COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

Reference: Government economic stimulus initiatives

FRIDAY, 9 OCTOBER 2009

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SENATE ECONOMICS

REFERENCES COMMITTEE

Friday, 9 October 2009

Members: Senator Eggleston *(Chair)*, Senator Hurley *(Deputy Chair)*, Senators Bushby, Joyce, Pratt and Xenophon

Participating members: Senators Abetz, Adams, Back, Barnett, Bernardi, Bilyk, Birmingham, Mark Bishop, Boswell, Boyce, Brandis, Bob Brown, Carol Brown, Cameron, Cash, Colbeck, Jacinta Collins, Coonan, Cormann, Crossin, Farrell, Feeney, Ferguson, Fielding, Fierravanti-Wells, Fifield, Fisher, Forshaw, Furner, Hanson-Young, Heffernan, Humphries, Hutchins, Johnston, Kroger, Ludlam, Lundy, Ian Macdonald, McEwen, McGauran, McLucas, Marshall, Mason, Milne, Minchin, Moore, Nash, O'Brien, Parry, Payne, Polley, Ronaldson, Ryan, Scullion, Siewert, Sterle, Troeth, Trood, Williams and Wortley

Senators in attendance: Senators Bob Brown, Cameron, Coonan, Eggleston, Fielding, Joyce, Ryan

Terms of reference for the inquiry:

To inquire into and report on:

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

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.

WITNESSES

Committee met at 9.04 am

CHAIR (Senator Eggleston)—I declare open this third public hearing of the Senate Economics References Committee inquiry into the government's economic stimulus package. So far we have heard from a variety of academic economists, the Governor of the Reserve Bank and representatives of the business community. Today we will hear from the Secretary to the Treasury, Dr Ken Henry. We welcome Dr Henry here today and thank him for his cooperation in providing answers to questions which were provided on notice.

These are public proceedings, although the committee may agree to a request to have evidence heard in camera or may determine that certain evidence should be heard in camera. I remind the witnesses that in giving evidence to the committee they are protected by parliamentary privilege. It is unlawful for anyone to threaten or disadvantage a witness on account of evidence given to a committee, and such action may be treated by the Senate as a contempt. It is also a contempt to give false or misleading evidence to the committee. If a witness objects to answering a question, the witness should state the ground upon which the objection is taken and the committee will determine whether it will insist on an answer, having regard to the ground which is claimed. If the committee determines to insist on an answer, a witness may request that the answer be given in camera. Such a request may also be made at any other time.

I remind members of the committee that the Senate has resolved that departmental officers shall not be asked to give opinions on matters of policy and shall be given reasonable opportunity to refer questions to superior officers or to a minister. This resolution prohibits only asking for opinions on matters of policy and does not preclude asking questions for explanations of policies or factual questions about when and how policies were adopted.

[9.06 am]

GRUEN, Dr David, Executive Director, Macroeconomic Group, Department of the Treasury

HENRY, Dr Ken, Secretary, Department of the Treasury

McDONALD, Mr Tony, General Manager, Department of the Treasury

McKISSACK, Mr Adam, Principal Adviser, Forecasting, Department of the Treasury

MORLING, Dr Steven, General Manager, Department of the Treasury

PARKER, Mr David, Executive Director, Revenue Group, Department of the Treasury

CHAIR—As I said earlier, Dr Henry, we thank you for your written responses to some questions provided by the committee, and we ask if you are agreeable for those answers to be made public.

Dr Henry—Yes, Mr Chairman, I certainly am.

CHAIR—Thank you. In that case, they will be published on the website of the committee. Would you like to make an opening statement, Dr Henry?

Dr Henry—If I could, please, Chairman.

CHAIR—Yes, please proceed.

Dr Henry—Thank you. I thank the committee for the opportunity to represent here this morning the views of the Treasury at these hearings. Our understanding of the purpose of this inquiry is for the committee to gain a better understanding of the effectiveness of the economic stimulus initiatives announced by the government since October 2008. We understand that the committee is also interested in whether changed economic circumstances provide a case for a change in the rollout of the economic stimulus.

The committee, as you have noted, has asked for information from the Treasury on our budget estimates of the size of the stimulus and impact on economic growth and employment, and we have provided a paper outlining this analysis. Obviously, we are happy to take questions on that analysis. Before taking those questions, I would like to offer some brief opening remarks.

The first point is that we will never know the precise impacts of the fiscal stimulus on the economy. The Australian economy has been through a period of unprecedented turbulence in the global economy, and that has impacted on the Australian economy through a number of channels. The policy response to the global crisis has been broader than the fiscal stimulus measures, with a substantial easing in monetary policy contributing to the macroeconomic stimulus. We have also seen significant movements in the exchange rate, most of which we would judge to be unrelated to domestic policy settings. While it is difficult to disentangle these various factors impacting on the Australian economy, the Treasury has produced its best estimates of the effects of the fiscal stimulus. Those estimates have been informed by economic modelling within the department, by international experience, by data from the Austrian Bureau of Statistics and by some private-sector surveys.

The paper that we have provided to the committee details how these estimates have been prepared. In summary, it notes that around $79 billion of what may broadly be characterised as fiscal stimulus measures are expected to impact on the economy over three years from 2008-09 through to 2010-11. The stimulus is estimated to have contributed one per cent to GDP growth in 2008-09, and it accounts for all of the economic growth in Australia in that year.

At budget we estimated the stimulus would add a further 1.6 per cent to GDP growth in the present year, 2009-10, and that the stimulus would then unwind and its impact on the economy would unwind as a recovery in private sector activity took hold. Higher gross domestic product associated with the stimulus was estimated at the time of the budget to support around 210,000 jobs and to reduce the peak unemployment rate by 1½ percentage points. In broad terms, the experience since the budget has supported our original estimates of the impact of the fiscal stimulus. So far these effects have largely been through the stimulus to household consumption from the cash payments.

Without this stimulus, we estimate that the economy would have contracted not only in the December quarter of 2008 but also in the March and June quarters of this year. Our estimates of these impacts are based on internal modelling informed by studies of the effects of fiscal stimulus by the International Monetary Fund, the OECD and a range of academic researchers. They are corroborated by ABS data, by private sector surveys on how the stimulus was spent and by an examination of the experience of countries that have not had such a large stimulus in place.

As the committee would be aware, the government has not published updated forecasts since the budget. It will do so in the Mid-Year Economic and Fiscal Outlook update, but it is no secret that the next set of economic forecasts will likely include stronger forecasts of gross domestic product growth and a peak unemployment rate lower than the 8½ per cent that was forecast at the time of the budget. Much economic data released since the budget has been more favourable than we or indeed others expected. Business and consumer confidence in particular have proved to be remarkably resilient. Australia’s export performance has also been surprisingly strong through the global recession.

There are therefore good reasons to be more optimistic than we were a few months ago. But we remain rather cautious about the near-term outlook. The world recovery is only in its early stages. Those elements of domestic demand that have performed the strongest have been assisted by fiscal and monetary stimulus and, in particular, household consumption and parts of business investment have been greatly assisted. Evidence of a self-sustaining recovery in private activity remains tentative at this time. Consequently, while there are both upside and downside risks, our expectation is that the Australian economy will continue to grow below trend for the next year or so.

Some forecasters, as you are aware, are expecting stronger outcomes. Even so, all credible forecasters are expecting the economy to continue to operate below its productive capacity in the next year or two, even taking into account the stimulus still to come. The IMF forecast released last week showed growth of 0.7 per cent for the Australian economy in 2009 and two per cent in calendar year 2010, and those growth rates are obviously still well below trend. The IMF forecast a peak unemployment rate of seven per cent in 2010, well above that consistent with full employment, all with the risk of emergent inflationary pressures. The IMF also reinforced the need for continued macroeconomic stimulus to support the recovery. They presumably take the view, as we do, that a positive revision to forecasts of the order that they have reported does not provide a sufficient case for an adjustment to the expansionary stance of fiscal policy.

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.

Chairman, I am sure that the committee members will have many questions for us, and we are happy to take them.

CHAIR—Thank you very much. Senator Joyce has said that he has to go to a meeting at 9.30, so we might go to him first.

Senator JOYCE—Dr Henry, I am going to go through about seven questions and then I will listen to what you have to say, so if we can just bear that in mind in our answers. I apologise for not being there. Obviously I am reducing my carbon footprint by trying to do as much of this as I can by phone.

When the Australian dollar was floated in 1983 by the Hawke and Keating government, one reason for the float was a recognition that a fixed exchange rate made monetary policy ineffective and that the increasing openness of the Australian economy to international trade made fiscal policy ineffective. Thus the Hawke-Keating government realised that Australia could only gain effective macroeconomic stabilisation through a float of the dollar and by placing primary emphasis on the use of monetary policy for macroeconomic stabilisation. Recognition of these facts has bipartisan political support, and had it until late 2008. So my question to you, Dr Henry, is: does the Treasury and the Reserve Bank agree that the assignment of fiscal policy to medium- and long-term goals and monetary policy to short-term stabilisation has served Australia well for a quarter of a century and, if you do believe that, what justifies the abandonment in 2008-09 of this policy assignment?

Dr Henry—I do broadly agree with that proposition. I do not consider that that policy assignment, as you refer to it, has been abandoned in the present period. The consensus that emerged in the 1980s, and perhaps more particularly following the recession of the early 1990s, was that there were considerable limitations in using fiscal policy to finetune the economy. Whilst there are considerable limitations also in using monetary policy to finetune aggregate demand and to finetune the economy, monetary policy is probably better able to play that role.

But certainly I never interpreted that consensus as implying that, when an economy is hit with an unprecedented negative shock, one should expect that monetary policy could play all of the role. Indeed, notwithstanding the consensus that you referred to, this is not the first occasion in the last 10 years on which fiscal policy has been adjusted in order to support aggregate demand. Senators might recall that in late 2000 there was an adjustment to fiscal policy settings, with a doubling, as I recall, of the first home owners grant precisely for that purpose. At that time, the economy contracted for one quarter and the policy response was an expansionary fiscal policy.

Senator JOYCE—So your answer is that this was an exception to the rule.

Dr Henry—That is probably not an unfair way to characterise it. The proposition that I am putting is that, notwithstanding that rule, there will be exceptional circumstances that warrant fiscal policy adjustment to assist a monetary policy adjustment.

Senator JOYCE—In the Asian crisis and 2001 US recession, much more reliance was placed on allowing the exchange rate and monetary policy to play a major role in short-run macroeconomic stabilisation, whereas fiscal policy in that instance played a minor role. In contrast, fiscal policy has played a major role in the government's current Australian macroeconomic policy. What explains the difference in the choice of macroeconomic policies? Were mistakes made in the Australian macroeconomic management of the Asian crisis and 2001 downturn? If so, where are those mistakes documented and how did the lessons learnt justify the greater reliance on fiscal policy?

Dr Henry—No, I do not consider that mistakes have been made on any of those three occasions. I think what each of those three occasions illustrates is that the appropriate policy response will depend upon the particular circumstances that the economy is confronting. In fact, my recollection of the period of the Asian financial crisis is that the exchange rate, indeed, did adjust and adjusted quite sharply and that monetary policy did not adjust—not immediately, anyway. Neither, of course, did fiscal policy. The exchange rate adjustment provided most of the cushioning of the economy that was required. In the second occasion to which you refer, it is true that there was a significant monetary policy adjustment—although, as I indicated earlier, we had ourselves had an expansionary fiscal policy in late 2000. So I do not think that it is true that in that period of weakness in the US economy the Australian policy response was left entirely to monetary policy. It certainly was not.

