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25 September 2009

Senate Economics Committee
Department of the Senate
PO Box 6100
Parliament House
CANBERRA CT 2600

Inquiry into the Government's Economic Stimulus Initiatives

Dear Sir

Ai Group welcomes the opportunity to provide input into this important inquiry into the Government's economic stimulus initiatives.

Ai Group supported the initial stimulus measures announced in October 2008. In our pre-budget Submission of January 2009 we called for further measures in light of the severity of the Global Financial and Economic Crisis (GFEC) and we welcomed the announcement of the further measures early in 2009.

Our calls for, and support of, decisive stimulus measures reflected the strength of our concerns about the impact on credit markets, confidence and global demand of the financial market shocks up to and including those in September 2008. We thoroughly supported the case for strong government intervention in the economy to support demand and to put a floor under the sudden erosion of confidence.

The fiscal stimulus measures adopted since October 2008 have been appropriate, timely, well targeted and effective. Further, our assessment of the current state of the economy is that, although it shows some promising signs, many of the positive features appear to be the result of the stimulus itself (both here and abroad) and that withdrawing measures or reversing domestic measures at this stage would jeopardise the sustainability of recovery. I attach a short note prepared by Ai Group's Economics team in support of these broad points.

That is not to say that Ai Group takes such significant outlays of taxpayers' money lightly or that we underestimate the size of the task involved in returning to sustainable budgetary settings. On the contrary, the sizeable budget deficits we are now confronting will call for the exercise of very firm fiscal discipline for many years. In fact on 7 May this year, ahead of the May Budget, I wrote an opinion piece in *The Australian* in which I drew attention to the importance of putting in place a credible plan to return the budget to operational surpluses. I attach a copy of that opinion piece for your information.

In Ai Group's comments on the Federal Budget, we reinforced the importance of this in making the following points:

> *[t]he Government has mapped a strategy for returning the Budget to surplus over a period that is comparable with the experience of previous recessions. There are risks to the growth rates projected beyond 2009-10 and our assessment is that more savings may be needed to address these risks.*

Naturally the risks to growth in the years beyond the current year remain relevant and they may well call for a degree of spending constraint and tax measures that ensure the budget recovery remains on track.

In this regard we also emphasise the important role that expanding the productive capacity of the economy can play in assisting fiscal consolidation. This adds further weight to Ai Group's longstanding view that Australia needs to pay considerably more attention to raising its productive capacity. A more productive, faster growing economy will assist in restoring the strength of our budgetary position as well as equipping us to better manage the demographic, competitive and environmental challenges ahead.

Yours sincerely

Heather Ridout
Chief Executive

ATTACHMENT

FISCAL POLICY SINCE OCTOBER 2008 AND ITS IMPACTS

The fiscal stimulus measures adopted since October 2008 have been appropriate, timely, well targeted and effective. Our assessment of the current state of the economy is that, although it shows some promising signs, many of the positive features appear to be the result of the stimulus itself and that withdrawing measures or reversing them at this stage would jeopardise the sustainability of recovery.

That is not to say that we take such significant outlays of taxpayers' money lightly or that we underestimate the size of the task involved in returning to sustainable budgetary settings. On the contrary, the sizeable budget deficits we are now confronting will call for the exercise of very firm fiscal discipline for many years. They also provide further weight to our arguments that Australia needs to pay considerably more attention to raising its productive capacity. A more productive, faster growing economy will assist in restoring the strength of our budgetary position as well as equipping us to better manage the demographic, competitive and environmental challenges ahead.

