrastructure was announced, which represented the outcome of planning that had been accelerated back in October when the first stimulus package was delivered.

This spending on long-term infrastructure was designed to increase the productive capacity of the economy and provide sustained medium-term support to the economy and jobs.

The Government extended the support it was providing to housing construction and foreshadowed its phased withdrawal. As I noted earlier, the manner in which this aspect of the stimulus package would be withdrawn was considered at its announcement. The Budget presented a timely opportunity to adjust this in the light of ongoing weak economic conditions.

The Budget also presented an opportunity for the Government to outline its medium-term fiscal strategy after a year in which circumstances had changed dramatically.

In doing this, the Government outlined its response to the $210 billion collapse in revenues across five years, which included the largest single-year collapse in revenues since the 1930s. Despite the collapse in revenues, Australia is still projected to have the lowest net debt as a proportion of GDP of all advanced economies and to relatively quickly return the budget to surplus.

There are a number of reasons for this, including a good starting point, the fiscal stimulus packages have been temporary in nature and do not build in structural spending, and the introduction of revenue and saving measures designed to impact the budget in two years time.

In outlining the medium-term fiscal strategy it was thought important that Government not attempt to offset the short-term collapse in revenues so as to not cut across the policy support for the economy and employment. But equally, it was important that the Government put in place policies that demonstrated its commitment to return the budget to surplus in the medium term.

Concluding comments

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regime and accept a higher rate of inflation while adjusting to the global commodity boom. This year he was addressing claims about the need for stimulus and discussing the ramifications of big falls in commodity prices, global recession and the prospect of very low inflation.

A key element of the Australian Government's responses, at least thus far, has been its ability to put in place policy responses that are slightly ahead of or at least coincident with the downturn in the real economy.

This is probably the first time this has happened to this extent in Australian history.

Will all this endeavour ultimately prove successful? Well as I said earlier, to date there have been some good signs.

There is also good evidence that without the stimulus package the economy would be in much worse shape.

The Australian Treasury estimates that without the stimulus packages the unemployment rate would have been forecast to peak at 10 per cent rather than 8½ per cent. With the stimulus, there are estimated to be up to 210,000 more people with jobs.

While an unemployment rate that is lower than it otherwise might be is a welcome outcome, an 8.5 per cent unemployment rate would still see nearly 1 million Australians out of work. And I have to say I think we still have a long way to go before we can feel comfortable about a global economic recovery.

Nevertheless, Australia's experience suggests that there is a significant role for governments in cushioning their economies from the worst effects of the global recession, especially in the knowledge of the adverse social and economic consequences that flow from periods of sustained high unemployment.

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[1] This speech reflects my experience working in the Prime Minister's Office from March 2008 to May 2009. I would like to thank Amanda Sayegh, David Gruen, Phil Garton and Jim Thomson for their helpful comments and suggestions.

[2] The US economy contracted by 1.5 per cent, the UK by 1.9 per cent, Canada by 1.4 per cent, France by 1.2 per cent, Germany by 3.8 per cent, Japan by 3.8 per cent, and Italy by 2.6 per cent.

[3] The IMF (2009) has published estimates showing that the fiscal multipliers associated with government infrastructure spending range from 0.5 to 1.8. That is, for each dolla
r of government infrastructure spending, from $0.5 to $1.8 of activity is generated. This is higher than the fiscal multipliers for government spending through tax rebates and welfare payments, which are around 0.3 to 1.0. However, tax rebates and welfare payments still produce higher fiscal multipliers than do tax cuts, which range from 0.3 to 0.6. As reported in the May 2009 Budget, the Australian Treasury's estimates of the effects of the stimulus packages are based on multipliers toward the conservative end of these ranges.

[4] As is common in the labour markets of advanced countries, changes in Australian employment tend to lag changes in economic activity by around six months. For example, while the unemployment rate was already rising through the year to the first quarter of 2009,

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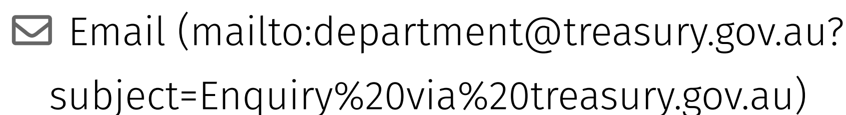

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