

***THE ROAD TO RECOVERY - AUSTRALIA, THE GLOBAL FINANCIAL CRISIS AND THE INTERNATIONAL PATH TO ECONOMIC RECOVERY***

**ADDRESS TO THE AUSTRALIAN AMERICAN LEADERSHIP CONVERSATION**

**NEW YORK**

**13 JULY 2009**

Thank you for that introduction

It is a privilege to be speaking here to such an esteemed crowd as part of the Consulate's 'Australian American Leadership Conversation' series.

I would like to specifically thank the Consul-General designate Mr Phil Scanlon.

It's also my first official overseas function since being appointed as the Assistant Treasurer of Australia.

On a personal note, it is an honour to hold such an office, not only as the first Tasmanian to do so, but also particularly in times as challenging - and as vital - as ours.

It is true that Australia's economy and financial system has demonstrated considerable resilience in the wake of the global financial crisis and recession.

Equally, though, Australia has not been immune.

Given our outward orientation and status as a key commodity exporter as well as a regional financial hub, the impact on Australia of the worst global downturn since the Great Depression has been inevitable - and substantial.

In my remarks tonight, I will talk about current conditions in the Australian economy and financial sector, before moving on to speak about the outlook and the next steps to be taken on the path towards recovery and the role of the G20.

I would like to briefly touch on how we got here - the factors which drove the global financial crisis in the first place.

**What caused the global financial crisis?**

We know that the global financial crisis arose after a period of unprecedented global prosperity.

With the considerable benefit of hindsight, we also know that this prosperity went hand in hand with the destabilising cocktail of abundant global savings, a pronounced 'search for yield' in financial markets and widespread underpricing of credit risk.

First, global imbalances saw a huge flow of funds from developing countries - particularly in Asia - to developed countries - particularly the US.

Together with expansionary monetary policy, this saw global real interest rates decline to historically low levels.

In turn, this contributed to strongly rising asset prices and, eventually, to a house price bubble here in the US and several other countries.

Concurrently, risks associated with financial innovation which helped to underpin this period of prosperity were underestimated.

Critical incentive problems in how financial sector management was remunerated, and how loans were written, were unrecognised.

Supervision in some countries was lax and fragmented, and cross-border risks were neglected in a piecemeal global financial architecture.

These forces were most evident in the US mortgage sector.

The now-obvious flaws in the origination and securitisation of 'sub-prime' loans has left a legacy of 'toxic' assets on bank balance sheets - a legacy which became a malignant force within the global financial system.

The severity of the crisis which followed was amplified by degree of leverage that had built up in the system over preceding years.

This leverage rendered the global financial system much more fragile than most people, including regulatory authorities, had realised.

I am reminded of my last trip to New York - it was last August, towards the end of the month, and even then, as we were careering towards the month of September that saw our global financial system come perilously close to collapse.

I had a range of meetings and discussions, and even then, the true and full extent of the fragility was not clear.

And so what we used to call the 'sub-prime crisis' became the world's first truly global financial crisis, and morphed into a global recession.

It is truly amazing what a year it has been since that last visit - for the world economy and I am sure for everyone in this room.

## **The impact of the GFC on Australia and the global economy**

The real economic impacts of the global financial crisis are staggering.

The most severe episode of financial market stress in decades was followed by the sharpest and most synchronised global downturn since the Great Depression.

Business and consumer confidence collapsed to unprecedented lows around the globe.

Trillions of dollars of wealth was destroyed.

Millions are joining jobless queues worldwide.

Production and trade have been decimated.

It is worth referring here to some observations made by Australia's Prime Minister Kevin Rudd just last week in Berlin in the lead up to the G8 Summit and meeting of Major Economies.

The Prime Minister compared several key metrics of the current global recession and the Great Depression to show just how serious the dimensions are of the challenge we face today.

He noted as a comparative example, the twelve months since the recent peak of world output in April 2008 with the twelve months following the 1920's peak in June 1929.

In the twelve months since April 2008, global stock markets have fallen by more than 40 per cent.

