1 Reform beyond the crisis

The global financial crisis and associated economic downturn have highlighted the importance of maintaining open and liberal trade policies. There has been a rapid contraction in world trade since 2008. In today's highly integrated global economy, any shift towards protectionist policies that locked-in such low levels of trade would come at a high cost.

The origins of the crisis, along with the substantial support delivered to the financial sector, have raised questions about the appropriateness of financial regulations and their administration in some countries. An efficient financial sector is crucially important to the world economy. Governments need to carefully consider how support is best phased out and what changes to regulations are necessary for the longer term.

The changed economic environment has a number of important implications for the nature and timing of national economic reform. Reforms that can most readily promote flexibility in labour and capital markets and ease fiscal pressures will be particularly important. Sound policy evaluation will be a central element in achieving these outcomes.

What has happened so far?

The emergence of the crisis

Although the crisis first emerged in housing and financial markets in 2007, it had a longer gestation. Some analysts had for some time expressed concerns about the risk of a disorderly resolution of imbalances in savings and investment between countries (OECD 2007; IMF 2005, 2007; Wolf 2005), rapid increases in house prices (IMF 2006b) and concerns over the assessment of risk in the United States housing market and the increased risk of certain financial innovations (Rajan 2005). As Olivier Blanchard, Chief Economist of the International Monetary Fund (IMF), described the emergence of the crisis:

> … In the first half of the 2000s, a benign environment led investors, firms, and consumers to expect a permanently bright future and to underestimate risk. Housing and other asset prices shot up, risky assets were created and sold as being nearly riskless, and leverage increased. So when housing prices turned around, and subprime mortgages and the securities based on them turned sour, the stage was set for the crisis. In the context of rapid global integration and deep and complex interconnections between financial institutions, the crisis quickly moved across assets, markets, and economies. (Blanchard 2008, p. 8)

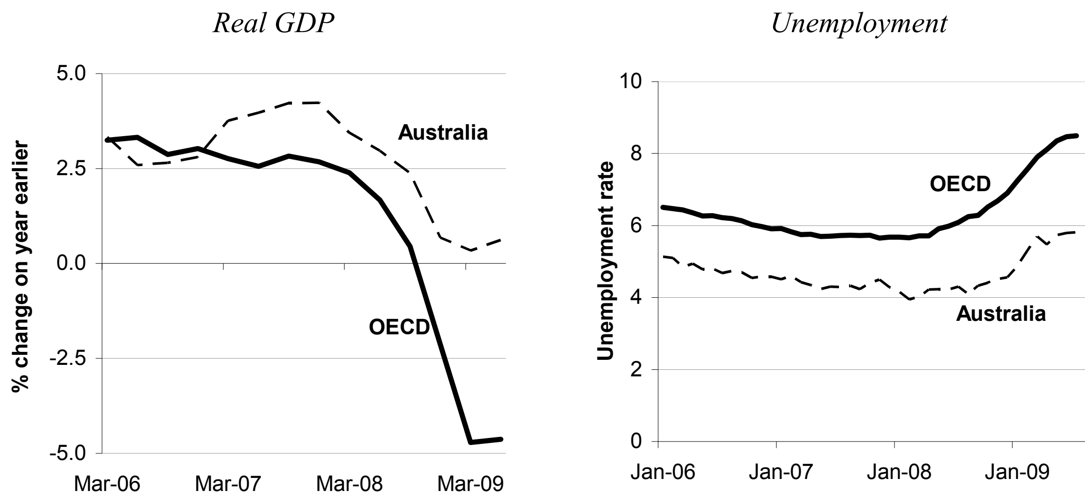
The collapse of financial markets and economic activity was initially most severe in the United States and Europe, but other countries were subsequently affected in two main ways.

- Reductions in economic activity in the United States and Europe reduced their demand for imports, causing world trade and commodity prices to drop. This particularly affected countries that relied heavily on trade for their economic growth, such as China, South Korea, Japan and Singapore. Prior to the crisis, East Asian exports to Europe and North America amounted to 12 per cent of the region's GDP (Pisani-Ferry and Santos 2009).
- A general reduction in demand for riskier assets reduced asset prices and the ability of firms to access finance. The collapse in confidence and consequent withdrawals of credit from global financial markets contributed to asset prices falling and a general 'flight to quality' in capital markets. Even when funds were available, higher financing costs threatened the viability of ongoing, or planned, investment projects.

As a result, world production and employment contracted dramatically in late 2008 (figure 1.1). Rapid falls in international trade were amplified by highly integrated global supply chains, and the reliance of trade flows on access to trade finance (Escaith and Gonguet 2009).

Australia has not experienced as severe a contraction in either production or employment compared to other countries. In part, this is because Australia's financial sector has remained comparatively resilient (box 1.1). The Australian Government has also provided substantial fiscal stimulus, amounting to 5.4 per cent of GDP, the third largest fiscal stimulus package (relative to GDP) among OECD countries (OECD 2009i).

Figure 1.1 **Gross domestic product and unemployment**[a]



[a] The Gross Domestic Product (GDP) chart shows the percentage change from the corresponding quarter in the previous year.

Source: OECD (2009h).

Policy responses to the crisis

There has been broad international agreement on the need for coordinated macroeconomic policies to help reverse the dramatic declines in world production and output. At a meeting in March 2009, G-20 finance ministers and central bank governors noted that:

> We have taken decisive, coordinated and comprehensive action to boost demand and jobs, and are prepared to take whatever action is necessary until growth is restored … Acting together strengthens the impact and the exceptional policy actions announced so far must be implemented without delay. (G-20 2009)

Measures to stimulate economic activity and support financial markets have been the most immediate policy responses by governments and central banks.

They have taken coordinated and unprecedented action to ease monetary and fiscal policy settings, such as through cuts in official interest rates, purchases of long-term government bonds (quantitative easing), cuts in income and other taxes and direct investments in infrastructure and other projects. Combined with decreases in government revenue — associated with falls in economic activity — several of these policies have the effect of substantially raising the level of public debt.

Box 1.1 **Australia's financial system and the crisis**

The effect of the financial crisis on Australia's financial sector has been less severe than in most other countries. Australia's major banks have retained their credit ratings (four of the world's nine AA-rated banks, as rated by Standard & Poor's, are Australian). And no Australian bank or other authorised deposit taking institution has failed, while in the United States, over 100 banks failed between January 2007 and August 2009 (FDIC 2009).

A number of reasons have been suggested for the relative resilience of Australia's financial sector.

