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ADDRESS TO THE ACADEMY OF TECHNOLOGICAL SCIENCES AND ENGINEERING – AUSTRALIA 2030 CONFERENCE

'GROWTH, CYCLES, CLIMATE AND STRUCTURAL CHANGE: TWO HARD DECADES AHEAD'

Thursday 11 November 2010, Sydney

-CHECK AGAINST DELIVERY –

Australians are enjoying the best of days, at least in relation to material standards of living.

Over the past two decades we have enjoyed the longest period of rising living standards, unbroken by recession, in history—our own, or that of any other developed country.

It shows.

We are back near the top of the developed world's league tables for per capita income, if we convert the national accounts into a common currency at the going exchange rates. Since early 2008, Australian income per person has exceeded that of the United States, and the gap has kept growing.

Our community's expectations of living standards has grown even faster than the capacity of the economy.

At the same time, our political culture has adjusted to these good times. Reform and structural change now means that there are no losers. Reform to most Australians now means a tax cut or improved service for myself. Business expects no less, and sees part of its core business as placing pressure on government to ensure that no reform is contemplated that would mean that its own business is a loser.

This is the world of the Great Australian Prosperity of the Early Twenty First Century.

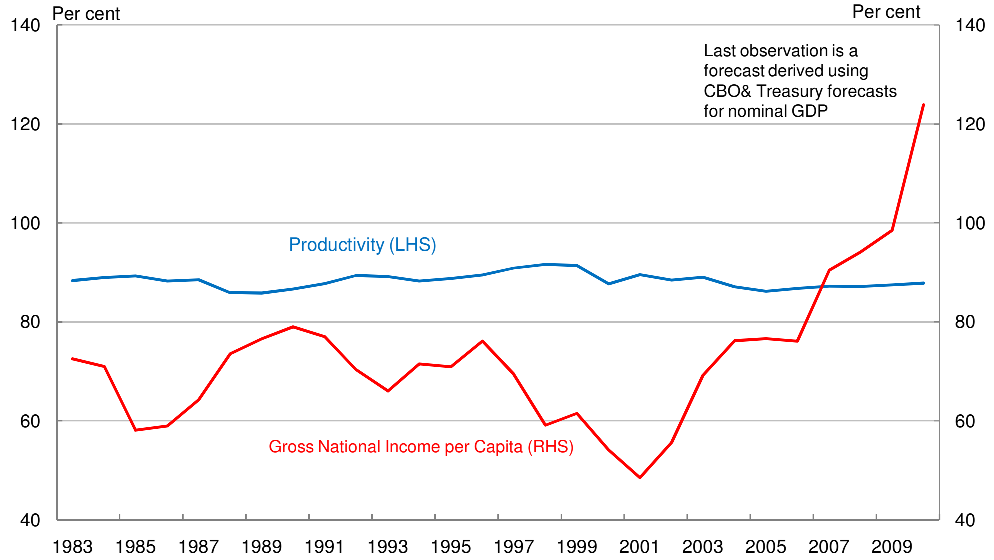
It is also the world of the Great Australian Complacency of the Early Twenty First Century. I have been calling it the Great Australian Complacency of the Early twenty First Century since early in 2005, but the phenomenon took on recognisable shape from about 2001.

When something is unsustainable, it probably won't last forever.

I will put up one chart that should raise questions about the sustainability of the Great Prosperity and the Great Complacency.

Labour Productivity & Gross National Income per Capita

(Australia as percentage of the US)