In the present circumstances, where we have been hit with a quite unprecedented negative external shock and a shock that has affected not just aggregate demand directly but also the functioning of credit markets, on this occasion the Australian government—and, indeed, just about all governments around the world—have judged it appropriate for there to be both expansionary monetary policy and expansionary fiscal policy.

Senator JOYCE—I will go into why I believe that they have a different view, and that is their latent monetary policy settings and interest rates. But there is considerable disagreement in the empirical literature about the magnitude and even the sign of the response of output to a fiscal stimulus, but a consistent empirical finding is that the fiscal multiplier is zero for open economies, which I believe Australia is, with flexible exchange rates. This is suggested by the Mundell-Fleming model. The most recent research that I have found confirming this empirical finding is in Ilzetzki, Mendoza and Vegh, who in the CEPR *Policy insight No. 39* from October 2009 summarised the results of a study of 45 countries—20 high-income and 25 developing. How does the Treasury square its views on the effectiveness of fiscal policy away with this research?

Dr Henry—I have not had an opportunity to read the paper to which you refer. I am certainly very familiar with the Mundell-Fleming model as a conceptual framework. My colleague, Dr Gruen, who is sitting right beside me, has had an opportunity to read that paper—indeed, he has a copy of it in front of him—so I refer that question to him.

Dr Gruen—Senator, you are right about this recent paper by those three authors you talked about, which was published by the Centre for Economic Policy Research, I think, just this month. As you say, they have got a large sample of countries and they are looking at how big the fiscal multiplier is. They make a series of interesting and relevant points and the one that you drew attention to was that, on average, it is the case that the fiscal multiplier for countries with fixed exchange rates tends to be significantly higher than the fiscal multiplier for countries with flexible exchange rates.

Senator JOYCE—That is correct.

Dr Gruen—That is what they conclude. If you read on in that paper, they also come to a further conclusion that is relevant to Australia. They break their sample into those countries that have a high trade share and those countries that have a low trade share, and the criteria they use is that your exports plus your imports have to be greater than 60 per cent. We are very clearly in the category of countries with a low trade share. Our trade share—exports plus imports—is about 40 per cent. The point they make in the figure immediately following the figure you reported is that, when you look at countries with relatively small trade shares, you find that they have significant fiscal multipliers. If you are looking at countries with relatively small trade shares like Australia, the fiscal multiplier is indeed substantial and the numbers that they quote are larger than the numbers that we have assumed in the fiscal multipliers that we have applied for the Australian fiscal expansion. So if you took their results literally, you might well conclude that the fiscal expansions that have been applied in Australia would have a bigger effect than the Treasury has assumed.

Let me make another point that is relevant to the current situation. The empirical analysis that this paper presents is over an extended period for a whole lot of different countries, and many of the downturns in which there has been a fiscal response that they are analysing would have been country specific rather than global. Why is that relevant? It is relevant because if there is a global downturn and everyone responds with fiscal policy then the exchange rate effect is much less important because everyone is stimulating their economies. If you like, you can think of the whole globe as a closed economy and in that world the relevant multipliers are the ones for a fixed exchange rate because the whole world is providing fiscal stimulus. So the results of this paper are certainly relevant but, when you have a global downturn or a global negative shock to which just about every country is responding with large fiscal packages, the relevant multipliers are higher because the spillovers work in both directions.

Senator JOYCE—Are you saying there that the actions of Australia are more the actions of a good global citizen, rather than specific actions based on a domestic economic policy? In effect, we are really riding on the coat-tails of the global effect of stimulatory packages to which we contributed a very minor part. With the premise of an open economy and floating exchange rates, we had the capacity to lower monetary policy. We had some reserves in where our interest rate was; we were not at near zero levels like other economies were.

Dr Gruen—I think the governor made it clear in his testimony that cutting interest rates to very low levels is something that you do if there is no alternative, but that there are attendant dangers in having extremely low interest rates, certainly for any extended period of time. So it is not as though cutting interest rates is completely costless and in all circumstances the only sensible response. After all, one of the arguments presented about what led to this global mess was an extended period of ultra-low interest rates in the US. We can debate how big a contributing factor that was, but it is certainly the case that a considerable body of opinion suggests that ultra-low interest rates in the U.S in the early 2000s were a significant contributing factor in the housing price bubble that developed in the US. So the idea that cutting interest rates further and for longer only has benefits is, I think, an argument that many people, including the Governor of the Reserve Bank, would not agree with.

Senator JOYCE—I may come back to that later if I have time. I will move on to another thing. I do not know if this question is to Dr Gruen or Dr Henry. In the 2009 budget papers there are several dramatic graphs that show the projected path of the economy with and without a fiscal stimulus. How were those projections obtained? Were they obtained from a model? If so, what was the model? If a model was not used, what research based evidence was used to develop the projections? How much uncertainty is in those projections? What were the standard errors that Treasury would put on those projections?

Senator CAMERON—Senator Joyce, can you point us to where that is—

Senator JOYCE—You would have to have a copy of the budget papers.

Dr Gruen—I have a copy of the budget. The GDP graph is on page 48. There is also an unemployment graph and a consumption graph, but I guess the GDP graph is—

Senator JOYCE—The one we are referring to.

Dr Gruen—We have provided significant detail on how these results were derived. It is in the paper that we prepared for the Senate inquiry and tabled a week ago. There is detailed description in there about how these estimates were derived. We used what we thought were reasonable fiscal multipliers and what we judged to be reasonable estimates of the time profile over which the spending would impact on the economy. Those estimates were informed, as Dr Henry said earlier, by a range of studies—by the IMF, the OECD and a range of academics—on the question of how big fiscal multipliers are.

Senator JOYCE—I am just trying to drill down to exactly what model you used.

Dr Gruen—We use a large number of models of different parts of the economy: consumption, employment and various other equations. We also have an economy-wide model which we use. At the end of the day, we take all of these things as inputs and apply judgment, informed by the evidence that we and others collect that we think is relevant. The crucial input into these calculations is one's estimate of the fiscal multipliers. We have provided a table in that paper that we presented to—

Senator JOYCE—I saw the multipliers. So you used a range of models?

Dr Gruen—We certainly use a series of different econometrically estimated equations and, as I said, an economy-wide model. It is certainly the case that the estimates that are presented in the budget are point estimates. They do not have associated standard errors, but there would certainly be—

Senator JOYCE—Why don't they have standard errors? The other question is about the transparency of your standard error test, but you do not have standard errors?

Dr Gruen—There are a large number of different studies which generate fiscal multipliers. It is not simply a single statistical test out of which comes a standard error. We can have a discussion about the range of plausible multipliers for Australia. We have provided different people's estimates of what—

Senator JOYCE—The Treasurer seems to quote them with great aplomb whenever he gets a chance. I just want to know exactly how many models were used in obtaining these.

Dr Gruen—I think I have said as much as I can say about that. As I say, we use a large number of single equation models for different pieces of the economy. We run our own macromodel. We look at the output of other people who run macromodels and we also look at what researchers and international institutions, such as the IMF and the OECD, have to say about what they think are the magnitude of fiscal multipliers.

Senator JOYCE—Where do you get your research based evidence from?

Dr Gruen—A range of people are doing this sort of work, including the paper that you quoted to us earlier.

Senator JOYCE—Did you use the CEPR policy insight? It came out in 2009.

Dr Gruen—It only came out this month. Clearly, we did not use papers that had not been published.

Senator JOYCE—So which papers did you use?

Dr Gruen—I have a folder full of papers here. There are very large numbers of papers on fiscal multipliers. I have 10 or 15.

Senator JOYCE—Which is the predominant one or do they all have equal weight?

Dr Gruen—No. One of the more important pieces of evidence that we used was a couple of academic studies of the consumption response to the 2001 US tax rebates.

Senator JOYCE—Can you tell me those?

Dr Gruen—Certainly. There is a paper by David Johnson, Jonathan Parker and Nicholas Soules, which was published in the *American Economic Review* in the mid-2000s. These researchers added questions to the consumer expenditure survey in the United States to assess the change in consumption expenditures caused by the 2001 federal tax income rebate, to see whether the permanent income hypothesis, which would suggest that very little of that money would be spent, was indeed borne out by the evidence. The amounts of money that were handed out to individuals in those tax rebates was, I think, US$300 or US$600, so they were of the same magnitude as the cash payments in Australia. Cash payments in Australia for many households were slightly more than that. The US handed out money of that magnitude and these researchers came to the conclusion that households spent between 20 and 40 per cent of their rebates on non-durable goods during the three-month period in which their rebates arrived. Roughly two-thirds were cumulative during this period and the subsequent three-month period. That study was published in one of the most prestigious economics journals.

Senator JOYCE—I will go back and grab the paper and trawl through it.

Dr Gruen—Just let me make one further point. It was on the basis of those estimates, which are similar to other estimates from similar studies undertaken by people, that we calibrated our estimates of how much of the December and April cash payments would be spent by consumers in the months following those rebates. We looked carefully at the evidence that we thought was relevant and we used it to the extent that we could.

Senator JOYCE—Maybe I will pick up with you again during Senate estimates. In evidence the Governor of the Reserve Bank said, 'In setting monetary policy, the RBA takes fiscal policy as given and then determines the monetary policy that is appropriate, conditional on that monetary policy.' Does the Treasury agree with this assessment? If so, suppose that the government had chosen a smaller fiscal stimulus; is the Treasury's assessment that this would have caused the RBA to provide a larger monetary stimulus in reaction to the crisis? If there had been a smaller fiscal stimulus and a larger monetary stimulus, is the Treasury view that the nominal exchange rate would have depreciated by more than it did? If so, would that depreciation have stimulated the economy and why was it necessary to adopt a fiscal stimulus that was so large as to limit the action by the Reserve Bank of Australia?

Dr Henry—I probably should take that question. As you know, although I sit on the Reserve Bank board and therefore have an unusual insight into the question you are asking, my practice has been to allow the governor to speak for the Reserve Bank board. Indeed, given the independence that the Reserve Bank has in the operation of monetary policy, I have always considered it inappropriate for me to venture an opinion—publicly, anyway—on where monetary policy settings would be had other things played out differently. But in respect of the question you have asked the governor has, indeed, already answered it in two respects. Firstly, he does not consider that the present stance on fiscal policy has created difficulties for the operation of monetary policy. Secondly, he has indicated publicly that interest rate settings were taken below the point that one might judge to be entirely consistent with everything else that was going on in the economy, because there was a level of insurance built into the monetary policy settings in case events turned out to be not as anticipated but actually worse than anticipated.

Senator JOYCE—Knowing you are on the Reserve Bank board, when you said, 'I probably should take that question,' I should have said, 'No, you can't; I want someone else to answer it.' But I will continue on.

CHAIR—Senator Joyce, we put you on now because you are going to a meeting, but you have had almost half an hour.

Senator JOYCE—Can I place any questions I have on notice? If Treasury agrees with the mainstream view that fiscal stimulus pushes up the exchange rate while monetary stimulus lowers the exchange rate, then it must be the case that current mixture of monetary and fiscal expansions are working in opposite directions on the exchange rate. What then justifies the rhetoric that monetary and fiscal policy are supporting each other?

Dr Henry—I think Dr Gruen has already answered this question, at least, in part. It is not at all clear to us in present circumstances, and I covered this in my opening remarks. The present level of the exchange rate can be explained, in large part, by domestic policy settings, either monetary policy or, for that matter, fiscal policy. Dr Gruen also indicated that whilst in rather simple conceptual models of a small open economy a fiscal expansion in one economy, when the rest of the world is not engaging in a fiscal expansion, might be expected to lead to an appreciation of the currency—and that is a standard Mundell-Fleming result, which you referred to earlier—that same result is not nearly as strong when the small open economy is engaging in a fiscal expansion in concert with fiscal expansions in the rest of the world.

