Harder Choices Ahead

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HARDER CHOICES AHEAD

The longest period of continuous economic growth in Australia since Federation began just over fifteen years ago. Average rates of growth have also been remarkably high during the recent expansion: not as high in absolute terms as during the 1950s and 1960s, but much higher relative to the average for the developed world than during the post-war boom.

Over these rich years, our country's capacity to meet its people's material needs and wants has expanded amply. The proportion of Australians in employment, while remaining lower than would be desirable on economic and social grounds, has risen considerably. Our households have been able to enjoy rapidly expanding payments from and services provided by Government, and, for the elderly rich, large reductions in taxation. These outcomes have been achieved alongside increasing expenditure on defence and internal security and on important attempts to stabilise communities in our external neighbourhood.

Sustained and steady economic growth has gradually eased the absorption into income-generating employment of many Australians who had been living on the margins of the national economy.

The long boom since 1991 has enhanced Australians' self confidence in ways that carry benefits for the quality of national life. We have been comfortable enough with ourselves to return to historically high rates of immigration in the early twenty first century, within which there has been more racial and religious diversity than at any time since Federation. High rates of immigration have been feeding back into stronger and more stable growth in total economic output.

Can these good times continue? What can we do to sustain the prosperity?

Two Dimensions of Prosperity: Avoiding Recessions and Raising Incomes

The recent prosperity has two elements. One is macro-economic: we have avoided a recession for over 15 years. The second is structural: average Australian incomes have been raised by increases in labour supply and employment, in the amount of capital with which each Australian works, in the productivity with which labour and capital are employed, and the prices of exports relative to imports.

Macro-economic elements of prosperity—the avoidance of recessions—involve maintaining growth in domestic incomes and expenditure and therefore economic activity in balance with the rate of increase in the productive capacity of the economy. If domestic expenditure runs too high for long enough, policy or market developments force sudden reductions in incomes and expenditure, and precipitate recession. In times like the present when imbalances are tending to take the form of excessive rather than deficient domestic demand, good macro-economic outcomes are supported by developments which facilitate restraint in domestic expenditure, as well as by changes that expand the productive capacity of the economy.

Structural elements of prosperity—rising average incomes for any given stage of the business cycle--are associated with productivity-raising economic reform, with increases in investment in human and other capital, and with improvements in the terms of trade.

The two dimensions of prosperity are separate but inter-related. It is possible to have macro-economic stability—sustained expansion of economic activity unbroken by recession—with low rates of growth in incomes. And it is possible to have high average rates of incomes growth alongside cyclical instability.

Nevertheless, the two dimensions of prosperity are generally helpful to each other. Recession hurts capital accumulation, including in the form of human skills, and productivity growth, so that stable economic growth supports growth in average incomes. Rapid expansion in the productive capacity of the economy or improvements in the terms of trade make it easier to restrain growth in incomes within the productive capacity of the economy and therefore to avoid economic instability and recession.

But there is one way in which the requirements of growth in average incomes and those of avoiding recession work against each other. A long period of expansion raises expectations that incomes and expenditure will continue to rise, and makes it more difficult to hold expenditure restraint within the growth in the productive capacity of the economy.

Macro-economic Elements of Recent Australian Prosperity

We have experienced such a long period of steady growth partly because the national monetary authorities improved their skills in keeping expenditure expansion on a fairly steady path, at rates of growth broadly consistent with increases in the economy's productive capacity, and were allowed by our political leaders to ply their craft. And we have done so well partly because a number of factors eased the task of reconciling demands for expenditure with the productive capacity of the economy.

Inflation targeting through the timely adjustment of interest rates by an independent Reserve Bank of Australia, mostly although recently insufficiently supported by cautious fiscal policy in the Commonwealth and the States, has made essential contributions to the durability of the prosperity.

Expectations of and demands for increases in incomes were dampened by the long period of wage restraint in the 1980s and early 1990s, and by the falls in employment and incomes during the 1990-91 recession. The lift in productivity in the 1990s as a result of reform raised the value of production more rapidly than demands for expenditure were increasing. This combination of circumstances supported the economic stability and sustained growth of the 1990s.