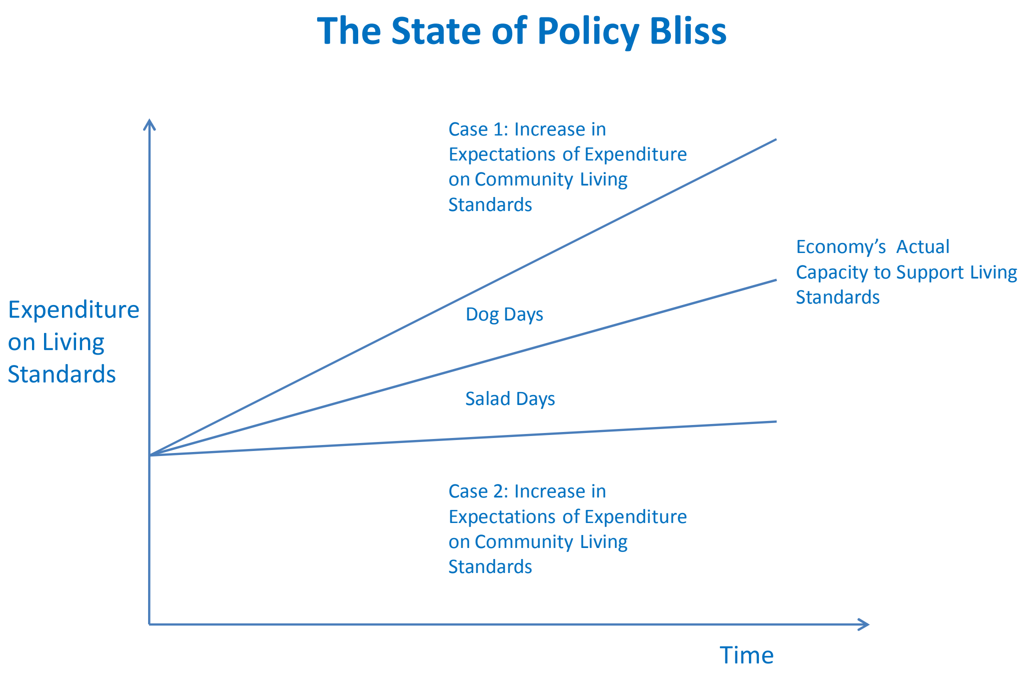
Source: Treasury, * Australian GNI/capita in $US converted at exchange rate of year concerned

The scale obscures the extent of the rise, but there was a substantial increase in Australian average productivity relative to the United States from about 1988 to nearly the end of the twentieth century. This was remarkable in our history. It is all the more remarkable in that the nineties was also a strong decade for American productivity growth.

As you will see on the chart, from the end of the century, our productivity relative to the United States started to fall again – even though this was not a period of strong American productivity growth.

Now look at the ratio of Australian incomes per person relative to the United States. It bounded up from about the time when our relative productivity growth headed downwards. It has bounded away since the Great Crash of 2008 left the Australian economy little scathed and set the old developed economies of the North Atlantic onto a new trajectory of stagnation.

I will structure my address this morning around the next chart, The State of Policy Bliss.



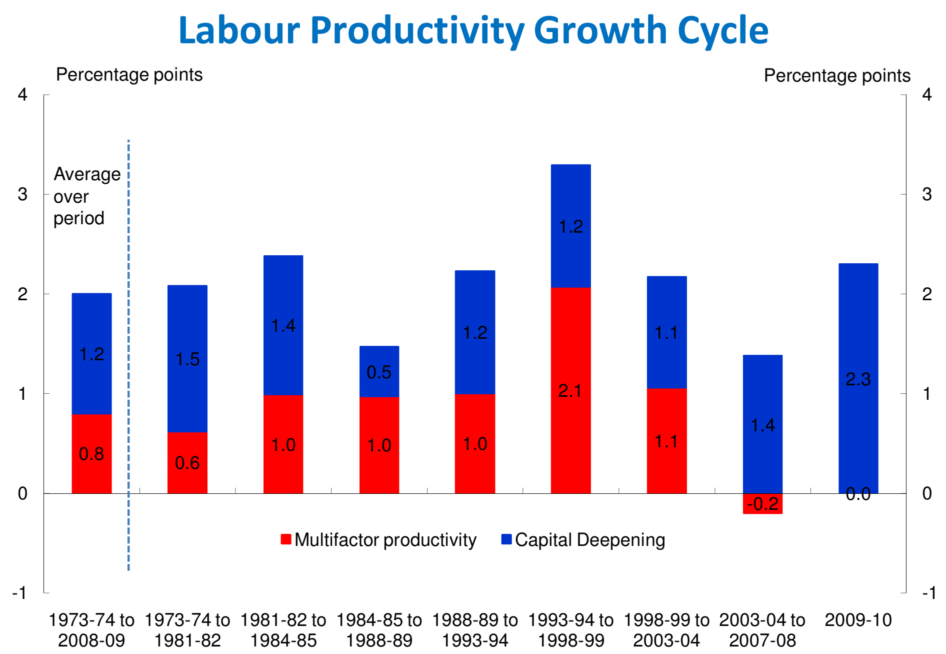
The message was there for individuals in Dickens' Micawber in the debtors' prison. Here I am talking about the State and the nation.

