The Global Financial Crisis of 2007-09
– an Australian Perspective

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1 INTRODUCTION

I am very grateful to the University of Western Australia and to the WA Branch of the Economic Society of Australia for inviting me to deliver this lecture, which commemorates the foundation Professor of History and Economics at this University, Edward Shann. I'm particularly conscious that this is an honour which has only rarely been extended outside the small circle of distinguished academic economists and senior economic policy makers.

There are three aspects of Shann's life and work that particularly resonated with me as I sought to become more familiar with them in the course of preparing for this lecture, two of which have been little remarked upon by previous lecturers.

The first of these is that he was born (125 years ago this year) in Tasmania, the State where I spent most of my formative years and to which I retain a strong allegiance. As my honours year dissertation supervisor, Alf Hagger, and his co-authors have recorded (Coleman, Cornish and Hagger 2006), Shann was named after a Hobart medical practitioner, Dr Edward Owen Giblin, 'presumably out of a debt … in some matter of life and limb'. In one of those meaningful co-incidences which recur endlessly in small communities like Tasmania, Dr Giblin's great-nephew Lyndhurst Falkiner Giblin would be one of Shann's professional peers in the 1920s and 1930s. A surprisingly large proportion of these men had some kind of connection with Tasmania, although Shann's ceased in at the end of the 1880s when his family moved to Melbourne. I am not aware of any evidence that he retained the same affection for his birthplace as, for example, Sir Roland Wilson, Australia's longest-serving Treasury Secretary.

The second aspect of Shann's life and work which holds particular relevance to me is that he was the first person to hold a position which we would today describe as chief economist at a commercial bank, similar to the one from which I have recently stepped down after nearly 14 years. As Snooks (1993) relates, in 1930 Shann was invited to act as economic consultant to the Bank of New South Wales, the forerunner of today's Westpac Banking Corporation, by its then General Manager Alfred Davidson. He spent the university vacation of 1930-31 at the Bank's head office in Sydney, and was subsequently released by the University of Western Australia to spend the whole of 1932 with the Bank. During this period he established an Economics Department consisting of himself and four economics graduates, whose function was 'to answer specific questions of an economic nature put to it, from time to time, by the General Manager and other bank officers', as well as producing 'a regular pamphlet of a general nature for circulation within the bank and documents for external distribution' (Hagger 2007). Shann's successor in this role, incidentally, was another economist with strong Tasmanian affiliations, Torleiv Hytten.

The third aspect of Shann's life and work which resonated with me was that he was an historian as well as an economist, holding lectureships in the former discipline at the Universities of Melbourne and Queensland prior to becoming foundation Professor of History and Economics at this University in 1912. I too have long found history absorbing, and although I've never pursued it to the same level as Shann I have often found especially intellectually rewarding those opportunities when it has been possible to combine the two disciplines in some way.

Much of Shann's published work sought to draw lessons from Australia's economic history in order to shed light on contemporary economic policy issues. And it is in that spirit that I now turn to a discussion of the global financial crisis of 2007-09 and its impact on the Australian economy.

2 ECHOES OF HISTORY IN THE GLOBAL FINANCIAL CRISIS OF 2007-09

In one of his best-known works, The Boom of 1890 – And Now (1927), Shann drew parallels between the boom of the 1880s, which preceded the depression of the 1890s (of which he retained strong childhood memories), and that of the late 1920s during which it was written. In particular, he highlighted the rapid growth in both public and private borrowings amidst an increasingly fragile international trade and financial environment as a key reason for the sharp downturn in the Australian economy in the 1890s, and called on Australia 'to put her house in order' lest that experience be repeated.

Shann's advice of course went unheeded, and Australia experienced another depression in the 1930s, although his reputation as a forecaster was presumably enhanced in much the same way as those of, for example, Robert Schiller or Nouriel Roubini have been as a result of their having been among the very few with any claim to have seen coming the global financial crisis of 2007-09 (Mihm 2008).

In much the same vein there are some clear parallels between the financial 'bubble' which preceded the most recent financial crisis, and the one which came to an end in October 1929.

Both episodes were characterized, especially in the United States, by:

- rapid financial innovation, facilitated in part by new technologies, and with which regulators were unable or unwilling to keep pace;
- an extended period of loose monetary policy followed by one of relatively rapid tightening;
- a general relaxation of credit standards on the part of lending institutions, and sustained efforts on the part of financial institutions to circumvent such regulations as there were pertaining to what these days is called 'capital adequacy';
- a substantial increase in leverage on the part of financial institutions and households;
- numerous instances of outright fraud and other forms of criminal behaviour (the full extent of which in the most recent episode is of course yet to be established); and
- increasingly pervasive expectations of continued asset price appreciation and, commensurately, a failure to comprehend the nature of the risks that were being borne or properly to measure and 'price' them.

