



28 September 2009

Opening Statement to Senate Economic Committee Inquiry into the Government's economic stimulus initiatives

by Rory Robertson (desk +61 2 8232 5128; mobile 0414 703 471)

Introduction

Good afternoon Mr Chairman and Senators. My name is Rory Robertson. I work as an economist at Macquarie Bank here in Sydney, and appear before the Committee today as someone whose job for more than two decades has been to observe and analyse the economy, financial markets and macroeconomic policy.

For the record, I worked for six years from 1988 as an economist with the Reserve Bank of Australia in Sydney, followed by a decade and a half in the finance sector as an economist at Bankers Trust and now Macquarie Bank, including my first four years with Macquarie (from 1999) based in New York.

Thank you for your time this afternoon, Mr Chairman. I'm appearing today in response to an informal invitation from the Secretary of this Committee. I don't claim to have a particular expertise on fiscal policy, but I'll do my best to explain the extraordinary economic situation in which it has been operating over the past year.

In my opening statement, I plan to discuss the macroeconomic backdrop, make some observations about the size and timing of the fiscal measures, and finish with a brief discussion on RBA policy and the exchange rate. I have a chart-set available to aid this discussion.

It is a pleasure to be here in front of you this afternoon, although if I had known ten days ago that the Governor of the Reserve Bank was going to open the batting today, I would have worked hard to find a convincing reason not to be available.

Appearing today after the RBA and the AOFM is a tough gig. I'll do my best but I doubt I'll be able to tell you much that is useful that you haven't already heard.

I have no strong axe to grind, except to argue that policymakers across the world were right to use all available measures to limit the risk of another Great Depression.

Extraordinarily sharp global downturn

As you are aware, following the collapse of Lehman Brothers in mid-September last year, global output, industrial production and trade cratered as almost never before.

The US economy – still the biggest economy in the world – and many others have suffered their most severe recessions since the 1930s. The US unemployment rate is heading into double-digits and seems likely to remain painfully high for many years.

Until at least March or April this year, policymakers across the globe felt they were dealing with the threat of a severe global recession morphing into another Great Depression.

Unlike some of the academic economists who appeared before this Committee in Canberra last week, I believe the threat of economic disaster was real, and that Australian policymakers - like most of their counterparts across the world - moved macroeconomic policy sharply in the right direction

Simply, my attitude is that it made sense for policymakers everywhere to use all available counter-cyclical tools in an urgent attempt to lessen the serious risk of economic disaster.

Moreover, the fact that the Australian economy is doing relatively well at present is not evidence that forceful stimulus measures were not necessary, but that a combination of good management and good luck has limited the damage so far.

The timely and forceful easing of monetary and fiscal policies, the stronger position of Australia's banking system, China's impressive shift in 2009 from bust to boom, and our rapid population growth all appear to be important reasons why Australia has outperformed.

To some extent, timely and forceful action by policymakers "caught" the Australian economy before it hit the ground. The economic story, however, is not all good.

Full-time employment and aggregate hours worked - variables that drive income and financial comfort in most households - have fallen by 3% and 3-1/2% from peak so far, and still are trending lower.

With full-time employment yet to stabilise, the economic recovery underway at present still is rather weak, or at least is only in its infancy.

February fiscal package structured to reduce severity of local recession

Back in early February, just before the announcement of the Government's \$42b fiscal package - its "Nation Building and Jobs Plan" - the RBA cut its policy rate another full percentage point, to 3.25%. (It cut again in April to 3%.)

The four-percentage-point drop in interest rates in the six months to February is by far the most-aggressive easing of RBA policy on record.

With the global situation having gone from bad to worse over our summer, the RBA's fear of severe recession in Australia clearly had intensified.

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.

The basic idea, of course, was that monetary and fiscal policies should work to support confidence and demand while the financial panic ran its course, the private sector "hunkered down" and the global economy contracted for the first time in generations.

As now is well known, the February package involved a "cash splash" worth over 1% of GDP, to be followed by the construction of a new building in each school, as well as a variety of other projects (including increased public and community housing, subsidies for home insulation and hot-water systems, funding to fix road and rail black-spots and tax breaks to prompt the bring-forward equipment investment).

The February package, designed as it was to support aggregate demand as quickly as possible, unavoidably was a "rush job". The second "cash splash" of \$13 billion (following a first-round \$10 billion in December) provided immediate support to consumers, household balance sheets and general economic confidence, with thousands of small and large projects to follow.

With the main boost from the stimulus scheduled to be felt sooner rather than later (Treasury chart), February's package seemed reasonably well-structured to limit the severity of Australia's recession.

A new building in each of almost 10,000 schools - an approach designed to ensure extra economic activity in every community in Australia - appeared as sensible as any of the alternatives on offer, assuming - as most observers did - that Canberra should do something substantial.

Happily, the economic backdrop today is much brighter than it was back in February. Global financial markets and the global economy have stabilised and the threat of Great Depression II has receded.

We will never know how close the global economy and financial system came to catastrophic collapse. I sense we were much closer to the abyss than many realised at the time, and many realise now.

Stimulus size, "value for money", withdrawal

The economic outlook remains uncertain - as always - but it seems rather less dire than it was 6-12 months ago. Australia's recession looks at this point to be somewhat smaller than our previous two recessions. Indeed, rather than shrinking, as earlier expected, GDP is estimated to have grown by 1% over the first half of the year.

There would be a strong case to "withdraw the fiscal stimulus" if the economy were "too strong" and threatening to "overheat". But that scenario remains some way off. Indeed, as noted earlier, full-time employment still is trending lower, and wages growth and underlying inflation still are decelerating.

Given the brightening of the economic outlook since February, however, it makes sense now to put greater weight on "value for money" from the many thousands of projects under way, and less weight on sheer haste to support aggregate demand.

In short, there's now more time available to ensure that the new buildings in our nearly 10,000 schools, and the 20,000 or so new homes set to be constructed, are close to what is needed. Similarly, a sharper cost-benefit pencil can be applied to the larger projects.

Reports of obviously wasteful spending should be investigated and judgements made. I'll leave those judgements to the experts; it (almost) goes without saying that most taxpayers would want to minimise wasteful spending.

On the total cost of the February stimulus package, many have noted that the estimated \$42 billion price tag is a lot of money. And so it is.

But everything is relative and with Federal revenues now around \$300 billion per annum, \$42 billion represents less than 4% of revenue over the standard four-year time frame.

Scaled against the overall economy, \$42 billion amounts about 1% of nominal GDP over four years.

Moreover, with one year's GDP now worth well over \$1 trillion and Budget measures typically costed over four years, fiscal developments in the \$30-60 billion range no longer are particularly unusual (chart).

For example, upside surprises to revenue were worth \$50-60 billion in each of 2005-06 and 2006-07. The *permanent* income-tax cuts announced in May 2006 and May 2007 each were costed in the \$30-40 billion range, *for first four years*.

Other policy initiatives announced over 2006-07 totalled \$38 billion, in what were good economic times. February's \$42b package was more clearly designed to fit the particular economic circumstances of the day, "custom made" as it was to be strongly counter-cyclical.

Importantly, the fiscal boost to growth from February's package is scheduled to peak this year and wind down automatically over the next year or two (Treasury chart, again).

The option of cancelling projects already announced – like reversing earlier tax cuts – would tend to improve the Budget bottom line at the cost of reducing future activity.

That might be a good or a bad idea, depending on your assessment of the particular projects, and your guess on whether the economy will be strong or weak over the next couple of years.

RBA policy and the Australian dollar

It is notable that the RBA's policy rate still is 3%, notwithstanding Governor Stevens having highlighted a desire to start lifting rates back "towards" more-normal levels as soon as the recovery is sufficiently robust.

Moreover, I'm expecting that policy rate will remain at 3% after the RBA Board meets next week, as it would be a rather bold decision for policymakers to start hiking while full-time employment still is trending lower.

Finally, another factor that feeds into the RBA's decisions on interest rates is the exchange rate. As the US dollar trended lower between 2002 and 2008, the Australian dollar trended higher, as did many other currencies.

With the US dollar in recent months hitting new lows for 2009, the Australian dollar has been heading towards 90 US cents and towards 60 on the trade-weighted index.

The appreciating Australian dollar mainly is a function of the depreciating US dollar, the sharp bounce-back in the Chinese economy and global commodity prices, and the general outperformance of the Australian economy.

The fact that the stronger Australian dollar hurts the growth prospects of our tradeables sector - in particular, parts of the manufacturing, agricultural and tourism industries - is one of the reasons why the outlook for employment growth is weak, and why it seems to me that any RBA tightening cycle over the next six months will proceed rather cautiously.

Thank you for your time, and I look forward to answering your questions.

Rory Robertson +61 414 703 471
Interest-Rate Strategist
Macquarie Debt Markets Division (Sydney)



Macquarie Research
Strategy



Chartset for discussion at Senate Economic Committee Inquiry into the Government's economic stimulus initiatives

Rory Robertson

rory.robertson@macquarie.com

0414 703 471

**Interest Rate Strategist
Macquarie Bank**

Sydney

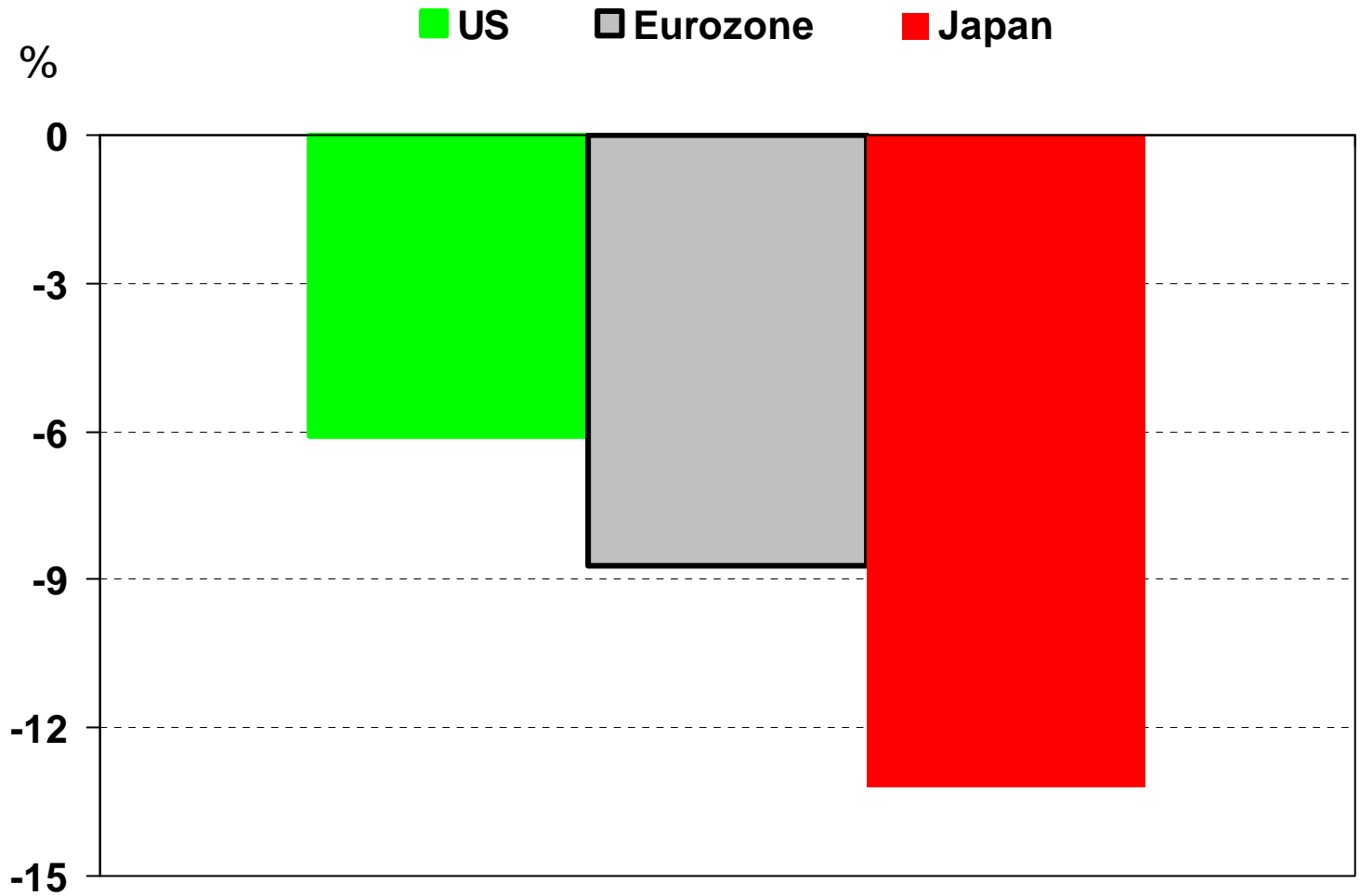
28 September 2009

In preparing this research, we did not take into account the investment objectives, financial situation and particular needs of the reader. Before making an investment decision on the basis of this research, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. Please see disclaimer.



