

The Policy Pitch - Global Influences on Australia - Melbourne 18 March

What major international factors have shaped Australia over the last ten years, and which issues are likely to have the most impact in the coming years? This seminar hosted a panel from Lowy Institute and Grattan Institute to discuss these questions and more.

Panellists: **John Daley**, CEO Grattan Institute
 Jim Minifie, Program Director Productivity Growth Grattan Institute
 Michael Fullilove, Executive Director Lowy Institute
 John Edwards, Nonresident Fellow Lowy Institute

JOHN DALEY: Good evening ladies and gentlemen, my name is John Daley, I'm the Chief Executive of the Grattan Institute, and it's my pleasure to welcome you here to the State Library of Victoria for the latest in our monthly series of *The Policy Pitch* seminar series which we're producing in conjunction with the State Library of Victoria. I should start by acknowledging the traditional owners of the land on which this event takes place and pay our respects to their Elders, past and present. And then I want to acknowledge a number of special guests in the audience, and I'm not going to get everybody, but in particular I'd like to acknowledge Dr Hamed Al Alawi, who is the Consul General from Oman, and John Wylie, who is the President of the Library Board of Victoria. And, of course, we're very grateful for the partnership that we have with the State Library in putting on this series which we hope will do something to improve the standard of policy debate in Melbourne at least and perhaps Australia more generally.

So tonight's event, I think it's the first time that we have had the leaders of the Lowy Institute and the Grattan Institute on the same platform. I know that Lowy Institute would like to think it's the leading think tank for international affairs in Australia and I suspect that Grattan Institute would like to think it's the leading think tank for domestic affairs in Australia. So Michael, it's great to have you here to share this platform. The excuse for tonight's function, if we need one, is a collection that Lowy Institute put out towards the end of last year called *Reports from a Turbulent Decade* which is the tenth anniversary collection of material from the Lowy Institute, a huge range of material and, if nothing else, contains the conclusive proof that in fact Lowy is also in fact the leading free market domestic policy think tank from Australia. It contains a fantastic piece by Mark Thirwell arguing that what we really need to do is to outsource the monarchy and have a three-year competitive tender, which I think puts anything that the IPA has published to shame in terms of its genuinely blue-blooded free market thinking. But of course, much more seriously, it contains a huge amount of thinking about how international affairs have shaped Australia over the last ten years, how international affairs have developed over the last ten years, and, indeed, where they might go next and, of course, those will be the topics for this evening. But before I go there I should introduce the others on the platform here with me.

On my right here is Dr Michael Fullilove, the Executive Director of the Lowy Institute. He's been associated with Lowy since its establishment; he wrote the feasibility study back in 2002 that said a Lowy Institute would be a really good idea and has served as the Director of its Global Issues Program, worked as a Visiting Fellow in Foreign Policy at Brookings Institution, and, of course, is now its Executive Director. On Michael's right is Dr Jim Minifie, the Director of the Productivity Growth

Program at the Grattan Institute. He's a leading economist and writer with a very strong grasp of the Australian policy landscape; he's a graduate in Economics from Stanford University and worked very closely with a number of Australian corporate leaders for seven years when he was the Chief Economist at The Boston Consulting Group. Then on my left I have Dr John Edwards. He's a Visiting Fellow at the Lowy Institute, an Adjunct Professor with the John Curtin Institute of Public Policy at Curtin University; is a member of the Board of the Reserve Bank of Australia; and from 2009 to 2011 he was Director for Economic Planning & Development for the Economic Development Board of the Kingdom of Brunei. So if there are any specifically Brunei-related questions tonight, they will be going to John.

So the format tonight is that we will, as they say, chat amongst ourselves for a little over the half the time. That will include using some of the questions that have been put in by a number of the people whom I hope are here tonight, that certainly said they were going to be here tonight and put in questions in advance, and then we will throw the proceedings open to the floor, invite your questions and hopefully we will all finish up by 7.15.

So, the topic, as I said, for tonight is essentially about how international affairs have developed over the last ten years, how they've shaped Australia and where, of course, are we likely to go in the next ten? And by bringing together an international think tank and a domestic think tank obviously what we wanted to do was focus in particular on that intersection. So I'll start, if I may, with Michael. Michael, what do you think are the really big things that have happened over the last little while and what might some of the implications be?

MICHAEL FULLILOVE: Well, thank you very much John, thank you John and Jim. Thank you the Grattan Institute for hosting us, I'm a great admirer of everything that Grattan is doing in Melbourne and we're delighted to, in the last few years, have you join us at the summit of Australian think tanks. Let me also recognise John Wylie, a friend of mine, and also Judith Sloane, one of the members of the Board of Directors of the Lowy Institute. Thank you for your introduction. Last week I gave a speech at the Press Club and I got a nice introduction, and I was reminded then of an event where I once saw Henry Kissinger speak. And the Chairman introduced Kissinger and said "There's no-one who needs an introduction less than Dr Kissinger" and the great man replied "Yes, but there's no-one who enjoys an introduction more". So I think it's the case for all of us, so thank you very much.

I guess I'm the only non-economist, but I suppose my subjects are equally dismal to economics, and they're politics and security and diplomacy. I recognise very much that there are links between the Australian economy and the world, if we go to the topic of today's session, that trade and investment are absolutely critical to our economy, but equally that the flow goes the other way, that the single biggest contributor to a country's clout and its presence in the world, which is what the Lowy Institute is most concerned about, is its economy. That it's economic success that builds soft power and makes a country attractive and makes other countries want to emulate you and work with you. It is economic success that allows you to afford the diplomatic and military capacities that I believe Australia needs. It's economic success that makes you attractive to immigrants and we need immigrants for our productivity and our entrepreneurialism. So I think the connection is a tight one.