If the community's expectations of expenditure on the standard of living are rising more slowly than the economy's capacity to support expenditure, we are in the Salad Days of economic policy. These are the days when bad policy looks alright, and good policy looks stellar, a reforming Government can ask for the modest short term sacrifice that is often necessary to generate large long-term gains. Losers from reform that is in the public interest will whinge, but they expect little sympathy. A wise government will work to ensure that the interests of the genuinely needy are protected from change that is in the public interest, and resources are available to put in place the necessary protections. It is likely that the essential conditions for macro-economic stability – steady growth with sustainably low unemployment and inflation – are kept in place; that expenditure growth stays within the growth of the productive capacity of the economy – give or take prudent variations in levels of borrowing.

The Dog Days come when the community's expectations of rising living standards run ahead of the economy's capacity to support increased expenditure.

We'll come back to Salad Days and Dog Days.

The next chart puts the acceleration of productivity in the nineties and the slow-down in the noughties into perspective.



Source: Treasury, Australian Bureau of Statistics

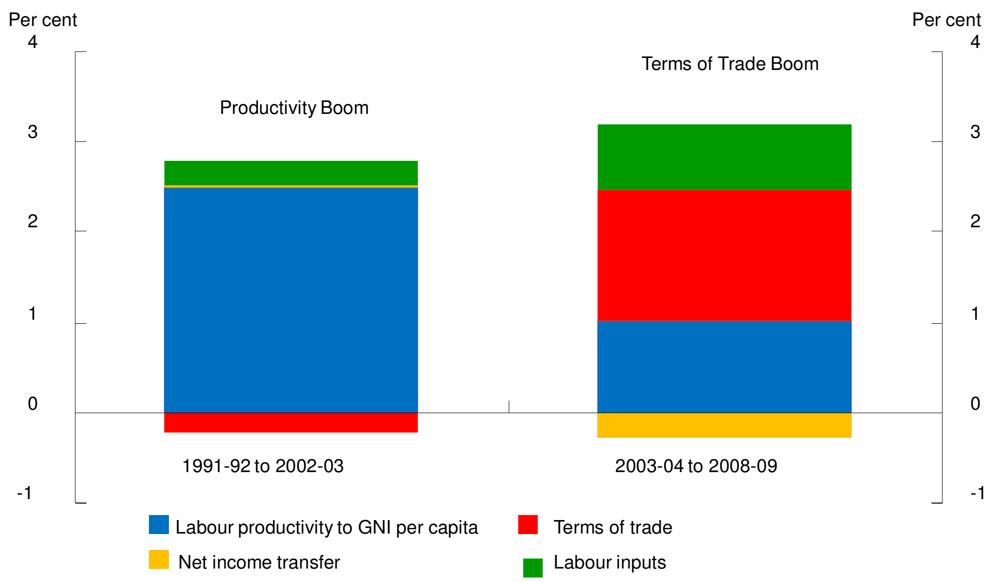
The post-1983 reforms extending to the end of the century, after a lag, were a major factor in lifting productivity growth to historically high levels. Even more importantly, the acceleration came from multi-factor productivity growth. This is the basis of sustainable increases in living standards. Unlike capital deepening, it does not have to be paid for by sacrificing current consumption (nothing wrong with that, but twenty first century Australians don't like to do it much), or by servicing capital inflow (the way we have funded much of the increase in twenty first century investment)

How, then, were we able to sustain growth in employment and living standards through the first decade of the twenty first century?

