

Response to Professor Tony Makin's Minerals Council of Australia Monograph – 'Australia's Competitiveness: Reversing the Slide'

KEY POINTS

- Professor Makin's criticisms of Treasury's estimates of the economic impact of the fiscal stimulus are based on a theoretical model that does not apply in Australia's case in general and assumptions that did not hold during the global financial crisis (GFC).
 - Specifically, the Mundell-Fleming model is based on an assumption of unilateral fiscal action, a high degree of trade openness and perfect capital mobility.
 - When these assumptions hold, the theoretical model suggests that expansionary fiscal policy will lead to a higher exchange rate, crowding out net exports and any positive aggregate demand effect from fiscal stimulus.
 - In reality, Australia's fiscal stimulus was undertaken in concert with most other advanced economies, Australia's trade share is small enough to imply significant positive fiscal multipliers and capital was less than perfectly mobile during the GFC.
 - Fiscal stimulus has been shown to have a positive impact on economic activity in these circumstances, both theoretically and empirically, including because the exchange rate channel is more muted.
 - Indeed, Australia's exchange rate fell sharply during the GFC, playing its intended shock absorber role by supporting net exports in response to a large external shock.
- Treasury's estimates were based on a conservative application of modelling results produced by the IMF and OECD on the impact of fiscal stimulus in Australia.
- Professor Makin also confuses Treasury's estimates as being a long-run assessment of the impact of fiscal stimulus on the economy.
 - Treasury's estimates have always been presented as a short-run analysis, finding that the fiscal stimulus made a significant positive contribution to Australia's real GDP and employment outcomes during the critical early stages of the GFC.
- The fiscal stimulus was put in place at a time of extreme global uncertainty, when the balance of risks was that – in the absence of sizable and timely fiscal stimulus – the Australian economy would experience a significant economic downturn that would be difficult to recover from.
- Partly as a result of the fiscal and monetary stimulus put in place, Australia managed to avoid the decline in output and employment experienced by other major advanced economies.

- Rapid and large monetary and fiscal policy stimulus played a critical role in increasing demand and promoting the early recovery of consumer and business confidence.
- The IMF and OECD have strongly endorsed the effectiveness of Australia’s fiscal stimulus response to the GFC.
 - The IMF commended the ‘quick implementation of targeted and temporary fiscal stimulus’ and the OECD concluded that Australia’s stimulus package ‘was among the most effective in the OECD’ and not only ‘helped to avoid a recession’ but also ‘had a pivotal role in boosting overall confidence’.

DETAILED RESPONSES TO PROFESSOR MAKIN’S CLAIMS

Professor Makin’s claims centre on the theoretical result generated by the Mundell-Fleming model that fiscal stimulus will have little or no expansionary effect on domestic economic output because it is crowded out by an appreciation of the exchange rate and the associated deterioration of net exports.

This standard Mundell-Fleming result seems to hold empirically for countries with floating exchange rates acting unilaterally, in a world with perfect capital mobility and for countries with high trade shares. This does not describe Australia’s situation during the global financial crisis.

Empirical studies find that the (negative) impact of the exchange rate on fiscal multipliers is significantly greater for countries with larger trade shares, as more of the stimulus spending is on imports and leaks offshore. As Australia has a relatively low trade share compared with other advanced economies, fiscal policy could be expected to be relatively more effective.

A well-known empirical study uses a threshold of exports plus imports equal to 60 per cent of GDP, and estimates that for countries with trade shares below this threshold, fiscal multipliers for temporary discretionary fiscal stimulus are positive and sizeable (Ilzetki, Mendoza and Végh 2013). Australia’s trade share is a little less than 45 per cent.

Rather than appreciate, the exchange rate fell sharply in the early stages of the GFC, supporting the Australian economy. Many countries undertook fiscal stimulus at roughly the same time, muting the exchange rate offset suggested by the one-country theoretical model described by Professor Makin. Moreover, the assumption of perfect capital mobility in the Mundell-Fleming model did not hold during the global financial crisis.

According to Professor Makin, “the IMF concluded in a survey of the effectiveness of fiscal stimulus that the evidence was ambiguous, with estimates of the effects of fiscal policy on national output differing ‘...not merely in degree but sign’”.

