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The Treasury and the Global Financial Crisis (A)

Into the maelstrom

"Ken, should I take my money out of the bank?"

"There's no need for that Mum. Australia's banks are among the best of the best in the world. They are firmly regulated, and have not taken any inappropriate risks."

"Well that is as it may be, but all my neighbours and friends are taking their money out all the same."

When Ken Henry, the Secretary of Australia's federal Department of Treasury, had this phone conversation with his mother shortly after the collapse of US financial giant Lehman Brothers in September 2008, it quaintly confirmed what he and his colleagues had begun to fear for some time. Despite the solidity of its own economic fundamentals, Australia was going to be significantly affected by the fallout from the meltdown of the US financial system that had been building momentum throughout the year.

As early as September 2007, Great Britain had experienced a bank run (on Northern Rock) followed by an expensive government bailout. Since then, one after the other, major US financial powerhouses had come under the gun because of their exposure to "bad debts". Some, like Bear Stearns, were bailed out when the US Government arranged a sale to a stronger financial institution. But when Lehman Brothers came to the brink, US financial authorities let it go under, sending major shock waves through global financial markets. Now governments and financial institutions around the world were sounding the alarm. Ordinary citizens like Ken's mother were reading the writing on the wall – and beginning to act on it,

This case was prepared for ANZSOG solely for teaching purposes by Professors Paul 't Hart and John Wanna (both Australian National University) . They were given access to Treasury documents and held eight semi-structured interviews with key Treasury officials. However, the views expressed in this case are exclusively the responsibility of the authors, and do not necessarily reflect those of the Department.

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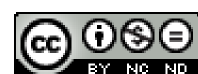

as data on ATM withdrawals and other major money movements were indicating, even in Australia.

Where would the developing cycle of fear, distrust and decline next manifest itself? What casualties would it claim along the way? And what should the Treasury, along with the other members of the Council of Financial Regulators (the RBA – the Reserve Bank of Australia led by Glenn Stevens; APRA – the Australian Prudential Regulation Authority led by John Laker; and ASIC – the Australian Securities and Investments Commission chaired by Tony D'Aloisio), advise the Government to do, to minimise the effects on the Australian economy of the now truly global economic turbulence?

A powerful central agency

The Australian Treasury department, located in the centre of Canberra's parliamentary triangle, was one of Australia's most respected government departments – a powerful central agency with a wide range of policy responsibilities, a reputation for solid if sometimes uncompromising analytical advice, and significant public credibility. It was able to recruit the brightest analytic minds and public policy "wonks". The Treasury commented and provided advice on almost every policy and Cabinet submission emanating from Commonwealth government departments. Its potential influence was formidable. Its key role in the transformation of Australia's economic architecture, initiated in 1983 by the Hawke-Keating government, has been widely noted and for the most part lauded.

The Treasury had not always enjoyed unqualified success. However, the new Rudd Labor Government (elected in late 2007) seemed more inclined to engage with the Department through its Treasurer, Wayne Swan, and its Strategic Priorities and Budget Committee (comprised of the Prime Minister Kevin Rudd, Deputy Prime Minister Julia Gillard, Swan and Finance Minister Lindsay Tanner). When the global financial crisis escalated in October 2008 and Australia was facing the prospect of recession, the Government knew that the Treasury had "form" when it came to managing major economic downturns. It had not performed well during the last big recession Australia faced in the early 1990s. This time around, it could not afford to drop the ball once more.

As clouds were gathering over the national economy in 1990, the Treasury believed that the automatic stabilisers (government expenditures which increase automatically in a recession and decrease automatically in a boom) and monetary policy would "cut in", and that not much else needed to be done. That judgment turned out to be wrong. Economic doctrine seemed to have been driving the nature (and timing) of the Treasury's advice. With this "hands-off" mindset, the eventual policy response was too late.

When the Hawke Government sought Treasury advice on how it should act in policy terms to combat what Paul Keating famously called the "recession we had to have", the department chose to sit on its hands. Later when the Treasury did proffer advice, it found it had little traction or influence. This meant, as one Treasury official observed, that "Treasury was not part of the conversation and the government didn't pay much attention to what we said."[1]

Australia had ridden out the Asian financial crisis of the late 1990s – the next major economic shock – without major difficulties. It had also navigated through the collapse of

[1] Unless otherwise noted, quotes of Treasury officials in this case study are taken from interviews conducted by the authors during November 2010.

one of its insurance giants (HIH) in 2001, with the 2003 Royal Commission report into the affair driving home the need for proactive and comprehensive regulation of the financial services industry. This had, among other things, resulted in the reorganisation of APRA and the formation of the Council of Financial Regulators.