For a few years into the century, after the end of the productivity boom, growth came mainly from a housing and consumption boom, financed by the banks, who themselves funded the growth in lending by borrowing on offshore wholesale capital markets to an extent that has no parallel in history – our own or that of any other developed country. It was imprudent, and our banks would have come to profound grief when international capital markets froze in the Great Crash of 2008 and its aftermath were it not for the quick and massive intervention of the Australian Government.

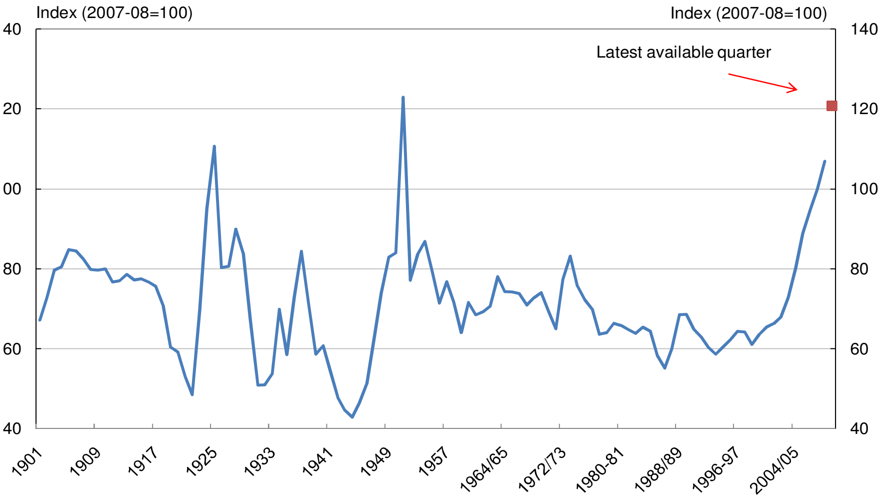
Unlike the Productivity Boom, the Debt-Funded Housing Boom was not sustainable, and would have ended in Australian tears were it not for the timely arrival of the China-led resources boom.

Components of Real Gross National Income Per Capita Growth



Source: Treasury

Terms of Trade

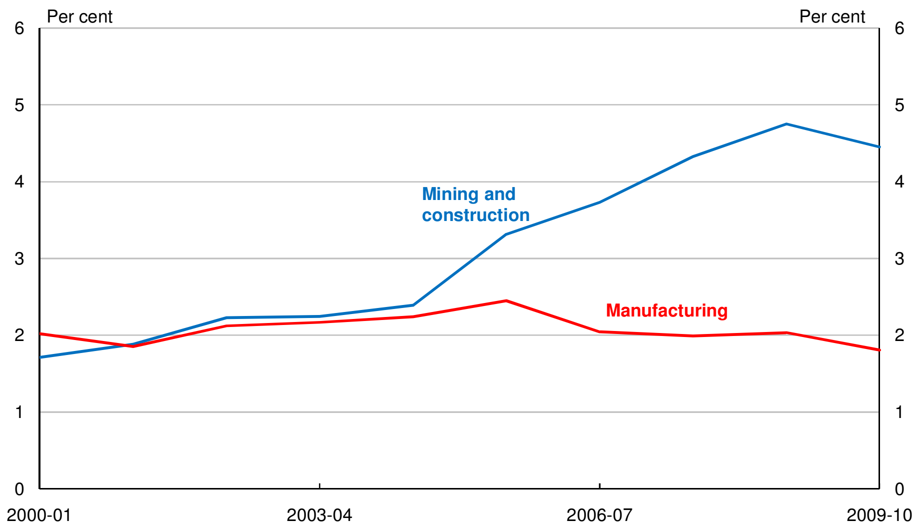


Source: Reserve Bank of Australia, Treasury, Australian Bureau of Statistics

It was not only the higher export prices that drove the resources boom. The lift in investment expenditure in the resources sector increased expenditure and incomes.

