

PART 2: THE GOVERNMENT'S RESPONSE TO THE GLOBAL FINANCIAL CRISIS

The 2008-09 Budget projected a surplus of \$21.7 billion in 2008-09 and strong surpluses in the following three years. This prudent position was a product of tough decisions to strengthen the Government's financial position. The Government was mindful of the risks associated with the deterioration in the world economy, and noted that a strong budget surplus would 'ensure a strong financial position at a time of heightened uncertainty in the international economy'. Since then, the balance of risks has shifted decisively to the downside. Australia's strong financial position has given it the fiscal flexibility to respond to deteriorating global conditions.

The collapse of the US investment bank Lehman Brothers in mid-September marked a new period of serious disruption and uncertainty for global financial markets. Since then, several other major global financial institutions have collapsed, and several countries have implemented emergency measures to support domestic financial institutions. Both overseas and at home, spreads between market and official interest rates have remained high, and stock markets have fallen sharply as well as exhibiting high levels of volatility. The outlook for growth in the world economy has deteriorated rapidly.

Economic conditions have changed considerably since the 2008-09 Budget as the global financial crisis has worsened. Though the economy and financial system are well placed to withstand the fallout, Australia is not immune from the global financial crisis. The damage being done to Australia's credit markets and growth prospects from the rapidly deteriorating world economy has required action. Accordingly, the Government has put in place a wide range of proactive measures, including the guarantee of bank deposits and bank wholesale funding and the \$10.4 billion Economic Security Strategy, which will help protect households and financial institutions from the impacts of the global financial crisis. These steps will support economic growth into the future.

DEVELOPMENTS IN THE GLOBAL FINANCIAL CRISIS

The sub-prime crisis that began in mid-2007 in the United States has caused financial institutions to lose confidence in lending to each other. This loss of confidence resulted in a credit crisis throughout late 2007 and 2008, with the supply of liquidity and credit to financial institutions, businesses and households gradually drying up, and interbank lending spreads widening.

This situation took a dramatic turn for the worse in mid-September 2008 when Lehman Brothers, the fourth-largest investment bank in the US, filed for bankruptcy. The collapse of Lehman Brothers led to a serious intensification of the global financial crisis. Confidence plunged – due to concerns over counterparty exposure to Lehman Brothers, further major institutional failures, and fear of a systemic crisis. Banks were

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considerably less willing to lend to each other and global credit markets effectively froze.

Significant developments continued, with the Bank of America acquiring Merrill Lynch, while Goldman Sachs and Morgan Stanley successfully applied to become commercial banks. American International Group, one of the world's largest insurers, had to take a loan from the Federal Reserve after a barrage of margin calls on credit default contracts it had written. The collapse of Lehman was followed by Washington Mutual on 25 September – marking the biggest failure of a US bank in history. By late September the contagion had spread to Europe, with the collapse of Belgium's Fortis, Bradford and Bingley in the United Kingdom and Iceland's Glitnir Bank. Germany had also extended support to its second-largest commercial property lender.