Still, Ken Henry, who had become Secretary in April 2001, was determined not to allow the fiasco of 1990-2 to happen again – especially if an Asian financial crisis or some other destabilisation of the system was to recur. If the world was going to be hit in 2008 by a global recession leading to a further bout of high unemployment, the Treasury was going to be better prepared. Over the years, the department adopted a four-stage systemic *modus operandi* it hoped would guide its navigation through the global financial crisis and provide rigor to its analysis and advice. These stages were both sequential and iterative. They were:

- **Diagnosis** – have the capacity to provide fast yet authoritative interpretations and sensible prognoses of unexpected, unwanted, uncertain economic developments;
- **Advice** – be prepared and able to offer sound decisions to inform government policy;
- **Communication** – be able to explain the situation to ministers, parliament, other departments, markets, and business stakeholders and even communicate directly with the community;
- **Delivery** – legislate for the necessary policy responses and support provisions, including considerations of feasible exit strategies.

Now, in the last quarter of 2008, the Treasury would have to do all of these at lightning speed and in unprecedented conditions, helping a still inexperienced government navigate the greatest economic conflagration the world had seen since the Depression of the 1930s. Would the department be up to the challenges this was likely to pose?

Learning from failure: building preparedness

By the early 2000s some Treasury senior executives had become worried that corporate memory was deficient. Only a few veterans left in the department had experienced an economic recession. To avoid being caught out when a downturn came along, they decided to undertake some "war-gaming" of economic shocks. This was reinforced by similar what-if risk management exercises undertaken in the Council of Financial Regulators (CFR) in 2004 and the International Monetary Fund in 2006. The collapse of HIH in 2001 and the forced nationalisation of the UK's Northern Rock bank in 2007 brought home the importance of doing further work on the direct and indirect exposure of Australian banks to financial instruments that relied upon US sub-prime mortgages.

These anticipatory and preparatory exercises were undertaken discreetly. They mostly involved the senior echelons of the Treasury, and in some cases, their counterparts in the financial regulators. Several mock economic crisis scenarios were run, challenging officials to spot and react to a sudden economic deterioration and the massive uncertainty it would generate in and beyond the markets. Most of these "abstract" exercises modelled a sudden severe recession in the "real economy" that increased unemployment dramatically. Other tests were then run on the effects on various sectors and on the medium-term fiscal position of the Budget. These simulations also tried to test the degree to which a major macro-economic downturn would affect the profitability of the banks (apparently none of the examined scenarios threatened the solvency of any of the major banks). The main worries emerging from the exercises were sudden lay-offs, a surge in unemployment, the cost to the

Budget and the long-term effects of getting (or not getting) those thrown out of work back into the workforce.

These contingency exercises proved useful in raising the mental preparedness of the Executive Board of the department. They also helped cement relations between key people in Australia's four main regulatory bodies represented in the Council of Financial Regulators. At the same time, none of the specific scenarios that were modelled – mainly economic slowdowns in the "real economy" and collapses of single institutions, rather than systemic financial instability and the world-wide credit freezes that were the result of it – resembled what Australia would face in late 2008.

Early signs that not all was well

At the change of government in November 2007 there had been early signs that all was not well, though – as Treasurers do – Swan began his tenure by publicly talking up the underlying strength of the Australian economy and its banking system. Behind the scenes however, the new Prime Minister in particular was anxious to know of the depth and magnitude of risks Australia faced.

On 29 February 2008, Kevin Rudd invited Ken Henry at short notice to accompany him on a flight to Gladstone specifically to discuss "what might go wrong". He wanted to know how a global financial crisis might affect Australia. At the time, Henry said he was not entirely sure since the dimensions of any looming crisis were unknown. There was a chance a serious financial meltdown might occur but its likelihood seemed limited. Treasury would need to undertake specific research and modelling to investigate the strength of the financial markets. He nevertheless took Rudd through a range of possible responses to a number of bad weather scenarios. The options included using the current strong fiscal balance sheet to provide economic stimulus; ways to ensure wholesale lending in financial markets; and the use of a planned financial claims scheme which could help mop up after the collapse of particular financial institutions. It was the first of innumerable conversations Treasury's top executives were to have with the Prime Minister and Treasurer about how global markets were tracking and what Australia could do to protect itself.