Where the Capital Deepening Went

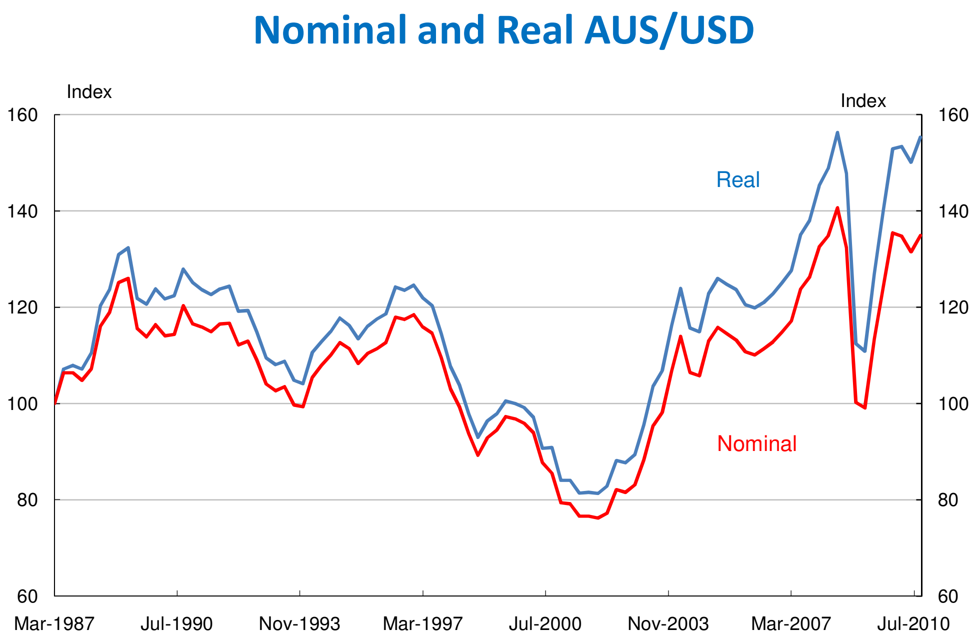
Investment as a share of GDP



Source: Treasury, Australian Bureau of Statistics

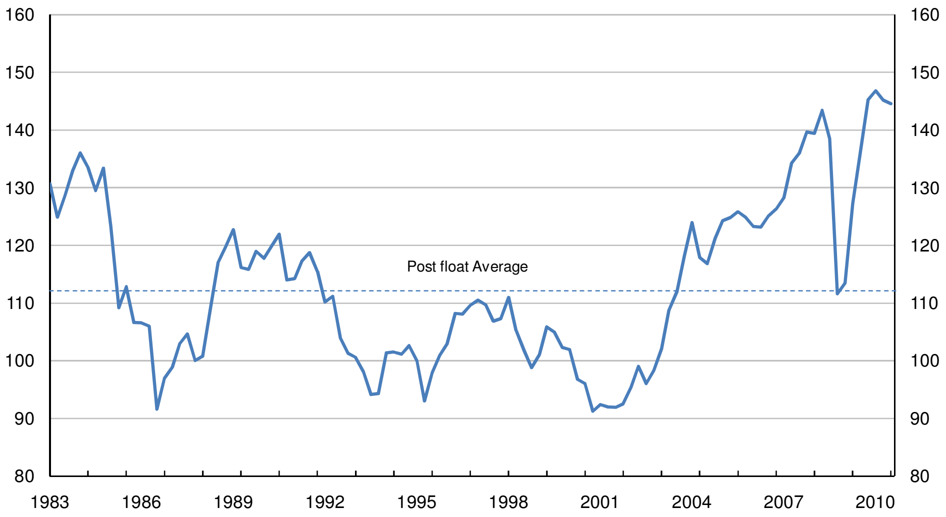
The resources boom puts great pressure on the rest of the economy, especially the other traded goods and services sectors, services (education the biggest, followed by tourism), the rural sector and manufacturing.

It does this partly through the increase in the real exchange rate (which is much larger than the nominal appreciation). (Economists internationally call this the Dutch Disease; we call it the Gregory Effect).