Some Complexities

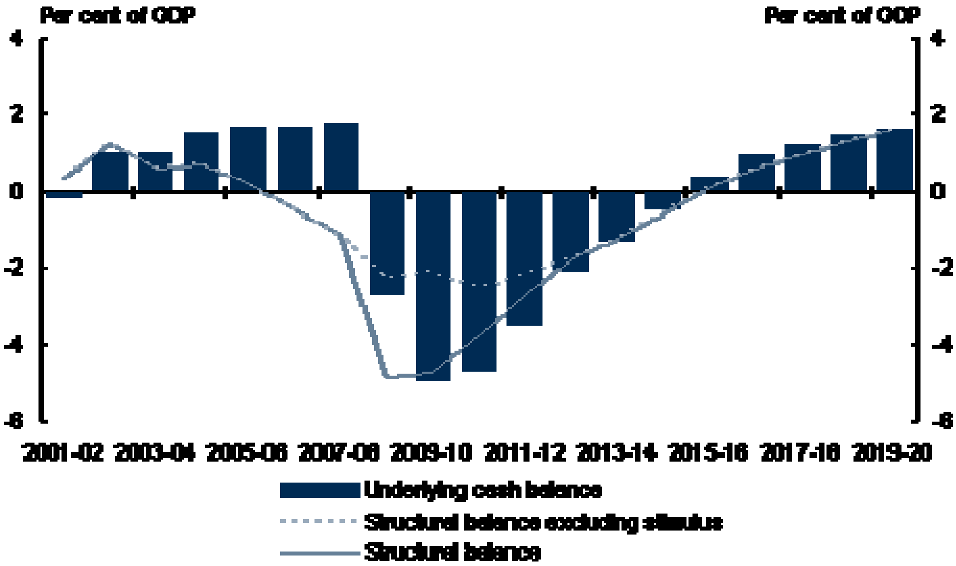
Fiscal policy measures since October 2008 have included a range of measures aimed at providing shorter-term stimulus in the face of the Global Financial and Economic Crisis (GFEC); the implementation from 1 July 2009 of previously-announced reductions in personal income taxation; a sizable increase in age pension payments; increased transfers to the States and Territories as a result of changes to intergovernmental arrangements and a very substantial program of infrastructure investment.

In Ai Group's view a significant proportion of these measures would have been pursued in the absence of the GFEC although in some cases the timing of expenditure may well have been brought forward in the face of the GFEC. This proportion includes the income tax cuts; the pension increases; the changes to COAG arrangements and a large share of the infrastructure investment. For many of these measures, in particular the investments in infrastructure, their rationale and impact does well beyond the provision of counter-cyclical stimulus to demand reaching well into the structural realm of expanding the productive capacity. This complicates the assessment of the fiscal policy measures introduced since October 2008.

Further complexities arise because the overall budgetary outcomes reflect a mix of stimulus and structural features and mix automatic stabilisers with discretionary policy actions.

The relative importance of the structural and stimulus elements are summarised in the following chart.

Chart 1: Structural Budget Balance



Source: 2009-10 Budget Papers Budget Paper No. 1, Statement 4

Economic Impact of Stimulus Measures

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Our calls for, and support of, decisive stimulus measures reflected the strength of our concerns about the impact on credit markets, confidence and global demand of the financial market shocks up to and including those in September 2008. We thoroughly supported the case for strong government intervention in the economy to support demand and to put a floor under the sudden erosion of confidence.

Looking back with the benefit of hindsight, albeit limited to less than a year, we note that the overwhelming view of international agencies is that in both an absolute and comparative sense, the Australian stimulus has been appropriate and effective.

In its assessment of August 2009, the IMF Executive Board:[1]

> *welcomed the targeted, temporary fiscal stimulus, which is expected to support domestic demand in 2009 and 2010. Given low public debt, they generally considered that there remains scope for further fiscal stimulus if warranted by circumstances*.

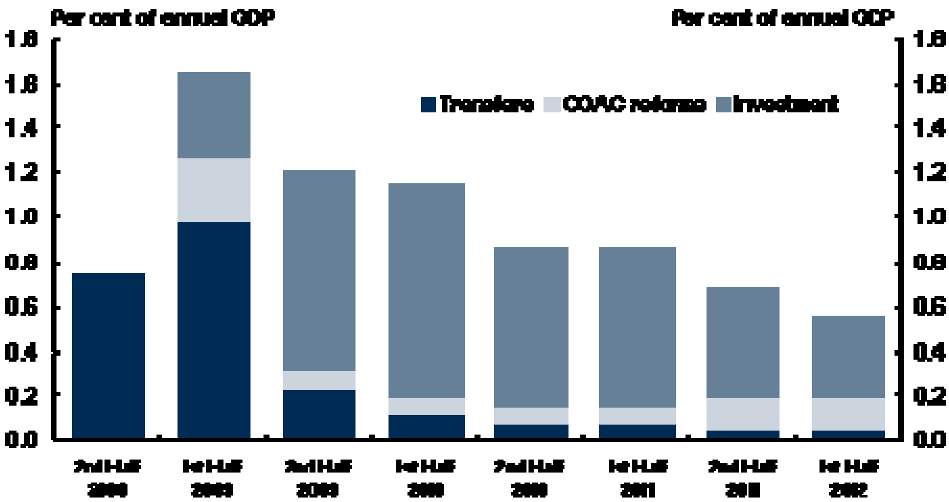
[1] IMF Executive Board, Public Information Notice No. 09/101, August 7, 2009

