

2009 Tasmanian Minerals Council – 14 May 2009
**‘Tasmania in the context of the Global Financial Crisis and
an Economic Outlook’**

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*[Information and analysis has been drawn from a range of sources; namely
published and unpublished material from ABS, Commonwealth Bank of Australia,
OECD, IMF and internal research and analysis]*

Thank you to Terry Long and the Minerals Council for inviting me back to speak again this year.

Last year when I spoke to this forum I told a story of a state that had been significantly transformed over a decade and a half. Tasmania, I said, was a state in which the fiscal position of the Government had been substantially consolidated – to the extent that a net debt burden of \$1.5 billion in 1991 had been gradually reduced over time, and in fact eliminated last year. In terms of the overall burden of state taxes on the community, we saw that Tasmania imposed the heaviest tax burden on its community in 1991 (at 10% above the national average), but that this had fallen to be the second lowest by 2002 (at 6% below the national average); and it has remained pretty much that way since.

I also explored the emerging gap that had clearly opened up between the economic performance of Tasmania and the rest of the nation, following the economic ‘slowdown’ of 1991-92. This gap could be seen through

pretty much any indicator by which you chose to judge it. Tasmania was suffering low levels of private investment; its key export destinations were struggling; there were generally low prices for many of its commodity exports; it had negative population growth; and there was significant public sector job shedding.

But Tasmania was transformed from a poor performing into a relatively robust state economy, following years of public investment, some large private infrastructure investments; sustained increases in the improvement of the quality and the extent to which capital was used in businesses generally (through substantially increased private investment); population growth; and a buoyant property market that - together with reasonably prosperous income rises, supported strong consumer demand.

Now they say a week is a long time in politics, and while economists talk in terms of quarters, they typically think in terms of eras, that may last as short as a decade and as long as several. But no one could deny that standing here today, a year ago could almost seem a lifetime past. I say a lifetime, because many of us would have watched the recessions of the early 80's and 90's with passing interest, just as we did the same when the Asian financial crisis struck and the Japanese economy was plunged into a deep contraction about a decade and a half ago.

However, what we are experiencing today is different. The events of today have the potential to have further reach, with much greater uncertainty as to the extent to which recession at the global and national levels will be felt, and how long it will last. What we have been experiencing since late last year is different, not just because it is a potent mix of financial and economic crises, but also because we have been witnessing what economists refer to as ‘systemic failure’. I will return to this last point shortly.

But let’s take a look at what has happened and what makes this recession we are entering into so different.

The fundamentals for this crisis were laid down over a long period of time in which the financial markets, governments, regulators, investors and household borrowers all became incredibly complacent about ‘risk’ and the ability of the market place to self-correct in a periodic and timely manner. While it can be argued that ‘free-markets’ are as good for the economy as they are dangerous, the wisdom for any regulating authority lies in the enviable but rarely achieved ability to perfectly anticipate and correct for that so-called source of market failure. When I refer to market failure I am talking of things such as price fixing through collusive anti-competitive behaviour; poor or incorrect information; having too much of something we think of as bad (such as pollution), or too little of

something we think of as good (such as charity work); or some other impact that tends to distort our collective behaviour. Arguably, too much regulation tends to result in an over-limiting effect, stifling economic growth and ultimately depriving the community more broadly of a higher standard of living; while too little on the other hand risks exploitation, poor income sharing and distribution, poor working and living conditions, and many other so-called 'laissez faire' ills – that some would argue are too numerous to just mention in passing!

But governments intervene in markets not only through regulation. They do so as well through what is broadly referred to as 'fiscal policy'. By fiscal policy I mean deliberate decisions by government to, amongst other things, impose or reduce taxes; provide or take away welfare support; give grants and other like forms of assistance; expand or contract public services; or build things, such as roads, hospitals, schools, ports and other essential economic and social infrastructure.

Which side of the policy divide you sit in judgment of such decisions will depend largely on your beliefs about the ability of the market place to provide for fair and efficient outcomes, versus the capability of government to guide the invisible hand towards a more appropriate result. In light of this, there is certainly no other time that I can remember in

which this fundamental issue has taken more prominence, or been so important, in public debate.

