

Flawed forecasts: how

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under the Freedom of Information Act reveals that although Treasury examined the policies of countries that had successfully managed sharp swings in resources income, such as foreign currency sovereign funds, it did not press the government to follow these examples.

Treasury put its view about the commodity boom's becoming permanent in a ministerial briefing to then treasurer Peter Costello in June 2007. The advice to Costello is just one example of the department's forthright thinking at the height of the mining boom.

A year later, Treasury declared in the Rudd government's first budget that the terms of trade, after rising to the highest level in 50 years, would surge by a further 16 per cent in 2008-09, despite the growing global uncertainty. This forecast is certain to be dramatically altered in the budget on May 12.

"Robust growth in the emerging economies is supporting further large rises in Australia's terms of trade from levels that are already the highest in more than 50 years," Treasury wrote in the 2008 budget's economic outlook.

The department expanded on this confident outlook two months later in its first substantial research paper on the boom, which argued that unlike other spikes in commodity prices, this one was likely to be more enduring. Australia need not worry about the so-called "resource curse" and could look forward to higher living standards.

"The prospect of the rise in the terms of trade being sustained therefore need not be considered a 'resource curse' that will simply create problems," the paper's authors concluded. "If well managed, the transition to higher terms of trade presents an opportunity to raise Australian living standards."

Warwick McKibbin is one of the few commentators to have advocated the creation of a foreign currency fund to deal with Australia's boom-bust cycle. Early in 2008, the academic with the ANU and Brookings Institution, who is also on the Reserve Bank board, called for windfall revenue from the resources boom to be parked in a Norway-style foreign sovereign fund.

Unlike the Future Fund, which is restricted to providing for public service pensions, this fund would hold assets in foreign currency and it could be designed to help manage the economic cycle. The money could be brought back into the country when the terms of trade declined, McKibbin argued at the time.

McKibbin says Australia could have amassed a foreign currency fund of between \$50 billion and \$100 billion had it earmarked additional revenue from the resources boom over the past few years. The money would now be worth considerably more in Australian dollars.

He argues that it was wrong to view the recent boom as permanent, and that viewing it as temporary would have driven an aggressive savings strategy. "You never know if it is permanent," McKibbin says. "By deciding it is temporary you should put some substantial part away — as much as you can."

The reasons policy failed on this front say a lot about the quality of public debate in Australia. McKibbin says special interests that ignored the national interest swamped debate.

McKibbin says he raised the concept of a foreign savings fund at several high-level meetings and plans to canvass it in greater detail in an address to an international conference in June. He believes Australia should start planning for the next upswing in commodities.

As for Treasury's silence on the issue, McKibbin notes that the department had its fingers burnt early this decade when it suffered paper losses from foreign currency investments because the dollar moved against it. Labor in opposition savaged the department for mismanagement, and the experience may have deterred new policy advice on foreign currency investments.

One senior official argues that Treasury refrained from pushing for a sovereign fund because private sector economists and newspaper commentators have not demanded such policy action.

It was difficult for Treasury to push the policy boundaries when many economic commentators were simply calling for the mining boom's billions to be channelled into



Treasury's economists did not warn the government that resources income from China was a temporary surge bound to be followed by a crash.

Photo: BLOOMBERG

massive tax cuts, which in turn fuelled inflation. *The Australian* newspaper, for example, in 2007 went as far as criticising Treasury for having failed to predict the mining boom, thereby denying massive tax cuts to people.

ANZ chief economist Saul Eslake, one of the few economists to have criticised Costello's spending binge, says most economists advocated tax cuts rather than structural reform because this was popular. He alleges Costello's aggression towards his critics made most economists fearful of criticising the government's management.

He also believes that warnings by the then US Federal Reserve chief Alan Greenspan about undue influence of sovereign funds on public companies could have helped suppress any push for an Australian sovereign fund.

Treasury appears to have taken up the US government's concerns about these funds. A briefing in November 2007 for officials attending the Group of 20 meeting said the combined value of the funds, at about \$US2.5 trillion, meant there were reasons to fear their power. "There exist concerns due to the sheer size of these investment vehicles, their lack of transparency, their potential to disrupt financial markets, and the risk that political objectives might influence their management," the Treasury paper says.

