Government Senators' Minority Report

Introduction

Terms of reference

On 8 September 2009, the Senate, on the motion of Senator Bob Brown, resolved to refer to the Senate Economics References Committee a range of matters concerning the Government's economic stimulus package for inquiry and report by 2 October 2009. Subsequently, the reporting date was extended to 27 October 2009.

The inquiry was conducted in accordance with the following terms of reference:

1. That the following matter be referred to the Economics References Committee for inquiry and report by 2 October 2009:

   The economic stimulus initiatives announced by the Government since October 2008.

2. That the Senate requests the committee:

   (a) to invite the Secretary of the Treasury, accompanied by any other officials he considers appropriate, to appear before the committee, on or after the morning of Monday, 14 September 2009, for the purpose of giving evidence on the matter;

   (b) to invite the Reserve Bank Governor, Mr Glenn Stevens, and other independent pre-eminent economists to appear before the committee, on a date to be determined by the committee, for the purpose of giving evidence on the matter; and

   (c) to hold public meetings to take evidence from those witnesses, in the form of a full update on the economic stimulus initiatives, which addresses:

      (i) the efficacy of the spending measures to date,

      (ii) the anticipated costs and benefits of continuing the spending measures,

      (iii) consequent change in the stimulus 'roll out' that ought to be entertained given the changed economic circumstances,

      (iv) anticipated impact of the stimulus spending on future interest rate movements and taxpayer liabilities,

      (v) an evaluation of the environmental impacts of the spending to date, and

      (vi) other related matters.

Background to the economic stimulus initiatives

The global financial crisis and global recession

From the middle of 2007, financial markets began showing signs of considerable turmoil as the realities of trade in exotic financial derivatives and the explosion in sub-prime lending that had characterised the finance market boom became clear.

As subsequent events would reveal, inadequate regulation and greed on the part of financial market players would set in train a sequence of events in the United States, the United Kingdom and Europe that would culminate in the collapse, nationalisation or government bailout of major banks, insurers and credit providers. These included Citigroup, American International Group, Northern Rock, Fannie Mae, Freddie Mac, Bank of America, Goldman Sachs, Morgan Stanley, Royal Bank of Scotland, Lloyds TSB, HBOS and a number of major continental European financial institutions. The list of institutions involved reads like a veritable Who's Who of those who only months earlier would have considered themselves "masters of the universe". As we now know, these emperors had no clothes.

Following the collapse of Lehman Brothers, it was clear that the world financial system was on the brink of collapse. Banks lacked the confidence to lend to one another and credit markets froze as financial markets began to price in the risk of a catastrophic systemic failure. Share markets experienced the steepest and most rapid falls in stock prices in nearly 80 years. Major currencies around the world, Australia's included, came under abnormally heavy selling pressure, although in Australia's case this has proved to be short term.

All of these circumstances fed into a dangerous feedback loop that saw market confidence crash, creating the conditions for an unprecedented falls in global trade, production and investment. By October 2008, it was clear that without government intervention, every advanced economy was heading for a deep and protracted recession.

Governments the world over, with the encouragement of the IMF and OECD, put in place fiscal stimulus packages while central banks added monetary stimulus by reducing official interest rates to unprecedented lows. In some cases, governments resorted to what is called "quantitative easing". By January 2009, the International Monetary Fund was forecasting the first worldwide recession in the post-World War II era.

The consequences of the global financial crisis have been pervasive. Since October 2008, there have been nearly 50 government sponsored bailouts of major banks around the world. Financial institutions have suffered losses and asset write-downs totalling around A$1.9 trillion. The banking system aggressively deleveraged resulting in huge increases in costs of capital and investment funds drying up around the world including in Australia.

Virtually every major advanced economy with the exception of Australia has fallen into recession and taken together, the G7 economies have contracted for five consecutive quarters.

Some of these countries would suffer their biggest falls in output on record. In the year to June 2009, GDP in the United States fell by 3.9%, in the United Kingdom by 5.5%, and in Japan, GDP fell by 6.4%. Collectively, the world's advanced economies have shrunk by 4.3% in the year to June 2009, with 29 out the world's 33 advanced economies experiencing recession. Only Australia, Greece, Korea and Slovakia have avoided technical recession.

The global financial crisis quickly developed into a global crisis of employment. In the United States alone, almost six million jobs have been lost since September 2008. Worldwide, the International Labour Organisation estimates that 60 million jobs will have been lost by the end of this year as a result of the global economic downturn.

Australia was not immune to the effects of the global financial crisis and took swift and decisive steps to cushion the Australian economy, community and families from the worst effects of the global financial crisis. On the Friday before the government acted (October

12, 2008) to introduce the Retail and Wholesale Bank Guarantee, the Australian share market suffered its biggest fall since the 1987 stock market collapse. Share prices fell 8.3 per cent in one day, wiping nearly $73 billion from the value of the share market, and taking the total loss for that week to just under 16%. In the week before the introduction of the bank guarantees, the Australian dollar fell 12.5 cents (16%) against the US dollar, the biggest weekly fall since the Australian dollar was floated in 1983.

The human impact of the global financial crisis has been severe and the Government was determined to cushion Australians from the worst impact of the crisis. Despite unfounded claims over the effect of the stimulus on interest rates and debt raised by the Coalition, the evidence to the inquiry from the Reserve Bank, Treasury, business and market economists demonstrates the correctness of the Government's approach.

Economic and social costs of severe economic downturns

Protracted downturns result in permanent dislocation from the labour market, skills atrophy, and risk creating an entire generation of unemployed. Otherwise viable businesses are destroyed and productive investments are foregone. This capital and skills destruction can permanently reduce an economy’s long-term capacity, to say nothing of the “scarring” effects of unemployment to the individuals involved.