Based on the May 2009 Budget estimates, the International Monetary Fund (IMF) has calculated that the federal stimulus over the years, 2008 to 2012, is equivalent to 7.9% of GDP, with the largest spending budgeted for 2009 and 2010. The components and spread across the years to 2012 of this analysis is reproduced below.[2]

	2008	2009	2010	2011	2012	Cumulative
Transfers	0.8	1.2	0.2	0.1	0.1	2.4
Public Investment	0.0	1.2	1.7	1.2	0.4	4.5
Public Spending	0.0	0.4	0.1	0.2	0.1	0.8
Private Investment	0.0	0.1	0.1	0.0	0.0	0.2
Total	0.8	2.9	2.1	1.5	0.6	7.9

This is further highlighted in the chart below, which shows the main annual breakdown of expenditure by major activities. As the following chart highlights, while much of the once off cash payments and bonuses are distributed by 2009-10, the next wave of community and major infrastructure projects flow through to 2011-12.

Chart 2: Composition of Fiscal Stimulus



Source: 2009-10 Budget Papers Budget Paper No. 1, Statement 4

It is important to note the large share of the fiscal stimulus allocated to infrastructure spending. While this investment will deliver a demand-side stimulus to the economy, it will also play its role in expanding the capacity of the economy to meet that supply.

The IMF has modeled the impact of the Government's plan on the economy, which is estimated will deliver a cumulative impact after 5 years of about 9.5% to 10 percentage points of GDP. There is considerable uncertainty about this estimate which lies in range of estimates of between 5.25 and 12.75 percentage points.

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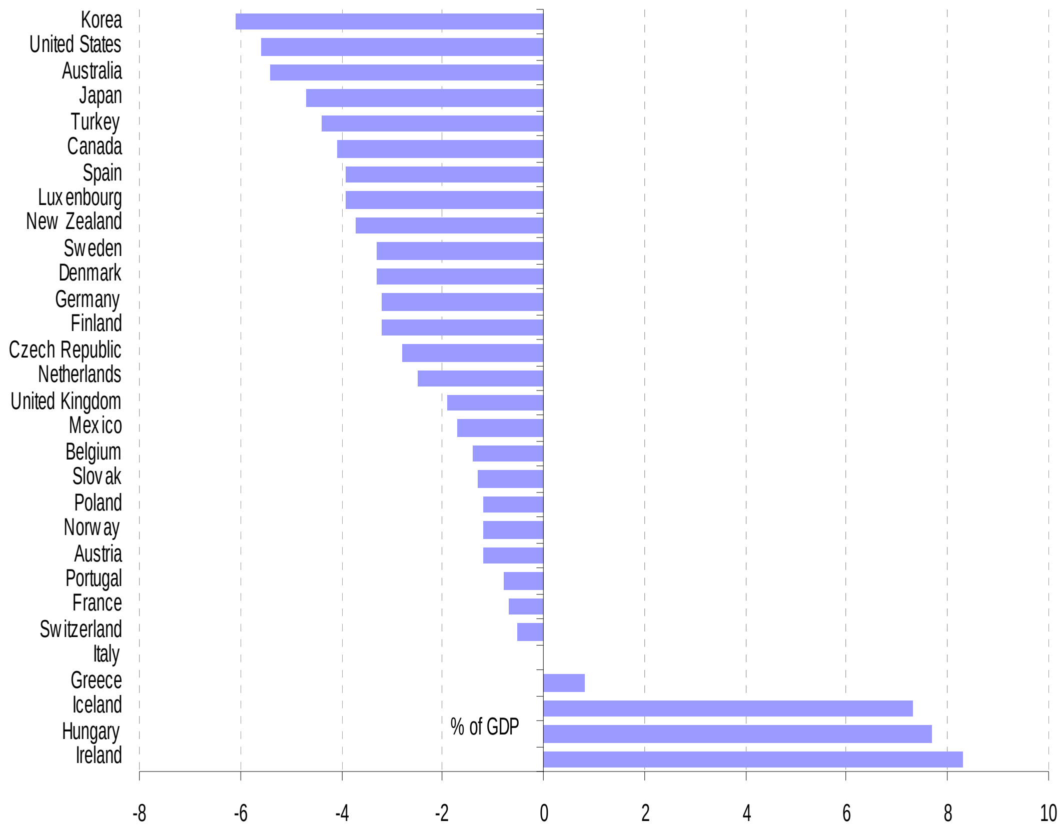
[2] IMF, Australia: Selected Issues, IMF Country Report No.09/249, August 2009, p.6.

