Key Challenges for Australian Economic Managers
– three key challenges

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THREE KEY CHALLENGES FOR AUSTRALIAN ECONOMIC MANAGERS

Introductory remarks by Saul Eslake – Program Director, Grattan Institute – at a Business Symposium organized by the Economics Society of Australia as part of its Annual Conference of Economists – Adelaide, 1st October 2009.

Australian economic policy makers face any number of challenges at the moment and it's not possible to do justice to them in 5-10 minutes. Hence in that time I am going to discuss three, without wanting to imply that there aren't others or even that the three I do mention are necessarily the most important.

Unwinding the extraordinary fiscal and monetary policy stimulus measures

The first challenge I want to mention – and I won't be surprised if the other panellists do as well – is that of unwinding the fiscal and monetary policy stimulus which has been provided over the past 12 months or so and which has been (in my judgement) an important reason (though not the only one) for Australia's remarkably benign experience of the global financial crisis.

I am *not* one who believes that the fact that Australia's economy has held up much better over the past 12 months than most others, or than was broadly expected at the onset of the crisis or even as recently as the May Budget, means that the stimulus was 'overdone'. Hindsight is always 20-20. Given that Australia had considerable scope, at the onset of the crisis, to use both monetary and fiscal policy more aggressively than most other advanced economies, it was reasonable to use it: the risks associated with doing so were (rightly) judged at the time to be less than those associated with proceeding more hesitantly, and even in retrospect I would assert that was the correct judgement.

Nonetheless, since the economy has come through the GFC and the ensuing global recession having sustained much less damage than was envisaged when the policy responses were being assembled, policy makers do need to be contemplating when, and how, to ensure that policy settings change commensurately with changes in the economic outlook and in the balance of risks around that outlook.

In this respect as in others, Australia's situation is somewhat different from that of most other Western economies. Fiscal policy settings in this country are *not* unsustainable from a medium-term perspective, having regard to the likely implications of demographic change (among other things). Almost every other government in the Western world would give its right arm, figuratively speaking, to be able to make projections of its public finances like the ones laid out in the May Budget (and it now seems highly probable that they were too pessimistic).

On the other hand, current Australian monetary policy settings *do* increasingly look unsustainable. That is not to say that the Reserve Bank erred in cutting the cash rate to its present level earlier this year. That was an entirely reasonable thing to have done given the forecasts which the RBA was working with at the time, and the balance of risks around them.

However the RBA would, in my opinion, be making a mistake if it maintained for too much longer monetary policy settings that were implemented in anticipation of a set of circumstances from those which, six months later, can with increasing confidence be said to look rather different. It would potentially be making the mistake which central banks in most other Western countries made – but which the RBA itself conspicuously didn't – earlier this decade of leaving interest rates too low for too long after a recession that turned out to be milder than expected.

Consumer confidence and retail sales seem to be holding up quite well even after the impact of the cash handouts has begun to fade; the August credit numbers released yesterday suggest that the decline in personal borrowing may have bottomed out; house prices have already risen nearly 8% so far this year, and the earlier declines in 'top end' prices have been reversed. It surely can't be long before the Reserve Bank decides that the risks of leaving interest rates at what Glenn Stevens has characterized as 'emergency levels' outweigh the risks of starting to return them towards more 'normal' levels.

In that context the primary responsibility of guarding against downside risks to the economy can for the time being be left to fiscal policy. That is, having regard to the fact that the fiscal stimulus measures were designed so that their impact would peak in the quarter just ended, and wind down subsequently, and that a significant proportion of what remains of those measures consists of infrastructure spending which is, broadly speaking, capacity- or productivity-enhancing, there does not seem to me to be a compelling case for cutting government spending or increasing revenue in, say, the next six months.

Rather what the Government should be doing in the fiscal policy area is:

- first, adhering with absolute fidelity to its commitment that any unexpected revenue windfalls are directed to the 'bottom line' rather than spent or given away in new tax cuts;
- second, to the greatest extent possible revisiting the trade-off made when the stimulus packages were being assembled between short-term impact on employment and activity (on the one hand) and long-term value for money (on the other), to place more emphasis on the latter and less on the former than seemed justified at the time; and
- third, fleshing out the commitment made in the Budget to hold real outlays growth to less than 2% per annum from 2010-11 onwards, a commitment which will require 'harder' decisions than the Government has been willing to make hitherto[1].