Another prominent critic of the government's reckless spending was Chris Richardson of Access Economics, a former Treasury economist who called for a much bigger savings effort, but he admits that neither he nor other economists articulated to the government the mechanism for achieving this end. Richardson puts the failure down not only to that of economists, but of political leadership. "Neither side explained to the Australian people that this was a temporary surge," he says. "It was not at all clear that it was permanent."

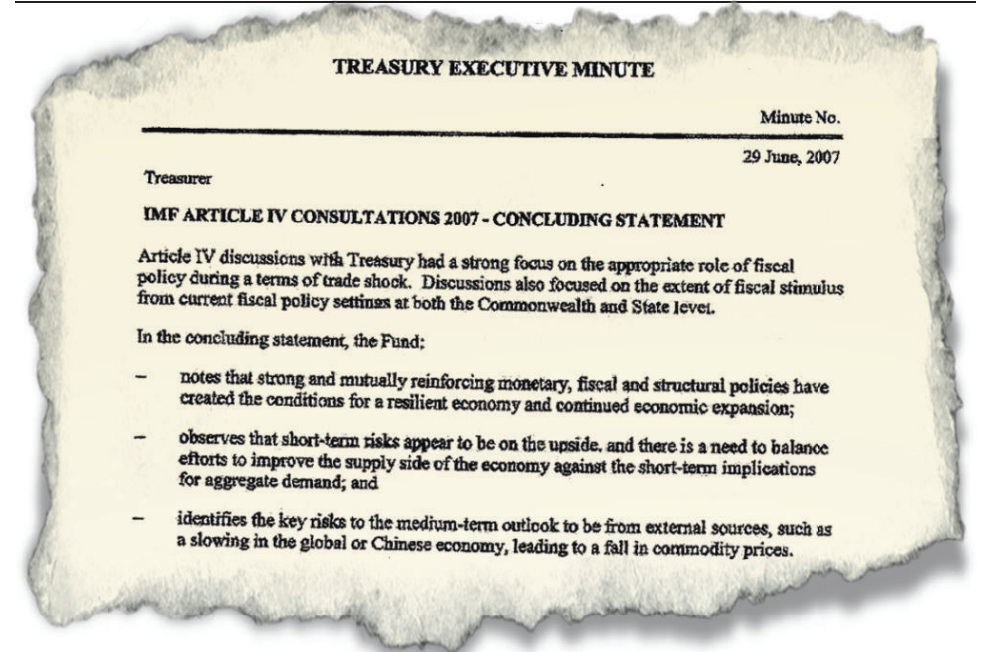
Rather than highlighting concerns about the pitfalls of windfall resource revenue, Treasury's analysis of the mining boom played down concerns about the resource curse, which is also known among economists as the "Dutch disease".

The department's most substantial work on the most recent boom, a July 2008 working paper titled *Structural Effects of a Sustained Rise in the Terms of Trade*, says that while previous booms have been "short-lived, there are reasons to believe that the current boom could be more enduring".

The paper, written by Treasury's principal adviser for forecasting, Adam McKissack, and three others from the domestic economy

Under wraps

Treasury documents obtained under Freedom of Information laws



SOURCE: TREASURY

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division, appears to be a badly timed piece of research that is already outdated. Senior officials in Treasury, including David Gruen, the executive director for the macro-economic group, also commented on the paper before it was published.

Despite having full knowledge of the Howard government's inflationary spending, the paper argues that "Dutch disease" effects from the high exchange rate have not flowed through to the traded goods sector as "strongly as could be expected".

The paper's only policy recommendations are to address the obvious skill shortages emerging in the resource-boom states of Western Australia and Queensland, in part by boosting immigration.

Its concluding paragraph says the resource boom is here to stay; Australians need not fear any negative consequences and can only look forward to higher living standards.

The paper does not represent policy advice as such, but its views are an echo of what had been put in the high-level briefing note to Costello in mid-2007. Treasury argued in discussions with a delegation of economists from the International Monetary Fund that the government faced a permanent increase in revenue from the surge in the terms of trade.