Senator JOYCE—This is my final question. Assume that Treasury would agree—you can tell me if you do not—that all taxation involves distortion to price signals that impose a cost to the community. From my reading, a rough rule of thumb used by economists—and I imagine this would include you—is that the magnitude of the welfare cost of taxation is proportional to the square of the tax rate. Given that the share of tax revenue in GDP is 22.5 per cent, or thereabouts, and the maximum tax rate on labour income is 47.5c in the dollar, the deadweight loss of each dollar raised by taxation revenue is between 5c and 22.5c in the dollar.

So the deadweight loss associated with the fiscal stimulus is between $2.4 billion and $10.7 billion. Could Treasury provide a more precise estimate of the deadweight loss incurred in raising $47 billion?

Dr Henry—I will make one comment on that. I am not sure that the argument you are running is an argument against the use of fiscal policy. It sounds more like an argument against the existence of government.

Senator JOYCE—I am all for removing a tier of government, Dr Henry, as you well know. I have written a paper on it.

Dr Henry—Yes, I am aware of that, Senator. But it is actually a serious question, because it is the case that, generally, taxes do distort economic activity. Those tax driven distortions either reduce the size of the economy below the size that it would otherwise be or in other ways impose welfare losses on citizens. That is generally the case. It is certainly not the case always, and as you would be aware, Senator, it is not the case if the tax is being used, for example, to correct for an environmental externality—and there are a large number of other interesting cases in which taxes that raise revenue actually turn out to be welfare enhancing rather than welfare detracting. But as a general point it is true. What is also true—and this is the reason why people get interested in tax policy—is that different taxes have different effects. For that reason, it is simply impossible to answer the question you have raised without knowing precisely which tax rates are going to go up and which tax rates might even possibly come down.

CHAIR—Senator Brown, as you are the person who referred this, we will go to you next.

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.

Senator BOB BROWN—And presumably the stimulus package then contributed to the final quarter of the financial year, but then we move into this financial year. Do you have the same view about the first quarter and potentially the second quarter of this financial year?

Dr Henry—We think that the peak impact on the economy was actually the June quarter and that in the quarter just finished, the September quarter, there is another substantial positive contribution to the economy from the expansionary fiscal policy. In the quarter that has just commenced, the December quarter, we expect to see a much smaller impact, possibly still positive but a much smaller impact. But, by the time we get to the March quarter of next year, because government spending in the fiscal stimulus packages is then lower in the March quarter than in the preceding December quarter, in the March quarter of next year fiscal policy actually detracts from growth. It makes a negative contribution to growth. We think that will be true in the March quarter of next year and, indeed, in each of the three subsequent quarters. So in every quarter of 2010 we do not see fiscal policy making a positive contribution to growth; quite the contrary, we see fiscal policy making a negative contribution to growth. If you take the year as a whole, we see fiscal policy reducing gross domestic product growth in 2010 by 1¼ per cent.

Senator BOB BROWN—To flesh that out a little, you see the stimulus package as contributing to a contraction in gross domestic product?

Dr Henry—Yes, that is correct.

Dr Gruen—Growth. Sorry; growth, not level.

Dr Henry—Not the level but the growth. If fiscal policy is expanded—so the level of government spending is increased—in a quarter, that will, other things being equal, expand gross domestic product or make a positive contribution to gross domestic product in that quarter. If government spending does not then stay at that new, higher level forever more, if it is then withdrawn and goes back to its earlier level, then it is going to detract from gross domestic product growth in subsequent quarters. So this fiscal stimulus package, because it is temporary—that is, there is just a temporary increase in government spending and not a permanent increase in government spending forever more—whilst it will have a positive impact in early quarters, must necessarily have a negative impact in subsequent quarters.

Senator BOB BROWN—But without it the negative impact would be even bigger—I mean, if we withdrew it?

Dr Henry—That is correct. So, as I said in my prepared remarks, if we were now to ‘cancel’ all of the spending anticipated in the fiscal stimulus package going forward, we reckon that that would subtract another 1¼ percentage points—

Dr Gruen—I think it is 1½.

Dr Henry—Is it 1½? Well, whether it is 1½ or 1¼ percentage points—from growth in 2010.

Senator BOB BROWN—I think you said 1.6 per cent.

Dr Henry—It is 1½; I am sorry.

Dr Gruen—A further detraction of 1½.

Dr Henry—You are quite right: 1½.

Senator BOB BROWN—Would I be right in assuming, then, that the stimulus package, in your view, should be rolled out as is, not to keep us out of recession but to keep us from less growth—that is, below-trend growth?

Dr Henry—Largely, yes. I would want to qualify that in one respect. I would not want to be interpreted as suggesting that, if it were ever the case that gross domestic product was growing below trend, there would therefore be a case for expansionary fiscal policy. As Senator Joyce indicated earlier, there is a general consensus that, in most circumstances, monetary policy can be relied upon to perform that role reasonably well if monetary policy is properly targeting inflation. In the present circumstances, however, as I indicated earlier, not only were we confronting the probability of gross domestic product growing below trend—let us say growing below three per cent or thereabouts—but we were confronting the real possibility of gross domestic product going negative, contracting very sharply. To our mind, that provided and provides a strong case for a fairly significant fiscal policy response.

In structuring the fiscal policy response, what was in our minds and in advice that we tended to government was that the government has a temporary role to play in effectively moving in behind a retreating private sector. Think of aggregate demand as having two components in concept: a private contribution to aggregate demand—household consumption activity and business investment principally, but also exports, or net exports, if you like—and also the public sector making a contribution to aggregate demand, and the circumstance that we were confronting was a collapse in private sector demand. We saw a case for government demand—public sector demand—increasing to some extent to come in behind that retreating private sector demand.

But at the same time we saw the probability of private sector demand coming back at some time in the future and in those circumstances, with the private sector contribution to aggregate demand increasing, it is of course appropriate that the government then withdraw, that public demand then withdraw. It would be appropriate for government demand to withdraw as the private sector is increasing even if the economy were still growing below its trend rate. Some level of withdrawal of stimulus would still be appropriate. I would not want to be interpreted as saying that simply because the economy is judged or forecast to be growing below trend that that in and of itself provides a case for an additional fiscal policy stimulus.

Senator BOB BROWN—But are not you indicating to the committee there that some withdrawal of the stimulus could be appropriate given the improved circumstances of the economy?

Dr Henry—No, what I am saying is that the fiscal stimulus package, in the way that it has been constructed, does withdraw public demand.

Senator BOB BROWN—Yes, I understand that, but spending at the moment on my back of the envelope is somewhere in the order of $3 billion or $3½ billion a month and we are going to have to pay them back. Ought we not be looking at reducing that rate of expenditure even though it is going to tail off in the interests of avoiding the potential of short-term pleasure creating long-term pain?

Dr Henry—These are the judgements that governments have to make obviously in the conduct of fiscal policy and, as I said in my remarks, if those payments that are already in prospect were now not to be made, the economy would grow at a rate even further below its trend rate of growth. That is to say, the unemployment rate would increase even further than we presently forecast. Now of course it is open to governments or parliaments to decide whether they want to take that trade-off or whether they would prefer to see the payments continue therefore providing at least some support to gross domestic product growth and the probability of a lower peak unemployment rate. That is precisely the trade-off that the government had to consider in constructing the package.

Senator BOB BROWN—We certainly have a lower unemployment rate than was anticipated when we were talking back in February. Taking that into account, aren't you concerned that if we don't put a brake on the stimulus spending at the moment we are going to have to raise taxes or cut services further down the line, which may have the effect of increased unemployment compared with where it would otherwise be in the years to come?

Dr Henry—Of course the stimulus that is being provided at the moment, to the extent that it is debt financed, will have to be repaid in the future. That means that at some stage in the future either government spending will be lower than it otherwise would have been or tax settings will be higher than they otherwise would have been. But that future time will be a period of faster growth in private sector activity and the judgement has been made that in those circumstances where the private sector is growing much faster than it is at the moment the government will have the ability to repay debt without doing damage to gross domestic product growth. That is, we consider that the economy will be able to grow at about its trend rate notwithstanding the fact that of course government spending will be lower than it otherwise could have been and/or tax revenue will be higher than it otherwise could have been. Those factors have been taken into account in the development of the package.

You raise another issue, an observation that the unemployment rate today on the evidence we have is not as high as we were anticipating the unemployment rate would be by now, and that is certainly the case. It is certainly the case that on the numbers that we presently have the Australian economy is performing better than we thought it would even taking into account the contribution to growth from the fiscal stimulus and the contribution to growth from the monetary stimulus and the continuing contribution to growth of the earlier depreciation of the exchange rate. There are other factors, but taking all those things into account, the outcomes to date—not all of them but certainly in the labour market outcomes—have been better than we had forecast.

So then the question is: given that the unemployment outcomes are better than we forecast, does that in and of itself constitute a case for adjusting the shape of the fiscal stimulus package, perhaps even cancelling payments that are presently in prospect? Our view is that the unemployment rate has not yet peaked—that is our view. Even though the unemployment—

Senator BOB BROWN—Can you say what you think it may peak at now? Have you got a revised estimate on that?

Dr Henry—We have been revising the forecasts—and they are, of course, the government's forecasts; although we prepare them, we do not publish them. The government publishes them and the government will be publishing those revised forecasts in the midyear economic and fiscal outlook. But for the purposes of this discussion, I think that we do not need our current forecast because, as I indicated earlier, the International Monetary Fund has just recently published a revised forecast of the Australian unemployment rate of around about seven per cent.

Senator BOB BROWN—Are you comfortable with that figure?

Dr Henry—I think that that is a reasonable figure for us to be talking about. Without publishing today the Treasury's revised forecast for the unemployment rate, I think that that is a reasonable figure to be talking about. The IMF is quite a credible organisation. They have a lot of information available to them and they talk to us quite a bit as well.

For the sake of argument, let us assume that that is a reasonable number to be talking about, then the question is rather: do we think seven per cent is too low? In advice that we would tender to government on that matter, we would not be saying that seven per cent is too low.

Senator BOB BROWN—Just on unemployment and looking at next year's budget, no doubt part of the stimulus to the economy that worked well was the $30 increase to pensioners. Do you see the merit in extending that to the six, seven or eight per cent of people who are out of work, those on a very low income who may benefit from a $30 increase to that poverty-level income?

Dr Henry—The question that you are raising is not really to do with the merits or otherwise of the fiscal stimulus. It is true that the increase in the age pension could be expected to have a stimulatory impact on the economy—that is true—but, as you are aware, Senator, the age pension was increased not principally for that reason. Of course, it is a permanent increase; it was not a temporary increase in the age pension that was subsequently withdrawn like the other fiscal stimulus measures. The question of whether there should be a complementary increase in the unemployment benefit, for example, is a policy question that goes to matters beyond the policy considerations bearing on the fiscal stimulus package, and it is properly a question for the Treasurer rather than for me.

Senator BOB BROWN—In the budget papers the government commits to:

… holding real growth in spending to 2 per cent per annum once economic growth is above trend.

… … …

… until the budget returns to surplus.

When do you expect the two per cent limit in real growth to take effect?

Dr Henry—The two per cent limit takes effect when we have the economy forecast to be growing above trend, which I think we estimated in the budget to be 2012-13. Am I right, colleagues? I think it was 2012-13—my colleagues are checking, but I think that is right—that was the first year in which we had the economy growing above trends. It is 2011-12, is it?

Dr Gruen—2011-12.