The IMF regards the mid-range estimate as the most plausible for Australia, but does acknowledge that the largest (upper bound) estimate is not outside the realm of possibility, "particularly if the infrastructure projects are targeted towards areas where bottlenecks have constrained the commodity sector."[3]

Some comparisons

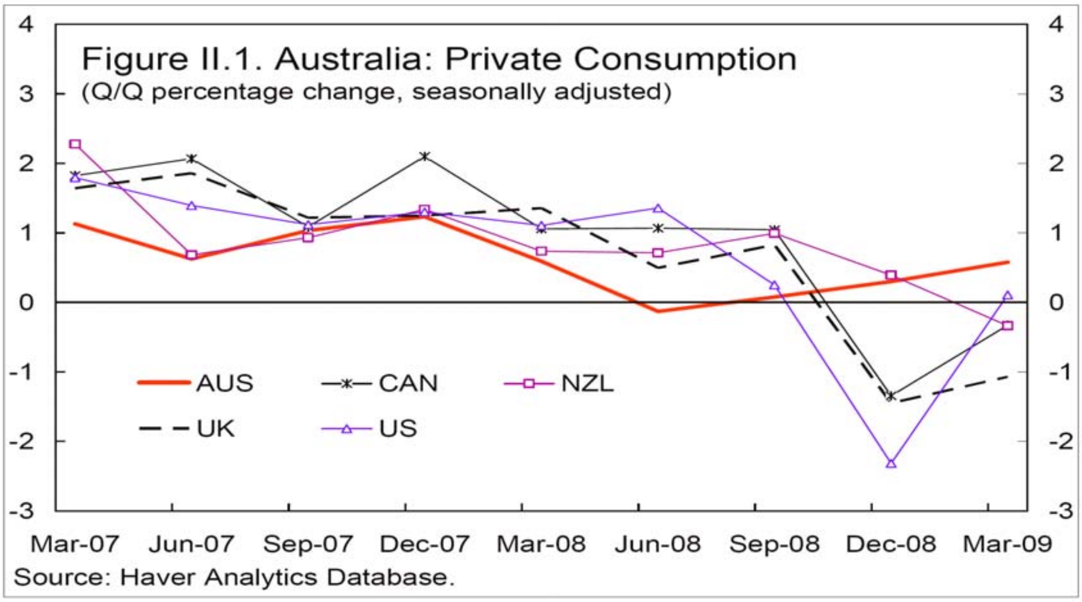
While it is certainly true that Australia's fiscal stimulus as a percentage of GDP is certainly larger than that of most other developed nations, as highlighted in the chart below showing the net effect of fiscal packages (counting both spending and tax measures) using OECD data, it has had the desired effect of preventing Australia from falling into a technical recession, the only developed nation that has avoided this outcome from the global economic and financial crisis.



One key measure impact of Australia's timely and decisive fiscal action can be seen from the chart below, which highlights the percentage change in consumption expenditure for Australia and a number of other OECD countries. Consumption is a key driver of GDP growth, and it has been the impact of the global economic and financial crisis on consumption spending that has marked (along with rising unemployment) recessionary conditions in many countries.