- Australia has a coordinated and centralised framework for the regulation of most financial enterprises. Gruen (2009) has argued that Australia's "more coherent regulatory structure", with the Australian Prudential Regulation Authority (APRA) acting as the single prudential regulator for the financial services industry, has helped avoid some of the issues experienced elsewhere. The evolution of Australia's system of financial regulation has been guided by a number of major reviews (Campbell (1981) and Wallis (1997)), the lessons of the East Asian financial crisis in 1997 and the collapse of HIH Insurance in 2001. In addition, following some earlier warnings of the risks of booming house prices and increased household debt (Macfarlane 2002), APRA stress-tested the capacity of financial institutions to withstand economic shocks. Also, in 2006, the IMF (2006a) undertook additional stress tests of major Australian banks under the Financial Sector Assessment Program.
- Some policy settings may have insulated Australia from the trends that emerged in other financial markets. On the role of the four pillars policy, the former Reserve Bank of Australia Governor, Ian Macfarlane commented:

  > It's hard to avoid the conclusion that the difference was there was no competition for corporate control in Australia. That saved us from the worst excesses that characterized banking systems overseas. (Macfarlane 2009)

  He further noted that there was not an excess pool of funds in Australia for which overseas investment opportunities needed to be found. This contributed to Australian banks not becoming large investors in subprime mortgages or 'exotic' assets.
- The Australian Government responded quickly, with guarantees of deposits and wholesale funding for deposit-taking institutions, along with other support for the financial sector. Australian institutions have accounted for 9 per cent of global issuance of government guaranteed debt between October 2008 and May 2009 (BIS 2009). This may have ameliorated earlier concerns about the exposure of Australian financial institutions to wholesale funding markets.

Support for financial markets and institutions has included guarantees of liabilities, purchases of illiquid assets (or their acceptance as security for loans) and equity contributions to troubled institutions, including (in some cases) government ownership. Some countries have linked this support to greater lending to domestic firms.

In the past year, there has also been a trend towards more trade-restricting policies. Although some countries, including Australia, have reduced barriers, trade-restricting measures have outnumbered trade-liberalising measures by at least two to one (WTO 2009c). With respect to new protective measures, there has not been substantial resort to traditional forms of border protection such as tariffs. However, on some estimates, governments have implemented over 150 protectionist measures since September 2008 — although the lack of historical data makes it difficult to ascertain whether this represents an increase from previous periods (box 1.2).

Most of the trade barriers introduced have been in areas where temporary barriers are permitted or where rules are not applicable. The most common include anti-dumping duties, subsidies to local production (particularly to the financial and automotive sectors) and non-tariff barriers (such as licensing conditions). Some governments have also introduced government purchasing preferences.

Policy settings for recovery

While short-term measures have been important in stabilising financial markets and improving macroeconomic conditions, longer-term measures and structural policies will be factors in determining how quickly the economy recovers, and the strength of future productivity and economic growth. To achieve rapid recovery and strong long-term growth, it will be important that governments:

- avoid resorting to policies that erect new barriers to trade, which may amplify the already rapid declines in trade, and potentially have long-lasting negative effects on world economic activity
- adopt financial regulations and institutional reforms that can strengthen the financial system, while not unduly restricting competition and innovation in financial services
- progress regulatory, competition and other structural policy reforms that encourage the best use of scarce capital and labour resources, which in turn will boost productivity, national income and government revenue.

Box 1.2 **Recent changes in trade policies**

The number of protectionist measures have outnumbered liberalising measures by at least two to one over the past year (WTO 2009c). In large part, protectionist measures have been concentrated in areas where temporary barriers are permitted (eg anti-dumping and safeguard measures) or where rules are not applicable.

- Most countries that have raised tariffs remain below the bound rates under the WTO or are not WTO members. For example, Russia (not a WTO member) has raised tariffs from 25 to 30 per cent on vehicles, as well as increasing tariffs on a range of other imports. India has raised tariffs on steel products and on aluminium imports from China within the range permitted by its tariff bindings.
- Some countries have implemented 'behind-the-border' mechanisms, which are less transparent than tariffs but have the same potential to restrict trade. Mandated 'buy local' government procurement policies, subsidies to certain industries and restrictive ad-hoc licensing requirements on imported goods are examples.
  - Enacted in February 2009, the *American Recovery and Reinvestment Act* requires federally funded projects in the United States to use locally-produced iron, steel and other manufactures (to the extent that this does not contravene trade obligations). Some governments in China, Canada, Japan and Australia (New South Wales) have also introduced purchasing preferences for locally produced goods.
  - Governments in at least ten countries have provided additional assistance to the automotive sector since the beginning of the financial crisis.
- Some countries have introduced or strengthened price support measures. For example, during 2009, the European Union and the United States have reintroduced previously suspended export subsidies for butter, cheese and skim milk powder and in the United States, support prices for selected dairy products have increased.
- There has also been some resort to temporary safeguard actions permissible under WTO rules, including an increase in the number of anti-dumping investigations. The number of investigations launched in 2008 was 28 per cent higher than in 2007. (Anti-dumping actions are typically counter-cyclical in nature and have yet to reach their previous peak.) The recent action by the United States to impose an additional 35 per cent tariff on tyre imports from China was undertaken as a temporary safeguard action.
- Some countries have introduced bans on imports of specific products — in some cases citing health and safety reasons. For example, some have banned pork and pork products in response to the A(H1N1) (swine) influenza pandemic, and India has banned Chinese toys due to concerns over lead-based paints.

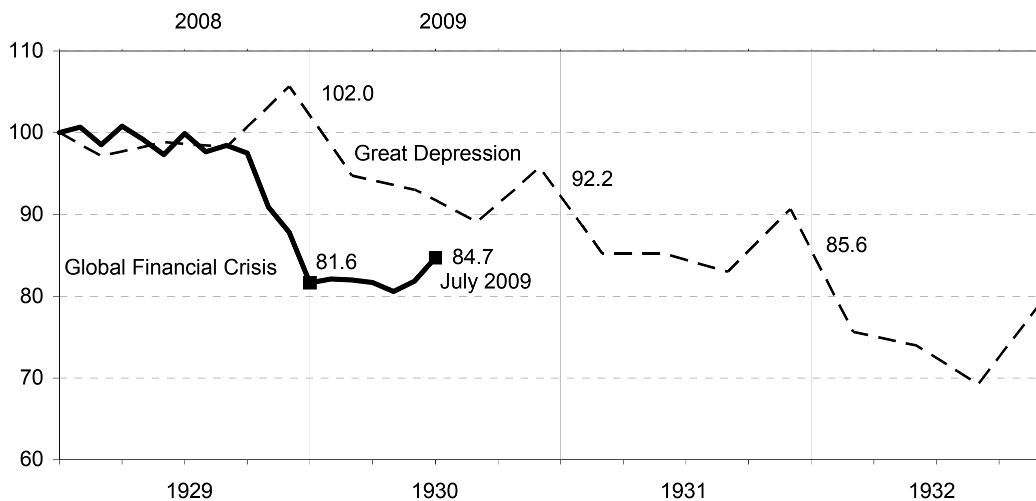
Notwithstanding the number of protective measures over the past year, some countries have recently reduced barriers. For example Australia, Brazil, China, India, Indonesia, Mexico and Russia have reduced some tariffs, and Australia, China and Malaysia have eased restrictions on foreign investment.