Evidence presented to the Committee demonstrates that the human, social and economic costs of severe downturns can be substantial and long-lasting. Professor Andrew Leigh highlighted the pervasive long-term costs of joblessness:

> "I think it is important to bear in mind how slowly economies tend to recover from recession. The unemployment rate of the late eighties was not again achieved until the late 1990s, and the scarring cost of unemployment is pretty substantial. I left school in 1990, just as the economy was hitting the skids, and that was a terrible time for young kids to leave school. So I think it is important, where government can, to try to smooth the economic cycle and not simply to see this additional two percentage points of unemployment as being a statistic but as being many young people whose livelihoods will be better if they do not spend a scarring period of unemployment early in their careers."[1]

> "We know that the best predictor of poverty in Australia is not having a job, so trying to minimise job loss is important in the short-term and, as I think we spoke about earlier, the long-term. If kids experience a period of unemployment early in their careers, you can see that in their wage trajectory and their occupation later on in their careers. They recover, but not fully. I think that is partly due to the loss of skills, the absence of gaining experience and just the psychological impact of the feeling that you are not worth employing. So, to the extent that policy can ameliorate unemployment, I think that should be a top policy goal."[2]

For these reasons, limiting the more severe consequences of economic downturns can have long-lasting benefits. This view was put by a number of witnesses before the Committee:

> "It is hard to imagine that anyone would strongly argue with the view that keeping people in work pays enormous dividends over the medium-term. Not only do we spare

[1] Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.28.

[2] Ibid, p.36.

them the pain and the inconvenience and the cost of a period of unemployment, but we spare the economy all the flow-on effects of them losing their jobs."[3]

"Long term joblessness leads to poverty (for example, Newstart Allowance is just $228 per week for a single adult), poor health, a loss of confidence and skills, tensions within families, and often the need to move to areas where housing is cheaper, which concentrates these social problems in the same areas. This means that many Australians will not 'bounce back' as the economy recovers. For example, over one on five Newstart Allowance recipients lack a decent and secure home, over one in four could not pay a utility bill (within the last 12 months) and over four in ten are unable to afford necessary dental treatment. If we can prevent high levels of long term joblessness from becoming entrenched, many of these social problems, and their high costs to Governments in future years, can be avoided. This should be a major objective for economic and social policy over the next two years. It is vital that the Government apply the same foresight and energy to this problem as it did to avoiding a more severe downturn in the first place."[4]

The Australian Government response to the global recession

The Australian government's stimulatory response to the collapse of financial markets and the looming collapse of the real economy has been part of an internationally coordinated response and has been four-fold.

The government:

1. Guaranteed the deposits of financial institutions and offered access to a government guarantee for their wholesale funding, a response made necessary by the extraordinary events up to October 2008.
2. Provided direct cash support to households to support consumer confidence, consumption and housing investment.
3. Committed to direct public investment in local infrastructure projects that could be undertaken immediately; providing support to employment in labour intensive construction and associated industries.
4. Committed to direct public investment in critical long-term economic infrastructure necessary for creating the conditions for a step up in productivity and thus, accelerating Australia's recovery from the effects of the global financial crisis.

The majority of evidence presented to the Inquiry was that the fiscal stimulus was an appropriate response given the scale and severity of the global crisis and that the stimulus has been effective in averting a much sharper and deeper downturn in the Australian economy:

"Avoiding the mistakes of the past, a consensus emerged to undertake speedy fiscal stimulus and monetary easing. The Australian government was right to take this path and in fact to act more quickly and decisively than most. While the return to more normal growth levels is still some time off, at the time of the announcement of the

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[3] Dr Richard Denniss, *Proof Committee Hansard*, 21 September 2009, p.64.

[4] Australian Council of Social Service, *Submission 2*, p.2

> December and February stimulus arrangements the economic outlook was deeply concerning and, given this, the scope and scale of stimulus was entirely warranted."[5]
>
> "I think the international consensus, including the OECD and the International Monetary Fund, is that Australia's policy settings, at least to date, have been quite consistent with what is generally regarded as an appropriate stance, including in respect of timeliness and being temporary and well targeted."[6]
>
> "I think the governments and central banks of the world did the right thing by acting as quickly and as forcefully as they could. I genuinely do believe the world was on the brink of a catastrophic economic and financial meltdown. I think that policymakers everywhere moved sharply in the right direction."[7]
>
> "It made sense for policymakers in Canberra to ensure that fiscal policy also put its shoulder more firmly to the wheel. Other economists can speak for themselves, but my guess is that the majority of financial-sector economists with public-policy backgrounds at the RBA and Treasury also felt that the February stimulus package made a great deal of sense."[8]

A view was expressed by a minority of academic economists that Governments should do little, if anything, to limit the impact of deep recessions on the economy and workers. The retrospective advice from a minority of academic economists who are completely opposed to government intervention in the economy demonstrates the difference between "blackboard economists" and those economists who have responsibility for fiscal and monetary policy of a real and practical nature.

The government set clear criteria that the stimulus be timely, targeted and temporary. The impact of the intervention through the stimulus package has assisted the economy avoid a recession with all of the associated negative social and economic implications.

The stimulus was designed intentionally to reach its maximum impact on growth quickly and then to gradually withdraw as a recovery in private sector activity builds. By design, the fiscal stimulus will be withdrawn gradually as the economy strengthens. This ensures that both arms of macroeconomic policy – fiscal and monetary policy – continue to work consistently during the economic recovery, as they did during the downturn.

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5 Greg Evans, Director, Australian Chamber of Commerce and Industry, *Proof Committee Hansard*, 28 September 2009, p.54.

6 Dr Ken Henry, Secretary of the Treasury, *Proof Committee Hansard*, 9 October 2009, p.15.

7 Rory Robertson, Economist, Macquarie Bank, *Proof Committee Hansard*, 28 October 2009, p.50

8 Rory Robertson, Economist, Macquarie Bank, *Opening Statement to the Senate Economic Committee Inquiry*, 28 October 2009, *Proof Committee Hansard*, p.2

The size and composition of the stimulus

The table below sets out the size and scope of the economic stimulus measures adopted by the government since October 2008. The measures include the Economic Security Strategy (October 2008), the Nation Building Package (December 2008), the Nation Building and Jobs Plan (February 2009) and measures included in the 2009-10 Budget.

