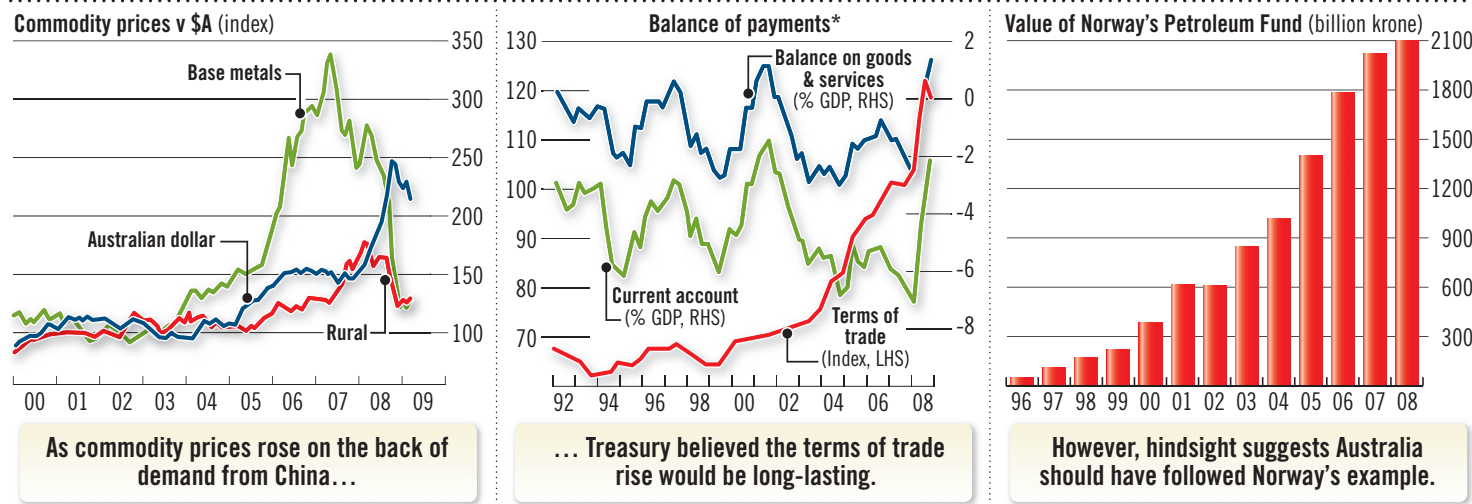


# Treasury misread boom

## Rear vision

### How Treasury got it wrong



\* Excludes RBA gold transactions

SOURCE: ABS

In the Treasury executive minute to Costello on June 29, Treasury reveals it has argued in the IMF talks that there could be a case for spending the additional revenue from the boom if the surge in Australia's terms of trade could be considered permanent.

In summarising the discussion, the brief to Costello says: "Article IV discussions with Treasury had a strong focus on the appropriate role of fiscal policy during a terms of trade shock. The IMF agree that there is a strong case for spending additional revenue from the increased terms of trade to the extent that the increase is considered permanent."

In defending increased spending, however, Treasury was possibly playing its institutional role as apologist for government policy, although it is unusual to support a loosening of fiscal policy when the economy is approaching full capacity.

The Reserve Bank was much more cautious in its assessment of the boom. In a paper to a conference in Canada in June 2008, governor Glenn Stevens said "no one can know whether a change of this nature is permanent or not". He went on:

"So markets and/or policymakers are often in the position of not knowing how much response to make. They may end up making or accepting a partial response in case it is permanent, but not, initially, the whole response, in case it is not. Indeed, one reason commodity prices across the board are so high is that producers did not anticipate the persistent nature of the stronger demand."

Reserve Bank economists, however, have shown little interest in advocating creation of a fund to help manage the commodity cycle.



The AFR made an FOI request for all ministerial briefs from January 1, 2005 to May 2008 on the role played by foreign sovereign wealth funds for managing windfall revenue from commodities; all briefs examining Norway's fund; and all briefs over the past year on managing natural resource revenue in Pacific neighbours and East Timor.

The request singled out the developing countries because, unlike Australia, they have put in place systems to deal with commodity income.

The 29 documents identified by the search show that from early 2006 on, Treasury studied best-practice models in several countries, particularly Norway's well-regarded model, but this analysis did not inspire a single ministerial brief to the Treasurer recommending he take note or consider new policy.