Real GDP growth in Big-3 economies

Annualised drop over Q4 and Q1

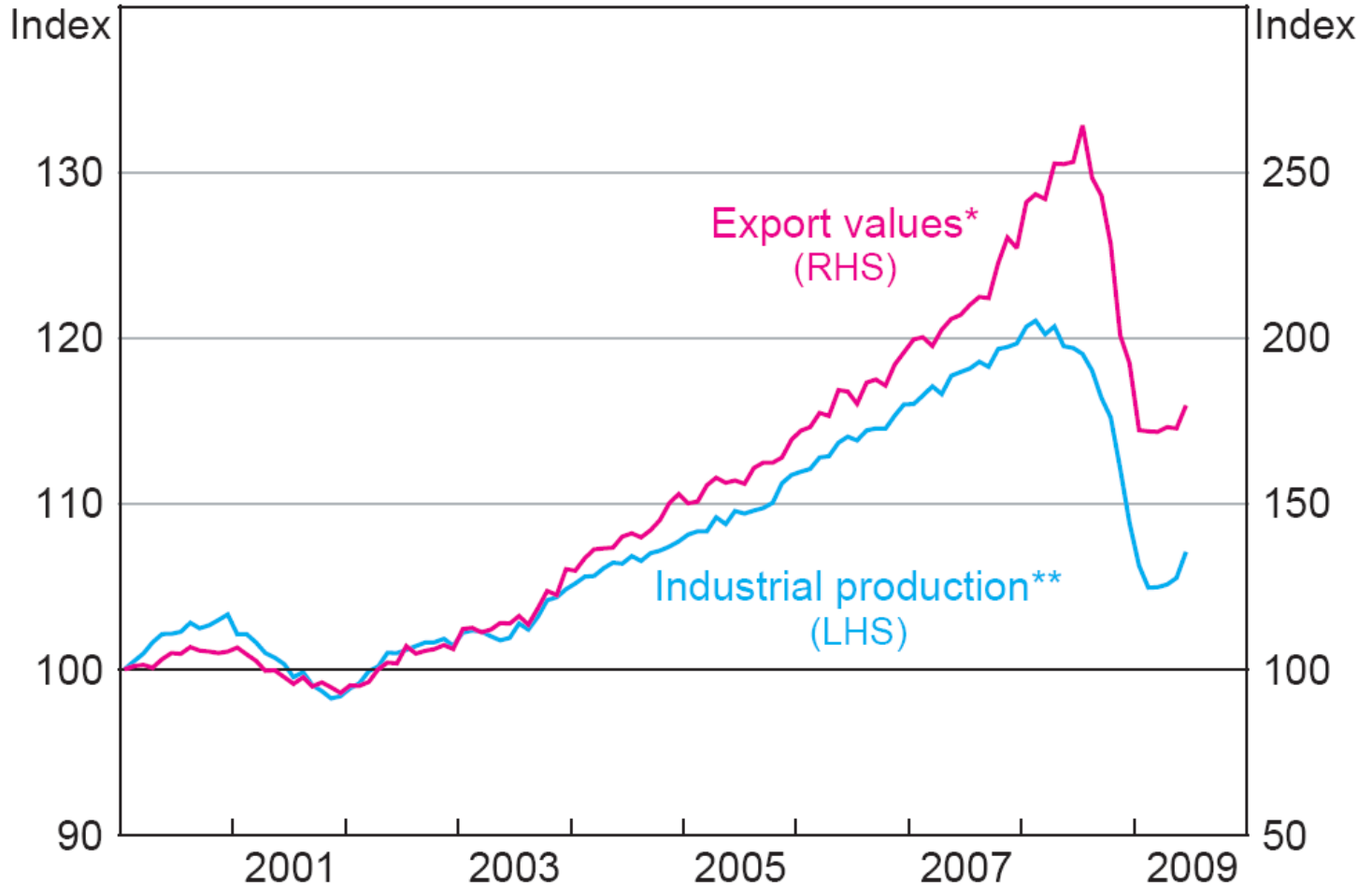


Source: Datastream, August 2009



Global Industrial Production and Exports

January 2000 = 100

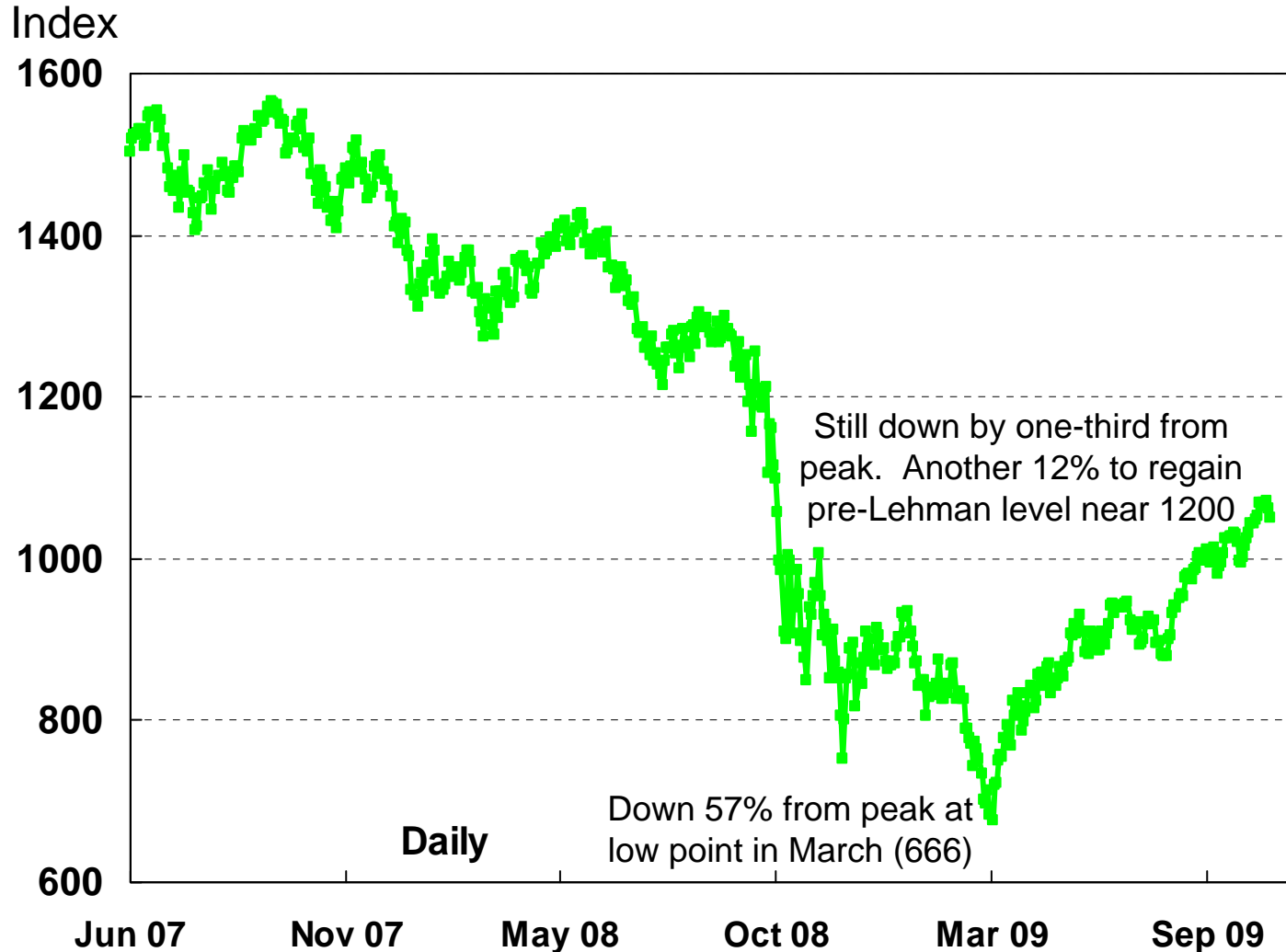


Source: RBA, August 2009



US Equities - S&P 500

(Global equity prices highly correlated with US equities)



Source: freelunch.com, September 2009



Global economy on brink of collapse

- *"I urge the Congress to act quickly to address the grave threats to financial stability that we currently face".*
Fed Chairman Bernanke, 24 September 2008
- *"We literally thought that we were on the verge of the Great Depression, and looking back I think we probably were."*
(Former) US Council of Economic Advisers Chairman Lazear
- *"It was, it is, probably the worst situation... we faced in peacetime".*
UK Chancellor of the Exchequer Darling
- *"...on that Monday and Tuesday [in October 2008] it was not possible even for those two banks [RBS and HBOS] really to be confident they could get to the end of the day".*
BOE Governor King

