Dealing with Global Economic Shocks: Theory and History

Tom Valentine*

Abstract

It is widely accepted that the government’s fiscal stimulus saved Australia from the worst effects of the Global Financial Crisis. This view has arisen although fiscal stimulus did not produce positive results in the US and UK cases. The present paper examines this proposition. First, it presents theoretical arguments supporting the view that fiscal stimulus is ineffective in a floating exchange rate regime. This issue has also been taken up by Dixon and Rimmer (2009) and Makin (2009). Secondly, it compares Australia’s experiences in the Asian Crisis at the end of the nineteen nineties and during the Global Financial Crisis. It concludes that a depreciating exchange rate protected the economy in the former case but was prevented from doing so in the latter by the fiscal stimulus.

Keywords: global economic shocks, floating exchange rate, fiscal stimulus.

JEL E44, E62, E63, E65

1. Introduction

The purpose of this paper is to consider what policies should be pursued in reaction to an economic downturn originating overseas. Its motivation is the widespread applause given to the Rudd Government’s reaction to the Global Financial Crisis (GFC). The discussion of these policies ignored a crucial factor – the floating exchange rate regime adopted in the Australian economy. A major reason for adopting such a regime is that it serves to insulate the economy against shocks emanating from overseas. In 2009 it was not given a chance to do so. Should we repeat this reaction in the face of future global economic shocks?

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The second part of the paper considers the theory which explains why fiscal policy is relatively ineffective under a floating exchange rate regime. The third section compares government reaction to the two most recent crises – the Asian Crisis at the end of the nineteen nineties and the GFC. Some comments will also be made about the most significant Global Crisis of the previous century – the Great Depression of the nineteen thirties.

2. Theoretical Underpinnings

The Mundell-Fleming (MF) model (see, for example, Mundell (1963)) throws light on the relative effectiveness of monetary and fiscal policy under different exchange rate regimes. Here we will consider a very simple example of their results. We will assume that capital is internationally mobile. That is, there are no restrictions on inflows and outflows of funds into or out of the Australian economy. Under this condition, the following relationship (called uncovered interest rate parity) will be satisfied:

\[ R_A = R_O + e^* \]

where \( R_A \) = the Australian interest rate.
\( R_O \) = the interest rate in a specific foreign currency and for the same term.
\( e^* \) = the expected depreciation of the Australian dollar against the specified currency in the period concerned. It applies to the same period as the interest rates.

Capital flows will ensure that this relationship is satisfied. For example, if \( R_O + e^* \) is greater than \( R_A \), funds will flow out of Australia to take advantage of the perceived higher expected return overseas. This will cause either:

- an increase in \( R_A \); or

- a fall in the value of the Australian dollar which will reduce \( e^* \).
Consider the effectiveness of monetary and fiscal policy under different exchange rate regimes.

**Fixed exchange rate:** Assume that the authorities increase $R_A$. Funds will flow in and as $e^* = 0$, $R_A$ will fall. That is, monetary policy is ineffective. In general $R_A = R_O$ so that the domestic interest rate must be equal to the interest rate in the currency against which the domestic currency is fixed.

Note that if market participants begin to doubt that the authorities can maintain the fixed exchange rate, $e^*$ will increase and a higher interest rate will be required. Indeed, the authorities will have to push $R_A$ up to maintain the fixed exchange rate. The local interest rate will be equal to the overseas interest rate plus a *depreciation premium*.

If a budget deficit is expanded, the economy will be stimulated. That is, fiscal policy is effective. However, this expansion can put pressure on local interest rates and the fixed exchange rate. This is why countries in the EURO zone must accept limitations on their fiscal policies.

**Floating exchange rate:** An increase in $R_A$ will cause an appreciation of the AUD so that $e^*$ increases maintaining the uncovered interest rate parity relationship. This appreciation will reinforce the tightening of monetary policy. Monetary policy is effective.

An increase in the budget deficit will cause an appreciation of the AUD increasing $e^*$. This will offset the expansionary effect of the deficit. Note that according to the twin deficits relationship,

$$\text{CAD} = (I - S) + D_f$$

where CAD is the current account deficit, $I$ is investment, $S$ is private saving and $D_f$ is the deficit of the whole government sector.