3 IMF, Australia: Selected Issues, IMF Country Report No.09/249, August 2009, p.6.

The cash and benefits payments made to households in late 2008 from the first stimulus package ensured that consumption expenditure continued to grow throughout the second half of 2008 and into 2009 compared to the rapid decline in consumption growth seen in many other countries. It partly contributed to Australia avoiding a technical recession.



Indeed, the second stimulus package appears to be “written all over” the June 2009 quarter National Accounts. The strongest consumption expenditure growth since December quarter 2007, in the middle of the global recession, was undoubtedly aided by the second stimulus payments.

Indeed, the spikes in retail spending growth in November 2008 and May 2009 were testimony to the follow-on effects of the stimulus payments on household spending. Further, continued growth in business investment (despite most economic forecasters expecting a decline) was boosted by the tax incentives offered by the Government to small business and other businesses for capital expenditure (see Ai Group survey data findings in next section). As indicated in the table below, these two factors alone contributed 0.8 percentage points to economic growth in the quarter, and helped to offset the negative impacts of lower dwelling investment and net exports.

	Quarterly growth (%)		Yearly growth (%)	Cont'n to quarterly growth (ppt)
	Jun-09	Mar-09	Jun-09	Jun-09
Household consumption	0.8	0.5	1.7	0.5
Dwelling investment	-5.5	-4.0	-10.9	-0.3
Business investment[1]	2.0	-6.5	-0.9	0.3
Public demand[1]	0.8	-0.6	2.6	0.2
Domestic demand	**0.8**	**-1.1**	**0.7**	**0.8**
Change in inventories	-	-	-	0.2
Gross national expenditure	**1.0**	**-0.9**	**-0.4**	**1.0**
Exports	1.0	2.0	-0.2	0.2
Imports	2.1	-7.6	-13.1	-0.5
Net exports	-	-	-	-0.2
Real GDP (E)	**0.7**	**1.2**	**2.9**	**-**
Statistical discrepancy	-	-	-	-0.1
Real GDP (A)	0.6	0.4	0.6	-

1 Excluding transfers. Source: ABS and ANZ

To date Australia has not seen net job losses to the extent anticipated not to the extent apparent in many countries.

A considerable proportion of this can be traced to the impacts of stimulus measures and in the sectors where they have had greatest impact to date.

In retail trade, after experiencing net job losses throughout much of 2008, in the six months to May 2009, there has been a net gain of 15,000 workers. Similarly, in wholesale trade there was been a net gain of 6,000 jobs over the same period, after experiencing declines in the previous six months. In construction, a traditional source of net job losses in previous recessions, the combined stimulus effort has contributed to no net job losses over the last year and a half, with a net addition of 5,000 jobs in the six months to May 2009.

Net job losses have largely been confined to mining, manufacturing, real estate and professional services. Without the Government's and RBA's prompt efforts, net job losses would most likely be higher. Treasury for example has estimated that without the economic stimulus, around 210,000 more Australians would be out of work by next year and the unemployment rate would peak 1.5 percentage points higher.

While fiscal and monetary policy has acted as one in getting the job done and making the economic downturn modest by past and overseas experience, the Australia economy is a long way a way from a sustained and robust recovery.

As the Acting Head of the Economics Department of the OECD recently stated:[4]