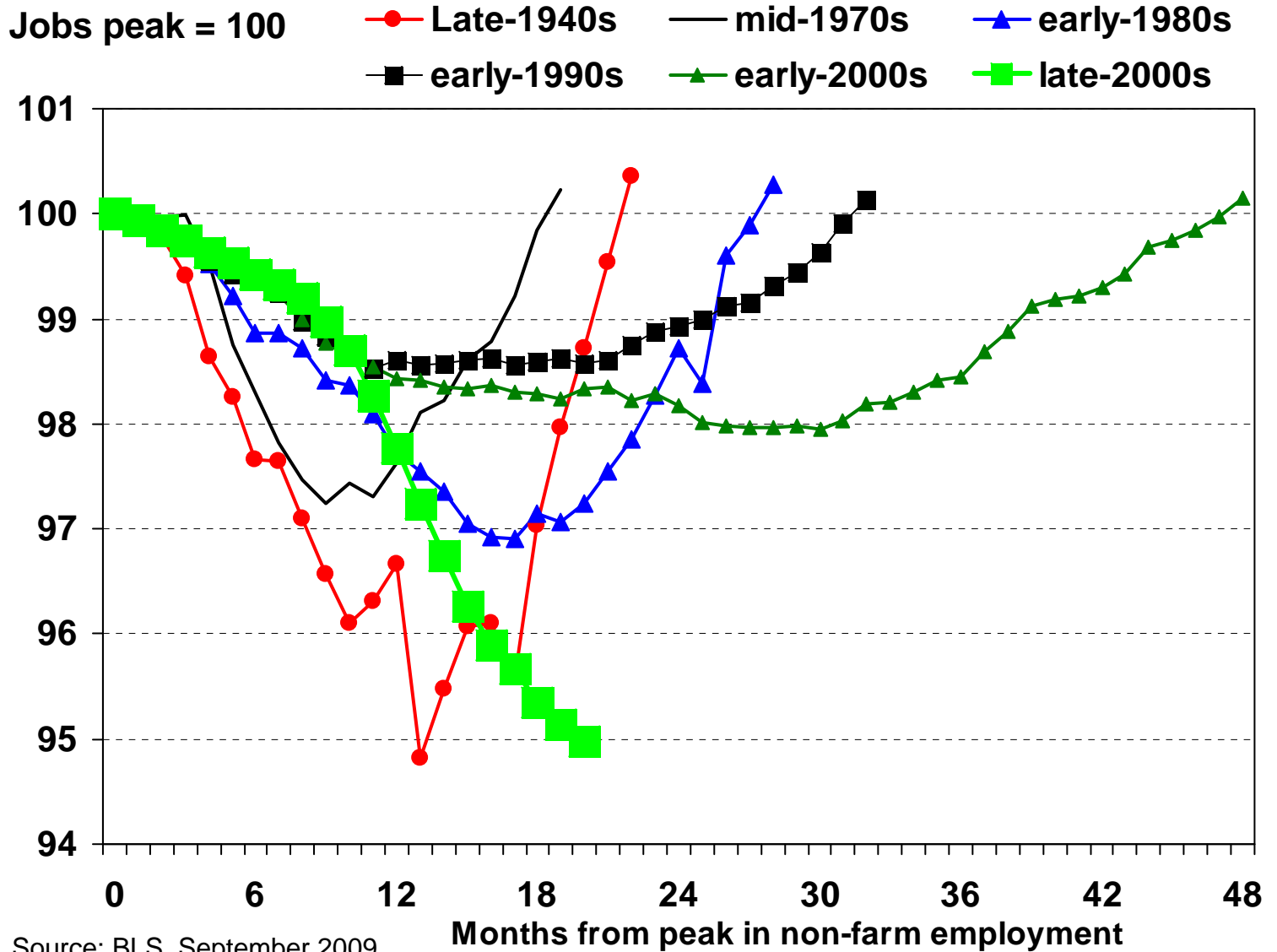
Source: Bloomberg, September 2009



MACQUARIE

Macquarie Research Strategy

Post-war episodes of US job losses





Policies to resist economic disaster

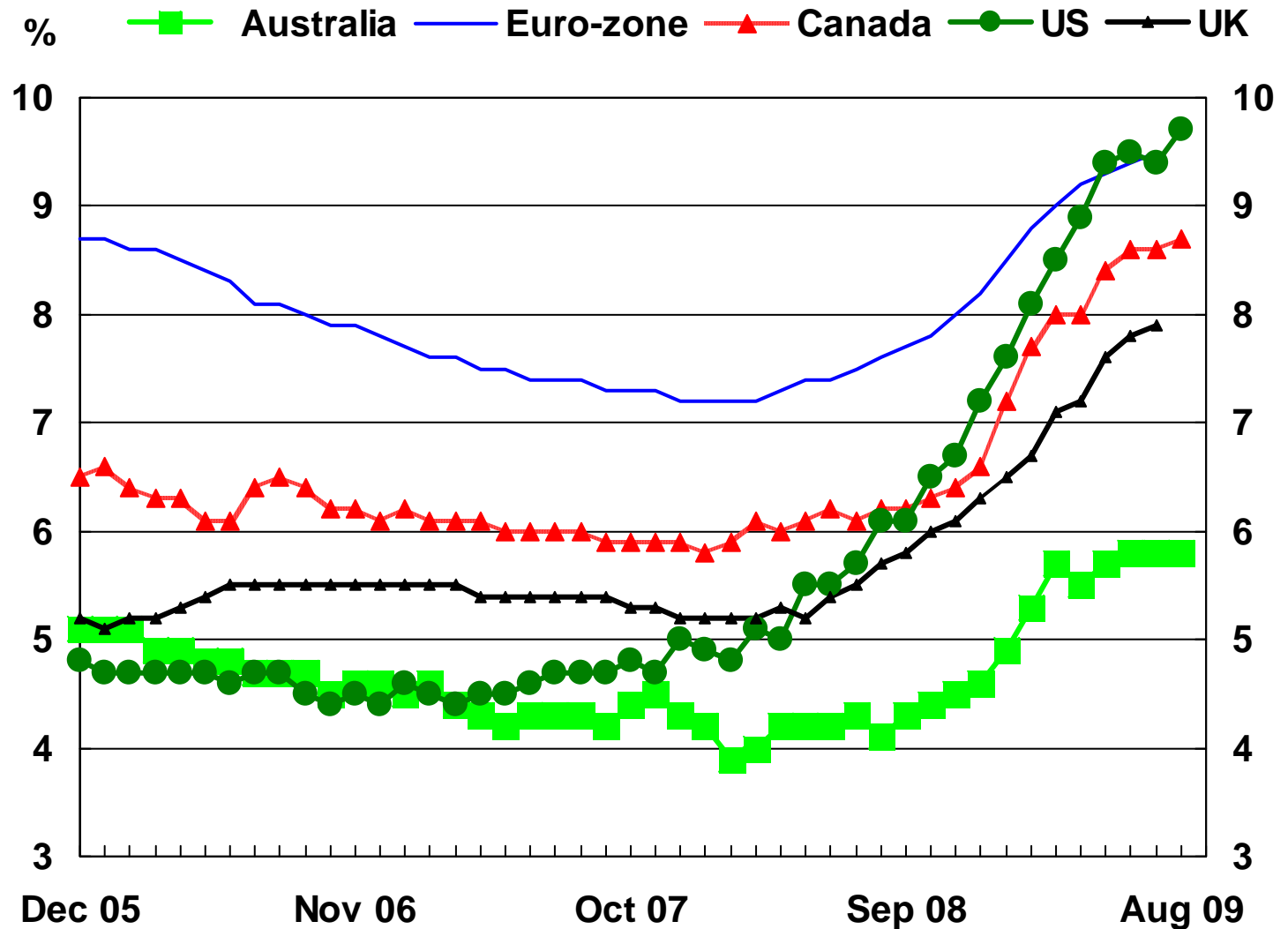
- In general, policymakers everywhere felt they were doing the opposite of what policymakers did in the 1930s
 - i. Governments globally guaranteed core of financial system
 - ii. Central banks globally cut policy rates aggressively to generational lows
 - iii. Central banks globally acted aggressively as “lenders of last resort”, some also introducing “unconventional” measures
 - iv. Governments globally eased fiscal policy, via cash transfers, extra infrastructure spending, tax reductions, etc
- **The aim of the game almost everywhere was to use all available policies aggressively to stabilise the financial system and demand, to avoid Great Depression II**
- **Happily, it’s a case of “so far, so good”**



MACQUARIE

Macquarie Research Strategy

Unemployment story brighter in Oz

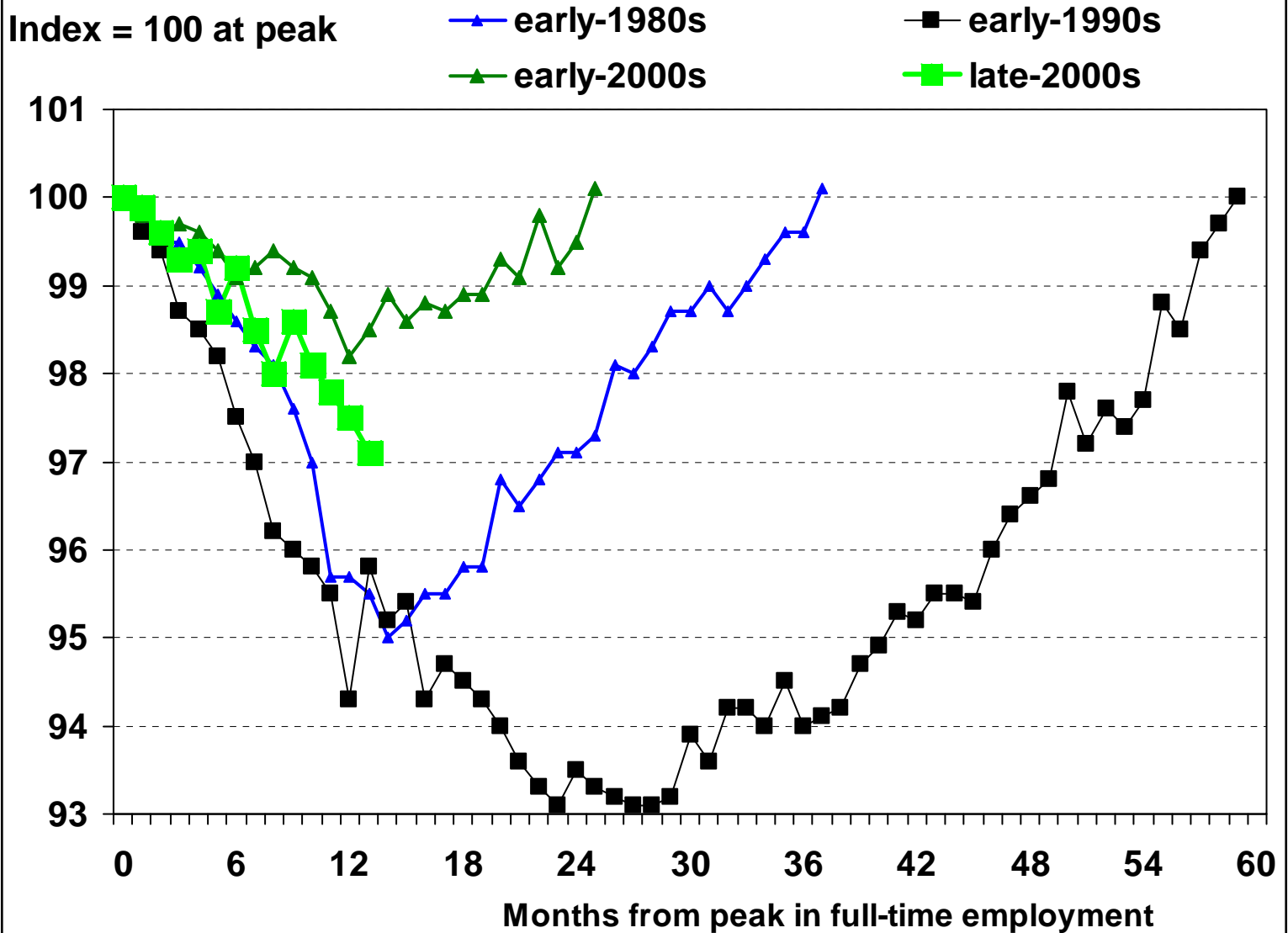


National sources, September 2009



MACQUARIE

Falls in Oz full-time employment



Source: ABS, September 2009



Good management and good luck

- The US and various other economies have suffered their most severe recessions since the 1930s
- Meanwhile, **Australia's late-2000s recession looks to be smaller than our savage recessions in the early 1980s and early 1990s**
- The Australian economy has benefitted from a **combination of good management and good luck**. Key factors limiting our downturn include:
 - Timely and forceful monetary and fiscal policy easing
 - Strong banking system, assisted by prompt and credible government guarantees
 - China in 2009 rebounding impressively from bust to boom
 - Rapid population growth
- To some extent, **policymakers caught our economy before it hit the ground**. Nevertheless, the economy remains weak, with full-time employment and aggregate hours worked still trending lower