When the US sub-prime mortgage sector began to collapse, it raised broader concerns about the US financial sector and economic prospects, but the general feeling was that it was a small part of the US financial system and the fallout would be contained. These concerns were relayed to Canberra in regular reporting. Concerns grew in early 2008, intensifying with the collapse of Bear Stearns, which was a precursor to the broader financial crisis that emerged in the following months.

Steve Morling was the Economic Counsellor to the Australian Embassy based in Washington. Morling was conscious that there was an emerging disconnect between the outlook for Australia and for the US. The Reserve Bank had increased interest rates in February 2008 and again in March 2008 in response to strong economic growth, rising terms of trade, and building inflationary pressures in Australia, but the US economy was already weak and financial conditions were deteriorating.

Both Treasury and the Reserve Bank were aware of the developments in the US, but as conditions worsened Morling became increasingly concerned about the risks around the US outlook, and the implications for Australia. With Australia's economy still performing strongly, it was difficult to fully appreciate the sense of gloom that was building in the US.

The reporting was cranked up as conditions deteriorated and by the time of the crisis in September reports were going back on a daily basis. Morling reported that several institutions were close to collapse and as each domino toppled more were added to the list. Morling also reported on concerns for the broader banking system, which was becoming increasingly stressed. The key development was the Federal Reserve's decision to let Lehman Bros go to the wall. This calculated gamble came as a major shock. Markets went wild and the financial sector effectively froze credit.

Treasurer Swan and Secretary Henry had visited the US earlier in the year. In discussions with a range of financial market participants and regulators they had an early taste of what was to come. Swan's next visit to the US in October 2008, confirmed his worst fears. The financial crisis was in full swing and the prognosis was poor. Things were so bad that there was no way Australia would be spared.

From disjointed to coordinated policy

As the financial crisis loomed, Australia's four financial regulators needed to coordinate their actions and utterances. APRA, ASIC, the Reserve Bank and the Treasury were already talking to each other regularly through the Council of Financial Regulators platform as well as in other constellations. Nevertheless, during 2007 and early 2008, monetary policy and fiscal policy were partly working against each other, reflecting the "countervailing forces," as the Government described the events impacting the Australian economy. The Reserve Bank was worried about rising inflation and excessive government spending or tax cuts which would serve to stimulate higher inflation. The Bank was raising interest rates to put a brake on economic activity. Meanwhile the Government was increasing spending.

The Howard Government had been giving almost annual tax cuts, while also accumulating significant budgetary surpluses. The then Treasurer Peter Costello had announced at the outset of the hard-fought 2007 election campaign that the Coalition would deliver $43 billion in tax cuts over the next three years if re-elected. With its new leader Kevin Rudd having touted his credentials as a "fiscal conservative" in the campaign, the Labor Government elected in November 2007 adopted most of the package, adjusting it only on the margins. A substantial tranche of these commitments was to be implemented in the 2008-09 Budget.

The Reserve Bank was still tightening monetary policy in March 2008, and the Federal Budget, brought down in May 2008, was mildly contractionary. The Australian Prudential Regulatory Authority meanwhile was confident it had a robust prudential regulatory framework covering the banks, non-banking institutions and the superannuation funds. Nevertheless APRA was preparing for the possible collapse of one or more institutions by finalising its Financial Claims Scheme.

Monitoring the growing crisis in the winter of 2008 saw the Council of Financial Regulators take a more coordinated stance. They were meeting regularly and emailing each other about what concerted action to take to maintain public confidence in the solidity of the economy and its key institutions. The Reserve Bank set the tone. Breaking with a long series of interest rate rises designed to cool an overheating economy, in early September 2008 it announced a cut of 25 basis points (1/4 percent). Later that month, the four regulators signed a memorandum of understanding on financial distress management. It established the principles for decision-making, the various responsibilities for each of the four regulators, detection strategies for financial stress, and a commitment to a "coordination of response" including communication.