The official data indicate that there was a sharp fall in productivity growth from the turn of the century. This removed what had been the main impetus to Australia's exceptional growth in the 1990s. The end of rapid productivity growth coincided with the cessation of the growth in the volumes of services and manufactured exports that had commenced in the mid-eighties (Chart 1). The loss of this potentially sustainable source of growth momentum (productivity growth), was offset for a while by an extraordinary housing and consumption boom, funded by bank debt, itself ultimately supported by external borrowing. The large and increasing imbalances between savings and expenditure that emerged with this new pattern of growth, reflected in a large and growing current external payments deficit, could not have been sustained for long. By late 2004, the scene was set for substantial downward correction in real domestic expenditure, with the possibility of recessionary consequences.

A recessionary outcome was avoided by another major shift in the sources of Australian growth. Over the past three years, unprecedentedly high metals and energy prices as a result of rapid growth in Chinese demand have lifted the incomes associated with given levels of Australian production, and raised business investment in export-oriented resource industries. The increase in the prices of Australia's main metals and energy export products lifted the annual rate of exports from Australia by $45 billion or about four and a half percent of GDP from April – August 2003 to the corresponding months of 2006. Increases in nominal levels of business investment in the resources sector and resources related infrastructure have been similarly large.

Assessing the Prudent Limits of Expenditure Growth

How do we know when growth in expenditure is too rapid for the maintenance of stable economic growth into the future?

It is common at any time for community discussion to focus on single indicators of the balance between expenditure and the economy's capacity to support it. Currently the favoured single measure is the recently past rate of inflation. Inflation above the 2-3% band indicates that expenditure and incomes growth are running too fast, and need to be corrected by interest rate increases.

But the adjustment of interest rates in response to a single measure of recently past economic circumstances can never be the whole of a successful macro-economic policy. The Reserve Bank, to be effective in managing interest rates to meet its inflation targets, looks forward to future developments in the economy. Future changes in exchange rates, or terms of trade, or expenditure propensities are relevant to future inflation rates, and must be taken into account in the setting of current interest rates, even if low future inflation is the only proximate goal of policy. The current account of the balance of payments, for example, is relevant to the extent that it affects expectations for future exchange rates or domestic expenditure levels.

Recent inflation a bit above the target band is almost certain to lead to an increase in interest rates next Wednesday morning, the third this year and the fourth since early 2005. Whether or not that increase will be enough to bring inflation back to desired rates, and whether the accumulation of interest rate increases that turns out to be necessary becomes a threat to continued growth, depends on a number of other economic developments. It depends on whether fiscal policy supports the expenditure restraint associated with the monetary tightening. It depends on how responsive wages growth turns out to be to moderate tightening of monetary policy. It depends on the myriad factors that will determine whether the Australian economy is able to return soon to a path of strong productivity growth. It depends on the usual random shocks affecting economic life—including the trajectory of the devastating drought in southern Australia. (The effects of the intensification of drought on the macro-economy are complex. For example, drought increases exports and reduces domestic prices for meat for a while as breeding stock are slaughtered, and later reduces exports and raises prices. The effects on demand are deflationary and direct effects on food prices eventually inflationary). It depends on the foreign exchange markets' reactions to the return to increasing Australian current account deficits that may come to be associated with the drought, with modest retreat in the terms of trade, with continuation of the twenty first century stagnation in services and manufactures exports, and with any tardiness in downward adjustment in real expenditure growth in the more challenging circumstances that are emerging for Australia.

It depends on the sustained extent of the China-related resources boom, given its central importance to the terms of trade and business investment.

Much of the increase in value added attributable to the resources sector appears outside the mining sector in the national accounts. Purchased inputs in the form of legal, financial, and other professional services, as well as manufactured inputs into resource production, do not appear as mining output. Housing investment over the past two years has been buoyant only in States and regions experiencing high levels of mining investment. The large increases in private business investment over the past two years are concentrated in the resources sector. The rise in prices of resource products and the general economic expansion associated with the resources boom have increased the revenue of State and Federal Governments by perhaps 4 or 5 percent of GDP between 2003-04 and 2006-07. The increases in Government expenditure and reductions in rates of taxation that this has funded have raised output of Government services and sectors supporting private consumption.