MACQUARIE

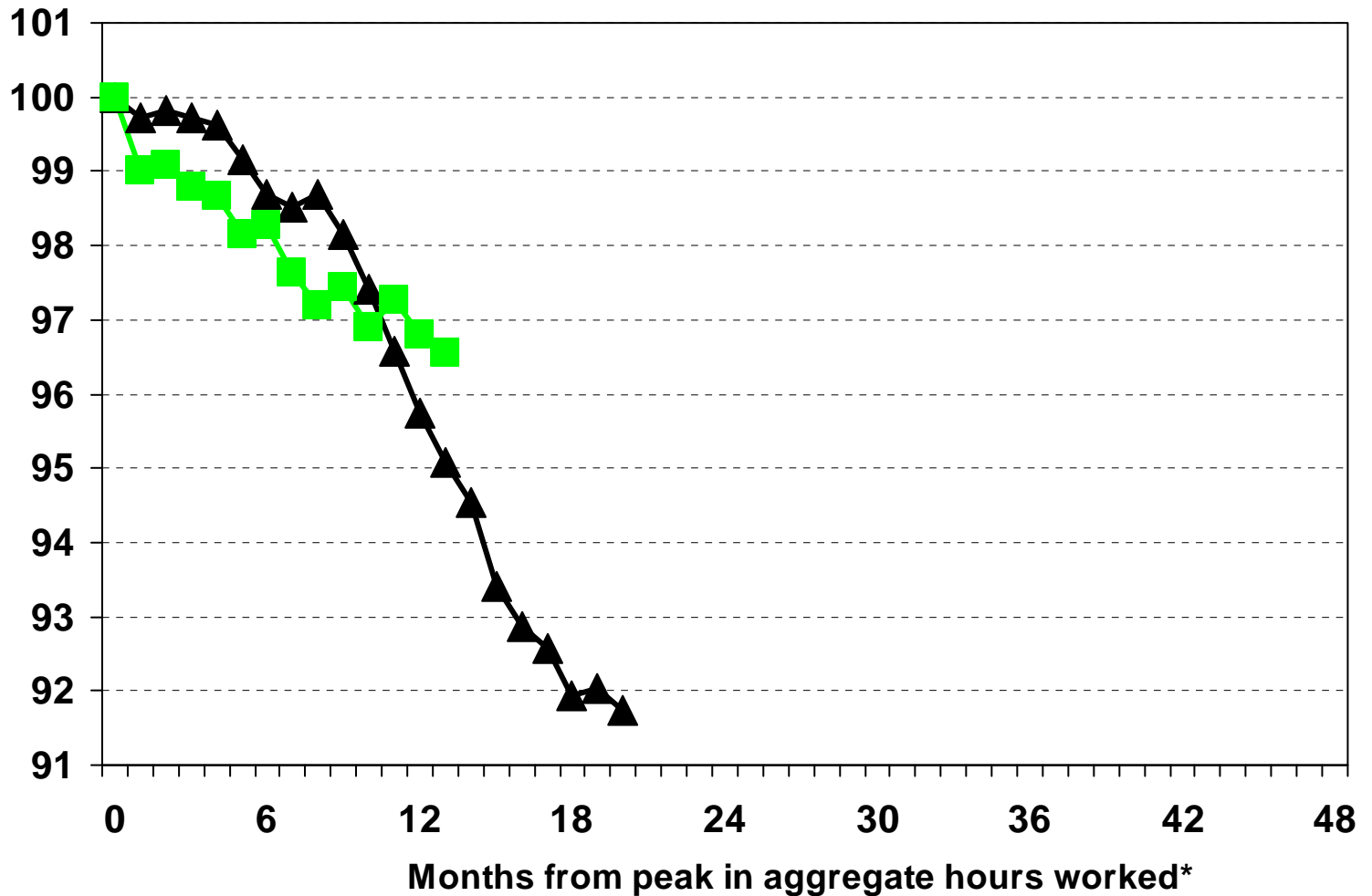
Macquarie Research Strategy

Falls in aggregate hours worked*

Index = 100 at peak

▲ US*

■ Australia



Source: BLS, ABS, September 2009 *US figures are for private sector only



MACQUARIE

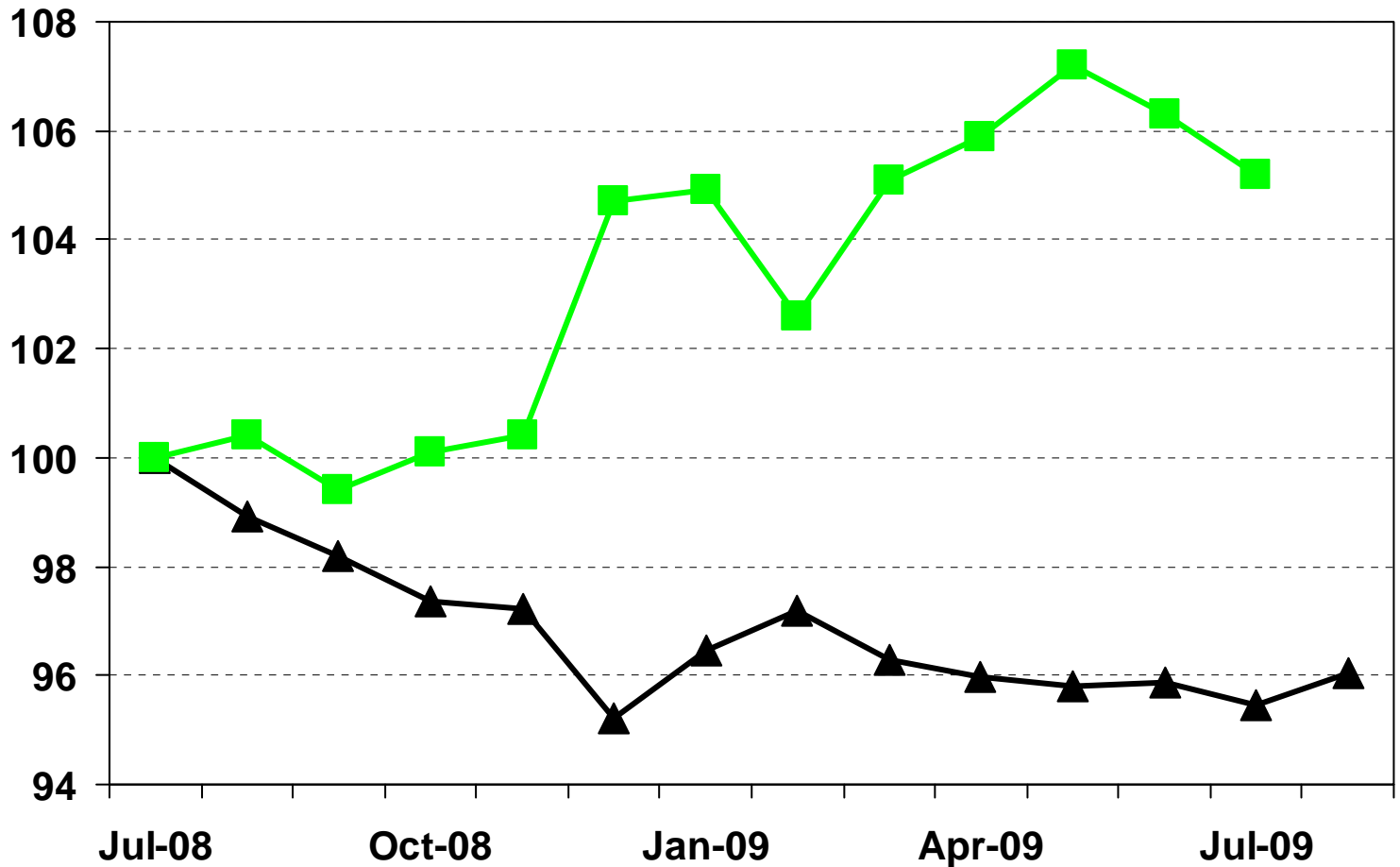
Macquarie Research Strategy

Retail turnover*

Index = 100
at July 2008

▲ US*

■ Australia



Sources: ABS, www.census.gov, September 2009

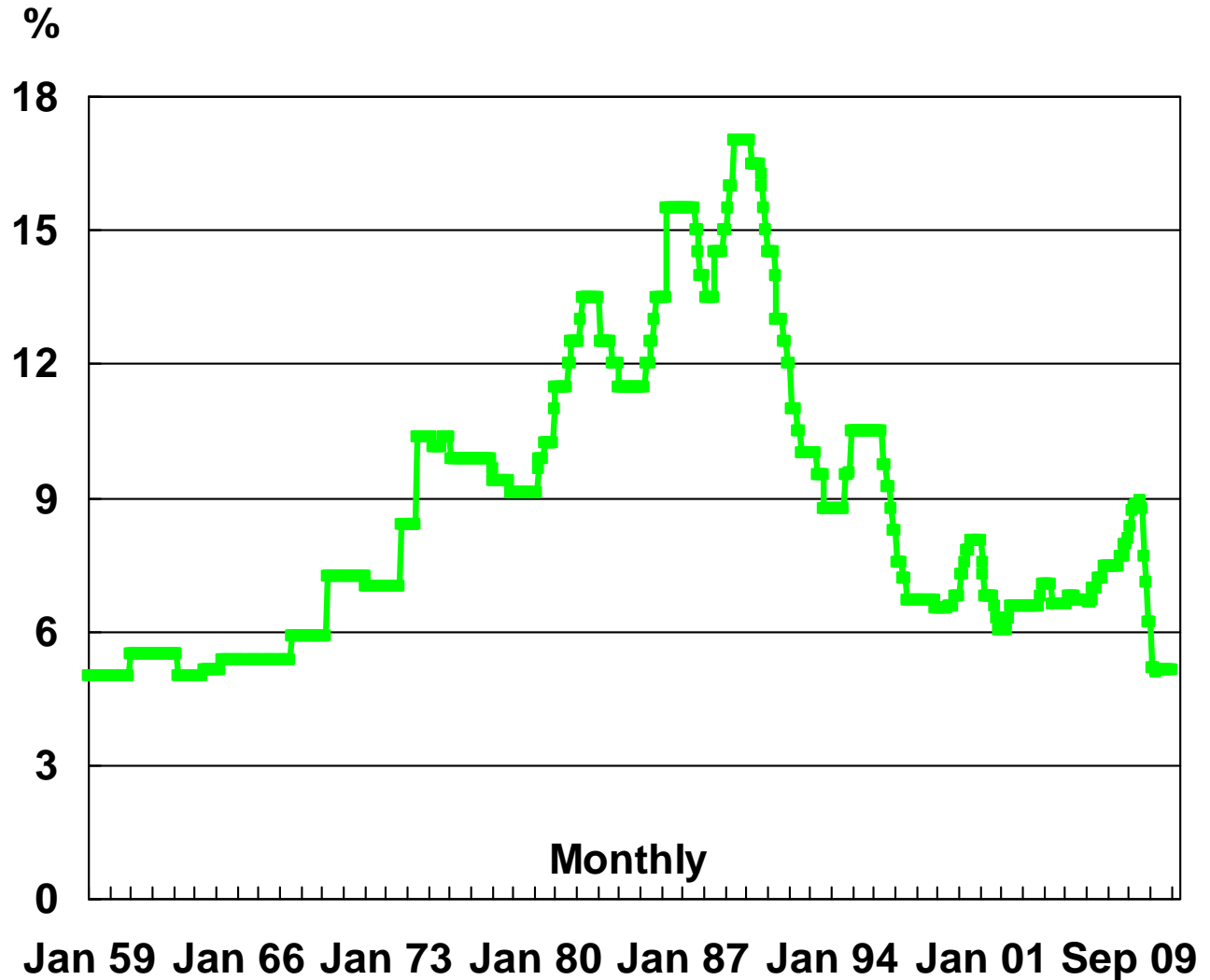
*For cleaner comparison, US figures exclude sales of autos and at gas stations



MACQUARIE

Macquarie Research Strategy

Oz mortgage rates at 4-decade lows

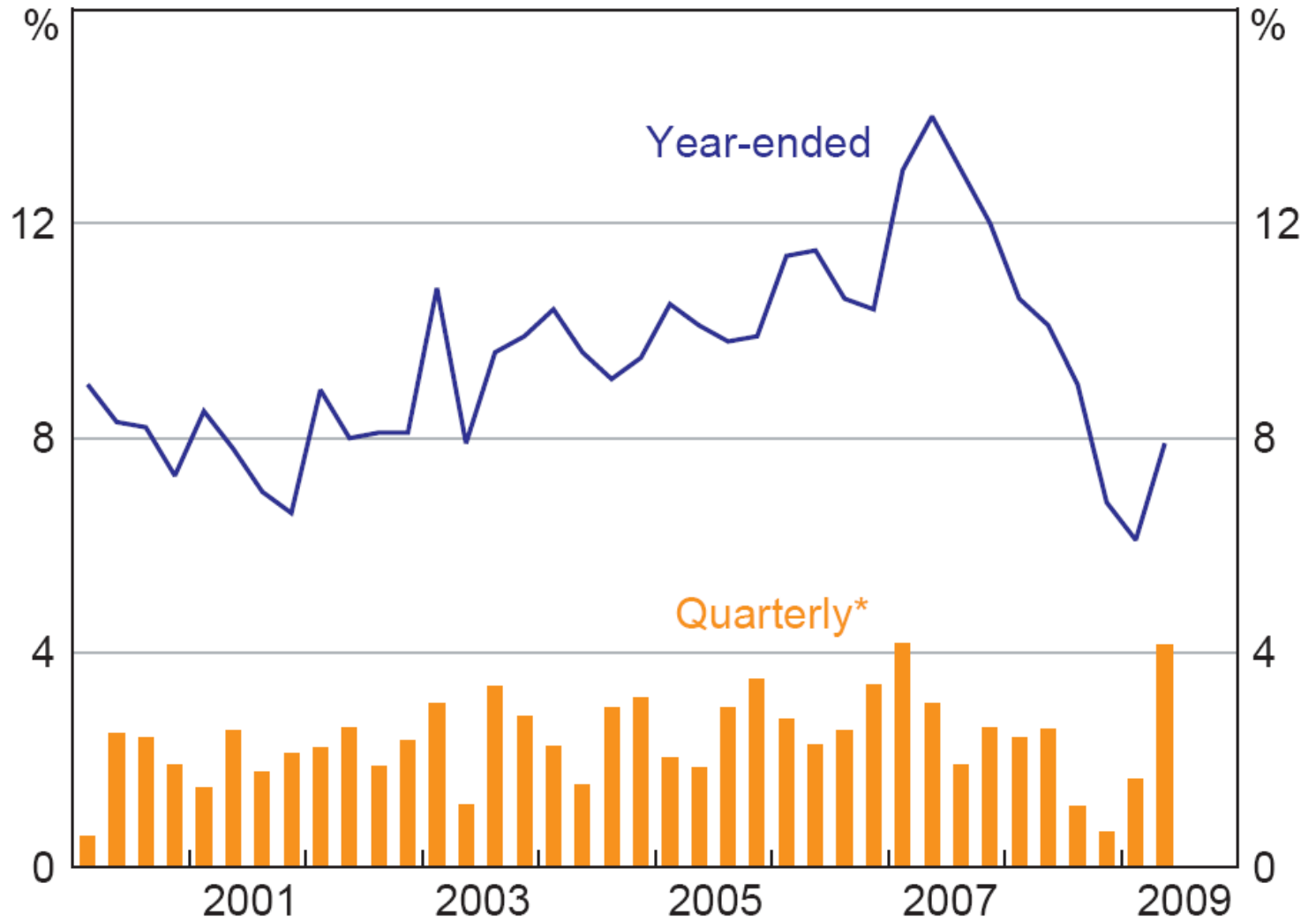


Source: RBA (Standard variable rate until June 2004, then Discounted rate), September 2009