Table 1: Composition of the fiscal stimulus[9]

Composition of fiscal stimulus ($b)	2008-09	2009-10	2010-11	2011-12
Transfers	**20.44**	**4.22**	**1.78**	**1.59**
Major fiscal stimulus packages				
Economic Security Strategy (consumption) (Oct. 2008)	9.55	0.65	0.07	0.00
Nation Building & Jobs Plan (consumption)	10.49	1.72	0.00	0.00
2009-10 Budget measures				
2009-10 Budget net pension spend[a]	0.39	1.86	1.71	1.59
Investment	**4.52**	**21.93**	**17.27**	**4.91**
Major fiscal stimulus packages				
Economic Security Strategy (investment) (Oct. 2008)	0.12	0.07	0.00	0.00
Dec. 08 Nation Building Package (all investment)	0.88	1.95	0.39	-0.19
Nation Building & Jobs Plan (investment)	2.04	16.19	10.03	1.67
2009-10 Budget measures				
2009-10 Budget infrastructure (investment)[b]	1.48	3.72	6.85	3.43
COAG Reforms	**3.50**	**1.78**	**2.23**	**3.57**
COAG funding package (transfers)	3.50	1.78	2.23	3.57
TOTAL	**28.46**	**27.93**	**21.27**	**10.07**

a. This is the net effect of the pension and carer reforms and structural savings

b. These amounts do not include the provisions for future equity injections for the National Broadband Network, which are subject to the outcome of the Implementation Study and subsequent commercial negotiations.

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9 Source: Treasury Briefing Paper for the Senate Inquiry into the Economic Stimulus Package; received by the Senate Economics References Committee, 2 October 2009.

Efficacy of the spending measures

Design of the fiscal stimulus measures

Against the criteria that the Government set for the design of the stimulus package – that it be timely, targeted and temporary – the majority of evidence to the Committee found that these objectives were met. The Governor of the Reserve Bank noted that:

> "The three Ts—temporary, timely and targeted—are a standard set of desirable criteria amongst people who talk about this. I think it is pretty hard not to conclude that it was quite timely. It was very fast. The bulk of it is temporary. Notwithstanding the discussion earlier about 2011 effects, the big impacts are in 2009, which is presumably the year in which the economy would need the most support. On the targeting, that is probably where people are going to differ about just what should be targeted. That inherently is, I think, largely a set of decisions which are properly made in the political realm. It is the job of the political process to make that decision."[10]

A similar view was put by one market economist:

> "In terms of the formulation, there may not have been a more sensible package. It is an unprecedented episode, but I am not sure there has been a package like this one. There was the cash splash designed to support the household sector ASAP. Then there was the idea of supporting economic activity more generally. Someone thought of building in pretty well every school in Australia, so there will presumably be nearly 10,000 buildings. That is obviously designed to generate extra economic activity in every community in the country. Then there are some of the longer term projects. To me that make sense. Other economists can speak for themselves, but I think most financial market economists, many of whom grew up in the Reserve Bank and Treasury, would think the package was reasonably well structured given the economic circumstances."[11]

Professor Andrew Leigh was asked his view on the efficacy of various stimulus measures, in particular the effect of the consumption and infrastructure elements of the Nation Building and Jobs Plan on employment and aggregate demand, as opposed to alternative proposals for tax cuts that have been advanced over the past year.

> "**Senator CAMERON**—One of the other arguments we heard this morning was that it would be better if we simply reduced taxes to business and let business get on with the job. What is your analysis of that approach?

> "**Prof. Leigh**—My favourite primer on multipliers is a Bookings Institution paper by Doug
> Elmendorf and Jason Furman that you are probably aware of and that I regard as a nice review of the literature. My read of that is that the multipliers are highest for

[10] Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard,* 28 September 2009, p.22

[11] Rory Robertson, Economist, Macquarie Bank, *Proof Committee Hansard,* 28 October 2009, p.43

> infrastructure, next highest for consumer handouts and lowest for business tax breaks."[12]

The economic impacts of the Government's stimulus measures

Treasury presented evidence to the Committee on the economic impacts of the fiscal stimulus packages. This analysis, outlined in the briefing paper[13] and confirmed in its appearance before the Committee, demonstrated the fiscal stimulus had played a critical role in keeping Australia out of recession.

> "**Senator BOB BROWN—**Thanks, Chair, and thank you, Dr Henry and gentlemen. The first question, of course, is: without the stimulus package—and we were talking with you last about the $42 billion stimulus package that was being considered in February—would we have moved into recession?
>
> "**Dr Henry—**It is our view that yes, we would. It is our view that, as I indicated in my opening remarks, in the year 2008-09, the fiscal stimulus accounts, on our estimates, for all of the growth that occurred in that year. Dr Gruen or others at the table may correct me if I get this wrong, but I think, in through-the-year terms to the June quarter of 2009, the Australian economy grew by 0.6 per cent, and our view is that without the fiscal stimulus the Australian economy would have contracted by 1.3 per cent through the year to the June quarter 2009. I think a contraction in the economy of 1.3 per cent through the year would be regarded by most people as a fairly significant recession."[14]

Treasury's analysis shows that in the absence of the fiscal stimulus, the Australian economy would have contracted for three consecutive quarters – in the December quarter of 2008, and the March and June quarters of 2009 – and by 1.3 per cent over the year to June.[15] Instead, in large part due to the fiscal stimulus, the Australian economy recorded positive growth of 0.6 per cent, making Australia the only advanced economy to grow in the year to June.

