

Weathering the Great Financial Crisis

‘Nothing’ happened – a policy success?

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Mum: “Ken, should I take my money out of the bank?”

Ken: “There’s no need for that Mum. Australia’s banks are among the best of the best in the world. They are firmly regulated, and have not taken any inappropriate risks.”

Mum: “Well that is as it may be, but all my neighbours and friends are taking their money out all the same.”

When Ken Henry, the Secretary of Australia’s federal Department of Treasury, had this phone conversation with his mother shortly after the collapse of US financial giant Lehman Brothers in September 2008, it quaintly confirmed what he and his colleagues had begun to fear for some time.¹ Despite the solidity of its own economic fundamentals, Australia was going to be significantly affected by the fallout from the meltdown of the US financial system that had been building momentum throughout the year. As early as September 2007, Great Britain had experienced a bank run (on Northern Rock) followed by an expensive government bailout. Since then, one after the other, major US and UK financial powerhouses had come under severe pressure because of their exposure to major losses from highly leveraged mortgage-backed securities trading that was at the centre of what would come to be called the Global Financial Crisis (GFC). Some banks, like Bear Stearns, were bailed out when the US Government arranged a sale to a stronger financial institution. But when Lehman Brothers came to the brink in late 2008, US financial authorities could not find a buyer and were forced to let it go under, sending major shock waves through global financial markets that quickly produced a global credit squeeze and subsequent bank failures and recessions. Governments and financial institutions around the world were sounding the alarm. Ordinary citizens like Ken’s mother were becoming increasingly concerned – and beginning to act, as data on ATM withdrawals and other major money movements were indicating, even in Australia.

And yet, during the global financial crisis that followed, Australia would become one of a handful of OECD economies not to experience a major breakdown in its financial institutions and the

only one to avoid an economic recession during the crisis. Dodging the danger, it managed to maintain its remarkable run of continuous economic growth (at the time of writing it has extended to a record-breaking 104 quarters and shows no signs of abating).

In *programmatic* terms, the core of the success therefore lies, in the non-occurrence of events and consequences that the policymakers keenly sought to avoid. The four major Australian banks - Westpac, the Commonwealth Bank, the Australia and New Zealand Bank (ANZ), and the National Australia Bank (NAB) all avoided the worst of the global financial crisis. Aggregate pre-tax profit at these four banks fell only marginally from A\$6.3bn in 2007 to A\$5.1bn in 2008 and A\$5.4bn in 2009. None one of the four banks had its credit rating downgraded; indeed, by late 2009 four of the nine global banks with an AA credit rating from Standard and Poor's were Australian (RBA 2009, 25). However, because they partly depended upon overseas funding to supplement their domestic deposit base, the Australian banks were not immune to the effects of the global financial crisis and they suffered from the global credit squeeze following the collapse of Lehman Brothers. Some smaller institutions could not obtain wholesale funding and failed, whilst the big four banks got their credit guaranteed by the government. However, no major bank went under.

A key reason for such outcomes was that Australia's major banks had remained, on the whole, focused on traditional banking practices. In particular, the big Australian banks did not become heavily involved in highly-leveraged financial trading in 'toxic' mortgage-backed assets emanating from the US. The two largest banks, Westpac and the Commonwealth, eschewed trading in US-originated mortgage-backed securities altogether. ANZ and NAB did accumulate some exposures in the years prior to the crisis which resulted in losses. Although NAB lost about \$1bn, such losses however relatively minor when compared to their overall balance sheets and the experiences of many overseas banks. No panic occurred in local financial markets, although bank share prices suffered for a period. Banks kept lending, money kept flowing through the economy. There were no mass foreclosures of homes whose mortgages could no longer be paid. Consumer and business confidence only suffered short-lived and minor dents. The much-feared mass unemployment and the attendant poverty, despair and pressure on social and human services systems did not eventuate. Success, in other words, lay in the active achievement of a series of 'non-events'.

Avoidance of economic malaise was the initial and main objective of the crisis response measures that were taken between October 2008 and April 2009, but did not remain the only one. The specific 'Keynesian' economic stimulus spending programs put in place had substantive objectives of their own in areas such as education, energy efficiency, housing and infrastructure. Some of them became the subject of intense controversy and failed to achieve these secondary objectives. So, while in terms of the main game, Australian regulatory systems and macro-economic performance proved exceptionally resilient, program success in some areas proved elusive.

In *political* terms, the main thrust of the regulatory, monetary, and fiscal policy measures taken prior and in response to the crisis was supported by a broad coalition consisting of the federal cabinet,

the Treasury department and the Council of Financial Regulators (which included, besides Treasury, the Reserve Bank of Australia (RBA); the Australian Prudential Regulation Authority (APRA); and the Australian Securities and Investments Commission (ASIC), the Business Council of Australia, and, importantly, a large proportion of the Australian public). The strong performance of the financial system in these turbulent conditions certainly enhanced the standing, including the international reputation, of all the regulatory institutions involved. Moreover, the prime minister, Labor Party leader Kevin Rudd, drew considerable political capital from his energetic performance as crisis manager in chief both at home and abroad (at international summits), at least during the first year following the collapse of Wall Street.