MACQUARIE

China – GDP Growth



* RBA estimates

Source: RBA, August 2009



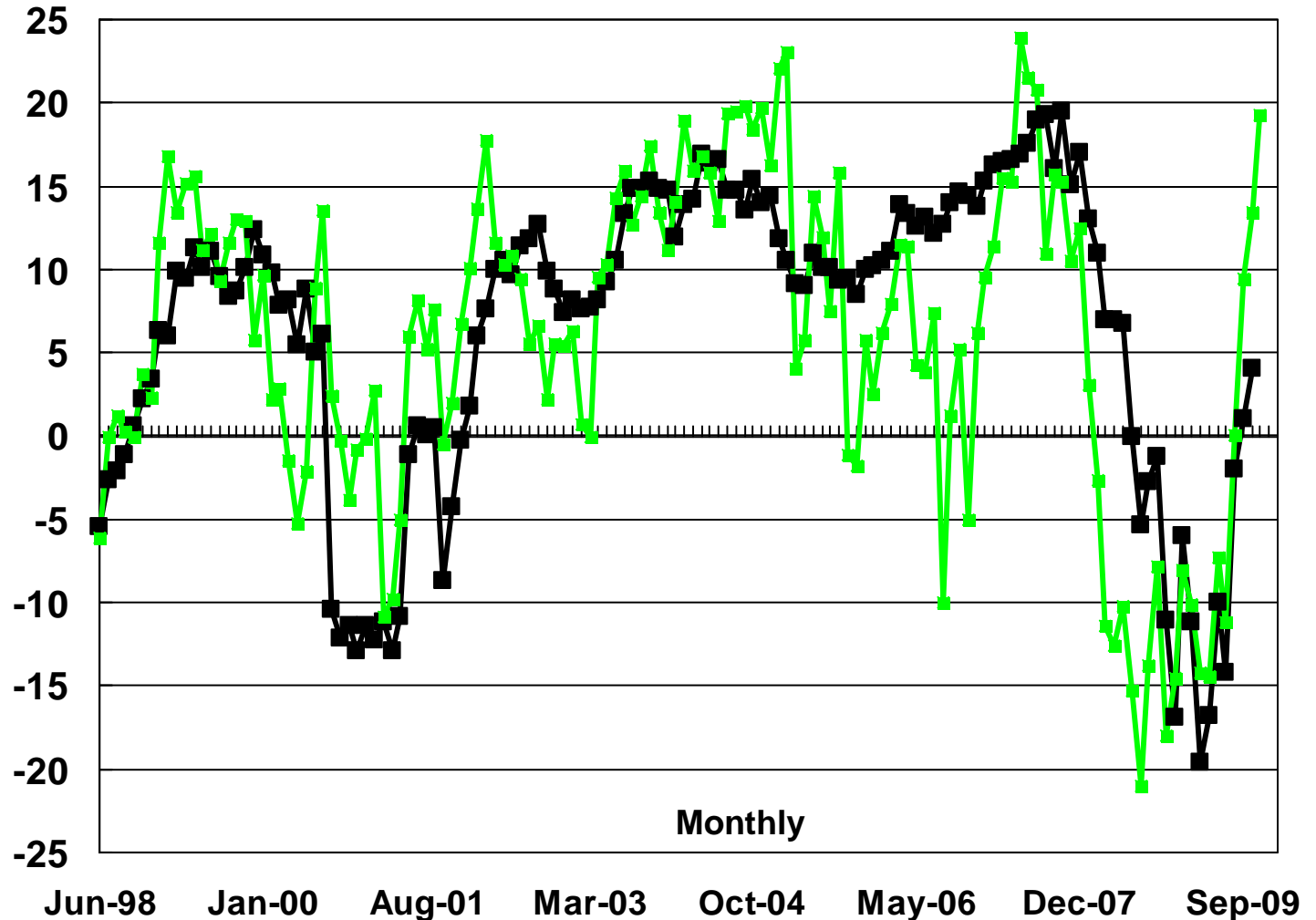
MACQUARIE

Macquarie Research Strategy

Australian confidence and conditions

■ Business conditions ■ Consumer confidence

Net balance (%)

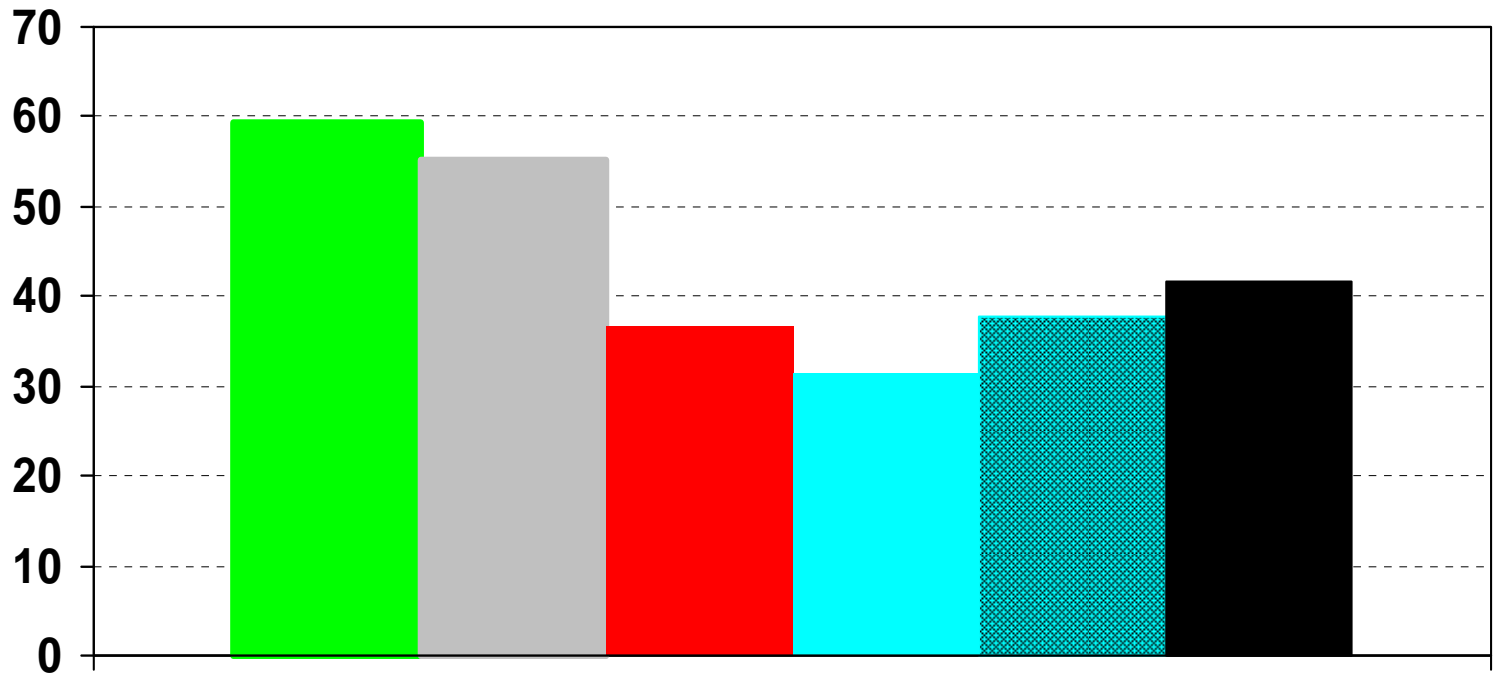


Sources: NAB & Westpac-Melbourne Institute, September 2009



Selected Federal fiscal developments (Treasury's costing over four years)

\$billion



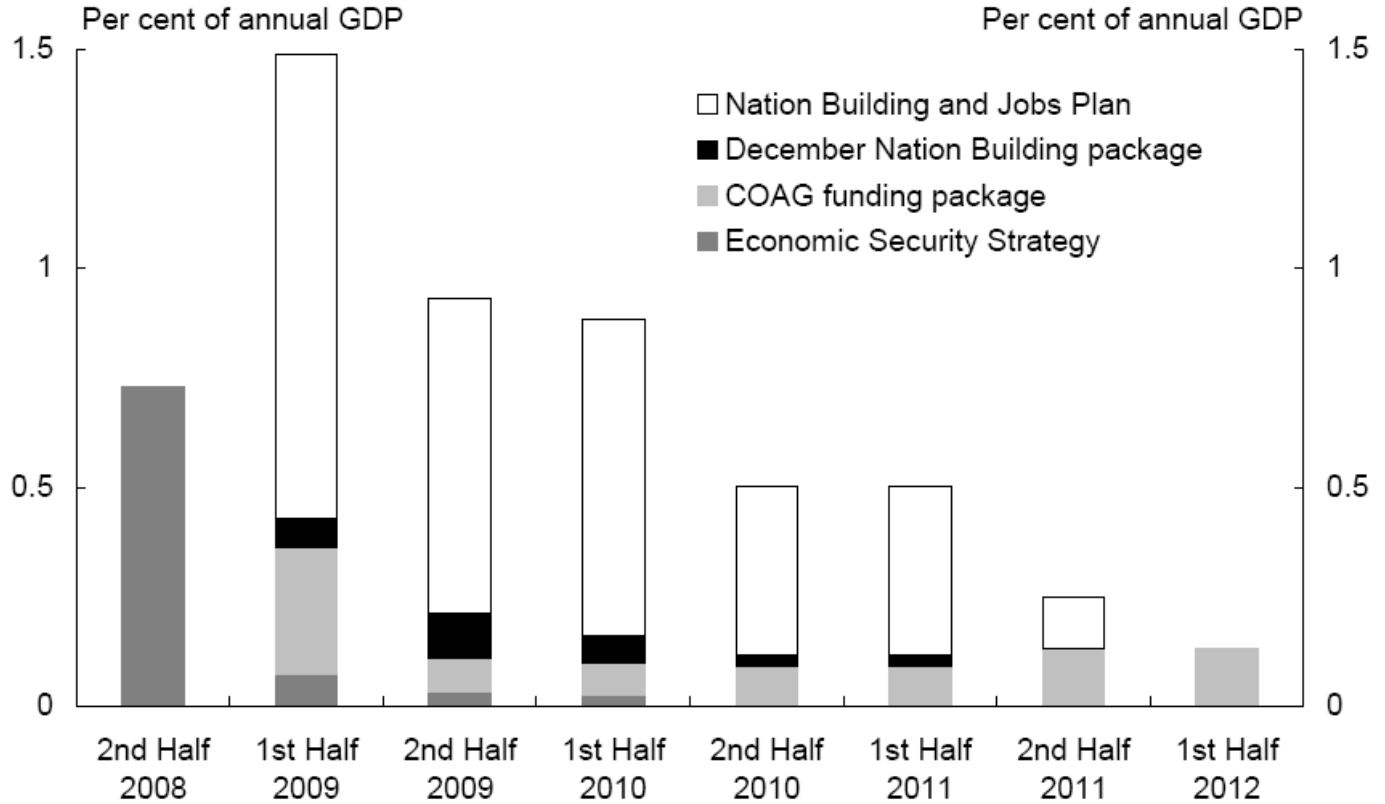
- Upside revenue surprises, May 2005 to May 2006
- Upside revenue surprises, May 2006 to May 2007
- Income-tax cuts announced May 2006
- Income-tax cuts announced May 2007
- Other policy measures announced over 2006-07
- "Nation Building and Jobs Plan" announced Feb. 2009

Source: www.budget.gov.au



MACQUARIE

Chart 2.1: Fiscal stimulus packages delivered by the Australian Government^(a)