The International Monetary Fund (IMF) has concluded that fiscal multipliers are positive for Australia. The IMF’s Global Integrated Monetary and Fiscal model has fiscal multipliers for temporary discretionary fiscal stimulus of around 0.5 for transfers to liquidity-constrained consumers, and 1.2-1.4 for government investment for Australia (IMF, 2009, page 4).

Similarly, the OECD (2009, page 138) estimate that fiscal multipliers for Australia are positive for at least the first two years. The OECD estimates for Australia are that the multipliers for public investment are 0.9 to 1.3 in the first two years, and that multipliers for transfers to households are 0.4 to 0.8.

Treasury's multiplier estimates were at the conservative end of the range suggested by the OECD and the IMF and were consistent with empirical evidence from the US on spending out of temporary tax rebates. Once spending propensities were adjusted for the import share of spending (assumed to be 15 per cent), Treasury's estimates of the fiscal multipliers for cash transfer payments and for government investment spending were 0.60 and 0.85.

According to Professor Makin, the claim that Australia's fiscal stimulus response saved 200,000 jobs is based on "spurious Treasury modelling of the long-run relationship between GDP and employment, without factoring in the flexible labour market".

Treasury's estimates of the impact of the fiscal stimulus on employment are based on the empirical relationship between real GDP and employment, which incorporate the observed implications of the flexible labour market. At the time the estimates were produced, Treasury's models suggested a long-run employment multiplier of around 0.75, which implied that, on average, a 1 per cent increase in GDP would lead to a $\frac{3}{4}$ per cent increase in employment over time. (The models have subsequently been updated and suggest a long-run multiplier of 1.)

The stimulus package was estimated to have a temporary impact on GDP, which would translate to a temporary impact on employment. The peak impact of the stimulus packages was estimated to be the addition of 210,000 jobs and the peak unemployment rate was estimated to be $1\frac{1}{2}$ percentage points lower as a result of the fiscal stimulus.

Other countries with flexible labour markets, like the US and UK, suffered big falls in employment in the early stages of the GFC, in contrast to Australia's experience.

According to Professor Makin, "Treasury predicted in the 2009-10 Budget papers that, reflecting the stimulus spending, the economy would be growing at an incredible 4.5 per cent on the basic GDP measure in 2012-13. In reality, GDP growth was under 3 per cent. In short, the fiscal stimulus measures, most notably the BER program, failed to deliver as originally expected and left a loss of competitiveness as a lasting legacy".

As stated in the 2010-11 Budget, Treasury's estimates are that the positive real GDP growth impact of the fiscal stimulus ended in 2009-10, with the withdrawal of the fiscal stimulus estimated to have detracted from real GDP growth in 2010-11 and 2011-12. Therefore, the effectiveness of stimulus spending is not a reason why real GDP growth did not achieve the 2009-10 Budget assumption (not forecast) of $4\frac{1}{2}$ per cent in 2012-13.

The 2009-10 Budget assumption of $4\frac{1}{2}$ per cent real GDP growth in 2012-13 was in line with the approach taken in budgets in the early 1990s, when above-trend rates of growth were assumed as the economy recovered from recession.

According to Professor Makin, "Close scrutiny of the pattern of aggregate expenditure recorded in the national accounts, especially for the December 2008 and March 2009 quarters, reveals that it was the behavior of exports and imports, not increased fiscal activity, that was primarily responsible for offsetting the fall in private investment due to the GFC".

In a mechanical sense, the positive growth in the expenditure measure of GDP over this period primarily reflected a reduction of expenditure on imports due to a decline in domestic demand. This tells us nothing about the effectiveness of the fiscal stimulus, which must be

judged against an unobservable counterfactual of what would have happened in the Australian economy in the absence of the fiscal stimulus.

