Bailout Bonanza!

The fall won't kill the global economy, argues **Julie Novak**. But how governments respond on the way down could.

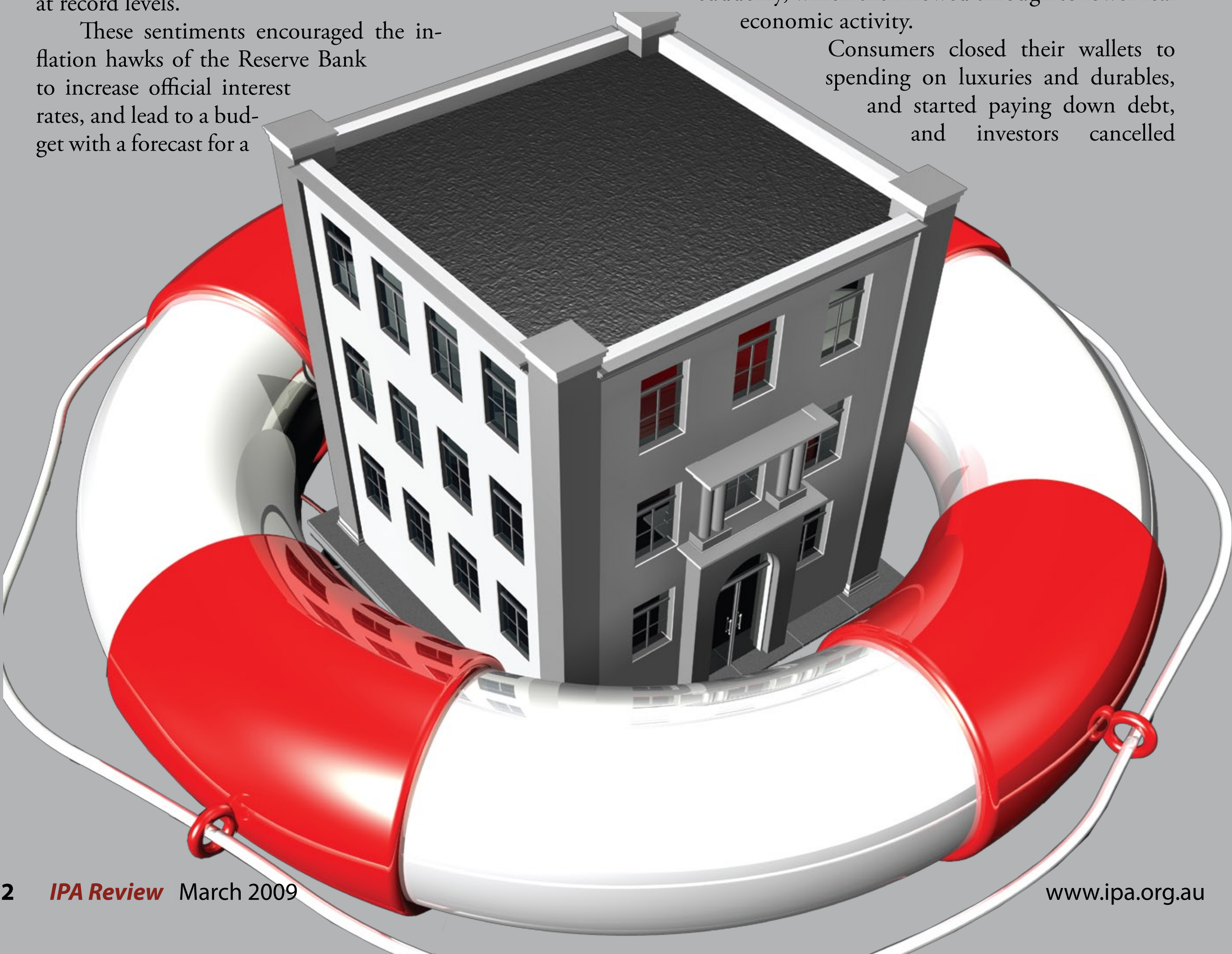
Periods of economic turmoil have a habit of exposing weaknesses in policy, whether it is through inexperience, a lack of understanding, or a combination of these.