Decisions to introduce a national carbon emissions trading scheme to correct for the environmental impacts of market failure, or to borrow substantially in an attempt to stave off recession, nationalise private debt or cushion corporate failure, are huge decisions that will impact for a long time to come. But these are real examples of decisions being taken by governments in response to the current circumstances

Who should we blame for this emerging calamity? Should we blame the so-called modern developments in financial reporting standards that have not only encouraged, but in many respects required the declaration of rising speculative asset and profit values as current balance sheet strengths? Or should we blame the unchecked permission of a relative few at the core of the financial world that are responsible for inventing (and I don't use this term lightly) new synthetic financial products that took high risk debt and blended it with other debt products to the point it was essentially unrecognisable to the hapless institutional and other purchasers? Or should we blame the basic naivety of those many, many millions of borrowers who got into property and other investments on the back of easy to obtain debt and the misguided belief that the market can only go one way –up!

The reality is there was no single cause of the present financial calamity because it was a toxic brew of risk taking; poorly understood (and in many cases both over and under) regulation; and the expectations of communities based on the belief that that the risks of gaining potentially high rewards either didn't apply to the activities in which they engaged – or moreover, didn't apply to them at all!

Now, I wouldn't for a moment suggest that we don't want active risk takers – indeed the world would be a boring stagnant place without them. On the other hand, while we wouldn't want everyone who thinks they can drive to be behind the wheel of a racing car, nor would we want everyone who thinks they can take risks to be gearing themselves to the eyeballs to become speculators in the market.

We don't want this for two fundamental reasons - one reason is that there's a good chance they are poor at assessing the value of their investment and could very likely find themselves in a position of financial default. This has implications beyond the individual. The other reason is that their misguided efforts will tend to unnecessarily drive up asset prices – which of course could have been good if you were a Packer, but not a Bond!!

Some of you may have been aware that the noted American author and humourist P J O'Rourke was recently in Australia to give an annual

lecture at the Centre for Independent Studies (in Sydney). I like Patrick O'Rourke, not just because of his humour and wit, but more so because of his command of economic history.

While he was here he contributed several editorial pieces, one of which I would like to quote from that appeared in *The Australian*. O'Rourke chose writings from Adam Smith's *Wealth of Nations* as the basis for his take on the global financial crisis and I think amongst the various points he did raise, there was one in particular that is worth noting. "Smith" he said, "spotted the cause of our financial disaster 232 years before 2008." "A dwelling house as such Smith wrote in the *Wealth of Nations* in 1776, "contributes nothing to the revenue of its inhabitant." Smith, he said, went on to point out that this were true even if the house were rented "as the house itself can produce nothing, the tenant must always pay the rent out of some other revenue." So Smith concluded that the revenue of the whole body of the people can never be in the smallest degree increased" by what O'Rourke referred to as "a tacky bunch of ugly condominiums and housing developments Voila! he says "subprime meltdown."

I will return to this point later, but while wry and amusing, it does in my mind highlight one of the fundamental challenges of the state of the world economic circumstance and outlook. On the one hand we were

involuntarily driven to this in part through the sad miss-beliefs of the American dream for all and any to own their own home, this acting eventually as a catalyst for events to bring down a highly unstable financial system. However, on the other hand, like it or not, we await the recovery of the American economy from those very same households up, to generate the process across many international economies that will lead to the turnaround on a road to global recovery.

Now whether you believe that what has happened is the result of a breakdown in the institutional and other roles played within our communities, a breakdown in our regulatory and governance arrangements, a breakdown in our collective commonsense, or simply a breakdown in the way free-markets should work – this, for the point of our discussion today, is largely irrelevant.

But an important point to take from what I have just described is this - in no small way, the behaviour of the individual has been reflected in the behaviour of many organisations. In this regard, we can unfortunately include the senior management and boardrooms of some of the largest – or I should say what were the largest private banking and other financial institutions in the world. And while it is not necessarily a bad thing each time a business goes under or is taken over, when they are of the size and significance of a Lehmann Bros, the waves from such a fall-out do not

subsidiaries close to the epicentre of the corporate collapse. For these institutions, whether we like it or not, have grown to a size and have a reach into so many other industries and businesses that lie well beyond their own national borders.

In this regard they can, in effect, be seen as if they are an integral part of the financial system itself. In other words, the failure of them can be commercially and financially catastrophic. This is what we refer to as systemic failure and this is what makes the present crisis so different from others in past decades; that instantaneous fallout of equal, or maybe even in relative terms greater magnitude, in what would otherwise seem a remote independent market.

The result of these collapses has washed through financial markets and stock markets generally, sending confidence plummeting and sapping markets of the healthy amount of risk we need to turn a dollar into three (as they say). This has been felt from the smallest investors such as self-funded retirees, all the way through to some of the largest individual and institutional investors. The impact on confidence everywhere is widely acknowledged as central to the second and third-round impacts, not only in the corporate sector, but in the broader community more generally. Restoration of confidence will, therefore, also be key to these events turning around. The \$64K question now though is - how badly and

widespread has confidence been dented and how long it will take households, business and the financial markets to once again feel confident to take risk?