As to its effects on household consumption, Treasury's modelling, supported by two recent Australian studies cited in the briefing paper, indicate that the transfer payments to households have led to growth in household consumption of 1.7 per cent over the year to June 2009, as opposed to a contraction of 1.3 per cent that would have occurred in the absence of the stimulus.[16]

Overall, Treasury estimated at Budget, that the stimulus measures added 1 per cent to GDP growth in 2008-09 and 1.6 per cent to GDP growth in 2009-10. In terms of its impact on employment, Treasury estimated that the peak impact of the stimulus at Budget was the

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12 Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.28

13 Treasury Briefing Paper for the Senate Inquiry into the Economic Stimulus Package; received by the Senate Economics References Committee, 2 October 2009.

14 *Proof Committee Hansard*, 9 October 2009, p.8.

15 Dr Ken Henry, Secretary to the Treasury, *Proof Committee Hansard*, 9 October 2009, p.2.

16 Treasury, Briefing Paper, op cit, p.6.

addition of 210,000 jobs, which in turn leads to higher employment levels throughout the forecast period. The peak unemployment rate is therefore estimated to be 1.5 percentage points lower than it would otherwise have been in the absence of the stimulus.[17]

The Governor of the Reserve Bank presented a similar view that the stimulus measures had been effective in supporting economic activity:

> "A straightforward reading of the economic outcomes would, I think, suggest that the various policy measures have been effective in supporting demand."[18]
>
> "If the intention was to support demand in the economy in a period in which we had a very serious global downturn and which all the indications were that that was going to affect Australia significantly, and if the intention is to provide some temporary support to demand in such a period, my conclusion would be that those measures have supported demand quite materially over the last—it is now September—probably nine or 10 months."[19]

Governor Stevens agreed with Treasury's view that the stimulus measures had kept the Australian economy out of recession.

> **"Senator BOB BROWN—**Do you think we would have faced a recession and/or depression in this country had these stimulus packages not been there?
>
> **"Mr Stevens—**I do not think we would have faced 'the Great Depression'. For the reasons I set out in my opening remarks—the root problem here of financial excesses, too much leverage, too much risk taken, housing market collapses et cetera that you have seen in these other countries — we did not really have that problem. We would have been affected. We would have had recession. I am not sure we would have had depression—personally I would not have thought that—but we certainly would have faced a deeper downturn than we have ended up having. And that is costly, of course."[20]

The view that the economic stimulus had been effective in supporting economic activity and employment was also shared by business groups:

> "Our assessment of the measures is that, in combination with interest-rate reductions and similar policy actions in other parts of the world, they have made a material difference to economic activity over the past nine months, and, had they not been in place, the economy would have deteriorated much more sharply than it has done."[21]

One of the principal motivations for the Government's economic stimulus package was to support employment. High unemployment has a human as well as an economic cost. Although Australia's unemployment rate has increased and may not yet have peaked, there

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17 Ibid, p.5.

18 Mr. Glenn Stevens, Reserve Bank Governor; *Proof Committee Hansard*, 28 September 2009, p.3.

19 *Proof Committee Hansard*, 28 September 2009, p.6.

20 Mr. Glenn Stevens, Reserve Bank Governor, *Proof Committee Hansard*, 28 September 2009, p.7.

21 Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p.63.

can be no doubt that had the Government not acted to support demand, the situation would have been much worse.

> "In terms of reducing unemployment relative to what it otherwise would have been, I think that it was an effective package."[22]

The majority of evidence presented to the Committee was that stimulus had been effective in limiting the impacts of the global recession on economic activity and employment in Australia.

It became apparent during the course of the inquiry that there is a significant divergence of opinion between those charged with the on-the-ground management of the Australian economy and those who could be referred to as "blackboard" economists about the efficacy of the stimulus measures undertaken so far. This divergence was put to the Secretary of the Treasury by Senator Cameron:

> **"Senator CAMERON—**We have had lots of academic economists come before us and argue, I suppose, their academic bias in terms of some of these issues. We have had lectures on Say's law, we have had lectures on the evils of Keynesianism and why we should be looking at Hayekian economic approaches. I am just wondering if all that lecture we got was really relevant in terms of the practical circumstances that governments and treasuries around the world face. Have you got any views on that? I am sure you have looked at some of the commentary and analysis that has been put to the committee. We have got to weigh all this up, I suppose.
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> **"Dr Henry—**I used to be an academic economist myself. It is easier to be an academic economist.
>
> **"Dr Gruen—**Are you going to leave it there?
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> **"Dr Henry—**No, look, the issues that have been raised in testimony before the committee, on my brief reading of them—and I have not read them perhaps as closely as I might have in answering this question—it is not that the issues that have been raised should be entirely discounted in all circumstances; certainly not. But, whilst being very aware of those issues for many years, I can tell you that, confronted with the crisis that the world has been dealing with these past 12 months or so, those few quibbles with the use of expansionary fiscal policy—or expansionary monetary policy, for that matter—or other actions of governments to prop up credit markets are not ones that I considered should detain us for too long. They were rather quickly put aside."[23]

Differences of opinion between economists are as old as the economics profession itself. The conduct of inquiries such as this will occasionally provide a battleground for the prosecution of economic debates which are at times essentially ideological in nature. One of the defining features of the global financial crisis is that its causes and remedies have undermined the central tenets of neo-liberal economics. Those academic and business economists who subscribe to neo-liberal economic theory have been quite active in recent

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[22] Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p.22.

[23] *Proof Committee Hansard*, 9 October 2009, p.13.

times defending their faith.

This is perhaps understandable; however, what government senators are mindful of is the need for public policy to reflect real-world circumstances and the needs of the people who are most likely to be hard hit by an economic crisis such as that which we have witnessed over the past year.

Government senators are of the opinion that in the absence of the stimulus, Australia's aggregate economic performance would have been far worse over the course of the past year than would have otherwise been the case in the absence of fiscal stimulus. Indeed, in the absence of the stimulus, Australia would have joined the rest of the developed economies in recession with its consequent catastrophic effects on employment, consumer and investor confidence and Australia's medium and long term economic prospects.

Costs and benefits of continuing the spending measures

Rationale for continuing with fiscal stimulus

The Australian government's response to the global financial crisis is part of a global response coordinated by the G20 in what has been an unprecedented global effort to support the level of economic activity to avert the worst consequences of a global recession.