Kindleberger's stylized description of the ensuing financial crisis is equally applicable to both episodes:

'Once the excessive character of the upswing is realized, the financial system experiences a sort of "distress", in the course of which the rush to reverse the expansion process may become so precipitous as to resemble panic. In the manic phase, people of wealth or credit switch out of money or borrow to buy real or illiquid financial assets. In panic, the reverse movement takes place, from real or financial assets to money, or repayment of debt, with a crash in the prices of commodities, houses, buildings, land, stocks, bonds – in short, in whatever has been the subject of the mania (1989: 5).

However there have also been some important differences between these two episodes, in particular:

- the financial crisis which preceded the Great Depression began with a stock market crash and subsequently spread to the banking system, whereas the most recent financial crisis began in the credit markets, and spread from there to the banking system and thence to the stock market;

- by way of contrast with the circumstances in which Shann was writing in 1927, in the most recent episode commodity prices did not peak until more than a year after the crisis began, and the subsequent decline in commodity prices has been much less pronounced than during the late 1920s and early 1930s.

The second of these differences is particularly important in the Australian context and I shall return to it later on.

3 'NEO-LIBERALISM' AND ALL THAT

It is in my view an egregious over-simplification to ascribe the financial crisis of the past two years solely, or even primarily, to the failings of 'neo-liberal orthodoxy' or to a combination of 'free-market fundamentalism, extreme capitalism and excessive greed'.

In making that assertion, I would not for a moment deny that 'excessive greed' did play a role in the boom which preceded the crisis, although I am inclined to think that it was no greater than that played by incompetence – particularly in the measurement and pricing of risk.

To the extent that greed was a factor, it was not confined to those earning huge bonuses on Wall Street or in the City of London but was rather a widely-shared attribute. And while it is almost unarguable that remuneration systems on Wall Street and the City of London helped to promote a warped view of the trade-off between risks and returns, the same can also be said of the legal systems of a majority of American states which permit borrowers to 'walk away' without penalty from mortgages whose outstanding principal exceeds the value of the property against which they are secured.

Nor would I dispute that the financial crisis stems in part from serious gaps and failings in the supervision and regulation of the American and British financial systems in particular, or of trading in financial derivatives; and that these gaps and failings were in part the result of conscious choices about how or what to regulate that were, in turn, partly informed by ideological beliefs about the efficacy of market forces, as Alan Greenspan (among others) has since acknowledged (Andrews 2008).

But that does not provide a satisfactory explanation as to how financial institutions from countries such as Germany, where so-called 'neo-liberal' beliefs have been far less influential than in the US or Britain, also came to have much the same failings of risk management as their American and British counterparts; or how the allegedly significant influence of so-called 'neo-liberalism' in Australia was nonetheless compatible with a regime of financial supervision which helped to prevent Australian banks from engaging in the kind of imprudent behaviours which caused so much grief elsewhere; or how housing and stock market boom-bust cycles have also occurred in countries such as China which have hardly been notable bastions of 'neo-liberal orthodoxy'.

More importantly, blaming the most recent financial crisis largely on 'market fundamentalism' or 'extreme capitalism' has the undesirable consequence of obscuring the role played in bringing it on by serious economic policy mistakes.

The first of these mistakes was that interest rates were left too low for too long in the United States and almost every other advanced economy in the aftermath of the mild (as they turned out) recessions of 2001.

It was not an error, given the very real risk of deflation in the aftermath of the ‘tech wreck’, for central banks to have cut interest rates to (then) post-war record lows. The mistake was rather in leaving them there until August 2004 in the US, and even later in other large advanced economies, long after the need for unusually low interest rates had passed.

This excessively long period of excessively low interest rates helped to fuel the asset price bubble which precipitated the financial crisis of 2007-09, just as excessively loose monetary policy on the part of the Federal Reserve in 1927 and 1928 fuelled the ‘bubble’ whose subsequent bursting precipitated the Great Depression.

Significantly, Australia’s central bank was, along with its New Zealand counterpart, the only advanced economy central bank not to have made this mistake. In my view this is one reason (albeit not the only one) why Australia has not experienced anything like the degree of housing market distress seen in the United States, Britain and some other European countries.

The second significant policy mistake which contributed to the most recent financial crisis was that made by emerging economy central banks (usually at the behest of their governments) in seeking to curb the appreciation of their currencies against the US dollar (or in some cases, seeking to prevent any appreciation at all) in the face of persistently large and increasing current account surpluses. This stance required them to become substantial purchasers of US dollars and sellers of their own currencies, thereby fuelling ‘bubbles’ in their domestic asset markets and contributing significantly to the growing pool of liquidity which in turn enlarged the asset price bubbles in the United States, Britain and other countries running large current account deficits.