Crisis: the Lehman Brothers collapse

Two weeks later, Lehman Brothers collapsed. There was the equivalent of a bank run on the money market mutual funds, which frequently invest in commercial paper issued by corporations to fund their operations and payrolls. In the US alone, withdrawal from money markets amounted to U$144.5 billion during one week, compared to U$7.1 billion the week prior. This interrupted the ability of corporations to "rollover" (replace) their short-term debt. In a dramatic meeting on 18 September 2008, US Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke met with key legislators to propose a U$700 billion emergency bailout. Bernanke reportedly told them: "If we don't do this, we may not have an economy on Monday."

The ripple effect of the Lehman crash was instant and global. Neither the Australian share market nor the value of the Australian dollar was spared. Treasury knew the Reserve Bank was going to make a substantial cut as the crisis deepened but thought that it would be of the order of 50 basis points (0.5%). However, given the rapidly deteriorating global situation, Bank Governor Glenn Stevens decided to propose a cut twice this size to underscore the point. The Treasury's David Gruen, who filled in for Henry at the Reserve Bank board meeting where the decision was made, agreed with and supported the case for the bigger cut.

The massive rate cut indicated that the Reserve Bank too had now shifted its frame towards managing a prospective economic downturn. It sent a clear message to local and global markets. Australia became the first country to make such a large cut in interest rates. It had the scope to do so with domestic interest rates sitting at seven percent, high by world standards at the time. Other central banks in other countries followed suit in a concerted effort to provide a circuit-breaker, but they had considerably less room to manoeuvre.

Combating collective fear

During the October long weekend that followed the rate cut, Australia's economic policymakers had to face a stark reality. Hysteria was a real possibility unless the government, the banks, businesses, consumers and depositors held their nerve and reaffirmed confidence in the system.

Henry's mother asking her son for advice on whether she also should withdraw her savings to safeguard them helped him realise the fragile psychology of community confidence in the market system. In parallel, Henry and his colleagues were hearing stories of businessmen going to banks with suitcases asking to withdraw millions in cash at short notice, and of security firms such as Armaguard and Chubb putting on second shifts to move the additional amounts of cash needed to keep banks and ATMs going. Cash withdrawals were going through the roof: A$5 billion was withdrawn in a few weeks. However impressionistic these signs were, they were significant in steeling the resolve of Treasury's top team. Perhaps more than the analytical data generated by the department's various policy divisions, these signals underscored the turbulence of the times. Suddenly, not a single bank or other financial institution could be allowed to collapse because of the knock-on effect to systematic confidence. In effect, *each* institution had now become "too important to fail".

Like the Reserve Bank, the Government had to act to ease growing market nervousness. As one official observed,

> "Any financial system works on confidence. And confidence is fragile. It all works on confidence. So this place [the Treasury] is a place where you give confidence back to the minister."

All participants felt a great sense of urgency in a context of world-wide market panic and government responses to stem the flow. Treasury Secretary Ken Henry was all for decisive action by the Reserve Bank:

> "As soon as you sense that there is a confidence issue, you've got to wrap the whole thing in a blanket…We realised that in the current climate, not a single APRA-regulated institution could be allowed to go under, precisely because of the impact this would have on the psychology of market confidence."

Or, in the more prosaic words of another Treasury executive: "Everyone knew time was of the essence. You had to whack before the market would open on the Monday."

In this spirit, key decisions were made quickly. First the government curbed speculative behaviour by announcing that "short-selling" (selling stocks you don't own until the price drops and then buying them back at the cheaper price) would not be permitted on local money markets as this was exacerbating the crisis. Secondly, following the Irish government's unilateral decision to guarantee bank deposits, the Rudd government issued a similar guarantee on savings deposits up to a total of $1 million. Thirdly, it applied a similar guarantee to wholesale funds for the banking and non-banking sectors. These latter moves in effect secured funds for both customers and the financial institutions.

Whilst made in the heat of the moment and with a clear national interest perspective in mind, this was also the first instance in which political considerations found their way into the crisis response process. While the Treasury had been considering a savings deposit guarantee, a political auction developed. The Opposition leader claimed it should be $100,000. The Government then chose to respond by going to all the way up to $1 million because the Prime Minister did not want to face questions about why the guarantee would not cover nearly everyone except for the very rich (with savings of much more than $100,000) who would stand to lose disproportionately in case of a bank failure.

'Getting ahead of the wave': the first stimulus package

Boosting confidence in the financial system was only part of the equation. The other big part of the October long weekend discussions was to do what had been unthinkable just three months before: boost aggregate demand in an economy that was at severe risk of sliding straight from potential inflation into potential recession mode.