Sources: WTO (2009a, 2009b, 2009c); WTO, OECD and UNCTAD (2009); GTA (2009); CEPR (2009).

The costs of higher protection

Recent contractions in world trade have been more severe and more rapid than those that occurred in the early stages of the Great Depression (figure 1.2). From its peak in April 2008, the volume of world merchandise trade has fallen by 16 per cent to July 2009. In general terms, trade flows grow faster than output in expansions, and fall faster in recessions. Protectionism can exaggerate such declines.

Figure 1.2 **World merchandise trade by volume**



Source: CPB (2009); League of Nations (1939).

The large reductions in trade during the Great Depression were exacerbated by the protectionist policies of many governments during the 1930s. The Smoot-Hawley legislation in the United States led the way, increasing tariffs on over 20 000 imported goods. Other countries responded by raising their own barriers. Protection levels more than doubled in the early 1930s in the United Kingdom, Germany, France and Italy. Some studies suggest that the protectionism of the 1930s explains at least 40 per cent of the drop in world trade (Madsen 2001; Crucini and Kahn 2003).

In the face of the severe reductions in trade evident in the current downturn, the OECD issued an early warning of the dangers of protectionism:

> Open markets for trade and investment are a key driver of economic growth and development. Keeping markets open will therefore be an essential condition for recovery and long-term growth. Yet, just as the need to maintain open markets is greatest, concerns about the consequences of liberalisation and the perception that liberalisation may have even contributed to the current crisis have been growing. If these concerns result in a wavering commitment to multilateralism and in rising protectionism, the crisis will become even worse and recovery will be delayed. (OECD 2008e, p. 8)

Risks of protectionism may be lower than in the past

While there has been an increase in protection over the past year there has not been widespread resort to protectionist measures. Some features of the modern trade environment, evolving since World War II, make this less likely than in previous economic downturns.

First, unlike the 1930s, multilateral trade rules provide a brake against an increase in protection. The Director-General of the World Trade Organisation (WTO) has observed that WTO rules '… provide a strong defence, and a unique insurance policy, against that happening' (Lamy 2009). This is because many advanced economies have negotiated under WTO rules to bind tariffs at rates not much above currently applied levels. Countries that raised tariffs above these levels would risk losing concessions and possibly face sanctioned, retaliatory action. In addition, WTO rules currently forbid the use of quotas and export subsidies (for all but agricultural products) and, in some instances, restrain the use of other protectionist measures.

Second, governments now have greater policy flexibility in responding to an economic downturn than in the 1930s. For example, in the 1930s, while governments adhered to the gold standard they could not implement independent and expansionary monetary policies. Policy attitudes of the day also restricted fiscal expansion. This lack of flexibility led some countries to adopt protectionist responses as a tool of short-term economic management. In particular, there is some evidence that during the Great Depression, protection increased more in countries that remained on the gold standard (Eichengreen and Irwin 2009).

Third, the more highly integrated nature of modern production processes involves components and partly-finished manufactures crossing borders more than in the past. In other words, world trade flows are now marked by greater vertical specialisation and intra-industry, cross-border trade. In OECD countries, 44 per cent of the average value of manufacturing output in 2005 was made up of imported inputs, up from 38 per cent in 1995 (OECD 2009g). In this environment, attempts to protect domestic industries through border measures are likely to impose higher domestic costs than before, and face greater domestic resistance. For example, two major American tyre companies recently opposed increased tariffs on tyre imports from China, because it would disrupt their Chinese-based operations (ICTSD 2009).

But risks remain and the costs may be larger

The more highly integrated nature of the world economy also means that changes in economic activity may have proportionately larger impacts on trade than in the past. This can be seen in the very sharp drop in trade experienced since the onset of the

crisis. In this environment, additional trade barriers could amplify output and trade declines and impair economic performance long beyond the crisis. The OECD has recently commented:

> The long-term implications of policy measures enacted during a crisis have sometimes been more important than the short-term beneficial effects on the crisis itself. The much greater degree of global economic integration today implies that even seemingly small restrictions would have larger economic impact, harming not only partner country economies and collective efforts to recover from the crisis but also the economy of the country applying the measure. (OECD 2009f, p. 4)

Moreover, the rules that govern the world trading system are not comprehensive — they do not cover all aspects of trade between countries, and not all countries are signatories to all provisions. WTO disciplines on 'behind-the-border' measures are generally less stringent than those placed on tariffs, quotas and export subsidies. WTO members can subsidise domestic production within certain constraints. In addition, only 41 WTO members are parties to the Agreement on Government Procurement, which aims to enhance the transparency of rules and laws regarding government procurement and ensure that they do not discriminate against foreign products or suppliers.[1] As noted above, a number of governments have recently introduced procurement policies that give preference to domestic suppliers.

There is also considerable potential for trade measures ostensibly aimed at health, safety and environmental objectives to be misused to protect domestic industries. Under existing WTO rules, countries can introduce trade barriers that are necessary to meet objectives in these areas. In this respect, some recent proposals for reducing carbon emissions propose a border tax on goods sourced from countries that do not have equivalent or more stringent programs to reduce carbon emissions. A recent joint report by the WTO and the United Nations Environment Program emphasised that a key challenge will be to prevent such proposals becoming a vehicle for disguised protectionism (WTO-UNEP 2009).

In addition, the number of preferential, regional or bilateral trade agreements has grown from nine in 1962 to around 230 today. The recent proliferation of preferential trade agreements (PTAs) may exacerbate the effects of increases in trade barriers. Although PTAs can capture some of the benefits associated with trade liberalisation, they can also divert trade to more costly suppliers and distort production and investment decisions. These distortions will be higher, the higher are a country's customs tariffs and other non-preferential trade barriers.

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[1] The WTO Agreement on Government Procurement is currently being revised to increase its coverage of procurement matters. Australia is not a member of the agreement but has obligations in regards to procurement in its trade agreements with the United States, New Zealand, Singapore and Chile.

What damage could increases in global protection do?

To illustrate the possible consequences of increased global protection, the Commission has modelled two scenarios involving increases in trade barriers (box 1.3). The results illustrate the magnitude of the potential costs of increased protection, all else unchanged. They are projections dependent on the modelling assumptions; not forecasts of what might actually happen. Although these estimates explicitly model the effects of increased tariffs, the results can also serve as a broad proxy for the general economic impact of other increases in protection (including subsidies or government procurement preferences).

In the first scenario, the Commission considered the potential costs of countries increasing their tariff rates to levels allowable under WTO rules (that is, applied rates increasing to equal the existing bound rates). If rates were to increase just to bound levels, a substantial fall in global output could eventuate — amounting to a fall of nearly 2 per cent of global output, that is around A$1 trillion, and an associated drop in world trade of around 8 per cent, in the longer run.