China is the most obvious case in point here – highlighted by the fact that from January 2001 through June 2008 China accumulated over US$280bn of securities issued by Fannie Mae and Freddie Mac, of which nearly $172bn was acquired in the last three years of this period; and by the fact that up until the first half of 2008 the Chinese authorities had been assiduously striving to dampen bubbles in their own stock and property markets. But China did at least allow some upward movement in its currency from July 2005 until July 2008. Other countries running significant current account surpluses – including Russia and the oil-producing nations of the Middle East – did not.

The most recent financial crisis thus has many fathers; and the objective of minimizing the likelihood of a recurrence of the turmoil of the past two years is unlikely to be well served by attempts to circumscribe the task of understanding its causes in order to supplant one set of ideological beliefs with another.

4 LEARNING FROM HISTORY

The importance of this understanding is underscored by the fact that governments and central banks have demonstrated, in their handling of the most recent financial crisis, that they are capable of learning from history.

Eichengreen and O’Rourke (2009) argued in April and again in June this year that, gauged by the course of stock prices, industrial production and merchandise trade volumes, ‘the world is currently undergoing an economic shock every bit as big as the Great Depression shock of 1929-30’.

However, what really put the ‘Great’ into the Great Depression was not so much the financial shock which preceded it as the succession of policy blunders which followed the financial meltdown.

In the United States, for example:

- over an interval of seven days in October 1931, the New York Fed raised its discount rate by 2 percentage points, from 1½% to 3½%, in order to counter speculation that the US dollar would follow sterling's departure from the gold standard, and held it at that level until February 1932 even though 522 banks failed in October alone (Bernanke 2002);

- in 1932, Congress enacted (and President Hoover signed) legislation embodying the largest tax increases in US peacetime history up to that point, including a doubling of income tax, an increase in the top tax rate from 24% to 63%, and increased corporate, petrol and motor vehicle taxes (Reed 2005);

- at the beginning of 1933, the Federal Reserve repeated its earlier mistake by again raising interest rates in order to counter speculation that the incoming Roosevelt Administration would devalue the US dollar against gold, exacerbating what Bernanke (2002) characterizes as the 'deepest plunge' in the US economy during the Depression;

- prior to all of this, in June 1930 Congress had passed, and Hoover signed, the Smoot-Hawley Tariff Act, sharply raising tariff rates and widening the range of imports to which they applied, striking a devastating blow to world trade, and prompting a wave of retaliatory measures from other nations whose economic downturns were exacerbated by the loss of exports to the US;

- and by refusing to attend the London Economic Conference shortly after his inauguration, Roosevelt effectively stymied the one significant attempt at international co-ordination of policy responses to the Depression.

Similar policy blunders were made in most other countries, although generally not as comprehensively as in the US; Australia, for example, 'did not share with the United States the experience of near monetary collapse' (Schedvin 1970: 207).

The economic policy-makers of the early 1930s were of course acting, for the most part, in accordance with the economic orthodoxies of the day. Nonetheless, with the admitted benefit of hindsight, it is hard to think of what else they might have done had it actually been their conscious intention to turn the financial crisis of the late 1920s into the economic calamity which subsequently ensued.

We should therefore take some heart from the fact that, in their responses to the most recent financial crisis, governments and central banks around the world have demonstrated a clear capacity to learn from history. Since the crisis began:

- central banks have reduced policy interest rates to unprecedentedly low levels, and expanded their balance sheets in order to deal with specific problems in the financial system and (in some cases) to demonstrate that monetary policy need not be impotent even where policy interest rates had reached their lower bound;

- central banks and governments have sought to prevent widespread bank failures, by guaranteeing wholesale borrowings and deposits, and where necessary using their own resources to re-capitalize banks or remove 'toxic assets' from banks';

- governments have allowed the 'automatic stabilizers' in their budgets to operate unimpeded and to undertake further discretionary fiscal stimulus even at the cost of incurring budget deficits unprecedented since 1945;

- governments have made genuine and, for the most part, successful efforts at international policy co-ordination through the G20 in order to minimize the risks of protectionism and those of some countries being perceived as 'free-riding' on the policy actions of others;

Taken together these amount to a concerted effort to ensure that the mistakes of the 1930s have not been repeated.

I do not mean to suggest that they have made no mistakes. With the benefit of hindsight, either the decision to 'rescue' Bear Stearns, or, having made it, and thus created the impression that no systemically important financial institution would be allowed to fail, the decision to allow Lehman Brothers to go into bankruptcy, was a mistake. And there are certainly strong grounds for criticizing particular elements of the fiscal stimulus packages which governments around the world have implemented in response to the economic downturn.