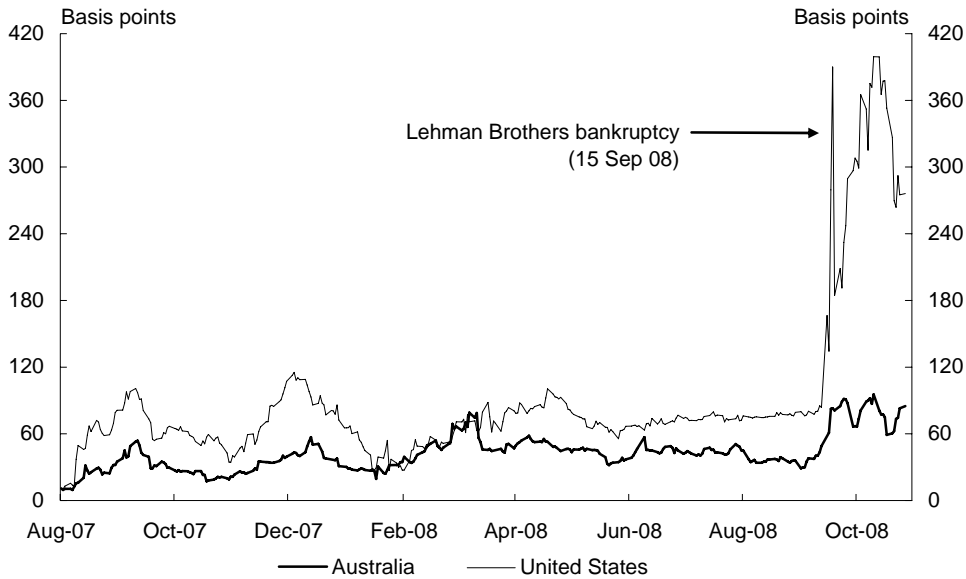
Early in October, the US Congress passed the *Emergency Economic Stabilization Act of 2008* providing US\$700 billion for the US Treasury to purchase the troubled assets of financial institutions and take direct equity stakes in financial institutions, with US\$250 billion available immediately. The US Government subsequently announced a plan to stand by all key financial institutions by purchasing equity from financial institutions and guaranteeing all senior unsecured debt issued by eligible financial institutions, as well as guaranteeing non-interest bearing transaction deposit accounts. Later in October, European nations also agreed to a package of measures to support the European financial system, including the guarantee of interbank loans and the purchase of equity in banks.

The immediate translation of the significant and sustained increase in strain on global financial markets is evident in Chart 2.1. The spread between the rate at which US banks lend to each other and the expected federal funds rate reached nearly 400 basis points in October. Despite Australia's minimal direct exposure to Lehman Brothers, banks' interest rate spreads in Australia also increased dramatically. Effectively, banks' funding costs immediately soared.

Global markets for equities, currencies and commodities saw extraordinary price movements, while yields on short-term government securities fell sharply – particularly in the United States. In Australia, from mid-September to mid-October, the ASX200 fell sharply from above 5000 points to around 4000 points, and the Australian dollar depreciated from above 80 to below 70 US cents.

During September and October it also became clear that the flow-through of global financial market developments to the real economy was going to be much more severe than previously anticipated.

Chart 2.1: Australian and United States interbank lending spreads



Note: Australian data are 90-day bank bill to Overnight Indexed Swaps. United States data are 90-day Certificates of Deposit to Overnight Indexed Swaps.
Source: RBA and Reuters.

THE EMERGING IMPACT OF THE GLOBAL FINANCIAL CRISIS ON THE REAL ECONOMY

Since Budget, the global financial crisis has intensified, with inevitable consequences – both globally and for Australia. After revising down its forecasts for 2009 GDP growth across the advanced economies from 1.4 per cent (in July) to 0.5 per cent, the International Monetary Fund recently summed up the global economic outlook in these blunt terms.

The world economy is now entering a major downturn in the face of the most dangerous shock in mature financial markets since the 1930s. Against an exceptionally uncertain background, global growth projections for 2009 have been marked down to 3 percent, the slowest pace since 2002, and the outlook is subject to considerable downside risks. The major advanced economies are already in or close to recession ...

The outlook for the US economy in particular has deteriorated since the Budget. The escalation of the global financial crisis and the continuing weakness in the US housing market will determine the length and depth of the expected recession, and these factors are expected to delay recovery until late 2009.

The euro area is expected to record little growth in 2009. Growth prospects have been significantly weakened by slower global industrial demand, the tightening in global financial conditions, and concerns over labour market prospects and consumption. The

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UK economy is expected to enter recession in the near future – the first time in 16 years – reflecting an expected contraction in domestic demand as well as the slowing in global growth.

The emerging economies will be impacted by the slowdown in advanced economies. China's growth in 2008 is expected to be over 2 percentage points lower than in 2007, with further slowing expected in 2009. This will have significant implications for the Australian economy, particularly if Chinese demand for resources weakens.

Australia is not immune from the global financial crisis. As outlined in Part 3, the forecast for GDP growth in Australia in 2008-09 has been revised to 2 per cent, down from 2¾ per cent at Budget. The unemployment rate is now forecast to rise to 5 per cent by the June quarter 2009 and 5¾ per cent by the June quarter 2010.

The global financial crisis has resulted in sharp falls on Australian sharemarkets. Household financial wealth fell by around 16 per cent through the year to the June quarter 2008, and global sharemarket falls since then have exacerbated this fall.