In the twelve months of the Great Depression, global stock markets fell by just over 20 per cent.

On other fronts the comparison is also extremely sobering.

Global trade fell by 17 per cent in the first twelve months of the current global recession, compared to a 10 per cent fall in the first twelve months of the Great Depression.

Global industrial output fell by around 13 per cent in the first twelve months of the current global recession - almost identical to the fall experienced in the first twelve months of the Great Depression.

On these metrics at least, the current economic recession is in several critical respects of a comparable magnitude to the Great Depression.

Virtually the entire advanced world has fallen into recession.

I say virtually because I have the benefit of standing before you tonight representing the only country of the advanced economies not to fall into recession immediately following the crisis.

The Australian economy grew at an annualised rate of 1.5 per cent in the March quarter - outperforming all others classified as 'advanced' by the IMF.

Australia now has the fastest growing economy of the advanced economies of the world.

Collectively, this group of economies contracted by an annualised 7.8 per cent in the quarter.

We are not playing down the ongoing impacts of the crisis - which inevitably and profoundly affects every Australian, as every American.

But this recent and positive domestic news has been encouraging.

So too have tentative signs from the US that the pace of economic contraction here may be moderating.

Obviously we aren't out of the woods yet - far from it.

But I'm sure you will agree that even the faintest of green shoots are better than the scorched earth with which we have been confronted all too frequently over the past 9 months.

## **Responses to the crisis**

I have referred to the stark comparisons between today's crisis and the Great Depression, but there is one difference between now and 1929, and that is the aggressive and coordinated policy response of global governments, including Australia and the United States.

There are a range of reasons for Australia's relatively strong performance.

These include the strength of our banking system, the quality of our regulators, our fiscal position, and - crucially - our geographical position on the doorstep of the world's most dynamic region.

I would also submit that another key explanation has been the swift and decisive policy response to the crisis from both the Rudd Government and the Reserve Bank of Australia.

Fiscally, the Government has delivered a series of stimulus packages.

The first of these was announced in October 2008 - only a month after the collapse of Lehman Brothers.

This was comprised mostly of cash bonuses to welfare dependent households and low-income working families - people likely to spend and inject money into the economy immediately.

The package also contained incentives to support housing construction - but, by mid-January, with the global economy in free-fall, it was apparent that further action would be required.

In response, in early February the Government announced its Nation Building Plan - a further \$42 billion stimulus package.

This includes further measures to support consumption in the short term, but it focuses primarily on infrastructure. In the first instance, its priorities are what we have come to call in Australia "shovel ready" projects - those that are ready for immediate development, such as school halls or community projects. They'll be followed by quick-starting, mid-scale infrastructure projects.

Seven out of every 10 dollars from the Nation Building Plan are going to projects designed to enable speedy construction and maximise the impact of the stimulus across Australia.

Projects that are being rolled out as we speak.

Projects that will be augmented by larger and longer-term nation building.

Simply put, we believe our stimulus packages have embraced all the hallmarks of world's best practice.

They are timely, they are targeted, and they are temporary.

And, crucially, they are supported by a medium-term fiscal strategy designed to return the budget to surplus in the medium term.

When the economy recovers and grows above trend, the Government will allow tax receipts to recover naturally as the economy improves, and to hold real growth in spending to 2 per cent per year until the budget returns to surplus.

Here I would like to stress just how strong a position the Australian Government will be in on the fiscal front.

Australia's net debt is by far lower than any of the major advanced economies - at 4.6 per cent of GDP in 2009 and forecast to peak at 13.1 per cent in 2014.

The collective net debt of the major advanced economies is 70.4 per cent rising to a peak of at 90.7 per cent in 2014.

Australia's Budget deficit for 2009-10 is 4.9 per cent of GDP - forecast to fall to 0.4 per cent by 2014.

The collective Budget deficit for all advanced economies this year is almost twice that of Australia - at 8.8 per cent. It's 10.4 per cent for the major advanced economies.

The Rudd Government has a well-formulated exit strategy to return the Budget to surplus over the cycle.