But the suggestion, surprisingly commonplace in financial market circles[1], that the US Federal Reserve's responses to the financial crisis must inevitably result in 'hyper-inflation' and/or a precipitous decline in the US dollar is in my view entirely misplaced. There is no parallel, as is surprisingly often suggested, between the expansion in the Fed's balance sheet since mid-2008 and the money-printing operations of central banks in Weimar Germany, war-time Nationalist China or post-war Japan and Hungary, any number of Latin American countries at different times since their independence, former Soviet bloc countries after the collapse of Communism, or contemporary Zimbabwe.

All of these historical examples involved attempts by government-controlled central banks to use the printing presses to maintain demand in the face of a collapse in the 'supply potential' of their economies, resulting from foreign occupation of their most productive industrial facilities (Weimar Germany), enormous war-time losses of human and physical capital (countries defeated in World War II), institutional collapse (former Soviet bloc countries), or egregious economic mismanagement and officially-sanctioned looting (various Latin American countries and Zimbabwe).

None of these situations applies to the US economy in 2009, nor is it likely to in 2010. From a monetarist perspective, the substantial increase in the monetary base as a direct result of the expansion in the Fed's balance sheet has not led to a dramatic acceleration in broader measures of the money supply. That is because the capacity of the financial system to create credit from a given amount of base money supplied by the Federal Reserve has been impaired by the erosion of its capital base and the uncertainty as to how much capital it needs resulting from the financial crisis.

Banks have left the bulk of the 'excess reserves' created by the Fed's balance sheet expansion on deposit with the Fed, rather than using them to expand credit. As a result, the 'money multiplier' (the ratio of, for example, M2 to base money) has almost halved since the onset of the financial crisis. Additionally, over the same period the velocity of money in the US has dropped by more than 13% to its lowest level in more than 20 years.

Provided the Fed adheres to its stated commitments to unwind its expanded liquidity facilities as the financial system returns to normal (see, eg, Kohn 2009), it is difficult to see how a sustained acceleration in inflation could occur in these circumstances. On the contrary, had the Fed been unwilling to engage in 'quantitative easing' as the financial crisis intensified, the broader US money supply could well have contracted by nearly as much as it did in the early 1930s (Eslake 2009) – which is exactly what Bernanke (2002) promised Friedman that the Fed wouldn't allow to happen again.

[1] See, for example, 'Gross Says Diversify from Dollar as Deficits Surge', Bloomberg, 3rd June 2009; 'US Inflation to Approach Zimbabwe Level, Faber Says', Forbes, 2nd June 2009

And from a Keynesian perspective, it is hard to see how a sustained acceleration in inflation could begin in circumstances where, even on the most optimistic forecasts, the US is likely to have an 'output gap' of around 5% of GDP during 2010.

Rather, the major medium-term concern for most of the world's major advanced economies surely has to be how they can attain sufficiently rapid growth to allow the public debt burdens which they have accumulated in the course of responding to the crisis to decline to sustainable levels as a proportion of GDP.

While countries such as the US and the UK have carried much higher levels of public debt relative to GDP in the years immediately after World War II, their ability to reduce them to tolerable levels was enhanced by rapid population growth, post-war reconstruction and the satisfaction of demand which had become 'pent-up' during the Depression and the War itself, and a willingness to tolerate higher levels of taxation than prior to the War. It is not clear that any of these factors will be of any assistance in the decade ahead. On the contrary, demographic change will operate in the opposite direction; and the US and the UK in particular also have to cope with much higher levels of household debt than had been the case in the decades following World War II.

It would seem that the best prospects for achieving sustained growth in advanced economies lie in the development and diffusion of new technologies – including perhaps those which will be required to respond to the challenges of climate change – which will unleash a sustained period of strong productivity growth, and in the export of goods and services to meet the requirements of emerging economies which seem better-placed to achieve strong economic growth over the coming decade. But such speculation is beyond the scope of the present talk.

5 AUSTRALIA'S RESPONSE TO THE FINANCIAL CRISIS

Each of Australia's past three major recessions has occurred in conjunction with a major international economic downturn. On that basis alone, and notwithstanding that Australia avoided falling into recession during the rather less pronounced slowdowns in the global economy which followed the Asian financial crisis of 1997-98 and the 'tech wreck' of 2001, the rapid downturn in the global economy following the intensification of the global financial crisis in September 2008 made it reasonable to infer that Australia's unprecedented period of sustained economic growth which began in the early 1990s was highly likely to come to an end.

Indeed by the December quarter of 2008, business confidence had fallen to a lower level than at any point during the recession of the early 1990s; and by early 2009, both the Reserve Bank and the majority of private sector forecasters were explicitly using the term 'recession' to describe the condition of the Australian economy.