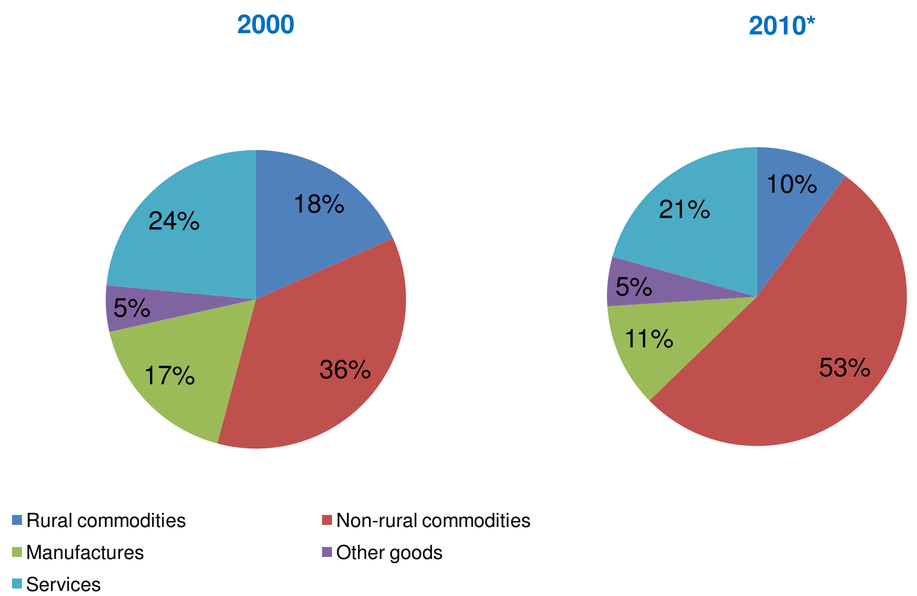
Source: Treasury, converted using core inflation rates

Real Trade Weighted Index



Source: Reserve Bank of Australia

Export Shares



Source: Treasury, Australian Bureau of Statistics, *2010 is 4 quarters to June 2010

The expansion of the resources sector also and separately puts pressure on the rest of the economy by squeezing other sectors' access to capital. There are always some limits to capital inflow, even in the heady days of imprudent expansion before the Great Crash. (These limits have been tightened by the Great Crash. Banks are somewhat constrained in expanding access to wholesale debt markets – the markets themselves are more cautious (and margins higher), and prudential limits on bank wholesale borrowing abroad are being applied more firmly. There is less risk in equity capital inflow, but since the Great Crash there has been less direct investment abroad from the United States and Western Europe, and while Asian sources of investment have become much more important, led by China, Australians have shown some ambivalence in remaining open to them.

This leads to what economists call the Rybczynski effect: disproportionate expansion of the most capital-intensive sector (in Australia, resources), requires a fall in real wages to maintain activity in the more labour-intensive sectors who contribute to the maintenance of high national employment levels. The Rybczynski effect could be offset by taxation of mineral rents, and accompanied by tax reductions or increased expenditures elsewhere in the economy. But when Treasury raised a crucial issue if questionable proposal in the Tax Review, we were unable to have an adult conversation about it. So in circumstances of constrained total capital inflow, the larger the expansion of our most capital intensive sector, the more the pressure on the availability of capital to other sectors.

The Gregory Effect would not be a problem for long-term growth if the increase in terms of trade and growth in investment were sustainable.

There is strong momentum in Chinese and other developing country growth, and it is likely to continue for a considerable while. However, it is likely that, despite this continued strong growth, the terms of trade will fall by a large amount with expansion of supply in Australia and elsewhere. Investment growth will level out and then decline. We will then again need large contributions from investment and exports from other traded goods and services industries, but they will have been seriously weakened by the large, temporary decline in their competitiveness.

So after a decade or so of Salad Days, and getting on to a decade of the great Australian Complacency, we are likely to face Dog Days for at least a while. Not necessarily starting tomorrow – terms of trade and growth in resources investment growth could even increase for a bit longer. But sometime early enough for our response to the onset of Dog Days to shape our prospects to 2030.