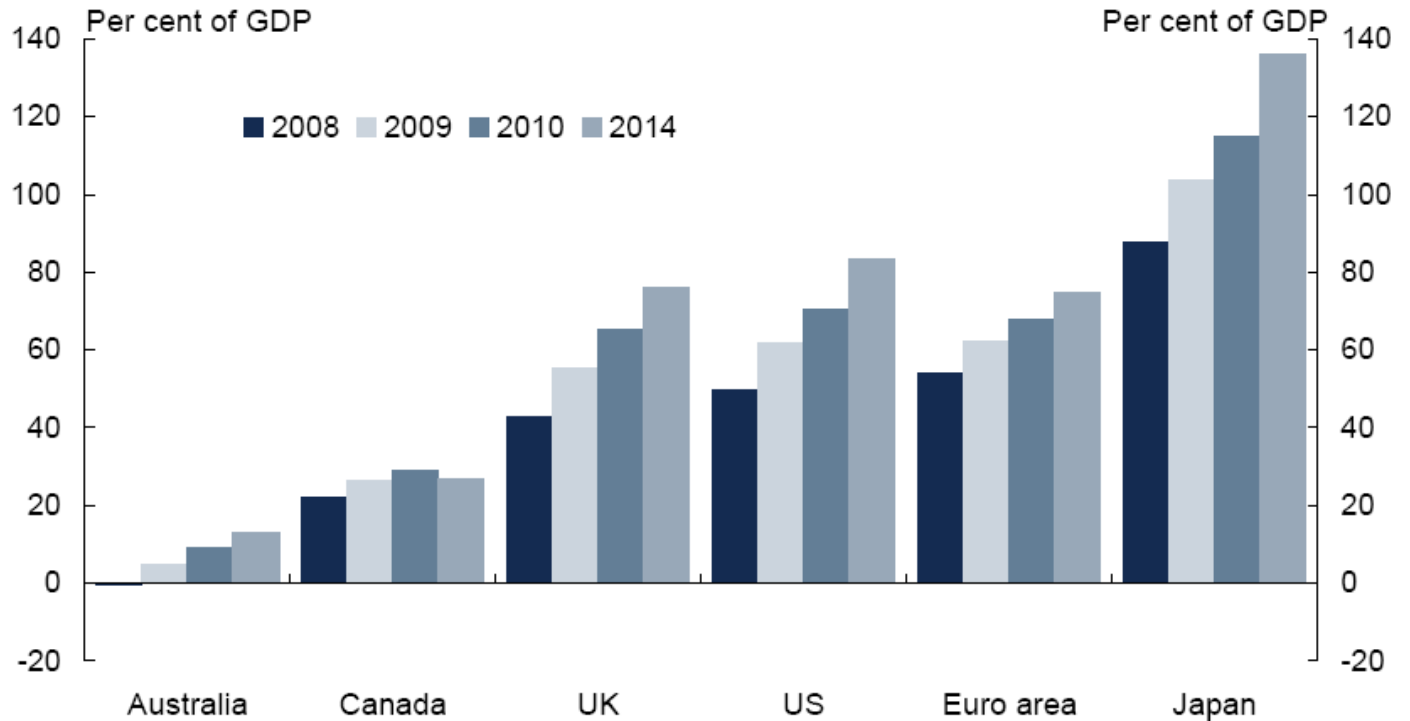
(a) Impact on underlying cash balance as a per cent of annual nominal GDP.
Source: Treasury.

Source: www.budget.gov.au, February 2009



MACQUARIE

Chart 5: Government net debt position for selected countries



(a) Treasury calculations.

Source: IMF *World Economic Outlook* April 2009 chapter 2 supplemental tables (net Government debt).

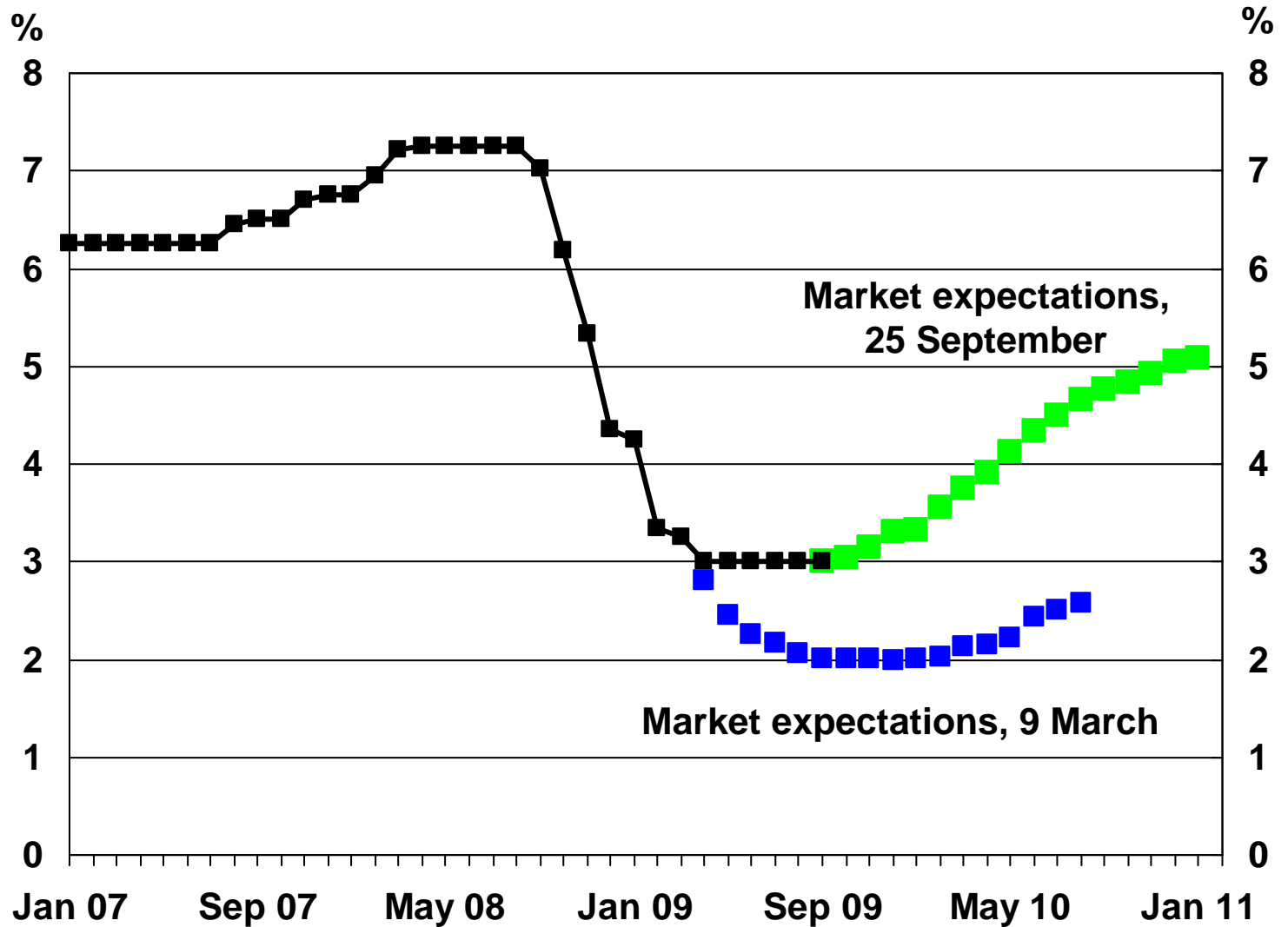
Source: www.budget.gov.au, May 2009



MACQUARIE

Macquarie Research Strategy

RBA cash rate & market expectations



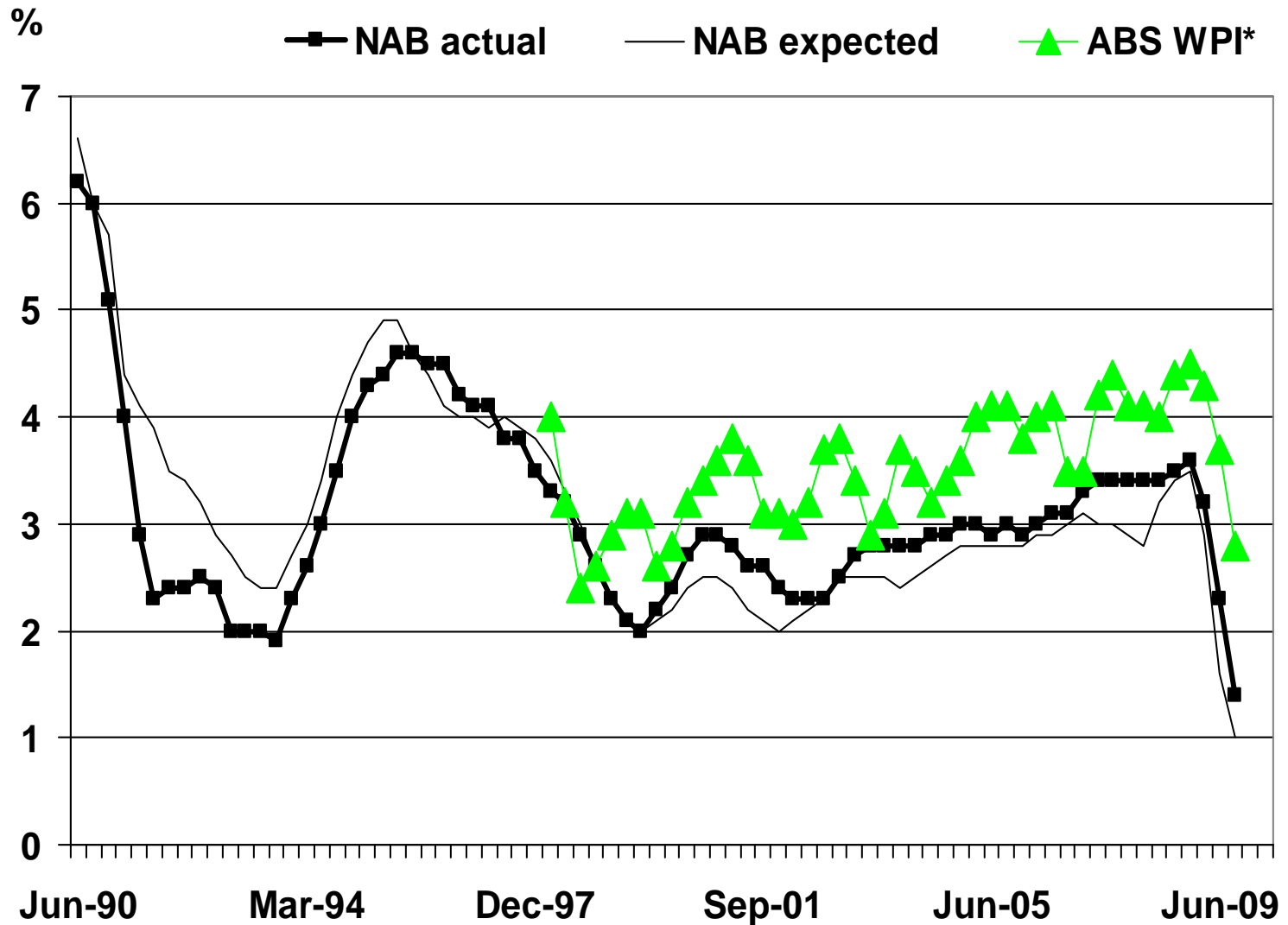
Sources: Reuters, September 2009



MACQUARIE

Macquarie Research Strategy

Annual growth in labour costs



Sources: NAB, MBL DM calcs, September 2009 *WPI = private Wage Price Index, 2 quarters annualised