You shouldn't be surprised to hear that Treasury has been focusing a lot of its time this year on where we think the next impact might emerge; what effect it might have on government revenues; what policy responses (if any) could be employed to either soften or avert the effect; and how this might impact investment and employment in our local state economy.

At the same time, you should be heartened to learn that we don't just sit there discussing these things amongst ourselves – in fact we have put considerably more effort this year into consulting with other organisations than ever before, this including other Treasuries, economic forecasters and analysts and some of our major financial institutions.

The fact that we find ourselves in such a largely unprecedented set of circumstances is extremely unfortunate, not the least because we are faced with such widely differing opinions on: (1) what the extent of the impact in Australia is now; (2) what the extent of the impact might be at its worst; (3) how long things will remain bad; and (4) to what extent we can expect a recovery when things finally do start to get better. Just about every conceivable position and proposition is reflected in someone's opinion and they all seem to be constantly changing – pretty

much daily! However, sifting through all of this using our own experience and judgement (based in no small way on imperfect and delayed information) and to the extent that we reasonably can, using our own quantitative work, is our task at-hand in the lead up to the next Budget presentation in just a few weeks time.

Late last week we had a visit from the senior economist of the Commonwealth Bank of Australia, who brought with him an impressive array of charts – several hundred in fact – in the form of snapshot indicators. These I found to be very useful and quite enlightening. However, to me one of the most enlightening indicators amongst them all was a bar chart based on IMF projections of potential financial write-downs across the global financial sector. Measured in US dollars, the total estimated potential write-downs amount to a staggering \$4.1 trillion. Now for most of us this sounds like a lot of money – and don't get me wrong here, even as a senior Treasury officer I think so too – but it is difficult to gauge the relative size of these losses without some measure as to either what the total market is worth, or alternatively how far we have managed to chew through this unenviable task so far, particularly in the context of what we already see as the results of the crisis to date.

It is estimated that the write-downs that have been announced to date total \$1.3 trillion – in other words, so far we have only seen about 1/3rd of the

possible financial losses in the system brought to account. Now obviously it may not turn out to be the case for one reason or another that the whole of the potential amount of losses is actually realised as such, and even if most of it is realised as a loss this may occur over a much longer period than was the case for the 1/3rd already announced - but it does go to highlight the magnitude of the risks that still sit out there and it could suggest that the financial institutions will for some time remain overly risk averse in terms of their lending to each other, which has of course been a key factor in why liquidity in the markets has decreased so quickly and dramatically.

So what does all of this mean for the national economy and more particularly the Tasmanian economy? Well I wouldn't go so far as to say "*it's anyone's guess*" (as tempting as that may be), but I will attempt to give you some context and idea as to what we are thinking in order to answer this question.

Firstly, the slowing in advanced economies at least was initially concentrated in the housing and financial sectors, but the collapse of Lehman Brothers in September 2008 was pivotal in broadening the economic slowdown. World growth is now expected to decline substantially below levels experienced in the past global recessions of the early 1980s and 1990s.

For Australia, the impacts have to date been somewhat muted compared to many of our trading partners. The most direct impacts have been through severe contractions in our export markets, the mining sector probably being the worst hit, with the effects most felt as a result of the rapid drying up of demand for our mining exports to China in particular. Now to some extent the falling exchange rate has acted as a hedge against declining demand for exports, but this of course will have varying effects across industry sectors.

The other main impact on Australia has been through the severe contraction in liquidity, which has squeezed bank margins and made it harder for those that have the confidence to invest in these turbulent times to do so.

In an overall sense however, China remains one of the single biggest influences on the likelihood and timing of a solid recovery for Australia and while I don't have time to look at all our trading partner issues, I will focus on China for this obvious reason.

It is also important to recognise that recovery in China's export markets (amongst which the US is key) is in turn going to be heavily influential in the recovery of China itself. This is not of course to say that domestic demand in China is unimportant – particularly as it relates to the construction industry. In 1992, investment in fixed assets in China

comprised just under 40% of GDP, with about one quarter of that relating to construction. As incomes and standards of living in China have increased over that period, so too has the role of the construction industry, to the point where last year investment in fixed assets constituted just under half of China's GDP, and half of that related to construction. That's almost a doubling of the contribution to GDP of the construction industry. Therefore, property construction now plays a role nearly equally as important to the one played by the Chinese Government's direct investment in public infrastructure.