Only a short twelve months ago, a newly elected Rudd government was warning of the effects of an overheated domestic economy. In February 2008, the Treasurer Wayne Swan said 'the inflation genie is out of the bottle', and the government brayed about the problems of sourcing skilled labour and materials to keep the economy chugging along at record levels.

These sentiments encouraged the inflation hawks of the Reserve Bank to increase official interest rates, and lead to a budget with a forecast for a bigger surplus for 2008-09 compared to the previous year. These measures were designed to take the economy off the boil. About the same time, however, deflationary pressures were building in the global economy with serious consequences for the Australian economy down the track. What started out as a collapse of the US sub prime housing market quickly led to the accumulation of bad debts throughout the interconnected global financial system.

This sparked a crisis of confidence in financial markets, translating into tightening credit conditions and subdued equity markets. Confidence in future economic conditions by spooked consumers and businesses dropped suddenly, which then flowed through to lower real economic activity.

Consumers closed their wallets to spending on luxuries and durables, and started paying down debt, and investors cancelled



or deferred their projects. Job layoffs commenced as businesses found they couldn't afford to retain staff in a rapidly slowing economy.

What the government does, and says, is vitally important in shaping economic outcomes. The more government intervenes haphazardly, and the more it blurs its messages, the harder it is for markets to get out of the slowdown funk with a spirit of confidence.

This is exactly what has happened in Australia. Initially, Prime Minister Kevin Rudd and Wayne Swan were at pains to suggest that the domestic financial system was sound, and that Australia's economic problem was not recession but niggling inflation genies and labour shortages.

However, the government was unable to sustain this rhetoric, as it proceeded from September 2008 onwards towards a flurry of interventions including:

- A government guarantee of deposits and wholesale funding of authorised deposit taking financial institutions.
- Increased grants to state and local governments including for infrastructure projects, to be spent as quickly as shovels could be picked up and used to dig holes.
- A $10.4 billion package of pre-Christmas spending measures, including payments to pensioners and family welfare recipients, a boost to the homeowners grant and a commitment to fast track infrastructure spending.
- A rolling package of bailout measures for non financial markets, including $6.2 billion for car manufacturers, $2 billion for car dealers and $22 million for childcare centres.
- A proposal to refinance existing commercial property loans, in an arrangement with the four major banks.
- A second stimulus package, worth $42 billion, including infrastructure support for states on schools and social housing, insulating houses, business tax breaks, and boosting welfare payments to 'support jobs now'.

The Reserve Bank operated in a panicked tandem with the government, dropping interest rates by an extraordinary 3.75 per cent since October 2008 in an attempt to splash money about the economy.

The bailouts have turned out to be a bonanza for inefficient, debt ridden businesses, yet are a huge burden on taxpayers and consumers alike.

The government's measures have been vigorously contested on all counts. Take the fiasco that was its handling of the deposit guarantee as an example. Non-bank financial institutions, such as mortgage brokers and investment funds, were forced to suspend redemptions to prevent capital flight from non-guaranteed to guaranteed deposits. Foreign bank branches in Australia were also ineligible for the guarantee, while financing costs for state governments increased dramatically.

It seemed that not all money was equal in the eyes of the government. The Treasurer insensitively suggested that depositors with frozen non-bank funds approach Centrelink for income support. Later, the Prime Minister suggested that non-banks should convert into banks, ignoring the fact that different institutions exist to competitively provide different financial products with varied risks.

The debilitating movement of funds was compounded by the guarantee being initially uncapped for deposits within all eligible institutions. Almost two weeks after the initial announcement, the government proposed a compulsory insurance premium on guaranteed deposits over $1 million. Two days later, the Treasurer then announced that the deposits over $1 million will only be guaranteed if a (voluntary) fee is paid.

All of this constant policy adjustment had come to nought, as it was reported in November 2008 that $15 billion had become frozen in major mortgage and property funds. Government financial activism reared its head, and the domestic financial market malfunctioned as a result.

The government's appetite for policy on the run has also been demonstrated by the fiscal stimulus packages. The government has pointed to a 3.8 per cent increase in retail spending in December 2008 as proof that its direct payments to pensioners and families worked. However, it is most unclear that a temporary bringing forward in consumption, enforced by government handouts, has produced any sustained increase in spending after the Christmas period.