It is in terms of the group of *process* criteria that this case deviates most from the ‘great policy success’ standard. As we will argue, the robust performance of the banking system was certainly helped by Australia’s relatively robust regulatory system, but there was a considerable element of luck involved. In particular, the main reason why the big Australian banks did become much involved in the highly-leveraged financial trading that was at the centre of the crisis overseas, was that the local banks were making strong profits in traditional mortgage markets and because regulation had reduced banking competition, a key driver of the bank behaviour and risk taking in the crisis-hit banks overseas markets. The luck involved was due to the fact that the key regulation that helped limit banking competition, the so-called four pillars policy, was in fact designed to *strengthen* competition. As for the subsequent fiscal stimulus, the process of designing, deciding and delivering it was by all accounts anything but methodical and balanced – it was hectic, intuitive, improvised, with political ambitions regularly trumping considerations of prudent management. Thirdly, and perhaps not surprisingly, the size, design and timing of the stimulus attracted robust and ongoing debate.

The ‘euphoria moment’ (Kelly 2014: 173) for Rudd, Treasurer Wayne Swan and the other key policymakers came on 3 June 2009, when the March quarter figure of 0.4% growth was revealed. To their immense relief and pride, it confirmed that they had pulled off what virtually every policymaker, bureaucrat and commentator had deemed impossible: avoiding two consecutive quarters of negative growth (the technical definition of recession). But the euphoria would not last.

As we reconstruct and interpret this case of economic risk management and crisis response, we invite the reader to focus on two questions:

- How can we account for the Australian financial and economic resilience during this period: to what extent was this avoidance of economic and social disaster due to *virtù* (purposeful regulatory, monetary and fiscal policy) and to what extent to *fortuna* (luck, coincidence)?
- How can we assess the fiscal policy response of the Rudd government: was the A\$70 billion spend ‘worth it’ – to what extent can it be counted as a policy success, or did it more closely resemble a ‘policy overreaction’ (Maor 2012)?²

Context: Learning lessons and switching gears in coping with systemic risk

Australia had “form” when it came to major economic downturns. The global recession of 1929 had hit Australia hard, and had destroyed the newly elected Scullin Labor government. Policy paralysis had resulted, and the depth and duration of the ensuing Great Depression left deep scars. The 1970s crisis of stagflation (high inflation plus recession) had also seen an initially muddled macroeconomic policy response which saw a pattern of stop/go economic growth and two recessions, one in the mid-1970s and another in the early 1980s (Bell and Keating 2018). The post-1983 Labor governments introduced a new and more successful approach built around a wage Accord with the unions. However, financial deregulation during the 1980s and the entry of foreign banks encouraged Australian banks to defend their market share through aggressive credit practices which led to a credit-fuelled asset price boom, especially in commercial property (Kelly 1992, 487-508; Bell and Keating 2018). Hence, financial deregulation and inept handling by the government and the Reserve Bank of Australia (RBA) saw a credit explosion and a property boom that eventually ended with high interest rates as a control mechanism and an inadvertent policy-induced recession in the early 1990s. Financial deregulation was aimed at letting markets play a greater role in the governance and operations of the financial and banking system. But this market perspective tended to limit or eschew concerns about ‘systemic risk’ in the system, marked by the build-up of doubtful debt and speculative activity in asset markets, especially as it turned out, in commercial property markets. This lack of oversight was a big policy mistake, as was the policy-induced recession. The senior journalist, Max Suich (1991: 16) offered the following observations:

The Reserve Bank of Australia must be judged to have been asleep at the tiller...The RBA, which during regulation had firm control of the banks, changed from nanny to couch potato, issuing instructions but taking little intelligent interest in how they were being observed – not least where the quality of bank lending was concerned.

The policy-induced recession that quelled the financial boom was a deep one and the recovery was weakened by slowness in reducing interest rates and a tardy fiscal policy response (Bell 2004). Economic policymakers were convinced that the automatic stabilisers (government expenditures which increase automatically in a recession) would ‘cut in’, but judgment turned out to be wrong, and a ‘hard landing’ and a deep and costly recession in the early 1990s resulted. The upside was that lessons were learnt and policy makers and central bankers became more determined to do whatever it took to try in future and ward off recessions (Bell and Quiggin 2006). The outcome has been that since the early 1990s Australia has avoided the worst fallout from both the Asian financial crisis and the GFC, sustaining the longest expansion in the history of any capitalist economy.

The banks were also hard hit by the early 1990s recession. The boom and bust resulted in the failure of some smaller institutions and the near-implosion of one of the majors, Westpac, which saw it write-off nearly \$6bn in bad debts (Carew 1997). ANZ had been in severe trouble, too, at that time.

That crisis had spurred institutional learning in the sector. A former Westpac Chief Executive, argues that ‘one of the reasons things went so right’, during the 2007/8 international meltdown, ‘is that they went so wrong in the 1980s and early 1990s’ (quoted in Cornell 2009). A former bank chief economist, John Edwards (2008) agrees: ‘Sixteen years later the salutary lessons of Australia’s last deep recession still influence the conduct of the major banks’. Edwards (personal communication) continues: ‘an entire cohort of bankers was emptied out after early 1990s and replaced with more cautious bankers’. Similarly, a former APRA Chairman, John Laker (2009, 52) argues that there were ‘enough reminders that good times come to an end for boards to stay focussed.’ ‘There was a whole generation of bankers who’d been burnt. That corporate memory was very important’.