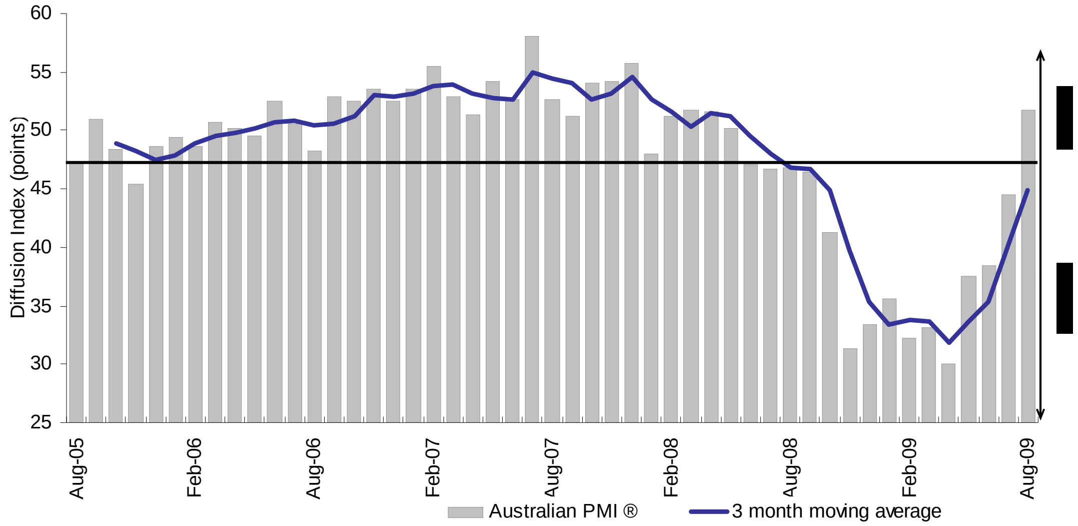
> *With a nascent recovery hopefully in sight it would be tempting to relax the extraordinary policy effort of the past nine months. Tempting, but wrong. Not only because post-crisis policy strategies need preparing but also because there is still more policy can do to ensure a faster and more robust recovery.*

Ai Group's Sectoral Performance Indicators

Ai Group's monthly surveys across the manufacturing, services and construction sectors are showing signs of improvement (although declines continue to be reported in the services and construction sectors). Nevertheless, the signs of improvement are yet to warrant the conclusion that we have reached a self-sustaining recovery.

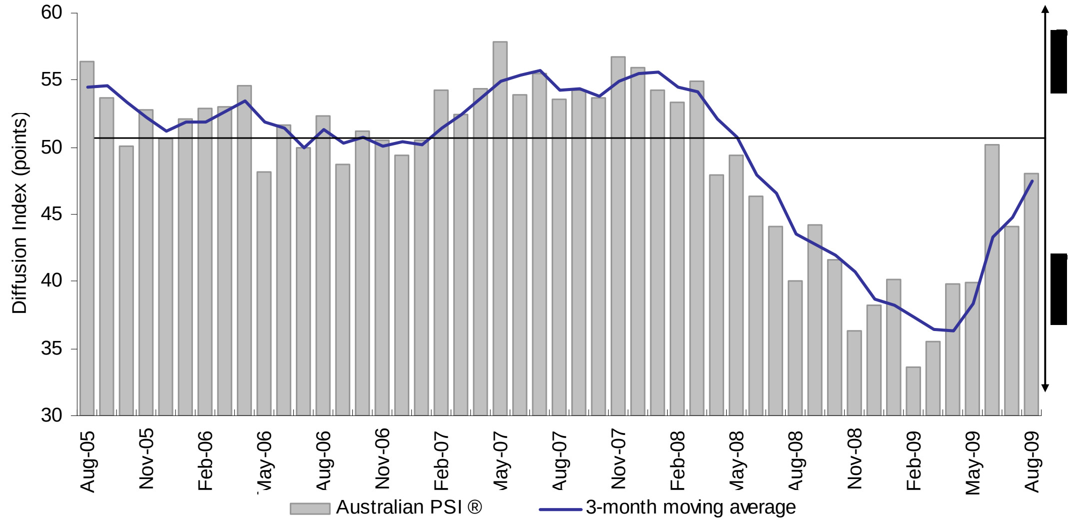
The common thread across Ai Group's monthly measures of industry performance, the Performance of Manufacturing, Services and Construction indices (Australian PMI®, Australian PSI® and Australian PCI®) is that all sectors have seen significant falls in activity. The declines in activity began in 2008 - in mid-2008 in manufacturing and services and a little earlier, in early 2008, in construction.