When I look ahead at how the world is changing, let me talk just maybe for a couple of minutes on that and then throw out a couple of implications on the domestic side. It seems to me that Australians are sleep-walking towards big changes in our international circumstances. It seems to me we're

approaching an inflexion point. And the reason I say that is that for most of our history the world has been run by countries like our own. When the world was painted pink we were a member of the British Empire in good standing. Throughout the whole of the Pax Americana we have been a treaty ally of the United States, and I don't think Australians fully understand how much that has served our interests. That we have prospered in a period when the international economy was dominated by Western countries; the international political system was dominated by the West; when American dominance was embedded in the international institutions that run the international order; when US military mite underwrote that order that was established by those institutions. And I do think those things are changing.

I think, regardless of what you think about the United States' resilience, I think the truth is that our great and powerful friends are becoming less great and powerful relatively speaking, it's very hard to deny that, and wealth and power are moving towards us. And we've heard the statistics a million times about all the upside in terms of the economic growth in our country, all the projections from the ADB and many other institutions that Asia will contribute more than half of the world's output by 2050, that perhaps half of the world's middle class will be in countries that are quite close to us. We've seen hundreds of millions of people lifted out of poverty in a country like China. I think these are all good things, but I guess the Lowy Institute looks often at some of the negative implications as well and the truth is that the economic growth that we're all excited about is magnifying interstate competition; it's not mitigating interstate competition. And you see half-a-dozen big powers jostling for advantage in our region. You see tensions on the Korean Peninsula, in the South China Sea, in the East China Sea. You see a lot of troubled bilateral relationships in our region, troubled by history, by nationalism, by clashing interests, and when you look at the bilateral relationship, perhaps most importantly, between the United States and China. I'm an optimist about the United States, but I'm a pessimist actually about the pivot to our region and, to me, the pivot is very important because the US presence in our region brings balance to the structure of forces in our region and I'm concerned really that the pivot has run out of puff, that militarily, politically, economically, it's much less impressive than we thought it might be. And, equally, when you look at the China side, I'm a bit concerned about Chinese foreign policy too. It's not that I think we should try to contain China, which is impossible anyway, but I'm worried about the unevenness and the unpredictability of Chinese foreign policy.

So I guess when you put all those things together, it seems to me there's quite a lot of downside risk and that's why I said last week that the tyranny of distance has been replaced by the predicament of proximity. And why is it a predicament? It's a predicament because there is upside and there is downside. We are close to the booming markets in our region, but we're close to potential hot spots. We're less isolated from our sources of prosperity, but we are less insulated from the sources of conflict. And we're much more bound up in it. We're in it. The geopolitical action has found us. After a long time wishing that we were in the middle of things, I think we are going to be in the middle of things. I don't want to speak over my time, but just throwing out a few thoughts about how that might relate to the debate in Australia.

I said at the Press Club that I think the predicament of proximity means that we should try to be a larger country. I didn't really just mean a big Australia and I didn't predominantly mean that, although I am in favour of immigration and I do think that immigration is a positive; it fills skill gaps; it improves our demographics; it improves the size of our economy; I think it has a benign effect on our per capita wealth. I think there are a lot of reasons to be in favour of immigration, but I really meant other things. I think, again, coming to the domestic issues, I think we need to start investing seriously in our

international capacities and somehow that has dropped off over the last quarter of a century. If you look at the Diplomatic Corps, in the late 1980s we deployed 900 Australian Diplomats abroad. Now, even though the international economy is no less important to us, the number of trips that Australians are taking abroad has increased five-fold, the region is changing before our eyes, and yet somehow we have a Diplomatic Corps that's one-third less. We have the smallest diplomatic network in the G20. We have almost the smallest diplomatic network in the OECD. We have fewer Diplomats abroad than Norway and Sweden and Belgium, countries that are smaller than us and are located more securely than us. And I think this is madness. I guess, turning that around doesn't have a huge budgetary implication, it might only cost a couple of hundred million dollars, but I think we need to get serious about it.

I think defence has much bigger budgetary implications because talk is cheap comparatively. Military matters are expensive. But there I see also a yawning chasm that has opened up in recent years between our ambitions and our capacities, where the general consensus in Canberra among all of the defence experts is these are the sorts of capabilities we require, this is the sort of benchmark that we should achieve in terms of defence spending. They talk about this 2% of GDP and, of course, you can question whether that's the right measure, but that's what everybody coalesces around and yet somehow that expenditure has slipped very substantially to levels not seen since before the start of the Second World War. I think that sends a very dangerous signal to the world, when a country says "These are our ambitions, this is what we think we need to do to operate in our environment, but this is what we're actually budgeting to do". I think you either need to lower your ambitions or you need to increase your capacities. So I hope very much that the new Abbott government follows through with their promise, the promise that Mr Abbott made in the election campaign, to get back to 2% by the end of the decade.

I'll finish there. I'll just finish on one final point John, and that is I would like to see Australia have a larger debate about these issues and that's why I'm so glad to be here in Melbourne and trying to piece together some of the international and domestic issues. I'm very struck by the triviality of much of Australia's debate about the world, how we end up focusing on foreign trips that are taken by senior ministers and foreign ministers as though a country of our size and importance can't afford air tickets. Maybe it's good for domestic policy think tanks, but it's hard for international policy to make news. But, to me, these issues are no less important to our future than superannuation or aging or any of the issues that the Grattan Institute writes on so brilliantly, but they're not treated that way I don't think in the national debate. They're not treated as something that affects all Australians, that has the potential to affect all of us and our country; they're treated as something that the Foreign Policy wonks at the Lowy Institute should deal with.

So I think we need a bit of a choice. Are we serious? Do we want to be a larger country with a larger debate, larger capacities, larger influence to affect the world in which we live? Or do we want to be a shrunken country with a cramped vision that's constantly banging on about the travel that our ministers are taking, that's not spending the money on the capacities we require? I think we need a conversation and I hope we think big.

