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Roundup

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Political awareness

Address to the International Project Managers Symposium in Canberra on
9 February 2007.

Ken Henry

Introduction

Thank you for the opportunity to participate in this symposium. The programme focuses on a number of critical facets of the business of project management in the public sector. The public sector environment is not in all respects different from the private sector one, but it is sufficiently different for practitioners to think very carefully before importing governance and management principles that appear to work effectively in the private sector. A failure to recognise the difference in environments has brought many trail blazers to grief.

This is not to say that public sector project managers don't have a lot to learn from their private sector counterparts. I know they do. But others will talk about that. It falls to me to deliver the cautionary tale.

I'm going to start with a case study in public sector project management. The case study doesn't illustrate all of the messages I want you to take away from this session; but it provides a rather graphic illustration of several of them. I'll round out the messages in the final section of the address.

While my comments are directed to the topic of political awareness, they reflect also on the role of the media. That's inevitable. The simple fact is that it is impossible to say anything sensible about the political environment without recognising the way in which it is influenced by the media. Indeed, I will be emphasising the critical role played by perceptions in the political environment. And I'm sure it has occurred to you that the media has a substantial impact on perceptions, especially on what we might think of as 'public perceptions'.

A case study in public sector project management

The case study concerns the management of the Australian Government debt. This is a somewhat arcane activity. There are few technical experts, and yet a considerable amount of technical expertise is required of those who undertake the activity. It takes place in facilities far removed from the public gaze, and yet it involves vast sums of money: tens of billions of dollars. The Parliament takes little interest in what goes on; the general public even less; until something goes wrong. And when something does go wrong, the intensity of the spot light shone on the activity is blinding. Does this sound familiar?

The case study is a bit technical. I will keep it as simple as I can, but, even so, I'm aware that it involves some level of complexity. That, of course, is also true of the projects you manage. Frankly, I can't see that much would be gained by taking you through a simple case study. If it's any consolation, at least I've only got one chart.

You are probably aware that the Australian Government's *net* debt was eliminated in 2005-06. Clearly, the Government has no need, on financing grounds alone, to have any debt on issue; but it has decided to maintain an amount, currently worth about $57 billion, in order to support the bond futures market.

The government debt on issue is managed by the Australian Office of Financial Management, a prescribed agency in the Treasury portfolio. Its mandate is to minimise the budgetary cost of Australian government debt, subject to an acceptable level of risk. These days, that management task involves judgement about the maturity profile of the debt — the profile is affected by, and can be manipulated by, the timing and magnitude of primary issuance of government bonds and by interest rate swaps.

Until recently, however, an additional means of debt management was employed. This additional means involved the use of cross-currency swaps, to achieve exposure to United States interest rates. Without going through all of the details, the effect was that debt issued in Australian dollars, at Australian interest rates, was swapped into $US denominated debt, obtaining exposure to US interest rates.

Since the late 1980s, any exposure to foreign currency debt has been voluntary. The Australian government first issued debt in the form of Commonwealth Government securities in 1912.[1] For the first thirty years, foreign currency debt averaged about 40 per cent of the total debt outstanding. In the post-Second World War period, up until 1988, foreign currency exposure averaged about 30 per cent of the total. Through that period, governments resorted to offshore issuance mainly because they had no real choice: their financing needs were too large for the domestic market to absorb at reasonable cost; off-shore markets exhibited greater depth and liquidity. But by the mid-1980s, the Australian market had developed to such an extent that offshore issuance was no longer necessary. The Australian Government has not borrowed directly in offshore capital markets since 1986-87.

The pattern of currency exposures that emerged when we considered that we had no real option but to borrow directly overseas wasn't based on any formal analysis or the result of rigorous debt management. As you might imagine, it just 'grew up' that way. But in the late 1980s, we started thinking about using cross-currency swaps deliberately to acquire an exposure to $US denominated debt, even though we were no longer issuing debt in foreign markets. The first cross-currency swaps to achieve $US exposure were undertaken in 1991-92.

Why would a debt manager voluntarily seek foreign currency exposure?

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1 For an account of the history of foreign currency debt, see the 2003-04 Annual Report of the Australian Office of Financial Management, pp 37-48.

Well, this is an interesting story. In finance theory there is a celebrated equilibrium condition referred to as 'uncovered interest parity'. Essentially, this says that if we compare two market-traded financial instruments that have identical risk characteristics except that they are issued in different currencies, than any gap in their yields must reflect market expectations of a movement in the rate of exchange between the two currencies.

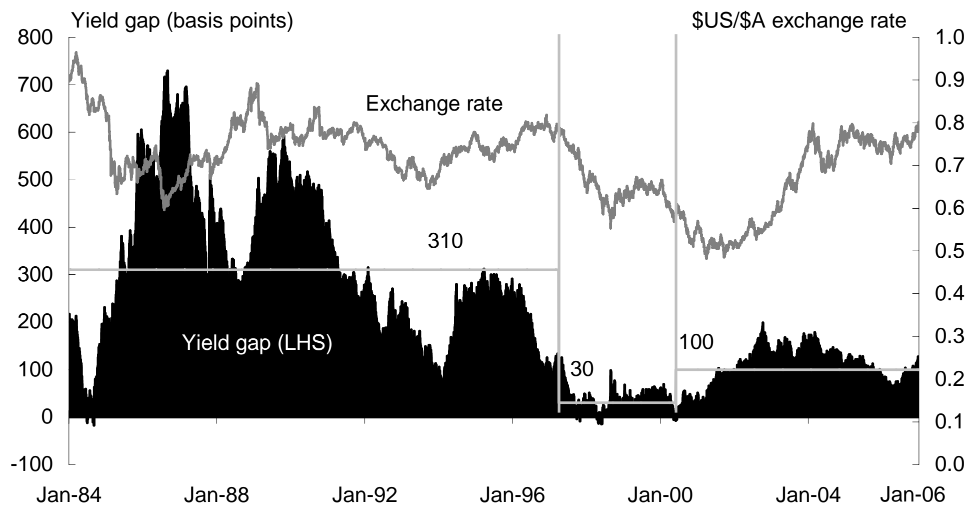
Thus, if Australian interest rates are higher than US rates, uncovered interest parity says that there must be an expectation of the $A depreciating against the $US. If interest rates are the same, then there must be an expectation of no exchange rate movement. And if Australian interest rates are less than US rates, there must be an expectation of the $A appreciating against the $US.

All of this makes a lot of sense. But does it accord with reality?

Chart 1 tracks the $US/$A exchange rate from the end of 1983, which is when the $A was allowed to 'float'. As you can see, between January 1984 and March 1997, the exchange rate experienced a fair degree of volatility but no clear trend. And yet, as the figure also shows, the gap between the yields on Australian and US 10-year government debt averaged 310 basis points — that is, 3.1 percentage points — over this period. If uncovered interest parity is right, that sort of yield gap must have been based on a market expectation of the $A depreciating against the $US by an average amount of 3.1 per cent a year. The fact that the exchange rate did not behave in that manner suggests that there is an unexplained *bias* in market expectations of the $US/$A exchange rate. But if that is the case, then we would have a lower expected cost of government debt if we paid US interest rates rather than Australian interest rates. We could achieve this either by issuing US dollar denominated debt in the US market, or by issuing Australian dollar denominated debt in the Australian market and swapping into US dollar instruments. Principally because of greater depth and liquidity in swap markets, the latter option would usually be the cheaper.

Thus motivated, in the late 1980s we adopted an explicit foreign currency benchmark, initially targeting 13 per cent $US exposure in the debt portfolio. This benchmark was based on research commissioned from expert external consultants JP Morgan. In 1996, following a review by the Union Bank of Switzerland (UBS), the benchmark was defined as a band of 10 to 15 per cent $US exposure. Why not 100 per cent? Well, while this would have meant a much larger expected saving to the budget, it would have come at a much higher exposure to risk — specifically, the risk of a large $A depreciation, leading to a significant loss on the final exchange of swap principal.

Chart 1: US$/$A exchange rate and yield gap



The expected return had two components: an expected saving in interest cost due to lower $US interest rates; only partly offset by an expected foreign currency loss, due to $A depreciation, on exchange of swap principal. Note that, as far as the theory as concerned, it doesn't really matter whether the yield gap is positive, zero or negative. What matters is the relationship between the yield gap and the expected movement in the bilateral exchange rate. Thus, even if Australian interest rates were *lower* than US rates, the strategy might still make sense provided there was good reason to think that the $A was going to *appreciate* strongly. In that case, there would be an expected additional interest cost, more than offset by a foreign currency gain on exchange of swap principal.

The strategy recognised that the calculated economic benefit of a voluntary exposure to US interest rates and to the bilateral exchange rate could be volatile, with quite large swings likely to be observed in a short time period but 'trend' economic benefits to be realised over a longer time period. The strategy was, therefore, a long term one. In a given year, the calculated economic benefit of the strategy might very well be a large negative — perhaps several hundred million dollars of calculated economic loss in any given year; but over a run of several years, there was a good prospect of the strategy delivering significant cost savings.

And, indeed, it did. Up until 1996-97 the cross-currency swaps strategy had realised cost savings averaging more than $100 million a year, and as at 30 June 1997 the cumulative economic gain on the portfolio stood at a sizeable $3 billion. Of course, much of this was an *unrealised* gain.

But then, beginning in the second half of 1997, following the onset of the Asian financial crisis, two things happened that called into question the soundness of the strategy: first, the $US/$A exchange rate depreciated sharply; and second, the yield gap collapsed.

I probably should mention that, on promotion to the Deputy Secretary level in 1998, I was given executive responsibility within the Treasury Department for, among many other things, both international financial affairs and debt management. These events were something of a baptism of fire.

As Chart 1 illustrates, between March 1997 and May 2000, the $A depreciated against the $US by 28 per cent, and the yield gap went negative; falling to -17 basis points. Over that three year period, the yield gap averaged only 30 basis points. Large *unrealised* foreign currency losses, averaging more than $1.2 billion a year, were reported for the years 1997-98 to 2000-01. By 30 June 2001 the cumulative economic performance of the portfolio was an *unrealised loss* of $2 billion.[2]

The strategy had been reviewed externally, and endorsed, on several occasions prior to 2000-01, including by BT, Carmichael Consulting and Coopers and Lybrand in 1997 and UBS Warburg Dillon Read in 1998. The Australian National Audit Office (ANAO), in a report released in 1999, did not recommend that the strategy be abandoned, but rather that it be re-examined as part of the next debt management consultancy.[3]

In the first half of 2000 the ANAO report was considered by the parliamentary Joint Committee of Public Accounts and Audit (JCPAA). In its report tabled in November 2000 the JCPAA endorsed the ANAO recommendations. While noting the risks associated with $US exposure, the JCPAA did not recommend any change to the cross-currency swaps strategy.

The story really got running in the early part of 2002, following Senate Estimates Committee hearings in February and March of that year.

It became a major political issue, run hard by the Opposition, both inside Parliament, including in question time, and outside of those chambers. Several public servants were subjected to personal denigration by members of the Opposition. The Opposition's target, of course, wasn't those public servants; it was the Treasurer.

The Opposition's campaign had a fair measure of support in the media.

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2 That is, had the portfolio been liquidated on that date, at prices and exchange rates applying at that date, the loss would have been $2 billion. These losses were not realised.

3 Report no. 14, 1999-2000: Commonwealth Debt Management.

The *Sun Herald*, for example, carried a photograph of me, captured while shopping on a Saturday morning in Queanbeyan, under the headline: '$7 billion loser'. I have no idea how the $7 billion figure was computed; but, then, neither, I'm sure, would the journalist.

Even the serious press gave the story a run. *The Australian*, in an editorial of 6 March 2002 headed 'Billions of bucks stop with Costello', warned that,

> the … deals … are … threatening to cost us billions' and opined that the 'swaps program was a deliberate attempt to make a quid by putting at risk billions of taxpayers dollars … Private companies would never do this, and even those company managers who hedge their bets and still lose money get thrown out.'

The Australian accused the Treasurer of several serious failings. These accusations were levelled by people who held themselves out as serious editors of a serious newspaper. They were very personal charges, clearly intended to be hurtful and politically damaging. And they were, it has to be said, opportunistic, unfair and inappropriate.

As it happens, the Treasurer's role in all of this was — on my assessment — beyond reproach. He had inherited the strategy from a number of his predecessors. When issues arose he dealt with them in a speedy fashion; immediately they were brought to his attention. His defence, if he needed one, was rock solid.

Our defence, on the other hand, didn't seem to convince anybody. Our strongest line of argument was that we always anticipated that we would lose money on the final exchange of swap principal through currency depreciation, and that while in some years this loss might more than off set the saving in interest cost, over the long term there would be a net saving. It was simply inappropriate, we maintained, to evaluate the performance of the strategy with reference to one year's movement, or even a few years' movement, in the market value of the portfolio.

As is often the case with political issues, as quickly as the controversy flared, it died out. It wasn't exactly a 'one-day-wonder', but by the second half of 2002 the only journalist still writing about it was Kenneth Davidson in *The Age*. Typically, Kenneth hasn't stopped writing about it.

There are, I think, four reasons why the story died.

First, many people would have had great difficulty accepting the proposition that the tight-fisted conservative Treasury, usually doing whatever it could to stop other people from squandering taxpayers' money, was itself gambling recklessly with the public purse.

Second, the Opposition's attack was blunted because:

- the cross-currency swaps strategy had been initiated by them when in government;
- the strategy had produced losses in its first four years of operation, cumulating to more than $600 million as at 30 June 1991 (measured in 2002 dollars); and
- people were confused by the Opposition's argument that, on the one hand, the Treasurer was engaging in risky currency speculation and, on the other, he should have quit his position when the numbers started going negative.

Third, by the middle of 2002, it was apparent that the $A had at least stabilised, and was probably in trend appreciation.

And fourth, and most importantly, the story was simply too complex. I must have read just about everything written on the topic at the time, and I have recently re-read a lot of it, and almost none of it makes any sense; an exception is the piece written by Ross Gittins in *The Sydney Morning Herald* on 4 March 2002, which carried the headline: 'Forex bum rap for Costello'.

Let's get back to the history.

Ironically, it was our seeking to *reduce* our $US exposure that brought the strategy unstuck. We had a benchmark that obliged us to keep the $US exposure between 10 and 15 per cent of the total stock of debt. The 15 per cent upper limit was a hard ceiling. Our problem was that the total stock of debt was declining as a result of the budget being in surplus and the $A value of the $US debt was increasing because of the weakening exchange rate. Denominator down, numerator up. We were in trouble. The only way to prevent the $US exposure from exceeding 15 per cent was to close-out a substantial volume of our cross-currency swaps. But this would have meant large purchases of $US — that is, large sales of the $A — in the foreign exchange market. In the view of the Reserve Bank of Australia, this 'would probably have speeded up the rate at which the currency was falling'.[4]

Following representations from the then Governor, a decision was taken in December 2000 to permit the benchmark upper limit to be breached. In September 2001, following a review of the benchmark, the Treasurer agreed that we should target zero foreign currency exposure. At that time, the exposure stood at $US 6.4 billion. This exposure was unwound according to a schedule agreed with the

4 Statement by the Governor, Mr Ian Macfarlane, 4 March 2002.

Reserve Bank. By the end of 2003 the net currency exposure on foreign currency derivatives had been eliminated.