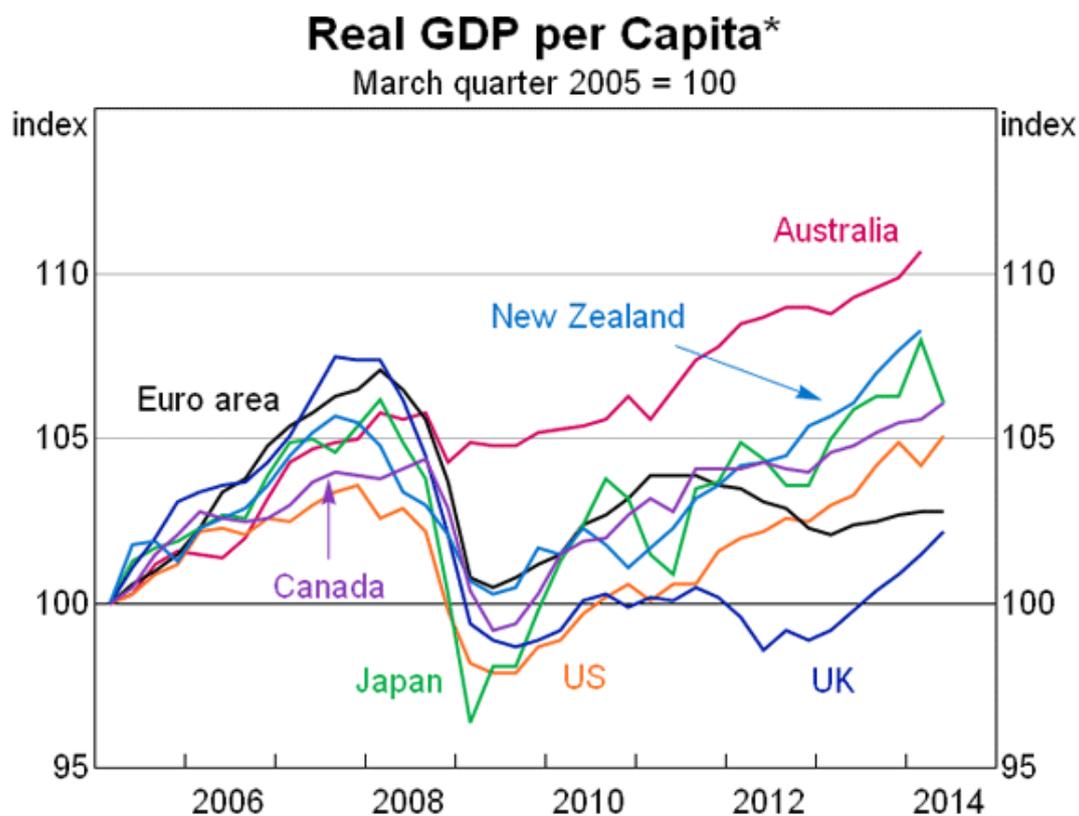
Rapid and large monetary and fiscal policy stimulus played a critical role in increasing effective demand and promoting the early recovery of consumer and business confidence in Australia. As global prospects deteriorated, Australian macroeconomic policy, both monetary and fiscal, moved rapidly to support aggregate demand.

Following the fiscal transfers to households, retail trade and consumption recovered sooner in Australia than in other advanced economies that were slower in implementing tax cuts or transfer payments to households and/or for which monetary policy easing had little effect on household income in the period.

By March 2009 Australia's retail trade was around 6.0 per cent higher than its pre-crisis level, while advanced countries' retail trade was about 3.7 per cent lower than its pre-crisis levels. It seems reasonable that the relatively large fiscal and monetary stimulus in Australia was at least partly behind this divergence.

Business and consumer confidence fell sharply during the downturn. However, confidence in Australia recovered faster than in any other OECD country. Business confidence started to recover from February 2009 and consumer confidence rebounded sharply in June 2009.

The fiscal stimulus also contributed to mitigating the severity of the shock to domestic production of goods and services, with Australia almost completely avoiding a fall in real GDP per capita – unlike many other countries (see chart below).



* Data are as of 2 September, 2014

Sources: ABS; Thomson Reuters

Source: Stevens, G, 2014, 'The Economic Scene' Address to CEDA Luncheon, 3 September, <http://www.rba.gov.au/speeches/2014/sp-gov-030914.html>.

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