Dr Henry—I am sorry: 2011-12. Of course it is 2011-12. That would be the first year in which that two per cent real commitment would become binding, if you like, on government expenditure.

Senator BOB BROWN—You have not readjusted that forecast time line in light of the—

Dr Henry—We have revised our forecasts or are in the process of revising our forecasts. We still consider—I hope I am not publishing a revised forecast in saying this, but I think it is still the case—that 2011-12 would be the first year in which we would be forecasting above-trend growth.

Senator BOB BROWN—In the final budget outcome on 29 September, the Treasurer announced an improvement in the budget bottom line of $5 billion. Do you expect that that may improve further by budget time next year?

Dr Henry—Of course, that was the budget outcome for 2008-09. That number will not change.

Senator BOB BROWN—But there will be other improvements?

Dr Henry—Yes, correct. I know what you mean. Correct me if I am wrong, but as I understand your question you are asking whether the improvements that we saw in 2008-09 would continue through into 2009-10 and subsequent years and whether we might see even further positive developments for the budget.

Senator BOB BROWN—Yes, in view of the changed circumstances we now have.

Dr Henry—That is an important question; it is also a complex one. The better fiscal or budgetary outcome in 2008-09 had two principal components, one on the revenue side and one on the expenditure side of the budget. I know that in a lot of commentary about it the whole $5 billion was presented as an improvement in revenue, and that was not the case; anybody who read the document would have seen that that was not the case. As far as the improvement in revenue is concerned, one has to be very careful in assuming that that upward revenue adjustment would have positive implications for revenue going forward. Sometimes a revenue adjustment is of a one-off nature. In that particular revenue adjustment there was a considerable one-off adjustment that we would not expect to see reflected in higher revenue collections in subsequent years. Notwithstanding that, because your question was also about other positive adjustments, it is generally—

Senator BOB BROWN—Can I tempt you to tell us what that one-off adjustment was?

Mr Parker—The question which you have asked was gone into in some detail in the FBO publication and in subsequent discussions. Just very briefly, to summarise it, there were two significant one-off events. There was a substantial company—I do not know the name of it; I am not permitted to know the name of it because of the secrecy provisions in the legislation—that found it had made an error in its instalment payments in the course of the year. It corrected that error in the final quarter and made a substantial payment. There were also a number of significant one-off profits generated in the foreign banking sector in Australia as a result of the global financial crisis, the movement in exchange rates and the remission by those subsidiaries in Australia of funds back to their parent companies, and as a result of that they paid a large one-off payment.

Senator BOB BROWN—Thank you. I refer to a comment from Dr Richard Denniss, an economist who came before the committee a week or two ago. He said that if Treasury thinks it will take seven years 'to get the budget back into the black, that suggest to me that taxes are too low'. He said it should not take seven years to get the budget back into balance. Britain is in a much worse situation than us and they are increasing taxes on high-income earners as of April next year. Would you like to comment on whether we should be taking seven years to get the economy back into the black?

Dr Henry—The medium-term projections we have done are based on a number of fiscal rules that the government has adopted. One of them you have already mentioned, and that is that when the economy grows above trend the increase in government spending will be limited to two per cent in real terms. So that is one. Another is that the tax revenue to GDP ratio will not exceed, on average, its level in 2007-08. Of course, it is always open to governments and to parliaments to take discretionary action in order to lift a tax to GDP ratio. But the government's medium-term strategy allows the tax to GDP ratio to rise with a recovery in the economy, and it rises principally as a result of the fact that we do not have flat taxes in Australia. So it is to allow that ratio to rise, but such that its average over the cycle does not exceed that 2007-08 level.

With a different fiscal rule, with a different rule on the tax to GDP ratio, of course it would be possible to have the budget deficit removed sooner. And, of course, with an alternative lower tax to GDP ratio rule, that would push out even further the time at which the budget comes into balance. So it is a policy choice, and the government has articulated the choice that it has made on that matter through its medium-term fiscal strategy.

Senator BOB BROWN—Do you think that seven-year wait should not be changed now that the economy is performing better than we thought?

Dr Henry—This gets to the second part of your earlier question, or what I understood to be the second part of your earlier question, and that is: given the changed economic circumstances, is it conceivable that we could experience stronger revenue growth in future years than what we have presently got factored into the budget? This is a matter that we have given a lot of thought to in preparing revised economic forecasts and revised revenue forecasts for the Mid-Year Economic and Fiscal Outlook. Again, it is for the government to publish those numbers rather than me, but we have thought quite deeply about that issue in preparing forecasts for that publication.

Senator BOB BROWN—And you are hopeful about a better expectation than we had before?

Dr Henry—It is generally the case that a stronger economy means strong revenue growth. But the reason I would want to sound a note of caution is that our tax revenue receipts are driven not directly by the growth in the real economy but rather the growth in the nominal economy. In particular, as we have discussed over several years in this committee, what happens to Australia's terms of trade has a very significant impact on revenue growth because of the significant impact on the size of the nominal economy, nominal incomes—just money incomes. That is the first point.

The second point is that revenue growth is related also to capital gains. Capital gains are not actually part of the nominal economy, they are not included in the Australian Statistician's measure of either real gross domestic product or nominal gross domestic product. Over the last five years before the global financial crisis hit and before we had a stock market correction and a correction in real estate prices and so on, our experience was that capital gains tax receipts were growing very strongly—every year we were getting more and more capital gains tax receipts and therefore revenue was growing at an even faster rate than the nominal gross domestic product was growing at. With the stock market correction and correction to rental housing prices and so on, and most of it has actually been in the stock market, people have realised capital losses. They are able to carry those capital losses forward to offset against future capital gains. So we are a bit cautious about forecasting a speedy return to strong revenue growth for that reason. We are also cautious about it because, even if you ignore capital gains and go back to the nominal economy for a moment, a lot of taxpayers have incurred tax losses related to negative profits, not capital losses but just negative operating profits. There is a significant stock of accumulated tax losses now sitting in the tax system and of course they can be carried forward as well and set off against future taxable income other than capital gains.

So there are two very good reasons. And we saw this when we came out of the early 1990s recession. We saw quite slow growth in revenue for those two reasons as well. But on this occasion we would see it is even more likely, particularly with respect to the capital gains tax component, that we will be in a period of quite slow revenue growth in a period in which, whilst nominal income appears to be growing quite strongly, we should not be at all surprised to find that tax revenue is not growing quite as strongly.

Senator CAMERON—Dr Henry, I would like to have a look back before we look forward on some of these issues. Some of the evidence we had to the committee took the view that we were actually facing a possible great Depression if there had not been internationally coordinated action. I looked at some of the statistics after the Lehman Brothers collapse in September: $43 trillion wiped off the value of the global share market in record time; the Australian stock exchange fell 8.3 per cent in one day; our dollar dropped 16 per cent in a week; the interbank lending market was shut down; the world's largest insurance company failed; America's fourth-largest investment bank and the world's largest provider of housing finance were bankrupt or bailed out; and entire banking systems were saved or nationalised. When you look back at what treasuries and governments around the world were faced with at that time, is it reasonable now to argue that governments have overreacted and panicked in response to the crisis? I ask you on two levels: on an international level was there overreaction and panic and in Australia was there overreaction and panic?

Dr Henry—It is not my view that there was overreaction and panic; no, that is not my view. And it is not the view either of the International Monetary Fund or of other international agencies that have looked closely at the policy responses of governments around the world. If anything, the charge that would be levied at quite a number of governments around the world is that they did not react as quickly as they might have. It is understandable because these were quite unprecedented times. There is no current policy adviser operating anywhere in the world, not in their professional lives anyway, who have lived through times like these. It is quite unprecedented and therefore it is understandable that some were slower to react than others. But I am not aware of any cogent criticism, by the international organisations certainly, along the lines that you have suggested, that governments around the world panicked and in their panic overreacted to the crisis. Indeed, in my opening remarks I referred to quite recent commentary from the International Monetary Fund encouraging governments to maintain expansionary policy settings. There has also been substantial positive commentary on the other things that governments around the world have done to ensure the stability of financial systems and to plug gaps in credit markets.

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.

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?

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 is 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.

Senator CAMERON—Thanks. If the decision is made, I suppose, then, we need to look at whether we need to have expansionary fiscal and monetary policy. The paper that has been quoted to the committee is by Elmendorf and Furman: *If, when, how: a primer on fiscal stimulus*. Is anyone aware of that? I say that, in broad terms, the issues that are raised there are whether you should have a stimulus package, when you should have the stimulus package, how it should be put together and, at the next level, whether it is timely, temporary and targeted. In the context of that analysis coming out of the Brookings Institute in the US, has Australia met that sort of academic analysis of what is proper to carry out in the face of the global financial crisis that was facing governments?

Dr Henry—I can answer that in general terms. 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.

Dr Gruen—I will add a little bit to that. One of the things that made this crisis so unusual and unprecedented—certainly from Australia's perspective—was that we got such a strong and unequivocal signal from the rest of the world in the middle of September that something truly catastrophic was happening in the global capital markets. We were very confident—and that confidence grew over a period of just a couple of weeks—that an enormous negative shock was coming our way. The shock had arrived in the sense that it had already had an impact on share markets and the exchange rate, as you explained, and it was very clear that that was going to lead to a very substantial negative shock to the real economy. Why is that relevant? In normal times, if the economy is gradually slowing and is perhaps going to go into recession you do not get anything like as clear a signal that now is the time to act. So one of the reasons why many people are suspicious of using discretionary fiscal policy is that it is very difficult to get the timing right. That was Australia's experience in the early-nineties recession. We went gradually downhill. There was a fiscal response, but it was very late. On this occasion, on 15 September Lehman Brothers fell over and over the subsequent week AIG went bankrupt. The spreads in the interbank markets went to levels no-one had ever seen before.

The Australian economy was doing fine in September, but it was very clear that this enormous shock was coming. Monetary policy was eased in the first week of October by one per cent and the government made decisions on 12 and 14 October to both guarantee the wholesale borrowings of our banks and put in a fiscal package of about one per cent of GDP—roughly $8½ billion of which was cash payments, which went out in early December. Why am I going through all of that? It is rare but extremely important that, if you get a signal in September and you can have cash in people's hands in early December, then you have done about as well as you can possibly do in responding to a shock in as timely a way as you possibly can. That is an extremely unusual situation and it radically changes the calculus of whether discretionary fiscal policy is a good idea or not.

Senator CAMERON—I do not have the latest IMF paper that you quoted earlier, but I do have a paper going back to 3 September from the OECD, from Elmeskov, the acting head of the economics department. I am looking forward a little bit, but what the OECD said is that there are numerous headwinds that the international economy faces and the pace of recovery is likely to be modest. It seems to me that a lot of the analysis that we have had here focuses very tightly on Australia. Over the years I have had many lectures about a globalised economy—from Treasury and other politicians. Given that we are in a globalised economy, what are the implications of these 'headwinds' on Australia?

Dr Henry—I will start off on this and Dr Gruen may wish to add to it. Our interpretation is consistent with that interpretation, at least in the way that you have put it. I have not read that article in detail, but our interpretation is similar, that there continue to be strong headwinds in the global economy. We interpret that as providing grounds for caution in respect of policy settings in Australia. Whilst it is undeniably the case that the Australian economy is performing better than we had earlier imagined and certainly better than we imagined at the time of the budget, that has had implications for our thinking about future forecasts for the Australian economy. Notwithstanding that, it is too soon to come to a judgment that all of this is behind us and that the Australian economy will not be adversely affected by future negative shocks coming in from the global economy. It still remains a distinct possibility that the global recovery could be a faltering one and that there could be both relatively low global growth and also unusually volatile global growth coming out of this particular global recession. This is a possibility that one should not discount, notwithstanding the stronger-than-anticipated outcomes in the Australian economy to date.