So how did the programme, after nearly 16 years of operation, finish up? Well, as Chart 1 shows, as the unwinding was occurring the $A was appreciating, from around $US 0.49 back up to $US 0.73. The $US exposure was unwound at a weighted average exchange rate of $US 0.647. Over the entire life of the policy net interest savings of $1,958.1 million were realised, partly off-set by losses of $1,174.4 million on exchange of swap principal, leaving a net realised *gain* to the taxpayer of $783.7 million. It has probably occurred to you, in looking at Chart 1, that had we not terminated the policy we would, today, again be sitting on a cumulative economic gain of several billion dollars. This might strike some of you as ironic.

Lessons for public sector managers

What are the lessons to be drawn from this episode, and how, in particular, do those lessons relate to your business?

The first lesson is that people who manage projects on behalf of taxpayers operate in an adversarial, combative, political environment. Everything they do has the potential to embarrass the government of the day and, if there is any prospect of its doing so, will be exploited by the opposition. In political jousting, facts play poorly relative to perceptions. And the jousters don't always care about the 'collateral damage' that may be inflicted on the professional reputations of public servants.

Second, while there may be many things that public sector project managers could do that they would have good reason to expect might save the taxpayer some money, that doesn't necessarily mean they should do them. They should think about the environment in which they operate. When the cross-currency swaps strategy was saving the taxpayer about $100 million a year, no commentator and no politician, government or opposition, had a thing to say about it. Even now that it is all over, the fact that it turns out to have benefited the taxpayer to the tune of nearly $800 million has gone almost completely unremarked. The only time any commentator or politician, other than the Treasurer, took any interest in the policy was when it looked like it was going wrong.

To put this in more abstract, but more general, terms, in the environment in which you work, penalties and rewards are not scored symmetrically. Losses are valued much more heavily than gains. And opportunity costs (that is, the expected return from doing something other than what one is currently doing) are very much undervalued. If you do something that saves the taxpayer a bucket of money, don't expect any external praise. But if you do something that costs the taxpayer any amount of money,

expect criticism, and expect that you are going to have to devote a lot of valuable time and effort in responding to that criticism. Accordingly, if there is something you can see to do that, from a project management perspective, has an expected cost saving, but would involve some risk of cost increase, think long and hard before proceeding. If you can cover your downside risk at acceptably low cost, you might want to do that. If you can't, you would want to be satisfied that the probability distribution is skewed very heavily in favour of a cost saving.

Note, too, that your political masters face the same asymmetry between penalty and reward as you do; or, at least, they perceive the same asymmetry and act as if the asymmetry exists.

A political career is, in itself, a risky choice. In seeking to ameliorate political risk, most politicians take a keen interest in 'issues management'. This can make them appear even more risk averse than the general population. With some notable exceptions, ministers usually appear to have a tolerance for risk that is close to zero. There are two main reasons for this. The first has to do with the relationship between politicians and the media: as a general rule, good news doesn't sell whereas scandal does. The second reason has to do with the relationship between the government and the opposition. Oppositions don't often praise government success but, for obvious reason, they do tend to be highly critical of failure — even when the failure is more imagined than real.

The third lesson keys off the observation just made about the media. It is that your performance may be judged, by your political masters, according to how well it plays in the media, or how well it would play if it became a matter of media interest. What you think of as 'project management', your political masters may well think of as 'issues management'. Now, I'm sure you have heard people say that you shouldn't believe anything you read, watch or hear in the media. Most people working in government would be aware of instances of highly inaccurate media report of things in which they are expert. You may well have formed the view, by extension, that all media stories are wrong. Well, believe it or not, that's beside the point. In the political environment in which you operate, what matters is not whether the story is true or false, accurate or misleading. What matters is whether the story is positive or negative, complimentary or critical, supportive or hostile. An important corollary of this observation is that if you are managing a risky project it might be worth devoting some effort to public education — in other words, media management — up-front, long before a risk materialises. It is clear, in retrospect, that we didn't do nearly enough of this in the cross-currency swaps project. When that story broke, we were on the back foot from day one. In managing the story, our task was made especially difficult by the complexity of the subject. As a general rule, the more complex the subject, the easier it is to criticise, and the more difficult it is to defend. The defence will always involve a level of complexity far higher than the, often simplistic, criticism. And complexity is

very easily interpreted as obfuscation. There is a fair chance that anything you say will be construed as a cover-up.

By the way, good politicians understand very well the importance of conditioning public expectations. Consider how often you hear a minister say, in response to a negative development, 'I've been saying all along that this could happen'? What they are really saying is 'I prepared you for this bad news, so it's not really bad news at all; indeed, it's not even news'.

The fourth lesson is that events in the short-term time horizon are overvalued relative to events at a distance. In the cross-currency swaps debate our argument, that it was inappropriate to focus on the performance of the strategy over a year, or even a few years, had no traction. Nobody bought it. If you have managed half a dozen projects, meeting all criteria relating to timeliness, scope and cost, and then have one, even relatively small, project that fails against one of those criteria, you will find that in the public consciousness that failure will — for some time at least — represent your entire biography.

These four lessons are the product of casual — if strongly motivated — empiricism spanning a couple of decades of public service. They don't come out of a political science text book. But it turns out that they do have considerable support in the relatively new area of behavioural economics. In the language of that discipline, the lessons are as follows:

The statement that you operate in a political environment is merely descriptive. But the first lesson also contained the proposition that, in the political environment, facts play poorly relative to perceptions. The central insight of behavioural economics is that people form judgements intuitively, not rationally. Intuition is not precisely the same thing as perception, but it has strong links to the essentially automatic processes of perception. Thus, judgments tend to be made quickly, effortlessly, automatically and emotionally. And they are affected strongly by current stimulation. As Nobel Laureate Daniel Kahneman (2003) puts it, 'the central characteristic of agents is not that they reason poorly but that they often act intuitively. And the behaviour of these agents is not guided by what they are able to compute, but by what they happen to see at a given moment.'

The second lesson is an illustration of what is called 'prospect theory'. The core ideas of prospect theory are that how you feel about some development depends upon your starting point (in technical language, your 'reference point'), and that people exhibit

loss aversion.[5] For example, if your income increases from $500 a week to $750 a week, you will be happier than if your income falls from $1,000 to $900 a week; even though in absolute terms you are financially better-off in the second case.

From the perspective of prospect theory, your typical minister exhibits extreme loss aversion.

Of course, the fact that your political masters might appear to have a close to zero tolerance for risk doesn't mean that they don't, in fact, take decisions that involve risk. I have already noted that the choice of a political career is inherently risky. But, beyond that, it needs to be observed that even doing nothing is not risk-less.

The consequence of 'doing nothing' can be labelled the 'counterfactual'. It might be tempting to think that the counterfactual is the relevant 'reference point', and that it is departures from the counterfactual that generate positive and negative outcomes. But, in fact, it is not that simple. It all depends on what people have been conditioned to expect. And that takes us to the third lesson.

The third lesson is an illustration of what is referred to as 'framing'. Ross Gittins explained this rather well in the article of his to which I referred earlier. As he explains it, 'the learned financial commentators fulminating about a "currency casino" have been led astray by the packaging'. One of the framing issues he identified was that the losses were perceived to have arisen from the *unnecessary* use of derivatives. Had the foreign currency exposure been obtained through the traditional method, accepted since 1912, of issuing conventional government bonds in foreign markets, 'we wouldn't be hearing a peep from the commentators, pollies or anybody else. The (hidden) forex loss would be accepted as no more than an inevitable consequence of the dollar's fall.'

And the fourth lesson illustrates two other phenomena frequently encountered in behavioural economics: 'accessibility' and 'prototype heuristics'. A 'fact' that has just been related to you is more accessible than an assessment of performance over time, especially since the latter requires computational effort. And in evaluating an experience that extends over time, there is a tendency to discount everything other than the most intense, and the most recent, instants of experience.

Behavioural economics, borrowing from the literature of behavioural psychology, is concerned, principally, with behaviour at the level of the individual. But it seems to me to describe pretty well what we observe in the political environment most of the time.

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5 In this material, and in much of what follows, I am drawing on Kahneman's (2003) excellent review article.

Had we understood these lessons of behavioural economics back in the late 1980s we probably would not have embarked on the cross-currency swaps strategy, even had we known with certainty that it would end up saving the taxpayer almost $800 million. At the very least, we would have devoted a lot more resources to 'framing'; to the conditioning of public expectations. The cross-currency swaps programme was a mistake; not in financial terms, but because our management of it turned out to be not well suited to the political environment in which public sector project managers operate.

In managing defence projects you have to be mindful not only of financial risks, but also others, such as technical and scheduling risks. I have concentrated, in these remarks, on financial risks. The lessons sketched out here apply equally to those other risk categories, each considered in isolation. But what if the levels of risk across these three categories are interrelated?

Well then we have a whole new level of complexity.

I'm not going to go through all of the permutations that are possible in the incredibly complex environment in which the public sector project manager operates. I'll simply illustrate one permutation, in which all three risk categories are, generally, positively correlated. This is a highly significant case, arising in almost all cases in which a decision is taken to source a large acquisition domestically — that is, from Australian producers — rather than to import it. These decisions don't always imply higher levels of financial, technical and scheduling risk; but often they do.

I draw attention to this case because some of you will be wondering why, if political decision makers are so risk-averse, they would ever take a decision to source complex product domestically.

I can think of two reasons. The first is that, because of the popular appeal of domestic sourcing (Australian production is 'good', imports are 'bad'), a decision to import is, by far, the more politically courageous. The second reason is that when things go wrong with a domestically sourced project, it is extremely unlikely that the political opposition — or the media for that matter — will pin the blame on the sourcing decision. More likely, the failure will be perceived to have been one of project management; your failure, not 'theirs'.

Responding to governments' approach to risk

So what protections do you have?

Well, the project approval arrangements implemented following the Kinnaird review afford you a considerable measure of protection; but only if you insist on those arrangements being followed.

Following the Kinnaird review, there is an increased focus on identifying and managing cost, schedule and technology risk as part of a rigorous two-pass project approval system. The rules require that an 'off-the-shelf' option is considered along with the more attractive customised options.

Defence projects examined by the National Security Committee of Cabinet first run the gauntlet of Defence's internal clearances, the Secretaries' Committee on National Security, and the Cabinet Secretariat. And they are commented on by other departments, including the Treasury.

I would want to encourage you to embrace these processes. I'm sure they will sometimes seem to you to be a nuisance; an unnecessary, cumbersome, overly bureaucratic set of arrangements designed simply to slow things up and make your job more difficult. But the fact is that you have much to gain from these processes and even more to lose if you don't. They are your opportunity to 'frame' the project; to condition expectations; and to protect yourself from unfair criticism down the track.

I appreciate that, in the contemporary environment, where there is an understandable, and appropriate, emphasis on public servants being responsive to ministers, there could be, on occasion, a temptation to cut corners, to facilitate a rapid decision and the staging of a high publicity announcement. Just keep in mind how exposed you might be if and when the whole thing turns pear-shaped and the world learns that you have flouted the post-Kinnaird procurement guidelines.

Of course, the rules are there also for the benefit of ministers. They aim to ensure that ministers are given comprehensive and clear advice on options, their implications and key risks. Ministers have endorsed the rules because, among other things, they test whether you understand and have considered all of the risks in formulating your advice. They provide a level of assurance that your professional judgment — which ministers would prefer not to second guess — can be relied on.

Having said that, the rules only take you so far. A lot still depends on the personal judgements you make; in particular, on the options and information you present to ministers and how you present them.

These judgments can be difficult to get right at the best of times. They can become next to impossible if you are unaware of the rigours of the political environment in which you operate.

In everything you do, keep these four things in mind:

- perceptions play stronger than facts;
- losses are valued much more heavily than gains;
- public education investments should be undertaken long before risks materialise; and
- when something goes wrong, few people will be talking about your record of outstanding prior achievement.

Reference

Kahneman, D 2003, 'Maps of bounded rationality: psychology for behavioural economics', *American Economic Review*, vol 93 no. 5, December, pp 1449-75.

Peer review in the context of regional integration

Blair Comley[1]

Peer review of economic policies by countries comprises peer learning, peer support and peer pressure. Durable peer review processes focus on mutual peer learning and support as peer pressure rarely works unless countries can be convinced that a policy is in their national interest. It requires a high degree of trust and respect, sharing of information, analytical and administrative capacity and legitimacy.

Proximity may lead to greater trust and openness, but it may also be associated with long-standing historical differences and grievances. In principle peer review could be a useful adjunct to other aspects of a regional integration strategy designed to bring mutual benefit to the participating countries. In the Asian context there appears ample scope for well designed peer review to contribute to domestic policy development.

1 The author is the General Manager of the Business Tax Division, Australian Treasury. From November 2003 to the end of 2006 he was at the Australian Delegation to the OECD and was vice-Chair of the Economic and Development Review Committee in 2005 and 2006. This speech was delivered at the First OECD — Southeast Asia Regional Forum, Peer Review Mechanisms — Macroeconomic Policies, Regional Economic Integration and Economic Development held in Jakarata in January 2007. The article has benefited from the contributions of Nina Davidson, Terry O'Brien, David Parker and Sam Rosevear. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

It is a great pleasure to be here today. In thinking about this topic it occurred to me that a useful question to address would be the following: 'what, if anything, is different about peer review in the context of regional integration?' In answering this question I will do three things. First, I will outline three aspects of peer review. These are peer reviews as peer learning, peer preview as support for domestic stakeholders, and peer review as peer pressure. In outlining these elements I will argue that peer learning is the core of peer review and that attempts to pursue peer pressure more aggressively will almost certainly undermine the process. Second, I will outline the preconditions necessary for peer review to work well. Third, I will comment on whether undertaking peer review in the context of regional integration helps or hinders constructive peer review. Naturally this last aspect will be heavily influenced by the specific regional integration project, but I think that some general observations can be made.

My discussion is focused on peer review between countries with respect to economic policy matters rather than peer review in the academic context or regarding other policies. In this context mutual discussions between countries about their economic policies often lead to recommendations for action agreed among the peers.

However, before exploring the detail, I think it is worth stating a key premise on which I believe peer review is based. This premise is that it is in our own interests for everyone else to be successful. This is true in the economic sphere. It is also true with respect to having successful, sound and stable institutions. To economists this is an obvious point that is implicitly rejected by many mercantilists. Put another way, the objective of peer review is to help each other to be successful in our own enlightened self-interest.

Three aspects of peer review

The term 'peer review' is often used to describe a wide variety of processes. However, I would argue that practical peer review combines three main elements. The three elements are:

- peer review as peer learning (or alternatively peer exchange);
- peer review to provide support for a policy that a country would already like to undertake; and
- peer review where the reviewers would like the country to do something that they do not want to do.

Peer review can usually be considered as involving the 'reviewers' (perhaps a few countries designated to lead questioning and discussion of the country under review); that country's 'counterparties' (the officials representing their government); and the 'other parties' to the review, countries which join the discussion led by the reviewers. In addition, where a permanent secretariat exists, they can play quite an important role. Whether this role is merely one that facilitates the process or leads to a fundamentally different outcome depends on the responsiveness of the secretariat to member countries and to the formal process of clearance for review documents.[2]

Peer review as peer learning

Arguably the most important aspect of peer review is genuine peer learning. This may sound a little counter-intuitive as the phrase peer review often invokes a more inquisitorial process, but I am convinced it is true. The nature of peer review is that it is a process whereby 'soft powers' are exercised, and those 'soft powers' are the power to convince people that there is a policy prescription worth following and to encourage all countries to think analytically about the lessons for their own national case of the country under review. Importantly, the directions in which the information flows are often from the reviewed country to the reviewer and to the other countries in the dialogue. In this respect the attitude of the reviewers is vital. Peer review works best when an atmosphere of constructive dialogue is created. Peer reviewers and other countries should be motivated by the question 'what can I learn from this process?' as much as 'what can I impart?'