And yet, as it has turned out thus far, Australia seems – alone among 'advanced' economies – to have avoided recession as most commonly (if erroneously, in my view) defined as consecutive quarterly contractions in real GDP.

Even by other yardsticks – such as consecutive quarters of contractions in real per capita GDP (of which we have to date had four) or real per capita gross domestic income (of which we have thus far had two), or the rise in unemployment (of 1.9 percentage points between the trough in February 2008 and the most recent figure for July 2009) – which suggest that Australia has experienced a recession, the downturn has so far been remarkably mild by the standards of previous Australian recessions, and by comparison with the experience in other countries which we traditionally use as benchmarks for assessing our own economic performance.

It is perhaps still premature to draw definitive conclusions as to why things have turned out this way – not least because, as the Secretary to the Treasury warned earlier this week, we cannot be sure that there will not be further financial shocks, or that the turnaround in the global economy which seems to be getting under way will be sustained.

However it is possible to point to a number of factors which appear to have been important in shaping Australia's experience of the financial crisis compared with that of other countries. The order in which I list these is not intended to convey any sense of their relative importance; nor is this list intended to be comprehensive.

First, Australia has been fortunate in that the composition and orientation of its trade has shielded it from one of the main channels by which the sharp downturn in discretionary spending in the countries at the epicentre of the financial crisis has been transmitted to the global economy – namely, the dramatic downturn in trade in manufactured goods.

For some economies, including many in the Asian region, this resulted in a decline in their exports of between one-quarter and nearly one-half in the space of six months. In Australia's case, however, manufactured goods account for only about one-fifth of our total exports; and while they have declined since the onset of the financial crisis (albeit not as much as for most other countries), that decline has not detracted much from our overall export performance.

By contrast, Australia's exports of commodities (which now account for over 58% of our total exports) have actually risen since the onset of the crisis, partly thanks to a fortuitous recovery in agricultural production but more importantly thanks to unexpectedly strong demand from China, in turn reflecting the efficacy of China's stimulus measures and some apparently opportunistic buying by Chinese importers. As a result, Australia has been one of very few economies whose exports have not fallen (in volume terms) since the first half of 2008.

Not only is this an important point of contrast between Australia's experience during the current crisis and that of other countries; it is also an important difference between Australia's experience during the current crisis and its experience during the late 1920s and early 1930s.

Ahead of the Great Depression, Australia's terms of trade peaked in 1927-28 and declined by 43% to their low point in 1930-31, reflecting the deep contraction in Australia's principal export market at the time, Britain (which had begun in the late 1920s) and magnified by the impact of the Smoot-Hawley tariff (and the retaliatory measures which it provoked from other countries) on commodity prices.

In the current episode, Australia's terms of trade did not peak until the September quarter of 2008, a year after the financial crisis began, and since then have declined by of the order of 18%[2].

This difference seems largely attributable to the fact that China, which is now Australia's second largest export market, has not experienced a protracted slow-down; and perhaps also to the fact that the world's major economies have avoided a widespread resort to protectionism.

A second explanation for Australia's relatively mild downturn is that (contrary to a number of widely publicized forecasts) it has experienced nothing like the degree of distress in its

[2] Based on ABS data for the March quarter 2009 and my estimate for the June quarter.

residential property market that has occurred in the US, Britain, Spain and some other European countries and also in some Asian centres.

This outcome is in part due to the fact that, for most of the past decade, Australia has been building fewer dwellings than required by growth in the number of households, resulting in a 'shortage' of housing of at least 85,000 dwellings (National Housing Supply Council 2009) and a rental dwelling vacancy rate since mid-2006 of less than 2%. This is in marked contrast to the US, where the housing boom of the first half of this decade was not only a 'price bubble' but a 'quantity bubble' as well, and where the rental vacancy rate has been close to or over 10% since 2003.

The comparative resilience of the Australian residential property market is also partly attributable to the fact that very few Australian home-buyers have found themselves in a position where they can no longer service their mortgages, and hence where they (or their mortgagees) have become 'forced sellers'.

Barely 1% of all Australian mortgages are 90 days or more past due, compared with 7% of all mortgages (prime and sub-prime) in the United States. The difference partly reflects the fact that 'non-conforming' lending (the Australian equivalent of 'sub-prime') has accounted for a vastly smaller proportion of the Australian mortgage market than of its US counterpart. It also reflects the effectiveness of the Reserve Bank's steady tightening of monetary policy from 2002 onwards – as noted above, much earlier than other central banks – in preventing as many Australians from over-committing themselves at unsustainably low mortgage rates as would almost certainly have done otherwise, and in taking some of the 'heat' out of the property market (especially in Sydney) that would otherwise probably have continued to intensify. And it also probably owes something to the fact that the overwhelming majority of Australian mortgages are at variable rates, which have declined more or less in line with the (significant) decline in the official cash rate – in contrast to the experience of borrowers in the US (and most other Western countries) where most mortgages are at fixed rates.