This relationship was developed to explain the link between the government budget deficit and the current account deficit.
Table 1 shows the twin deficits relationship in Australia over the period 1992/93 to 2008/09. In the early part of the period current account deficits arose from a deficiency of domestic funds arising from large budget deficits. Policymakers subsequently adopted policies to create surpluses in these budgets. They were successful in doing this, but the gap between investment and saving became positive and increased sharply over time.

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account Deficit</th>
<th>Private Sector (I-S)</th>
<th>Government Borrowing (GB)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992/93</td>
<td>14.2</td>
<td>-8.9</td>
<td>23.1</td>
</tr>
<tr>
<td>1993/94</td>
<td>15.2</td>
<td>0.8</td>
<td>14.4</td>
</tr>
<tr>
<td>1994/95</td>
<td>26.4</td>
<td>9.8</td>
<td>16.6</td>
</tr>
<tr>
<td>1995/96</td>
<td>20.2</td>
<td>6.4</td>
<td>13.8</td>
</tr>
<tr>
<td>1996/97</td>
<td>16.2</td>
<td>11.7</td>
<td>4.5</td>
</tr>
<tr>
<td>1997/98</td>
<td>22.5</td>
<td>27.7</td>
<td>-5.2</td>
</tr>
<tr>
<td>1998/99</td>
<td>32.7</td>
<td>32.9</td>
<td>-0.2</td>
</tr>
<tr>
<td>1999/00</td>
<td>31.7</td>
<td>42.5</td>
<td>-10.8</td>
</tr>
<tr>
<td>2000/01</td>
<td>17.3</td>
<td>12.6</td>
<td>4.7</td>
</tr>
<tr>
<td>2001/02</td>
<td>18.9</td>
<td>17.6</td>
<td>1.3</td>
</tr>
<tr>
<td>2002/03</td>
<td>37.7</td>
<td>44.3</td>
<td>-6.6</td>
</tr>
<tr>
<td>2003/04</td>
<td>46.2</td>
<td>52.7</td>
<td>-6.5</td>
</tr>
<tr>
<td>2004/05</td>
<td>56.9</td>
<td>65.1</td>
<td>-8.2</td>
</tr>
<tr>
<td>2005/06</td>
<td>54.3</td>
<td>62.2</td>
<td>-7.9</td>
</tr>
<tr>
<td>2006/07</td>
<td>59.4</td>
<td>65.5</td>
<td>-6.1</td>
</tr>
<tr>
<td>2007/08</td>
<td>73.3</td>
<td>79.6</td>
<td>-6.3</td>
</tr>
<tr>
<td>2008/09</td>
<td>37.3</td>
<td>-3.4</td>
<td>40.7</td>
</tr>
</tbody>
</table>

Source: Statistical Tables, RBA Website

This occurred because of a sharp decline in Australian personal saving. The household saving ratio fell to close to zero in the latter part of the period.

The problem for economic policymakers in Australia is that when household saving is close to zero and the budget is in balance, private investment must be funded largely by offshore borrowing. A government budget surplus eases the pressure on the current account. The rubric that a government should maintain a surplus over the cycle hardly answers this need.

Tatom (2006) points out that for the US there is little correlation between the current account deficit and budget deficit. However, this is to be expected. The relationship given above is
an identity, but if the \((I - S)\) term is left out, there is no reason for there to be a strong relationship between the remaining two terms.

There is a cognitive dissonance in our understanding of the economic role of budget deficits/surpluses. The recent surpluses were seen as necessary to pay down public debt. In fact there is no reason why a government should not run a deficit if the borrowing is used in productive investment. Also, a reasonable amount of outstanding government debt (risk-free assets) is useful in providing an anchor for financial markets. A recent criticism of the government’s packages—generational inequity—is also invalid. If the packages work, future generations will be better able to meet the obligations arising from them. The question is—do they work? The true reason for budget surpluses is to offset our very low saving rate and to prevent current account crises. It appears that in creating surpluses we have been, in the words of T.S. Eliot, doing the right thing for the wrong reason. The problem with this situation is that there is a strong temptation to stop doing the right thing once the original reason is identified as false.

Assume now that the government increases its deficit (or reduces its surplus). Assume also:

- the deficit has no monetary effects, i.e. it does not affect interest rates. This is the case in Australia with the cash rate which is set by the RBA. However, bond rates will react to the deficit because of the need to sell bonds to fund it. That is, bond rates will increase;

- investment is not sensitive to the government deficit. It is likely that investment has actually fallen because of the downturn; and

- saving is approximately zero. (In fact, it has recently increased a little.).