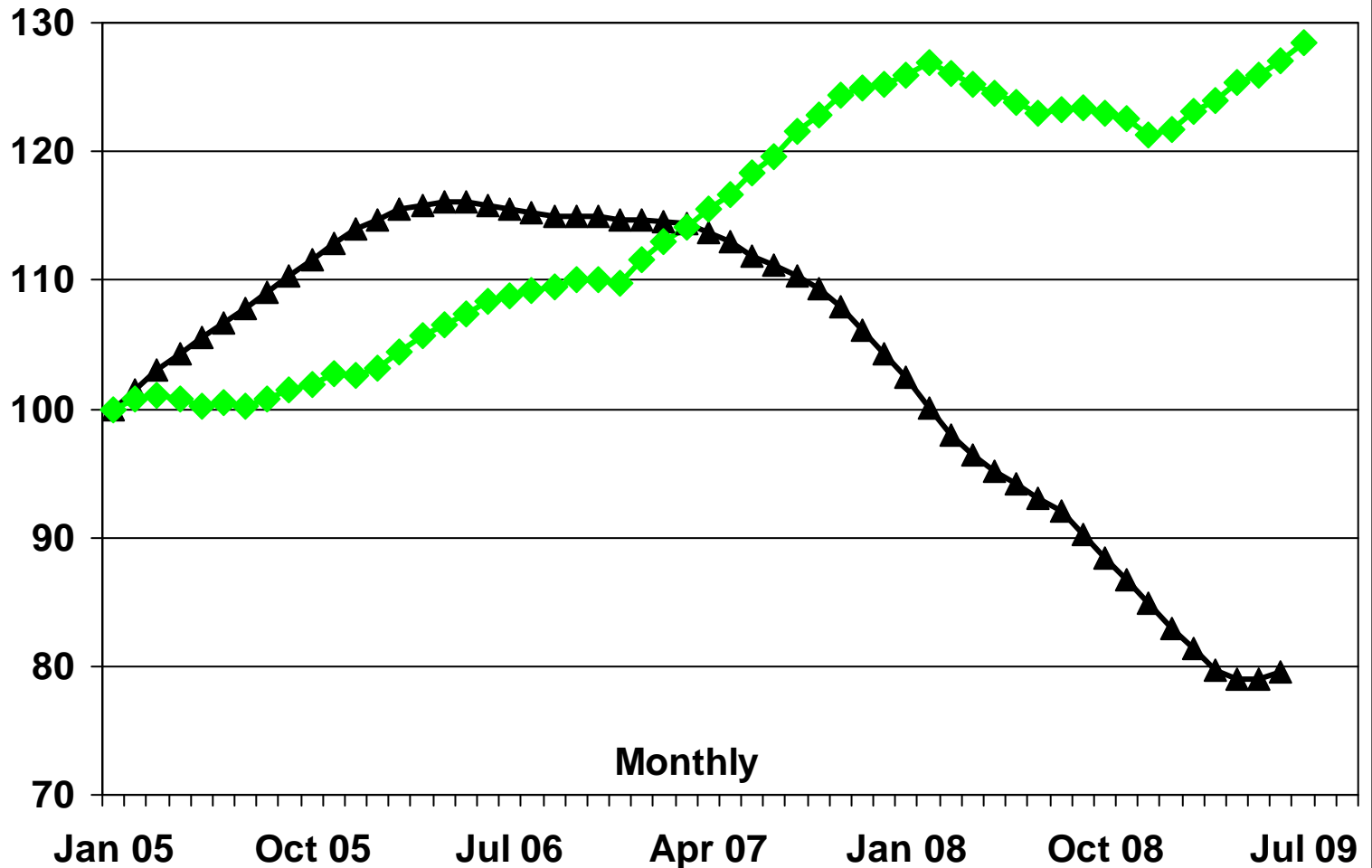
MACQUARIE

Macquarie Research Strategy

US and Oz house prices

Index: Jan-2005 = 100

▲ US: Case-Shiller ◆ Oz: RP Data-Rismark



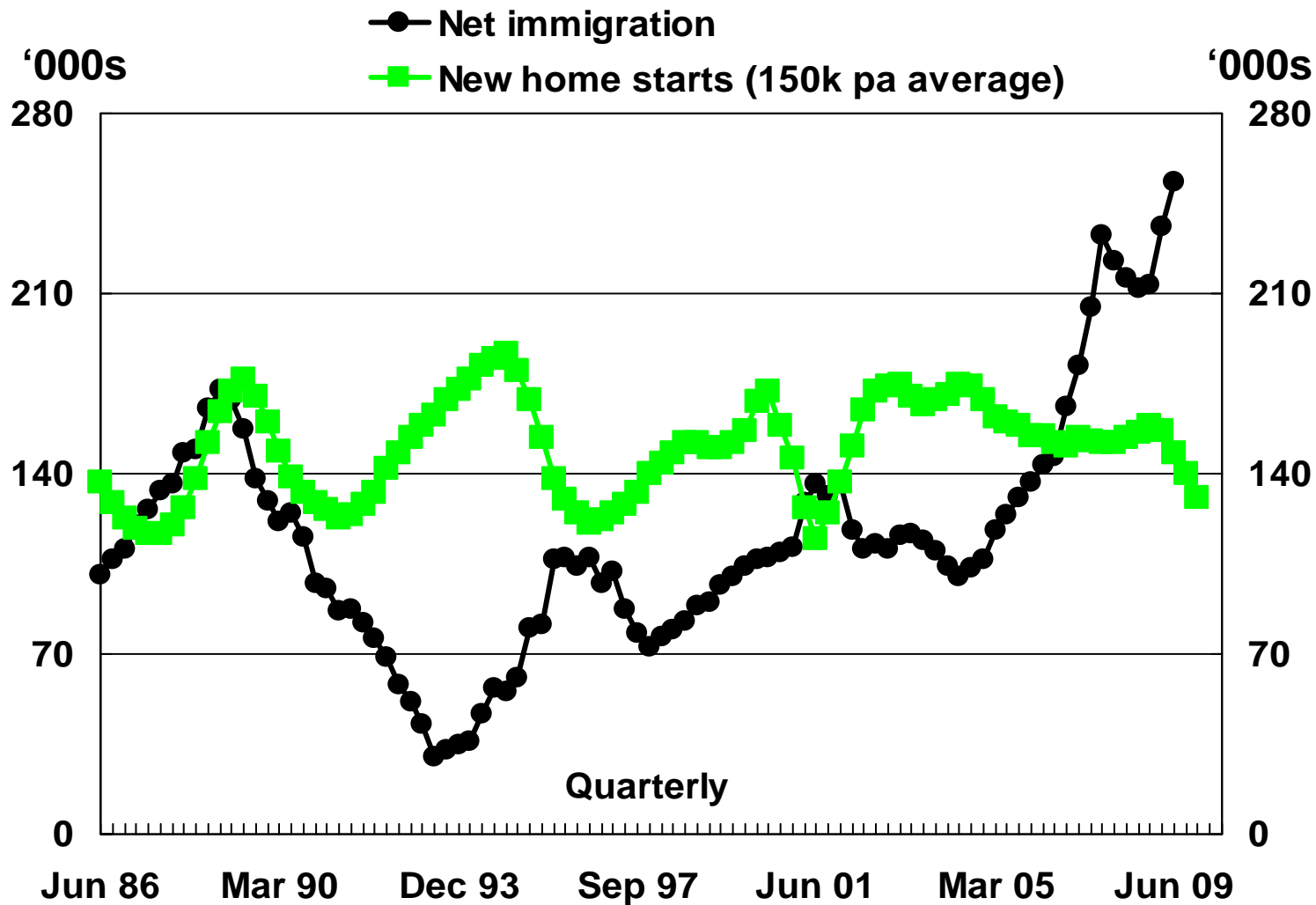
Sources: RP Data-Rismark, S&P Case-Shiller (20-city index), September 2009



MACQUARIE

Macquarie Research Strategy

No overbuild in Oz housing

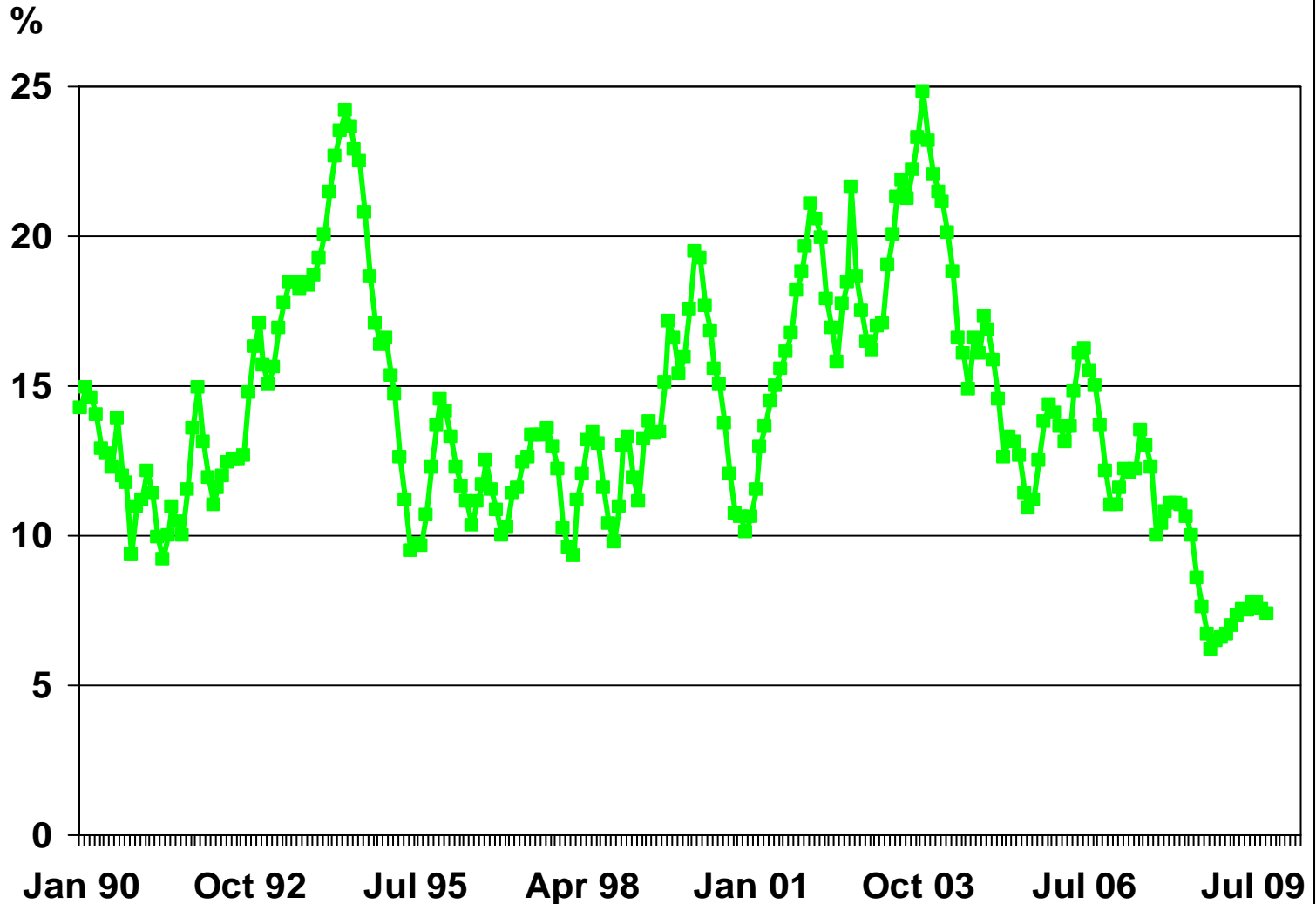


Source: ABS, September 2009



Oz housing credit growth

Three-month-annualised change



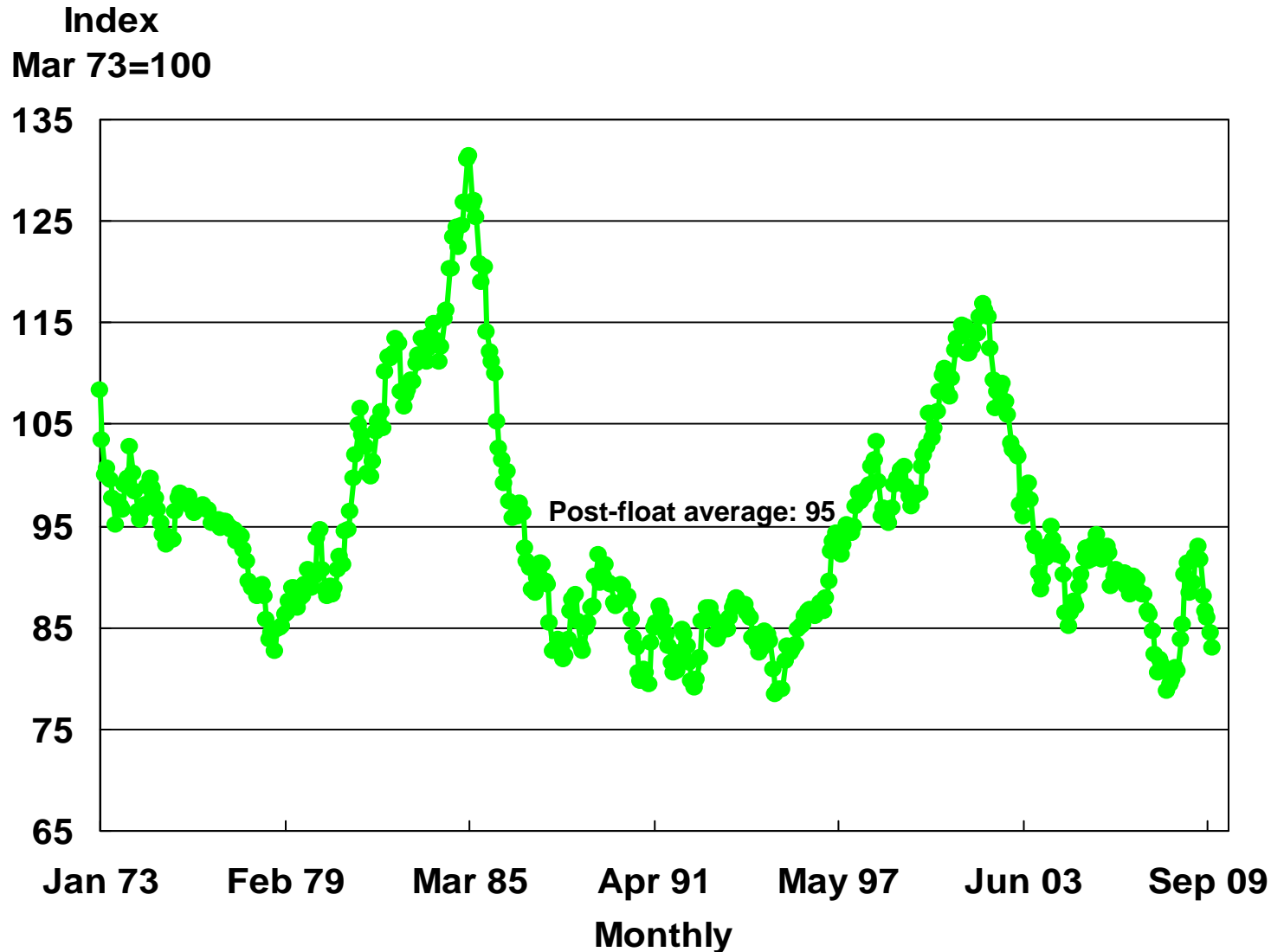
Source: RBA, September 2009



MACQUARIE

Macquarie Research Strategy

Real US Trade Weighted Index



Source: Federal Reserve, Major currencies, September 2009



MACQUARIE

Macquarie Research Strategy

US TWI versus A\$

— US TWI (major currencies; LHS) — A\$/US\$ (RHS)