The fact that very few Australians with jobs have lost them during the current downturn may also have contributed to the dearth of 'forced sales' in the Australian residential property market, although it is worth noting that the US housing 'bubble' burst some 18 months before unemployment began rising, and that one-third of the decline in US house prices which has occurred since mid-2006 occurred before unemployment began rising. And although there clearly have been some 'forced sales' at the top end of the housing market, resulting in some significant price declines in that segment, these appear to have been largely offset – as far as measures of average house prices are concerned – by gains at the lower end of the market (probably aided by increased government assistance to first home buyers).

A third explanation for Australia's relatively mild downturn thus far lies in the strength of the Australian banking system. The four major Australian banks are among only 11 in the world to have retained a AA credit rating or better.

This stems partly from the generally more prudent management of their affairs by the Australian banks themselves – although former Reserve Bank Governor Ian Macfarlane (2009) has suggested that it also owes something to the effect of the 'four pillars' policy in eliminating the competition for corporate control and hence, in his words, 'saving us from the worst excesses that characterised banking systems overseas'.

It also reflects the stronger regime of prudential supervision under which Australian banks operate, compared with those of the United States or Britain, with no scope for the 'regulatory arbitrage' which has characterized the supervisory regime in the US nor, especially following the collapse of HIH in 2001, with the same 'light-handed' philosophy informing the approach to financial system supervision in both countries. It is almost certainly not a co-incidence that the Canadian banking system, which is similar in structure to

Australia's and whose supervisory arrangements provided the template for the system created in Australia after the report of the Wallis Inquiry, has proved similarly resilient.

To digress for a moment, that doesn't mean, however, that we can afford to be complacent about the Australian financial system. Australian banks have become heavily reliant on overseas wholesale borrowings, and although the provision of government guarantees has kept that funding channel open during the financial crisis, it is clearly undesirable for those guarantees to be maintained indefinitely and I would think it prudent for the banking system as a whole to be less vulnerable to the fluctuating whims of the international money markets. It would instead be preferable, on a number of grounds, for banks to fund more of their lending operations through deposits, which in turn raises questions about the tax treatment of deposits compared with that of other savings vehicles.

There would also appear to be some serious gaps in the supervision of unlisted investment vehicles in Australia, despite the fact that failures in this sector have been the cause of considerable distress in every financial upheaval that Australia has experienced in over five decades. The continued willingness of a small but not insignificant number of Australians to entrust large proportions of their savings, or indeed borrowed money, in vehicles of dubious provenance and integrity in the hope of above-average returns is a source of ongoing bemusement.

There is probably no desirable regulatory or legislative means of directly curbing those desires. What should be clear is that the Australian response of relying largely on disclosure – leading to the proliferation of ever-longer and less-intelligible 'product disclosure statements' – is not working.

Consideration should instead be given to imposing capital and liquidity requirements on unlisted investment vehicles, and perhaps also to restricting the types of people to whom such investments can be offered.

A fourth explanation for the relative mildness of Australia's economic downturn lies in the effectiveness of the policy responses to it. By comparison with previous economic downturns in Australia, and in some important respects by comparison with policy responses in other economies during the most recent financial crisis, the responses of Australian policy makers have been for the most part well-timed, well-targeted and appropriately-calibrated.

In the case of monetary policy, once the Reserve Bank came to the conclusion that the 'balance of risks' around the outlook for the Australian economy had tilted decisively to the downside – which appears to have been around August, and to have been importantly influenced by a recognition that the Chinese economy had slowed and that the substantial rise in Australia's terms of trade (and the associated boost to Australia's national income) had started to go into reverse - it cut interest rates unusually aggressively by comparison with previous periods of monetary easing. The minutes of successive Reserve Bank Board meetings make it clear that the Bank was consciously acting on the risks, as it perceived them, of a marked slowing in the Australian economy rather than relying predominantly on incoming economic data. At successive Board meetings it cut interest rates by more than consensus market expectations.

As things turned out, there was no need for the Reserve Bank to engage in 'quantitative easing' of the sort undertaken by the Federal Reserve or the Bank of England (although the purchases of mortgage-backed securities by the Australian Office of Financial Management could perhaps be seen as a variant of that). But the Reserve Bank was ahead of many other central banks in devising new facilities to provide liquidity to the Australian financial system when it was required.

Monetary policy has proved to be more effective in cushioning the impact of the financial crisis in Australia than in other countries, partly because there was more room for rates to decline here than elsewhere (another 'benefit', perhaps, of the extended period of monetary tightening which preceded the financial crisis); partly because the Australian banking system has continued to function in a more or less normal fashion, unlike the banking systems in the US and several European countries; and partly because, as noted before, the vast majority of Australian lending is at variable rates, so that the reduction in monetary policy interest rates was in large part passed on to end-borrowers (albeit, especially for small businesses, less than fully).