The third point can be expanded upon. The Ricardian Equivalence Theorem (see Abel (2008)) asserts that consumers will increase their saving in line with the future tax liabilities arising from a deficit. There is considerable disagreement over the degree of foresight.
actually shown by consumers. In addition, Tatom (2006, p. 15) argues that one-off payments tend to be saved because consumers do not see them as an addition to their permanent income. This seems to have been the case with many recipients of handouts from the two stimulus packages. To the extent that $S$ increases, the stimulation delivered by the packages will be reduced. Table 1 indicates that $(I - S)$ fell sharply in 2008/2009 as a result of the fall in investment and increase in saving over that year.

The conclusion of this discussion is that fiscal stimulus is likely to be ineffective in an economy with a floating exchange rate. A fiscal stimulation is an accelerator connected to a brake (the appreciating currency). This point is explored in the appendix in the context of the basic macroeconomic model.

The twin deficits identity holds whether there is a floating or fixed exchange rate regime. However, in the case of a floating exchange rate regime, an increase in the budget deficit causes an increase in the current account deficit. However, in a fixed exchange rate regime, an increase in the budget deficit causes an increase in the interest rate which causes adjustments in the other two terms in the twin deficits relationship.

The same points can be made in a different context. Note that:

$$\text{CAD} = \text{CIF} - \Delta FX$$

where $\text{CAD}$ is the current account deficit, $\text{CIF}$ is the capital inflow and $\Delta FX$ is the increase in RBA foreign currency reserves. This equation says that the foreign currency needed to cover the current account deficit can be obtained from capital inflow or provided by the RBA running down its foreign exchange reserves.

The implications of this equation can be appreciated by considering the effect of a fiscal expansion. In a floating exchange rate regime $\Delta FX = 0$. Then the exchange rate must change sufficiently to allow the CAD to increase to match the higher value of CIF needed to fund the fiscal expansion. That is, the exchange rate must appreciate to create a higher CAD.
In a fixed exchange rate regime, the exchange rate and, therefore, the CAD cannot change. When CIF increases, the central bank will need to offset this increase by buying up foreign currency. Putting this another way, a fiscal expansion creates an undervalued (or more undervalued) currency and increases the foreign currency reserves of the central bank.

3. Two Global Crises

3.1 The GFC

The causes of the GFC are discussed in detail in Valentine (2009). Briefly, they were:

- a decline in lending standards which created a large pool of subprime debt and a reduction in saving in countries such as the US, UK and Australia (i.e. a regulatory failure);

- the missing saving was made up by high saving countries such as China and Japan who ran large current account surpluses;

- these factors combined with a loose US monetary policy generated an asset price bubble, particularly in the US housing market;

- the bursting of this bubble led to a rate of default which was well above historical averages;

- this toxic debt was packaged into asset backed securities which because of globalisation was distributed around the world, but particularly to Europe; and

- losses on the securities led to a ‘credit crunch’ in which banks became reluctant to lend, particularly those whose equity fell
below the regulated level. This restriction caused a slowdown in economies around the world.

3.2 The Fiscal Stimulus

The government reacted to the modest downturn in the Australian economy precipitated by the Global Financial Crisis with an expensive fiscal stimulus. The stimulus package consisted of $10.4bn before Christmas in 2008 and a further $42bn in February 2009.

The stimulus packages included:

A $10.4 billion Economic Security Strategy including:

- $4.8 billion for pension reform
- $3.9 billion for low to middle income earners
- $1.5 billion for first home buyers, and
- $187 million for new training places

Additionally, the decision was made to bring forward the commencement of national building projects to 2009.

- $300 million to build local community infrastructure
- $15.2 billion COAG funding package

A $42 billion Nation Building and Jobs plan including:

- a one off cash payment of $950 to eligible families, students, single workers and others
• up to $200,000 for each school to be spent on maintenance or building renewal

• building large scale infrastructure such as libraries and halls for schools

• installing ceiling insulation in 2.7 million homes

• building 20,000 new social housing dwellings

• a temporary investment tax break for small businesses buying assets

• the installation of boom gates at rail crossings

• $650 million on local community infrastructure and maintenance

We will say nothing about the more ludicrous (and tragic) aspects of the stimulus which can be largely attributed to the undue haste with which it was cobbled together. Certainly, in the weekend over which the package was created, no cost/benefit studies were performed and no preparations were made.