Submissions to a Senate inquiry on the $42 billion package have indicated that the additional spending measures proposed by the Rudd Government rank poorly on efficiency and effectiveness criteria, and will have little effect in shielding Australia from the global recession.

It is unlikely that shoveling infrastructure money to inept state governments will improve our long run competitiveness. There is also very little chance that the economy can get back on its feet through a pink batts inspired recovery.

The budgetary impact of the stimulus measures have been heavily scrutinised, and for good reason. The May 2008 budget projected an accrual fiscal balance of $23.1 billion for this financial year. By December, the surplus had

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slumped to a threadbare $5.8 billion on the back of the initial fiscal stimulus package. The latest figures now show an expected budget deficit of $22.4 billion, with persistent deficits and growing public debt over the next four years.

In effect, a decade of inculcating an anti-deficit culture in Australian political and economic life—a very worthwhile task—has gone out the window with a Keynesian inspired spending spree by the Rudd Government.

The federal government's moves to bail out industries were part of a bigger outbreak of 'bailout mania' across the globe. This exercise turned out to be a bonanza for inefficient, debt ridden businesses, yet will be a huge burden on taxpayers and consumers for years to come.

The government's bailouts attempted to preserve existing economic activities and jobs. However, these attempts to defy economic gravity prevent resources from being reallocated from failed businesses to higher valued uses. It has weakened the capacity of markets to clear away inefficiencies, and will prolong the pain of the adjustments required.

Regrettably, the damaging fallout from the Rudd Government's actions is yet another case of economic history left unappreciated. As far back as 1929, Ludwig von Mises argued government interventions create distortions, encouraging policymakers to impose more interventions to solve the problems caused by the initial intervention. Kevin Rudd's least favourite economist, Friedrich Hayek, described a similar process in his 1944 classic *The Road to Serfdom*.

Apart from an unwillingness to learn economic lessons, governments often fall prey to 'action bias' in the hothouse of modern politics. In other words, governments prefer to act quickly, either reactively or proactively, to be seen to 'do something' and so receive electoral attention (and hopefully acclaim).

There is strong circumstantial evidence to suggest that the government's eagerness to shield Australia from a global financial and economic maelstrom reflected an action bias on their part. Questioning of Treasury officials by the Senate Estimates Committee last year revealed that Treasury had not modeled the economic impact of the fiscal package. In an additional estimates meeting in February this year, it was conceded by key bureaucrats that judging the effectiveness of stimulus measures may be impossible. When government feel a rash of spending coming on, the notion of stewardship of taxpayers' money—requiring careful, painstaking analysis of the net benefits of various interventions—goes out the window.

It is in the difficult times that the economic credentials of a government get tested. With economic regime uncertainty and confused messages, the Rudd Government has been found wanting and the Australian people are likely to pay dearly for it.

Whatever you do, don't turn to Keynes

Some economists are claiming that Keynes is the right man to read for this season of economic turbulence. For example, the prominent American economist Greg Mankiw wrote in the *New York Times* that 'if you are going to turn to only one economist to understand the problems facing the economy, there is little doubt that the economist would be John Maynard Keynes.'

Even in these economic times, this statement remains a controversial one. Some of the greatest economic liberals identified flaws in Keynesian thinking. William Hutt critiqued the 'demand deficiency' view of Keynes, and warned of the economic dislocations of budget deficits. Friedrich Hayek warned of the impact of deficits on inflation. James Buchanan and Richard Wagner noted political incentives encouraging deficits, but warned of the consequences for inflation and an oversized public sector. Government deficit financing, a cornerstone of Keynesian fiscal policy, is simply bad for the health of an economy.

We ignore the lessons of modern economic history at our peril. As Commonwealth Treasury showed, in 1995–96 (four years after the 1991–92 recession) the underlying Commonwealth budget deficit was at 2 per cent of GDP. This was worse than the average underlying deficit of 1.4 per cent of GDP from 1975–76 to 1995–96. General government net debt rose to over 19 per cent of GDP in 1995–96. Fiscal consolidation by the previous government was required to restore normalcy to Australia's budgetary settings.

The Commonwealth and state governments would be wise to avoid the Keynesian economic recipe of fiscal deficits as an ongoing pursuit.

- Julie Novak