Treasury had been quietly assessing the efficacy of various domestic fiscal stimulus instruments, comparing the economic benefits of tax cuts, direct payments, and infrastructure spending. It had calculated which worked best, and which quickest. It had also pondered which mix of these instruments might work better.

By now, the department's Executive Board, in normal times no stranger to robust debate, had started to "hunt as a pack", as one interviewee put it. Another observed:

> "You fall back on trust among colleagues: there wasn't really the opportunity to come to a view before going to see the Treasurer. He sometimes got to see some of us putting different views before a meeting. We were okay with that, because we agreed on the underlying fundamentals."

Above all, the Board was interested in getting the "biggest bang for the buck" – or in its technocratic jargon "assessing the efficacy of the various fiscal multipliers to keep domestic demand buoyant".

There had been much discussion in academic and policy circles about the relative merits of tax cuts versus cash injections. The US had long favoured tax breaks, but the Treasury – primed as it was to prevent the "too little, too late" fiasco of its 1990-92 recession management experience – began to feel that a cash stimulus as a direct "windfall bonus" would maximise spending in the short term. "We simply wanted money out of the door. We wanted speed of flow-on within the economy, not necessarily 'solidity' of spending." This meant less importance was attached to the substance on which the money was spent, so long as dollars got into people's pockets quickly.

> "We knew we would be distributing funds to dead people, and people living overseas. But we also know that their number was negligible, and that cash transfers could be delivered so much quicker than any tax cut could. We were happy to make that trade-off."

In a crisis, the objective is averting a catastrophe rather than elegantly designing or redesigning existing arrangements.

The first stimulus package – somewhat ominously titled the Economic Security Strategy by a prime minister who saw the meltdown as the economic equivalent of a national security crisis – entailed government spending of some $10.4 billion (0.9 % of GDP). It was hastily put together over a weekend of intense deliberation, for implementation in November 2008.

It was a couple of days of fluctuating proposals and counter-proposals, during which the "Gang of Four" of Rudd, Gillard, Swan and Tanner bunkered down with their key advisers and closest senior officials. Drawing on accumulated experience, knowledge and know-how, they made quick and sharp assessments of options. In Henry's now much-cited phrase, the Treasury's advice to the Government was to "go hard, go early, go households." One of his colleagues recalled:

> "You had to have a cash splash. It didn't matter what you spent it on. Ken was very strong on that. It was to be a confidence-inducing demonstration by a new government that they were in control and had the matter in hand; that there would be no repetition of the early nineties experience of foot-dragging in the face of recession."

The idea was to get money into the hands of consumers with a high propensity to spend and who might be facing a household liquidity problem if credit dried up or banks threatened to foreclose on their mortgages. The problem was how much to spend and who to give it to who would spend it quickly. Senior officials worked closely with the "Gang of Four", iteratively discussing options, before the Government decided on a package worth $10 billion.

There were some intense internal debates about the efficacy of fiscal stimuli with some officials still preferring to allow markets to run their course. There was less argument about who should receive the "cash splash". The focus would be on those with low incomes and with an existing benefits relationship with one of the government's tax or welfare agencies (namely the various pensioners, those households on Family Tax Benefit). In addition extra training places were funded, targeted to occupations facing lay-offs, along with an extension of the first home-buyers' scheme to assist young families.

Facilitating a global approach

Meanwhile, the big international economies, including the US, the UK, France, Germany, Italy and Japan were beginning to be buffeted by the crisis. Each had different regulatory arrangements, different political systems and governments of different complexions. As a severe credit squeeze (and sometimes a total freeze) began to grip international markets,

concerted efforts were needed to unlock the system. However the G-8 club was having difficulty mobilising to agree on a strategy of coordinated action. France was reluctant to act in the face of what it termed the Anglo-American disease. Germany did not want to be left footing the bill for the whole of Europe if northern European banks defaulted or European Monetary Union countries got into substantial deficit. The US was in the midst of a Presidential election campaign and was prevaricating by vigorously debating the merits of any stimulus measures. Britain had already nationalised one bank (Northern Rock) and was reeling at the magnitude of the pending crisis. Perhaps most significantly, the G-8 forum no longer reflected the changing global economic realities, offering no voice to budding giants like China, India and Brazil.