Australia's fiscal policy response has also been unusually effective by both historical and international standards.

The idea of active counter-cyclical fiscal policy fell into disfavour after the recession of the early 1990s, in Australia and elsewhere, partly because of the perceived political, legislative and administrative obstacles to implementing fiscal measures in a timely manner; and partly because of the increasing acceptance in official and academic circles of 'Ricardian equivalence' (the idea that fiscal policy actions were likely to be rendered ineffective by offsetting private sector reactions).

Hence fiscal policy came, from the early 1990s until the onset of the financial crisis, to be assigned to 'medium term objectives' such as 'increasing national saving'.

It was probably helpful in fashioning a timely fiscal response to the deteriorating economic outlook in the second half of 2008 that it was possible to characterize it as being required by overseas developments, of which Australia had considerable warning, rather than calling for (as was the case in the recessions of the early 1980s and early 1990s) an acknowledgement by the incumbent government that that contrary to its repeated earlier denials, the economy was either in, or at risk of falling into, recession – an acknowledgement that governments always have difficulty making.

But not only did the timing of the successive Australian fiscal packages turn out to be unusually appropriate; their magnitude and composition also contributed significantly to their effectiveness.

According to IMF staff estimates (2009), Australia's discretionary fiscal policy measures are equivalent to an average of 1.9% of GDP over the years 2008-2010, compared with an average of 1.3% for the G20 economies as a whole, and larger than for any other 'advanced economy' member of the G20.

Moreover, the various fiscal packages appear to have been constructed with a view to maximizing their immediate impact on economic activity.

The two cash hand-outs, which together accounted for almost 30% of the total discretionary fiscal stimulus, were more likely to have been spent than tax cuts (which formed a large part of the fiscal stimulus enacted in the United States and Britain), and it would seem to date that more than half of them have been. And even though part of them has been saved rather than spent, it is I think fair to say that the cash handouts have allowed Australian households to increase their saving – as many of them no doubt wished to do in response to the decline in their wealth during the financial crisis – in roughly the same proportion as American households have done, without needing to cut their consumption spending as American households have been obliged to do.

Some other elements of the fiscal stimulus packages – in particular the 'small ticket' infrastructure spending on school facilities – have embodied a trade-off between timeliness and long-term value.

From the perspective of long-term value for money, it would undoubtedly have been preferable for there to have been more infrastructure spending of the type included in the

2009-10 Budget and less of the type provided for under the heading of 'Building the Education Revolution'; but from the perspective of immediate impact, the 'small ticket' infrastructure spending has almost certainly been more effective in preserving or creating employment. And some of this 'small ticket' infrastructure spending has been directed towards important long-term goals, such as the construction of an additional 20,000 social housing dwellings.

I have been a long-term critic of programs of assistance to first home buyers which rely on putting cash in their hands, thereby allowing them to pay more for housing than otherwise. In my view, the predominant result of such programs is to inflate the price of the existing stock of housing, and thereby to enrich vendors, rather than the more desirable objective (in the Australian situation) of increasing the housing stock. And I think that criticism applies to the increase in the First Home Owners' Grant for purchasers of existing housing which was included in the first fiscal package of last October. However I concede that the (larger) increase in the FHOG for purchasers of new housing has induced a timely increase in new housing construction.

However, notwithstanding these reservations, I have no criticism of the magnitude of the fiscal measures enacted in response to the financial crisis. Nor do I see any grounds for sensible criticism of the budget deficits which have been incurred to pay for them, or the public debt which will result from them.

According to the 2009-10 Budget Papers, the Australian Government's net public debt will reach $188bn by 30 June 2013[3]. While this is a record amount in absolute terms – as is the $300bn of gross debt which has featured more prominently in political debate – as a proportion of GDP (which is surely the more appropriate figure for historical or international comparisons) it represents just 13.6% - below the most recent peak of 18.5% of GDP in 1996, and a level that would be beyond the imagination of almost any other advanced economy government in the world to project.

There is no principle of economics or public finance which says that the optimal level of debt for a government is zero, let alone a negative number; and to argue otherwise is to elevate an accounting principle above sound economics in a way that evokes memories of the policy mistakes made in the early years of the Great Depression.

Whether it is appropriate that a budget be in deficit or not, and by what order of magnitude, is entirely dependent on the economic context, and (to some extent) on the pre-existing condition of the government's balance sheet (in the sense that a government which already has a large level of net public debt may be less able to run a large budget deficit than one which does not).