Ai Group Performance of Manufacturing Index

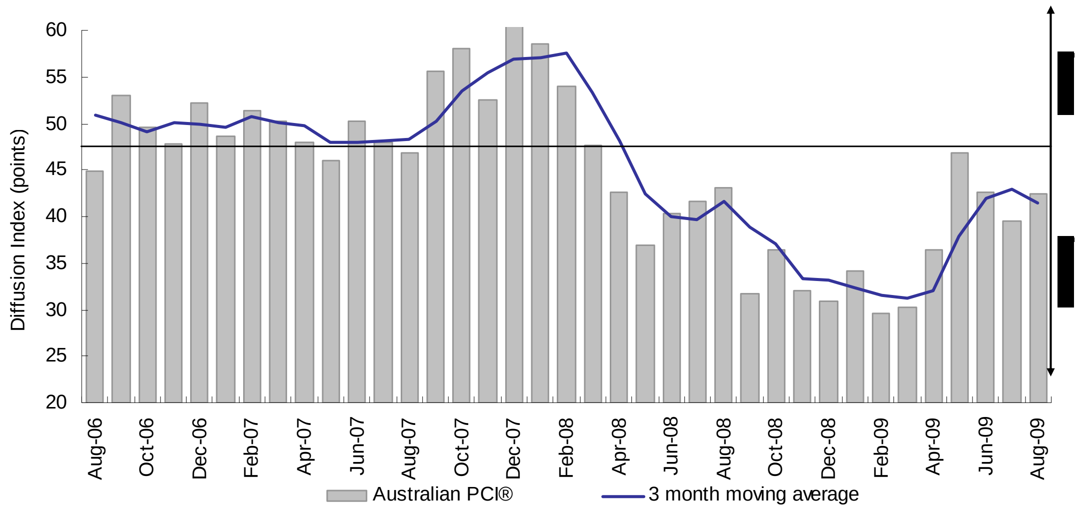


4 OCED Economic Outlook, June 2009, p.8

Ai Group Performance of Services Index



Ai Group Performance of Construction Index



The decline in all three sectors was initially associated with the RBA's decision to lift interest rates sharply throughout 2007 and into early 2009, as it attempted to slow the economy and take pressure off inflation. The declines accelerated sharply in the aftermath of the global financial crisis and were were steepest in the first four months of 2009 across all three sectors.

Since then, and reflecting the impact of low interest rates on interest rate sensitive sectors such as consumer demand and housing; the Government's cash payments to taxpayers and the boost to the first home buyers grant, the rate of decline in activity has decelerated.

There have been some signs of a stabilisation in the levels of activity in the manufacturing sector with the Australian PMI® breaching the 50 point level separating expansion from contraction in August for the first time in fifteen months.

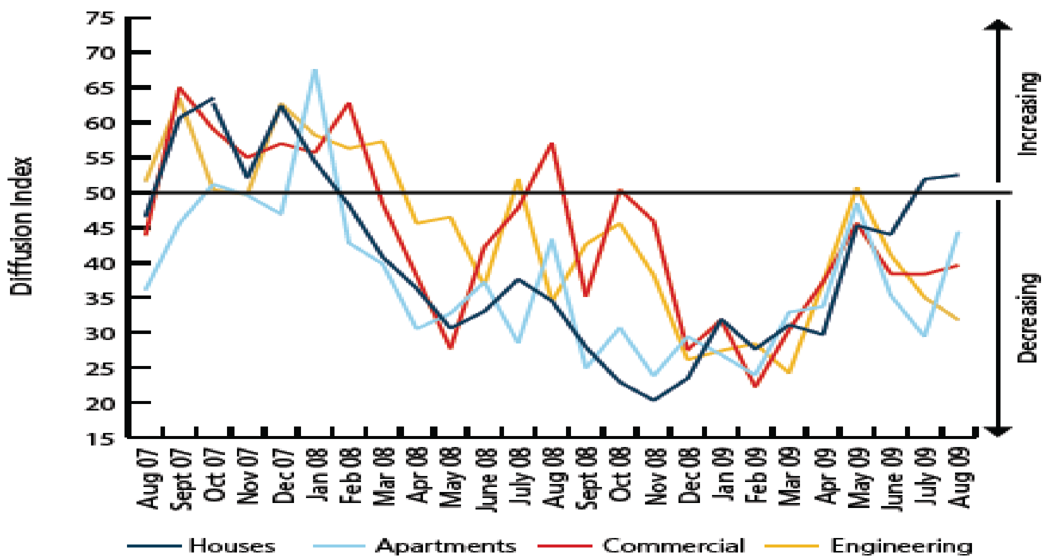
This improvement reflects in part a significant rise in consumer-driven sectors including clothing and footwear and food and beverages and interest rate sensitive areas such as construction materials.