In the second scenario, the Commission considered the potential costs of a more widespread resort to protectionism. In doing so, it modelled larger increases in protection, involving countries breaching their WTO obligations — raising tariffs on sensitive products such that average tariffs reached 20 per cent (close to the *level* to which many countries' average tariffs increased during the 1930s). Under this more extreme scenario, economic output could fall by around 3 per cent, or over A$1.5 trillion.

Although the likelihood of such a protectionist response may be considered relatively low, the estimated size of these changes indicates the importance of defending the existing, liberal trading arrangements.

- The estimated costs of the high protection scenario are almost three times the projected decline in world GDP for 2009 of 1 per cent (IMF 2009e). More importantly, while world GDP is forecast to return to growth in 2010, the costs of increased protection would persist, manifesting as a curtailed recovery from the economic downturn.
- The impact on global output of the high protection scenario is significantly above the scenario in which protection increases only to WTO-allowable levels. While the Commission stresses the illustrative nature of these results, they clearly highlight the benefits of the negotiated rules of the existing multilateral trading system, and the importance of continuing adherence to them.

- While there has not been substantial resort to protection to date, unemployment is still rising in many countries. As a result, pressure to protect vulnerable industries is likely to increase.

Box 1.3 **Estimating the consequences of protection**

The current piecemeal protectionist responses, noted by the WTO, are likely to reduce trade and growth and potentially dampen recovery. Larger and more widespread protectionist responses would raise potential impacts and costs.

While it is not possible to foresee how border protection levels might rise, modelling of tariff-change scenarios can provide an indication of the impacts and costs of illustrative increases. For this report, two scenarios were considered.

- Under the first scenario, tariff rates in all countries (except the ‘entrepot economies’ of Hong Kong and Singapore) are projected to increase to the rates allowable under WTO rules, so-called ‘bound’ rates. Tariff rates in the United States, China, Taiwan and the European Union change little in this scenario, since most of their tariffs are currently applied at bound rates.
- Under the second scenario, tariff rates on items of merchandise trade on a number of sensitive products (except in Hong Kong and Singapore) increase proportionately such that each country’s average tariff increases to 20 per cent. The sensitive products include dairy products, iron and steel, motor vehicles and parts, chemicals and plastics and textiles and clothing. According to the WTO (2009c), recent protectionist measures have been concentrated in these sectors.

The Commission has used the GTAP model, a well-known, multi-region and multi-sectoral general equilibrium model, to estimate the potential longer-run impacts of these scenarios. For the purposes of these calculations, the GTAP database has been aggregated into 20 individual national economies and 5 multi-country, regional groups. There are 57 industry sectors in each country group. Policy changes or ‘shocks’ are applied to the model, with effects determined by the linkages between industries and regions, assumptions about the economic behaviour of firms and households, and resource constraints.

In the modelling, a longer-term perspective is adopted. Under this approach, it is assumed that labour is mobile between regional industries and that it responds to changes in the relative competitiveness of industries. Aggregate labour endowments are assumed fixed (that is, not affected, in the longer run, by tariff policy changes, as such).

It is also assumed that capital stocks by region and industry adjust in order to equilibrate the expected and actual rates of return on capital. Under this assumption, increases in tariffs would be expected to initially reduce average returns to capital, ultimately leading to a lower capital stock and output potential. Capital would also be reallocated between regional industries according to the relative loss in the competeviveness of those activities.

Quantitative modelling is useful in ascertaining the key implications and economic costs of protection, however, it does not capture all of its costs. It is likely that, among other things, protectionist responses would reduce the cooperation and trust necessary to achieve successful multilateral trade reform or reduce the scope of any agreement ultimately reached. Countries may also be less inclined to reduce unilaterally their own barriers, potentially reversing progress in recent unilateral tariff reductions (particularly in the Asia-Pacific region). Protectionist responses would also erode the incentives of producers to innovate and achieve productivity improvements. Higher protection may also encourage some countries to seek preferential trade agreements, which cannot offer the same opportunities for increased trade and economic activity as multilateral liberalisation.

What action can be taken?

So far the risks and consequences of resurgent protectionism have been recognised by most governments, and reflected in various commitments. However, these commitments are not binding and, as noted above, they have not prevented some governments from increasing protection in some areas.

Since January 2009, the WTO has been reporting each quarter on new trade restrictions that its monitoring reveals. Although worthwhile as a means of drawing attention to the extent and potential costs of new protectionist measures, these reports have relied on the voluntary provision of information by WTO members. Forty-one of 153 WTO members, and 14 of the G-20 members, have provided information for the WTO's latest reports.

In its *Trade & Assistance Review 2007-08*, the Commission recommended the strengthening of reporting obligations and other transparency mechanisms. Such mechanisms could be particularly important currently, as many of the recently introduced trade barriers have taken a less transparent form. Indeed, some have noted that the WTO's monitoring has already revealed areas where knowledge of trade policies was previously lacking (Evenett et al. 2009). Enhanced monitoring processes could be used as a basis both to begin a process of unwinding protective measures introduced during the crisis and to progress multilateral reform in new areas.

Making progress in the Doha Round of multilateral trade negotiations would itself help discipline the introduction of new protective measures. For example, the dairy export subsidies introduced in the United States and Europe in 2009 would have been prohibited under existing Doha proposals. Bound and applied tariff rates also would be more closely aligned, further limiting the ability of countries to raise trade

barriers under WTO rules. Overall, it has been estimated that world GDP could be raised significantly by successfully completing the Doha Round (Adler et al. 2009, Anderson and Martin 2006 and Hertel and Keeney 2006). The current economic environment makes it more important than ever that the Australian Government continues to press for its completion.

However, the Doha Round is not expected to cover a number of trade policy areas, including some that have featured recently in response to this crisis. Of particular concern is the proliferation of domestic preferences in government procurement and the scope for future industry protection in the guise of 'environmental protection'.

- Any trade measures motivated by the objective of reducing carbon emissions should be implemented in ways consistent with the rules-based trading system. In the current circumstances, there is a heightened risk of concerns about climate change being used as a shield to implement protectionist measures under existing WTO rules.
- Since late 2008, at least 15 countries have imposed policies that discriminate against foreign supplies in government procurement processes. In Australia, the New South Wales Government recently introduced procurement guidelines that provide a 20 per cent price preference for locally supplied goods (and an additional 5 per cent preference for goods sourced from regional areas). All other states maintain procurement policies that aim to give a degree of preference to local industries.[2] Such policies not only risk reducing the value of government spending for taxpayers, but also provide a poor demonstration effect internationally, and are a liability when seeking to encourage other countries to reduce protection.

Financial sector support and regulation

Key policy responses to the financial crisis have been those relating to the financial sector. These have included:

- the provision of substantial support and assistance
- proposals to reform regulations governing financial markets and institutions.

[2] Generally, where states' procurement policies give preference to local industry, the granting of preference is in accordance with obligations under Australia's preferential trading agreements.

