Treasury set for wrong crisis

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POLICYMAKERS worldwide have been bracing for a new global financial crisis spinning out of Europe for the past six months.

The coming crisis would primarily hit the financial sector, Treasury secretary Martin Parkinson told a Senate estimates committee last week.

The exact course was hard to predict, but a Greek default and that country's forced departure from the eurozone could be highly disruptive and "clog up" global financial markets.

Australia was much better prepared to tackle this crisis than it was the one that followed the collapse of Lehman Brothers in 2008, Parkinson argued, because banks have greatly reduced their dependence on global wholesale markets and their supervision is much tighter. He envisaged a global banking crisis that Australia could manage because of the prudential strength of our financial system, backed by a central bank able to cut rates and a government with the budget strength to provide stimulus if necessary.

The crisis that Treasury is preparing for may yet transpire, but it needs to focus on the one occurring right now as demand ebbs from the global economy.

The global growth outlook has deteriorated since the budget was handed down a month ago. The budget papers say: "Global economic growth is expected to improve over the forecast horizon, driven by the US and emerging Asia, particularly China." But this does not tally with the figures that have emerged in the past four weeks, showing a slowdown in China, the US, India and Brazil and a deeper recession in Europe.

The crisis you prepare for is never exactly the crisis you have. When, in the mid-2000s, Treasury war-gamed a recession and looked at what it had done wrong in the early-1990s, one of its conclusions was that it was too slow to recognise the extent of the downturn. It had clung to its forecasts showing a return to normal conditions over the year ahead in the face of data showing something quite unusual was going on. The lesson Treasury drew was that when the numbers look bad, they probably are. But the events of 2008 were so dramatic, with world financial markets freezing within two weeks of the collapse of Lehman, that it was obvious a global downturn was imminent.

A Greek default or the failure of a Spanish bond auction could yet cause a similar panic. Treasury's figuring is that it would not be as bad. Sovereign debt does not have the opacity of the derivatives based on sub-prime mortgages which corroded trust in 2008-9 and the world, like Australia, has strengthened banking supervision since then.

The normal market measures of financial market stress, such as the American VIX index that measures share price volatility or blowouts in bank funding costs, are not at extreme levels. They are not behaving as if the world economy were toppling at the edge of a precipice, about to be thrust into the void by events in Europe. Instead, the big moves in markets over the past month -- the heavy fall in world sharemarkets and the drop in government borrowing costs to record lows -- reveal a loss of confidence in the growth outlook. In the absence of dramatic events, the turning points in an economy cannot be identified with certainty until many months afterwards.

It was not until September 2010 that the official US National Bureau of Economic Research felt sufficiently confident to say the low point in the crisis was reached in June 2009. It is hard to gauge the economic temperature in real-time, but policymakers do not have the luxury of waiting until all the evidence is in.

What appears to be under way is a fall in global demand. The emerging nations that led the world economy out of the darkness of the 2008-9 downturn are suffering this time. Europe is the heart of the problem but growth is slowing everywhere.

Wayne Swan has been providing reassurance that the budget forecasts are not threatened by the adverse turn of events. The Treasurer notes that his department's forecasts for both Europe and the US were a lot more pessimistic than those of the International Monetary Fund. Swan suggests that the budget already provided for the downturn we are now witnessing.

However, Treasury's global growth forecast of 3.5 per cent this year rising to 4 per cent by 2013 was identical to that released by the International Monetary Fund in April. It is the downgrading of global growth since then that is the biggest threat to the budget.

The IMF defines a world recession as global growth falling below 3 per cent. The run of bad data to which markets are reacting suggests the world economy is heading for recession already and likely to remain there. The lesson Treasury drew from the 1990s recession may not have been of great value in 2008, but it is relevant now.

Parkinson tried last week to engender confidence in the economic control-room, saying Australia possessed "all the instruments" it needed to deal with the crisis it believed was in prospect. "We actually do have very extensive capacity in all of those instruments." For the financial crisis he is anticipating, he is confident that regulators would be able to secure the banking system in the event that access to global funding were suspended while preserving public confidence.

But for the economic slowdown on our doorstep now, the options are a lot more limited. The fall in the dollar, which can go further, will be a great help. The Reserve Bank has another 3.5 per cent of rate cuts before it hits zero.

The government should not fight to preserve its promised surplus in the face of sinking revenue, but it no longer has the latitude with financial markets or with the public to repeat the extravagant fiscal intervention of 2008-9.

And the Treasurer needs to be more candid about the emerging risks to the budget outlook.