The first document — a minute in July 2006 by Kirsty Laurie, from Treasury's budget policy division — notes that Norway's model of investing all the oil revenue into a foreign currency fund "promotes exchange rate stability".

That is, putting the money into foreign currency avoided the pitfalls that inspired the Norway model, namely Holland's experience in the 1970s when a sudden influx of North Sea oil revenue over-inflated the currency and the rest of the economy. This experience gave rise to the term "Dutch disease". Since its float in 1983 the Australian dollar has

experienced wild swings as a result of shifts in commodity prices.

Warning about the painful adjustments that result from living on commodity income, Laurie concludes: "Norway appears to be very conscious of avoiding the Dutch disease so that restructuring costs are not excessive when petroleum revenue declines."

Laurie is co-author of an influential paper released immediately after the 2007 election that documented the gross fiscal excesses of the Howard government. The paper, published in the Treasury Economic Roundup in early 2008, shows that from 2004-05 new spending decisions and income tax cuts reduced the budget surplus by \$314 billion, out of a total revenue increase of \$334 billion.

"Effectively, the additional revenue from the commodity boom has been spent, or provided as tax cuts," the authors conclude.

The analysis shows that one of the main channels for Australia to experience the inflationary effects of the Dutch disease is through excessive government spending. This was noted at some length during the IMF consultations in 2007. The IMF said in its talks with Treasury that Costello's last two budgets were "providing a stimulus in an economy with limited spare capacity".

A second Treasury paper on managing windfall resource revenue — written in August 2007, after the IMF raised its concerns — identified the dangers of being inundated with commodity revenue. The paper, Commodity Hedging for Government, by Michael Bath, said that in these circumstances governments "struggle to avoid pro-cyclical fiscal policies". This is exactly what happened in last years of the Howard government.

Bath's paper focuses on the role of commodity-linked sovereign funds to deal with the "negative side effects associated with a sudden increase in revenue". He says the Norway fund model seeks to "immunise the budget from oil price volatility".

Bath's paper, of which about a page is deleted under Section 22 of the FOI Act, makes clear that Australia's Future Fund does not play a role in insulating the economy from swings in commodity income. The fund, which holds all its assets in local currency, is limited to addressing the impact of population ageing on public finances by building up assets to pay for public service pensions.

Norway's fund has more far-reaching objectives. "It transforms the wealth associated with a non-renewable, finite stock of resources into a perpetual source of relatively steady revenue," Bath's paper says, before concluding that the Norway model is "an excellent case study in managing commodity risk in a manner that maximises fiscal sustainability".

Treasury did succeed in convincing the Howard government to divert some of the windfall revenue into new funds to pay for future outlays for pensions, higher education and health.

**Even Papua New Guinea, which is widely regarded as a basket case of mismanagement and corruption, offers some lessons to Australia.**

But as Bath says, these funds do not help insulate the budget from volatility in commodity income, and nor do they help manage commodity risk. Key differences are the fact that successful models invest only in foreign currency, and the amount of revenue diverted is vastly greater than what Australia has attempted.

The Norway fund was launched in 1996 to manage the revenue from North Sea oil. All Norway's oil-related revenue bypasses the budget and flows directly into the fund, which invests in foreign currency government bonds and blue-chip equities. The government draws down on the fund after seeking approval from parliament. Essentially, the country spends real interest on its natural resources, and it will be able to keep doing this every year, long after the oil resources have been exhausted.

The fund now known as the Government Pension Fund was worth 2275 billion kroner (\$473 billion) on December 31, 2008, and has doubled in value since 2004. Sovereign wealth funds, like super funds, have been hit by the global financial crisis, although some have been insulated because they invested solely in government bonds.

Treasury's detailed analysis of international experience also covered examples found in Russia, Chile, Alaska and Papua New Guinea, among others. The analysis shows that other countries were setting up sovereign wealth funds or refining their policy frameworks to squirrel away surplus revenue from the resource boom while in Australia the policy response to the challenge was limited.

A briefing paper in May 2007 by Laura Doherty to Treasury's general manager for the G20, former ANU professor Gordon de Brouwer, notes that in April that year the Russian parliament transformed the Oil Stabilisation Fund into a Future Generations Fund and a Reserve Fund. Russia invested all its assets in high-grade government bonds and foreign securities, the paper observes.