The Fiscal Stimulus was based on a simple version of the Keynesian model (called by the famous economist Joan Robinson, the “bastard Keynesian model.” See Laidler (2008, p.730)) often taught in introductory macroeconomic courses. It does not include an exchange rate and we can view this as an assumption that the exchange rate is fixed. Keynes adopted this assumption in 1936 when it was appropriate, but he was aware of the implications of abandoning this assumption. It also fails to incorporate a wages sector and a measure of the impact on the economy of the need to finance the budget deficit.

Keynes was fully aware that policy makers have a choice between fixing the exchange rate and controlling the domestic economy. This is indicated by the following quotation taken from his Essays in Persuasion and dated 1923:
“If the external price level is unstable, we cannot keep both our own price level and our exchanges stable. And we are compelled to choose.

In pre-war days, when almost the whole world was on a gold standard, we had all plumped for stability of exchange as against stability of prices, and we were ready to submit to the social consequences of a change of price levels quite outside our control, connected, for example, with the discovery of new gold mines in foreign countries or a change of banking policy abroad. But we submitted, partly because we did not dare trust ourselves to a less automatic (though more reasoned) policy, and partly because the price fluctuations experienced were in fact moderate. Nevertheless, there are powerful advocates of the other choice.”


Also, it is worth noting that while Keynes supported deficit spending to deal with a slack economy, he believed that the cash budget should be balanced and deficits should only be created in the capital budget, i.e. for the creation of productive capital assets (see Backhouse and Bateman (2008)).

The earlier discussion showed that under a floating exchange rate regime, monetary policy is effective and fiscal policy is ineffective. Therefore, the reaction to the Global Financial Crisis should have been a monetary policy reaction. In fact, the RBA took a year to react to the emergence of the problems in the US financial system in late 2007 and actually increased the cash rate over that period.

3.3 Two Crises

It is surprising that the government reacted as it did at the end of 2008 because it had a case study to inform its reactions – the Asian Crisis which began in 1997. That Crisis was greeted with the same media hysteria as the GFC. However, the government did not panic and create a huge fiscal stimulus. The Australian dollar depreciated and this insulated the Australian
This point is illustrated by the following data:

<table>
<thead>
<tr>
<th>Quarter</th>
<th>USD Exchange Rate</th>
<th>Commodity Prices (USD)</th>
<th>Commodity Prices (AUD)</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997 J</td>
<td>0.7455</td>
<td>38.1</td>
<td>37.5</td>
<td>8.2</td>
</tr>
<tr>
<td></td>
<td>0.7198</td>
<td>37.4</td>
<td>38.3</td>
<td>8.1</td>
</tr>
<tr>
<td></td>
<td>0.6527</td>
<td>35.8</td>
<td>40.0</td>
<td>7.9</td>
</tr>
<tr>
<td>1998 M</td>
<td>0.6634</td>
<td>34.5</td>
<td>38.2</td>
<td>7.9</td>
</tr>
<tr>
<td></td>
<td>0.6135</td>
<td>32.4</td>
<td>39.8</td>
<td>7.9</td>
</tr>
<tr>
<td></td>
<td>0.5945</td>
<td>31.3</td>
<td>39.4</td>
<td>7.7</td>
</tr>
<tr>
<td></td>
<td>0.6139</td>
<td>30.7</td>
<td>36.8</td>
<td>7.3</td>
</tr>
<tr>
<td>1999 M</td>
<td>0.6293</td>
<td>30.7</td>
<td>36.1</td>
<td>7.1</td>
</tr>
<tr>
<td></td>
<td>0.6596</td>
<td>30.3</td>
<td>34.2</td>
<td>6.7</td>
</tr>
<tr>
<td></td>
<td>0.6536</td>
<td>31.6</td>
<td>36.0</td>
<td>7.0</td>
</tr>
<tr>
<td></td>
<td>0.6538</td>
<td>31.7</td>
<td>36.7</td>
<td>6.7</td>
</tr>
<tr>
<td>2000 M</td>
<td>0.6055</td>
<td>32.7</td>
<td>39.7</td>
<td>6.6</td>
</tr>
<tr>
<td></td>
<td>0.5986</td>
<td>33.5</td>
<td>41.8</td>
<td>6.2</td>
</tr>
<tr>
<td></td>
<td>0.5433</td>
<td>33.9</td>
<td>45.4</td>
<td>6.0</td>
</tr>
<tr>
<td></td>
<td>0.5540</td>
<td>33.3</td>
<td>45.0</td>
<td>6.3</td>
</tr>
<tr>
<td>2001 M</td>
<td>0.4890</td>
<td>33.0</td>
<td>48.4</td>
<td>6.5</td>
</tr>
<tr>
<td></td>
<td>0.5075</td>
<td>34.0</td>
<td>48.7</td>
<td>6.9</td>
</tr>
<tr>
<td></td>
<td>0.4923</td>
<td>34.0</td>
<td>49.8</td>
<td>6.8</td>
</tr>
<tr>
<td></td>
<td>0.5106</td>
<td>32.6</td>
<td>47.0</td>
<td>6.8</td>
</tr>
<tr>
<td>2002 M</td>
<td>0.5316</td>
<td>33.6</td>
<td>47.5</td>
<td>6.4</td>
</tr>
<tr>
<td></td>
<td>0.5648</td>
<td>33.9</td>
<td>44.0</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Source: RBA Statistical Tables