In policy process terms, monetary policy and regulatory lessons were also learnt. The RBA finally found a workable monetary policy approach based on flexible inflation targeting. It was also determined to try and avoid any further policy-induced recessions and handled the Asian financial crisis of the late 1990s adroitly by not raising interest rates and defying pressure on the currency by financial markets (Bell 2004). The central macroeconomic policy challenge after the recovery from the early 1990s recession became that of preventing the economy from overheating. By the early 2000s only a few veteran policymakers had experienced an economic recession. To avoid being caught out when a downturn did come along, Treasury officials decided to undertake some “war-gaming” of economic shocks. These anticipatory and preparatory exercises were undertaken discreetly. They mostly involved the senior echelons of the Treasury, and in some cases, their counterparts in the financial regulators and at the International Monetary Fund. Several mock economic crisis scenarios were run, challenging officials to spot and react to a sudden economic deterioration and the massive uncertainty it would generate in and beyond the markets. Most of these exercises modelled a sudden severe recession that increased unemployment dramatically. Other tests were then run on the effects on various sectors, the profitability of the banks, and on the medium-term fiscal position of the Budget. The main worries emerging from the exercises were sudden lay-offs, a surge in unemployment, the cost to the Budget and the long-term effects of getting (or not getting) those thrown out of work back into the workforce. A financial and banking crisis was not one of the contingencies considered.

There were also important regulatory shifts. Given the RBA’s lackluster performance in bank regulation in the 1980s and early 1990s, in 1998 the RBA was stripped of prudential regulation of the banks and financial institutions and the task was given to the new Australian Prudential Regulation Authority (APRA). A further critical event was the 2001 collapse of one insurance giant HIH. The episode revealed a lack of regulatory alertness on the part of APRA. APRA’s former Chief Executive, Graeme Thompson, observes that the regulator was initially established under a broad approach designed to be ‘non-intrusive [and] non-prescriptive’ (quoted, Clark 2009). A subsequent Royal Commission in 2003 encouraged APRA to adopt a ‘more skeptical, questioning and, where necessary, aggressive’ regulatory stance (quoted in Bell and Hindmoor 2015: 278). APRA subsequently adopted

this approach and remained confident it had a robust prudential regulatory framework covering the banks, non-banking institutions and the superannuation funds.

The role and approach APRA has adopted and the political support it has been given have also been important in sustaining and bolstering its capacities. On the whole, APRA has established a close but authoritative relationship with the banks. It relies far less on black letter law enforcement of the kind found in jurisdictions such as the US, and more on supervision and suasion, trying to inculcate sound risk management principles amongst the banks. As APRA's David Lewis (2008, 6) notes, 'It is a relationship that recognises that regulation works best when its goals and principles are internalised within the culture of the institutions being regulated'. APRA regulated in a way that supported prudent mainstream banking, and certainly, APRA's approach was a far cry from the 'light touch' or permissive regulatory approach in the UK (Turner 2009, 86-8) and the US (National Commission 2011, 52-66) in the run up to the crisis. Successive federal governments have also supported APRA's approach. The senior economist, Ian Harper, argues that in Australia, 'we are allowed to get on with regulation. We can distinguish between the role of the executive government and the public service. Regulators are allowed to get on with the job' (quoted in Cornell 2009). APRA's Charles Littrell (2011, 5) underlines the importance of political support for the bank regulator: 'Effective intervention over the necessary years and decades is impossible without broad public-sector support, most of all from politicians across the political spectrum. If you show me a country where politicians listen to the banks more that they listen to regulators, I will show you a country which is guaranteed to have a banking crisis'.

But Did APRA Save the Australian Banks? – No, But Competition Policy Did

In explaining why Australia's banks avoided the GFC, the former federal Treasurer, Peter Costello, is wrong when he emphasises that it was strong 'regulatory and prudential arrangements that kept capital requirements strong, subprime lending low and toxic derivatives out of systemically important institutions' (*Sydney Morning Herald*, October 8th 2009). Indeed, APRA's prudential regulation did not keep 'toxic derivatives out of systemically important institutions,' given the above noted exposures of two of the major local banks to such securities. APRA's regulatory and supervisory effort was mainly focussed on risks associated with mainstream or traditional balance sheet banking in mortgage markets and commercial lending. The fact that NAB and ANZ engaged in what turned out to be risky securities trading prior to the 2007/8 international financial crisis underlines that fact that APRA did not directly seek to limit non-traditional banking and it was not particularly focussed on US mortgage-backed securities as a source of risk. As APRA's Charles Littrell, explains, as far as exotic securities were concerned, 'There wasn't a lot of analysis going into it' (quoted in Bell and Hindmoor 2015:). The Australian bank that was most exposed to the GFC was NAB. As one of its former senior managers explains in relation to APRA's oversight of the Bank's US mortgage-backed securities trading, 'we wouldn't have been doing it if APRA had concerns about it, okay? Now whether they understood it any more than the banks, I don't think so' (quoted in Bell and Hindmoor 2015: 281).