Support for financial markets and institutions

The recent government support to financial markets and institutions has helped stabilise markets and prevented a more drastic downturn in economic activity. The IMF recently stated:

> Unprecedented policy actions undertaken by central banks and governments worldwide have succeeded in stabilizing the financial condition of banks, reducing funding pressures and counterparty risk concerns, and supporting aggregate demand. (IMF 2009a, p. 1)

Nonetheless, the provision of any form of assistance to particular economic activities can bring costs too. Apart from any budgetary burden of such assistance, government support to the financial sector may influence how financial institutions assess risk and can create potential for 'moral hazard'.

Financial institutions that receive government guarantees, or other forms of support, can thereby generally attract more funds than competing financial intermediaries. Due to the incentives that are created, those institutions receiving support, and potentially the financial sector as a whole, may take on risks that are not optimal. There will be consequences both within countries (with firms receiving support being advantaged over those that do not) and between countries (financial institutions in countries that do provide support will be advantaged, other things being equal).

To some extent, such effects are already evident. For instance, non-depository financial institutions, which generally have not had access to government guarantees and other forms of support, have found it difficult to compete (Samuel 2009),[3] and developing countries have expressed concerns over the influence of government guarantees on global capital flows (WTO 2009c). According to the Bank for International Settlements:

> Econometric analysis indicates that the differences between the spreads paid by individual banks reflect to a large extent the characteristics of the sovereign guarantor (such as its rating or the timeliness of payments in case of default of the issuer), whereas bank-specific factors (such as its credit risk) play only a minor role. This finding represents an example of the distortions that may stem from government intervention, because it implies that "weak" banks from "strong" countries may have access to cheaper funding than "strong" banks from "weak" countries. Such a pricing of risk is not what one would expect in a well functioning and efficient market. (BIS 2009, p. 3)

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[3] In this regard, the IMF (2009b) has commented 'Smaller nonbank lenders have been particularly hard hit, as they do not have central bank support or low-cost deposit funding to fill the void left by the securitization market shutdown' (p. 1).

It is difficult, however, to disentangle the effects of government policies from the normal 'flight to quality' that is likely to occur in a financial crisis or economic downturn. As the WTO recently commented:

> Capital flows to emerging markets may be reversing not only as a response to regulatory actions in home countries, but also as a natural result of risk aversion, global liquidity crunch (deleveraging), and solvency concerns. Thus, even without government pressure to do so, financial institutions are more likely in the current circumstances to re-focus their activities on their core geographical markets at the expense of their non-core operations in other countries. (WTO 2009c, p. 28)

For the above reasons, governments have designed financial support to be temporary. The Australian Government has announced the guarantee of deposits for an interim period of three years, and proposes to remove the wholesale funding guarantee once market conditions 'normalise'. In addition, the risk-based fees that the Australian Government charges to access the guarantee (for wholesale debt issues or deposits over $1 million) may lead financial institutions to progressively discontinue their use. Other governments are considering the 'exit strategies' required to remove the range of support mechanisms that they have provided.

For a number of reasons, it may prove difficult to withdraw the temporary assistance that has been granted to avert systemic collapse.

- First, the timing of the removal of support will need to balance the achievement of the broad stabilisation objective with the need to avoid undue support to the financial sector.
- Second, government support can in itself build a constituency for it to be maintained. The introduction of support in some countries caused others to respond with their own support schemes (to avoid capital flowing to the countries offering guarantees). Countries that seek to remove support ahead of others may face similar pressures. Ultimately, such opposition may cause assistance to persist, even if its removal would deliver greater (albeit more widely spread) benefits to the community.
- Third, the removal of assistance alone will not necessarily remove the 'moral hazard' problem. As assistance was provided when some financial institutions were at risk of commercial failure, the financial sector may expect that similar assistance would be forthcoming to prevent failure in the future. Governments therefore cannot simply 'take the assistance away' by formally terminating the temporary measures.

To address these complications, national and international arrangements may be needed to ensure that the removal of assistance does not create its own destabilising effects. Such arrangements should seek to implement best-practice design principles

for the provision of financial sector guarantees (Basel Committee on Banking Supervision 2009 and ANZSFRC 2009), and to ensure that the financial regulatory framework encourages financial institutions to consider all of the commercial risks and costs of their decisions, while recognising systemic risks of financial sector activity.

Reform of financial regulations

The financial crisis has led to calls for strengthened financial market regulations. G-20 leaders have established the Financial Stability Board to develop proposals to reform financial regulations with the aim of delivering greater financial stability, and governments in the United States and Europe have developed detailed proposals for change (US Treasury 2009, de Larosière 2009 and HM Treasury 2009).[4] In broad terms, the current proposals are intended to enhance monitoring of systemic risks, remove gaps in regulation, impose more stringent prudential and liquidity requirements, better align remuneration practices with commercial outcomes, increase international regulatory coordination (particularly of cross-border institutions) and standardise and improve disclosure for, and regulation of, complex financial products. Some changes have already been made to the Basel II accord (including the treatment of off-balance sheet and securitisation activities). G-20 leaders have agreed on further changes that will be phased in as financial and economic conditions improve, with the aim of implementation by end of 2012.[5]

The proposed changes have two main rationales.

- Some changes are targeted at deficiencies in financial regulations and their administration that were highlighted during the financial crisis. In particular, there are concerns that, in some countries, the financial regulatory framework was not sufficiently responsive to the emergence of systemic risks (as opposed to the prudential soundness of any individual institution). There are additional concerns over the sufficiency of the consumer and investor policy settings in housing and financial markets in some countries.

- Regulatory changes may also be needed to address moral hazard concerns.

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[4] The Financial Stability Board comprises senior representatives of national financial authorities from 24 countries, international financial institutions, standard setting bodies and committees of central bank experts. Australia is represented on the Board by the Reserve Bank of Australia and The Treasury.

[5] Basel II is the second of the Basel Accords. The accords are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. APRA has adopted the Basel II framework as the standard for the prudential regulation of Australian authorised deposit-taking institutions.

The precise issues and proposed solutions vary across countries but there is broad acceptance of the need for changes to financial regulations.

> Financial regulation was not equipped to address the risk concentrations and flawed incentives behind the financial innovation boom … the task now is to broaden the perimeter of regulation and make it more flexible to cover all systemically relevant institutions. (IMF 2009c, pp. xix-xx)

Nonetheless, there are obvious risks that changes being made to financial regulations may unduly restrict competition, innovation and ultimately the productivity of this key sector. Over the past thirty years, many countries have liberalised their financial regulatory settings and reduced barriers to investment between countries. These reforms increased access to credit for businesses and households, contributed to reduced interest rates and drove higher rates of economic growth (Bekaert et al. 2005; Jayaratne and Strahan 1996). Greater competition in the financial sector also reduced costs and increased the number and type of financial products provided to consumers (PC 2004d). Recent excesses in the degree of complexity introduced into some financial products, and shortcomings in the management of these innovations, should not obscure these substantial benefits.