There are effectively two expectations as to how China will handle its rapid slowdown in growth from a rate, which approached 13% in fiscal 2007, to something close to 6% this year (which in Chinese terms is a pretty stagnant economy). One expectation centres on the role of the government in using its massive financial surpluses to stimulate the domestic economy, with an eye to supporting the construction sector in particular, but having little regard in the near-term to its export sector.

The other expectation has China suffering a similar fate to that of the US after the onset of the Great Depression, in which a hugely export geared and focused economy is suddenly faced with substantial overcapacity, rapidly rising unemployment and a complete inability of domestic consumption to fill the void. As we well know, this led to more than

several years of painful adjustment, not just for the US, but its major trading partners as well. You have all already no doubt heard the news reports of millions of lay-offs in China, forcing many who had fled their rural existence to the major regional centres and cities, only now to retrace their steps in response to the grim reality of a plummeting demand for labour.

After almost two decades of phenomenal growth, it is likely that the Chinese government will be keenly aware of the potential for civil and political unrest should recession type circumstances worsen and linger. It is probably a telling sign then that the government has responded to these circumstances with massive fiscal stimulus measures of its own.

Some analysts are now beginning to suggest that the worst is over though. The dramatic plunge in exports from China seems to have been arrested; crude steel production has now begun to increase again (even if only slightly); the growth in newly started projects is once again positive and financial institution loans look to be in the early stages of recovery. Of course how the recovery is spread across China will also matter, with the relatively 'rich' coastal areas having suffered the most, along with the southern province of Guangdong – the heart of China's export manufacturing activity.

But the government seems to be focusing a lot of its stimulus effort on some of the less fortunate regions that, before the onset of the current crisis, were relatively worse off than the previously rapid growth areas I just mentioned. Furthermore, it is still unknown to what extent ‘crowding out’ of private sector activity will occur due to the substantial government spending which is driving its stimulus efforts.

These are all factors that will impact the prospects of a global recovery generally, but there are indications that even a modest recovery in domestic demand in China will benefit Australia more than it may do other countries. This is in large part because about 80% of Australian exports to China are estimated to remain in China. Together with the fact that our domestic financial sector has proven to be more robust than those of other countries (in particular the US and Europe), this could, therefore, highlight why Australia would be seen as a relatively safe place to have been when the crisis hit last year.

On a final note with respect to the national economy, the issue of job security will continue to hang over a relatively large proportion of the population, as unemployment is expected to rise to a peak of between 8-10%, depending on whose prediction you lean towards. We know that this impact has already been spread well beyond the financial sector as the cancelation and deferral of major capex projects in Australia

continues to unfold. The impact has been felt through the loss of skilled and semi-skilled jobs. However, with a concerted effort by all governments in Australia to not only maintain, but bring forward their infrastructure spending, this should offer the prospect of an easing for rising unemployment in the construction sector at least, with some flow-on effects to other sectors.

The Tasmanian economy has experienced very strong growth over the past few years, led by consumption and more recently private and public investment, thus resulting in very strong employment growth. However, Tasmania cannot be expected to remain immune to the deteriorating national and international conditions. The impacts of evaporating confidence will no doubt be felt here as they have been elsewhere, but the extent to which this is occurring is still difficult to determine. This is why the business and consumer confidence surveys offer important insight. They give us a 'feel' for the mood of the business and household communities – that all important ingredient of human behaviour I referred to earlier.

As a small open economy, Tasmania is dependent on international export markets and the performance of the national economy. How Tasmania will be affected has been difficult to anticipate, though to date the direct impacts have generally been industry specific rather than economy-wide.

The mining and manufacturing industries have been among the first to be affected, due to falling international demand and falling commodity prices. Some forward indicators of activity have also shown an easing in recent times and it is likely that these will deteriorate further in coming months.

Somewhat surprisingly, the residential property sector has experienced price maintenance in the lower price to upper-middle price brackets (at least until very recently), even in the face of a substantial decline in turnover, that commenced around this time last year, but 'bottomed-out' towards the end of calendar 2008. Most of the activity in the past 6-8 months, however, has been in the first-home-buyer segment of the market. This has tended to support prices in the mid-range of the market, but hasn't to date trickled through to the upper end of the market. Of significant consequence is the fact we have had stable house prices, because this means that with increasing or even stable incomes, affordability is not getting worse. At the same time, Tasmanians have been spared the negative wealth effects of falling house prices experienced elsewhere. This will help to underpin consumer spending.