Learning from peer review is multidirectional, and 'what you get out is proportionate to what you put in'. While the reviewers and the counterparties may be focused on the country experience under examination, the other parties may be wondering (and debating with their domestic authorities) 'what do country A's lessons and country B's lessons have in common?'; or 'why does this policy work in country A, but not in country B?'

This observation is not surprising when one pauses to think about the nature of the peer review processes. It is only natural that the reviewed country knows more about

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2 In the context of the OECD's Economic and Development Review Committee (EDRC) the role of examiners (lead countries) has diminished over time. In practice the examiners act as lead discussants with the Committee as a whole performing the role of reviewers. This evolution may reflect the longstanding nature of the EDRC (it has held over 1,000 meetings), the frequency of the meetings (around 25 per year) and the continuity of delegates to the meetings. Less well established processes may need to rely more heavily on a subset of countries in initiating discussions. Also in the EDRC context, the Secretariat is very responsive to the collective view of the Committee, partly reflecting the fact that review documents are released under the auspices of the Committee itself as adopting reports under a consensus rule.

their country than the reviewers. Indeed, while there may be cases where reviewers are better informed, these are likely to be the exception to the norm. It is natural that authorities representing a country will have a much better appreciation of the specific circumstances of their country than the reviewers.

This last point has become increasingly true given the shift in focus of macroeconomic peer review and surveillance. There is now a much greater understanding that macroeconomic analysis is not very useful without strong links to structural policy which drive the supply potential growth of the economy. The OECD's EDRC process prides itself on undertaking macro-structural analysis. This reflects the clear understanding that the interaction of macroeconomic and structural policies is the key to understanding an economy. Two examples illustrate this point well.

- First, the European Central Bank (ECB) is sometimes criticised for not behaving more like the United States Federal Reserve. Much of this criticism is unfounded as it fails to take account that the Fed faces a very different set of product and labour markets than the ECB. A central bank dealing with some areas with implicit wage indexation and influential unions cannot behave the same way as a central bank operating in an economy with very weak employment protection legislation and substantial inter-regional labour mobility.

- Second, external observers often compare favourably the resilience of the Australian economy to Europe. It is true that sound macroeconomic policies and a flexible exchange rate play an important role in delivering resilience. But it is also true that highly competitive product markets, with the implied discipline to factor markets, play a very significant part in allowing the smooth absorption of economic shocks — both negative (such as the global slowdown of the start of this decade) and positive (such as the commodity-price driven improvement in Australia's terms of trade).

It is not true that macroeconomic policy lends itself to simplistic one-size-fits-all solutions. But it probably is true that macroeconomic experts can readily discuss the appropriate macroeconomic settings in a country with recourse to a relatively small set of data. I have certainly observed this in the context of the EDRC. Members can easily debate the merits of inflation targeting, flexible exchange rates and centralised versus decentralised wage bargaining. It takes a lot more homework to debate the merits of the regulatory arrangements around infrastructure or network industries. In practice this homework will rely a lot on information provided by the reviewed country.

Furthermore, the scope for peer learning with respect to structural policies is large, particularly where countries face common problems, but there is no consensus around solutions. For example, many OECD countries face a common problem of growing numbers of people receiving sickness, disability or incapacity benefits. Many OECD

countries acknowledge the problem and are keen to learn from countries that seem to be making progress on the issue. Accordingly, the new approaches that have been introduced in Denmark and the Netherlands excite a lot of interest — when these countries are reviewed the reviewers are not looking to criticise, they are looking to learn.

When trying to benefit from peer learning, peer reviewers often have in mind the following question ‘when I see a policy that looks successful, is there some country specific factor that means it would not be applicable to my country?’ This is a critical question, and is at the heart of both the inquiring and respectful nature of peer review. It recognises that policies often evolve in countries in response to the specific cultural, institutional and historical context. Policies rarely come into being for no reason. The flipside of this is that the good peer reviewer does not jump to the conclusion that a particular policy is bad and should be changed without carefully considering the country-specific context. The question that should come into the mind of a good peer reviewer when they see a policy that does not make sense to them is ‘what am I missing; what factor might exist that I do not understand?’ Of course the benefit of peer review is that the reviewer can actually ask this question, and in giving the answer the reviewee may reflect on whether the current policy is the best policy that can be pursued.

The process of information exchange described above relies on a high degree of openness. If a country chooses not to disclose key information, then the opportunity for peer learning is significantly diminished. Accordingly, the conduct of the participants is vital. Many have commented that peer review is a fragile process. This may partly reflect the fact that if one participant acts in bad faith, then it can undermine the spirit of trust that allows free exchange of information and genuine learning. Accordingly, good peer review processes need to be nurtured as an appropriately constructive approach often needs time to develop.[3]

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3 This is analogous to negotiation contexts. Some negotiation theorists distinguish between distributive and integrative negotiation. Distributive negotiation seeks to divide a given set of resources. Integrative negotiation seeks to expand the set of resources for mutual gain. That said, integrative negotiation can only be achieved if the parties agree to exchange information with a view to finding mutually advantageous exchange. If parties fear that the other party will behave in a narrow distributive sense, then it will hamper the chances of achieving mutually beneficial gains. Peer review is similar. Parties must be prepared to share information in order to achieve mutual gains. However, if parties fear that others will behave distributively (for example by using information to their advantage in a parallel negotiating context), then the benefits of the process can be eroded (see Bazerman and Neale 1992).

Peer review as peer support

The second aspect of peer review is peer review that facilitates domestic reform. Reviewed authorities may already wish to implement a particular policy, but may need additional support due to political economy considerations.

Peer review may be most helpful where a particular policy is in the national interest, but powerful vested interests stand in the way of its introduction. Peer review can assist by providing an independent analysis of the facts of the situation, one that may carry more weight in shifting public opinion than an assessment made from within the country as internal assessments may be perceived to be driven by their own vested interests.

The relevance of this leg of peer review is critically linked to the credibility and weight given to the particular peer review mechanism. For example, it has often been argued that the influence of OECD reviews is inversely related to the size of the reviewed country (partly related to the vibrancy and competitiveness of its domestic marketplace for policy ideas, and the depth of its domestic analytical processes). In the US political context peer review by an international organisation appears to have little weight — indeed it may actually be counterproductive to positively influencing public opinion. Similarly, some countries may view outside advice as inappropriate and unhelpful.

In this respect it is important to highlight the role of the counterparty in the peer review process. Internationally, the counterpart generally represents the government of the reviewed country. That said, in practice the counterpart may be a subset of that government that may consult and coordinate in varying degrees with other parts of government. Practice in this area varies considerably.

There may be different country-specific dimensions to this counterparty variation. These variations are as numerous as the different forms of government. However, some of the most notable variations in counterparties are:

- Instances where there is a separation of the executive branch of government and the legislative branch. The executive typically is the counterparty in international peer review and may have interests that are not aligned perfectly with those of the legislature.

- Variations within the executive branch of government. For example, in some processes the Ministry of Economics may be the counterparty with the responsibility of representing the government of the reviewed country.

- Variations between levels of government in non-unitary systems. In federal systems this may involve differences between the interests of the national, provincial and local government levels.

Implicit in this is the fact that the results of the peer review are published. Other channels of peer review do not necessarily require the results to be transparently available. But, as the OECD (2003) notes,

> … the government of the reviewed country can also come under pressure from the press and the public to accept the recommendations [but] … officials of the country under review may welcome advice from outside that supports unpopular policy changes … which they themselves feel are necessary for the longer term good of the country.

Peer review as peer pressure

The third aspect of peer review is where the peer review process seeks to make a country do something that it does not want to do. I would argue that this rarely if ever works, unless the policy is actually in the interests of the reviewed country. This then begs the question 'if it is really in the interests of the reviewed country, then why do they not do it in the first place?' It also raises the question 'why would the peer reviewer be better placed to know what is in the best interests of the reviewed country?'

There are many ways to think about this question. However, a useful way to think about this may be to reflect on Yew Kwang Ng's (1983) taxonomy as to why people disagree. Ng argues that there are three reasons why people disagree. First, people can differ in their basic value judgments. Second, people can differ regarding statements of fact. Third, people can make errors of logic. My belief is that the third category is rarely the reason for prolonged differences of opinion, at least at the level of policy. Accordingly, differences are likely to arise over the first two elements.

Turning to the first element, it is possible that different countries may genuinely seek different objectives. I believe that if this is the case, then peer review should respectfully note the different objectives and limit any comments or suggestions to how these objectives can be met in the most effective manner. In this area, one does need to be very careful. It is not uncommon that objectives are stated that are not ultimate objectives. Once these objectives are appropriately clarified, generalised and reformulated, then there is often scope for constructive policy dialogue.

For example, OECD (2004) has a very good discussion of policies to promote recycling. Many countries have quantitative targets for the volume of recycling. If these targets were interpreted as the objectives of policy, then there would be little scope to discuss

the merits of the policy. However, if the objective is really to promote environmental amenity, then there is scope for constructive dialogue of whether quantitative recycling targets are the best instrument for pursuing this broader goal. Indeed, the OECD concluded, and by a process of consensus the countries accepted, that there were better ways to achieve the broader environmental goal.[4]

Ng's taxonomy relates to why individuals disagree. However nations are not individuals. Accordingly, an additional related source of difference may be that different countries place different weights on the importance of furthering different groups, or that political rules may advantage one group over others. Again, if this is genuinely the case, then peer review should restrict itself to suggesting policies that may better achieve the given objective or improving transparency to empower domestic stakeholders with information about the effects of current arrangements.

The second element lends itself to exchange of information. In particular, certain country specific factors may mean that critical facts differ, leading to quite different policy conclusions. For example, I would argue that the extent of product market reform in Australia has meant that labour markets operate more efficiently than might be guessed from the state of labour market regulation. Product market reform has squeezed economic rents out of the system, requiring labour market actors to behave in a manner that is consistent with a highly resilient and growing economy. However, I should be wary in applying this lesson of Australian economic reform to other countries. Some other countries may believe that labour markets should be reformed first as the interaction of liberal product markets with unreformed labour market institutions may lead to even more restrictive measures being sought by labour market actors.

Perhaps more concretely, a Scandinavian may be relatively relaxed about high marginal tax rates on labour income, judging the international mobility and hence the labour supply elasticity of high income earners to be low. An Australian or New Zealander may take a different view based on a concern that the English-speaking labour market provides a powerful pull factor that cannot be ignored.

With respect to this last point, it becomes clear that peer review as peer pressure may really be just another form of peer review as peer learning. The process of peer review may convince a country that what they thought was in their interest is not. But it must be stressed that the country must be convinced on the merits of the case unless there are possible sanctions outside the peer review process. For the moment I will not pursue this, but merely note that introducing sanctions in my view takes us out of the

4 Comley (2007) provides a fuller discussion of these issues in the context of reform of environmentally harmful subsidies.

realm of pure peer review. Indeed sanctions may significantly hamper peer review by inhibiting the free flow of information that is integral to genuine peer review and support.

Conditions under which peer review works well[5]

The foregoing discussion implies a number of conditions that are required for peer review to work well:

- first, there must be a high degree of trust and respect between the parties to the peer review;
- second, parties must be prepared to share information freely and openly;
- third, the peers must have at their disposal sufficient analytical and administrative capacity to conduct the peer reviews;
- fourth, the peers must be seen to have legitimacy in the eyes of domestic constituents; and
- fifth, the reviewed country counterparty must be seen as legitimate in the eyes of the domestic constituents.

Peer review in the context of regional integration

The premise that I asserted at the start was that peer review is based on the idea that it is in all countries' interests for another country to be economically successful. This is true in general, but is an even stronger proposition in the context of regional economies where economic geography suggests that interests are more intertwined.

In principle peer review in the context of regional integration is no different to peer review elsewhere. However, depending on the nature of the regional integration project peer review may be more or less difficult to conduct successfully.

I do not want to go through the conditions for successful peer review in an exhaustive manner. Readers will have in mind their own examples of regional integration projects. Proximity may lead to greater trust and openness, but it may also mean that long-standing historical differences and grievances may exist. Near neighbours may be

5 Kanbur (2004) outlines three broad criteria for successful peer review: competence; independence; and competition. OECD (2003) outlines four elements: value sharing; commitment; mutual trust; and credibility.

seen as informed and legitimate reviewers, or to be too coloured by their own national interests to constructively enter into a dialogue.

There is one issue that I would like to focus on — the role of potential sanctions in peer review. It is worth looking at the list of conditions for successful peer review and asking 'how would the existence of potential sanctions affect the peer review process?'

My answer to this would be that it would almost certainly diminish the usefulness of peer review. As the OECD (2003) has noted,

> … peer review is a discussion among equals, not a hearing by a superior body that will hand down a binding judgment or punishment. A state may be more willing to accept criticism, and its neighbours to give it, if both sides know it does not commit them to a rigid position or obligatory course of action.

Perhaps more importantly, a peer is much less likely to share information if they believe that the information may be used against them now or in the future. In terms of the taxonomy of peer review, sanctions may cripple peer review as peer learning and peer review as peer support and leave only the weak limb of peer review as peer pressure. Further, once the voluntary flow of information from the reviewed country dries up, then peers would have to ramp up the resources used to conduct the review. This could leave to a vicious cycle of limited disclosure, intrusive questioning and even weaker trust. Kanbur (2004) makes a similar point when he states that,

> … IMF reviews work like OECD reviews in rich countries not using IMF resources, but not so in poor countries dependent on them. When a review is, or is perceived to be, the 'only game in town', or 'too big a game in town', the high stakes set up dynamic pressures that can undermine trust.

The same lesson flows from the experience of the World Bank, where analysis of desirable policy reform and recommendations are usually bundled with International Development Association or International Bank for Reconstruction and Development lending programmes at more or less attractive interest rates. The experience of recent decades is that there have been few development successes from trying to 'buy' reforms through concessional lending and policy conditionality; the key ingredient of success is 'country ownership' of the need to make the reform in question (World Bank 2005).

One could argue that attempts to ingrain peer review in the European Union have been hampered by exactly this issue. Peer review within the European Union cannot escape the fact that the legal structure of the Union constrains the actions of the member states. Countries must always be wary that information disclosed in one context may be used elsewhere. The open disclosure of information is not encouraged.

If a country is not prepared to air its faults, then even well intentioned observers are unlikely to be able to help.

Naturally, the European Union is a special case of regional integration. It is a model that has moved well beyond information exchange and cooperation given its myriad common policies and well-developed institutional architecture. Accordingly, other experiments in looser integration projects with the absence of sanctions have less to fear.

In contrast the prospects for peer review in the Asian context do not appear to be hampered by the formal structures of legalistic integration. Accordingly, there appears ample scope for well designed peer review, focusing on respectful peer exchange to contribute to domestic policy development.

Conclusion

Peer review can be thought of as having three aspects — peer learning, peer support and peer pressure. Durable peer review processes focus on peer learning and support. Peer pressure rarely works unless countries can be convinced that a policy is in their national interest. Viewed through this lens, successful peer pressure should best be thought of as another form of peer learning — a peer learning where the country may initially be unconvinced of the merits of the case.