Senator CAMERON—You indicated in your initial remarks that if we remove the stimulus, as some have argued, there would be, I think, a 1.25 per cent reduction in growth. I am not sure.

Dr Henry—Just to clarify—I think I am responsible for the mix-up in this: the stimulus package, as it has been instructed, we think we will withdraw about 1¼ per cent from growth in 2010. That is because the level of government spending in that year will be lower than the level of government spending in the preceding year—that is all.

Dr Gruen—In 2010-11.

Dr Henry—In fiscal year 2010-11, sorry. So 1¼ per cent in 2011. But I also said that, if we were now to withdraw the stimulus, growth in 2010-11 would be 1½ percentage points lower again.

Senator CAMERON—What does that mean in terms of job numbers and your normal multiplier?

Dr Henry—I think I indicated in my opening remarks about 100,000 additional unemployed.

Senator CAMERON—So 100,000 Australians could lose their jobs, according to the Treasury estimates, if we listened to some of the arguments out there and withdrew the stimulus right away?

Dr Henry—If you withdrew the stimulus right away, and you withdrew all of the stimulus right away, yes, we would consider that the increased in unemployed would be of that order of 100,000 jobs. It could quite possibly be more than that.

Senator CAMERON—Given the social consequences of that, that is quite obviously very worrying. But it would also have an effect on confidence in the business sector. This is an issue that treasuries around the world have been looking at as well, this issue of confidence. If we suddenly reversed our strategy on this, what would it mean for confidence in business? Is there some analysis of that?

Dr Henry—Everyone has a view on that, I am sure. Business confidence and consumer confidence are notoriously difficult things to forecast. We have been very encouraged by the rebound in consumer confidence and business confidence that appears to have occurred. It certainly is a good thing for our short-term economic prospects. It is a good thing for consumer spending. It is also a good thing for business investment spending. That rebound in confidence, I think, is well based, because the Australian economy is clearly performing better than people had feared. So I think it is a well based rebound in confidence. But, as we have seen in the quite spectacular volatility in the consumer and business confidence indices, business and consumer confidence can turn around quite quickly. One should therefore be cautious about the impact of very large discretionary policy decisions at a time like this. That is probably all I could say about it. I am certainly no expert in forecasting business and consumer confidence.

Senator CAMERON—I want to go to the make-up of the stimulus package that the government has introduced. There are a number of levels, and a number of different timings, that were implemented in terms of the fiscal stimulus to allow pensioners and people to get out there and keep the economy going. But we have had some discussions about productivity. There have been very shallow discussions about productivity in this hearing. The sort of analysis that some have put to the hearing is that basically all of this spending was just thrown at the economy. But a lot of the nation-building package and the budget infrastructure measures have an implication for longer-term national productivity, have they not? Has the Treasury done any analysis on the implications for longer-term productivity improvements coming from this package?

Dr Henry—We do not have precise numbers that would estimate the impact on productivity of the capital spending that you have referred to. 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.

Dr Gruen—Can a add one other slightly different angle on that? 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 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 and to a considerable extent one of the whole justifications for trying to stabilise the business cycle is so that people can get on with their lives and not have to worry about this sort of stuff.

Senator CAMERON—There has been criticism of the cash payments, the $4.8 billion and the family tax benefit of $3.9 billion. The derogatory term has been ‘the cash splash’. We have had two different points of view given to the committee on these cash payments, one from Professor Lay that says, ‘Yes, they did stimulate retail spending and were very important,’ and one from Professor Sinclair Davidson basically saying that this was just a nonsense and should not have taken place. What is Treasury’s view on those two conflicting arguments.

Dr Henry—Dr Gruen may wish to add to this, but on the evidence that we have seen—informed by both the ABS data on retail sales and of course the national accounts but also by private sector surveys—suggests that quite a significant proportion of the cash payments were indeed spent by households. That suggests to us that those cash payments had quite a significant stimulatory impact. Most of the fiscal stimulus that we have seen to date has been those cash payments. I indicated earlier that on our view, while the economy grew by 0.6 per cent through the year to the June quarter, without the fiscal stimulus package—and that means primarily without the cash payments—the economy would have contracted by 1.3 per cent. It is pretty clear from that figuring which side of that argument that we would sit on.

Senator CAMERON—The other arguments that we have heard are in relation to interest rates and debt. The argument has been that this will lead to higher interest rates in the future and that basically there will be this massive debt burden. Can you explain in relative terms the debt burden in Australia? Is it sustainable? How does it compare with other international economies?

Dr Henry—There is obviously a net debt in Australia. While it was once negative, it is now going into positive territory. But as a proportion of gross domestic product the net debt of the Commonwealth government is quite low in comparison with most other countries—virtually all other countries. We have certainly not regarded it as an unmanageable level of net debt. It is the sort of increase in net debt that we considered capable of being well managed by the future conduct of prudent fiscal policy settings. While it will likely take a considerable number of years for the net debt to be reduced all the way back to zero, we nevertheless see that as a quite realistic prospect.

Senator COONAN—The RBA now believes that the economy grew slightly in the year ended 30 June and expects 0.5 per cent growth this year, instead of a contraction of the same amount, with a lower peak in the jobless rate. We have discussed that. The final budget outcome from 2008-09 shows a modest improvement of $5 billion from the May budget in the underlying cash deficit and revenue is now obviously seen to be stronger than expected. Commonwealth borrowing is $11.5 billion less than forecast. There have been some private forecasts, as you mentioned in your opening, Dr Henry, that expect the budget to return to surplus by 2013 instead of 2016, with debt peaking at about $80 billion below budget. What I want to concentrate on just for the purposes of this question is going forward rather than discussing with you the various views about why and how big and how much et cetera. What I am interested in is why the Treasury does not appear to have a plan B. You may do.

I want to ask that question in the context of evidence received from the Reserve Bank governor, who said, and I hope that I am accurately reporting this, that both expansionary and fiscal policy need to be reined in or withdrawn gradually. He said that he was comfortable with the stimulus package in its timeframe, given that it will phase out. I am sorry that this is a bit long to have as a preliminary—I am trying to be fair and accurate here. My reading of it is—and correct me if I am wrong about this—that the fiscal stimulus is designed to expire by mid 2012 as the cash components and the school building program and the bigger infrastructure projects progressively finish. It seems to me that more than half the fiscal stimulus is still scheduled to take place from next year and more than a third from 2011. The plan B that I am talking about is in the context of whether or not with improved conditions there is a real danger of overshooting if it continues the way that it appears to be going, particularly with the pickup in the trade with China and so on.

The governor said that in those circumstances it is the Reserve Bank's job to make sure that the economy does not overheat. He said:

> As to whether there is a case for the government to have in their top drawer a kind of plan B that seeks to wind this back faster next year, there might be.

He added that deferral of some of the fiscal stimulus spending might have some attraction. Can you talk about—

Senator CAMERON—For accuracy, he went on to say, 'How feasible that is, I cannot answer.' That was the full quote.

Senator COONAN—I am certainly not misrepresenting what the governor said. I am being careful not to misrepresent in any way what the governor said.

Senator CAMERON—I have got it in front of me.

Senator FIELDING—If I can come in here, from the transcript, this is what Mr Stevens did say:

> Whether they need a plan B or whether one should be implemented is, of course, a topic of debate.

So I think it is fair point to raise. That is what Stevens said: it is a topic of debate.

Senator COONAN—In that context, I am interested to know from Treasury's point of view if you have a plan B and what plan B might look like.

Senator CAMERON—And is it feasible?

Dr Henry—Of course, if there were a plan B, it would be the government's plan B. As you know, we provide advice to the government. We provided a lot of advice to the government and we certainly assist them in the development of policy, but it would be their plan B, not ours. So in that sense the Treasury does not have a plan B, and I am not able to indicate to the committee the nature of discussions that we have been having with government over the past several months about both the unfolding economic impact of the stimulus as we perceive it—and we are paying very close attention to the way that the stimulus is impacting on the economy—and also the question of whether, on the basis of the evidence we see to date, there might be a case for any sort of modification of the fiscal stimulus package or, if you like, whether there would be a case for a plan B to be developed.

We are in discussion with the government all the time about the state of the economy, the stance of policy and the appropriateness of the present stance of policy, but it is for the government to decide whether the government at any future time might want to adjust the package or indeed implement some other complementary measure. It will be for the government to make announcements about those matters at an appropriate time.

Senator COONAN—I appreciate that. Has the government sought advice about either winding back or deferring any part of the stimulus package?

Dr Henry—I think I just said that we have been talking to the government on a very frequent if not always regular basis about the impact of the stimulus package on the economy and about what is still to come and so on. I can simply refer to continuing discussions.

Senator COONAN—And continual advice from Treasury?

Dr Henry—Continual advice from the Treasury—correct.

Senator COONAN—On the topic of the impact of the stimulus and whether or not any part of it should be withdrawn or deferred?

Dr Henry—The difficulty I have in answering that question is that, if I were to indicate an affirmative in response to that question, some might draw the conclusion that the government had come to a particular policy view, and it is not appropriate for me to indicate whether the government has come to a particular policy view or not. So I do not really see how I can answer the question of whether the government has asked for advice on particular options without running the very real risk of having my answer construed as a statement that the government has come to a particular view on the question of the appropriateness of present policy settings. It is certainly not for me to announce on behalf of the government whether it has or it has not.

Senator COONAN—No. I am not expecting you to do that, but does Treasury have under consideration the appropriateness or otherwise of whether to withdraw or defer any part of the stimulus still to be rolled out?

Dr Henry—We are monitoring developments very closely. We have heard the Treasurer say publicly on a number of occasions that, if the circumstances arose that warranted an adjustment to the stance of fiscal policy, the government would of course—I think he says ‘of course’ when he says this—consider adjustments to the stance of fiscal policy, but that is on the basis of the circumstances of the time warranting an adjustment. Given that that is the government’s clearly articulated position, it is our job to ensure that (1) we are monitoring economic developments very closely and (2) were we called upon to advise the government on what sorts of adjustments might be made to policy, we would be in a good position to do so.

Senator COONAN—I also want to ask about another aspect that came out of evidence given by Mr Stevens. I am summarising here. He acknowledged that there was a trade-off between monetary and fiscal policy. Do you agree with that?

Dr Henry—In normal circumstances there is a trade-off between monetary—

Senator COONAN—Spending and interest rates.

Dr Henry—yes—between fiscal policy and monetary policy. In normal circumstances and even in extreme circumstances, there can obviously be a trade-off between the two things. I do not know whether you were going on to suggest that, therefore, it is necessarily the case that one is always working in opposition to the other, which is how some people have interpreted that.

Senator COONAN—I was not going to put it quite that way.

Dr Henry—Okay.

Senator COONAN—I was interested in your view as to the effects of the expansionary fiscal policy at a time when monetary policy is being reined in.

Dr Henry—Do you mean at a time when monetary policy is being tightened?

Senator COONAN—Yes.

Dr Henry—A monetary policy tightening would—other things being equal—in itself have a dampening impact on aggregate demand. A fiscal stimulus would have its effectiveness blunted for that reason. If monetary policy was being tightened and a fiscal stimulus was occurring at the same time, then the effectiveness of the expansionary fiscal policy would obviously be blunted.

Senator COONAN—But wouldn't the expansionary fiscal policy also contribute to the general stimulus in the economy, the general consumption and demand, that would feed into the need to tighten monetary policy?