Regulatory changes that served to inhibit competition and innovation, without yielding cost advantages in terms of increased stability or consumer protection, could put these benefits at risk. Designing the most efficient financial regulatory settings involves balancing the risks and costs of financial instability against the risks and costs of inhibiting productivity.

To illustrate the possible impacts of ‘excessive’ regulation, the Commission has used the GTAP model to estimate the effects of higher costs in the financial services sector across OECD countries under a stylised scenario.[6] The modelling indicates that for a 1 per cent reduction in financial services productivity combined with a 1 per cent increase in capital costs across OECD economies, global output would be over 0.5 per cent lower than otherwise over the longer run.

While these estimates provide an indication of the potential costs of excessive regulation, they do not directly capture all of these. Beyond providing access to capital in a cost-effective way, a well-functioning and efficient financial sector should also allocate capital to the most profitable firms and exert pressure on those firms to maintain high standards of corporate governance. Some evidence suggests

[6] The GTAP model is a well-known, multi-region and multi-sectoral general equilibrium model of the world economy. For the purposes of these calculations, the GTAP database has been aggregated into 20 individual national economies and 5 regional groups. There are 57 industry groups in each country or regional group (box 1.3).

that financial deregulation had its greatest beneficial impact on increasing the quality, rather than just the quantity, of lending (Jayaratne and Strahan 1996).

Moreover, the above results are not estimates of any particular regulatory option. Such costs do not imply that well-targeted improvements to financial sector regulations will not deliver net benefits. However, the estimates highlight the importance of clearly identifying the benefits of any proposed regulatory changes, and establishing that they would, in practice, outweigh the likely costs of that change.

Given the relative resilience of Australia's financial sector, there has not been pressure to date for fundamental changes to its regulatory framework. However, it is unlikely that Australia's settings will remain unaffected by the crisis. In addition, in light of the substantial support given to the Australian financial sector, the appropriateness of Australia's pre-crisis regulations may come under review.

As with changes to the regulation of financial markets more broadly, any significant changes to Australian financial sector regulations should only be implemented following a thorough examination of the likely costs and benefits. Some have called for another comprehensive review of Australia's financial regulatory system, along the lines of the earlier Campbell and Wallis inquiries, and the more recent Corporate and Financial Services Regulation Review in 2006 (Gans et al. 2009). The Australian Government agreed, prior to the financial crisis, with the recommendation of the Regulation Taskforce for regular reviews of major regulations every five years (Australian Government 2006). In preference to piecemeal regulatory changes, with their attendant risks and potential for unintended consequences, the Commission would see value in a wider, more encompassing review of financial market regulation.

Securing future economic growth in Australia

A series of reforms over the past 30 years have increased the productivity, competitiveness and flexibility of the Australian economy. Key elements of these reforms removed obstacles to the adjustment of prices in response to market pressures, and restraints on the movement of labour and capital to more productive uses. The consequent greater flexibility of the economy should facilitate the adjustments required in response to the economic downturn and ultimately improve the speed and sustainability of recovery.

Nonetheless, the strength of Australia's economic recovery will also be determined by further economic reforms that influence how productively Australia employs its

economic resources in the future — a theme central to the Commission's recent submission to the *Inquiry into Raising the Level of Productivity Growth in the Australian Economy* (PC 2009e). In the Commission's assessment, policies that unduly raise business costs, channel investment into uneconomic projects or introduce rigidities into product, labour or capital markets are likely to crimp recovery and impede future growth.

As in the past, therefore, factors influencing Australia's future productivity performance will be the key to our prospects for economic growth and higher living standards. Even small changes in productivity growth can have substantial long-term effects. For example, in the latest Commonwealth Budget, the Australian Treasury's projections assume a long-term labour productivity growth rate of 1.5 per cent (Henry 2009). This compares with an estimate of 1.75 per cent in previous reports — such as the Commission's report on the ageing population (PC 2005b) and Treasury's intergenerational reports (Treasury 2002, 2007). If Australia were to achieve the higher rate, GDP would be 3 per cent higher by 2025 than otherwise — an increase of over $5 000 per household in today's dollars.[7]

The influence of the financial crisis on policy settings

The financial crisis has not changed the importance of implementing reforms that increase Australia's productivity and living standards over the longer term. By the same token, the circumstances of the financial crisis have changed the economic environment within which reform takes place. Rebalancing reform priorities in response to this changed environment is necessary, because every reform cannot be progressed at the same pace and time. Attempting too much, can be a recipe for achieving too little.

In particular, the financial crisis and the economic downturn have placed additional emphasis on:

- *Increasing flexibility in capital and labour markets.* Reforms that remove impediments to investment or employment opportunities will facilitate the adjustments that are required in response to the economic downturn.
- *Responding to the challenge of a more fiscally constrained environment.* Achieving future planned reductions in budget deficits will require governments

[7] Labour productivity growth is the normal variable adjusted in economic projections. However, more important for Australia's future economic wealth will be changes in multifactor productivity. Multifactor productivity growth accounts for the full costs of additional capital and labour inputs (PC 2009e).

to concentrate more forensically on the appropriateness of existing expenditure, testing its cost-effectiveness and maximising the efficiency of new expenditure.

- *Maintaining vigilant policy evaluation processes*. A policymaking environment in which budgetary pressures are paramount may introduce a bias towards 'off-budget' regulation rather than 'on-budget' expenditure. Rigorous evaluation and review processes are needed to screen policy proposals for net benefits and weed out costly existing programs.

These considerations point to three key areas for policy attention.

- First, spending associated with various stimulus measures should be targeted at projects that provide the greatest payoffs to the community.
- Second, assistance to specific sectors introduced during the crisis needs to be gradually removed, and other areas of industry assistance reviewed or reformed.
- Third, pushing ahead with a range of targeted productivity-enhancing reforms will facilitate a strong recovery and higher levels of future economic growth.

Getting the most out of stimulus spending

The Australian Government's stimulus spending has naturally been largely focused on raising aggregate demand and maintaining levels of economic activity in the short-term. The first phase of spending took the form of cash transfers and increased subsidies to first home buyers. Subsequent phases are focusing on investments in schools, communities and home insulation, and 'nation building' investments in transport, telecommunications and other infrastructure.

While not involving recurrent expenditure programs, much of this spending will still have long-term economic effects. In particular, most infrastructure investments will remain in place for many years, typically decades. Governments across Australia are currently planning investments in infrastructure amounting to over $250 billion — equivalent to nearly 1 year's investment spending for the entire economy.

Projects that are well-selected and well-regulated should more than pay for the financing they require. Indeed, there is the potential for them to assist recovery *and* to improve the long-term performance of the Australian economy. However, infrastructure investments that are not well-allocated can impose a double burden: with future generations having lower incomes than otherwise, while still needing to service the debt incurred in financing such assets.