JOHN DALEY: Thank you Michael. Jim, we might go to you and talk about to what extent do you think and do you see international affairs perhaps affecting Australia even more directly? Michael I think has spoken about the more longer run things and the things that we could do in response to those, if you like, international strategic impacts; what about the international economic impacts?

JIM MINIFIE: So Australia is a highly open economy, what happens internationally strongly affects what occurs domestically. And I'd just like to cast our minds back a little bit outside this one-decade window back to 1997, the Asian financial crisis which was widely anticipated would have a large and negative effect on Australia. The commentary at the time was that a recession was very likely and that there would be a prolonged period of disruption and a slow recovery. Now, nothing like that happened. We actually sailed through as part of that now rather famous or even mythical 22-year uninterrupted expansion which, of course, was not entirely uninterrupted if you look on a quarter-by-quarter basis. But nevertheless, we sailed through that disruption much as we've sailed through a number of others and there are reasons for that; it wasn't all good fortune. And so thinking about the way in which this turbulent global decade has translated into, in many respects, a period of really unmatched continuous improvement in living standards I think is worth reflecting on. And let me just sample out a couple of the key dimensions. There are many channels in which what happens internationally affects us domestically and I suppose the two most important are the trade channel and the finance channel.

Let me just turn quickly to trade. Again, just fast-forward five years from 1997 to 2002, the dollar was somewhat up from its lows, we were still very much of the view that the new economy was where it was at and Australia had a huge battle to get up to the global technology frontier. Then the resources boom happened with all of its associated disruptions, but that contributed to an increase in Australia's national income of about 13% and committed living standards to continue to improve despite the fact that productivity growth fell off a cliff at about the same time and, indeed, for related reasons. And that period of growth has been associated with a number of really special characteristics. So the first is that comparing Australia to all of the resource-based economies around the world we experienced a higher rate in US dollars of accumulated investment in the resources sector than any other resources economy in the world; over half-a-trillion dollars at market rates. Bigger than Russia, bigger than Canada, and that's obviously underpinned our recovery from the financial crisis, and I'll touch on that in the finance points.

The second point is that it obviously led to a big reshaping of the domestic economy and what I think is really critical to understand is the relative weight of things that were in our control collectively, as a polity, and things that were largely or optimally out of control. And let me just make two polar cases there, one is the position at industry level of manufacturing versus the rest of the economy. Manufacturing had long been in relative decline, that decline sped up somewhat during the resources boom and largely as a result indeed of the very high nominal and real exchange rates. That's a process that optimally you probably just let happen, and later we can talk about some of the reasons why that seems to be optimal.

But the other big structural shift that occurred during the period was really an outcome of collective choice and that is through the government budget process we financed a big expansion in a number of areas, particularly around health and community services expenditure, which have got positive aspects to them but, nevertheless, are absolutely inside the control of the polity and need to be thought about in the context of the possibility that the terms of trade may not stay that high and that our ability to pay for a significant fraction of the population to be providing these non-traded services might not remain at such high levels. And so I think when it comes to thinking about domestic policy in this international context of trade, you have to really distinguish between what you just let happen versus what you've triggered and potentially have permitted to overshoot.

Let me just turn quickly then to the other channel around finance. There are two important dimensions of the finance channel, one of them is the foreign direct component, which I think broadly trade theorists would say is all to the good; you get insights, you get learning, you get the transmission of knowledge from the international corporations that will then be spun out into increased Australian capability. The other channel for which there's a degree of ambivalence is the direct finance channel and there's been a lot of concern about, in a sense, the other boom that occurred in Australia which is the house price boom and associated change in household and bank balance sheets. As it turned out, we seem to have really had a manageable period even on that front. We learnt through the Global Financial Crisis that we're very exposed on the liability side to banks. We didn't have a lot of losses in terms of things that banks bought that went bad, but they were certainly subject to interruption in terms of the finance channel but there are steps government could and did take that made that relatively smooth-sailing as well.

So the overall perspective, I guess, from a domestic Australian policy stance is we seem to have a number of settings – and I won't touch on all of them, it's the openness, it's the flexible exchange rate, relatively flexible labour market and so forth – that have permitted us to ride the volatile shocks coming from external forces and, in a sense, opportunistically capitalise on them as they came. That's quite an impressive positive story.

JOHN DALEY: Thank you. So John, that's a very happy view of the world. Is it one you share and to what extent do you think that the international game, particularly around international economic relations, might change that picture?

JOHN EDWARDS: Thanks John. I'd like to reflect just for a few moments about the last ten years and then about the next ten in terms of international influences on the Australian economy. I think the most striking thing about the last ten is that although the Australian economy has always been affected by international influences, the impact over the last decade has been singularly strong, even within our own experience, and let me give three examples. The first is the benefit that we had from the biggest concerted economic expansion in the global economy ever which terminated in 2007. We benefited from that and the part of it that we most benefited from, of course, was the continuing expansion of China at colossal growth rates and the demand that it exerted on the rest of the world for energy, minerals and other resources and, particularly, from 2003 for our iron ore. And that is of course the origin of our resources boom which began in 2003 with very striking increases in iron ore prices.

So they were very big influences, they've changed us. I rather disagree with Jim about the ways in which they've changed us and I'll come back to that in a moment. And, of course, the other huge influence over that same period was the Global Financial Crisis in 2007 and it's perfectly true that we were not remotely affected as other advanced economies were, and for good reasons, but we were affected. We were affected: our growth rate slowed very substantially and you might say has not yet recovered; household behaviour changed quite dramatically; we had big losses in industries that were connected with a leverage debt, commercial property construction and so forth; all of which took some considerable adjustment for Australia.