The significant fall in consumer confidence over the course of 2008 in Australia as well as the rest of the world raises the potential for weaker growth in household consumption and dwelling investment, as households feel less confident about their capacity to spend and borrow.

The impacts flowing from the global financial crisis have also affected the corporate sector. Businesses continue to face tighter credit conditions and higher funding costs, and falling asset prices have also raised the cost of capital funding from the sharemarket. Business conditions generally, and investment intentions specifically, have become subdued.

The global financial crisis will have a substantial impact on the Government's budget position. As a result of deteriorating global economic circumstances, revenues have been revised down, particularly from 2009-10, and expenses will increase as the effects of a global slowdown flow through to Australia. See Part 4: Fiscal Strategy and Outlook.

POLICY RESPONSES TO THE GLOBAL FINANCIAL CRISIS

The 2008-09 Budget prudently struck a balance between tackling inflation and responding to the risks posed by global economic conditions. The Government was acutely aware that the global financial crisis could deteriorate markedly. It strengthened the Government's financial position by allowing the automatic stabilisers to work and building a \$21.7 billion surplus – a buffer – in order to provide the flexibility necessary for future policy action. The Government supported households by delivering tax cuts and payments to pensioners and carers.

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The Reserve Bank of Australia, with responsibility for both monetary policy and the overall stability of the financial system, has also taken action this year to protect growth and financial stability. It provided timely liquidity to financial institutions as international money markets became dysfunctional. In September and October, it reduced the official cash rate from 7.25 per cent to 6 per cent.

The dramatic shift in the macroeconomic outlook since the Budget has required the Government to implement timely and proactive policy responses to help reduce the possibility of a severe slowdown in the Australian economy, and to help shield Australians from the impact of the global financial crisis. These responses include the following.

- On 20 May, the Government announced, on the authority of the Treasurer, its decision to increase the issue of Commonwealth Government Securities by up to \$25 billion to ensure the smooth operation of Australia's financial markets, boost the range of assets that the Australian Office of Financial Management (AOFM) could invest in, and expand the securities lending facility of the AOFM.
- On 2 June, the Treasurer outlined Australia's response to the recommendations of the Financial Stability Forum on enhancing the resilience of financial markets and financial institutions. This included introducing legislation to establish a Financial Claims Scheme to provide depositors and general insurance policyholders with timely access to their funds in the event of a financial institution failure, and changes to the regulatory framework to allow better management of failing financial institutions.
- On 3 July, the Council of Australian Governments (COAG) agreed to measures to strengthen the protection of consumers of financial services across Australia, with the Commonwealth taking over responsibility for the regulation of mortgages, mortgage brokers, margin lending and non-bank lending. On 2 October, COAG endorsed an implementation plan for the regulation of remaining areas of consumer credit.
- On 19 September, the Australian Stock Exchange amended its authorised products list effectively to prohibit naked short sales not otherwise allowed under the *Corporations Act 2001*. On 21 September, the Australian Securities and Investments Commission banned covered short selling for a period of 30 days, subsequently extended to 18 November. Limited exceptions apply to this ban. On 23 September, the Government released draft legislation on disclosure arrangements for covered short sales.
- On 26 September, the Government announced its intention to purchase \$4 billion of residential mortgage backed securities (RMBS) to support competition in the market for housing finance following the dislocation of the Australian RMBS market.

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- The Government has been working with international counterparts to reform the global financial architecture to make sure these events do not happen again. The Treasurer joined meetings of the IMF and the G-20 in mid-October for this purpose and will attend the G-20 finance ministers and central bank governors meeting in Brazil on 8-9 November 2008. The Prime Minister will attend a G20 Leaders' meeting in Washington on 15 November 2008 to advance international cooperation in responding to the global financial crisis.

As the outlook for financial markets and the global economy deteriorated further – particularly after the collapse of Lehman Brothers – it became apparent that more action was required. In response, the Government announced it would guarantee deposits and wholesale funding of authorised deposit-taking institutions, and invest a further \$4 billion in RMBS, bringing the total investment to \$8 billion. The Government also delivered a \$10.4 billion Economic Security Strategy to strengthen the economy and support households during the global financial crisis.