Keen to forge a breakthrough on a concerted international approach, in late 2008 Kevin Rudd convinced the outgoing US President George Bush and Prime Minister Gordon Brown to drive the global strategy through the G-20[2]. This had the benefit of securing Australia a seat at the table. So high was concern about the health of the global financial system that finance ministers and central bank governors of the G-20 met on six occasions between October and November 2008. The G-20 Washington summit of 14-15th November, where the nations committed to streamlining financial and fiduciary regulation regimes, was compared in significance to the agreement that laid the foundation of the post World War II international monetary order, and labelled a Bretton Woods II accord. Rudd claimed it as a major foreign policy coup.

Monitoring impact and stepping up expenditure

From October 2008 through January 2009 Ken Henry and his colleagues on the Treasury's Executive Board briefed Rudd, Swan and often the other members of the Strategic Priorities and Budget Committee "Gang of Four" almost every day. The Department of Prime Minister and Cabinet was always represented too. And there was intensive ongoing traffic with Swan and Rudd's offices.

> "You had thrown out the money. Now you were managing carefully so that nothing could interfere with its taking effect. …To give you an example: we visited each of the 27 foreign banks represented in Australia. Why? Because there was a scare that they might withdraw and we needed them to stay as they were crucial partners in consortiums for commercial property development. The Australian banks were saying to us that they would not be able to increase their exposure in case foreign banks would withdraw. We devised a government guarantee scheme for major property development projects, which was shot down in parliament."

All this was work going on in the background, and keeping lots of Treasury staff very busy during the normally slow summer period.

As early as November, Treasury started advising the Treasurer that more probably needed to be done. This led to another set of measures being announced just before Christmas 2008. The Government committed $4.7 billion (or 0.4% GDP) to "off the shelf" state infrastructural projects that could start immediately and could help to maintain employment levels in the construction and supply industries.

[2] The G-20 consists of the G-8 nations: Canada, France, Germany, Italy, Japan, Russia, the UK and the US, as well as Argentina, Australia, Brazil, China, India, Mexico, Saudia Arabia, South Africa, South Korea and Turkey and the European Union.

Towards stimulus II: How much more to inject, and how?

By this time, no one at Treasury was worried about any inflationary pressures the stimulus measures would generate. The common assumption was that recession was unavoidable anyhow; the stimulus would hopefully soften the landing the national economy was likely to experience. The department advocated a trial and error approach: provide some stimulus, step back to see how it worked, and then decide if another dose was needed. As one official explained:

> "Part of our job in advising governments in troubled economic times is giving them the courage to 'do nothing', to sit and wait to see measures they have already committed to taking effect even in the face of intense lobbying by skittish business interests. This sometimes gets translated into pressure from the Minister's office for 'more action', which we then have to persuade to hold fire."

Treasurer Wayne Swan however was more inclined to take some time to put together one big package early in the New Year. This led to sustained discussions about the size, scope and speed of impact of a raft of measures that were being floated by various participants. Schools were attractive targets for infrastructural spending initiatives because they were located on government land and thus could move quickly to construction without having to go through time-consuming planning processes.

Also around Christmas time, the Prime Minister became concerned that the government was not doing enough to avert increased unemployment. Treasury's estimates that unemployment might jump well above 5 percent, possibly more, became a real driver of decisive action. The aim was straightforward, as one official stated: "keep people out of Centrelink … We did not want to lose yet another generation to long-term unemployment as we had done in the early nineties."

The $43 billion Nation Building and Jobs Plan (3.5 % of GDP), announced on 3 February, that emerged from these discussions consisted of various measures besides another wave of cash injections to households. Cheques of up to $950 per person were sent to those who qualified, including the unemployed, employees earning less than $100,000, students, self-funded superannuitants, and farmers meeting certain criteria. The major spending programs targeted nation-wide construction drives on schools, social and defence housing, roads and rail infrastructure. In addition, there were "green" programs, subsidising the uptake of renewable energy technology and the installation of household roof insulation.

Given the political noise about "sugar hits" following the pre-Christmas cash injections, and the much larger scale spending that was now being contemplated, a range of government programs would be used to pump money into the domestic economy. As one official recalled,

> "There was more concern now than in October about the package's 'branding' and 'leaving a legacy'. Rudd wanted things that were 'not a transient part of the landscape' (as cash splashes and tax credits by their very nature were), but tangible achievements that his government could point to years down the track."