Well, that brings us up to now, these three great events in which we participated affecting us very directly in Australia and we're now, of course, in the course of a domestic transition away from the very big influence of mining investment. But, again, we face, in answer to John's question, I think

quite a favourable global economy. We have first, over the next several years, to experience the normalisation of monetary policy in the US, Europe and Japan, and that's going to have a big effect as these countries ultimately get round to raising interest rates, probably not for several years but you can see that that process has already commenced. But on the whole that'll probably be pretty good for us. It means that, hopefully, we will have a narrower gap between our interest rates and those of other advanced economies and that may be associated with a lower value for our dollar, which I think would be a very good thing. That's one thing.

The other thing is I think we can show today that a concerted global recovery has once again commenced. The US is growing around about 3%, Japan growing around about 2%, Europe growing over 1%, and China continuing to grow around about 7%. It's slightly different concerted expansion from the one that we had through 2007 in that the world growth rate will be somewhat lower. But not because at this point the US growth rate is lower, but because China's growth rate is lower, that and some of the other major developing economies, but nonetheless, it seems to be reasonable to expect that this upswing will continue. And it will also, I think, have the characteristic that although China's growth rate will be slower, ultimately probably within that decade certainly getting down to 5%, it will continue to be very favourable for us and the reason is that China will continue to urbanise; half of the steel that China produces, and it's the world's biggest producer, is used in domestic construction. So we're very highly leveraged basically to China's domestic construction, which is, in turn, high leveraged to urbanisation, and urbanisation in China is continuing. According to the UN figures, over the next 10/15 years another 300million people will be moving from rural areas to the cities in China, the rate is similar to the rate over the last 20 years, and that will support a continuing demand for Australian resources.

I guess there's a question mark in my mind about the outlook for the US and to the extent that we will share some of the US problems: demography; in the US in particular, a problem of restoring a budget balance which is even more demanding than here; a particular problem of distribution of income in the US which is vastly uneven compared to here. So it may be that the concerted expansion proves to be lesser amplitude than before but, nonetheless, we will, I think, benefit from it and there'll be favourable circumstances for us to continue the expansion which, as Jim says, is now in the 23rd year.

Let me just mention John, since I've got the microphone, I'm not sure that the mining boom made quite as much difference to us as Jim does. For example, he mentions a figure of 13%, I think, of income and I'm not quite sure where this number comes from. But when I do the numbers, if you compare 2012 to 2002 - that is the whole period of the mining boom - the increase in Australian income attributable to the mining boom appears to be about 3%. The increase in economic activity attributable to the mining boom, and mostly it's a transfer from other activities, again appears to be about 3% of the real economy. And it's also, I think, important to bear in mind that on most measures - income, output, exports - we did at least as well and on many measures a lot better in the ten years prior to the boom than we've done since.

JOHN DALEY: Thank you. Maybe if I could just start by responding in terms of trying to draw a few of those threads together. I think one of the really interesting questions here is the extent to which those things overseas made a difference. I think we all agree the short answer is, one way or another, a lot. And there's a second question which is to what extent could Australia have done anything that would have created more benefit? I think there's probably a much more interesting question which is to what extent could Australia have done things that meant that the benefits were much smaller? And then, of

course, there's those same questions going forwards. And I would argue that there's probably not much Australia could have done about many of these developments, whether it's the growth of China, whether it was the Global Financial Crisis, or whether it was the shift in Australian housing prices which was ultimately, I suspect, largely a result of long run falling interest rates. Very little Australia could have done that meant that we did better than we did. We did extremely well, we can argue about exactly how well out of the mining boom, but we did well out of the mining boom. We did relatively not too badly about the Financial Crisis and clearly there was very little that we could have done to have stopped it happening internationally.

On the other hand, I think there are a lot of things that we could have done that would have made those things much worse. So we could have severely restricted the extent to which people could invest in the Australian mining boom. We could have tried to fix the exchange rate, as we indeed did in previous mining booms. We could have tried to interfere much more in terms of interest rates and, again, that would probably have left us much less well off than we were. And I suspect that the major thing to learn about the last ten years was that the impact of international affairs, it's mainly the things that you do wrong that could have had a really big impact and really the big impact for the next ten years perhaps is continuing not to kick those own-goals. Because, again, when we look from a Grattan Institute perspective of what can we do about the Australian domestic economy, what choices have we got that will really make a difference, we see key choices around the age at which you can access the pension and superannuation; the balance we have between corporate income and indirect taxes; the way that we encourage or don't encourage female workforce participation, particularly around marginal rates of take home pay after you've paid tax, given up welfare and paid for childcare. Now, all of those things are things that Australian governments can influence and none of them are particularly influenced by international events.

Similarly, if you look at the big budgetary challenges that Australian governments have got, foreign affairs is there but it's a relatively small piece of the overall pie; defence is there, it's about 6% of all Australian government expenditure and we will doubtless talk a little later about the extent to which we could or should either increase or decrease our defence expenditure; but if you think that you have a serious budgetary problem most of the answer is going to come from answers well outside of foreign affairs and events because they frankly are just not the really big numbers in the overall scheme of things. So I'd suggest the biggest thing we might need to worry about are things that we continue not to do badly and many of the things that will make the difference, if you like, in a positive direction from here may be things that are less important. So that's at least a thesis to start with.

So Michael, maybe if I go back to you and ask the first more directed question: let's imagine you've got this thesis about Australia, a big Australia being a better Australia, one that would be a more important actor on international affairs. Let's imagine that as of today Australia had the same size as the United Kingdom in terms of its economy - we'll assume, for the purposes of argument, that we do not have all of the United Kingdom's current economic problems - but we're that size, so we're about double where we are at the moment. We have the United Kingdom's Diplomatic Corps - I don't know what the numbers are, but I'm imagining substantially larger than Australia. We have their historic diplomatic clout. What would we do with that and how would it make a difference to Australia in terms of how we live our lives today?