Given the complexities and uncertainties of efficient project selection, it is important that rigorous processes are used in determining investment priorities. The Government has affirmed that efficient public investment in infrastructure requires the application of detailed cost-benefit analysis and transparency at all stages of the decision-making process, to ensure that the highest economic and social benefits are delivered (Australian Government 2008c). It has committed to apply rigorous evaluation criteria to allocations from the newly established 'nation building' investment funds (covering health, education and economic infrastructure). For example, Infrastructure Australia provides advice on the projects that the Building Australia Fund should finance (covering investment in transport, communications, energy and water infrastructure).

These guidelines have not been universally applied to date, however. For instance, funding has been announced for projects that Infrastructure Australia had not evaluated (such as, the O-Bahn track extension in South Australia) or had not assessed as 'ready to proceed' (including the Oakajee Port in Western Australia and the Bruce Highway in Queensland). In addition, the decision to build a National Broadband Network, although endorsed by Infrastructure Australia, was not based on detailed cost-benefit analysis. At the Commission's recent conference on evidence based policy, concerns were expressed about the rigour of some of the cost-benefit analyses that have been undertaken (PC 2010).

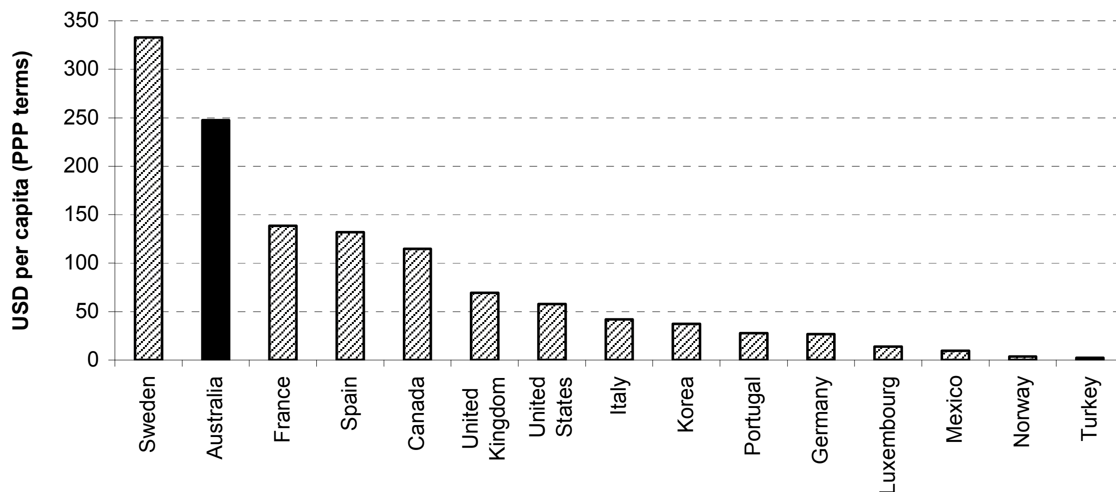
The consistent application of rigorous project evaluation methods remains fundamental to ensuring that investments are the most beneficial. This requires the identification and assessment of feasible investment options, including options to expand, upgrade or refurbish existing assets. At times large-scale, greenfields projects may provide positive returns and have intrinsic merit. However, projects with some of the biggest payoffs can involve addressing bottlenecks in existing networks. Increasing the transparency of project evaluations could play a role in ensuring a balanced assessment of benefits and costs and improving the overall quality of project analysis.

Governments also need to maximise the benefits of engagement with the private sector. Almost all public investments require some involvement with the private sector, from design and construction through to financing tasks. Taking the time to select the best project delivery option, and having the skills to negotiate the most appropriate allocation of risks between the parties, ensures that projects not only offer, but deliver, value for money (PC 2008i; Chan et al. 2009).

Ensuring that assistance to industry delivers net benefits

The policy response to an economic crisis typically involves some government assistance to selected industries. The Australian Government has recently provided additional assistance to the automotive, financial and car-finance sectors. Indeed, the Australian Government's total assistance package for the automotive sector, announced in November 2008, is among the largest of the recently announced programs in per capita terms in OECD countries (figure 1.3). It has also announced increased subsidies for research and development spending and recently agreed to provide support for Australian suppliers to bid for government projects.

Figure 1.3 **Recent international assistance to the automotive sector**[a]
US dollars per capita (PPP terms)



[a] The assistance relates to recently announced programs to support domestic automobile sectors in OECD countries through subsidies, tax breaks and special investment schemes (including 'cash for clunkers'). Programs announced after June 2009 are not included.

Sources: OECD (2009k); Daley (2009).

Certain forms of assistance — such as some research and development funding and some measures with environmental objectives — can deliver net community benefits. Other policies with industry assistance implications — such as adjustment assistance — can also be justified on social or equity grounds or, currently, to promote economic stabilisation.

However, costs are always incurred when providing assistance to specific industries. In many cases, these will outweigh the benefits because such assistance diverts scarce economic resources from more efficient firms and industries, ultimately weakening the performance of the wider economy. In addition, more

readily available assistance can divert managerial attention towards seeking such support, rather than improving a firm's productivity or product quality.

It is therefore important that governments monitor and re-evaluate the measures they have put in place in response to the crisis. Some of the support is designed to be temporary in nature. But experience shows that, once granted, assistance can be difficult to remove. Where removing temporary measures proves problematic, independent and public reviews can enable the costs of not doing so to be more widely recognised.

There is also considerable scope to rationalise the industry assistance that predates the crisis. The Commission's latest *Trade & Assistance Review* identified that industry assistance in 2007-08 amounted to over $17 billion in gross terms, and $9 billion in net terms (PC 2009d). Although some assistance is well-targeted, and likely to generate net benefits, there is scope for governments to reduce and rationalise some elements.

- The Commission's recent report on drought assistance demonstrated the gains from reform (PC 2009c). In particular, 'exceptional circumstances' interest rate subsidies and state-based transactions subsidies were found to be ineffective and, perversely, encouraged poor management practices.
- In a study of science and innovation policies, the Commission concluded that generic R&D tax concessions mostly benefited the recipients, and failed to generate substantial additional R&D investment (PC 2007a). Current proposals for a tax credit scheme, which on some measures will increase the concession for generic R&D investment, raise concerns over whether enough additional R&D would be induced to justify the increased public cost.[8]
- Australian governments intend to spend over $23 billion to 2011-12 on programs to reduce carbon emissions (PC 2009d). Some of these measures are directed at specific technologies to reduce emissions, which may not prove to be the most cost-effective. Over $6 billion is also allocated to assist firms to adjust to the proposed emissions trading scheme. Such assistance requires careful design so that it does not create perverse incentives and shift an undue emission reduction burden onto other, unassisted, parts of the economy, nor encourage high-cost low-emission technologies.
- The Commission's *Trade & Assistance Reviews* have also identified further areas where review is needed, such as defence procurement, assistance to the

[8] Existing arrangements deliver a 7.5 cents after-tax concession for every dollar spent on research and development. The tax credit would increase this concession to 10 cents for large firms and 15 cents for small firms.

tourism sector and state, territory and local government assistance to industry (PC 2008e).