The export share of the value of Australian production has begun to rise again over the past three years, but only because of the contribution of the resources sector (Chart 2). The increase in price of metals and energy has contributed more than the whole of the increase (Charts 1 and 2). The resources boom is a China boom because China has accounted for most of the increase in world demand so far in the twenty first century for most metals, and a high proportion of global growth in demand for energy. Strong growth in Chinese demand has created scarcity and upward pressure on world prices.

Will Rapid Growth in Chinese Demand Continue[1]?

The short answer is yes. Annual increases in Chinese total and import demand will tend to grow absolutely larger each year for as long as rapid Chinese economic growth is maintained. China is approaching the turning point in economic development, at which unskilled labour becomes scarce and increasingly expensive and comparative advantage moves swiftly towards more capital-intensive industries and processes. Chinese growth for many years will tend to use metals and energy intensively.

The rapid Japanese economic growth of the postwar period slowed when Japan's average incomes and productivity entered the range of the world's developed economies in the mid-1970s. China started its period of rapid growth much further behind the (constantly advancing) frontiers of productivity and incomes in the world's developed countries. Its growth momentum is powerful, as a result of Chinese people's deep commitment to change to secure higher living standards, the embrace of the market economy, China's acceptance of deep integration into the international economy and its prodigious savings and investment rates. But even at the 9.5 percent average rates of growth of the 28 years of reform, and the even higher contemporary rates, it will take several decades yet for average levels of productivity and incomes to reach the developed world's frontiers. It is more likely than not that China will reach these frontiers over the next half century, if not over the next few decades. At that time, China would account for more demand for metals and energy than the whole of the current developed world together.

In this year's budget papers, the Australian Treasury talks about China being the world's largest economy in purchasing power terms in about 15 years. That result would be exceeded if Chinese growth continued at the average rate of the past 28 years.

Growth on the scale of contemporary China is unprecedented. The barriers to continued growth, while formidable, are in many ways less daunting than those that have already been overcome in the reform era. Principal amongst the immediate contemporary economic challenges is the containment of potentially inflationary pressures associated with unprecedentedly large and rapid accumulation of foreign exchange reserves through the combined effects of a trade and current payments surplus, and high inflows of direct foreign investment and speculative capital. Faced with this challenge, the Chinese authorities' first and erroneous instinct was to raise interest rates and to intervene directly in enterprise investment decisions to secure lower rates of investment. It is unnecessary to make the reduction of investment shares exceeding 43% of GDP a priority when savings rates are around 50%. Measures to reduce investment are likely to be counterproductive, with high interest rates exacerbating capital inflows, and lower growth in domestic demand increasing the trade and external current payments surplus.

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[1] See Ross Garnaut and Ligang Song (eds) (2006), The Turning Point in China's Economic Development Asia Pacific Press at The Australian National University, Canberra.

There are recent signs of China adopting more promising approaches to the correction of macro-economic imbalances. The renminbi exchange rate, partially separated from its United States dollar peg in July 2005, has been allowed to appreciate at a modestly faster rate over the past two months. There is growing acceptance that economic growth rates at or in excess of 10 percent per annum are sustainable and probably necessary for the management of trade tensions with major trading partners.

China is now to a considerable extent a market economy, subject to the normal cyclical pressures. The scale and domestic heterogeneity of the Chinese economy are on the whole stabilising, and the period when an economy is rapidly catching up with the world's most productive economies is generally one in which it is easier to maintain growth momentum. China's prodigious domestic savings and accumulation of foreign exchange reserves provide a buffer against external shocks.

But there will be times—not now, but from time to time--when the strength and composition of growth generate inflationary pressures that require monetary tightening and retrenchment of expenditure, which for a while slow growth to well below average and sustainable levels. China's huge and growing influence on global price formation in metals and energy markets ensure that these will be difficult times for Australian economic growth.