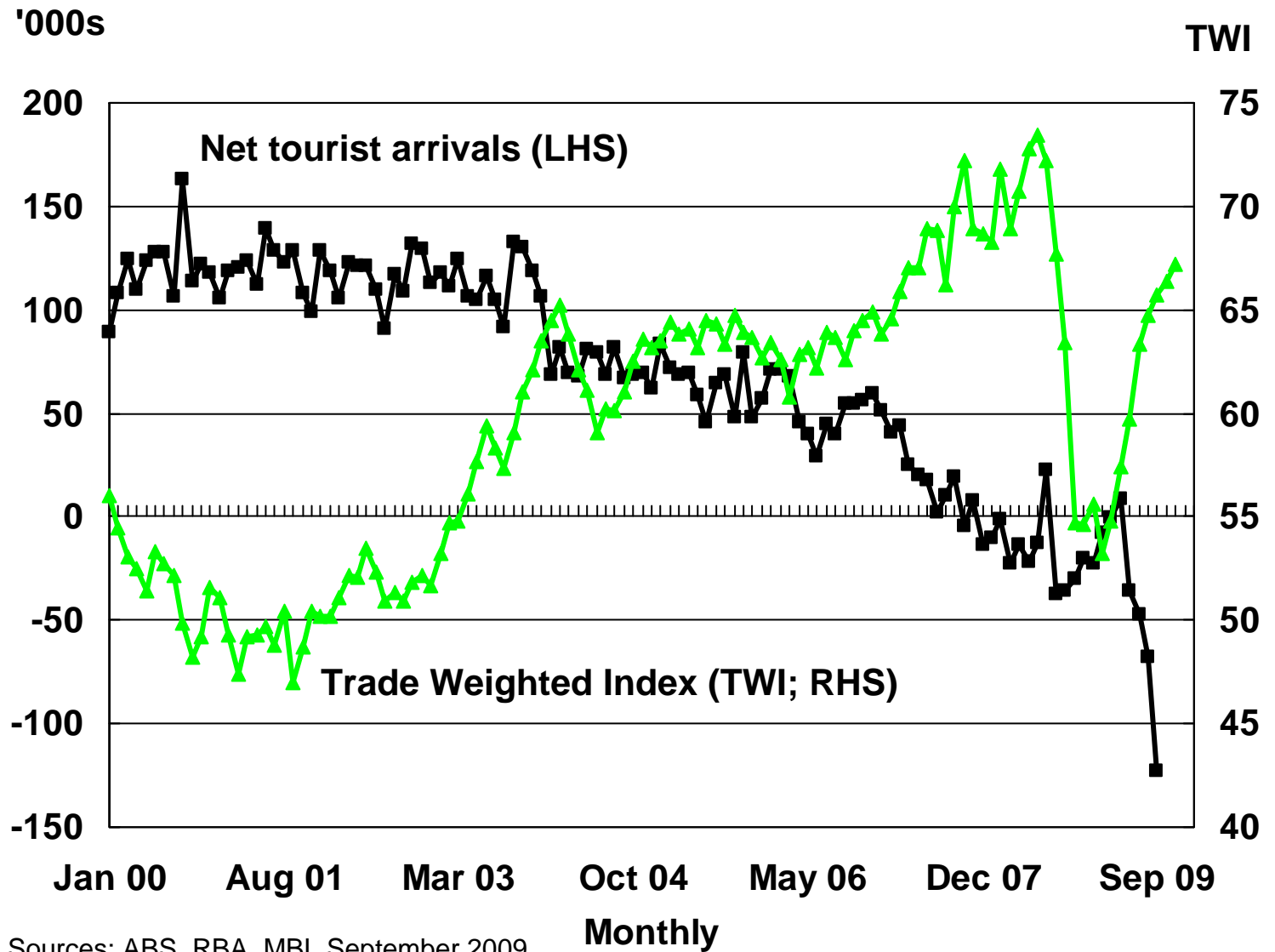
Sources: RBA, Federal Reserve, September 2009



MACQUARIE

Macquarie Research Strategy

Oz-bound tourism crushed by strong A\$

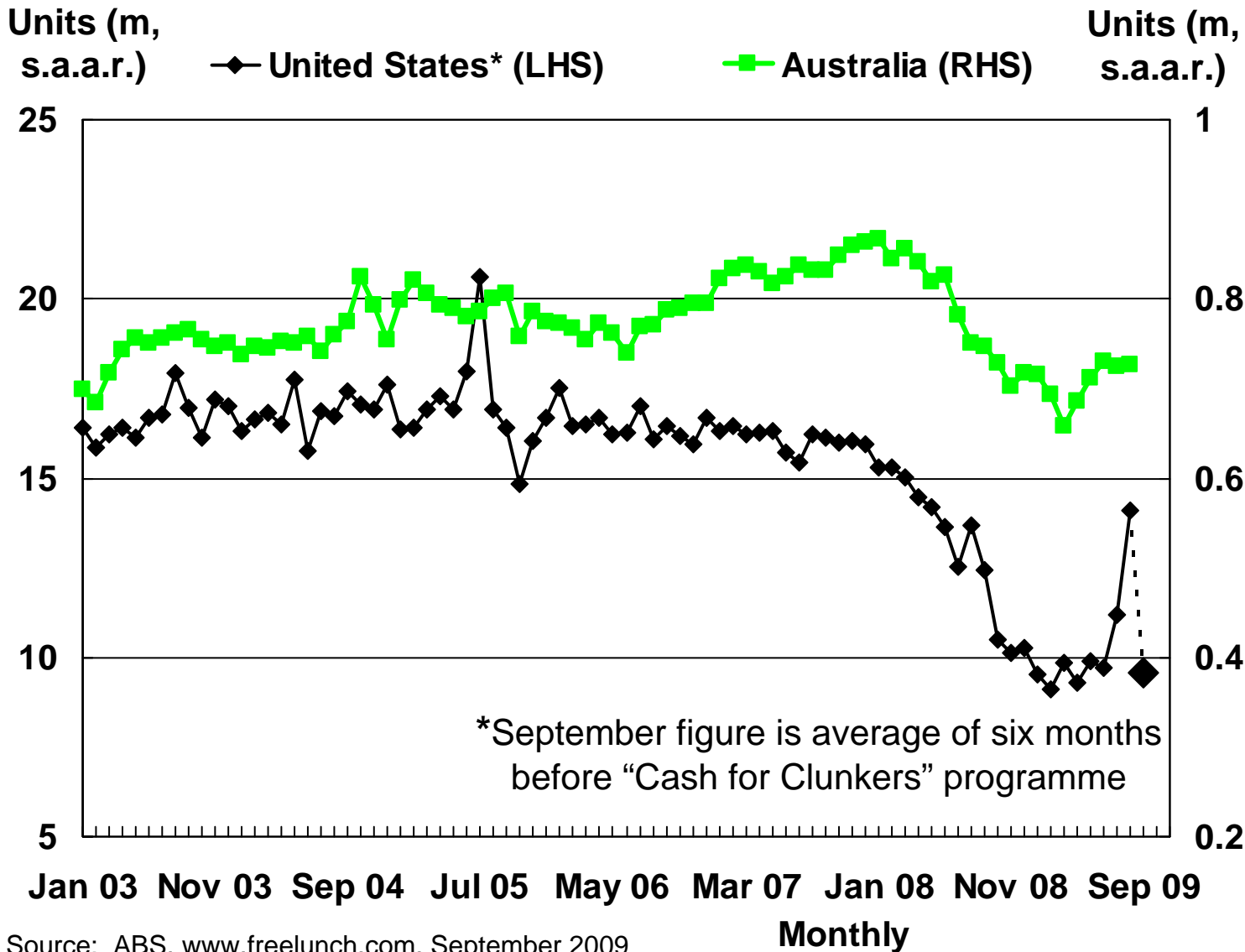




MACQUARIE

Macquarie Research Strategy

US and Oz car and SUV sales*





This information has been prepared on a strictly confidential basis by Macquarie Bank Limited ABN 46 008 583 542 ("Macquarie") and may neither be reproduced in whole or in part, nor may any of its contents be divulged to any third party without the prior written consent of Macquarie. This information is not intended to create legal relations and is not binding on Macquarie under any circumstances whatsoever. This information has been prepared in good faith and is based on information obtained from sources believed to be reliable, however Macquarie does not make any representation or warranty that it is accurate, complete or up to date. The information may be based on certain assumptions or market conditions. If those assumptions or market conditions change, the information may change. No independent verification of the information has been made. Any quotes given are indicative only. Any reference to past results is not necessarily indicative of future results. No part of this information is to be construed as a solicitation to buy or sell any product, or to engage in, or refrain from engaging in, any transaction.

To the extent permitted by law, neither Macquarie and its related bodies corporate ("Macquarie Group") nor any of its associates, directors, officers or employees, or any other person, makes any promise, guarantee, representation or warranty (express or implied) to any person as to the accuracy or completeness of this information, or of any other information, materials or opinions, whether written or oral, that have been, or may be, prepared or furnished by Macquarie Group, including, without limitation, economic and financial projections and risk evaluation. No responsibility or liability whatsoever (in negligence or otherwise) is accepted by any person for any errors, mis-statements or omissions in this information or any other information or materials. Without prejudice to the foregoing, neither Macquarie Group, nor any of its associates, directors, officers, employees nor any other person shall be liable for any loss or damage (whether direct, indirect or consequential) suffered by any person as a result of relying on any statement in or omission from this information. Nothing in this information should be construed as legal, financial, accounting, tax or other advice. Macquarie Group or its associates, directors, officers or employees may have interests in the financial products referred to in this information by acting in various roles including as investment banker, underwriter or dealer, holder of principal positions, broker, lender or adviser and may receive fees, brokerage or commissions for acting in those capacities. In addition, Macquarie Group and its associates, directors, officers or employees may buy or sell the financial products as principal or agent and as such may effect transactions which are not consistent with any recommendations in this information. This information is distributed in the UK by Macquarie Bank Limited, which is authorised and regulated by the Financial Services Authority. This information is distributed in European Economic Area by Macquarie Bank International Limited (MBI), which is authorised and regulated by the Financial Services Authority. This information is distributed in the US by Macquarie Capital (USA) Inc. ("MC(USA)"). If this information is distributed in Taiwan, it is strictly for the benefit of the intended recipients as institutional investors only and is not for public circulation in Taiwan. Macquarie is not an authorized institution under the Banking Act and does not carry on banking business in Taiwan and hence, not subject to the supervision of the Taiwan Financial Supervisory Commission. Distribution in New Zealand is by Macquarie New Zealand Ltd ("MNZL"), in Hong Kong by Macquarie Securities Limited ("MCSL") and in Singapore by Macquarie Capital Securities (Singapore) Pte Ltd (Company Registration Number: 198702912C)("MCS(S)PL"). If the information is distributed in Hong Kong, this information is for the general information of professional investors only. Macquarie does not carry on banking business in Hong Kong, is not an authorized institution under the Banking Ordinance and not subject to the supervision of the Hong Kong Monetary Authority. MC(USA), MCSL, MCS(S)PL, MBI and MNZL are not authorised deposit-taking institutions for the purposes of the Banking Act 1959 (Commonwealth of Australia), and their obligations do not represent deposits or other liabilities of Macquarie. Macquarie provides a limited guarantee to the Monetary Authority of Singapore in respect of Macquarie Capital Securities (Singapore) Pte Limited for up to SGD25m under the Securities and Futures Act 2001 (A42/2001). Macquarie does not guarantee or otherwise provide assurance in respect of the obligations of any of the other named entities. © Macquarie Group 2008