The most significant decision of the G20 governments has been to inject US$5.5 trillion worth of stimulus to the global economy. The result of this coordinated action has seen the thawing of credit markets, recovery in equity markets, stability begin to return to labour markets and a return of consumer and business confidence. Despite this, 'there continue to be strong headwinds in the global economy'.[24]

Earlier this month, IMF Managing Director, Dominique Strauss-Kahn cautioned governments of the risks of premature withdrawal of fiscal stimulus:

> "For a start, the crisis is not over. The recovery will be sluggish, and private demand is not yet self-sustaining. The spectre of de-leveraging will be with us for some time. And on the demand side, consumption is still tentative, especially in countries where household balance sheets remain weak. Rising unemployment is likely to cast a long shadow. Even as growth recovers, it will take some time for jobs to follow suit. Indeed, unemployment will continue rising in many countries through 2010…So, the global economy remains in a very precarious position. Premature withdrawal of policy support could kill the recovery. For sure, policymakers should design credible exit strategies. But it is too soon to implement them."[25]

The view presented by business groups is that the Australian economy has not reached the point where the fiscal stimulus should be withdrawn.

> "Despite improving economic news and improving consumer and business confidence levels, the fundamentals of the economy remain fragile. This is according to both official statistics and the surveys of the ACCI. We expect the labour market to

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[24] Dr. Ken Henry, *Proof Committee Hansard*, 9 October 2009, p.14.

[25] Dominique Srauss-Kahn, Managing Director, International Monetary Fund, Opening Address to the 2009 Annual Meetings of the Boards of Governors of the World Bank Group and the International Monetary Fund, Istanbul, October 6, 2009.

> continue to worsen and note the shift from full-time to part-time employment has to some extent masked the severity of the slowdown. Retail trade remains subdued, as does business investment, and credit conditions continue to constrain opportunities for business. Most importantly, international conditions amongst our trading partners remain weak. In conclusion, we do not believe these are the circumstances where fiscal stimulus should be withdrawn; noting that in any case the design of these arrangements sees a phased wind-down."[26]

> "While we see the measures as having made a very positive contribution, we do not think we can say that the economy is out of the woods yet. We remain concerned that a considerable share of the promising signs that we see in the economy are closely related to the stimulus itself rather than to a self-sustained rise in demand. We expect further rises in unemployment and further falls in hours worked, both of which will flow through the economy more broadly, and we remain conscious of the lagged impacts of the falling commodity export prices on company profits, investments and dividends and the impacts that that will also have as they flow through the economy. For these reasons we are very wary of calls for the fiscal measures to be wound back ahead of the inbuilt schedule for their withdrawal. We think that this could undermine the recovery that appears to be taking hold."[27]

Indeed, Dr Henry pointed out that if the stimulus package were to be withdrawn now, it would risk stalling the economy and a further 100,000 jobs could be lost.[28]

Several witnesses were concerned at the dollar cost of the jobs created as a result of the stimulus packages.[29] However, these concerns ignore the fact that tens of thousands of Australians have kept their jobs as a result of the stimulus. This affords the economy a measure of protection in the medium term as people still in employment continue to support demand in that they still have income to spend.[30]

The economic impact of unemployment has the potential to cause irreversible damage in local economies. This is especially so in rural and provincial centres. Even during the boom of recent times, there were regions in which unemployment remained unacceptably high. The loss of further jobs in many of these places could lead to irreversible decline.[31]

A significant feature of the labour market changes resulting from the effects on Australia of the global financial crisis is the fall in aggregate hours worked, in the order of 3.5%.[32] Rather than shedding labour as has been the case during earlier economic downturns, employers and employees have been agreeing to reduce hours. While this reduction has not always been voluntary, the shift from full-time to part-time employment has to some extent masked the downturn in the labour market. As Dr. Burn of the Australian Industry Group noted:

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26 Greg Evans, *Proof Committee Hansard*, 28 September 2009, p.55.

27 Dr Peter Burn, Associate Director, Public Policy, Australian Industry Group, *Proof Committee Hansard*, 28 September 2009, p. 63.

28 Dr. Ken Henry, *op cit*, p.14.

29 For example, Dr Steven Kates, *Proof Committee Hansard*, 21 September 2009, pp 4-5, 8.

30 Dr Richard Denniss, *op cit* p.64.

31 Dr. Richard Denniss, *op cit* p.67.

32 Mr. Rory Robertson, *op cit* , p.40.

> "I think the reduction in hours worked works out at about an equivalent of 250,000 (full-time equivalent) jobs fewer than a year ago."[33]

The most recent labour market data indicates that Australia's rate of unemployment fell in September to 5.7 per cent; making Australia the only developed economy to experience relatively stable labour market conditions in recent months. There is however no cause for complacency over Australia's employment performance. Close inspection of the employment data reveals that over the past twelve months, full-time employment has fallen by a little over 151,300 jobs, equivalent to about two per cent of the workforce. The stark fact remains that there are still 658,000 Australians who want a job but do not have one.

The reality is that total employment is a lagging economic indicator and a number of recent economic forecasts point to continuing softness in the labour market over the next year. As indicated above, unemployment may not have yet reached a peak and in the opinion of government senators, any withdrawal of the fiscal stimulus to which the government has committed itself would have the very strong potential to lead to further, unnecessary job losses.

A particular area of concern to government senators is the unacceptably high level of youth unemployment and the dramatic decline in apprenticeship commencements over the past year. The Minister for Employment, Education and Workplace Relations recently told the House of Representatives that this decline is in the order of 20 per cent.[34]

The Minister informed the House that in order to arrest this decline, the government is making some minor adjustments to the stimulus package to encourage an increase in the number of apprenticeship commencements. This entails redirecting $100 million of Job Fund money toward a concerted effort to "kick-start" apprenticeships.[35]

Long-term benefits of fiscal stimulus

One of the central elements of the Government’s stimulus spending has been spending on infrastructure, including the Building the Education Revolution program and transport infrastructure projects. Several witnesses were concerned that the infrastructure program was not good value for money.[36] However, it was also noted that infrastructure spending can and does create jobs.[37] Building essential roads does have a payoff.[38] Much of the planned infrastructure will have an impact on the supply side capacity of the economy, which will increase the economy’s long-term productivity level.