### **Current health of the Australian financial sector**

The Rudd Government has also introduced a number of measures to bolster confidence in the Australian financial system and help ease the funding pressure on financial institutions and State Governments

This includes the guarantee of deposits and wholesale funding announced last October.

The Australian equity market was hit hard by the crisis.

Shares fell by 54 per cent between November 2007 and March 2009.

However, more recent signs from the markets have been encouraging.

Since early March stocks are up by 26 per cent (as at the end of 30 June 2009), in line with similar improvements in the US and elsewhere.

Spreads in money markets have eased.

Banks have slightly reduced their precautionary holdings of liquid assets.

The RBA has seen less need to accommodate large holdings of central bank balances by private banks.

And there has been evidence of an increase in investor appetite for corporate debt.

More broadly, Australia's financial system has demonstrated resilience, with major banks remaining well-capitalised and profitable.

Australia's four largest bank holding companies are among a group of only 8 - yes, only 8 - of the 100 largest banking groups in the world rated AA or above by Standard & Poor's.

That means that a full half of all the world's AA rated or above banks are located in Australia - a considerable vote of confidence.

They have also recently bolstered their Tier 1 capital ratios with substantial and successful equity raisings.

They have procured large inflows of deposits in the past few months as they actively seek to diversify funding sources away from offshore wholesale markets.

They have also been making selective use of the Government's wholesale funding guarantee locally and abroad, raising more than \$100 billion in long-term funding under the scheme.

A few other steps we've taken that will certainly be of interest here in the United States, as another great federally organised nation, relate to State borrowing and consumer regulation.

On state borrowing, we have legislated for a Federal Government voluntary guarantee of state-level borrowing.

On consumer regulation, we have introduced legislation to refer all the remaining areas of State regulation of financial services, consumer credit and financial consumer protection to the Federal Government. This will mean single, standard, ongoing national regulation of all financial services - a first for a Federal country and an important insurance policy for the future strength of our economy and regulatory system.

I would mention two other important market integrity areas where we have acted decisively to further bolster the strength of our system - namely short selling and credit rating agencies.

On short selling we have legislatively banned naked short selling and put in place a comprehensive, world-leading disclosure framework for covered short selling.

On ratings agencies, it is little noted but in Australia we were one of the first jurisdictions to move to require full local licensing of ratings agencies and to back this with a tough, enforceable requirement for the agencies to comply with the IOSOC Code of Fundamentals on ratings agencies.

Non-compliance can lead to license removal.

So, overall, we are encouraged by the resilience and the progress we have seen so far.

## **Economic Outlook for Australia**

But, as I said before, we are not out of the woods yet.

At the time of our national Budget in May, Treasury forecast a contraction in GDP in the next financial year, ending in June 2010.

As in the US, consumer spending has weakened in the face of declining housing and financial wealth and declining employment prospects.

Businesses are also under pressure, with higher borrowing costs, weaker demand and profits weighing on investment.

Exports are expected to fall significantly, with the sharp deterioration in the growth prospects of our major trading partners expected to result in a loss of \$50 billion in export income in 2009-10.

And prices for our key bulk commodities have fallen sharply —although it is worth nothing that, even allowing for the forecast decline in export prices, Australia's terms of trade would remain around 45 per cent higher than the average in the decade prior to the commodity boom.

However, we have seen some positive signs following the introduction of the stimulus packages - particularly the measures designed to provide immediate support for consumption.

For example, between November 2008 - when the first stimulus payments were made - and May 2009, retail trade in Australia increased by 5.9 per cent.

In contrast, retail trade in US, Japan and the euro area and elsewhere has fallen sharply.

And following GDP growth in the March quarter, consumer confidence has rebounded significantly from long-term lows in the wake of the crisis.

Consumer sentiment increased by 9.3 per cent in July, following on from a strong increase in June.

As such, consumer sentiment has increased by 23.2 per cent over the past two months - the largest two-month gain since the survey began in 1975.

There is clear evidence that the global recession is affecting the Australian economy and its full impacts still have some way to run.