Peer review may be more or less difficult in the context of regional integration. In principle peer review could be a useful adjunct to other aspects of a regional integration strategy designed to bring mutual benefit to the participating countries. However, where regional integration projects involve deepening legal and economic commitments it is important to disentangle sanction regimes from peer review to ensure that the free disclosure of information is incentive compatible.

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Australia's G-20 host year: a Treasury perspective

Gordon de Brouwer and Luke Yeaman[1]

Australia has been a member of the Group of Twenty Finance Ministers and Central Bank Governors (G-20) since its inception in 1999. In 2006, Australia hosted this prestigious forum, culminating in a meeting of the world's most influential economic leaders in Melbourne in November.

This paper sets out Treasury's perspective on Australia's experience in hosting the G-20, particularly in terms of developing a practical and substantive agenda, strengthening the place of the G-20 in the international architecture, and providing opportunities to reinforce Australia's favourable international economic reputation.

1 The authors are General Manager of the G-20 and APEC Secretariat and Senior Advisor, G-20 and APEC, respectively, in the Treasury. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

The G-20 is a forum that promotes open and constructive discussion between developed and developing countries on key issues related to global economic stability. Finance Ministers[2] and Central Bank Governors of the G-20 met in Melbourne on 18-19 November last year to address the world's key economic and financial challenges. These challenges included keeping global inflation in check, modernising the governance and policies of the IMF and World Bank, achieving global security in energy and key resource minerals, strengthening capital markets and facilitating the movement of people to meet the challenges of demographic change, and sharing practical ideas and experience in securing domestic economic reform and advancing international trade reform. This meeting was supplemented by many dozens of bilateral meetings between the various ministers, governors, heads of the IMF and World Bank, and key interested parties such as business and non-government organisations. The Melbourne G-20 meeting of Finance Ministers and Governors was the most important international economic policy meeting that has been held in Australia.

Preparation for the Melbourne meeting was substantial.

G-20 Ministers and Governors agreed at their meeting in Berlin in November 2004 that Australia would host the forum in 2006. For the purpose of determining the chair of the forum, G-20 countries are split into five groups, with the chair rotating between groups.[3] Australia's group was slated to host in 2006 and, under the G-20's informal practice, the 2004 host, Germany, approached the group about possible chairs. The group informally nominated Australia, and this was discussed by senior officials at the G-20 deputies meeting in Frankfurt in October 2004 and agreed by Ministers and Governors at the G-20 meeting in Berlin.

Preparations for the 2006 meeting began as soon as Australia was selected as chair in November 2004. A secretariat for G-20 and APEC (which Australia chairs in 2007) was set up in November 2004 in the Treasury, and the long process of budget and financial preparation, staff recruitment and development, preparation of analysis and policy advice, and logistics preparation and implementation began. A G-20 Secretariat was

2 In international fora, Finance Ministers are the equivalent of the Treasurer in Australia.

3 Group 1 consists of Australia, Canada, Saudi Arabia and the United States and provided the chair in 2001 (Canada) and 2006 (Australia); Group 2 consists of India, Russia, South Africa and Turkey and provided the chair in 2002 (India) and 2007 (South Africa); Group 3 consists of Argentina, Brazil and Mexico and provided the chair in 2003 (Mexico) and will do so in 2008 (Brazil); Group 4 consists of France, Germany, Italy and the United Kingdom and provided the chair in 2004 (Germany) and will do so in 2009; and Group 5 consists of China, Indonesia, Japan and Korea and provided the chair in 2005 (China) and will do so in 2010.

also set up in the Reserve Bank of Australia (RBA), which worked closely with Treasury's G-20 and APEC Secretariat and Australia's two G-20 deputies.[4]

Having the Australian Treasurer chair the G-20 in 2006 was a once-in-a-generation opportunity to lead a key global forum. This article sets out how Treasury approached its responsibilities in supporting the Treasurer who, along with the RBA Governor, led the G-20 in 2006 and chaired the Melbourne meeting. It includes some reflections on the role of the G-20 forum.

Australia's approach to chairing the G-20 was founded at the outset in its strategic objectives for the forum. Australia had three major strategic objectives for the G-20 meeting. The first was to ensure that key issues in the global economy were brought to the table and addressed in a substantive and practical way to support global development and stability. The second was to strengthen the position of the G-20 as a pre-eminent forum in the global economic and financial policy architecture, with a strong focus on encouraging rules-based and market-focussed national policies and international cooperation among members. The third was to use the forum to enhance Australia's international reputation and bring the best global policy analysis into domestic decision-making. Policy and logistical planning were jointly directed to meet these strategic objectives.

In this article, we outline Treasury's approach to support the Treasurer in achieving these strategic objectives for the G-20.[5]

4 Australia's G-20 deputies during Australia's 2006 host year were Dr Martin Parkinson, Executive Director, Macroeconomic Group, Treasury and, until his appointment as Governor of the Reserve Bank of Australia in September 2006, Mr Glenn Stevens as the Bank's then Deputy Governor. Dr Malcolm Edey, Assistant Governor (Economic), fulfilled the role of Australia's central bank deputy following Mr Stevens' appointment as Governor.

5 Treasury is undertaking a similar process in preparing for the APEC Finance Ministers meeting which the Treasurer will host in 2007.

G-20 policy outcomes

The G-20 meeting was held under the theme 'building and sustaining prosperity'. The Treasurer chose this theme because it encapsulated his view that the G-20 should address the key issues at play in the world economy in a practical, substantive and sustainable manner.[6]

At their meetings, the practice has been for G-20 Ministers and Governors to focus on a relatively small number of issues to ensure they can address them in sufficient depth. An agenda with three to five major themes is a full one. Policy preparation throughout 2005 focussed on selecting themes for the 2006 host year.

The major legacy issues from China's 2005 host year were reform of the Bretton Woods Institutions (BWIs) — the IMF and World Bank — and the challenges of demographic change, especially in relation to how capital markets and the movement of people can best facilitate adjustment to rapid population growth in many developing countries and ageing in both developing and industrialised economies alike. The ongoing focus on demographic issues in the G-20 was due to an intervention by the Treasurer at the 2003 meeting on the need for a clear understanding of the various impacts of demographic change and how countries can ensure that the benefits are captured and costs minimised. BWI reform and demographic change were priority areas for

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6 The Treasurer spoke or wrote publicly on the G-20 on many occasions during 2006. He discussed the G-20 in the following speeches: Address to Asialink lunch, http://www.treasurer.gov.au/tsr/content/speeches/2006/023.asp; Address to the Australian and South African Business Lunch, Johannesburg, South Africa, http://www.treasurer.gov.au/tsr/content/speeches/2006/018.asp; and address to the Australian Chamber of Commerce and Industry Annual Dinner, 1 November 2006 http://www.treasurer.gov.au/tsr/content/speeches/2006/024.asp. The Treasurer also contributed the following newspaper articles: 'The G-20: An Australian Perspective', *China Daily*, 16 October 2005; 'The Global Monetary Fund needs to Reform its Quotas', *The Financial Times*, 20 August 2006; 'Opportunity for World Leaders to Sample Melbourne', *The Age*, 4 September 2006; 'G20 Provides Opportunities to Assist Poorest Countries', *The Age*, 27 October 2006; 'A Golden Opportunity to Shine on the International Stage', *Sydney Morning Herald*, 13 November 2006; 'G20 Keys Unlock Economic Growth', *The Australian*, 14 November 2006; 'Trade Key to Ending World Poverty', *The Age,* 16 November 2006; and 'Brave New World', *The Herald Sun*, 16 November 2006. Australia's G-20 finance deputy in 2006, Dr Martin Parkinson, also made some public comments on the G-20, including 'The Role of the G-20 in the Global Financial Architecture', Address to the Lowy Institute for Economic Policy and Monash University Faculty of Business and Economics http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1171, and 'The G-20 — Addressing Global Challenges', Address to the Australian Business Economists Luncheon, http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1185. Dr Parkinson also contributed the following newspaper article: 'Growth is the Best Weapon against Poverty', *The Age,* 13 November 2006. This article draws extensively on these various speeches and newspaper articles.

Australia and, from discussions with other G-20 members in 2005, it was clear that there was a broad-based desire for these two issues to stay on the table in 2006.

Two other issues were identified as being relevant for Ministers and Governors to examine. The first was energy and minerals security. With rising and volatile energy and minerals prices, uncertainty in markets, and increasing concern about the reliability of supply and demand, this was (and remains) a key international issue. It was also one that was well-suited to the G-20, given the mix of major energy and minerals producers like Australia, Brazil, Canada, Indonesia and Saudi Arabia, and key consumers like China, Europe, India, Japan, Korea, and the United States. It is a topic of direct interest to the G-20 because developments in these markets can materially affect macroeconomic stability and growth, and have a range of important implications for fiscal and monetary policy. More generally, finance ministers have a general interest in, and responsibility for, ensuring that their countries' economies function well.

The second issue was maintaining the focus on, and momentum for, domestic economic reform within G-20 countries. One of the G-20's landmark achievements was the endorsement of a *G-20 Accord for Sustained Growth*, agreed in 2004 under Germany's leadership.[7] The G-20 Accord sets out the commitment of members to effective macroeconomic frameworks, competitive markets, and strong domestic institutions. The Treasurer was interested in discussing practical ways to implement the reforms embodied in the Accord with his colleagues. Building a political and social consensus on the need for, and content of, reform can be a key impediment to implementation. A discussion on the political economy of reform was seen to be well-suited to the characteristics of the G-20 meeting, with its open and informal style and the privacy afforded by a tight restriction on the number of people in the meeting room.[8]

Along with these four issues — BWI reform, demographic change, energy and minerals markets, and advancing economic reform — a regular session examining current challenges in the global economic and financial outlook would also remain on the agenda. For this session, there was concern that discussions on global conditions can be repetitive, and heavily based on the latest views of the international institutions such as the IMF, World Bank and OECD, or revert to countries around the table listing recent developments in their economies. To encourage a policy-relevant discussion in Melbourne, it was agreed to have a theme-based conversation on the challenges of

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7 See http://www.g20.org/documents/publications/2004_g20_accord_for_sustained_growth.pdf

8 There are 44 Ministers, Governors and heads of International Financial Institutions (IFIs) at the meeting table, and one supporting official from each country and international institution also allowed in the room. There is no video or audio recording of the meeting.

managing monetary and fiscal policy in the face of sustained above-trend global growth. The IMF and World Bank were asked to prepare short background papers on the subject, and selected countries were invited to open the general discussion.

As the key themes for Australia's host year became more defined throughout 2005, one issue that needed to be resolved was how to address development challenges. Development issues are a core part of the G-20's focus, reflecting the broad developing and developed country membership. The approach taken in 2005 by China had been to focus on development as a stand-alone theme. This allowed the G-20 to engage in the global debate occurring at the time around the Millenium Development Goals five years on from 2000. The approach taken by Australia for 2006 was that development should be embedded and highlighted in discussion and action on all of the major policy themes addressed by the G-20. This would not preclude special topics, such as aid effectiveness and the aid donor architecture, being addressed at members' discretion.[9]

Given agreement on the key themes for Australia's host year, policy preparation for the G-20 shifted focus at the start of 2006 to working out the detail of the material to be presented to Ministers and Governors for their consideration and decision in November, as well as continuing to contribute to debate in other forums on key issues such as BWI reform. The sequence of G-20 officials' meetings provided the structure for this preparation. G-20 deputies met twice in Australia during 2006, the first time in Adelaide in March and then in Sydney in October. At their first meeting, deputies examined challenges to the ongoing global expansion, shared insights into addressing impediments to domestic economic reform, explored views about BWI reform and a way forward on IMF quota and voice reform in particular, and explored ways to improve the effectiveness of aid. At their second meeting, deputies focussed on BWI reform, ways in which energy and minerals markets could support global economic stability and prosperity, and possible responses to the challenge of demographic change.

These meetings were supported by three workshops: the first in February in Tokyo on reform of the BWIs; the second in Banff, Canada, in June on energy and minerals markets; and the third in July in Sydney on the financial market dimensions of demographic change. These workshops brought experts from around the world to discuss the key substantive analytic and policy issues in each of these three themes with G-20 officials, with these insights brought directly into the following deputies' meetings. The background papers from these workshops were made available to the public on the Treasury and RBA websites. These workshops and deputies' meetings

9 Improving aid effectiveness was discussed by deputies at their meeting in March in Adelaide, and the Treasurer spoke on this issue at the meeting in Melbourne in November.

required extensive preparatory work within Treasury and the RBA and close engagement with other relevant government agencies and G-20 counterparts. These meetings enabled the development and testing of ideas in preparation for the meeting of Ministers and Governors.

Ministers and Governors had a substantive discussion on the issues selected by the Treasurer as priorities for Australia's host year. Their key decisions are expressed in the communiqué issued after the meeting.[10]

Each of the policy themes addressed by G-20 Ministers and Governors not only had specific and practical outcomes but also set in place a broader cooperative, strategic and stabilising approach to dealing with the issue. Three examples illustrate this.

The first is reform of the BWIs. Reflecting its origins, the G-20 has always maintained a focus on making the IMF and the World Bank more effective and legitimate. The G-20 was created in the aftermath of the financial crises in the second half of the 1990s, in recognition of the growing influence that emerging market economies now have on global financial stability.

There was a widespread view at this time that the IMF had failed to anticipate and effectively respond to these crises. One of the contributing factors identified was the failure of the Fund's governance arrangements to keep pace with the changes in the world economy, which eroded its effectiveness and authority. In particular, the quotas of fast-growing emerging market economies, including in Asia, had failed to keep pace with their increasing global economic weight.

While the responsibility for reform of the BWIs is a matter for the governance bodies of these institutions, other bodies can play an important role in finding and developing a consensus for reform.

Having laid some important groundwork the previous year, the G-20 played a key role in 2006 in helping move the IMF membership to agreement on an historic package of IMF quota and voice reforms in September 2006.

IMF Governors agreed to a package of reforms comprising early quota increases for the most significantly underrepresented economies (China, Korea, Turkey and Mexico) as a down-payment under a first stage of reform, and a commitment to deliver, over the next two years, a second stage involving a new quota formula designed to reflect members' economic weight, further quota increases for significantly underrepresented

10 See http://www.g20.org/documents/communiques/2006_australia.pdf.

members, and an increase in basic votes to strengthen the voice of low-income countries in the IMF.

The G-20's contribution involved building political support for reform, maintaining momentum at critical points, and contributing on the substance of proposals. In particular, the G-20 devised the two-stage approach to reform that was instrumental in achieving consensus within the IMF. It was largely through the G-20 that the international community agreed that quota and voice reform was necessary to enhance the Fund's legitimacy, identified it as a priority, committed to resolving the issue, and outlined a credible and feasible path to deliver an outcome.

In November, G-20 Ministers and Governors reaffirmed their commitment to delivery of the second-stage of IMF quota and voice reform and set out priorities for further significant reform of the IMF and the World Bank, including strengthening policies and instruments of the institutions and transparent, merit-based processes for the selection of management. The international economic community is now looking to the G-20 to help deliver on the second-stage of IMF quota and voice reform. South Africa, as host of the G-20 in 2007, has made further reform of the IMF and World Bank a key theme within its G-20 work programme.