The impact of the Asian Crisis is shown by the fall in the index of commodity prices in terms of US dollars (CPUS). However, the exchange rate fell and the index of commodity prices in Australian dollars (CPA) actually went up over the period considered. Specifically, CPUS fell by 20.4% over the period June 1997 to June 1999 whereas CPA fell only by 8.8%.

Thereafter, the exchange rate depreciated further and CPA actually increased although there was little change in CPUS. This increase was reflected in a significant reduction in the unemployment rate. This episode illustrates how a floating exchange rate insulates the economy from shocks arising overseas, making further government action unnecessary. This example also suggests that a floating exchange rate is particularly appropriate for an...
economy, such as Australia’s, which depends on commodity exports. Commodity prices move in wide cycles and it is desirable that the exchange rate move in a counter-cyclical fashion.

The same thing was happening in the first quarter of 2009. The dollar fell and this was stimulating the economy. Growth was unexpectedly high in the first quarter of 2009 because of the contributions of net exports. Then the Australian dollar increased sharply in value in a way that was not justified by increases in commodity prices. In the fourth quarter of 2009 growth was again unexpectedly strong. However, the contribution of government spending was almost exactly offset by the negative impact from net exports. An increase in business investment made the difference, but this increase is probably due to low interest rates and improving sentiment.

The effect of the movement in the exchange rate can be tracked by examining developments in the RBA Australian dollar index of commodity prices:

<table>
<thead>
<tr>
<th>Month</th>
<th>USD Exchange Rate</th>
<th>Commodity Prices (USD)</th>
<th>Commodity Prices (AUD)</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2008</td>
<td>0.9626</td>
<td>116.8</td>
<td>91.0</td>
<td>4.2</td>
</tr>
<tr>
<td>September 2008</td>
<td>0.7996</td>
<td>121.5</td>
<td>109.8</td>
<td>4.3</td>
</tr>
<tr>
<td>December 2008</td>
<td>0.6928</td>
<td>99.2</td>
<td>109.9</td>
<td>4.6</td>
</tr>
<tr>
<td>January 2009</td>
<td>0.6438</td>
<td>96.2</td>
<td>105.1</td>
<td>4.9</td>
</tr>
<tr>
<td>February 2009</td>
<td>0.6454</td>
<td>92.9</td>
<td>106.1</td>
<td>5.3</td>
</tr>
<tr>
<td>March 2009</td>
<td>0.6873</td>
<td>87.7</td>
<td>97.8</td>
<td>5.7</td>
</tr>
<tr>
<td>April 2009</td>
<td>0.7265</td>
<td>81.0</td>
<td>84.2</td>
<td>5.5</td>
</tr>
<tr>
<td>May 2009</td>
<td>0.7912</td>
<td>76.7</td>
<td>74.5</td>
<td>5.7</td>
</tr>
<tr>
<td>June 2009</td>
<td>0.8114</td>
<td>79.9</td>
<td>73.8</td>
<td>5.8</td>
</tr>
<tr>
<td>September 2009</td>
<td>0.8801</td>
<td>83.3</td>
<td>71.7</td>
<td>5.7</td>
</tr>
<tr>
<td>December 2009</td>
<td>0.8969</td>
<td>88.3</td>
<td>72.7</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Source: RBA Statistical Tables

Over the period June 2008 to June 2009 CPUS fell by 31.6%, but CPA fell by 18.9%. For the remainder of 2009 CPA continued to fall although CPUS increased. Over the period
covered by the Table CPUS fell by 24.4% and CPA by 20.1%. This was a result of the appreciation of the Australian dollar.