What did save the Australian banks from the worst of the GFC were the generally cautious bankers in Australia, scarred, as noted above, by the early 1990s banking crisis. Arguably the most important factor however was regulation; not prudential regulation, but regulation of a different type, centred around competition policy in the banking sector. In the early 1990s in the face of attempted takeover activity amongst large financial institutions that threatened to limit competition, the federal Labor government formulated the ‘six pillars’ policy which prevented the four largest banks and the two largest insurance firms from merging. The subsequent Liberal government removed the insurance companies from the policy, creating a ‘four pillars’ policy amongst the banks (Bakir 2005). Four pillars is designed to ensure market competition, though it has created an oligopoly amongst the large banks.

The main import of the four pillars policy however is that although it was designed to sustain competition in the banking sector, it has actually reduced competition in a critical sense. It has essentially outlawed the takeover market for the big banks and thus reduced competitive pressure on the banks from hostile takeovers. The former Governor of the Reserve Bank of Australia (RBA), Ian Macfarlane (2009, 42), argues that by reducing the threat of corporate take-over, the four pillars policy reduced the pressure upon the largest banks to protect their share price and short-term profits by engaging in ‘excessive lending and risk taking’. The policy reduced competition ‘to a sustainable level and thus prevented our banks from moving too far in the risky direction... that saved us from the worst excesses that characterised banking systems overseas’. A Commonwealth Bank senior risk officer, agrees: ‘in a market dominated by the four major banks none of us had compelling incentives to go down the risk curve and grow our books as much more contested markets have’ (interview, 29 February 2012). Bell and Hindmoor (2015) show that the success of the Canadian banks in similarly avoiding the GFC stems from the same kind of regulation that structures the national banking market to prevent big bank takeovers and hence moderate competition. They also show that the more intense competitive pressures and active takeover markets in banking were a key source of pressure that pushed the banks in the US and UK to take on extra leverage and risk in the run-up to the GFC. The Australian national market structure in banking is thus very different to that found in the US and UK. In these latter countries, successive governments have aimed to reduce barriers to competition (Claessens 2009). In the lead up to the crisis, competitive pressures shaved bank margins and profits and had the unintended effect of encouraging the banks to expand leverage and risky trading operations in order to sustain or boost profits.

It has also been the case, unlike in many other countries, that the Australian property market, although highly inflated, did not collapse, bubble-like, and thus did not expose the banks. One factor for stability here was regulation. Unlike the US, Australia has full-recourse mortgages, meaning that banks could pursue loan defaulter’s assets, encouraging the latter to be prudent. Monetary policy was also important. During the 2000s the RBA ran a higher interest rate policy than was the case in many overseas countries, especially in the US. The RBA also raised interest rates to deliberately help cool and stabilise the property market in 2003 and 2004, when a degree of overheating was apparent. In

jawboning and in pre-emptively raising interest rates, the RBA was one of the few western central banks prescient enough (and perhaps bold enough) to tackle this form of asset price inflation (Bell 2004). The result of such actions, together with strong demand, helped stabilise the market, underpin economic growth, expand the balance sheet of the banks and support strong bank profit performance in a sustainable manner. Indeed, the big banks gained market share and won high profits. As the RBA's Ric Battellino (ASIC 2009, 48) has argued, 'The banks chasing profitable lending opportunities in Australia could grow their balance sheet by 15 per cent a year... without having to take on new additional risks'. Former bank chief economist, Saul Eslake, comments that 'the Australian banks didn't feel under any need to enhance their income or profit generating performance by acquiring risky, and as it turned out toxic securities, in the way that US and European banks did' (quoted in Bell and Hindmoor 2015: 268).

Since the financial deregulation, Australia has faced one major financial calamity (the early 1990s crisis) and two close shaves (the Asian financial crisis and the GFC). In a world where such calamities are now all too frequent, in Australia, major lessons have been learnt and policy generally served us well, especially since the mid-1990s. Australia has thus developed a distinctive national style of banking regulation. Prudential regulation has been strengthened, but as argued, the main form of regulation, the four pillars policy, which helped steer the banks away from excessive risk taking was not designed for this task but was designed instead to sustain banking competition. In fact, it limited certain forms of competition in what turned out to be a very beneficial way. The policy outcomes in question then were an accident, there by dint of good luck. In other words, the policy design process was aimed at something else, not at helping to limit competition and stabilize risk in the banking sector. This underlines the fact that policies can sometimes have beneficial unintended consequences. Luck and happenstance can matter.

A further political consideration in relation to policy support and legitimacy is that banking regulation has long been a feature of the Australian policy landscape, except for the 1980s when it was (wrongfully) assumed that markets could successfully govern the system. Indeed, controls over the banks are popular, seen as legitimate by voters, and are thus politically sustainable in Australia. The four pillars policy is disliked by the banks which have lobbied to retrench it, arguing they need to merge in order to grow in scale to become more internationally competitive. This however argument has been rejected by successive governments, which have been supported because the policy is electorally popular in a political culture that distrusts the big banks (Bakir 2005). Financial and banking regulation thus have high legitimacy in Australia. Given recent banking scandals over rate fixing, assistance to money launderers, and poor customer service, more regulation is likely to be on its way.