The most likely setbacks to continued long-term rapid economic growth in China over the next two decades are political rather than conventionally economic. Economic change on the scale and at the pace of contemporary China generates huge pressures for change in the political system. The manner of the Chinese Government's management of these pressures will determine whether political instability at some time knocks China from its path of sustained high growth. There is cause for optimism in some Chinese leaders' recognition of the importance of these issues. But the outcome will hang on the views, disposition and authority of particular leaders at the times in future when the unfolding of events requires critical judgements to be made about the pace and character of political systemic change.

The external political challenges are also potentially destabilising. The worst case for the sustainability of growth is severe conflict with the United States, involving military confrontation.

The two potential flash points for conflict with the United States involve lingering unresolved issues from the Cold War in Northeast Asia: the reunification of Taiwan with China; and the future of North Korea. The risk contours of the Taiwan issue are well understood in Washington and Beijing. The early approach of the new Bush administration raised alarms, but recent developments, including Sino-American cooperation on what the Bush administration calls the War on Terror, has reduced the risks of catastrophic misjudgement on other issues. The recent North Korean nuclear weapons test creates large problems for China and the United States, but each has responded in a way that has supported productive bilateral relations. Any long-term solution to the Korean problem involves gradual economic reform and opening to the international economy in the North. China and South Korea have accepted responsibility as the crucial players in this main long term game. The powerful States with crucial interests in Northeast Asia are groping towards an arrangement that will support continuation of the long-term Chinese strategy on the opening of the North Korean economy, alongside cooperation between China and the United States in monitoring and containing the immediate nuclear threat. This week's announcement of the resumption of the six party talks suggests progress.

So while there are cyclical economic and long-term political risks, it is likely that China's strong growth will continue for a long period ahead. Before it has run its course, the contribution of Chinese demand for resources will be augmented by large contributions from other developing countries, first of all India. These developments are likely to keep average resource prices and Australian resource investment levels in the first quarter of the twenty first century well above those of the last quarter of the twentieth. But around higher average levels of export prices and business investment in the resources sector, there will still be wide fluctuations.

In the most favourable circumstances, the contribution of the China resources boom to Australian growth won't keep on getting bigger. Average minerals and energy prices will ease significantly from recent levels as international supply capacity expands. Investment in the Australian resources sector is likely to remain high, but not to continue increasing at the rates of recent times.

The China boom so far has been felt mainly through the increase in prices for Australian minerals and energy exports to global markets, and not only to China. Over the past year, it has been experienced as well as greatly expanded business investment. Over a longer period, rapid growth in Chinese exports of manufactured goods, especially labour-intensive products, has been instrumental in steadily improving Australian terms of trade through the import side.

A third favourable effect of the China boom for Australia will become increasingly important for the rural sector in future. Rapidly rising incomes in China have increased demand for high-value agricultural products. The increased demand for some of these, embodying relatively little land relative to labour—horticultural and aquacultural products and a wide range of processed foods, in which China has comparative advantage--have been met by rapidly expanding domestic production. For others—directly or indirectly the output of broadacre farming with its intensive use of land, such as grains, oilseeds, dairy and some meat products—China's import demand has grown strongly. For the latter, growing Chinese imports have put upward pressure on global prices—for example, for oil seeds earlier in the current decade. But global agricultural supply differs from minerals and energy. The time that lapses from decisions to invest to the expansion of output is relatively short, sometimes playing itself through within a single year. As a consequence, the large increase in global oilseed prices associated with increased Chinese imports a few years ago was followed by swift and immense expansion of supply from Latin America, and early downward correction of temporarily high prices.

Nevertheless, the continuing increase in Chinese demand is the source of upward pressure on the prices of broadacre agricultural products. This will intensify as the effects of China-influenced demand for energy works its way through global agricultural markets. Recent calculations using the International Food Policy Research Institute's global models suggests that current energy prices could encourage use of fuels of agricultural origin to an extent that raises global prices of grain and oilseeds to 30 to 40% above what they otherwise would be. For Australia, this will be a partial offset to the decline in terms of trade deriving from the likely fall in metals and energy prices.

Structural Implications of Current Tendencies

The shifts from Australian economic expansion based on increasing productivity, through the housing and consumption boom, to the resources boom, have profound implications for the structure and location of economic activity in Australia and for the distribution of incomes amongst Australians. They reverse some major structural changes deriving from economic reform in the 1980s and 1990s that had been helpful to the maintenance of economic stability.