Dr Henry—I can conceive of circumstances in which that would be the case, such as, if the economy was operating above its potential level, with growth well above trend growth and with strong inflationary pressures. I can imagine that, in such circumstances, if there were then to be an expansionary fiscal policy, the Reserve Bank would feel the need to respond with tighter monetary policy. But, as you would understand, Senator, from earlier evidence, we are a long way from being in such economic conditions at the moment. There has been no evidence presented to this committee that I am aware of, and certainly none presented by the Governor, that suggests that we have any imminent inflationary pressures. We have an economy that is well below its potential level of output, with growth below the potential rate of growth and with rising unemployment. In those circumstances there seems to me—and I interpreted the Governor's statement the same way—little risk of an expansionary fiscal policy creating an issue for monetary policy.

Senator COONAN—Does it have no impact on monetary policy?

Dr Henry—I am pretty confident that thus far it has had no impact—no implications for monetary policy.

Senator COONAN—What are the implications for the expansionary fiscal policy, the roll-out that I mentioned a little earlier, going forward for interest rates?

Dr Henry—Significantly—and this is why I have taken some time to try to explain this point—all through next year, fiscal policy will be detracting from growth. It will be taking away from aggregate demand, not adding to aggregate demand.

Senator COONAN—Right. I will come back to that in a moment.

Dr Henry—That is, it will not be adding to growth in the economy. We could, of course, advise the government to have fiscal policy make an even larger negative contribution to growth but, notwithstanding that, on our assessment, in every quarter in 2010, fiscal policy will be making a negative contribution to growth.

Senator COONAN—The governor observed that there are dangers in keeping monetary policy too accommodative for too long, in the sense that it could lead to imbalances. Are there similar dangers for the economy in keeping fiscal policy overly stimulatory for too long?

Dr Henry—In concept, yes. But the fiscal stimulus package that the committee is considering is a temporary fiscal stimulus package, and its peak impact on the economy has already passed. Its impact on the economy was positive in the September quarter and will probably be positive in the December quarter. But, as I indicated earlier, going into next year it will be negative.

Senator COONAN—I just want to come to some points about some of your comments on growth. I am going to your paper rather than your comments. You noted that the estimates show not just the economic effects of the pure stimulus packages but include additional spending items. Does that have any impact on the accuracy of the estimates? I will see if I can clarify that for you. You note that the economic impacts are estimated only for the three-year forecast from 2008-09, which means that the full economic impact of the measures over the life cycle of the measures is not shown. That seems to me to be only a partial estimate. Have I got that wrong?

Dr Gruen—We do not forecast beyond 2010-11. In principle, when the next year becomes part of our forecasting period, we will present—

Senator COONAN—For the life of the measures?

Dr Gruen—Indeed.

Senator COONAN—I see what you mean.

Dr Gruen—Beyond 2010-11, we make projection assumptions about what the economy will be doing.

Senator COONAN—The response notes that the winding down of the fiscal stimulus will subtract 1.2 per cent from 2010-11. There would also be subtractions from growth, presumably, in years further out as the budget returns to surplus but the effects are not shown.

Dr Gruen—That is right.

Senator COONAN—My description of it is that the fiscal stimulus shifts grow through time by pulling growth forward. Does the stimulus add to growth in total over time, or not?

Dr Henry—Maybe and maybe not. Eventually we would see the economy tracking back to its potential level—a level that it would have been at had there not been a global financial crisis, had there not been a substantial negative shock to private sector demand and had there not been the fiscal stimulus package. So eventually we would see the economy back at the same point. But there is a qualification on that—and it is one that Dr Gruen referred to earlier, though maybe he did not make the point quite as starkly as I am about to make it. The qualification is that, if a recession is bad enough and sufficiently protracted, an economy can lose a substantial amount of its productive resources, both labour and capital. Labour and capital that become unemployed in a recession, if it is sufficiently deep and sufficiently long, may never be put back to work. So it is possible that a recession can be significantly deep and sufficiently long that the economy's future potential level is impaired.

Senator COONAN—But in this case you have said the downturn was shallower.

Dr Henry—Yes. So in this case, because the fiscal stimulus occurred as early as it did and because it was as large as it was, we are hopeful that there will be no long-term impairment of the level of gross domestic product.

Senator COONAN—But can we be sure that the overall effect of the budget measures through time is to add to growth, or do we just not know?

Dr Henry—As I indicated, the best-case scenario is that you end up where you would otherwise have been if none of this had happened. I think that is the best-case scenario, and there are reasonable grounds for thinking that that is indeed where we will end up.

Senator COONAN—I want to ask Dr Gruen about his earlier answer about multipliers. I do not think he has answered this, but he may have. You will obviously tell me if you have, Dr Gruen. The estimates assume positive government multipliers and that government spending adds to growth. At the risk of impugning the academics, it is not always accepted by the academic world. Of course, as was mentioned a little earlier, it is because, either through taxes or borrowing, it has got to come from somewhere and it is less money being spent by someone. The lowest spending, then, would have negative multipliers, wouldn't it? Is there an assumption that the net effect—that is, the positive multiplier less the negative multiplier—is positive? Is that what you are assuming with the multipliers?

Dr Gruen—There is no question that there are, in principle, some offsetting effects. One of the famous ones is something called Ricardian equivalence. The idea is that consumers who are in a position to smooth their consumption through time will realise that the extra government spending now implies extra government debt which will need to be paid back at some time in the future and they respond by reducing their consumption now. Ricardian equivalence is something about which whole conferences are run and there is a huge amount of sometimes heated debate about just how relevant it is as an empirical proposition. It certainly works in theory; the question is how relevant it is to the real world. I have done some research on this myself. Many years ago I went out and asked people how much they knew about the level of Australian government debt. I then asked academic economists how much they thought people would know, and it turned out that the academic economists massively overestimated the amount of knowledge of the people I had asked. So my reading of the evidence is that it is more convincing for economic economists than it is for the real world. That is not to say that there is not some effect; I think there is almost certainly some effect. As we have said in the budget papers and elsewhere, I think if anything the multipliers we have used in our analysis are at the conservative end of the international consensus, so they would comfortably include the possibility that there is some Ricardian behaviour and you would nevertheless have multipliers that are at least as big as the ones that we have assumed.

Certainly, in the evidence that I reported on earlier to Senator Joyce, which was of that 2001 example where there were tax rebates to consumers in the US, the academic evidence from that experience as well as our own suggests that there is a lot of non-Ricardian behaviour in response to cash payments. If everyone was Ricardian, you would not have seen a 3.8 per cent increase in retail trade in December. That is an extreme version of the way people behave. There is almost certainly some of it, but it is limited.

Senator COONAN—I am interested in trying to bring it down to an answer that meets what I am trying to get at. Why is there a presumption that governments spending money adds to growth in a net sense, and why is it assumed that the positive multiplier from government spending is always larger than the negative multiplier from private sector spending foregone?

Dr Gruen—I think the answer to that is that it depends very much on the state of the business cycle. If you are in a fully employed economy, our presumption would be that the multiplier would be close to zero—to the extent that, if you are in a fully employed economy and the government engages in expansionary fiscal policy then a range of offsetting things will happen which will completely crowd that out. Whether it is the private sector responses that you are talking about or the anticipation that the Reserve Bank will tighten monetary policy in order to offset it, leading to the exchange rate rising, there are a range of ways in which that will be offset. In a fully employed economy, I would agree with you that the best estimate would be a fiscal multiplier of zero. In a situation such as that Dr Henry talked about earlier, in which private sector demand is retreating and public sector demand is acting to take its place, the strong balance of evidence is that such spending has a positive multiplier, and I think that is accepted by the IMF, the OECD and by most interested observers—not all, but most.

Senator COONAN—Moving to this very thorny problem which Dr Henry alluded to in his opening comments, that it is very difficult to know all of the precise impacts in looking at indicators for an economic outcome or an economic result, and that the better than expected performance of our economy is broader than the fiscal measures, to my way of thinking not only is that perfectly logical but Mr Stevens agreed with that and said that it is very difficult to disentangle them all. Has Treasury done any serious work, analysis and modelling on quantification of the various factors? We did try to ask for that and, without putting too fine a point on it, it seems that Treasury make very specific claims in respect of the impact of the fiscal stimulus but do not make the same kinds of claims or provide modelled weighting for the other factors at work, such as the effect of monetary stimulus and, to some extent, not the exchange rate and the other factors that have been talked about.

Senator COONAN—We did provide estimates on monetary policies. In the remarks that we submitted a week ago we did provide quantification on monetary policy based on the bank study from 10 years ago.

Senator COONAN—For the purposes of the committee, can you now provide some weighting as to what impact you think those various factors we asked for had on the better than expected performance in the economy?

Dr Gruen—As Dr Henry said earlier, the outcome for the year to the June quarter of 2009 was GDP growth of 0.6 per cent. Our estimate was that, without the fiscal stimulus, growth would have been minus 1.3 per cent. The difference is just under two per cent in economic growth. We have presented an estimate for monetary policy in which we estimate that the reduction in real borrowing rates has been about 2½ per cent—that is, converting nominal to real. That is the first thing you have to do: move from the cash rate to an estimate of what has happened to the real interest rate, because underlying inflation has changed. That is the first calculation that we have presented. Then you have to take account of the fact that margins have risen over this time so borrowing rates have not come down by as much as the cash rate. Once we take those two things into account, our estimate is that—and these calculations were done before the quarter-point rise in the cash rate earlier this week, but they would not affect these calculations very much, as you can tell from the numbers—a 2½ percentage point reduction in the real interest rate would contribute something like 0.85 per cent to GDP in the first year, and that number is overly precise.

As you would be aware, the big cash rate reductions began in October last year. We had big cash rate reductions between October and February. It has not been a full year over which the cash rate has come down by that amount so, given that it has been less than a full year, we would estimate that the monetary policy's contribution to growth over the year to the June quarter—

Senator COONAN—Is that growth and employment?

Dr Gruen—It would have implications on employment—absolutely. The monetary policy's impact on growth over the year to the June quarter would be somewhat less than 0.85 per cent. We are making the argument that the fiscal policy's contribution to growth over that period has been substantially larger than the contribution of monetary policy, but we would be the first to admit that there are uncertainties around all these estimates—there always are. There are a couple of points we make in talking about the particular estimates that we have presented on monetary policy, and those points are relevant. First of all, they go to the fact that, because it was global shock, monetary policy was being eased everywhere by very substantial amounts. One of the transmission mechanisms of monetary policy, when it is operating in one country, is that when you cut interest rates very substantially the exchange rate comes down. If everybody is cutting interest rates by roughly the same amount, that transmission mechanism is not available to any individual country. That would mean that monetary policy probably had less impact than these estimates would suggest.

Working the other way—I am an economist, so I have things on both sides—households are more indebted than they used to be. That leads you to think that perhaps monetary policy is more powerful than it was, on average, over the period over which these estimates were derived. Having said that, our best estimate would be that fiscal policy has made a bigger contribution to growth over the year to the June quarter than monetary policy.

Senator COONAN—What about movements in the exchange rate?

Dr Gruen—We have not presented quantitative estimates. The reason we have not done that is that, as you would be aware, the Australian dollar is very sensitive, both to commodity prices and to, if you like, prospects for global growth. One of the interesting things that has happened over this crisis is that a very strong correlation has developed between movements in the Australian dollar and movements in the US stock market. When the US stock market has gone up, the Australian dollar has tended to go up at roughly the same time, and visa versa. Why might that be? The reason is that, in this environment, the US stock market was signalling changing perceptions of the state of the large economies, and those perceptions were feeding through to perceptions about Australia's prospects. So, when you have a big negative shock to the global economy, and the Australian dollar falls, working out the net effect of that on Australian growth is even more difficult than the other things that we were attempting to do—so we have not chanced our arm on that. So, if you like, the Australian dollar has been responding to very substantial shocks in the global economy. And the Australian dollar definitely acts as a cushion for us. It is one of the strong reasons why having a floating exchange rate is very much in Australia's interests. But it does mean that it is very difficult to answer the question: what has been the effect? A fall in the Australian dollar almost certainly helps growth but, if the cause of that fall in the Australian dollar is a very substantial fall in commodity prices, the net effect may well not be positive.