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[33] Dr. Peter Burn, *op cit*, p 67.

[34] Hon. Julia Gillard MP, *Proof House Hansard*, 19 October 2009, p.27.

[35] *ibid*

[36] See, for example, Dr. Steven Kates, *op cit*, p E5; Professor Sinclair Davidson, RMIT University and Institute of Public Affairs; Proof Committee Hansard, 21 September, 2009 p.49; Professor Tony Makin, *op cit*, pp 81, 87

[37] Professor Andrew Leigh, *op cit*, p.29

[38] Professor Andrew Leigh, *op cit*, p.31

> "But we have some confidence that there will be expansions of capacity that will come from some of the investments in infrastructure."[39]

> "But it is certainly the case that that capital or infrastructure spending component of the fiscal stimulus package—significant pieces of it, at least—is intended to enhance future supply capacity. We would generally expect that that would have some positive implications for future labour productivity growth."[40]

Dr Gruen, Executive Director, Australian Treasury also highlighted the long-term economic benefits from the fiscal stimulus that arise from limiting the skill and capital erosion typically associated with deep and protracted economic recessions.

> "It is also reasonable to argue that to the extent that you avoid a more serious downturn you get less loss of skills and you do less damage to the human capital formation that goes on the job. It is reasonable to argue that the fact that Australia has managed to have a much smaller rise in unemployment, both up until now and in prospect, than in other countries probably means that there are some—they are modest but nevertheless they exist—long-term productivity benefits. Deep downturns have a scarring effect on people."[41]

In the opinion of government senators, the view that stimulus spending in the circumstances that have accompanied the global financial crisis should only be seen as incurring costs is disingenuous.

The view that there only costs associated with fiscal stimulus ignores the very great costs to business, their employees and to the economy and society as a whole that would accompany not undertaking fiscal stimulus measures.

Consequent changes in the stimulus "roll out" given the changed economic circumstances

Based on the evidence put before the Committee confirming the remaining fragility of the global economy, despite signs of nascent recovery in some areas, government senators are of the opinion that no persuasive evidence was put to us that would persuade us to adopt the view that economic conditions have changed sufficiently to warrant withdrawal of the fiscal stimulus measures.

Indeed, it is the view of government senators that the considerable weight of the evidence to this inquiry favours the continuation of the stimulus measures to provide appropriate support to the economy and employment.

The package of stimulus measures has built into it a staged withdrawal of the measures. This is a prudent design measure and we consider calls at this stage for immediate withdrawal of the stimulus would cost more jobs and threaten Australia’s economic recovery.

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[39] Dr. Peter Burn, *op cit*, p.68

[40] Dr. Ken Henry, *op cit*, p.15

[41] Dr David Gruen, Executive Director, Macroeconomic Group, Treasury, *Proof Committee Hansard*, 9 October 2009, p.15

In this regard, we note the following remarks of Dr. Henry:

> "Some commentators seem to have interpreted our peak unemployment rate forecast of 8½ per cent as a target. Apparently, if the forecast were then to be revised down to, say, seven per cent, we should revise the stance of fiscal policy in order to get our forecast back up to 8½ per cent. Needless to say, we find that sort of argument a little peculiar.
>
> "The effect of fiscal stimulus on growth likely peaked in the June quarter of 2009. We are beyond the period of peak impact of the fiscal stimulus. From that point, as stimulus is to be gradually withdrawn, the contribution to economic growth will subside and it will soon turn negative. Indeed, on our estimates, the fiscal stimulus package will make a negative contribution to GDP growth in every quarter in 2010—that is, commencing in just a few months time.
>
> "It is on the public record that the Treasury has advised the government that withdrawing the stimulus more quickly could risk stalling the economy and causing a steeper rise in the unemployment rate. To illustrate the point, if all the stimulus scheduled to impact in 2010-11 were cancelled, that would mean a further detraction of 1½ per cent from GDP growth and the loss of up to an additional 100,000 jobs. I say 'further detraction' because on our figuring the fiscal stimulus package, in the way it has been constructed, is already likely to detract about 1¼ per cent from growth in that year. It is unlikely that the recovery in private sector demand would be sufficiently strong for the economy to withstand such a sudden withdrawal of public sector activity without significant costs in terms of lost output and higher unemployment."[42]

Impact of spending measures on interest rates and taxpayer liabilities

Interaction of fiscal stimulus and monetary policy

It was pointed out by both Treasury and the Reserve Bank that the in-built withdrawal of fiscal stimulus will ensure that both arms of macroeconomic policy – fiscal and monetary – will be working in the same direction during the economic recovery.

The Governor of the Reserve Bank, Mr. Stevens, observed that interest rate rises would be the natural result of moving into a phase of economic expansion and that during this recovery phase both fiscal and monetary policy would be working consistently. He told the Committee:

> "In due course both fiscal and monetary support will need to be unwound as private demand increases. In the case of the fiscal measures, this was built into their design. The peak effect of those measures on the rate of growth of demand has probably already passed. The extent of support will tend to tail off further over the next year or so. In the case of monetary policy, the bank has already signalled that interest rates can be expected at some point to move off their current unusually low levels as recovery proceeds. These adjustments back towards more normal settings for both types of macroeconomic policy are what should be expected during the recovery phase of a business cycle. Our most recently released set of forecasts—the ones

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[42] Dr. Ken Henry, *op cit,* p.3.