However, we are encouraged by recent signs that our stimulus packages are helping to support activity and jobs.

### **IMF Article 4 views on Australia**

And you don't just have to take my word for it.

Following recent Article 4 consultations in Australia, the IMF concluded that while growth is indeed well below trend, "the downturn has been milder than in most other advanced economies".

This, the IMF said, was because of "strong commodity exports, a flexible exchange rate, a healthy banking sector, and a timely and significant macro policy response".

The IMF endorsed our approach to fiscal stimulus, and noted the timely and appropriate policy interventions - including deposit and funding guarantees - to help bolster confidence in the financial system.

The IMF also commended our clear commitment to return to surplus in the medium term, noting that "few other advanced economies have adopted such a clear commitment".

It has also noted that Federal Government debt is projected to remain low compared with other advanced economies.

This strong endorsement of our response so far has been reiterated by the recent IMF upgrade to growth forecasts for Australia.

However, we will not be resting on our laurels.

### **US reforms and lessons for Australia**

In particular, we have taken strong interest in the proposed reforms set out in the United States White Paper on Financial Regulatory Reform.

These are broad ranging reforms built to restore markets and consumer confidence.

And by working towards the goals set out in the White Paper, the US will be taking significant steps to support the international efforts to restore global financial stability, and to support the G20 recommendations.

Australia is also working on regulatory reform in a number of areas nominated by the White Paper.

In cooperation with G20 and other international agencies, we are working on enhancing regulatory protection, such as credit rating agencies, prudential and accounting standards, hedge fund regulation, data collection arrangements, consumer credit protections, and regulation of over-the-counter derivatives.

Australia has been a strong contributor to the G-20 process and has been active in providing information on its own regulatory experience where it will help in consideration of the issues.

Australia is fully supportive of the constructive role the G20 can play.

Our aim, in line with the Prime Minister's ambition of 'creative middle-power diplomacy', is not simply to be present, but wherever possible, to contribute ideas and innovations.

The process of regulatory reform is a long and difficult one.

But it is vital that we demonstrate progress in addressing the numerous regulatory deficiencies that were exposed by the global financial crisis.

I note that the White Paper calls for a number of reviews and papers to further inform the development and implementation of the reforms.

Over the next week I will be holding a range of talks with key regulators, including the Federal Reserve, the SEC and the New York Federal Reserve, and key market participants, to gauge the views on the ground concerning the White Paper and what it means for current global discussions.

The Rudd Government is pleased that the Obama Administration is taking this challenge seriously and in the lead up to the G20 Leaders summit in Pittsburgh, here in the United States, I applaud the open and wide ranging approach that the US is taking to regulatory reform.

### **Next steps to be taken on path of recovery**

From Australia's perspective, as well as tackling the difficult task of regulatory reform, it is particularly important that countries take decisive steps to repair their financial systems.

In March this year, G20 Finance Ministers agreed on a strategy for financial repair and recovery.

This was based on a three-step process:

- comprehensive stress tests to assess the viability of financial institutions;
- addressing the impact of toxic assets on their balance sheets; and
- ensuring that they have sufficient capital to ensure the supply of credit to the real economy.

More broadly, if financial markets continue to stabilise and the global economy returns to trend growth, it will be necessary to coordinate the gradual removal of the extraordinary fiscal, monetary and financial measures that have been adopted.

The G20 can play a valuable role in facilitating this coordination.

It can also assist in building a stable foundation for future economic growth by providing a forum for more fundamental reform to the global economy and international financial architecture.

I am confident that the Pittsburgh G20 Summit will prove as successful as London.

I am confident that it will again demonstrate what can be achieved when Leaders of the world's major economies come together to pursue their common interest in addressing the current crisis and creating a better framework for sustainable long-term future economic growth.

I would conclude this evening noting just how valuable it is to be here in New York as Assistant Treasurer, to meet with the key participants in the US financial community and to have a dialogue also with the leading Australians here in New York.

New York has itself been hit particularly hard by the global recession but, as always, its resilience shines through.

Thank you, and I am happy to take questions.