Senator COONAN—Are you able to extend that to any assessment of the impact of the external demand for Australia's resources?

Dr Gruen—One can look, if one wants—and I could present you with those numbers—at how much exports have contributed to growth in the last two quarters. I think they have made a small contribution to growth in the last two quarters. As Dr Henry said in his opening remarks, the fact that Australian exports have done as well as that, actually contributing to growth, is another reason why Australia has done much better than other countries. There is no question about that. Our expectation in the budget was that exports would fall, so there is no question that exports have held up significantly better, particularly commodity exports. But we did not provide quantitative estimates of how big an effect that was. In the first half of 2009, even though the value of Australia's exports fell by over 20 per cent, the volumes grew by about three per cent. So that made a small contribution to Australia's growth.

Senator COONAN—Going to your estimates of the effects on growth and employment of the fiscal stimulus, what is the margin of error? Can you quantify it, say, to within a tenth of one per cent, one full per cent or something broader than this? I am just trying to get a handle on what your view is of how accurate this is—or how accurate it can be, rather than what it is.

Dr Gruen—That is a good question. We do provide in the statement that we tabled a week ago a range of estimates, from the OECD and from the IMF, for these different multipliers. So there is certainly a range here—if you look, for instance, at the OECD's second-year estimates of the multipliers. These numbers are presented as ranges. The numbers that we use tend to be at the bottom end, or even a bit lower than these ranges. So, if anything, there is uncertainty but I would say that most of the uncertainty would be on the high side. In other words—and I said this earlier—I think that, if anything, our estimates of the fiscal multipliers are conservative. If they are in error, I think they are more likely to be in error on the low side than on the high side.

Senator COONAN—But there certainly are a range of views on the effect of that.

Dr Gruen—Indeed.

Senator COONAN—Thank you. Just coming back to some earlier answers that were given, the Governor said that if the $20 billion or $30 billion of the remaining stimulus were cancelled—I think he said 'deferred'—it would lead to interest rates staying lower for longer.

Dr Gruen—Can you point me to where he said that?

Senator COONAN—I cannot do it right this very second but I will come back to it. If you want I will get the exact quote. It might take me a moment because I do not have it to hand.

Dr Gruen—I think we have it, Senator.

Senator COONAN—Sorry; it seems I did not make a note of it.

Dr Gruen—Here it is. He said:

If the presumption is an impact on demand that is $20 billion or $30 billion less, over three years that is a level of demand that is nearly a per cent of GDP a year lower. So, all other things being equal, the course of the economy would be a bit different. What we are responding to is total demand, more or less, rather than where it comes from. It is really the total that counts most. So in that hypothetical scenario, yes, I think that would have some bearing on the future path of interest rates. It is a bit hard to say how much—

Senator COONAN—Yes. Do you have a comment about that? It seems to suggest that if stimulus of this magnitude were not still to hit the economy that interest rates would remain lower for longer—or may remain lower for longer. There are a lot of assumptions in that, as there are in all of our discussions.

Dr Henry—If I can interpose here, if I read this correctly I think what Mr Stevens is saying is that interest rates would be lower only if the economy were doing worse—if I can use somewhat colloquial language.

Senator COONAN—Yes, but it is doing better.

Dr Henry—What it says is that what matters is total demand and that if, with a smaller contribution from the public sector, there was lower total demand then in principle interest rates would be lower, but only because the economy would not be performing as well.

Senator CAMERON—Would that mean higher unemployment?

Dr Henry—There would be higher unemployment and so on.

Senator COONAN—The flip side also has to be true, doesn’t it, if the economy continues to grow as it currently appears to be doing? With all the indicia that we have seen over the last couple of weeks you have already said, without giving a precise figure that there will be revised figures—we all know that—for growth. Doesn’t that put a slightly different complexion on the answer you have just given?

Dr Henry—As I indicated earlier, there would be a different complexion on the answer if those revised forecasts were to paint a picture of an economy above its potential level of output, growing at a rate that is faster than its potential rate of growth, with an unemployment rate falling rapidly and with rising inflationary pressures. But that economy is a long way away from the sort of economy that any Australian forecaster that I am aware of imagines this economy to be.

Senator CAMERON—We are not at irrational exuberance quite yet, are we?

Dr Henry—I hope not.

Senator COONAN—I have some more questions if there is some time.

Senator FIELDING—Dr Henry, what are the impacts of the fiscal stimulus package on inflation?

Dr Henry—As indicated earlier, the fiscal stimulus package is being implemented at a time of low inflationary pressure, when measures or forecasts of underlying inflation have generally been tracking down, not up. It is quite possibly the case that, in the absence of the fiscal stimulus package, forecasts of underlying inflation would be falling more rapidly than they are—that is always a possibility. With unemployment rising quite rapidly and the economy in deep recession, it is quite likely that inflationary pressures would in that economy would be falling quite sharply. But, in the circumstances that we are in, where we do not have the economy in a deep recession and we do not have the unemployment rate accelerating rapidly, we still have underlying inflation at a relatively low level despite the fiscal stimulus.

Senator FIELDING—What impact, though, has the fiscal stimulus package had on underlying inflation?

Dr Henry—Do you want a precise number?

Senator FIELDING—I would not mind a number, but I would not mind you talking it through—because there is an impact, In the statement you provided, you did not mention impacts of the package on employment, GDP or underlying inflation. Just take me through that.

Dr Henry—An implication of what I have just said is that, if we were to abstract from and forget about everything else and simply focus on the question—in the absence of this fiscal stimulus package, would underlying inflation be lower or higher?—it would be lower. But that is all I can say.

Senator FIELDING—That is right, but that is how economics is done—you hold everything else stable and you look at what the impact would be. I fully understand that, but that is what I was getting at—

Dr Henry—Actually, generally we do not. That is why it is so complex. If only we could.

Senator FIELDING—You also sit on the Reserve Bank board. Would you explain to me the reasons why the Reserve Bank board put interest rates up. I read the statement, which I assume you had some part in. Why have interest rates gone up in the last few days?

Dr Henry—As I indicated earlier, the governor of the Reserve Bank speaks for the Reserve Bank board, and that is the only practical way that monetary policy can be truly independent in its operation in Australia. I cannot add anything to the remarks that he made. I can repeat the remarks that he made if it would be helpful to the committee.

Senator FIELDING—Not all of his remarks but certainly the inflationary part, because that was the major driver that I think the economists took out of it. There was still a problem with pressure on inflation; underlying inflation was higher and therefore interest rates needed to go up.

Dr Henry—Actually, what he said was that underlying inflation should continue to moderate in the near term—by that he means fall—but now will probably not fall as far as earlier thought.

Senator FIELDING—The issue that I have is that you made some comments on 5 February at a committee hearing, in relation to macroeconomic policy—I do not want to quote you out of context here, but it is important when it comes to these issues:

> My assessment is that the weakness in aggregate demand that we are confronting in Australian economy—

I am just quoting from the *Hansard*—

> calls for both very substantial reductions in interest rates and very substantial fiscal stimulus. I think it is the case that—well, it is certainly the case—that these two arms of policy are working in the same direction—

the same direction—

> and complementing one another.

I want to go through something here. The fiscal package has not changed from the day we actually put it into place. It has not generally changed, the size of it. When you look at aggregate demand, the size of it is still the same. We are still rolling it out the same way. Things have changed. The Reserve Bank have noted that change and they have significantly changed their view—and you are on the board as well. The view is that there needs to be substantial reduction in interest rates. That was only in February 2009. We have got the reverse happening now, they are going up, and there is no change and you are not even saying to this committee whether you have done any analysis on a plan B of actually doing what the Reserve Bank has done, changed their view and started to go in the opposite direction, while you are not sharing with us whether you have actually done a plan B to defer some of the payments. I am not talking about stopping it but deferring it over a longer period of time to make sure that the fiscal and the monetary policy are complementing each other and working forward together.

Dr Henry—I think fiscal and monetary policy are still complementing one another. I think that is the point.

Senator FIELDING—I think you also said they were going in the same direction.

Dr Henry—I do think they are going in the same direction. The official cash rate of interest at the moment is 3.25 per cent notwithstanding the increase earlier in the week. Now, 3.25 per cent is a very low cash rate of interest. It is a very long time since Australia has had a cash rate of interest at a level of 3.25 per cent.

Senator FIELDING—Dr Henry, I just want to make it clear that you said in February 2009 that the Australian economy calls for very substantial reductions in interest rates—February 2009. A few months later we have now got them going up and a significant change in direction and there has not been any significant change in direction in the stimulus spending. It just seems odd to me that you have got one actually going in a different direction.

Dr Henry—What I was talking about back in February was the monetary response that had occurred and the fiscal policy response that the government had announced. The cash rate of interest on 4 February, so the day before I spoke, was 3.25 per cent, the same as it is today. Sorry, the day before it was actually 4.25 per cent. When I was talking it was 3.25 per cent, which is the same as what it is today. I was referring to the fact that the cash rate of interest had been cut from 7.25 per cent in early September down to seven per cent on 3 September and then to six per cent in October. So it had been cut by 400 basis points from its height. I was suggesting that that was an appropriate adjustment to monetary policy, to bring the cash rate down from a high of 7.25 per cent to a level of 3.25 per cent.

Senator FIELDING—It was not seven per cent when you made that statement.

Dr Henry—Sorry?

Senator FIELDING—When you made that statement they were not at seven per cent. I am being quite clear from that point of view.

Dr Henry—No, it was 3.25 per cent, the same as it is today.

Senator FIELDING—Let me ask the question to try to cut to the chase. Quite clearly, there has been a change in monetary policy from one direction to the other. Okay?

Dr Henry—Yes.

Senator FIELDING—From reductions to an increase—not just holding but to an increase. There has not been a change in the fiscal stimulus package spending from when it was first put together to today. That says they are not going in the same direction.

Dr Henry—I do not quite see it that way. I think what matters, with respect to the direction of monetary policy—and this is the way economists usually talk about it—is whether monetary policy is expansionary or contractionary. In an assessment of whether monetary policy is expansionary or contractionary what matters is not whether the last move in interest rates was a small increase or decrease but where the level of interest rates today are, relative to some concept of a neutral rate of interest. While ever the cash rate is below some concept of a neutral rate of interest—and I am not prepared to put a number on what a 'neutral rate' is, but it is obviously a lot higher than today's cash rate—notwithstanding the fact that yesterday, the day before, or the day before that, the cash rate may have been adjusted upwards by quarter of a percentage point, it is still an expansionary stance for monetary policy. On the other hand, in order for fiscal policy to remain expansionary, unlike interest rates, for fiscal policy to continue forever to be expansionary we would have to be continually increasing government spending. And we are not doing that, either.

Senator FIELDING—Maybe the concern that needs to be addressed is that Australians would hate to find that they are paying more for their mortgages through higher interest rates. The increase in interest rates for mortgages goes up faster than it would otherwise have done because of the way the physical spending package is, without changing it. If, for example, there was some plan to spend the fiscal stimulus package slower from hereon, would that take less pressure off inflation and maybe see interest rates not go up as fast? Do you see what I am getting at?

Dr Henry—Yes, I see what you are getting at.