SUPPORTING CONFIDENCE IN AUSTRALIA'S FINANCIAL MARKETS

On 12 October and 24 October 2008, the Australian Government announced measures to enhance the protection of Australian financial institutions.

The decision to guarantee deposits and wholesale funding of authorised deposit-taking institutions was made in response to the serious deterioration in global financial markets, which threatened the ability of Australian financial institutions to access funding. The deterioration had potentially serious implications for liquidity and lending activity. This action was also necessary to ensure that Australian institutions were not placed at a commercial disadvantage in attracting new funds relative to their international competitors that had received similar government guarantees.

The likelihood of these guarantees being drawn on is low. The regulation and supervision of Australia's financial institutions is strong, effective and coherent. Australian banks are well capitalised and have limited exposure to the type of sub-prime mortgages that are found in the US and also to the US, UK and European institutions that have faced insolvency during the turbulence of the past year.

The Government's decision to purchase RMBS will assist in the functioning of the RMBS market and support competition in mortgage lending in Australia.

Box 1: Measures taken to support confidence in Australia's financial markets

Guarantee of deposits of authorised deposit-taking institutions

The Government is providing a guarantee of deposits of authorised deposit-taking institutions in Australia, for a period of three years from 12 October 2008.

Until midnight on 27 November 2008, all deposits held in eligible institutions will be guaranteed without charge. From 28 November 2008, a threshold of \$1 million will be applied per customer. Deposits below this threshold will continue to be guaranteed without charge. Deposits above this threshold and any deposits held in foreign bank branches will only be guaranteed if the institution has applied for the guarantee and agreed to pay the relevant fee.

The vast majority of Australian households and businesses – around 99.5 per cent – have deposit balances that are below the \$1 million threshold. These deposits will continue to be covered by the Government guarantee free of charge. The threshold targets the fee towards the small number of depositors with large deposit balances, such as wholesale investors. It will ensure that the guarantees do not provide an incentive for these investors to substitute deposit products for short-term money market securities and other investments.

This guarantee provides certainty to Australians that their deposits in Australian banks, building societies and credit unions are safe, and reinforces the strength of Australia's financial institutions. It will also help support consumer confidence in a challenging economic environment.

Guarantee of wholesale funding of authorised deposit-taking institutions

The Government is providing a guarantee of eligible wholesale funding of authorised deposit-taking institutions in Australia until market conditions normalise.

Until midnight on 27 November 2008, all eligible wholesale funding will be guaranteed without charge. From 28 November 2008, wholesale funding will only be guaranteed if the institution has applied for the guarantee and agreed to pay the relevant fee.

This guarantee will enable Australian institutions to raise funds overseas with the same level of support as foreign institutions that have received government guarantees and will help restore confidence in credit markets. This will ensure that Australia's financial sector can continue to lend to Australian corporations, businesses and households, helping to support economic activity during a time in which the economic outlook is uncertain.

Box 1: Measures taken to support confidence in Australia's financial markets (continued)

Purchasing \$8 billion in residential mortgage-backed securities

The Treasurer has directed the Australian Office of Financial Management (AOFM) to purchase a total of \$8 billion of residential mortgage-backed securities (RMBS) from a wide range of Australian lenders. This action follows legislation passed by the Government in June 2008, which expanded the range of high-quality assets in which AOFM can invest.

The AOFM will invest the \$8 billion in prime, AAA-rated RMBS that meet strict criteria in relation to the quality of the underlying mortgages. The investment will be of particular assistance to lenders that are not authorised deposit-taking institutions (ADIs) (that is, lenders that are not banks, building societies or credit unions), as non-ADI lenders are particularly reliant on funding from RMBS issuance.

Over the past decade or so, non-ADI lenders have been an important source of competition in the mortgage lending market. However, the dislocation in international credit markets and the associated tightening of the Australian RMBS market has impacted on these lenders' ability to exert competitive pressures.

The Government's initiative will support competition in Australia's mortgage market from a wide range of lenders, including non-ADI lenders.