This sharp fall caused by the appreciation of the Australian dollar would have had a contractionary effect which offset the stimulatory effect of the Fiscal Stimulus. In addition, the ten year bond rate increased from 4.22% p.a. in December 2008 to 5.47% p.a. in December 2009 which would also have had a contractionary effect. We obtained little benefit from the Australian fiscal stimulus. However, we did gain from a fiscal stimulus—the Chinese one. China, of course, had an exchange rate which is fixed in the short term.

Although the unemployment rate increased in 2009, it did not rise to the forecasted level over 2009, but this was largely due to the wage restraint shown by the private sector. Real wages, calculated from average weekly earnings obtained from the national accounts and the consumer price index, fell by 2.1% over 2009. The government took no action in this area although it seems sensible that if we are concerned about unemployment, we should attempt to control it by using the most proximate instrument-wages growth.

So far, little has been said about the impact of wage increases on the slowdown. The only exception is Dixon and Rimmer (2009). In the nineteen thirties, a wage reduction occurred in the interests of “sharing the burden”. It would be counter-intuitive and counter-factual to argue that real wages do not affect unemployment (see Valentine (2004)). In this environment the government should be urging wage restraint. However, in commenting on possible changes in wages policy, the Prime Minister says (Rudd (2009, p. 26)):

“Neo-liberals such as Alan Moran, of the Australian Institute of Public Affairs, argue that the cost of the recession should be borne by employees, through wage cuts and retrenchment – exactly the position of the US Treasury Secretary Andrew Mellon at the outset of the Great Depression”.

This comment draws on a line of thinking that has surfaced in recent discussions of recovery policy. It is based on a concept of “fairness”. We should discover who was responsible for the Crisis and only those people should pay any cost. In fact, we have all suffered a loss
already and the major aim now must be to minimise further losses. The choice posed by the
Prime Minister is non-existent; the actual choice is between wage cuts or retrenchment.

It is difficult to reduce nominal wages (see Dwyer and Leong (2000)). The government could
have considered suspending the superannuation guarantee charge (SGC) for a short period.
This approach would have the advantage of falling equally on all workers (including public
sector workers) and not reducing workers’ take-home pay (and, therefore, their expenditure).
Such a policy could be combined with a staged increase in the SCG percentage in later years
in order to minimise the unfavourable long-term effects of its suspension on the saving ratio.
In the long-run we need more saving, but we did not need it in 2009. That is, we need to save
for a rainy day but not on a rainy day. Alternatively, the Commonwealth government could
have subsidised the States in return for an equivalent reduction in payroll tax.

As a long-term policy, it might be useful to tie the SGC to the RBA commodity price index.
This will mean that more will be saved when the economy is doing well, but less when it is
facing hard times. In the latter case, the cost of labour is reduced so that unemployment is
contained. Alternatively, the SGC could be linked directly to the unemployment rate.

In a floating exchange rate regime, the monetary authorities are able to set domestic interest
rates. When there is a global shock, the appropriate monetary policy reaction is to reduce the
cash rate. Over the period June 1997 the cash rate fell from 5.50 to 4.75. Over the period
June 2008 to December 2009 the cash rate fell from 7.25 to 3.75, in spite of which the AUD
appreciated strongly over 2009.

This suggests that monetary policy settings were appropriate in the two periods considered.
However, the cash rate was increased over the first half of 2008 although it was clear that an
international financial crisis was emerging.