Senator FIELDING—If we end up paying for it twice, we pay for it at higher interest rates because we are worried about inflationary pressures, but we find we are spending more fiscal stimulus package, which is putting upward pressure on inflation. Why would we not roll out less of the physical stimulus package and leave interest rates a bit lower?

Dr Henry—It might be that members of some of those households you are referring to in one of those scenarios might not have a job.

Senator FIELDING—I understand.

Dr Henry—They might have a mortgage and very low interest rates and be out of work. They might find it small consolation to be told, 'You are better off than you would have been had you still had your job and had the interest rate been a quarter of a percentage point higher.' This is the sort of consideration that people charged with responsibility for fiscal policy have to factor in when they are taking decisions about the size of a fiscal stimulus package and its profile over time. There is a trade-off here, and we could have lower interest rates and more people out of work.

Senator FIELDING—You actually could also hold back on the monetary policy and tweak both. What I am asking is: has there been any modelling done between the two of you on optimising them rather than letting them run independently? You head one and sit on the board of the other. That is an advantage on one hand. But how independent are they, then, if you have the same people running both? Could you manage both better so that you are not forcing people out of their homes through higher interest rates faster otherwise because of more fiscal spending than maybe the economy needs to keep those people in jobs?

Dr Henry—Notwithstanding the fiscal stimulus that has occurred to date, the unemployment rate has nevertheless gone up considerably. It is our view that the unemployment has not peaked yet, notwithstanding the fiscal stimulus. So I do not know that I accept the proposition that we could achieve a similar unemployment outcome with a smaller fiscal stimulus package. I do not know that I accept that proposition.

CHAIR—One of the factors that you referred to was the strength of the commodity market, which was somewhat unexpected, in supporting our economy. Is that largely dependent on the Chinese economy? Sectors of the Chinese economy, such as the manufacturing sector, are fairly depressed. What is your view of the long-term prospects for the Chinese economy in terms of our reliance on it assisting the maintenance our current economic position?

Dr Henry—I might observe that I recall Dr Gruen saying somewhat offhandedly recently that some of the biggest and most vocal detractors of Australia's fiscal expansion point instead to the highly successful fiscal expansion of China. There is no doubt that the expansionary fiscal policy of the Chinese government has supported unexpectedly strong growth in the Chinese economy. So stimulatory fiscal policy appears to have worked in that economy. The Australian economy is one of the clearest beneficiaries of that and that operates, obviously, through the maintenance of quite strong demand for our commodity exports. We are quite optimistic about the future growth prospects of the Chinese economy. We are quite optimistic, therefore, about the continuation of strong demand for Australia's commodity exports.

But the fiscal stimulus in the Chinese economy will abate at some stage, just as our fiscal stimulus package here will abate at some stage. Just as we are forecasting that the private sector demand will come back in Australia and replace the presently high but temporarily high public sector demand in Australia, in the case of the Chinese economy we would be expecting that as the fiscal stimulus abates other components of aggregate demand will come back in China as well.

The big question mark over the Chinese economy with respect to the various categories of its aggregate demand is whether the Chinese economy can go back to as heavy a reliance as it has had on external demand—that is, demand external to the Chinese economy. To put it another way: can the Chinese economy be successfully rebalanced between a reliance on exports and a reliance on components of domestic demand? That rebalancing has to occur at some stage. As I think we discussed earlier, the prospects for the developed world, which has to date been the principle market for Chinese exports, going forward are for growth that is not as rapid that they experienced over the past five, six or seven years. So it is highly likely, therefore, that the Chinese economy will be confronting weaker export markets or export markets that are not growing as rapidly as their export markets were growing earlier.

I am nevertheless optimistic about the growth prospects for the Chinese economy, because there is so much capital investment potential in the Chinese economy. It is an economy with a very high domestic saving rate, as you know, but it is an economy that also has a very high investment ratio. There is significant potential for that investment ratio to remain very high for quite a long period of time.

CHAIR—Yesterday, Professor Ross Garnaut made some criticism of government spending and the continuance of the current expenditure and suggested that spending was likely to put upward pressure on interest rates and inflation as well. Would you like to make any comment on that?

Dr Gruen—The comments from Ross Garnaut that were reported in the paper this morning are in a book that has yet to be published. We are not in a position to talk about them, because the book is going to be launched on 12 October, as I understand it.

CHAIR—I suppose that you cannot make preliminary comments on matters that you have not seen and read. But this question of additional expenditure is quite an interesting one. How much of the stimulus was scheduled to have been spent to date? You could take that on notice, if you wish. How much stimulus has been spent to date—the actual expenditure as compared to the scheduled expenditure? How much stimulus is due to be spent into the future? Are there any anticipated delays in rolling out the various items of expenditure?

Dr Henry—We have addressed some of that in the paper that we have provided to the committee. We will take on notice whether there is additional information that we can provide to the committee.

Senator RYAN—Dr Henry, has Treasury estimated the additional number of first homeowners who have purchased houses as a result of the increase in the grant—that component of the stimulus?

Dr Henry—I do not believe that we have.

Senator RYAN—Have you estimated the increase in housing prices that would have happened as a result of that particular policy?

Dr Henry—No, we have not.

Senator RYAN—Given that you have an estimate of the trend of interest rates for your own work, have you done any work about the impact on interest rates on those who have bought homes as a result of the policy or brought home purchasing homes as a result of the policy?

Dr Henry—No, we have not. In preparing our economic forecasts, we take account of market expectations of future interest rates. But that is all we have done in preparing our forecasts for the aggregate economy.

Senator RYAN—Would it be fair to say that we have no evidence or analysis to say whether or not that particular policy has been of any value?

Dr Henry—No, I would not think that at all. I do not have precise numbers to give you, but I would not draw such a strong conclusion from the fact that we are not able to put precise numbers on all of your questions.

Senator RYAN—If we cannot have precise numbers, what other metrics or measurements would one use to measure the performance or worthwhile nature or otherwise of that particular part of the stimulus package, if we do not know how many people were buying houses who otherwise would not?

Dr Henry—I could refer you to the Australian Bureau of Statistics housing finance publication. The most recent publication, for August 2009, indicated that the total number of loans to first home buyers in August was 48.5 per cent higher than in October 2008. Since October 2008, the total number of loans to first home buyers summed to 158,786.

Senator RYAN—But we do not know, presumably, whether they are purchases that were deferred because of last year or purchases brought forward or initiated because of the first home owners grant?

Dr Henry—That is true, but one can have a look at the historical series that accompanies that release. Were you to do so, you would see that the more recent months have been periods of historically quite exceptional levels of loans to first home buyers. I think they were unprecedented levels. Anyway, it is quite clear from the chart that the levels of the past few months have been extraordinarily high and well above the long-run average. The long-run average is about 9,000 a month. In recent months they have been tracking at 18,000 to 18,500 a month.

Senator RYAN—No modelling was undertaken before the policy. Those figures have appeared subsequently. What was underpinning the announcement of this particular policy? If not modelling, what underpinned this particular advice?

Dr Henry—What underpinned the advice was a view that, were the first home owners grant increased in the way that it was increased, there would be a significant increase in the number of loans to first home buyers. It seems that that advice was correct.

Senator RYAN—I will not cover the interest rate issues again. They seem to have been covered sufficiently. With respect to inflation, we had a similar inquiry before the finance and public administration committee in February into the UEFO document and stimulus. I will try and paraphrase you and, if I misquote you, please say so. We were discussing the growth assumptions in the forward estimates and forecasts of UEFO which were underpinning the increase in economic growth and revenues to government which underpinned your forecast to see the debt being repaid. That was above the long-term average. One of the reasons you outlined at that point was that, after coming out of a downturn, one can have higher than long-term average growth rate due to underutilised capacity in the economy. Have I characterised—

Dr Henry—Yes, that is correct.

Senator RYAN—Given the forecasts for unemployment are different than they were even in that document in February, does that in any way cause you to question or rethink the assumptions about growth? It strikes me that, given the differences in unemployment, we may not have the same level of underutilised capacity in the economy and therefore the same opportunity for above long-term average growth.

Dr Henry—That is correct, Senator. As I indicated earlier, we are in the process of revising our forecasts to provide to the government for inclusion in the Mid-Year Economic and Fiscal Outlook. In those forecasts we will be addressing the very point that you have raised.

Senator RYAN—I am sorry if I have not gathered an answer to this question but you have mentioned on occasion along with Dr Gruen the concept of a full employment economy when we were discussing multipliers earlier. Do you have a view at the moment on what the non-accelerating inflation rate of unemployment would be? We are currently at 5.7. We were at 3.7 a couple of years ago. What rate would you consider to be a full employment economy, so that we could make an assessment as to whether or not such stimulus packages were warranted?

Dr Henry—We have got into the habit of using a number of around about five, and we have used that in the budget. One of the things that we have learned over the past many years now as the unemployment rate has tracked ever lower—that is, before this present period when the crisis hit—is that the non-accelerating inflation rate unemployment could be a moving feast.

Senator RYAN—And could it conceivably depend on things like labour market regulation?

Dr Henry—Absolutely; that is right. So I would not want to be held to a precise number, but it is significantly below where we are today. Indeed, to go back to my earlier remarks, over the period ahead we would see the Australian economy moving further away from the non-accelerating inflation rate of unemployment before it starts to move back toward it.

Dr Gruen—Can I just add a little bit to that. It may sound that 5.7 is not that much above five, but there is another thing that has been going on in this downturn that I think we are all aware of—and it has been a very good thing—which is that employers have managed to hold on to their workforce in large measure by cutting the number of hours worked by people. So we have seen a very much bigger fall in hours worked in the economy than we have seen in employment, and so the level of unemployment in a sense understates the amount of spare capacity in the economy at the moment.

Senator RYAN—I appreciate that, and I know there are other data that can be measured, but it partly depends on individuals' preferences to work extra hours, presumably.

Dr Gruen—I think it also depends on the downturn being relatively short-lived and shallow. It is a very welcome development, but the fact that employers are able to do this is predicated on the fact that demand returns and the economy begins to recover. If you have a more drawn out downturn then, with the best will in the world, employers will not be able to continue to hold on to workers when they do not have productive things for them to do.

Senator RYAN—Most of the other issues I had have been addressed, but I have one more with respect to the rise in unemployment that we have seen. Is it the Treasury's view that the rise has been purely as a result of the global economic situation or are there domestic factors at work?

Dr Henry—I think the rise in unemployment we have seen can be explained by the collapse in aggregate demand. Absent the global financial crisis, I do not see any way we would have seen this sort of increase in unemployment.

Senator RYAN—That is why I am wondering. I appreciate that it has had an impact and, given that you said a minute ago that you see the trend as being further up rather than down, even using the measure of total hours worked and we look at the employment capacity of the economy, do you see that change as being solely the result of the collapse in aggregate demand as a domestic reflection of the global economic situation or the domestic factors at work?

Dr Henry—Certainly most of the increase in unemployment that we have seen to date, and I think I would say all of the future increase in unemployment that we will see, can be ascribed to the collapse in aggregate demand.

Senator RYAN—The reason I am asking this, Dr Henry, is that we accept that the unemployment rate is the product of various things and, if there were an issue of labour market regulation that was assisting a trend one way or the other, then presumably that informs economic policy and the modelling you undertake, because one would not want to be using a stimulus package to address an increase in unemployment or an underutilisation of employment that was the product of factors other than changes in aggregate demand.

Dr Henry—That is correct, Senator.

CHAIR—A number of senators would like to put questions on notice so if you are happy to do that and have the answers back by next Thursday, including some from Senator Joyce who is online, we would appreciate that. With that, I think we will conclude this hearing and we thank the Treasury for appearing today.

Committee adjourned at 12.06 pm