> released in August—assume that that occurs. Such an outcome would mean that fiscal and monetary policy would be acting broadly consistently, as they did when they were moved in the expansionary direction when the economy was slowing."[43]

ACCI also noted that rising interest rates were a product of the economic recovery:

> "Interest rates will go up as the economy recovers. That is quite separate from anything the government is doing with respect to fiscal stimulus."[44]

Government borrowing and crowding out

In evidence to the Committee, Governor Stevens rejected the proposition put by Coalition senators and Professor Sinclair Davidson that government borrowing would "crowd-out" private investment and raise interest rates. Governor Stevens made the point that Australia's debt level is low and manageable by international standards and that government borrowing occurs on global markets and therefore has no material impact on interest rates.

> "My point is that the Australian government borrows in a global market. There are free global capital flows here and long rate in Australia is driven more strongly by what happens in global markets than by what happens here, frankly, at the sorts of debt levels we are talking about."[45]

> "If we find that Government borrowing rates are a lot higher in the years ahead, I don't think it will be because of Australia's outcomes."[46]

Government finances

The Australian Government budget – like budgets of governments around the world – has been impacted by the global recession, which has resulted in sharp falls in expected tax revenues. The Government has had to borrow to meet the revenue shortfall caused by the global recession and to support economic activity and employment.

At Budget, it was made clear that early and decisive fiscal stimulus was "essential to support economic activity and jobs, along with investment in the economy's future productivity. Investment in nation building infrastructure and world-class universities and hospitals will position Australia to take full advantage of the global recovery."[47]

Notwithstanding the impacts of the global recession, the Australian government's balance sheet remains strong. The Australian government has lower debt and lower deficits than any of the major advanced economies and the Government's fiscal strategy will ensure that as the economy recovers, the budget will return to surplus, and government debt will fall.

While the United Kingdom, the United States and the Euro zone economies are expected to face public debt levels in excess of 80 per cent of GDP by 2014, and Japanese public debt

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[43] Mr. Glenn Stevens, *Proof Committee Hansard*, 28 September 2009, p. 4.

[44] Mr Greg Evans, ACCI, *Proof Committee Hansard*, 28 September 2009, p. 57.

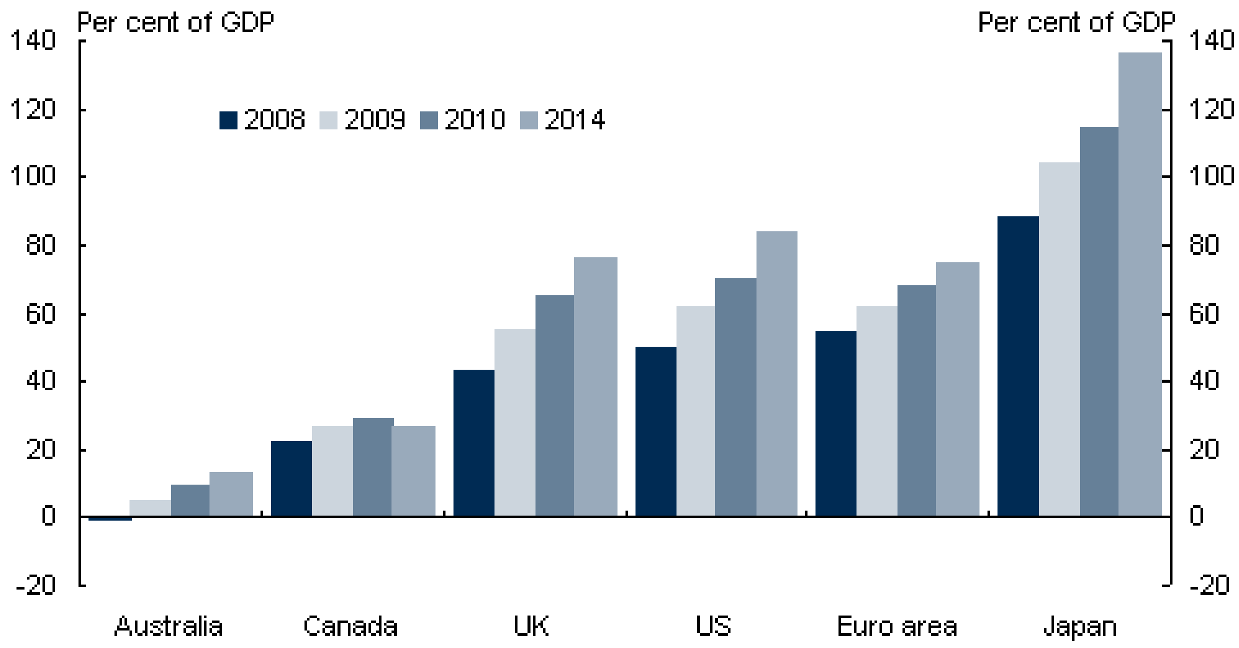
[45] Mr. Glenn Stevens, *op cit*, p.15

[46] *Ibid*, p.12

[47] Budget Paper No. 1 2009-10, p.1-51

will approach 140 per cent of GDP, Australian public debt 'will peak at 13.8 percent of GDP in 2013-14 declining to around 3.7 per cent in 2019-20.'[48]

Australia's net debt position relative to selected advanced economies over the period to 2014 is set out in the following chart:



Source: Budget Paper No. 1 2009-10, p.1-52

There can be no argument that the state of Australia's government accounts is superior to any other comparable economy. The evidence presented to the Committee was that the projected levels of government debt are small by international comparison and manageable.[49] These points were summed up by the testimony of the Reserve Bank Governor, who noted that:

> "I would have to say that I think the prospective debt that we are going to have—according to the budget outlook—for a country like Australia ought to be seen as quite manageable."[50]
>
> "There is not much argument that the state of the government accounts in this country is just so superior to virtually anybody with whom we would want to compete. "[51]

[48] *ibid*

[49] Mr. Glenn Stevens, op cit, p.9; Mr. Neil Hyden, CEO, Australian Office of Financial Management, *Proof Committee Hansard*, 28 September 2009, p.32; Mr. Rory Robertson, Economist and Division Director, Macquarie Bank, *Proof Committee Hansard*, 28 September 2009, p.41; Dr Ken Henry, Secretary, Department of Treasury, *Proof Committee Hansard*, 9 October 2009, p.16; Professor Andrew Leigh, *Proof Committee Hansard*, 21 September 2009, p. 34

[50] Mr. Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p.9

[51] Mr. Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 28 September 2009, p.16

The Government outlined in the Budget a clear fiscal strategy to return the budget to surplus and reduce debt. As the economy strengths, stimulus will be phased down by design, revenues will recover and the Government has committed to holding real spending growth to less than 2 per cent a year until the Budget returns to surplus. At Budget, it was estimated that this strategy would return the budget to surplus by 2015-16 and reduce the level of net debt as a share of GDP to 3.7 per cent by 2019-20.