Crisis preparedness: Monetary and fiscal policy alertness

When the Rudd government took office in November 2007 there had been early signs that all was not well in the world's financial systems. Notwithstanding its publicly talking up the underlying strength of the Australian economy and its banking system, behind the scenes, the government, and new Prime

Minister in particular, was anxious to know of the depth and magnitude of risks Australia faced. If in 2008 the world was going to be hit by a global financial crisis, a banking collapse and/or a recession leading to a bout of high unemployment, it would have to be better prepared than it had been in 1990, let alone in 1929. Indeed, the management of the GFC in Australia (and elsewhere) displayed a strong commitment to avoid the errors of the past, as well as a growth in perceived political responsibilities. Structural economic change in the form of the burgeoning growth of the financial sector had exposed large numbers of increasingly leveraged Australian households (and the government) to the vagaries and risks of financial markets. It was also the case that societal expectations regarding government support and assistance in times of crisis had become far more acute over the decades (Walter 2017).

On 29 February 2008, Kevin Rudd invited Ken Henry at short notice to accompany him on a flight to Gladstone specifically to discuss ‘what might go wrong’. He wanted to know how a global financial crisis might affect Australia. At the time, Henry said he was not entirely sure since the dimensions of any looming crisis were unknown. There was a chance a serious financial meltdown might occur but its likelihood seemed limited. Treasury would need to undertake specific research and modelling to investigate the strength of the financial markets. He nevertheless took Rudd through a range of possible responses to a number of bad weather scenarios. The options included using the current strong fiscal balance sheet to provide economic stimulus; ways to ensure wholesale lending in financial markets; and the use of a planned financial claims scheme which could help mop up after the collapse of particular financial institutions.

It was the first of innumerable conversations Treasury’s top executives were to have with the Prime Minister and Treasurer Wayne Swan about how global markets were tracking and what Australia could do to protect itself. In discussions with a range of U.S. financial market participants and regulators Swan and Henry had had an early taste of what was to come. Swan’s subsequent visit to the US in October 2008 confirmed his worst fears. The financial crisis was in full swing and the prognosis was poor. Things were so bad that there was no way Australia would be spared.

As the financial crisis loomed, Australia’s four financial regulators needed to coordinate their actions and utterances. APRA, ASIC, the Reserve Bank, and the Treasury were already talking to each other regularly through the Council of Financial Regulators platform as well as in other constellations. Nevertheless, during 2007 and early 2008, monetary policy and fiscal policy were partly working against each other, reflecting the “countervailing forces,” as the Government described the events impacting the Australian economy. The Reserve Bank was worried about rising inflation and excessive government spending or tax cuts which would serve to stimulate higher inflation. The Bank was raising interest rates to put a brake on economic activity.

Meanwhile the Government was increasing spending. The Howard Government had been giving almost annual tax cuts, while also accumulating significant budgetary surpluses. The then Treasurer Peter Costello had announced at the outset of the hard-fought 2007 election campaign that the Coalition would deliver \$43 billion in tax cuts over the next three years if re-elected. With Rudd

having touted his credentials as a “fiscal conservative” in the campaign, his Government adopted most of the package, adjusting it only on the margins. A substantial tranche of these commitments was to be implemented in the 2008-09 Budget. The Reserve Bank was still tightening monetary policy in March 2008.

As the US situation worsened, policy adjustments were starting to happen. The Federal Budget, brought down in May 2008, was mildly contractionary. Breaking with a long series of interest rate rises designed to cool an overheating economy, in early September 2008, the RBA announced a cut of 25 basis points (1/4 percent). Later that month, the four regulators signed a memorandum of understanding on financial distress management. It established the principles for decision-making, the various responsibilities for each of the four regulators, detection strategies for financial stress, and a commitment to a “coordination of response” including communication. Was the system ready for the shock that was about to hit?

Crisis response policies

Regulatory responses

The ripple effect of the Lehman crash was instant and global. Neither the Australian share market nor the value of the Australian dollar was spared. Treasury knew the Reserve Bank was going to make a substantial cut as the crisis deepened but thought that it would be of the order of 50 basis points (0.5 percent). However, given the rapidly deteriorating global situation, Governor Glenn Stevens recommended and the Reserve Bank Board adopted a cut twice this size to underscore the point. The massive rate cut indicated that the Reserve Bank too had now shifted its frame towards managing a prospective economic downturn. It sent a clear message to local and global markets. Australia became the first country to make such a large cut in official interest rates. It had the scope to do so with domestic interest rates sitting at nearly seven percent, high by world standards at the time. By 2015 interest rates in Australia had been reduced to only 2 per cent, though this was higher than the almost zero rates in the other advanced economies, partly due to higher local growth, a continued boom in property markets, and the impacts of China’s stimulus in boosting Australian resources exports. Other central banks in other countries followed suit in cutting interest rates, a concerted effort to provide a circuit-breaker, though they had considerably less room to maneuver. Unlike in the US, UK, and Europe however, the RBA did not subsequently engage in bold monetary policy stimulus in the form of quantitative easing.

During the long weekend in October that followed the rate cut, Australia’s economic policymakers had to face a stark reality. Hysteria was a real possibility unless the government, the banks, businesses, consumers, and depositors held their nerve and reaffirmed confidence in the system. Henry’s mother asking her son for advice on whether she also should withdraw her savings to safeguard them helped him realise the fragile psychology of community confidence in the market system. In parallel, Henry and his colleagues were hearing stories of businessmen going to banks with suitcases asking to withdraw millions in cash at short notice, and of security firms such as Armaguard and Chubb

putting on second shifts to move the additional amounts of cash needed to keep banks and ATMs going. Cash withdrawals were going through the roof: A\$5 billion was withdrawn in a few weeks.