Dealing with the economic issues arising from our growing ties with China

A second important challenge will be thinking through the consequences of our increasingly important relationship with China. That relationship has worked very much in Australia's favour in recent years, including through the global financial crisis. It has meant, for example, that Australia's exports have held up much better than those of almost every other advanced economy. It would also appear to have provided us with one means of financing our current account deficit a time when our previously favoured method – overseas borrowings by the Australian banks – was not available. And it seems likely that this relationship will continue to confer significant economic benefits on Australia for some time yet to come.

And yet there are also some important challenges arising out of this relationship.

For example, persistently strong Chinese demand for Australian resources exports will keep the Australian dollar at a higher level vis-à-vis other currencies than would be the case otherwise. That is not necessarily a bad thing for the economy as a whole; but it will create adjustment pressures in sectors of the economy for whom a strong A$ is a distinctly negative factor (such as agriculture, manufacturing, tourism and education) and, inevitably, pleas for assistance from those sectors.

Continued strong Chinese demand for Australian resources exports will likely see the re-emergence of concerns over shortages of skilled labour and infrastructure bottlenecks that were front-of-centre in the period immediately before the onset of the GFC.

It will also revive the tensions between the 'resource-rich' States and the rest of Australia over the distribution of GST revenues and the financing of infrastructure.

[1] Note that by 'hard' decisions here I mean decisions which may be unpopular with voters whose votes actually determine elections, unless they are persuaded that those decisions are in the national (and possibly in their own longer-term) interest - as distinct from decisions which are unpopular with voters who will either never vote for the incumbent government, or who will nonetheless always vote for it. Such decisions (for example, to means test benefits paid to high-income earners) may well be 'good' decisions; but they are not 'hard' decisions in the sense intended here.

The likelihood of continued strong growth in demand for Australian resources exports should prompt us to think carefully about how we optimize the long-term gains from our resource endowments. Much of the benefits of the pre-GFC commodity price boom were dissipated in income tax cuts and cash benefit payments. We applauded ourselves for running budget surpluses while other Western countries (for whom higher commodity prices represented a loss of national income) were running deficits.

If there is to be another commodities boom we need to start comparing our medium-term fiscal strategies with those of other commodity producers such as Norway or Chile. In other words we need to be thinking about establishing some kind of sovereign wealth fund, and about writing some rules which govern the circumstances in and terms on which future governments can draw on such a fund.

In that context, and for other reasons, we should be conscious that should China for any reason experience a significant downturn in its economy independently of developments elsewhere in the world – as it did for example in the early 1990s – then Australia now stands to be more severely affected by that than most other advanced economies, just as we have derived greater benefit from China's extraordinary turnaround over the past twelve months than any other advanced economy.

Reversing the deterioration in Australia's productivity performance

A third key challenge for Australian economic policy-makers – and the one which is my major focus at the Grattan Institute – is that of reversing the deterioration in Australia's productivity performance over the past decade.

Productivity growth since the last cyclical peak in 2003-04 has averaged just 1.1% per annum – well below the average of 2.7% per annum over the previous decade (which comprised two complete productivity growth cycles) and half the long-run average. Relative to the US as a crude benchmark for 'best practice', Australian labour productivity has fallen from a peak of 88% in 1999 back to 80% in 2008 – in effect reversing all of the gains in relative performance that Australia made in the 1990s.

Australians haven't notice the effects of this abysmal productivity performance because they have been masked by the income effects of the gains in the terms of trade over the same period.

It is of course true that the rapid rise in minerals and energy prices which have driven these terms of trade gains have also prompted increases in mining industry investment and employment which have yet to be reflected in increased output, and enabled the exploitation of lower-yielding ore bodies, both of which have detracted from measured productivity in the mining sector. However those (and other abnormalities in the utilities sector) do not fully explain the deterioration in Australia's productivity performance.

And yet if we are not able to turn that deterioration around, then our relative standard of living is likely to start declining again once the terms of trade eventually pass their peak – as it did after the resources boom associated with Japan's industrialization phase peaked in the mid-1970s. And this could well co-incide with the peak impact of demographic change on the size and structure of our labour force, and on our public finances.

Hence a third key set of challenges for Australian economic policy makers lies in the wide gamut of issues – infrastructure investment, education and training, innovation, regulation, competition policy, trade and investment policy, taxation policy and incentives for business investment – which in different ways exert an influence on Australia's absolute and relative productivity performance.