Remarks to Senate Standing Committee on Finance & Public Administration Inquiry into Government Fiscal Stimulus Measures

By Saul Eslake, Chief Economist, Australia & New Zealand Banking Group Ltd (9th February 2009)

I should emphasize at the outset that my participation in this Inquiry is strictly in a personal capacity and that the views I express here should not be interpreted as being those of my employer or any of its executives.

In the last few months it has become increasingly apparent that, notwithstanding its resilience during the first year of the global financial crisis, the Australian economy faces a much bleaker outlook in 2009. The sharp downturn in the world economy, including in particular China and other Asian economies, in the second half of last year and the grim outlook for the major advanced economies in 2009 has greatly increased the risk that Australia, too, will experience a recession this year.

The current downturn in the global economy has a number of features unusual in the post-War era – in particular, the role played in inducing it by the large and protracted decline in asset prices (leading to a sharp increase in households' propensity to save), the impaired condition of much of the world's banking system (severely interrupting the normal process of intermediation between borrowers and lenders), and the risk of deflation (a persistent and widespread fall in consumer prices).

These features make it less likely that the current downturn can be ameliorated, and an eventual recovery induced, by conventional monetary policy responses – chiefly, lower interest rates.

Reductions in official interest rates have not been fully passed on to borrowers (this has been less of an issue in Australia than in other countries); borrowers have been and will be less inclined to respond to lower interest rates by borrowing and spending more, as they might ordinarily do; banks and other lenders have become more cautious about lending, even at lower interest rates; and households and businesses are more inclined to save the cash flow benefit of lower interest rates that do reach them.

Of necessity, therefore, fiscal policy must play a larger role in dealing with the current economic downturn than the conventional wisdom of the last few decades has generally allowed. The advice of international organizations such as the OECD and IMF, which have hitherto traditionally been opponents of active fiscal policy, has recently been quite unambiguous in this regard.

The distinctive features of the current downturn also shape the form which the fiscal policy response should take. In the environment now prevailing, and likely to prevail for some time, income tax cuts are, as with lower interest rates, likely to be saved, especially by those (upper income earners) who typically derive the greatest benefit from tax cuts.

Although there is a strand in the academic economics literature which asserts that people are more likely to spend out of tax cuts which they believe to be permanent, there is no compelling reason to believe that people will regard any tax cuts offered in the present environment (of deteriorating budget deficits) as being permanent, no matter how they are described (and in the Australian context at least some precedents for disbelieving any such assertions).

Hence the most effective fiscal policy response in the current unusual circumstances is likely to take the form of increased government spending. Ideally, as has been emphasized by others (including to this Inquiry), any such increases in government spending should be 'timely' – that is, having their impact at the point when the economy is most vulnerable; 'targeted' – that is, designed so as to derive the greatest amount of benefit in terms of supporting activity and employment for the amount spent; and 'temporary' – so as not to be still providing stimulus any longer than required.

The measures proposed by the Government at the beginning of February amount to about 3½% of one year's GDP (albeit spread out over a number of years), and are thus broadly commensurate with those envisaged, on average, in other countries (as summarized on page 71 of *The Economist* for 31 January).

The Government's proposals broadly meet the 'timely' criterion. Their impact is likely to be felt in the quarter in which the money is initially disbursed, and in the following one or two quarters. Unlike fiscal policy measures undertaken during previous downturns, they have been calibrated to be 'pre-emptive' rather than 'reactive'.

The Government's proposals are also, by deliberate construction, 'temporary'. There are no permanent subtractions from revenues or additions to expenditures, other than the interest associated with the borrowings required to finance the deficits resulting from these measures and the 'parameter variations' to estimates of revenues reported in the *Updated Economic and Fiscal Outlook*.

This is probably the most attractive design feature of the Government's proposals. It avoids the problem of the stimulus continuing after it has ceased to be necessary – and thus adding to upward pressure on interest rates once a recovery has eventually got under way – which has been a failing of previous attempts to use fiscal policy to counter the effects of recession.