MICHAEL FULLILOVE: As a Republican, that's not a thought experiment I often take myself through, but while I'm thinking about that let me come back to the interesting point you made which is a slightly

pessimistic point perhaps about the role of government in human affairs where you put the challenge out there: what are the positive things that governments could do and maybe the best thing they can do is not make big mistakes. And I guess I would take a more positive view of that than you, at least in the area of international affairs.

I think you can identify moments in the foreign policies of recent Prime Ministers where they did move the ball up, where they did identify a gap in the international system, where they did do things that both contributed to global welfare and also advanced Australia's interests. And if I think of the last few Prime Ministers we've had, I think a lot of them have tried to grapple with the lack of robust institutions in our own region which is a really 19th century region compared to Europe, where they have very strong institutions. And I think of Bob Hawke who really came up with the APEC idea; my former boss when I was a very young man, Paul Keating, who upgraded it, gave it a battlefield promotion to a leader's meeting within APEC. I mean, APEC has come off the boil now, but for a while there it played a very positive role in bringing the US President and the Chinese President together; they previously had not met on a regular basis. It put our leaders in the room with all these other leaders. To me, that's a positive thing.

If I think of Mr Howard's intervention in putting East Timor on the path to independence, not that we've necessarily been repaid for that, but was that the right thing to do? I think it was because I think it was wrong that the Timorese were denied their independence and I think it was the right thing for Australia to do. I don't know if it affected superannuation or health or aging or any of those other issues, but to me it was the right thing to do. I think Kevin Rudd played a pretty important role in elevating the G20 to the status of the premier forum for international economic collaboration during the Global Financial Crisis. That's not to say that the G20 is the bee's knees or the answer to all the problems, but it is now an extremely important forum, it's one where we can advocate for a transparent, open, rules-based international order, and it's one where we can also advocate for our own interests. It's a group of which we're a member. So was that a positive thing? I think that was.

I think Gillard stood up this strategic dialogue with the Chinese and, again, I think that's positive. I mean, I said before I'm a bit negative about Chinese foreign policy, but all the more reason actually that you want to thicken ties with China. I mean, I believe that we should be thickening our ties with the United States too, but I don't say we should be thinning out our ties with China. So, I guess to try to make an optimistic point, I don't think it's just that we're a leaf blown around and buffeted and the only hope that we have is that we don't stuff things up. I think that from time-to-time Australian leaders come up with policies that are both ambitious and creative but, at the same time, are coherent and have the hard work and the attention to detail that's required.

But to come to your actual question, what if we were Britain? What if we had the Queen as our Head of State? Oh, wait a sec, we do have the Queen as our Head of State. I mean, Britain has a lot of things to draw on; it's not just its economic size. It's a member of the Security Council; it's a nuclear power which changes things in the international system. But I think that the United Kingdom uses those resources in ways that are very significant. It plays an outsize role. Given that it's a country of 60million people it is really at the centre of many of the global issues that have to be resolved. I mean, it's remarkable really that a small to medium-size country of 60million people is right at the heart of the biggest debates going on in the world, whether it's climate change or Syria or the Iranian nuclear program, or North Korea; partly through the quality of their diplomats. One thing actually when you work in the UN system for even a year or two, you realise that the quality of British Diplomats and

their excellence in drafting means that in the Security Council they wield outsize influence because people always say “Let the Brits draft this document because they usually come up with a good draft”. They often have the pen, as they say in New York. And anybody who’s negotiated a contract or an agreement knows that the person who has the pen or who sits at the actual keyboard has a lot of influence.

Now, does that matter? I suppose this is the existential question you’re getting at. Does it matter to have influence? Does it matter to have a voice? Does it matter to be able to express your preferences? I have to say, it does. I would prefer to be expressing my preferences a) because I’m self-interested and because I think I can protect my own interests, and b) because I happen to think that Australia, compared to a lot of countries, has a good broad view of the global welfare and I’d much rather us influencing those debates than certain other countries.

JOHN DALEY: Thank you. Well John, let’s take a practical example of that if we can. Let’s look at the G20. Obviously it has a strong economic agenda planned with Australia as its President this year. Let’s assume for the purposes of argument that Australia manages to get all of the G20 countries to play nicely in Brisbane in a number of months’ time; let’s assume that all of those countries more or less adopt the Australian position, whether because of the excellence of our diplomats or because everyone’s temporarily mistaken us for the United Kingdom or simply because that turns out to be in their self-interest. How would that change Australia? If we really get that kind of consensus at the G20, what would be the practical outcomes, obviously internationally, but then for us as Australians?

JOHN EDWARDS: I can’t remember what the occasion was, but Michael mentions APEC and I had an occasion recently to pick up an old file of national action plans that were mandated. All the APEC countries agreed that they would adopt action plans to fulfil an agenda of faster growth, deregulation, removal of restrictions and so forth and so on. These action plans were absolutely immense, I mean, they were almost hard to pick up and every APEC country of course contributed one of these things; quite hard to read; it must have been so painful for people to have assembled them. Well, did they make a difference? Probably zero. I would think zero from this kind of exercise and I would think zero from the G20 in a similar exercise. I mean, I think it’s worth doing. The G20 I think has been a good framework for advancing agreement on international financial regulation, which I think is important. It may be – I think that’s very undecided – it may be a useful vehicle for some better international coordination on tax, although I think the OECD is probably doing most of the work there. But as a forum for concerted planning for enhancing growth, I think, John, zero.

JOHN DALEY: Thank you.

MICHAEL FULLILOVE: Can I ask my colleague one question, John? I should have asked him this on the plane on the way down. Leaving aside the APEC national action plans - one of which John’s obviously dropped on his toe - what about the G20’s crisis management role, John? I mean, do you not think that the G20 in London, for example, had a benign effect?

JOHN EDWARDS: No, that’s exactly right. It’s like an army, you know? You’ve just got to keep it trained, you’ve got to keep recruiting, you’ve got to have exercises, but actually it’s only useful to you in a war. And G20 is worth preserving just in case we get into another crisis and it’s worth keeping the machinery well-oiled and functioning. But to say it’s useful in a crisis, which indeed it was, is not to say that we would expect it to make a difference to the global growth outlook, for example.