There are limits on the extent to which much government expenditure can promote productivity growth and the wider performance of the Australian economy. The benefits of past reforms have largely been a consequence of policies that involved little government spending. Rather, they were focused on lowering barriers to competition, removing price distortions and reducing regulatory constraints and burdens. Likewise, much of the future reform agenda is appropriately directed at improving the effectiveness of government spending and removing barriers to higher productivity.

Progressing productivity-enhancing reform

Over recent years, Australian governments have together mapped out an ambitious reform agenda, aimed at boosting productivity, increasing workforce participation and improving the quality of public services (box 1.4). The agenda also seeks to address a number of other important objectives, including affordable housing, overcoming Indigenous disadvantage and environmental sustainability.

The development of this agenda largely predates the crisis, but it remains crucial to Australia's future economic performance. The Commission has estimated that the achievement of identified infrastructure reforms and reductions in regulatory burdens could increase GDP by nearly 2 per cent. Other reforms to enhance workforce participation and increase productivity (through health, education and workforce participation reforms) could deliver even larger gains (PC 2006b). (The latter gains would materialise over a lengthy period, with some requiring significant public investment.)

While reforms with longer-term payoffs remain important in the current fiscally-constrained circumstances, reforms that can achieve early improvements in growth prospects, with little or no fiscal outlays, have obvious attractions. Governments have already made substantial progress in a number of areas and, prior to the economic crisis, the Business Regulation and Competition Working Group prioritised a list of 27 regulatory 'hot spots'. Governments have also established a number of reviews to evaluate reform options, such as the Review of Australian Higher Education (Bradley 2008) and a review of Australia's health system by the NHHRC (2009b).

While the Commission recognises the influence of institutional and other factors that may limit the progress that can be made in certain areas, it sees the following areas as candidates for prioritisation.

Box 1.4 **The COAG Reform Agenda at a glance**

The COAG Reform Agenda encompasses a broad range of policy reforms, across a number of areas:

- *Business regulation and competition reforms* include measures to create a seamless national economy, particularly through the establishment of national or harmonised regulatory systems. Other areas include implementing previously agreed energy, national transport and other infrastructure reforms, as well as establishing more effective regulatory review and evaluation processes.
- *Health and ageing reforms* focus on improving the quality and access to health services and the effectiveness of the health workforce, as well as policies to prevent disease and illness by addressing levels of obesity, smoking, diabetes, physical activity and healthy eating.
- *Productivity reforms* include measures to improve early childhood development, school and vocational education outcomes, including through improvements in literacy and numeracy and in teacher quality and accountability. Vocational education and training reforms seek to increase skill levels and provide additional training places for job seekers and existing workers.
- *Disability services reforms* include measures to enhance the quality of life for people with a disability and their carers.
- *Climate change and water reforms* include the introduction of a national renewable energy target scheme, streamline associated policies aimed at reducing carbon emissions, the establishment of new governance arrangements for the Murray-Darling Basin and the facilitation of national water markets.
- *Housing reforms* are aimed at improving access to affordable housing, improving access to housing by Indigenous people, enhancing the capacity of the community housing sector and improving housing supply.
- *Indigenous reforms* are intended to close the gap on Indigenous disadvantage, particularly by increasing access to early childhood education, schooling, vocational education and health services and promoting safe communities and improved governance arrangements.

Source: COAG (2008f); Australian Government (2009d).

First, reforms aimed at improving regulations can yield substantial compliance cost savings and improve efficiency at little fiscal cost (and, indeed, in some cases may yield a fiscal payoff). Among regulatory reforms deserving special attention are those directed at:

- achieving nationally uniform occupational health and safety laws
- increasing workforce mobility through mutual recognition, greater harmonisation and rationalisation of trades licences and health workforce registration and accreditation practices

- improving the efficiency of environmental and development assessment processes
- removing unnecessary impediments to investment in the oil and gas industries.

Second, enhancing the incentives for efficient investment under the national access regime will promote private sector investment in infrastructure and help to reduce the demands for government spending in this area. The Australian Government has announced its intention to establish time limits on access decisions, allow binding exemptions from declaration (for at least 20 years) and other reforms to streamline the access pricing process. In its *Review of Price Regulation of Airport Services*, the Commission (PC 2006g) also recommended legislative changes to ensure that the entry bar for declaration can be restored to a level that provides greater certainty to investors and encourages investment.

Third, regulatory review and evaluation processes will continue to have a crucial bearing on the quality of regulation itself. Australian governments have agreed to introduce more effective regulatory gate-keeping mechanisms that would increase the use of cost-benefit analysis, require the cumulative burden of regulation on business to be considered and increase transparency (COAG 2007b). Despite this, not all commitments have been implemented and a detailed timeline has not been agreed. In addition, the Commission's recent *Annual Review of Regulatory Burdens on Business* identified a need for a number of improvements to processes at the Commonwealth level, including increased opportunities for consultation and the creation of a central register of regulation impact statements (PC 2009b).

Many of these reform areas are already 'in the queue', with governments having agreed on the necessity of reform and, in some cases, making significant progress. It should therefore be possible to implement them quickly.

There are other items that have been on the agenda for some time which deserve revisiting. These include restrictions on competition in the pharmacy sector, the regulation of ports, coastal shipping and other transport reforms, and restrictions in the broadcasting sector and the use of radio spectrum. Reforms in these areas may not be achievable immediately, but they have the potential to contribute to Australia's economic potential over the medium-term.

Longer-term reform imperatives

Notwithstanding the potential prioritisation of certain reforms, continuing to make progress on the broader reform agenda for the long term, remains important regardless of the effects of the financial crisis. Health and education constitute almost a third of government spending and 15 per cent of GDP, and are a major influence on the wellbeing of Australians. More cost-effective service provision in

those and other human services offers large potential benefits. In addition, increased educational attainment and better health can also lead to increased workforce productivity and participation. In this regard, the Prime Minister recently announced that the Productivity Commission would be asked to undertake a series of reviews on ways to improve both the efficiency and effectiveness of human service provision (Rudd 2009). Particular attention will be paid to the promotion of productivity and workforce participation. An early review will examine Australia's aged care needs for the next 20 years and advise on appropriate arrangements.

Taking advantage of all opportunities over time is especially important given the size of expenditure in these areas and projected increases associated with an ageing population.

The lessons from earlier reform experiences, notably the National Competition Policy, indicates that reforms under a broad-based program can be complementary and mutually reinforcing. They widen the distribution of benefits and the costs of some reforms can be offset by the benefits delivered by other reforms, easing overall adjustment pressures. Achieving progress across priority reform areas that can yield early benefits will also help the economy grow out of the economic downturn and reduce future fiscal burdens. Higher productivity and incomes also ultimately provide the means of achieving the broader social and environmental objectives of importance to Australians.