The conclusion that should be drawn from the events of 2008 and 2009 is that the appropriate
reaction to an economic shock emanating from overseas is to ease monetary policy and to
rely on a declining exchange rate to insulate the economy from the shock. No benefit can be
obtained from a fiscal stimulus.
3.4 Other Policies

A number of other policies were suggested or actually introduced to deal with the GFC. First, the government guaranteed deposits with deposit taking institutions and banks’ offshore borrowings. These guarantees made explicit the implicit guarantees which have existed for some time. In the short-run they were a reaction to irrational withdrawals of funds from banks. Banks provide the deposits which form the basis of the payments system and there is a public benefit in maintaining a view that these deposits are risk-free. Many commentators believe that the US decision to allow Lehman Brothers to fail in September 2008 was a major step in deepening the Crisis. The guarantee was also necessary to ensure that banks had access to funding and to prevent a “credit crunch” from developing. The initiative was not entirely successful in achieving the latter objective. There are two problems with this policy which are:

- they reinforce “moral hazard” in which managements take excessive risks because they believe that the government will bear the cost if things go wrong;

- there were unintended consequences. For example, there were outflows of funds from deposit funds which were not guaranteed. Some managed funds had to suspend withdrawals to deal with the outflows.

Nevertheless, the extent of moral hazard arising out of a guarantee of deposits is not as great as that arising from the related policies adopted in other countries. These involved “bailing out” banks often by buying shares in them (a process often loosely described as “nationalisation”). In these cases, the management is protected which could provide it with an incentive to increase its level of risk taking. In particular, to the extent that the support of banks arises because they are “too big to fail”, they have an incentive to become bigger, e.g. by increasing their leverage.

Second, the Crisis has led to demands for financial reregulation. Rudd (2009) is a typical example. These demands have reversed the results of discussions in the seventies and
eighties of the last century which concluded that financial regulation had been extended to a point where the costs far exceeded the benefits. It is true that the Crisis indicates a need for some adjustments but wholesale reregulation is certainly not called for. The things that could be done include:

- put lending under a single regulator (in Australia, APRA would be the desirable choice) and ensure that it is done in line with traditional credit standards;

- as suggested by Valentine (2007), these standards should include a maximum loan to valuation ratio (LVR) which can be reduced if an asset price bubble is emerging;

- as Neal (2008) has argued, hedge funds need to be regulated especially with respect to disclosure of their degree of leverage. Since many of these funds are registered in tax havens, this regulation would have to be done on an international basis;

- credit default swaps (CDS) have created problems, largely because they have been provided by an assortment of institutions which generate significant counter-party risk. It has been suggested that “clearing houses” should be established for these instruments to minimise this risk. However, it should be noted that CDS represent a small part of the derivatives market. In 2007/2008 turnover in credit derivatives in Australia was 0.32% of total derivative turnover (AFMA figures) and there have been few problems in other areas of the market; and

- the role of credit rating agencies needs to be reconsidered and their basic conflict of interest (their fees are paid by the issuers of the paper they are rating) removed.
It is important that this process does not involve the prohibition of or unnecessary restriction of the use of the financial instruments or processes which were abused in the run up to the Crisis. These include derivatives, leverage and the securitisation of mortgages. Equity release (borrowing on equity in homes) is desirable because it releases saving for investment in more productive (i.e. higher yielding) activities.

Third, there have been some unfortunate moves towards increased trade protection. Demands to “buy American” or “buy Australian” have emerged. Bremmer (2009, p. 52) cites a number of other tentative signs of a demand for increased protection. These calls neglect one of the major lessons of the Great Depression – that precipitating a trade war deepens and lengthens the recession rather than the reverse. It is accepted that the depth of the Great Depression was greatly increased by the Smoot-Hawley tariff in the United States which provoked similar tariffs in many other countries (see Scitovsky (2008, p. 147)).

One objective of tariffs is to maintain a high level of wages in the protected industries. It was argued above that it is actually desirable to reduce wages in a severe downturn. A tariff supports the wages of some workers at the expense of the jobs of others. It has been argued that the Smoot-Hawley tariff retarded recovery in the United States because it supported an inappropriately high level of wages (see, for example, Smiley (2002, p. 63)). Tariffs protect some workers’ jobs and income, but put others into unemployment. Also, tariffs cause consumers to pay higher prices for their purchases and this burden falls disproportionately on poorer consumers, i.e. tariffs are regressive. It is to be hoped that political leaders can resist populist pressure to repeat this error.