Indeed one of the primary reasons why governments should seek to run budget surpluses during cyclical expansions is to give themselves latitude to run deficits during contractions, without being unduly constrained by considerations of longer-term fiscal sustainability (as many other countries have been during the current episode).

In that context, Australia's fiscal response is also notable for its emphasis on measures which are temporary in terms of their impact on the fiscal balance, as opposed to permanent reductions in taxes or increases in recurrent expenditures which impart continuing stimulus beyond the point at which it is called for.

[3] It now seems likely that these and other projections in the 2009-10 Budget will turn out to have been pessimistic.

Nor, at least at this stage, does it seem reasonable to assert, even with the benefit of hindsight, that Australia's monetary and fiscal policy response has been 'too large'. Rather, the sensible conclusion would seem to be that Australia's relatively large policy response is an important reason why Australia's economy has weathered the global financial crisis better than many others.

And surely, given what was generally thought to be the 'balance of risks' at the time when these policy responses were formulated, and the likely costs of making an error of judgement, it was better to have erred on the side of doing 'too much' rather than 'too little'. Once again, the experience of the Great Depression is instructive in that regard.

6 A BRIEF LOOK FORWARD

Even if it is premature to declare that either the financial crisis, or the economic downturn which it induced, is over, it is surely not too early to be thinking about how Australia's benign experience of it (by comparison with other countries) should inform where we go from here.

While I do not support calls for the magnitude of fiscal stimulus to be scaled back, I think there is room for refocussing what remains of it towards longer-term objectives.

I acknowledged earlier that in constructing its stimulus packages, the Government had made trade-offs between short-term effectiveness in supporting economic activity and jobs and longer-term value for money that seemed entirely appropriate at the time. But it may now be sensible to revisit that trade-off in the light of more recent experience.

For example, should some of the funds allocated to building school facilities be re-directed towards programs designed to improve the quality of teaching? Should some of the funds allocated to the First Home Owner Grant (even after it steps down in October and again in December) be re-directed towards providing additional housing?

Australia's experience of the financial crisis should also inform our thinking about other long-term challenges.

For example, to the extent that Australia avoided having a 'housing bust' because the Reserve Bank's actions in tightening monetary policy earlier than most of its peers, and because financial institutions for the most part avoided extending mortgage finance to households of marginal creditworthiness, we should be particularly wary of making that mistake in the recovery phase from the financial crisis. We should be thinking about the extent to which distortions in the tax system encourage 'excessive' borrowing, especially for speculative purposes (and hopefully the Henry Review will facilitate such thinking).

To the extent that Australia has been 'saved by China' from a more serious downturn, we need to be conscious of the possibility, referred to by Reserve Bank Governor Stevens last month, that we could be more seriously affected than other countries by any significant downturn in the Chinese economy. And to the extent that China's demand for Australia's minerals and energy resources continues to grow at a rapid rate, the Australian dollar is likely to remain at higher levels relative to other currencies than seemed likely during the depths of the financial crisis, with attendant consequences for the non-resource sectors of the Australian economy.

That consideration, and others, should lead us to a renewed focus on productivity growth as the basis for Australia's long-term prosperity, an issue which fell very much by the wayside during the minerals boom which preceded the onset of the financial crisis. Our success or otherwise in that endeavour will have a large bearing on whether we are, in the words of one of Shann's best-known works, 'bond or free'.

7 CONCLUSION

Graham Snooks (1993) relates that towards the end of his life, Shann 'lost some of his old confidence' in his diagnosis of Australia's economic circumstances and his prescriptions for dealing with them, partly as a result of his encounter with Keynes at the London Economic Conference in June 1933.

According to Snooks, he told colleagues at Adelaide University where he took up an appointment in early 1935 that he was 'going to spend the next few years retraining himself in economics'. Tragically, we shall never know where that effort may have led him.

In the wake of the global financial crisis of 2007-09, economists have cause to ponder the adequacy of their intellectual frameworks for understanding the way economies, and especially financial systems and markets, function. Many of what had come to be widely-accepted verities – including the 'efficient markets hypothesis', the merits of self-regulation, the assumptions that people behave in rational and predictable ways, the use of statistical models to measure risk – have been seriously challenged by the course of events. So too has our reputation for being able to forecast crises and cyclical turning points.

On the other hand, if I may be permitted to use that hackneyed phrase in this context, economists can also take heart from the fact that they, and those whom they advise, have shown themselves capable of learning from history, from their own mistakes and those of others; and that the role which thoughtfully constructed and targeted economic policy can play in responding to crises (even if they aren't very good at seeing them coming) has been enhanced.

I would like to think that Edward Shann the economist and historian would be able to take at least some comfort from the way his intellectual heirs and successors, especially in the country to which he was so devoted, have applied themselves in circumstances similar in many respects to those which he found so troubling.

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