Similarly, in terms of the services sector, since the March quarter the decline in activity has decelerated. According to survey respondents, this reflects benefits from improvements in consumer and business confidence, business investment, and housing sector conditions, illustrating the continuing role of monetary and fiscal stimulus in supporting the economy.

Sectors which have seen significant improvement in new orders include the consumer driven accommodation, cafés & restaurants and personal & recreational services sectors and the interest rates driven property & business services sector.

The construction sector has seen a more moderate improvement in conditions with activity falling at a less steep rate since the June quarter 2009. This has been driven largely by an improvement in the housing sector, which saw two months of rising activity to August 2009, and a sharp reduction in the rate of decline in apartment activity. Both these sectors have benefited from low interest rates and the boost to the first homebuyer subsidies.

Ai Group indices for construction sector activity



Commercial and engineering construction activity remains very weak; though this may be expected to improve as government boosts to infrastructure spending have a stronger impact on the economy into 2010.

Other Ai Group research

In conjunction with American Express, Ai Group released a report, *Looking towards the upturn – business strategies and priorities* in August 2009.

A key finding of this report, which is in line with the indications drawn from the sectoral performance indices, is that one in every six respondents believed that an improvement in business conditions was already underway, with a further one-quarter of all respondents expecting an improvement in economic conditions in either the third quarter (10.5%) or fourth quarter (14.7%) of 2009.

The first and second quarters of 2010 are equally popular responses, with 16.4% and 16.0% of companies anticipating an improvement in these periods respectively.

The important role of policy was reinforced by the finding that the Federal Government's Small Business and General Business Tax Break initiative has influenced the investment plans of almost 30% of respondents.

The impact of the Government's investment incentive has been most evident in terms of new car sales. With sales of motor vehicles in free fall from throughout 2008 and into the early months of 2009, declining by 23%, new car sales have recovered considerable lost ground since April, with a 14% jump by June 2009 (easing back to a 7% increase in July).

The Outlook for Recovery

The signs of improvement in conditions in the manufacturing, services, and construction are positive and the relevant indices have been improving on trend since the end of the March quarter.

However, given the persistent declines in activity since the first half of 2008, activity remains at relatively subdued levels and there are a number of important risks around the potential for a sustained rise in activity across industry sectors.

- The improvement in conditions reflects the substantial policy stimulus in place since the second half of 2008. The importance of policy is emphasised in recent official retail sales data, which has shown some weakness since the impact of the government's taxpayer cash payments has begun to fade. Too early a removal of policy stimulus risks weaker domestic demand growth.

- In terms of improvements in consumer and housing demand, there is a risk that the expected upwards drift in the unemployment rate and associated reduction in the sense of job security may make consumers and homebuyers more cautious – particularly if this occurs during a period when official and/or commercial interest rates are rising.

- The global economic recovery remains uncertain, particularly among the developed economies. In part, this reflects the ongoing uncertainty in major financial markets, which has constrained credit availability and increased finance costs. This global market uncertainty has been reflected in Australian credit conditions and availability, though to a lesser extent than overseas. Market participants expect global financial market uncertainty to persist at least over the balance of this year making the likelihood of a fragile global economic recovery the most likely scenario.

- While developing economies in Australia's region have shown strong growth, this has been driven by strongly expansionary policy settings. This is particularly the case in Australia's main trading partner China, where growth has reflected stimulatory monetary policy, part of which has leaked into rising asset prices, and infrastructure spending. Chinese consumer demand remains constrained. Furthermore, the weakness in developed economy markets also places a significant constraint on export driven demand in some of Australia's key markets, including China and Japan. Net exports have been a key, though unexpected, driver of Australia's better than expected performance since the onset of the global financial crisis.

As well, Australia's strong dollar is acting to both put a brake on Australia's export growth potential and constrain overall demand growth.