Perhaps more than the analytical data these signals underscored to the policymakers the turbulence of the times. Suddenly, not a single bank or other financial institution could be allowed to collapse because of the knock-on effect to systematic confidence. In effect, each institution had now become “too important to fail”. Like the Reserve Bank, the Government had to act to ease growing market nervousness. As one official observed, “Any financial system works on confidence. And confidence is fragile. It all works on confidence. So, this place [the Treasury] is a place where you give confidence back to the minister.”

Treasury Secretary Ken Henry was all for decisive action by the Reserve Bank: “As soon as you sense that there is a confidence issue, you’ve got to wrap the whole thing in a blanket... We realised that in the current climate, not a single APRA-regulated institution could be allowed to go under, precisely because of the impact this would have on the psychology of market confidence.” Or, in the more prosaic words of another Treasury executive: “Everyone knew time was of the essence. You had to whack before the market would open on the Monday.”

Key decisions were made quickly. First the government curbed speculative behaviour by announcing that “short-selling” (selling stocks you don’t own until the price drops and then buying them back at the cheaper price) would not be permitted on local money markets as this was exacerbating the crisis. Secondly, following the Irish government’s unilateral decision to guarantee bank deposits, the Rudd government issued a similar guarantee on savings deposits up to a total of \$1 million. Thirdly, it applied a similar guarantee to wholesale funds for the banking and non-banking sectors. This in effect secured funds for both customers and the financial institutions.

Whilst made in the heat of the moment and with a clear national interest perspective in mind, this was also the first instance in which political considerations found their way into the crisis response process. While the Treasury had been considering a savings deposit guarantee, a political auction developed. Opposition leader Malcolm Turnbull claimed it should be \$100,000. The Government then chose to respond by going to all the way up to \$1 million because the Prime Minister did not want to face questions about why the guarantee would not cover nearly everyone except for the very rich (with savings of much more than \$100,000) who would stand to lose disproportionately in case of a bank failure.

Overnight Keynesianism: the first stimulus

Boosting confidence in the financial system was only part of the equation. The other big part of the October long weekend discussions was to do what had been unthinkable just three months before: boost aggregate demand in an economy that was at severe risk of sliding straight from potential inflation into potential recession mode. Treasury’s Executive Board was interested in getting the ‘biggest bang for the buck’ – or in its technocratic jargon “assessing the efficacy of the various fiscal multipliers to keep

domestic demand buoyant”. Treasury had been quietly assessing the efficacy of various domestic fiscal stimulus instruments, comparing the economic benefits of tax cuts, direct payments, and infrastructure spending. It had calculated which worked best, and which quickest. It had also pondered which mix of these instruments might work better.

There had been much discussion in academic and policy circles about the relative merits of tax cuts versus cash injections. The US had long favoured tax breaks, but the Treasury – primed as it was to prevent the fiasco of its 1990-92 recession experience – began to feel that a cash stimulus would maximise spending in the short term. Less importance was attached to the substance on which the money was spent, so long as dollars got into people’s pockets quickly: “We knew we would be distributing funds to dead people, and people living overseas. But we also know that their number was negligible, and that cash transfers could be delivered so much quicker than any tax cut could. We were happy to make that trade-off.”

The first stimulus package – somewhat ominously titled the Economic Security Strategy by a prime minister who saw the meltdown as the economic equivalent of a national security crisis – entailed government spending of some \$10.4 billion (0.9 % of GDP). It was hastily put together over a weekend of intense deliberation, for implementation in November 2008. It was a couple of days of fluctuating proposals and counter-proposals, during which the Cabinet’s Strategic Priorities and Budget Committee, SPBC, Rudd, Swan, deputy prime minister Julia Gillard, Swan and Finance minister Lindsay Tanner - quickly dubbed the “Gang of Four” - bunkered down with their key advisers and closest senior officials.

In Henry’s much-cited phrase, the Treasury’s advice to the Government was to ‘go hard, go early, go households.’ The idea was to get money into the hands of consumers with a high propensity to spend and who might be facing a household liquidity problem if credit dried up or banks threatened to foreclose on their mortgages. The problem was how much to spend and who to give it to who would spend it quickly. Senior officials worked closely with the ‘gang of four’, iteratively discussing options, before the Government decided on a package worth \$10 billion. There were some intense internal debates about the efficacy of fiscal stimuli with some officials still preferring to allow markets to run their course. There was less argument about who should receive the ‘cash splash’. The focus would be on those with low incomes and with an existing benefits relationship with one of the government’s tax or welfare agencies (namely the various pensioners, those households on Family Tax Benefit). In addition, extra training places were funded, targeted to occupations facing lay-offs, along with an extension of the first home-buyers’ scheme to assist young families.

Keen to forge a breakthrough on a concerted international approach, Rudd convinced the outgoing US President George Bush and then UK Prime Minister Gordon Brown to drive the global strategy through the G-20 rather than the G-8 mechanism. This had the benefit of securing Australia a seat at the table. Concern about the health of the global financial system was so high that finance ministers and central bank governors of the G-20 met on six occasions between October and November 2008. The G-20 Washington summit of 14-15th November, where the nations committed to

streamlining financial and fiduciary regulation regimes, was compared in significance to the agreement that laid the foundation of the post-World War II international monetary order, and labelled a Bretton Woods II accord. Rudd claimed it was a major foreign policy coup.