4. Conclusion

The Australian economy is highly integrated with the global economy. It will always be affected by external shocks and there is little we can do about it except maintain flexibility, e.g. in the exchange rate and wage levels. Nevertheless, there is a package of policies which could have been used to minimise the impact of the GFC on Australia and can be used to deal with any future downturn in the economy. It also applies to other economies which have been highly deregulated and have a floating exchange rate (e.g. the US and the UK). It is the
package which would have moved Australia out of the Great Depression (see Valentine (1988)). It also represents the consensus on the US recovery in the nineteen thirties. See Romer (1991). This package includes:

- a low interest rate policy;
- changes which reduce labour costs for employers;
- facilitating a low value for the Australian dollar; and
- judicious expenditures on productive infrastructure projects.

However, it is unwise to expand the budget deficit because this will cause an appreciation of the Australian dollar which will offset the stimulatory effect of the deficit and could lead to current account problems.
References


Appendix A

A Macroeconomic Model Including Exchange Rate Effects

The following macroeconomic model illustrates the points made in the previous subsection.

Expenditure \( C + I = A + aCP + b(Y - T) \)

\( CP = \) commodity price index

Exports \( X = -eE + gCP \)

Imports \( M = d(Y - T) + hE \)

Exchange Rate \( E = mDf + nCP \)

\( Df = \) budget deficit

\( = G - T \)

The rationale for this equation is that increased government borrowing leads to capital inflow which causes the currency to appreciate.

An empirical equivalent of this equation is:

\[
E = 0.517 + 0.00105CPUS\$ + 4.75GB + 0.010IRD
\]

\[
(9.93**) \quad (2.75*) \quad (3.88**) \quad (2.07*)
\]

\( R^2 = 0.442 \quad d = 1.38 \quad 83 - 08 \)

where \( CPUS\$ = \) RBA commodity price index in US dollars

\( GB = \) government borrowing

\( IRD = \) interest rate differential based on 3 month US and Australian interest rates

\( R^2 \) is the coefficient of determination and \( d \) is the Dubrin-Watson statistic. The figures under the coefficients are \( t \) – statistics. Asterisks indicate levels of significance – one asterisk
shows significance at the five percent level and two asterisks show significance at the one percent level.

First, we find the equilibrium income.

\[ \text{AS} = \text{AD} \]

\[ Y = A + aCP + bY - bT + G + (X - M) \]

Now, \( X = -emDf + (g - en)CP \)
\[ M = d(Y - T) + hmDf + hnCP \]

Therefore,

\[ Y = A + aCP + bY - bT + G - emDf + (g - en)CP - dY + dT - hmDf - hnCP \]

\[ (1 - b + d)Y = A + (b - d)Df + (1 - b + d)G - (e + h)mDf + (a + g - n[e + h])CP \]

\[ Y = \frac{A}{1 - b + d} + \frac{(b - d)}{1 - b + d}Df + \frac{G}{1 - b + d} - \frac{(e + h)mDf}{1 - b + d} + \frac{(a + g - n[e + h])CP}{1 - b + d} \]

\[ = \frac{A}{1 - b + d} + \frac{1}{1 - b + d}((b - d) - [e + h]m)Df + G + \frac{(a + g - n[e + h])CP}{1 - b + d} \]

Note first that the impact of commodity prices on equilibrium income is reduced by their impact on the exchange rate, then on exports and imports (=n[e + h]). This outcome illustrates the role that the exchange rate has in adjusting the economy to fluctuations in commodity prices. For example, an increase in commodity prices leads to an appreciation of the dollar which reduces exports and increases imports. This reduction in net exports reduces the degree of overheating that the increase in commodity prices might otherwise engender. In this way the floating exchange rate serves to insulate the Australian economy from overseas developments.
The model also illustrates how the stimulating effect of an increase in the deficit is offset by an appreciation of the currency which causes much of the stimulus to leak overseas. The effect of the deficit on equilibrium income is reduced by the term $-[e + h]m$.

If $(e + h)m = 1$, the coefficient of $Df$ is $-1$. Then, an increase in $G$ which is fully reflected in the budget deficit will have no impact on equilibrium income. This is the condition under which the deficit is fully reflected in the current account deficit ($M - X$). That is, all of the additional funding for the deficit is obtained from overseas.

It is often asserted that under a floating exchange rate regime, fiscal multipliers are close to unity (a low value). This will be the case if $(b - d) = (e + h)m$. 