ECONOMIC SECURITY STRATEGY

The Economic Security Strategy is a discretionary fiscal stimulus package of around 1 per cent of GDP, overwhelmingly focused on the first half of 2009 and tightly targeted at those sectors of the economy showing the greatest weakness – household consumption and dwelling investment. The \$10.4 billion package, announced on 14 October 2008, also provides relief to those people in the community whom have been struggling in the past couple of years to meet rising costs for housing, petrol and food, particularly those on low incomes or with children and other family members to support. The package consists of:

- \$4.9 billion for an immediate down payment on long-term pension reform – a one-off payment of \$1,400 to eligible single pensioners and \$2,100 to eligible pensioner couples, including Commonwealth Seniors Health Card holders, as well as a one-off payment of \$1,000 to Carer Allowance recipients for each person in their care;
- \$3.9 billion in support payments for low and middle income families – a payment of \$1,000 for each child in families eligible for Family Tax Benefit (A);

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- \$1.5 billion investment to help first home buyers purchase a home – from the date of the announcement to 30 June 2009, the Government will introduce the First Home Owners Boost for established homes of \$7,000 (to take the total grant to \$14,000), and for newly-constructed houses of \$14,000 (to take the total grant to \$21,000); and
- \$187 million to create 56,000 new training places for the 2008-09 Productivity Places Program.

The Economic Security Strategy will also accelerate the implementation of the Government's nation building agenda, bringing forward the commencement of investment in nation building projects to 2009.

The measures outlined in the Economic Security Strategy will help strengthen and stabilise the economy in the current global economic environment. The package will provide a boost to consumption through the lump sum payments to pensioners and carers and the one off payment to families, while the First Home Owners Boost will help stimulate activity in the housing sector, including investment in new dwellings. The bring-forward of infrastructure development will further stimulate economic activity, while also enhancing the productive capacity of the economy. The new training places will particularly assist disadvantaged job-seekers.

Nearly all of the stimulus to the economy from the Economic Security Strategy will be delivered in 2008-09. The stimulus is large enough to make a significant contribution to those components of aggregate demand that are expected to be most vulnerable in the first half of 2009, while maintaining future surpluses, allowing strategic investment in the nation's future and leaving some further room to move if additional action is needed. The package fits squarely with principles underlying effective discretionary fiscal stimulus (see Box 2) and complements the boost expected from interest rate cuts, which are expected to have much of their impact on growth after the first half of 2009.

In the absence of the Government's Economic Security Strategy, economic growth would have been significantly weaker than currently forecast. The Strategy is expected to result in a boost to the level of real GDP growth of between half and one percentage point over the next several quarters, providing a significant boost to household consumption and supporting a recovery in dwelling investment over the forecast horizon.

Household consumption growth had already slowed sharply before the announcement of the package, weighed down by an extended period of relatively high interest rates, petrol and food prices and significant falls in household wealth as the global financial crisis led to sharp declines in global sharemarkets. In the June quarter of this year, household consumption experienced its first decline since the September quarter 1993.

Without the package it is likely that consumption growth would have remained very weak in the near term, with further falls in consumption possible. With household

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consumption directly comprising around 60 per cent of GDP and having important implications for other areas of expenditure, this would create significant headwinds for overall economic growth. The package will provide a significant boost to consumption growth by providing additional income and bolstering consumer confidence.

Likewise, forward indicators of the housing market released before the package, including growth in building approvals and housing finance, had shown that dwelling investment would have remained very weak over the forward estimates, despite strong underlying demand. In part, this reflects the impact of the gradual tightening in monetary policy from 2002 to 2008 and increasing costs for housing construction.

Box 2: Principles underlying effective discretionary fiscal stimulus

There are times when discretionary fiscal stimulus can assist monetary policy and the automatic stabilisers in stimulating the economy quickly. Based on past experience, a fiscal stimulus needs to be used selectively and with carefully designed policies that are:

- **early** – the measures need to be formulated and implemented quickly, so that sufficient stimulus is provided when it is most needed;
- **temporary** – so as not to increase risks to inflation, interest rates and the fiscal balance, which could reduce growth prospects in the medium to long term; and
- **targeted** – to maximise the addition to GDP growth for any given budget outlay.

Inevitably a decision on when to introduce discretionary fiscal stimulus will come down to a matter of judgment about balancing the risks to the economic outlook, bearing in mind the need to be timely and decisive in determining the need for policy action.