As early as November, Treasury started advising that more probably needed to be done. This led to another set of measures being announced just before Christmas 2008. The Government committed \$4.7 billion (or 0.4% GDP) to ‘shovel-ready’ state infrastructural projects that could start immediately and could help to maintain employment levels in the construction and supply industries. By this time, no one was worried about any inflationary pressures the stimulus measures would generate. The common assumption was that recession was unavoidable anyhow; the stimulus would hopefully soften the landing the national economy was likely to experience. The approach was one of trial and error: provide some stimulus, step back to see how it worked, and then decide if another dose was needed.

The second stimulus

Around Christmas time, the Prime Minister became concerned that the government was not doing enough to avert increased unemployment. Treasury’s estimates that unemployment might jump well above 5 percent, possibly more, became a real driver of decisive action. The aim was straightforward, as one official stated: “keep people out of Centrelink ... We did not want to lose yet another generation to long-term unemployment as we had done in the early nineties.”

The \$43 billion Nation Building and Jobs Plan (3.5 % of GDP), announced on 3 February 2009, that emerged from these discussions included another A\$12 billion wave of cash injections to households, including cheques of up to \$950 per person for the unemployed, employees earning less than \$100,000, students, self-funded super annuitants and farmers meeting certain criteria. In addition, A\$23 billion in major capital works programs were launched, targeting school buildings (situated on Crown land, which enabled quick movement from plans to shovels), social and defence housing, roads and rail infrastructure. In addition, there were “green” programs subsidising the uptake of renewable energy technology and the installation of household roof insulation (A\$4billion).

Given the political noise about ‘sugar hits’ following the pre-Christmas cash injections to citizens, and the much larger scale spending that was now being contemplated, a wider range of government programs was used to pump money into the domestic economy. Rudd wanted things that were not a transient part of the landscape - as cash splashes and tax credits by their very nature were - but signature achievements of his Labor government.

During the drafting of the second stimulus package, Rudd and Swan were acutely aware of the risks to the country’s fiscal position and reputation that this entailed. This led to an ironic situation: “The impact on the surplus was a major concern of Rudd’s during the Stimulus II discussions. Now it was us at Treasury having to push the politicians to spend rather than the reverse. Rudd was concerned about his reputation for fiscal prudence. We took him through various components of aggregate demand

and showed him what would happen if we did not intervene in a big way. Essentially, we had to turn him onto a Keynesian over the summer of 2009.”

The Government’s concern for its economic reputation had already been on public display following the announcement of the first stimulus package. It was clear to informed observers of economic policy that the combination of unprecedented public stimulus spending, higher levels of unemployment and decreased tax revenues would push the budget into deficit. However, the Prime Minister and the Treasurer were initially most reluctant to be caught saying so in public. They first tried to avoid speaking the ‘D-word’ at all. When that became clearly preposterous, they used softening language (“temporary deficit”) to counter opposition claims that the Government was throwing all caution to the wind and was using the economic conditions to embark on an unmitigated spending spree.

At the same Rudd did not hesitate to try and use his new convictions as a political weapon against the Liberal opposition. He found time in his summer schedule to write an essay, published in the February 2009 issue of *The Monthly* magazine, in which he denounced the ‘neo-liberalism’ that had failed to civilize global capital and extolled the ‘social democracy’ the world now required to clean up the mess. The essay and the robust debate it generated confirmed a trend that had begun with the first stimulus package and had been reinforced in the public debate over the second package: economic crisis management had become a matter of high politics.

Analysis: Success, luck or failure?

By any standard, the GFC was a remarkable episode in Australian public policy. The sheer scale of the crisis response moves that were made continues to impress: the RBA’s dramatic series of interest cuts in the early months of the crisis (adding up to 4.75% overall) - bold moves that set a global precedent; the government’s sweeping deposit guarantee; two stimulus programs comprising dozens of billions; and a total stimulus of 4.5%GDP in about eighteen months. These were audacious moves, outright ‘policy gambles’ under conditions of radical uncertainty (Dror 1983). The key question, of course, is: does all this end up to being a ‘great policy success’ – a triumph of willed non-occurrence of negative events? Some key observers certainly seem to think so. Kelly (2014: 160), for example, posits that ‘Australia survived the financial crisis without a recession because of two factors – the pre-crisis strength of its financial position and soundness of its banks; and the speed with which monetary and fiscal action was taken when the crisis hit.’

Was the fiscal stimulus a good thing?

In their review of the Rudd government’s economic policy, Garnett and Lewis (2011: XX) conclude that ‘[t]he evaluation of the impact of the stimulus package on jobs and growth is unlikely to be settled empirically and, as with many debates in economics, views will, to a large extent, depend on the politics and the economic doctrine adhered to.’ Much of that debate hinges on which criteria one privileges, and what causal claims one is prepared to accept.

Focusing on *programmatic* criteria, the income support components of the stimulus can be said to have been fully successful to the extent that: (a) the money reached people's pockets as quickly as intended; (b) the proportion of money lost or distributed to people not entitled to it was (very) low; (c) a significant proportion of the money was actually spent, and spent quickly, by consumers so as to give a clear boost to domestic demand to make up for anticipated and actual reductions in foreign demand; (d) the experience of this quick and massive handout and the spending it elicited contributed significantly to business and consumer confidence in the economy so as to preserve the psychological foundation underpinning future business and consumer behaviour necessary for continued economic growth.