The second example of a substantive policy outcome is the approach taken to energy and minerals markets. In Melbourne, Ministers and Governors pointed to some specific ways to strengthen these markets, including targeted reductions in fiscal subsidies (which tend to obscure the incentives to reduce demand for resources and look for efficiencies or sustainable alternatives when prices rise), strong support for the Extractive Industries Transparency Initiative (which provides for more transparency between extractive firms and source countries), and extending the Joint Oil Data Initiative to natural gas and with countries applying a common definition in estimating reserves (to provide more accurate data for consumer countries and markets).

More than these specific initiatives, the G-20 in Melbourne marked a strategic way forward to address energy or, more broadly, resource security. Regarding the stability of supply of, or demand for, energy and minerals as a 'security' issue can lead countries to try to rush to 'lock in' supply or demand as the solution to their problem, possibly inducing others to act in the same way and sharply increasing competition for access to resources. Rather than delivering 'resource security', such an approach can weaken stable access to supply or demand, raise the political heat and focus on securing national interests through any available means, destabilise international relations, and potentially increase the risk of conflict. The G-20 explicitly acknowledged the challenges of, and countries' concerns about, stable supply and demand, and firmly pointed to feasible and sustainable economic solutions to address them.

The G-20 agreed that the most sustainable way to address resource security is to make sure that markets work as well as they can. This can be achieved by: ensuring firms are in a position to explore, extract and trade; enabling the huge investment required to allow the expansion of supply, with almost half of this investment needed in developing countries; and facilitating trade to ensure that predicted substantial increases in demand can be met by supply.[11] The specific initiatives taken by Ministers and Governors at the meeting are practical ways to deliver a market-based response to energy and minerals security. Looking ahead, the challenge for the G-20 is to facilitate a broader discussion on the key principles that underpin well-functioning markets and the adequacy of the existing domestic and international architecture governing firm behaviour, investment and trade.

The third example of strategic policy outcomes in the G-20 is demographic change. 2006 marked the third year in which Ministers and Governors addressed a key aspect of demographic change. The G-20 looked at the broad implications for economic growth in 2004, for labour mobility in 2005, and for capital markets in 2006. The continuity and depth of approach has meant that there is a solid understanding of the many dimensions of the demographic challenge that countries face, as well as a good sense of the interconnections between them and of the need for international consultation and cooperation in addressing them. The 2006 meeting also came up with some specific initiatives to gain more information on costs and benefits of greater portability of pension and health benefits and on the adequacy of financial market instruments to manage long-term pension liabilities.

Two other outcomes of the G-20 meeting are particularly noteworthy. Ministers and Governors expressed particular concern about the Doha Development Round and the serious threat that growing protectionism and a failure to secure substantive trade liberalisation could pose to the global economy. They also agreed to convey and actively address these concerns within their own governments. In addition, Ministers and Governors underscored the importance of helping countries reap the benefits of higher aid and debt relief, and avoid a new build-up of unsustainable debt. They emphasised that increased development financing must be accompanied by improved aid effectiveness to achieve the Millennium Development Goals and agreed that the G-20 will work toward improving aid effectiveness and good governance in the period ahead. By the time of the meeting, all G-20 countries had pledged their support for the *Paris Declaration on Aid Effectiveness*.

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11 Projections by the International Energy Agency (IEA) suggest the world energy demand will rise by almost 50 per cent from 2004 to 2030, with around US$8 trillion of new investment needed in the oil and gas sectors alone over the next 30 years — or around US$320 billion a year.

The role of the G-20 in the international architecture

The second strategic objective that Australia had in chairing the G-20 was to strengthen the forum as a pre-eminent part of the international economic and financial architecture.

Australia is a medium-sized market-based economy, highly dependent on an open and robust global economic system of trade, investment, finance and people movement. As such, we have a fundamental and abiding interest in a structure of international relations which is rules-based and supports the operation of markets as the primary tool for allocating resources within, and between, economies.[12] The fact that the G-20 has taken this approach from its inception and that its membership is active and encompasses all the major regions and countries of the world means that the G-20 is a forum of primary interest and importance to Australia.

Cross-border economic interactions and interdependencies are now so extensive and broadly based, that most of the economic issues which policymakers face go well beyond national borders and have become inherently international. Consistency of policy across national borders and cooperation in information sharing and policy outcomes can be important. Globalisation has encompassed developed and developing countries alike and the latter have become a larger and increasingly important part of the world economy.

The original reason for setting up the G-20 was as a mechanism to bring systemically important industrialised, emerging-market and transition economies together to help prevent financial crises and ensure international global financial stability. The substantive work of the G-20 in its early years focused on strengthening not only the Bretton Woods institutions but also domestic financial systems and monetary and fiscal frameworks, on the basic premise that well-structured systems and macro policy frameworks reduce the likelihood of domestic policy-induced crises and contagion. The creation of the G-20 was an explicit acknowledgement that strengthening the international financial system has to actively involve key developing countries.

It was understood at the time that the focus of the G-20 could evolve and broaden over time. As Paul Martin, the inaugural chair of the G-20 and then Canadian Finance Minister, said in 1999: 'There is virtually no major aspect of the global economy or international financial system that will be outside of the group's purview'. As the financial crises receded in time and as members strengthened their domestic macroeconomic frameworks, the focus of the G-20 broadened to other economic issues, including demographic change and, in Australia's host year, energy and minerals

12 See 2006-07 Budget Paper No. 1, Statement 4: Australia in the World Economy.

markets. Table 1 summarises the key issues addressed each year since 1999, showing that discussion has broadened over time. It also shows the agenda has contracted to fewer issues recently so that each can be discussed substantively.

Table 1: Major policy issues addressed by the G-20, 1999-2006[13]

1999
Financial system vulnerability, crisis prevention and management
Codes and standards
BWI reform
Exchange rate regimes
2000
Financial system vulnerability, crisis prevention and management
Codes and standards
Financial abuse/crime
Capital flows and capital account liberalisation
BWI reform
Exchange rate regimes
Globalisation and regional integration
Principles for domestic economic policies
2001
Financial system vulnerability, crisis prevention and management
Codes and standards
Financial abuse/crime
Capital flows and capital account liberalisation
BWI reform
Globalisation and regional integration
Principles for domestic economic policies
2002
Financial system vulnerability, crisis prevention and management
Codes and standards
Financial abuse/crime
Capital flows and capital account liberalisation
BWI reform
Exchange rate regimes
Globalisation and regional integration
Principles for domestic economic policies
Aid effectiveness, poverty reduction

13 This does not include reference to the discussion at the start of each G-20 meeting on global economic and financial conditions.

Table 1: Major policy issues addressed by the G-20, 1999-2006 (continued)

2003
Financial system vulnerability, crisis prevention and management
Codes and standards
Financial abuse/crime
Exchange rate regimes
Globalisation and regional integration
Principles for domestic economic policies
Aid effectiveness, poverty reduction
2004
Financial system vulnerability, crisis prevention and management
Codes and standards
Financial abuse/crime
Capital flows and capital account liberalisation
BWI reform
Exchange rate regimes
Globalisation and regional integration
Principles for domestic economic policies
Demographic change
2005
BWI reform
Globalisation and regional integration
Principles for domestic economic policies
Demographic change
Aid effectiveness, poverty reduction
2006
BWI reform
Principles for domestic economic policies
Demographic change
Energy and minerals markets
Advancing economic reform
Aid effectiveness, poverty reduction

The broadening coverage of issues discussed by the G-20 reflects the value that its members accord it. In large part, this appears to reflect three factors. First, the issues that the G-20 addresses are central to the stability of the global economy and finance. Ministers and Governors have to tackle substantive and often difficult issues that are directly relevant to the prosperity of the G-20 membership countries.

Second, as a result of the specific make-up of its membership, the G-20 brings together the key countries and regions relevant to address these issues. Given the degree of interaction and interdependence between countries and the growing importance of some developing countries, it is no longer possible to address key economic or financial issues without a combination of industrialised and emerging market

economies. Financial markets are now deeply interconnected and 'shocks' in one can be rapidly transmitted to others. Global imbalances are just that — global. Demographic change affects all countries and the scope for 'demographic arbitrage' between developing young countries and developed old ones is considerable. Energy and minerals security cannot be addressed without the likes of key consumers like China, Europe, India, Japan and the United States being at the table with key producers like Australia, Brazil, Canada, Russia and Saudi Arabia. The membership of the G-20 makes the forum important.

Third, the style of the meeting itself hopefully makes it useful to Ministers and Governors. The aim is to provide an environment conducive to substantive and rigorous discussions between principals. This is facilitated by the privacy afforded by having few officials in the room, and relaxed and conversational interaction being encouraged by the Chairman. The objective is to make the meeting one that Ministers and Governors genuinely want to attend and participate in.

The policy agenda and logistical arrangements — down to the size and shape of the table and 'feel' of the meeting room — were all planned to make the meeting interesting, relevant and enjoyable for Ministers and Governors and encourage easy exchange between them. In this way, the Melbourne meeting provided an opportunity to consolidate and enhance the relevance of the G-20.

One element that is important in this respect is that for a number of years, the growing role of the G-20 as a global issue circuit-breaker has become apparent. For example, there was deadlock within the OECD in addressing the effect of tax havens on the revenue base in other countries. The G-20 entered this policy debate and, with a different membership, was able to form global consensus on the need to avoid abuse of tax havens. In addition, the G-20's role in 2006 in the outcome on IMF quota and voice reform helped break a long-standing deadlock within the IMF. When delivered, a new quota formula will represent the first major change in the way quotas have been calculated since the 1960s. The G-20 was able to perform this role because of its broader representation including key emerging market economies when agreement on the issue was not possible within the G7 or the IMFC. Similarly, by having a wider set of countries with direct interests join the discussion and by broadening the focus beyond energy to minerals, the G-20 was able to broker a more practical and comprehensive market-based approach than the G8 on resource security.

The G-20 has been able to reach consensus on issues that have become jammed elsewhere. This in part indicates the importance of having a range of forums examining issues: some overlap between forums can be useful in working through issues and finding (or making) opportunities to strike agreement.

The ability of the G-20 to find consensus on issues that other forums could not may also reflect something about the nature and balance of country membership in the G-20. The G-20 comprises the systemically significant countries of the world rather than just the big economies. It includes mid-sized economies like Australia, Canada, South Korea, South Africa, Mexico and Turkey.

Having mid-sized countries at the meeting can strengthen the forum and its ability to reach consensus. In the first instance, having key mid-sized countries at the table provides a higher degree of legitimacy to decisions. The G-20 is not a universal institution (like the IMF or World Bank) but it does comprise around 90 per cent of world GDP, 80 per cent of world trade and two-thirds of the world's population. The active engagement of the key mid-sized economies ensures that the forum's decisions are not just the big countries deciding things for the rest of the world. Having mid-sized countries actively participating in the forum also provides an opportunity to broker consensus between, and concessions by, the big countries that they are not able to make between themselves. Tensions between major economic powers can make it hard for them to find agreement at times and having relatively smaller countries with a stake in effective international mechanisms at the table can ease pressures, provide a circuit-breaker, and help facilitate finding a common position.

Looking forward, this feature of the G-20 — as a mechanism to ease frictions between the world's economic powers — is one to be nurtured. The G-20 works and so the focus should be on consolidating its role and strengths, as outlined above. The effectiveness of the G-20 suggests that it provides a natural forum for economic engagement between key industrialised and emerging market countries.

This can be seen to have implications for the policy engagement of the G7 with developing countries. The G7 is a grouping of industrialised countries. As has been stated before, it is now broadly recognised that many of the economic issues that require global solutions cannot be addressed by industrialised countries alone: the G7 cannot 'solve' global economic problems, even if it can be a useful forum for its members to form and articulate their own perspectives. A narrow model of G7 engagement with developing countries, such as a G7+BRICS model[14], appears limited in comparison to the G-20 because it lacks the broader legitimacy and opportunity for consensus provided by having key mid-sized countries at the table. Other difficulties with G7+BRICS type discussions, at least as currently configured, are that they are relatively euro-centric, rather than reflective of the main regions of the world, and treat the BRICS as 'guests' to part of the discussion by the G7 countries. The G-20 draws broadly across major regions and treats all members as equal partners.

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14 BRICS refers to Brazil, Russia, India, China and South Africa.

The G-20 can provide a powerful tool to address tensions between various groups of countries, be they tensions within regions, among developing or industrialised countries, or between regions and between developing and industrialised countries. The G-20 provides an opportunity to resolve differences between countries at the meeting itself or on the margins in bilateral meetings between countries.

The balance of global economic influence is changing, and the G-20 is an important step in addressing this. One challenge that the G-20 faces is to help facilitate and smooth the economic rise of a range of diverse emerging market or transition economies, including China, India, Brazil and Russia, into the mainstream of global policy influence and cooperation. Forums like the G-20 can do this not just by providing reference points for sustainable development in emerging markets but also by providing a discipline on the actions of the incumbent industrialised countries — especially to limit defensive protectionism — and greater predictability as to how incumbent economic powers will react to emerging ones. This process is not necessarily a smooth and uncontroversial one; the G-20 is one of a set of international mechanisms to support the process.

The agreement by G-20 members on the importance of medium-term macroeconomic policy frameworks and competitive and open markets to meet supply and demand, as shown by the *G-20 Accord on Sustainable Growth*, is important in facilitating adjustment because it marks acceptance of a broad common approach to economic management. But it does not resolve all challenges because countries can mean quite different things when they talk about 'market mechanisms'. Countries have different perspectives and preferences about the desirable degree of public ownership, the extent to which competition should operate (especially when it impacts on social cohesion or induces change), and the desirable amount of variation in prices (be they prices of financial assets, labour, food or energy).

Differences in perspective can give rise to a rich and lively discussion, and the expression of these differences is a necessary step to working out how to resolve issues. To the extent that views about the desirable features of markets differ more among the G-20 than in smaller, more homogeneous groups like the G7, it should be expected that the consensus or compromise forged within the G-20 will differ from that formed in smaller groups. An important implication of this is that the G-20 will not act as if it is just a bigger G7; it is a different beast. Agreements forged within the G-20 will not necessarily be the same as G7 agreements.

Australia and the G-20

The third strategic objective in hosting the G-20 was to use the forum as a means to directly advance Australia's interests. This has a number of dimensions.

In the first instance, having the Australian Treasurer as Chairman of the G-20 provided an opportunity to reinforce Australia's reputation as a strong advocate for, and example of the power of, sustainable economic policymaking, openness, and flexibility. It was, too, an opportunity to demonstrate the value of Australia as a practical, fair and principled player in international economic relations — a country that is able to articulate what the issues are and then help find common ground on them in a way that advances economic stability and prosperity. Having the meeting in Melbourne also provided an opportunity to showcase Australian life and business.

Hosting the forum provided other important opportunities. While Australia is a mid-sized economy, it has a relatively small population. Understanding how thinking on issues is developing around the world and drawing practical insights from the experience of others who are facing similar problems are all important in ensuring that policy advisors and decision makers are adequately equipped to address issues as they arise. Hosting the G-20 provided wide engagement with other countries and exposure to the best of analysis, ideas and informed economic policy judgments around the world. Chairing the forum also provided an opportunity to build closer political, economic and official ties with our strategic partners, making it easier to pursue national goals.