The outlook for employment has weakened though, following strong trends through all of calendar 2008. Lead indicators of employment, such as the ANZ employment advertisements series, are now falling and it is

only in recent months that we have seen the effects of industry and export contraction really beginning to show a marked effect. ABS data on the labour market in Tasmania show a general softening in employment, together with an increasing shift away from full-time employment to part-time employment. A complete reverse of the trend Tasmania has experienced over the past 6-8 years.

Finance approvals have reduced significantly at the national level, and have also begun to decline at the state level. This reflects a tightening of available credit and reduced commercial profitability. This is one area that could possibly work to suppress a recovery in confidence and the much needed re-emergence of what I would refer to as 'sensible risk taking'. The increase in private levels of investment over the 5 years to last year have been key to driving the transformation of the Tasmanian economy, and to lose this momentum now could result in a stalling of economic activity beyond what government expenditure might otherwise seek to offset. As I said earlier, a dramatic loss of confidence was in many respects responsible for the rapidity and breadth of the financial crisis, which in turn has had an almost unprecedented impact on what is generally being referred to as the 'real economy'.

Merchandise exports have plateaued at the state level, just as they have at the national level. As is the case with most trade globally, the outlook for

Tasmanian exports is weak for the short-term, as all of Tasmania's major trading partners are facing, or are in, a major economic slowdown.

In fact the growth of Tasmania's major trading partners is projected to remain very low. Even if several of them are anticipated to have recovered somewhat in fiscal 2010 from the zero or negative growth rates they will experience in fiscal 2009. This is consistent with World Bank and OECD expectations of continuing large contractions in the volume of world trade. Therefore, these factors will undoubtedly continue to place downward pressure on Tasmania's exports for the time being.

There has also been a marked decline in building work yet to be done in Tasmania, which has been predominately driven by a reduction in non-residential work. This is of concern in so far as it relates directly to the issue of confidence and private investment.

Although Tasmania's economic performance has to date remained resilient, even as the national economy has exhibited a marked slowdown, it is vulnerable and there remains down-side risk and uncertainty surrounding the short and medium-term outlook.

It is not surprising to us at Treasury that the effects of these crises have been slower to hit Tasmania than elsewhere. If you look at past experience, which we have done, you will find that the typical lag in

Tasmania feeling the effects of a recession or downturn is between 6-12 months. The same has often been the case for the recovery period, although this is a little harder to gauge in general terms, because each instance of recovery has had influences that to some degree were particular to the national economy, the nature of the downturn and the state of the Tasmanian economy at that time. What, we can say with some confidence though, is that the impacts of global and national events will flow through to Tasmania, and economic growth in 2009-10 is likely to be appreciably lower than it will finish up being in 2008-09.

I would caution to add though that the fundamentals of the Tasmanian economy remain sound for the long-term and when I say appreciably lower economic performance I don't mean that the state will suddenly go into reverse gear or contract - experiencing massive unemployment, and a major flight to the mainland of capital and skilled labour. However, while we will not escape some impacts, we can remain confident of being relatively better off than many small regional economies in other parts of the world and even Australia for that matter.

What we can also say is, that unlike WA and Qld that are heavily dependent on their mining sectors for good fortune, Tasmania has a relatively more diversified economic base, with local consumption, exports to the rest of Australia and international exports all with a

substantive role to play in taking up our production – this will act as a sort of natural hedge as we won't be totally reliant on the performance of any one of these alone for recovery.

Summary

In closing, let me say that what has gone on throughout the world since mid-2008 could be argued to be a major correction that was long overdue. The factors at play have been many and varied.

Australia, and indeed Tasmania, are both well clear in geographic terms, but have essentially been drawn in to these unfolding events through the misfortune of our trading partners, together with the effects of a severe contraction of liquidity and confidence in financial markets.

Tasmania can not expect to continue to enjoy the strong growth in economic performance it has experienced in the past 5 years in particular. But, it is difficult to see how the state could now start going backwards, although this is not to say things won't be subdued for a year or so.

To a large extent, however, we are dependent on the emergence of recovery elsewhere. This is true for the mining sector as much, if not more, than for any other industry sector. Tasmania's mining sector is somewhat different in its make-up to those heavily focused on bulk ferrous metal exports, so our experience will differ from some of the

national stories you may read. Our main trading partners (next to mainland Australia) are: Japan; Korea; China and Hong Kong, which are all close to, if not already experiencing, their own forms of recession.

For the mining industry, local conditions matter a lot in terms of costs and skilled labour availability – these have little to do with the demand for your product. I am aware that activity in the industry here is sending signals of both confidence (through both active and planned investment and expansion) and contraction – this must mean that there are both threats and opportunities visible on the near horizon. You of course are best placed to make that judgement.

Thank you.