For its capital works components, a comparable program evaluation test can be set up. Their programmatic success hinges upon: (a) the scale and timing of actual expenditures taking place; (b) their primary effects on business continuity in the various construction industries involved; (c) their secondary effects, e.g. the extent to which the construction works undertaken contributed to the government's non-economic goals for the various programs, i.e. enhancing the quality of education, reducing Australia's carbon emissions, and bringing down household energy bills, to name a few; (c) the absence or minimal size of unintended consequences including: fraud and misappropriation of funds, stimulus-fuelled upward adjustment of the exchange rate and interest rates, price hikes in the construction sectors, and other implementation mishaps; (d) the extent to which the government's strategy for recouping the significant additional outlays and bring the budget back in the black in the medium-term worked as planned.

On virtually none of these measures was there an undisputed verdict. Each proved contentious among economists. Much depended also on when the math was being done and which of the range of objectives and conditions were being emphasized. While there is a range of summative judgments out there, the main positions analysts have taken are that, on balance, the stimulus was an historic success; that it was largely ineffectual and that the absence of recession was caused by other factors; and that it was a costly and painful failure.

Not surprisingly actors in the Rudd government but also senior Treasury officials were and have since remained of the first view. In their reading of the evidence, the all-important Keynesian multiplier effect of government expenditure was robust. Henry's successor as Treasury secretary Martin Parkinson asserted that Australia's fiscal multiplier was about 0.7 for the cash handouts (such as the \$900 cheques – but see the more cautious assessment of Leigh 2012) and up to 1.3 for public investment (such as the building of school halls). Deputy secretary David Gruen hailed the speed of the operation, describing it as '...an extraordinarily rapid fiscal policy response', an assessment later echoed by the OECD. Nobel prize winner Josef Stiglitz provided welcome support, stating: 'Kevin Rudd ... realized that it was important to act early, with money that would be spent quickly, but that there was a risk that the crisis would not be over soon. So, the first part of the stimulus was cash grants,

followed by investments, which would take longer to put into place. Rudd's stimulus worked: Australia had the shortest and shallowest of recessions [sic] of the advanced industrial countries' (Stiglitz 2010, see also Ahlens, 2009; Quiggin 2013).

The second position is represented in the work of economist Tony Makin, who concluded that 'fiscal stimulus was not primarily responsible for saving the Australian economy from a narrowly defined recession in the March quarter of 2009, but a combination of lower interest rates, a major exchange rate depreciation, strong foreign demand for mining exports, especially from China, and a then more flexible labour market (Makin 2016: 12). Moreover, 'the nature of Australia's fiscal stimulus was misconceived because it emphasized transfers, unproductive expenditure such as school halls and pink batts, rather than tax relief and/or supply side reform, as occurred for instance in New Zealand where marginal income tax rates were reduced, infrastructure was improved and the regulatory burden on business was lowered. The scale of spending was unnecessarily large and subsequently proved counterproductive by working against keeping interest rates and the exchange rate lower for considerably longer, as occurred during the Asian crisis' (Makin 2016: 13).

The third position was taken by the Opposition and many Murdoch press commentators. In addition to emphasizing the alleged ineffectiveness of spending, the outright negative assessment of the stimulus policy hinges upon a commitment to balanced budgets. And indeed: if deficit and debt are taken to be deep negatives to be avoided at all costs, there is no way in which Australia's GFC response can be seen as anything other than a policy overreaction. This negative verdict was exacerbated by deep skepticism, later vindicated by the course of events, about the government's claims concerning the speed with which the deficit would be repaired.

In terms of *process* evaluation, the critics attacked the alleged fraud, abuse and goal displacement in the school building program, and were given a field day when the home insulation program turned into a political nightmare upon the deaths of four apprentices in unrelated incidents in quick succession, as well as a number of fires in houses that recently had had installation installed. The 'pink batts fiasco' was born, triggering inquiries, ministerial apologies (and a demotion) and a A\$1 billion inspection and remedial action effort – notwithstanding the fact that sad though they were, these incident rates actually constituted an improvement on the industry's average (Hinterleitner and Sager 2014).

Finally, the *political* assessment of the episode is mixed. As mentioned in the introduction, the stimulus packages were broadly supported by the policy community and organized business. They initially boosted the government's popularity and in particular that of its highly active and highly visible prime minister. But that success was relatively short-lived. Rudd's strategy to reframe the terms of the economic policy debate – pushing neo-liberalism to the margins – was much less successful, and he quickly abandoned the effort. In the medium term, certainly after the 2010 federal election, the political success of the stimulus had all but evaporated. The public had forgotten the economic 'non-event' yet

remembered the pink batts and the allegations of mismanagement that had started to dog the government in the second part of 2009. And as the years passed, the Opposition successfully played the deficit card as the government, now led by Julia Gillard, failed to make good on its promise of a speedy return to surplus.

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¹ Portions of this chapter and the Treasury officials quoted in it stem from Paul 't Hart and John Wanna, *The Treasury and the Financial Crisis*, part A and B, John L. Alford Case Library teaching cases. See: www.anzsog.edu.au.

Notes