Impact of fiscal stimulus on the exchange rate

During the course of the inquiry, there was some concern expressed over the impact of the stimulus package on exchange rates. Dr Gruen noted that in a global downturn, when every country is implementing fiscal stimulus at the same time, the exchange rate effects are muted, or non-existent.[52] Rather, Treasury observed that recent movements in the exchange rate were likely to be unrelated to domestic policy settings.[53] Dr Gruen noted that the Australian dollar is sensitive to changes in the global economy, especially to movements in commodity prices and the US stock market. Therefore, working out the impact of the stimulus package on exchange rates is a difficult task.[54] However, there can be little doubt that the floating exchange rate has allowed us to weather the economic storm better than might have otherwise been the case.

Environmental impact of spending measures

No direct evidence was placed before the Committee or submissions made on this term of reference. However government senators note that as part of phase 3 of the stimulus package, the government has committed $4.5 billion in the Clean Energy Initiative to assist Australia’s transition to a low-pollution economy. This figure includes $1 billion in existing funds that will deliver a number of substantial measures aimed at enhancing innovation and investment in clean energy generation. There are three core elements to the Clean Energy Initiative:

- A $2.0 billion investment over nine years in carbon capture and storage (CCS) projects under the CCS Flagships program to support the development of industrial-scale demonstration projects for CCS technology in Australia. The projects are expected to include a carbon dioxide storage hub and projects to demonstrate a range of technologies to capture carbon dioxide from coal-fired power stations. The successful deployment of CCS will facilitate Australia's transition to a low-pollution economy, generate the low-pollution jobs of the future, and help preserve the value of Australia's coal exports.
- A $1.5 billion investment over six years in the Solar Flagships program that will demonstrate large-scale solar-thermal and solar photovoltaic technologies. The program

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[52] Dr. David Gruen, Executive Director, Macroeconomic Group, Department of the Treasury, *Proof Committee Hansard*, 9 October 2009, p.5.

[53] Dr. Ken Henry, op cit p.2.

[54] Dr. David Gruen, Executive Director, Macroeconomic Group, Department of the Treasury, *Proof Committee Hansard*, 9 October 2009, p.21.

will comprise up to four solar projects operating in the national grid, with an additional capacity of 1,000 megawatts. Together with the existing $100 million Australian Solar Institute, the Solar Flagships program will help position Australia as a world leader in solar energy generation with clear benefits for the environment.

- A new independent renewable energy innovation body, Renewables Australia, resourced with initial funding of $465 million over four years to support renewable technology research, commercialisation and deployment. Renewables Australia will support high priority research and investment with the ultimate aim of progressing new technologies to the market while also lowering the cost of existing renewable technologies. Renewables Australia will also support and advise government, industry and the community in the promotion and development of renewable technologies and relevant research and development in essential renewable-related systems, including renewable energy transmission infrastructure.

There is a clear need to persist with the climate change policy agenda despite the current economic circumstances. The Government is committed to tackling climate change and positioning Australia to prosper in a carbon constrained world. Government senators reject the argument put, not necessarily to this inquiry, but certainly elsewhere, that the global financial crisis means that climate change mitigation efforts should be curtailed or abandoned.

Government senators are of the opinion that there are clear environmental benefits to be derived from the investment the government is making in the programs described above and that any winding back of the stimulus would necessarily involve a significant reduction in those benefits.

Conclusion and recommendation

The series of events that began to unfold in the second half of 2007, the effects of which manifested themselves in most dramatic fashion in the last quarter of 2008 have had in many cases a catastrophic impact on many of the world's advanced economies.

Australia was never immune from the global financial crisis and the government took swift, decisive action to avert its worst effects on the Australian economy and the families who rely on secure, long-term employment for their financial security.

The great weight of the evidence on the effectiveness of the government's fiscal stimulus measures is that the government's approach has been the correct one.

Protracted economic downturns have long-lasting and in many cases, permanent detrimental effects on employment, skills, investment and productivity that can reduce the long-term capacity of the economy. The social and economic costs of recessions are pervasive and lasting.

The government's stimulatory response to the very real threats posed by the global financial crisis has been part of a globally coordinated response to the real-economy collapse that loomed in late 2008. The weight of the evidence put before this inquiry leads government senators to conclude that the government's fiscal stimulus was an appropriate response given the scale and severity of the global crisis.

The stimulus has been designed to have its maximum impact on growth and employment quickly and then to gradually withdraw as private sector activity recovers and the economy strengthens. The design of the stimulus ensures that both arms of macroeconomic policy – fiscal and monetary policy- continue to work consistently during the recovery phase, as they did when the economy turned down.

Government senators are of the opinion that the inquiry demonstrates that in the absence of the fiscal stimulus measures, Australia's overall economic performance over the past year would have been far worse than would have been the case in the absence of any stimulus. Without fiscal stimulus of the scale and structure of that implemented in the past year, there is no doubt that Australia would have experienced a quite severe recession, with all its attendant effects on employment and Australia's longer term economic prospects.

Recommendation 1

Government senators recommend that the government's stimulus packages continue to be implemented to provide appropriate support to the economy and employment.

Senator Annette Hurley

Deputy Chair

Senator Louise Pratt

Senator Doug Cameron