The second stimulus would bring the Government's total fiscal injections to around $70 billion over four months, not counting the contingent liabilities to which the Government was potentially exposed through the bank guarantees. During the drafting of the second stimulus

package, Rudd and Swan were acutely aware of the risks to the country's fiscal position and reputation that this entailed. This led to an ironic situation:

> "The impact on the surplus was a major concern of Rudd's during the Stimulus II discussions. Now it was us at Treasury having to push the politicians to spend rather than the reverse. Rudd was concerned about his reputation for fiscal prudence. We took him through various components of aggregate demand and showed him what would happen if we did not intervene in a big way. Essentially, we had to turn him onto a Keynesian over the summer of 2009."

Into the political fray?

The Government's concern for its economic reputation had already been on public display following the announcement of the first stimulus package. It was clear to informed observers of economic policy that the combination of unprecedented public stimulus spending, higher levels of unemployment and decreased tax revenues would push the budget into deficit. However, the Prime Minister and the Treasurer were initially most reluctant to be caught saying so in public. They first tried to avoid speaking the "D word" at all. When that became clearly preposterous, they used softening language ("temporary deficit") to counter opposition claims that the Government was throwing all caution to the wind and was using the economic conditions to embark on an unmitigated spending spree.

However, Rudd did not hesitate to try and use his new convictions as a political weapon against the Liberal opposition. He found time in his summer schedule to write an essay, published in the February 2009 issue of the *Monthly* magazine, in which he denounced the "neo-liberalism" that had failed to civilise global capital and extolled the "social democracy" the world now required to clean up the mess.

The Rudd essay[3] and the robust debate it generated confirmed a trend that had begun with the first stimulus package and had been reinforced in the public debate over the second package: economic crisis management had become a matter of high politics. There was no "rally around the flag" effect in this time of economic upheaval. On the contrary, government and opposition were trying to leverage the situation to jockey for position, alternatively claiming credit for Australia's solid starting position going into the crisis and blaming one another for advocating controversial policies (either "too much" or "too little").

This hardening of the political climate surrounding the unprecedented measures the government was taking to buffer the economy from the impact of the global crisis gave Treasury's leaders another set of challenges. Given the highly-charged political reception that the second stimulus package was receiving, Henry and colleagues had to weigh some unpalatable options. Would they stand silently by whilst the vagaries of the political process, such as criticism of Treasury advice in the Opposition-controlled Senate, put essential business and consumer confidence at risk? Or would they come out publicly to defend their advice to government? Doing so would entail spending considerable institutional and personal reputational capital for what they believed to be in the national interest. But they knew that it would also come at a potentially debilitating price in the form of criticism about the department's ostensible "politicisation".

This was a sensitive matter for the executive, because in normal circumstances, public servants provide policy advice to the government on a confidential basis and it is not

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[3]Rudd, K, The Global Financial Crisis, *The Monthly*, February 2009.

generally considered appropriate for them to publicly justify their advice or a Government position. However, in these unusual circumstances, the Government had made the Treasury advice public, and indicated that they had acted upon this advice. It was crucial to the success of some of the policies that the public and economic and financial market agents understood that the Government had acted on advice from its key economic advisers.

The executive was conscious that two pivotal factors provided authority to the Treasury brand: the department's reputation for political neutrality as well as for its top-quality analytical expertise. Going public to defend its advice to Government risked compromising both as it would be seen as defending the Government position.

Conservatives had already questioned the department's reputation for neutrality after the leaking of a 2007 Henry speech with thinly veiled criticism of some of the Howard government's economic policy stances. Treasury had already had a taste for the pressures it might come under. When the government announced its banking guarantees, *The Australian* ran a story claiming that Ken Henry and Reserve Bank Governor Stevens had disagreed about the nature and scope of this scheme. Henry then found himself before a Senate committee with hostile opposition senators probing the issue. He felt he had no alternative but to actively defend the Treasury's advice, already in the public domain.

It had been a difficult experience. As one interviewee recalled, "The politicisation of the macro-policy in late 2008 and early 2009 was unfortunate. We would have liked to have seen more bipartisanship around the stability of the financial system and the anti-recession measures." The reality was that there wasn't any, and now that the fate of the second stimulus package was in the balance the leadership challenge for Henry and colleagues was: should Treasury go out there and do it again?