The strong and diverse growth in export volumes, most powerfully for non-traditional services and manufactured exports, came to a halt at the beginning of the twenty first century (Chart 1). The residual growth in manufactured exports contained large contributions from processed metals, based on Australia's natural minerals and energy endowments, and benefiting from the resources boom in 2005 and 2006. One surprising feature of Chart 1 is the weak growth in resource export volumes since 2000. The volume of resource exports will grow more strongly in the years ahead, as the high rates of investment in the sector and its supporting infrastructure are reflected in increased output. This will take the edge off the decline in export values associated with the expected moderate retreat in export prices.

Real growth in Australian exports lagged behind the real growth of the total economy. This indicates a retreat from the deepening integration into the global economy since the mid-1980s. Chart 2 reveals that the ratio of the value of exports to GDP fell through the early years of the twenty first century, after large increases through the previous one and a half decades. The ratio has begun to increase again over the past three years. More than the whole of the increase in the ratio of export value to GDP came from the increase in prices for resource products. The ratios of the value of manufactured, services and rural exports to GDP have each declined over the past six years, after one and a half decades of rising shares for manufactured and services exports.

Chart 3 indicates that while growth in exports to China has been extremely strong, it has also been considerable to Japan, Korea and other developing Asia. Most of the increase to other countries has been the result of rising global prices for metals and energy. (Chart 3 shows that exports to the United States in nominal terms have actually fallen despite rapid growth in total United States imports from the rest of the world over this period. This is despite the discrimination in favour of Australian trade with the United States and against other countries inherent in the FTA).

The increased concentration of Australian exports in minerals and energy products in recent years, reversing the diversification from the mid-nineteen eighties, has complicated macro-economic management in two major ways. First, it has made Australian terms of trade more volatile, making greater demands on cyclical variations of reserves of various kinds through the commodity price cycle. Second, it has concentrated growth momentum in the northern and western regions of the country, exacerbating the problems facing the old Australian heartland in the southeast as it comes to grips with the end of the housing and consumption boom. The adjustment challenge facing the great cities of the southeast has been exacerbated by the extension and entrenchment under the GST arrangements of the historical tendency for Federal-State financial relations to distribute income away from New South Wales and Victoria.

The best response to more volatile terms of trade, and a useful response to the divergent economic fortunes of the resource-rich and old Australian regions, is a cautious fiscal policy. There has been some debate in Australia over the past year about the appropriate fiscal response to the resources boom. Accumulating a major part of the exceptional revenues as budget surpluses makes two types of contribution to economic stability. First, it establishes the fiscal capacity to hold up economic activity through deficit spending during the inevitable easing of the resources boom. More importantly, it reduces the pressure for contraction of other tradable goods and service industries—which happen to be concentrated in the southeast - when the demands of the minerals and energy industries are at their heights. It reduces upward pressures on inflation, interest and exchange rates, and eases skills and other bottlenecks. It maintains more of the country's tradable manufacturing and services capacity, for subsequent utilisation and expansion upon the easing of the resources boom.

How big a budget surplus is big enough? Prudence would argue for a majority of the increment in revenue being kept initially as budget surplus, until the sustained extent of the fiscal dividend from the China-related resources boom has revealed more of itself, and while skill and other bottlenecks and more general inflationary pressures threaten further increases in interest rates. That would argue for a surplus of several percent of GDP—about twice the level expected for this year. Fiscal policy could then be eased gradually as the future levels of the terms of trade and business investment in the resources sector become clear, and as inflationary pressures ease.

The Prospects for Continued Productivity-Raising Reform

Growth based on increasing productivity and investment in Australians' skills is potentially sustainable, and its benefits are likely to be spread broadly through the Australian community. The good news is that after the slump in productivity growth in the early twenty first century, there is still considerable potential for raising Australia's productive capacity through reform.