JOHN DALEY: Thank you. Michael, we're here in Victoria which, as you know, has a quite substantial international presence for its state government. Now, one of the questions that came in from the registrants was around to what extent do state – as in state government or, indeed, even municipal governments – have a role in international affairs? And does it matter? And, indeed, will it matter more or less, do you think, over the next decade?

MICHAEL FULLILOVE: What a great question. I think that subnational actors can play a very important role and you're seeing cities in particular develop their own foreign policies in a way. I mean, I'm exaggerating, but I think cities can be very vibrant units that have particular interests and I don't think all the action takes place at the national level. But I think that states are still the primary unit in the international system and I think the events in Crimea in the last couple of weeks should demonstrate that to all of us.

After 9/11 the pendulum really swung away from people worrying about state-on-state conflict to worrying about non-state actors, to worrying about Al Qaeda and other terrorist groups and other sorts of groups like that. And there's no doubt that an attack like 9/11 is enormously disruptive and has all sorts of unpredictable and basically negative implications for the international system, for example the United States engaging in a foolhardy invasion of Iraq. However, having said that, it is the state-on-state conflict that really disrupts the international system. It was the invasion of Iraq, it was the over-reaction of the United States more than the tragedy of the people killed on 9/11 that did the lasting damage to the United States. When you look at what's happening in Crimea, you look at unmarked Russian soldiers on the streets of a sovereign country; that to me is something very sinister. That can spiral out very quickly. Quickly you can go from situation normal, as we did a few weeks ago to wondering what's going to happen in the central square in Kiev, to a sort of de facto invasion by one country of another. Those are very serious matters.

And so yes, I think state governments can have their own interests, they can pursue their interests, and so can cities. But to go back to the dismal, sort of, tragic element of international relations, it is still the decisions that our Prime Ministers and Presidents and Foreign Ministers make and, in particular, how they array themselves against other powerful jostling nation states that really affects all of us. If you think about the great global growth that we've all spoken about, the platform for that has been a peaceful and stable international order. And if you had the big states that we trade with actually in shooting wars with each other, or in something close to that, then I think all of Jim and John's numbers would be put out.

JOHN DALEY: Well, to take those numbers, because even if we do keep it peaceful there are clearly some things that could go wrong. Jim, you talked about the very large increase in Australian house prices and, as you pointed out, a large chunk of that has essentially been funded from overseas. A question that came in was essentially have we increased our exposure as a result of overseas banking crises and to what extent could we or should we do anything about that?

JIM MINIFIE: So it is just worth reflecting on what must have driven those house prices up, and it's a complex mixture of households becoming more confident that a recession wasn't going to remove their ability to repay so they're willing to take on more debt; the historically low global interest rates which, to a degree, bled over into Australia as well although, as John said, there's been a significant differential; and then, again, an understanding on the part of the banks that they were able, essentially, to service that increased willingness to borrow on the part of households. Now, what we

saw during 2008 through 2010 is the interruption on the liability side for the banks can be very material and that problem in principle could recur. There's an ongoing expiry of bank bonds which have got an average length of three or four years, and so all of that debt needs to be turned over. So it's conceivable that you could have in circumstances where global capital markets again tend to withdraw out of their home countries, that there would be another interruption.

But having said that, given that we do have the option of guaranteeing from time-to-time and using the public sector balance sheet to guarantee the banks, the prospects of a big disruption coming from that liability side just don't look that large. Now, as for what you should do about it there is then the question of whether banks with an implicit government guarantee should have free rein to expand to a scale that is judged to be optimal by the operators of those banks, or whether in return for the guarantee there ought to be some additional limitations put, that's an area where there are a range of views. My view would be that there's a quid pro quo and that it would be risk-increasing to permit a full response. Now, the reality is that we do have a range of restrictions and so whether you need to shift from where we are now is a debate for the specialists.

JOHN DALEY: Thank you. At this point we should throw it open to the floor. So if I can invite a few people to ask the first questions. I should point out that I have done a lot of seminars in my five years at Grattan and I know there are always more questions at the end than at the beginning. So I strongly suggest you put your hands up early.

AUDIENCE: I'm interested in the comments that Jim made around productivity and the decrease in productivity, particularly in relation to the periods of the resource boom and Michael suggesting to us that we're about to come to an inflexion point. So I put it to the whole panel, what could we do to try to take lessons from that to try to improve our productivity going forward, indeed, if we are going to have a different international environment?

JOHN DALEY: John, do you want to talk about productivity?

JOHN EDWARDS: Well, just a few thoughts. The big downturn we had, particularly in labour productivity growth, during the mining boom was partly associated with the boom. I mean, we had a huge fall in labour productivity in mining in particular. Although the mining industry in aggregate contributed to productivity growth because its productivity is so much higher than other industries and it doubled its workforce but, nonetheless, it didn't have the effect that it had in previous periods of pulling the average right up. So that was one of the reasons and, of course, there are other reasons connected with what we were doing in utilities and in mining where we were spending a lot more money without getting a lot more output, and that affected our multifactor productivity.

Well, I think the good news is that, at least on the labour productivity measures, we do seem to have come back in the last 18 months. Productivity growth is now between one and two, which is probably as good as it's going to be. If we can keep it up that would be very good. My own view is that the most important thing for our productivity and, indeed, the most important thing for our economic success over the next 20 years, in terms of first order issues, is going to be what we do on human capital, that is what we do in education and training. It's troubling, for example, that we're slipping behind in vocational education training spending now and that the GONSKI package is under threat. That I think in terms of Australia's comparative advantage, in terms of our ability to seize the opportunities presented to us by an expanding Asia, many of which will be in services, it's all going to be about human capital and that's a ball we shouldn't drop.