Like Russia, East Timor has invested all its surplus oil revenue into US government bonds and after just two years of saving amassed \$US4.2 billion, all of it insulated from the global downturn. The value of East Timor's fund is already about 10 times the size of its non-oil gross domestic product.

Even PNG, which is widely regarded as a basket case of mismanagement and corruption, offers some lessons to Australia. A December 2007 note on PNG's medium-term fiscal strategy by Stuart Kinsella says the 2008-2012 budget strategy creates a new concept of "normal" mineral income, which is the amount of revenue that could be derived in the absence of a commodity boom.

The benchmark is set at mineral income equivalent to 4 per cent of GDP. Income above this level is used to both retire public debt and to fund public investment.

PNG's strategy is clearly used not only to save money during the boom times, but to also protect the country during the down times, Kinsella notes.

"Movements in world commodity prices, particularly on the down side, are an important risk factor to the outlook for PNG revenue over the next few years," he writes.

The policies adopted by PNG and East Timor reflect the influence of Australian Treasury officials who have been seconded to the governments of both countries, although at home the department did not appear to drive similar policy solutions.

It seems extraordinary that while examining international practice in detail, Australia has never considered any of these policy options for managing its commodity income. There might be no better time than now, when the pain of another commodity famine is becoming acute, to prepare a set of policies to deal with the next boom.

The Treasury discounted the cost of the AFR's FOI request in view of public interest considerations.

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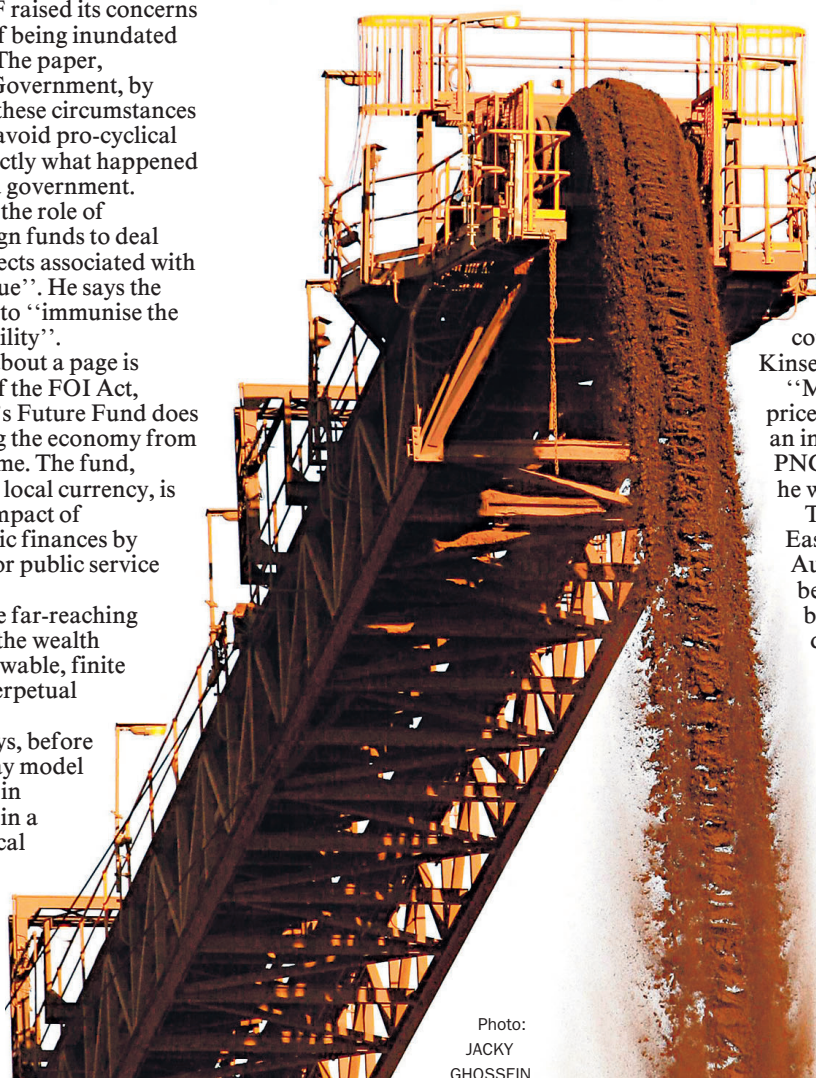


Photo: JACKY GHOSSEIN