Closer to home, hosting the G-20 provided an opportunity for Treasury to strengthen its own capabilities. This included strengthening internal capacity for analysis of key economic issues, especially on energy and minerals markets and demographics, better understanding of counterparts and stakeholders, and strategic policy development. The learnings for Treasury have gone well beyond improving in-house technical policy expertise. Treasury was responsible not only for developing policy advice for the Treasurer on the G-20 but also for the logistical preparations and arrangements for the Melbourne meeting, as well as the officials' meetings that led up to it. The skills to prepare for, and run, these meetings had to be developed and this marked an important step forward in the skills set available within Treasury, notably with strategic planning, risk analysis, project management, and stakeholder communication skills. These are important skills and the challenge is to ensure that they are retained and extended as appropriate.

Conclusion

The Group of Twenty Finance Ministers and Central Bank Governors is a global forum of considerable strategic importance to Australia. Hosting the G-20 meeting in 2006 was a once-in-a-generation opportunity for Australia, particularly in helping to achieve practical policy cooperation on issues affecting global economic prosperity, strengthening the place and role of the G-20 in the international architecture, and advancing Australia's reputation and interests. The Melbourne meeting achieved substantive policy outcomes — particularly with respect to reform of the Bretton Woods institutions and seeking economic and market solutions to achieve energy and minerals security — as well as generating the opportunity for frank and substantive exchange between Ministers and Governors on the issues they addressed.

Chairing the G-20 has now passed to South Africa, with further progress expected on major global policy challenges. We look forward to continuing to work closely with our management troika counterparts from South Africa and Brazil (the 2008 chair) to continue the success of the G-20.

Corporate social responsibility and financial performance in the Australian context

Matthew Brine, Rebecca Brown and Greg Hackett[1]

The concept of social responsibility of corporations has engendered considerable interest in Australia in recent years. While previous research on the relationship between corporate social responsibility and financial performance has largely been based on international data, this paper examines the relationship between the adoption of corporate social responsibility and the financial performance of companies within Australia. A number of economic drivers for corporate social responsibility have been identified that may explain its voluntary adoption by companies. Our preliminary results revealed no statistically significant relationship between corporate social responsibility and financial performance; however, a number of opportunities for refining the research were identified.

1 The authors are from Corporations and Financial Services Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Geoff Miller and Jim Murphy. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

There is currently a debate on the extent to which company directors and managers should consider social and environmental factors in commercial decision making. An approach to decision making that routinely encompasses these factors may be described as corporate social responsibility.

A view is emerging that corporate social responsibility can contribute to the financial performance of a company. This approach, which has been described as the 'enlightened shareholder approach', suggests that corporate decision-makers must consider a range of social and environmental matters if they are to maximise long-term financial returns.

This paper presents some preliminary findings about the relationship between the adoption of corporate social responsibility and the financial performance of Australian companies, and identifies opportunities for further quantitative research in this area.

Corporate social responsibility

While there is no universally accepted definition of corporate social responsibility, it is usually described in terms of a company considering, managing and balancing the economic, social and environmental impacts of its activities (PJC 2006). The notion of corporate social responsibility as a part of the core business operations of a company, rather than a separate 'add on', distinguishes it from corporate philanthropy which may be funded out of operations that are damaging to the communities in which business is conducted.

The extent to which company directors and managers should consider social and environmental factors in making decisions, rather than focusing exclusively on maximising short-term accounting profit, has been the subject of much discussion in recent years. In Australia, the issue has been raised in the context of corporate donations following the 2004 Boxing Day Tsunami, the (eventual) decision by the James Hardie group to fund asbestos liabilities owed by former subsidiary companies, and most recently the findings of the Cole Royal Commission that the AWB may have engaged in unlawful conduct to secure export contracts to Iraq. International developments in corporate law have also played a part in promoting interest in this issue, for example the reformulation of directors' duties in the United Kingdom

Companies Act 2006 to recognise more explicitly the 'enlightened shareholder' model of corporate governance.[2]

In 2006, both the Parliamentary Joint Committee on Corporations and Financial Services and the Corporations and Markets Advisory Committee released reports examining the extent to which Australian companies should adopt corporate social responsibility. The reports concluded that corporate social responsibility can be an important means for companies to manage non-financial risks and maximise their long-term financial value.

> … a well managed company will generally see it as being in its own commercial interests, in terms of enhancing corporate value or opportunity, or managing risks to its business, to asses and, where appropriate, respond to the impact of its activities on the environmental and social context in which it operates. Companies that fail to do so appropriately may jeopardise their commercial future (CAMAC 2006).

Companies that embrace the concept of corporate responsibility are realising that the long-term financial interests of a company are not 'mutually exclusive' with acting fairly in the interests of stakeholders (other than shareholders) (PJC 2006).

The reports also confirmed that Australian corporate law provides sufficient flexibility for corporate decision-makers to consider social and environmental factors when making commercial decisions.

Economic drivers for corporate social responsibility

Drawing on the experiences of those companies that have adopted corporate social responsibility, commentators have identified several ways in which this approach to business decision-making may lead to improved financial performance.

The following 'economic drivers' have been identified by the World Economic Forum and Business in the Community as explaining the voluntary adoption of corporate social responsibility by companies across the world (ADL 2003). It is suggested that these drivers do not operate in isolation, and that different companies may have different drivers. Various drivers may also be stronger in different sectors and for

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2 Section 172 of the Companies Act 2006 imposes a duty on directors to promote the success of the company, and in doing so to have regard to: the long-term consequences of any decision; the interests of employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of operations on the community and the environment; and the desirability of the company maintaining a reputation for high standards of business conduct.

different companies. A move to adopt corporate social responsibility may arise from a combination of drivers.

Employee recruitment, motivation and retention

Recent surveys indicate that corporate social responsibility is increasingly an important factor in attracting and retaining a talented and diverse workforce (Globescan Inc 2005). Companies that account for the interests of their employees by offering good working conditions will achieve better performance in terms of quality and delivery, and, therefore, experience higher levels of productivity.

Learning and innovation

Learning and innovation are critical to the long-term survival of any business. Corporate social responsibility can be a vehicle for business to respond to environmental and societal risks and turn these into business opportunities.

Reputation management

Companies operate in a market of opinion. How companies are judged by customers, suppliers and the broader community will have an impact on their profitability and success. Corporate social responsibility offers a means by which companies can manage and influence the attitudes and perceptions of their stakeholders, building their trust and enabling the benefits of positive relationships to deliver business advantage.

Risk profile and risk management

Corporate social responsibility offers more effective management of risk, helping companies to reduce avoidable losses, identify new emerging issues and use positions of leadership as a means to gain competitive advantage.

Competitiveness and market positioning

Corporate social responsibility branding can draw consumers away from competitors and thereby improve profitability.

Operational efficiency

Corporate social responsibility can offer opportunities to reduce present and future costs to the business thereby increasing operational efficiency.

Investor relations and access to capital

The investment community is increasingly viewing corporate social responsibility as akin to long-term risk management and good governance practices. Recent surveys indicate that analysts place as much importance on corporate reputation as they do on financial performance (Hill & Knowltown 2006).

Licence to operate

Companies that fail to manage their responsibilities to society as a whole risk losing their licence to operate — a concept whereby a company's stakeholders grant the company an unwritten authority to do business. This may be evidenced by favouring competitors, boycotts or calls for deregistration.

Previous research

There have been a number of studies based on United States and European data that seek to test the extent to which the economic drivers for corporate social responsibility deliver improved financial performance. The studies adopt different methodologies for measuring corporate social responsibility and financial performance, and not unexpectedly present quite different results.

A notable source is a meta analysis undertaken by Orlitzky et al (2003), who integrated 30 years of research from 52 previous studies and used meta analytical techniques to support the proposition that corporate social performance and corporate financial performance are positively correlated and statistically significant. Interestingly, the meta analysis found a higher correlation between financial performance and a company's management of its social impact than between financial performance and a company's management of its environmental performance.

Studies by investment analysts and funds managers on the performance of socially responsible investment fund products and sustainability indices are also regularly reported in order to attract investors and encourage participation.

For example, in 2005 AMP Capital Investors published an analysis of the corporate social responsibility rating technique it uses to manage its Sustainable Future Australian Share Fund. By applying its rating technique to the approximately 300 listed Australian companies and analysing their financial performance from a 10 year period, it determined that companies with a higher corporate social responsibility rating outperformed companies with a lower corporate social responsibility rating by more than 3.0 per cent per annum over a 4 and 10 year period (Rey and Nguyen 2005).

Similarly, in 2003 the Dow Jones Sustainability Indexes (DJSI), which includes over 300 companies from 22 countries that lead their industries in terms of corporate sustainability, reported that, compared with the previous year, the DJSI World Index outperformed the mainstream market. During this period, the DJSI World Index increased by 23.1 per cent, whereas the mainstream indices, the Dow Jones World Index and the Morgan Stanley Capital International (MSCI) World Index, increased by 22.7 per cent and 21.2 per cent, respectively (in USD) (SAM Indexes GmBH 2003).

This paper seeks to contribute to the existing body of work in this area by examining the extent to which corporate social responsibility contributes to financial performance in the Australian context.

Measuring corporate social responsibility

An initial challenge in testing the relationship between corporate social responsibility and financial performance is identifying those companies that have adopted corporate social responsibility. This is because corporate social responsibility reflects an approach to internal decision making, the presence or absence of which may not easily be determined by external observers.

The approach that was adopted for this paper was to identify those companies that issue a sustainability report, and treat those companies as having adopted corporate social responsibility. The preparation of a sustainability report provides information to external stakeholders about the conduct of a company, allowing consumers, employees, investors and others to make informed decisions when dealing with the company. Importantly, the preparation of a sustainability report also provides company management with information about social and environmental performance, facilitating improved decision making. It may be the case that it is not until information is collected for public dissemination that senior managers become aware of an issue.

Generally sustainability reports provide information about a company's environmental performance, such as energy efficiency, water usage and greenhouse gas emissions, as well as their social performance, such as their staff recruiting and retention policies and engagement with stakeholders. There are a number of voluntary reporting guidelines and sets of indicators available for these companies; the most widely used is the Global Reporting Initiative.

One limitation of this approach to identifying companies that have adopted corporate social responsibility is that it may give more of an indication of a company's willingness to report, rather than the extent to which company decision makers consider social and environmental factors in making decisions. While acknowledging

this limitation, we would caution that one should not understate the usefulness of sustainability reporting as an indicator of corporate social responsibility for the above reasons.

An alternative approach to measuring corporate social responsibility would be to draw on existing corporate social responsibility indices such as the Corporate Responsibility Index. This index was initially developed in the United Kingdom by the Business in the Community initiative, and is administered in Australia by the St James Ethics Centre. Participating companies are assessed against a corporate responsibility framework, including an examination of how corporate responsibility is translated from strategy into mainstream management practice, and how material risks are monitored and managed. The company's response is then externally audited, and results published. The reason this approach was not used for this exercise was that a relatively small amount of companies participate at this point in time.

A second alternative approach to measuring corporate social responsibility would be to draw on the criteria used by socially responsible investment funds to identify appropriate investments. The Ethical Investment Association (2006) has stated that there are now $11.98 billion in managed investments and super funds that identify themselves as socially responsible (EIA 2006). The reason that this approach was not used for this exercise was that the investment criteria vary across investment funds, and there is no objective means for determining which is superior.

Methodology

We examined the relationship between financial performance and corporate social responsibility across the top 300 ASX listed companies for the 2005 financial year. A total of 277 companies remained in our sample after companies with missing data were eliminated.

As discussed above, we based our corporate social responsibility measurement on whether companies made separate sustainability disclosures beyond what is required of them by the regulatory framework. Data was gathered from publicly available information, as well as a confidential list provided to us by the Department of Environment and Water Resources and the Centre for Australian Ethical Research. As in the study conducted by McWilliams and Siegel (2000), our measure of corporate social responsibility is a dummy variable.[3] This variable has a value of one if the firm

3 As there is no quantitative measurement of corporate social responsibility in Australia it was not possible for us to quantify this value. Using a dummy variable allowed us to measure the effects of corporate social responsibility on financial performance by saying that it is either present for a particular company or it is not.

has adopted corporate social responsibility and a value of zero if it has not (Gujarati 1999).

Accounting measures, as opposed to market measures, were used to evaluate the financial performance of each company. The financial performance measures used were return on assets, return on equity and return on sales. Each of these accounting measures gives us different information about a company (McGuire, Sundgren and Schneeweis 1988).

Return on assets represents the amount of earnings (before interest and tax) a company can achieve for each dollar of assets it controls and is a good indicator of a firm's profitability. Return on equity measures how well a company uses reinvested earnings to generate additional earnings, giving a general indication of the company's efficiency. Return on sales is equal to a firm's pre-tax income divided by total sales, measuring a firm's profit per dollar of sales (Bodie, Kane and Marcus 2002).

Cross sectional regression analysis, utilising the ordinary least squares method, was used to test the hypothesis that corporate social responsibility would improve the financial performance of an organisation. Our independent variable was corporate social responsibility with financial performance used as the dependent variable, controlling for size (total sales and total assets) and risk (ratio of long-term debt to total assets).

Results

Initially we regressed the entire data set as a whole in order to determine whether we would find an overarching relationship for the 277 companies. Preliminary results showed that the adoption of corporate social responsibility led to an increase in sales and an increase in equity. In comparison, the adoption of corporate social responsibility led to a reduction in return on assets. All results, however, were statistically insignificant and no reliable results could be obtained from these initial regressions.

Following these results, we split the data set into specific industries in order to determine whether this would have an impact on our results.[4] While a number of results revealed potential relationships between the adoption of corporate social responsibility and a company's financial performance, none of the results were statistically significant.

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4 Companies were split into their corresponding industries which included energy, materials, industrials, consumer discretionary, consumer staples, health care, financials, information technology, telecommunication services, utilities and property trusts.

Our inconclusive results on an industry basis may have been the result of our small sample size. After splitting our data into separate industries a number of tests included very few companies that had adopted corporate social responsibility. Also, some industries included only a very small number of companies in the first place, reducing the probability that we would receive a result that would be statistically significant.

Comment

In summary, our regression analysis on the majority of the ASX 300 companies did not reveal any statistically significant relationship between the adoption of corporate social responsibility and financial performance. However, in conducting the analysis a number of opportunities for refining the research were identified. As such, this paper could be considered as a first step in testing the relationship between financial performance and corporate social responsibility in the Australian context.

The over-riding research constraint we faced in conducting this analysis was the lack of a reliable measure of corporate social responsibility. Although assessing return on equity, return on assets and return on sales is relatively clear cut, the same cannot be said about assessing the extent to which corporate decision-making encompasses the social and environmental consequences of a course of action.

Our research has highlighted the need to develop better measures of corporate social responsibility within Australia. An increasing uptake of indices such as the Corporate Responsibility Index may assist in this regard. More reliable measurement of the extent to which a company has adopted corporate social responsibility will allow a more accurate analysis of the effect on financial performance.

There are a number of areas where future research in this area could proceed. Firstly, our analysis included most of the ASX 300 firms. Increasing our sample size, potentially the ASX 500, may allow for a better measure of the effect that the adoption of corporate social responsibility has on the financial performance of Australian companies. It may also be useful to determine whether significant relationships emerge and change as longer term financial information becomes available (Tsoutsoura 2004). The study period could be extended, and short-term and long-term measures of financial performance could be employed (Aupperle, Carroll and Hatfield 1985).

It may also be useful to use a one year lag between the measurement of financial performance and the corporate social responsibility measure to determine whether there may be a lag associated with the implementation of social responsibility and improved financial performance (Blackburn, Doran and Shrader 1994). Alternatively, a one year lag could be used to test whether better financial performance leads to an

increase in the level of corporate social responsibility for an organisation (Waddock and Graves 1997).