JOHN DALEY: Thank you.

AUDIENCE: Thanks to everyone for the conversation, it's been really enjoyable. Michael, I've got a question for you. You said that we should be increasing our defence spending and military spending. To do what? What would this increased defence force do? Or would they be like the G20 Sherpas sitting well-oiled on the sideline for a war?

MICHAEL FULLILOVE: Well thank you. I nearly came in actually when John said that armies are no use except in the case of a war, except that I thought to interrupt a colleague twice would be a bit excessive. Look, increasing expenditure on defence is about choices that a government makes. It's about whether it prioritises the things that a defence force can do and it's always difficult, especially I think for governments on the left, to prioritise defence because there are many other appealing choices that are put in front of decision makers, whether they're education, vocational spending, GONSKI, the NDIS, funded paternity leave, all these things. I guess all I can say is that, to my mind, the most important duty that a national government has is to protect its territory and the citizens of the country that it governs. I think every Prime Minister feels that very strongly. That's the most important thing. I think that having a more capable military would help us to hedge against alarming scenarios.

Let me sketch out two possible scenarios. We could have a future Cold War between the United States and China or, even worse, we could have a China that advances and an America that retreats; in other words, a reckless China and a feckless America. And having extra strategic weight helps us to hedge against those scenarios. It gives us different options. It gives us extra weight in the eyes of our allies and friends. It makes us more formidable in the eyes of potential adversaries. It increases our ability to have strong defence relationships with other regional countries. It increases our ability to contribute to stability in the South Pacific where the rest of the world basically looks at us every time the Solomon Islands goes pear shaped or something's happening in East Timor or Fiji or, God forbid, Papua New Guinea, the world will look to Australia. So I think there are lots of things that militaries can do, but even if it were limited, as you said, to actually defending the country and our citizens in a time of conflict that, to me, is important enough to choose to make the Australian military more capable than it is now.

JOHN DALEY: Michael, the counterargument to that would be we currently spend, in 2012, about \$27billion on defence. If we increased it from about 1.7% of GDP, which is more or less where we are now, to 2% that would be an extra \$5billion, so it would move from, roughly speaking, about \$28billion to \$33billion in today's terms. And if we then put that into context and say alright, the US is spending about \$646billion, so that's about 20 times what we are. Indeed, the only countries that are allied to the United States that spend more than we do are the United Kingdom, France and Germany. So actually, the rest of NATO individually, although there's a number of countries that are substantially larger than us in terms of economies, we actually spend more on defence than they do, at least at the exchange rates that we were into in 2012. They've changed marginally since then, but not outrageously so. And then yes, we spend substantially less than China and Japan but when China is spending \$120billion, is moving from £28billion to, say, \$33billion really going to make that much of a difference?

MICHAEL FULLILOVE: Well, I guess it's not really ultimately about the money we spend, is it? The money we spend is a proxy for the things that we can do, and I'm using that number even though I alluded to the fact in my speech that expressing defence spending as a percentage of the GDP

makes no sense. I mean, we should really be thinking about outputs. We should be thinking about what are the specific defence needs of a country like Australia? A country that's I think the fifth or sixth largest country in the world; a country that has search and rescue responsibility for 10% of the Earth's surface, as we're seeing at the moment where we're in charge of leading the search and recovery efforts in the Indian Ocean for MH370; a country that is a long way away from its traditional allies; a country that is extremely open economically; a country that has enormous coastline that it needs to patrol.

So I think it leads into a much more complicated and technical discussion about what are the actual things we need to do? But I would say, for example, we obviously need a new submarine fleet. We need submarines that have the range and the duration and the stealth and the resilience and the ability to stand on station, and those boats are extremely expensive to build. And in the 2009 and 2013 Defence White Papers the government, in its wisdom, said "We need a new fleet of boats that can do these things" but it continued to put off those decisions. So, I don't think it's simply a matter of where we rank in a league table if, indeed, your league table is exactly right; I think it's what do we need to do I order to play the role that we want to in the world.

I suppose it's natural for security people to focus more on diplomacy and economists to focus more on trade, but they're also linked aren't they? So, for example, it is naïve to think that the negotiation of the free trade agreement with China will take place in complete isolation from the political relationship between Canberra and Beijing. That's not how China operates. China engages in economic state craft - there's an excellent Lowy Institute paper published a couple of months ago to that effect on our website - and so that's why I'd say it's not so much just the diplomacy element or the trade element, but it's how we balance them. How do we deal with this new strategic triangle that has sprung up in the last few years when China overtook Japan as our leading trading partner; where now our leading trading partner is a peer competitor of our strategic ally, the United States; when what happens between the United States and China will have profound implications for how we relate to the United States and how we relate to China. So therefore managing that triangle and preventing it from becoming toxic and making sure we get the trade outcomes that we need, but also making sure that our security interests are protected, requires good diplomats.

JOHN DALEY: Thank you.

AUDIENCE: My question is probably also for Michael, but feel free to comment anyone else. Last year one of the things the government did was to downsize and fold AusAID back into the Department of Foreign Affairs & Trade. In the context of discussion about increasing military spending and also perhaps expanding the Diplomatic Corps, I'm just interested perhaps in your opinion on what the role of foreign aid is in establishing diplomatic and economic relations in our region and whether you think that's something we should also be looking at increasing spending on?

MICHAEL FULLILOVE: Well, I'll have the first go but I don't want to dominate, so I'll try to be quick. I think aid is important. It's important in our own interests and it's important in the interests of the people that we're trying to help. I think the problem with the aid program was that the expenditure had become a little unbalanced in the sense that if you looked at the overall international expenditure to defence, as John says, was something like \$26billion or \$27billion; I think the aid program was up to around \$5billion or \$6billion; the diplomatic element of things was less than \$1billion. And when you put the numbers like that and you say to people "Does that sound right? Does it sound right to spend

five or six times what we spend on diplomacy on aid?" I think most people think that the balance wasn't quite right.