The early, decisive action taken by the Government is helping ensure that Australia is better placed to withstand the impacts of the global financial crisis.

The package is consistent with the Government's medium-term fiscal strategy of maintaining a budget surplus, on average, over the medium-term. The Government will also continue to allow the automatic stabilisers to operate through the Budget to help stabilise demand.

CONCLUSION

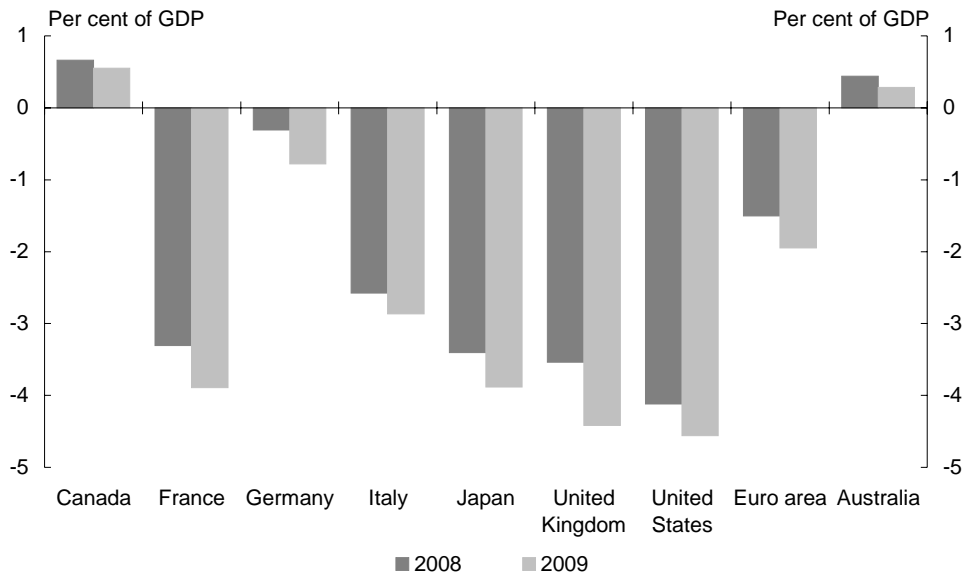
Australia's economy is in a much stronger position to withstand the fallout than most other countries. Economic growth remains solid and compares favourably with other advanced economies that are close to, or in, recession. Australia will also continue to be a major beneficiary of the economic growth resulting from the industrialisation of emerging economies such as China and India. Furthermore, the Australian housing

market does not possess the excess of physical stock that is evident in some overseas markets, particularly the United States.

The regulation and supervision of Australia's financial institutions is strong, effective and coherent. In its Global Competitiveness report issued on 8 October, the World Economic Forum ranked Australia in the top four countries out of the 134 countries it assessed in terms of the soundness of our banks and in the top three in terms of auditing and reporting standards. Australia's largest four banks are among only 11 of the world's top banks with a AA credit rating or above. Prior to the sub-prime crisis, sub-prime loans accounted for around 15 per cent of the US mortgage market. However, in Australia the closest equivalent to sub-prime mortgages – non-conforming housing loans – continue to make up around one per cent of outstanding housing loans in Australia. The soundness of Australia's financial system reflects the fact that Australian banks, building societies and credit unions have almost no presence in the Australian non-conforming housing loan market.

With regard to macroeconomic policy settings, the Government continues to budget for surpluses, while most other countries are in significant deficit (see Chart 2.2). In addition, the Australian Government's balance sheet is in a net asset position. This outcome gives Australia a level of fiscal policy flexibility that is unusually strong among advanced economies. The Government, in conjunction with the economic regulators, is prepared to take the necessary action required in these uncertain times.

Chart 2.2: Budgetary positions for selected countries in 2008 and 2009



Source: International data are for all levels of the general government sector, sourced from the IMF World Economic Outlook, October 2008. They refer to calendar years. Australian data are for the Australian Government general government sector, sourced from the Australian Government Treasury. They refer to financial years (2008-09, 2009-10). This chart compares selected countries' budgetary positions using their primary budget balance, which may differ from Australia's.