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George Turner: Australia's first treasurer

John Hawkins[1]

The following article is the first in a series of biographies of Australia's federal treasurers.

George Turner, a former Victorian treasurer and premier, was Australia's first treasurer, and despite battling ill-health brought down the first four federal budgets. He was a cautious treasurer whose budgets were balanced, and he limited federal expenditure. Revenue was raised from somewhat protectionist tariffs, and most of it was redistributed to the states. Turner was so widely respected for his diligence and competence that the leaders of all three major parties of the time reputedly offered him the post of treasurer.

1 The author is from Domestic Economy Division, the Australian Treasury. Comments and support from Amy Burke, Steven Kennedy and Carol Murphy are appreciated. The views in this article are those of the author and not necessarily those of the Australian Treasury.

Introduction

The Right Honourable Sir George Turner, PC, KCMG, was Australia's first treasurer, and brought down the first four federal budgets.[2] Manning Clark said of him that 'balancing the books was his great passion in life'.[3] This made him an ideal choice for the job of treasurer, at a time when it was more of an accounting role than an economic one. Competent rather than charismatic, he was so admired for being 'hardworking, conscientious and reliable'[4] that all the party leaders and prime ministers of the time (the Protectionists Barton and Deakin, the Free Trader Reid and Labor's Watson) reputedly offered him the job as treasurer.

Turner's career before Federation

George Turner was born in Melbourne on 8 August 1851, the son of English immigrants. His father was a cabinet-maker, but in a literal rather than political sense. George's exposure to politics came early, as at the age of 14 he started work for John Edwards, a solicitor who was a member of the Legislative Assembly. He completed an articled clerks' course and was admitted as an attorney in 1881. He married English-born Rosa Morgan in 1872 and was 'fortunate in finding a partner who assisted him at every step and constantly pushed him forward.'[5]

Turner's political career took off quickly. He was elected to St Kilda City Council in 1885, served as mayor in 1887-88, and by 1889 was representing St Kilda in the Victorian parliament as a Liberal Protectionist MLA. He quickly rose to the ministry, being appointed Commissioner for Trade and Customs in 1891 and also Solicitor-General from 1892.

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2 He had also presented six Victorian budgets.

3 Clark (1981, p 122). This rather dour characterisation is shared by other historians. Crisp (1990, p 190) writes 'nor was George Turner … a man of lively imagination'. McMullin (1991, p 136) suggests 'no Victorian premier has had less charisma'. Rickard (2006, p 109) commented 'few political figures have been so celebrated for their dullness'. Similar views were expressed by his peers. Deakin writing anonymously in 1905 said 'his colourless policy fitted a colourless personality'. He later described Turner, in his posthumously published memoirs (1944, p 66), as 'the average man … in dress, manner and habits exactly on the same level as the shopkeepers and prosperous artisans who were his ratepayers and constituents … as a speaker he was as plain, commonplace and even slangy as Reid, but had none of the rich humour … he had no enthusiasms'. A contemporary journalist recollects Turner as 'not a profound or original thinker'; Campbell-Jones (1935, p 105).

4 In the words of Deakin's biographer, La Nauze (1965, p 217). Deakin himself (1944, p 66) said that 'his faculty of work was enormous, his love of detail great'. Another contemporary, and future treasurer, Joseph Cook described him as 'one of the most useful public men Australia has ever known'.

5 Deakin (1944, p 68).

When the government fell in the depths of the 1890s depression, Turner reluctantly became Opposition Leader (with the support of Alfred Deakin and Isaac Isaacs).[6] In 1894 a successful vote of no confidence led to an election which made Turner Premier of Victoria.

He also took the treasury portfolio. The Victorian economy was still suffering very high unemployment and net emigration. The government had a large budget deficit, which Turner set about correcting. He cut public works and spending on education and defence, and introduced a graduated income tax.[7] Following a royal commission, he amalgamated local savings banks into the State Savings Bank of Victoria in 1896.

In mid-1897 Turner, and the other premiers, attended Queen Victoria's diamond jubilee, and he was appointed a privy counsellor and received a KCMG and honorary degrees from Cambridge and Oxford. He returned to an easy victory in the October 1897 election, with Labor support. During his second term, the budget deficit was eliminated. However, when some country Liberals and disaffected radicals crossed the floor in November 1899, Turner's government fell. He regained office at the November 1900 poll, and introduced legislation for old age pensions, before resigning in February 1901 to enter federal politics.

While Premier, Turner had been a supporter of Federation. He topped the poll to represent Victoria at the 1897 federation convention.[8] While an influential member of the finance committee, illness and an overseas trip meant he missed many of the sessions. He proposed a new capital be created in a territory carved out of New South Wales. Long a supporter of Edmund Barton, he argued (perhaps decisively) for his appointment as Australia's first Prime Minister.[9]

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6 An anonymous obituary (*The Age*, 25 April 1916, p 7) remarks that 'never did a politician accept the leadership of a party with greater reluctance'.

7 These were characterised as 'desperate remedies' in that anonymous obituary, but appear to have been accepted as necessary by the public.

8 Turner also represented Victoria ex-officio at the Premiers' Conferences on federation in 1895 and 1899.

9 The first Governor-General, the seventh Earl of Hopetoun, had initially approached William Lyne to form a government, apparently on the grounds he was premier of the largest state. This 'Hopetoun blunder' as it became known (the expression originated with Deakin) was an odd choice, given Lyne's opposition to federation; La Nauze (1957). Despite Lyne offering Turner a ministry, he spurned Lyne's advances. Campbell-Jones (1935, p 23) believes Turner 'told him flatly that he ought to advise the Governor-General to send for Sir Edmund Barton'. When Lyne was unable to form a credible ministry, Barton was commissioned.

Turner's first term as treasurer

Barton appointed Turner as treasurer in his first (interim) cabinet and reappointed him after the first federal election in 1901, when Turner was elected unopposed as the member for Balaclava. (There are some reports that Turner was not necessarily Barton's first choice.[10] Barton may have sounded out former NSW treasurer, and chair of the 1897 federation convention's finance committee, William McMillan, who apparently preferred to be deputy leader of the Free Trade Party than join the protectionist Barton ministry.)

Speaking to the press, Barton explained 'the Treasurer will superintend all matters relating to customs and finance, commonwealth loans, the taking over of state loans and cognate matters'.[11] Using personnel seconded from state treasuries, Turner set to work before his department was formally established. George Allen, with whom Turner had worked at the Victorian Treasury, was appointed Secretary of the Treasury in July 1901 with four other staff. By January 1902, Treasury had taken on another four staff and all bookkeeping functions were then performed in-house. By 1903 staff had reached almost twenty, including four future secretaries.[12] Turner established the office of Auditor-General. He described Treasury's work as 'being chiefly ledger keeping and the inspection of accounts'.[13] In this they were quite rigorous; in the 1901-02 Budget, government expenditure was budgeted to the pound as £3,777,207.

Turner opened his first Budget speech (8 October 1901) by referring to the greater difficulty of preparing a federal compared with a state budget, particularly in gathering information on a consistent basis. He stressed the need to avoid 'extravagant expenditure', despite the abundant revenues, arguing that this might starve the states of funds so that 'they will feel inclined to curse rather than bless federation'. Much of the speech involved assurances that the proposed expenditure by the federal government was comparable to that of the states on the functions which they transferred. His second budget speech (23 Sept 1902) contained a lengthy discussion of the expenditures and revenues of the post office. The revenues and expenditures in the states before and after federation remained a large part of his third budget speech (28 July 1903), although Turner foreshadowed moves away from this 'bookkeeping'

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10 This claim is made by Barton's recent biographer in Bolton (2000, p 218). A letter dated 16 September 1900 from Barton to Deakin (National Library of Australia, *Deakin Papers*, 1540/14/1) shows that Barton had spoken to McMillan (and another free trader, Edward Pulsford MLC) about a ministerial position but Barton described the talks as 'unpromising'.

11 Reported in *Sydney Morning Herald* (31 December 1900, p 7).

12 Together with Allen, they provided almost fifty years of leadership; Treasury (2001). Allen served as secretary, and James Collins as his deputy, for the whole of Turner's time as treasurer.

13 *Hansard*, 23 January 1902.

procedure to treating the federal government as having 'one pocket and one purse'. The budget speeches were continually interrupted by questions, often quite detailed, and it is a tribute to Turner's mastery of his work that he was able to respond to them so well.[14]

Turner soon gained a reputation for parsimony in his stewardship of the national finances. According to one story, this extended to drafting his first budget on shaving paper as an economy measure.[15] Turner's hands were somewhat tied by the constitution. Section 87 provided that, for at least the first decade following federation, at least three-quarters of net revenues from customs and excise must be transferred to the states. But Turner passed them more than this share.[16]

The main source of revenue was tariffs, and assisting Customs Minister Kingston shepherd tariff bills through parliament took up a lot of Turner's time. The opposition Free Trade party would oppose any tariff they regarded as protectionist rather than just revenue-raising and the Labor Party's views were split on whether tariffs preserved jobs for Australian workers or just increased the prices of necessities.

In preparing the 1901-02 Budget revenue estimates, in some places Turner used 1899 rather than 1900 data arguing there was an unsustainable surge in import prices in the latter year, and a build-up in stocks by importers fearful of increased tariffs. (So the 'prudent' projections for external trade in recent budgets have a long pedigree.)

Economic conditions were hard during most of Turner's first stint as Treasurer. The rural economy had barely recovered from the drought and global recession of the 1890s, and there was another drought in 1902. However, with Turner as Treasurer, government expenditure was generally kept close to budgeted amounts.

Table 1: George Turner's budget outcomes (£ million)

	1901-02	1902-03	1903-04	1904-05
Customs and excise revenue	8.9	9.7	9.1	8.8
Other revenue	2.4	2.4	2.5	2.7
Commonwealth expenditure	3.9	3.9	4.3	4.3
Payments to states	7.4	8.2	7.4	7.1
Balance	0.0	0.0	0.0	0.0

Sources: Barnard (1987, pp 257-8).

14 As Campbell-Jones (1935, p 107) puts it, 'he worried through the dry statistics till he understood them. He could explain every line of the estimates'.

15 This story is told by Campbell-Jones (1935, p 109) who looked back on Turner as 'the most economical minister that Federation has known' (p 108).

16 Turner argued he 'did not object to our hands being tied' as 'when the Federal Treasurer has an immense surplus, there is always a temptation to incur expenditure'. (*Hansard*, 18 October 1904).

Turner appears content to have been a cautious steward and was not particularly innovative.[17] If he was criticised, it was for being overly cautious.[18] Alfred Deakin described him as having 'to find his principles as he went on, for there was no theoretical basis for them' and regarded him as having a 'determination to compromise his way out of all difficulties'. Nor was he any great orator and writer; Turner himself said his budgets lacked poetry.[19] In his parliamentary speeches, Turner generally stuck to the areas of finance and trade. But both his political peers and the general public seemed to have regarded him as doing a sterling job as treasurer and in the 1903 elections he was again elected unopposed.

Turner had shown no interest in succeeding Barton as prime minister. He turned down the chance to act in the role while Barton attended Edward VII's coronation and suggested he might not seek a second term in parliament.[20] This allowed Deakin to establish himself as the natural successor as Protectionist party leader. When Barton moved to the High Court in September 1903, Deakin retained Turner as treasurer.

Turner's first period as treasurer ended in April 1904 when the Labor Party withdrew support for Deakin and Labor's leader, Chris Watson, formed a government. Turner was sufficiently well-respected that Watson purportedly asked Turner to stay on as

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17 For example, in 1902 Turner ignored Alfred Conroy's suggestion that the budget be delivered before the start of the financial year to which it refers. In 1903 he showed no interest in a suggestion for introducing decimal currency.

18 Barton commented on Turner's death that 'his errors, if any … were on the side of being over-cautious in expenditure'; *Argus* (14 August 1916, p 6). His contemporary, the then Labor Senator George Pearce went further in his memoirs (1951, p 56), arguing that Turner 'was perhaps the most careful custodian that office has ever had'. However, Pearce argued Turner starved federal departments and passed on too much revenue to the states. When federal spending had later to be raised, this caused tensions with the states which had assumed following treasurers would continue Turner's generosity to them.

19 The unlikely exemplar 'whose budgets are always poetic' and delivered in 'graceful diction' (*Hansard*, 23 September 1902) was Philip Fysh, who had served as Tasmanian Treasurer in the 1870s and 1890s and was a cabinet colleague of Turner. In his 1903 Budget Speech, Turner apologised to members that 'no great mass of figures can be very interesting, and for that reason I, in turn, sympathise with honourable members who have to listen' (*Hansard*, 28 July 1903). But according to one press article, Turner was unusual among the treasurers in writing his own speeches (*Punch*, 16 September 1909).

20 In May 1902 Turner told friends that poor health meant he planned to stand down at the end of his term, and he confirmed this when it was put to him by a journalist; *Sydney Morning Herald*, 5 May 1902.

treasurer.[21] Turner declined, possibly due to his poor health, and Watson assumed the post himself.[22]

Turner's second term as Treasurer

When Watson's government fell in August 1904, George Reid led a Free Trade-Protectionist coalition. With Deakin declining to participate, Turner was offered the role of the senior Protectionist member of the government.[23] He refused the offer. By this time, his health, poor for many years, had become a serious issue. In June 1904 he has been unconscious for several days after two operations. As Turner himself put it, 'I broke down my health in trying to fight against the bad times' (*Hansard*, 29 June 1905).

But despite his illness, Turner was persuaded to return as treasurer.[24] He brought down his fourth and final federal budget in October 1904. In the accompanying speech, there was again a lot of discussion about how the individual states were benefiting from federation. There was also a lot of discussion of domestic sugar production, and the extent to which it displaced imported, and hence dutiable, sugar.

His times after being Treasurer

Deakin gave a speech on 24 June 1905, which was widely interpreted as a 'notice to quit' to Reid, whose government was soon replaced by a Protectionist one led by Deakin with Labor support (essentially a return to the arrangements of 1901-1903).

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21 This was described as a rumour in the contemporary press; *The Age* (25 April 1904, p 5). By the time obituaries were being written for Turner, *The Age* (25 April 1916, p 7), it was reported as fact and is stated as such by Serle (1990). Rickard (2006) is more cautious only saying 'it is said …' The question is discussed further in Hawkins (2007).

22 Watson's tenure as Treasurer will be described in an essay in the next *Economic Roundup*.

23 There are conflicting accounts of how much power was on offer. Reid in his memoirs (1917, p 237) claims 'it was arranged that Sir George and I should be 'equal in all things' 'and this was also reported at the time; *Sydney Morning Herald*, 19 August 1908, p 5. But Turner himself said he 'refused to take the position of *second-in-command* because I felt I should break down' (*Hansard*, 29 June 1905). The truth may be somewhere in between. The government was officially referred to as the Reid-McLean ministry (of the many other coalition ministries in Australia's history, only the Bruce-Page administration was named after two leaders), but Reid was clearly superior to McLean in it.

24 There are again conflicting accounts (all given in *Hansard*, 29 June 1905) of the relevant conversations. Reid asserted that Turner, despite being 'stricken down with illness', was 'forced into this Ministry' by Deakin. Deakin denied this, claiming that at the time he was so surprised that he had asked Reid 'however did you contrive to convince a man in such a state of health to assume the responsibilities of office?' Turner himself said that while Deakin had not 'forced' him into the post, he 'pressed' him to take it up. See La Nauze (1965, pp 399-401) for a further account.