Productivity growth stagnation is a hard starting point. Stagnant multifactor productivity means that we start out with a flat curve for the economy's capacity to support expenditure in the Chart on the State of Policy Bliss.

Several influences will put downward pressure on that curve. Our heavily indebted private sector will carry a large burden if there is any upward tendency in global interest rates. Be careful what you wish for in China removing its payments surplus.

The huge backlog of infrastructure and education expenditure will require foregoing some consumption in public or private sectors if the macro-economic sums are to add up.

We are living in a world in which the global balance of economic and strategic weight has been changed fundamentally by the economic success of the large developing countries and by the stagnation in the North Atlantic countries after the Great Crash. We are still working out how to make the new international system work. There will be demands for increased real defence expenditure in this world (as in the current expectation of a 3 per cent per annum increase). There will be a choice of guns or butter; or guns or infrastructure. The latter choice is really a choice between guns now and security later, as a failure to restore sustainable growth would weaken us strategically at later times.

The world's tardiness in dealing with human-induced climate change (to which Australia has contributed a great deal, despite our economy facing larger damage from unmitigated climate change than that of any other developed country), is already affecting productivity growth, and this effect will increase with each passing decade, and of course increase much more beyond the 2030 horizon.

Sooner or later, Australia and the world will have to come to grips with effective climate change mitigation. This will inevitably involve some short-term cost to productivity, to be recouped many times in reduced productivity losses later on. My Climate Change Review suggested that early strong mitigation using efficient means would have cost us one to two tenths of output growth per annum in the early years. Later action and use of less efficient means will make the cost much larger, as well as making it harder to avoid larger losses from climate change itself in later years.

There are risks of things going badly wrong in the Dog Days; of slipping into policies that entrench slow growth in employment and incomes.

GETTING BACK TO SALAD DAYS.

These could be great decades for Australia, in an Asian region entering the harvest period of its economic development, with a self confident Australia drawing strength from its two decades of prosperity and from the growth in familiarity with our Asian environment enriched during this time by the immense growth of our exports of education services and the high education and skill content of a large immigration program.

But it can only be great if we quickly renew the focus on productivity growth. That means coming to grips with a huge backlog in investment in infrastructure, education and training. It means remaining open to international immigration and capital, and investing in the capacity to make that all work.

It requires looking at hard issues like tax reform and climate change with an eye to the national rather than the private interest. That, above all, requires us to restore the political culture of the reform era. It requires us to turn our backs on the political culture of the Great Australian Complacency, where we indulge sectional resistance to change that is in the national interest.

I don’t think that we will get it right without a major national focus on reducing short term benefits for long term ends. That will require some sharing of restraint for a while. Not much sign of that just now--although the 2 per cent limit on real public expenditure growth is tough by historical standards, if falling short of what may turn out to be required. We can take comfort from the fact that Australia has done what is required before. We did it better than other countries as we found our way out of the depths of the Great Depression. We did it in the eighties, as we reversed a long history of miserable relative productivity performance. I am afraid that Australians will have to do it again. It will be much easier if we can get back into a culture of productivity-raising reform before circumstance forces our hand.

One last word on the budget. I have taken the extent of the boom associated with strong external demand for resources and its effects on Australian economic structure as a given. It is unlikely that any policy directed explicitly to reduce the extent of resources investment at the height of the boom would be beneficial. However, the boom is a good time to introduce new policy affecting the resources sector that is desirable at some time and might have the incidental effect of slowing investment during a transition period. More importantly, it is a time for large fiscal surpluses, which would reduce upward pressures on the real exchange rate and also pressures on capital markets. I have been suggesting substantially higher surpluses since 2005, with the important exception of the period covered by the Great Crash and its immediate aftermath. It is now almost too late; but not if we turn out to still have before us a significant period of continued growth in resources investment. And it is certainly not too late to put in place arrangements that seek to ensure stronger anti-cyclical fiscal policy in the next resources boom.