A more flexible labour market would help. We must wait to see whether recent changes in industrial relations law are to be an effective vehicle for its delivery. Many economists, myself included, saw the biggest economic and social gains from the new system coming from the opportunity that it provided to shift the focus of concern for living standards of low-income Australians from wages alone, to the integration of wages, social security and taxation. This would require fundamental reform of the taxation and social security systems to radically reduce marginal effective tax rates, along the lines that I outlined to this conference in early 2005. The first Fair Pay Commission decision, and the absence of integrated reform of tax and social security affecting low-income workers, tell us that gains of this kind are at best a long way away.

In the meantime, the embodiment of Australia's genius for legislative and administrative complexity in the new industrial relations laws compounds the transactions costs associated with mindlessly complex arrangements for taxation, social security, immigration, Commonwealth-State fiscal, and now in the era of FTAs and rules of origin, external trade policy. These are all areas where there would be large gains from simplifying reform.

Trade liberalising decisions announced between 1983 and 1991 removed most of the old Australian protection. They provided the major impetus to the lift in Australian productivity in the 1990s. While there would be no comparable gains from removing remaining elements of protection, these gains would be worthwhile. Amongst other things, removal of the protection that remains would abolish the transaction costs on the import side embodied in the tangle of rules of origin deriving from Australia's participation in FTAs.

Reform is required to reduce the myriad barriers to efficiency and expansion that ended fifteen years of strong export growth from the services sector half a dozen years ago (see Chart 1). Action to remove the damaging effects of privatisation without sound mechanisms for regulation of private monopolies in the telecommunications and civil aviation sectors would help all service exports. Efforts to understand the inhibitions on tourist and student travel to Australia from Indonesia, Malaysia and other Muslim countries could be important. For many parts of the services industries, the GST increased costs without providing export rebates, and we could be asking whether there are cost-effective remedies for this distortion.

Two years ago I talked about the great Australian complacency of the early twenty first century. Amongst other things I argued for increased focus on investment in human resources and infrastructure to ease emerging bottlenecks to Australian economic growth. These have become much more important subjects for Australian economic policy debate since then, but we are still in the early stages of translating good thoughts into effective decisions. Alongside increased investment in education, training and skilling of established Australians, a large skilled immigration programme remains an essential underpinning of sustained strong growth. Greater community confidence in the traditional Australian insistence that workers newly from abroad have all of the rights of established Australians would help to maintain support for high rates of immigration.

The Prospects for Sustaining the Boom

In all of the uncertainty surrounding future Australian economic growth, there are some things about which we can be confident.

The average rate of real income and expenditure growth that is consistent with economic stability will be substantially lower over the next few years than the average for the past one and a half decades. The utilisation of opportunities for restoring stronger productivity growth will take time—above all, time for the open and honest public discussion of the need for far-reaching change that is the foundation for durable reform in a democratic polity.

We can be confident that there will be no repeat of the easy and temporary income gains of the housing and consumption boom of the early twenty first century. We are still living with the imbalances generated during that episode, and any early attempt to rely again on these sources of expansion would precipitate currency depreciation, higher inflation, and a restrictive Reserve Bank response. And while Australia will continue to do well from Chinese and other Asian economic growth, the best of outcomes will see some reduction in the terms of trade and easing of the rate of growth in business investment. The intensification of Australian reliance on resource exports will mean more volatile terms of trade, and occasional large downward adjustments to incomes, expenditure and activity unless reserves have been built to high enough levels to cushion the shock.

Steady economic growth—the avoidance of recessions—will still be possible. But only if Australians are able to reduce expenditure growth to within the tighter limits set by the lower trajectory of productivity growth and some fall in the terms of trade. This will not be easy after the recent period of rapid fiscal expansion and private income and consumption growth.

In the early twenty first century we have drifted into thinking that there are no hard choices to be made among the many good things to which Australians aspire: between guns and butter; between guns now, and economic investment and growth now bringing greater security later; between wage increases for low-income workers, and taxation and social security reform and higher levels of employment; between tax cuts and lower interest rates.

We will have to reacquaint ourselves with hard expenditure choices. If we do not make the adjustment promptly, the operation of the financial and labour markets will do the adjusting for us. We will regret the passing of a remarkable period of Australian prosperity.