Turner was hurt that Deakin had not consulted him about the speech,[25] and this, combined with his ongoing poor health, led him to hand over the treasurer's job to John Forrest. Turner moved to the backbenches and retired at the 1906 election.

Turner resumed his legal practice and chaired the State Savings Bank of Victoria. With the burdens of office removed, his health improved somewhat and he enjoyed bowls and gardening. He died suddenly on 13 August 1916 of heart disease, aged 65.

25 Deakin's biographer La Nauze (1965, p 399) refers to 'the sorrowful reproaches of the weak and ailing Turner'.

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Key themes from the Treasury Business Liaison Programme — November 2006 and February 2007

As part of Treasury's Business Liaison Programme, Treasury officials met with around ninety businesses, collectively employing over half a million Australians, in Sydney, Melbourne, Perth, Bendigo, Ballarat and Mandurah and some industry organisations in Canberra in November 2006 and February 2007.[1]

Retailers are generally optimistic about economic conditions. The mining sector, and hence the Western Australian economy, continues to be a source of strength. The drought is having a serious impact on farmers, pushing up food prices, and retailers report that sales in regional centres have been affected. The labour market remains tight but companies are not reporting accelerating wages.

Treasury greatly appreciates the commitment of time and effort made by the businesses, industry associations and government agencies that participate in the programme.[2]

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1 A detailed explanation of the Treasury Business Liaison Programme is provided in the Treasury *Economic Roundup*, Spring 2001.

2 This summary reflects the views and opinions of participants. While Treasury's evaluation of the economic outlook is informed by findings from business liaison, a much wider range of information and data are utilised to ensure a rigorous assessment of the Australian economy.

Retail sales

Retailers report mixed conditions in the latter part of 2006 and early 2007. The easing in petrol prices, and continued strong growth in employment, is helping maintain growth in sales volumes. While some stores noted a significant impact on sales from the interest rate increases in August and November of 2006, others reported an apparent lack of any impact. Sales of large discretionary items such as whitegoods and outdoor furniture seemed most affected, particularly in the outer suburban 'mortgage belt'. Purchases of luxury food items and entertainment have also been cut back. Unusually mild temperatures in December hurt sales of some products. A number of retailers noted an increasing swing towards healthier foods.

Continuing the pattern of recent quarters, retailers spoke of particularly strong sales growth in Western Australia and south-east Queensland, reflecting the strength in the mining sector and strong population growth. Their sales continue to be weakest in New South Wales, but are improving in Victoria.

In the November meetings, sales in rural towns seemed relatively unaffected by the drought but by February, retailers were experiencing an impact.

Manufacturing and construction

Manufacturers supplying products to the mining and construction sectors continue to enjoy very strong conditions. Some food producers tell of drought conditions limiting their access to raw materials, and this is flowing on to packaging companies. The breaking of the drought would quickly restore supplies of grains and vegetables to manufacturers of food products but manufacturers of meat products anticipate being more affected in the longer term given the culling of cattle herds.

A change in customer preferences away from larger cars, which manufacturers largely attributed to high petrol prices, is leading to a reduction in Australian vehicle production.

A few manufacturers say they are increasing exports. (For example, sales of Australian wine to Scandinavia are rising.) Some Australian subsidiaries of international manufacturers explain that both exports and imports are rising as global production is being rationalised with countries specialising in particular lines. Even when manufacturing in Australia was not being increased, some Australian subsidiaries report they are winning a large share of design work from their foreign parent.

A succession of new large infrastructure projects is said to be underpinning the construction sector, although activity in NSW and Victoria is slowing. Some retailers plan to build new stores, especially in areas such as south-east Queensland where

population is expanding. Some companies are commissioning new buildings combining warehouses, small factories and head offices. Dry conditions are allowing construction projects to be finished quicker.

Housing

The housing sector remains soft, with industry contacts expecting investment in the residential market to remain weak. Builders note a drop in traffic through display homes since the interest rate rises, suggesting further weakness ahead. Industry sources opined that house prices are at best rising modestly in the eastern states, and falling in outer suburban areas. By contrast, house prices had been booming in Perth and Darwin during 2006, to levels some financiers thought unsustainable.

Education

Exporters of education services say they are expanding their business, with India a growing market. While overseas students might prefer to study in the United Kingdom or United States, Australia is seen as offering better value with lower tuition fees and living costs. There is also increasing overseas interest in vocational training in Australia.

Among domestic students, universities report an increasing interest in studying accounting and finance but only a modest increase in students taking engineering courses.

Business investment

Wholesalers and retailers are investing in better information technology to lift their efficiency.

Mining companies are embarking on new projects to expand capacity. Most mining companies continue to report difficulties in obtaining certain equipment, such as large tyres, although a few think the problem is easing. Changing practices are making tyres and equipment last longer and suppliers are gradually catching up with the backlog of orders.

Employment

Businesses differ in their employment intentions, but overall planned increases exceed cuts. In many cases, business leaders suggest that the need for increased labour due to market growth is offsetting any reduction from productivity improvements.

A lack of skilled labour is reported as constraining increases in output by some companies. Skill shortages are particularly viewed as a problem by the mining sector, or companies with workers such as engineers and electricians whose skills are readily transferable to the mining sector.

Project managers and good mid-level managers are regarded as hard to find in many industries. Financial professionals, such as the more analytical accountants, are also scarce. There is a shortage of nurses. In Western Australia, employers are also finding difficulty in hiring unskilled labour. In the eastern states, there are also certain types of unskilled workers in short supply, such as salespeople in affluent suburbs and fruit pickers.

Wages and other costs

Outside the mining sector, few firms report accelerating wages, even when they were facing difficulties in hiring and retaining staff. Some are offering retention bonuses to staff who stay for a number of years, and some report increasing expenditure on training. Employers in Western Australia say the high house prices there are making it harder to attract staff and putting pressure on them to pay rental allowances. Some companies describe providing better facilities and accommodation for mining workers, but many firms are not facing any pressure to improve these forms of remuneration.

Retailers report large rises in rents, especially in shopping malls, while manufacturers are bracing for price increases of rural products as a result of the drought.

Prices

Compared to a year ago, more businesses seem able to pass on price rises. Retailers appear to be expanding margins, helped by falling prices for imported goods. They comment that competition is driving down prices for fashion clothing and furniture.

Vegetable and cereal prices are rising due to the drought. While retailers in November had expected increased slaughterings to depress domestic meat prices markedly (albeit temporarily), it appears that higher global meat prices resulted in the price fall being only marginal.

Regional areas

Drought conditions are having a serious impact on farmers. In addition, Victorian fruit crops were affected by frosts in late 2006. At the November meetings, contacts were not reporting much knock-on impact in regional towns, but by February this impact

was notable. Retailers commented that sales in some coastal areas were weak, reflecting the weakness in local tourism.

The February business liaison round included meetings in Ballarat and Bendigo. As had been observed in other regional cities, there is a long-term trend for activity there to strengthen at the expense of surrounding small towns and villages. Rural shoppers were preferring to do all their shopping and other business in one trip.

Ballarat and Bendigo both benefit from having diverse economic bases, which means they are less affected by the closure of some manufacturing operations. Higher petrol prices are reducing visits by day-tripper tourists. As noted above, retail sales to farmers, and indirectly to residents, are being adversely affected by the drought. In the medium term, concerns about water restrictions are seen as eroding some of the lifestyle attractions of the towns. This is exacerbating the skill shortages that are evident there despite unemployment rates above the national average. More residents are commuting to jobs in Melbourne due to improved transport links and regional cities offering more affordable housing.

What's new on the Treasury website

The Treasury's website, www.treasury.gov.au, includes past issues of the *Economic Roundup*. Some of the other items posted on the website since the previous issue of Roundup that may be of interest to readers are listed below.

Speeches

'Revisiting the Policy Implications of Population Ageing' (May 2007). Address to the Australian Business Economists, by Dr Ken Henry, Secretary to the Treasury.

http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1260

Looking ahead, Australia will face demographic challenges with workforce participation set to fall as a consequence of population ageing. While labour productivity growth is projected to grow by an annual average rate of 1.8 per cent over the next 40 years (*Intergenerational Report 2007*), the same rate as over the past 40 years, growth in real GDP per person is expected to be somewhat slower than its historical average due to population ageing.

With the labour market now at as close to full employment as it has been any time in the past 30 years, this presents some implications for economic policy. Not only is there an ongoing need to conduct fiscal and monetary policies in a way that satisfies the requirements of their medium-term frameworks, there is also a need to avoid policy interventions that don't add to supply capacity since these can be expected to be detrimental to productivity and GDP per person growth.

'Connecting Consumers and the Economy: The Big Picture' (March 2007). Address to the 2007 National Consumer Congress, by Dr Ken Henry, Secretary to the Treasury.

http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1242

This year the Productivity Commission will produce the first substantial review of Australia's consumer policy framework since 1984. Consumers have reaped substantial dividends from extensive economic reforms over many years, including widespread deregulation and trade liberalisation. National Competition Policy has facilitated more competitive markets in areas like infrastructure and public monopolies. The challenges of consumer policy will be met best by bearing in mind four key principles: (1) competitive markets drive consumer welfare and consumers drive competitive markets; (2) government intervention in the market should utilise the regulatory or non-regulatory tool best suited to each situation; (3) government policy should not impede, but should rather support, the expansion of national markets; and (4) government policy should empower consumers, protecting them when appropriate.

'China, manufacturing and the resources boom' (March 2007) Address to Australian Industry Group forum on 'Global priorities for Australia' by Dr Steven Kennedy (General Manager, Domestic Economy Division) and Phil Garton.

http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1238

China's rapid expansion is putting downward pressure on world manufactures prices while underpinning the surge in commodities prices. China's impact on world manufactures supply has not so far been exceptional compared to past growth phases in Japan and other Asian economies, and China has also become an increasingly significant importer of manufactures. High commodity prices have led to expansion of the mining and construction sectors, particularly in Western Australia and Queensland. In a fully-employed economy, this could only occur by drawing resources out of manufacturing and other sectors. So far, however, increased employment growth in the mining states has come from attracting additional workers into the labour market from within these states. This suggests that an induced increase in labour supply has moderated the effects of the resources boom on manufacturing.

Budget Papers

Budget Strategy and Outlook 2007-08

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1256

The Australian economy is expected to grow strongly in 2007-08, after being affected by severe drought in 2006-07. The economy is expected to grow by 3¾ per cent in 2007-08, assuming a return to average seasonal conditions and a partial recovery from the drought. Productivity is expected to increase in 2007-08, and the participation rate is expected to remain high. An underlying cash surplus of $10.6 billion is forecast for 2007-08.

Annual Report

Australia and the International Financial Institutions 2005-2006

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1240

This publication reports on Australia's interaction with the International Monetary Fund, Asian Development Bank and the World Bank during the 2005-2006 financial year. It combines three publications previously titled Australia and the IMF, Australia and the World Bank and Australian and the Asian Development Bank.

Working papers

2007-02: HECS for TAFE: The case for extending income contingent loans (April 2007)

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1252

Bruce Chapman, Mark Rodrigues and Chris Ryan

The public vocational education and training (VET) system is now one of the few areas in Australia's tertiary education system where students are required to pay up-front fees without access to loan assistance. These arrangements may lead to sub-optimal educational outcomes to the extent that prospective students reject a VET education on the basis of short-term financial constraints. This paper presents a case for introducing an income contingent loan to the VET sector. Data is used from the first three waves of the Household Income and Labour Dynamics in Australia (HILDA) survey to establish that there are indeed significant private returns to VET qualifications. An income contingent loan is argued to enhance access to these benefits, and the form that such a loan might take for VET is considered, as are the implications for the Commonwealth Government with respect to potential subsidies associated with the design parameters.

2007-01: Asymmetric Investment Returns and the Sustainability of US External Imbalances (February 2007)

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1233

Phil Garton

The widening of United States current account deficits since the late 1990s has had only a limited effect on net income, as the US has enjoyed both higher yields and larger valuation gains on its foreign assets than it incurred on foreign liabilities. This is mostly explained by structural factors, such as the relative safety of the US and its foreign liabilities being mainly debt while its assets are mainly equities, which tend to yield higher returns (including valuation gains). If these factors persist then the need for future external adjustment might be less than conventional analysis suggests.

Other Publications

Intergenerational Report 2007

http://www.treasury.gov.au/contentitem.asp?NavId=035&ContentID=1239

The Australian Government's second intergenerational report provides a basis for considering the fiscal outlook over the long term and the sustainability of economic growth in light of Australia's ageing population and other factors.

It finds that the Australian Government's long-term fiscal sustainability has improved since the first intergenerational report in 2002, although demographic and other factors continue to pose substantial challenges for economic growth and long-term fiscal sustainability.

Sources of economic data

The following table provides sources for key economic data. Australian Bureau of Statistics (ABS) data can be obtained over the internet at http://www.abs.gov.au. The Reserve Bank of Australia information is available at http://www.rba.gov.au. Similarly, OECD information is available at http://www.oecd.org. Information on individual economies is also available via the IMF at http://www.imf.org.

International economy	
Output, current account balance and interest rates	OECD Main Economic Indicators
Consumer price inflation	ABS cat. no. 6401.0

National accounts	
Components of GDP, contributions to change in GDP	ABS cat. no. 5206.0

Incomes, costs and prices	
Real household income	ABS cat. nos. 5204.0 and 5206.0
Wages, labour costs and company income	ABS cat. nos. 5204.0, 5206.0 and 6302.0
Prices	ABS cat. nos. 6401.0 and 5206.0
Labour market	ABS cat. no. 6202.0

External sector	
Australia's current account, external liabilities and income flows	ABS cat. nos. 5368.0, 5302.0 and 5206.0

Past editions of *Economic Roundup*

Details of articles published in the past two editions of the *Economic Roundup* are listed below:

Summer 2007

Trends in infrastructure

Australia's infrastructure policy and the COAG National Reform Agenda

Improving the investment climate in APEC economies

Evidence on the child care market

Australian net private wealth

Spring 2006

The 100th *Economic Roundup*

Managing prosperity

The Participation Modelling Project

Older men bounce back: the re-emergence of older male workers

Reflections on the global economy and the Australian mining boom

Does Australia's geography affect labour productivity?

Budget policy and risk expenditures

An economic survey of developing countries in the Pacific region

Greater international links in banking — challenges for banking regulation

2005-06 in review: high terms-of-trade, low unemployment

Index of *Economic Roundup* feature articles, speeches and submissions by topic, 1988-2006

Copies of these articles are available from the Treasury. Written requests should be sent to Manager, Domestic Economy Division, The Treasury, Langton Crescent, Parkes, ACT, 2600. Telephone requests should be directed to Mr Chris McLennan on (02) 6263 2756. Copies may be downloaded from the Treasury web site http://www.treasury.gov.au.

Correction to *Economic Roundup*, Summer 2007

There were errors in the article on 'Trends in infrastructure' in the Summer 2007 issue of *Economic Roundup*. On pages 6 and 7, in the titles on charts 4a and 4b, 'capital stock per head' should have read 'capital stock to GDP ratio'. In the paragraph immediately above chart 4a, 'capital stock per capita' should have read 'capital stock to GDP ratio'. In the paragraph immediately below chart 4a, 'capital per head of population' should have read 'capital to GDP ratio'.