Ideally, any suggested changes to the Government's proposals which would entail permanent reductions in revenue or increases in spending (such as an increase in Newstart Allowances or other payments to the unemployed, for which there is an arguable case) should be funded – at least after the present downturn has passed – by reductions in other areas of government spending or by an increase in taxes.

The Government's proposals don't stack up quite as well against the 'targeted' criterion:

- the Government does seem to be unduly focussed on timing major cash handouts so as to minimize the likelihood of consecutive quarters of negative real GDP growth and hence what media commentators, much more so than economists, refer to as a 'technical recession' (I have described this elsewhere as the 'Technical Recession Avoidance Program' or TRAP). The current set of proposals may well succeed in this aim, but to me the objective seems rather spurious;
- the $12.4bn cash grants component of the current proposal is less tightly targeted to those most likely to spend it than the previous (Economic Security Strategy) package. Some of it will go to quite affluent households (including to second income earners in such households) who are more likely to save it than spend it;
- while I don't doubt that the $28bn of infrastructure spending will directly boost aggregate demand and employment in a timely manner, a different emphasis within this component could perhaps have produced greater long-term gains for an equivalent amount of spending.

- it's not clear, for example, that giving every school in the country the opportunity to upgrade or acquire halls, laboratories and libraries (though there are undoubtedly many which are sorely needed) provides the best means of boosting productivity over the long term, or of addressing other long-term challenges such as climate change or altering patterns of water use.

Perhaps the argument in favour of 'small-scale' proposals such as those which make up the bulk of the infrastructure component is that they can be done quickly – ie, there is a trade-off between 'targeting' and 'timely' – and that economic infrastructure objectives will be dealt with in a separate package. However to the extent that the latter is the case, this may have some bearing on judgements about the appropriate size of this particular package.

I conclude with some observations on the impact of the Government's proposals on the condition of Australia's public finances.

The budget deficits envisaged in the *Updated Economic and Fiscal Outlook* are not excessive by historical or international standards. UEFO forecasts the budget deficit to peak at 2.9% of GDP in 2009-10, compared with peaks during previous recessions of 4.1% in 1992-93 and 3.3% in 1984-85, and with the OECD's most recent forecast of OECD area budget deficits peaking at 4.1% of GDP in 2010 (a forecast which does not include the stimulus now close to being enacted in the United States).

The budget deficit may well end up being larger than currently projected if there additional fiscal measures are brought forward or if the economy fares worse than currently forecast, but there is room for that without exceeding previous peaks. And history (which on this point is conveniently summarized in a recent paper by Carmen Reinhart and Ken Rogoff (2009)) suggests that the ultimate fiscal cost of episodes such as the present one ends up being considerably greater if appropriate ameliorative action is delayed.

Likewise the levels of public debt projected in the *Updated Economic and Fiscal Outlook* are not excessive or alarming by either historical or international standards. UEFO forecasts that net public debt will reach 5.2% of GDP by the end of June 2012. Again, it could easily be more than that, especially if the $200bn borrowing limit envisaged in legislation presented to the Parliament is fully utilized. But the UEFO projection compares with the previous peak of 18.5% of GDP in 1995-96, and with OECD forecasts of net government debt of 48% of GDP for the OECD area as a whole (a forecast which is also likely to be an underestimate).

It is of course true that the debt envisaged in the UEFO forecasts will need to be serviced and (perhaps) eventually paid off; and that the scope for doing so through asset sales is considerably less than was the case with the previous peak level of public debt.

It may well be that servicing or repaying the debt incurred now will ultimately require higher taxes. That would be, in many ways, regrettable; but it may also reflect the fact that the tax cuts implemented in the middle years of this decade were only sustainable to the extent that the commodities boom which largely paid for them continued (which it hasn't). I would also argue that a modest increase in debt now and (if necessary) taxes later is preferable to much larger increases in debt and taxes (to say nothing of other policies that could be characterized as 'frankly, bad') which might eventually prove unavoidable if the economic downturn were to be come much worse as a result of policy inertia.

Reference:

Reinhart, Carmen and Rogoff, Kenneth (2009) 'The Aftermath of Financial Crises', Paper presented to the American Economic Association, 3 January, available at http://www.economics.harvard.edu/faculty/rogoff/files/Aftermath.pdf.