So I don't per se have a problem with redressing that balance, so long as that's what we do. And last week at the Press Club I said let's make sure that the savings from merging AusAID into DFAT are preserved within DFAT. Let's make sure that some of the savings from reducing the foreign aid budget are preserved within the international portfolio broadly defined. Let's redress the balance slightly, still maintain our fantastic aid program, but if we can trim some let's put it back into the international portfolio. Because if we strip it all out and give it to John's priorities then we're making the international tool chest smaller, whereas I think we should make it bigger.

JOHN DALEY: John's priorities I suspect are a little bit like Joe's: he'd quite like the numbers to balance and that means that we're probably going to have to trim from a number of places.

AUDIENCE: When I was born, quite a few years ago, the marriage vow was still in operation but by the time I entered the workforce women had control over their fertility and we were educating more and more and more of them. Perhaps a follow-on from that last question about how aid was directed globally, but I did read some interesting facts last week on the economic cost of domestic violence and the way women are treated around the world and clearly there's an economic impact here that we're educating women, but we're not using them as productively as we could, and John you mentioned that earlier. So given that we do have this extraordinary investment in educating the women of Australia, what is this international responsibility that we carry to do a better job of using them? And what do we really think about this economic impact of the cost of domestic violence, which is significantly increasing in this country?

JOHN DALEY: Well, let me take the domestic piece and then I might pass to Michael. Look, I wouldn't pretend to be an expert on everything and I'm definitely not an expert on domestic violence or the costs of it, but it's easy to see why it would be very material. As you know, we have published at Grattan Institute pointing out the importance of female workforce participation and that there are very substantial traps, effectively tax and welfare traps, that we have created that mean that for many women essentially they go backwards financially if they work for more than three days a week and consequently many of them don't for periods of seven or eight years. And there's a real question about whether that's an optimal policy setting and, indeed, we can see countries around the world that have got different policy settings and wind up with much higher rates of workforce participation.

So that's, I will be honest, the limits of my expertise on the topic and I don't know whether, John, you'd like to add something to that?

JOHN EDWARDS: Well, only to say that it's certainly true that the increased participation of women in the workforce over the last three decades has been hugely helpful to Australia's economic growth. But I'm rather puzzled by this issue about the economic cost of violence towards women. I mean, I don't think it would matter what the economic cost was, it is not acceptable behaviour, right, and it ought to be something that we're vigilant to prevent.

JOHN DALEY: Michael, I think there was an international aspect to that question which is to what extent should Australia be expending its diplomatic resources more than it is already in terms of advancing the cause of female education, workforce participation and, obviously, non-violence internationally? Is there an extended role for Australia there do you think?

MICHAEL FULLILOVE: Well, we're stretching at the bounds of my knowledge too. I think there is in the sense that, as John said, bringing women more effectively into the workplace, educating women, giving them options in their lives, is good for their countries, it's good for their national welfare. So yes, I think that should be a priority of our aid policy. I'm not quite sure what DFAT could do about it in a diplomatic sense, but I think it's a good thing so we should encourage it.

JOHN DALEY: Thank you.

AUDIENCE: An observation for the last ten years is that what has emerged is "too big to fail", the banking system "too big to fail". What are the consequences of that mindset, both economically and also politically, in the next decade?

JOHN DALEY: Do you want to talk about that, John?

JOHN EDWARDS: Well, too big to fail. I think the Governor of the RBA has made the point quite well and made it some years ago, that even if we did accept that they're too big to actually fail, they're not too big that in the event of unsuccess you wouldn't remove the entire management and you wouldn't restore any equity, that is all the shareholders would lose their equity and the managers would go, there's no doubt, and there may be other penalties. But, having said all that, we are in the circumstances and it was demonstrated again in 2008 that as a practical matter you can't allow these institutions to collapse and take everybody else with them.

JOHN DALEY: Thank you. On that somewhat sober note we might need to conclude this evening. Obviously I'd like to thank our colleagues from Lowy Institute, Michael and John, immensely for traveling from Sydney to join us for this event; my colleague Jim Minifie for being here. When I first started at Grattan Institute five years ago one of the things I did was talk to a number of think tanks and I will confess I had a great deal of extremely helpful advice from Lowy Institute, and I think it's certainly made a difference to the way that we set up Grattan. So I think we should put on the record that that's really been an important influence.

I'd like to thank all of the guests here today for coming. It's been terrific having your perceptive input and your attention. I hope you enjoyed it and I hope that you will come to further events in this series. As you may have noticed, it's a monthly series that we're holding here in conjunction with the State Library and we hope that it will make a contribution. So that then leads me to thank the State Library, again, for the venue. When we were first setting this up I said to Sue, who's the Chief Executive, "You do realise that you are sitting on far and away the best venue for holding public seminars inside the CBD of Melbourne" for a whole variety of reasons that get people in theatre really excited but otherwise perhaps not. But it is a great venue and we deeply appreciate the chance to use it.

Depending on who you are interested in, you can keep abreast of Grattan events by signing up to our mailing list on our website; Lowy events by signing up to their mailing list on their website; and State Library events by signing up to the mailing list on their website; or, of course, you can do all three, and we would encourage you to do so. And I've already plugged the book once Michael, but I'll plug the book again relentlessly, so this is *Reports from a Turbulent Decade*, no doubt available from Lowy's website as well as from very, very good bookstores. As I said, a collection of fascinating essays written over the last ten years by people from Lowy Institute on a wide variety of topics that are really very insightful about Australia and the world and the way that the two interact. And then finally, if I can just mention to those guests who've been invited to join, particularly John Wylie, afterwards, if you

could please follow the ushers to the Red Rotunda room and, for others, we wish you a very pleasant evening.

Thank you for coming and we look forward to seeing you next time. Thank you.

END OF RECORDING