The Policy Pitch - *Dynamism or descent: What can Australia do to avoid the slow growth trap?*

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Much of the rich world has been trapped in sluggish economic growth for almost a decade. Australia has avoided the slow growth trap so far. But as the mining boom subsides, incomes, employment and wages have stagnated and underemployment has crept up. Non-mining investment has not picked up much. The government is struggling to balance the budget while interest rates are at record lows.

At this Policy Pitch event, three Australian economists discussed the low growth problem and Australia's prospects and policy priorities:

- Why has the rich world stagnated since the financial crisis of 2008?
- Is Australia at risk of joining the low growth club?
- What can policymakers do to avert a slowdown and reignite growth?

Moderator: Dr Jim Minifie, Director Productivity & Growth, Grattan Institute

Speakers: Riki Polygenis, Head of Economics, NAB
Guay Lim, Professional Research Fellow, Melbourne Institute of Applied Economics & Social Research

SARAH SLADE: My name is Sarah Slade and I'm the Head of Digital Engagement & Collection Services here at the State Library. It gives me great pleasure to welcome you all to *The Policy Pitch* tonight. This seminar is held on the traditional lands of the Kulin nation and I wish to acknowledge them as the traditional owners. I would also like to pay my respects to their elders and to the elders of other communities who may be here this evening. I'd like to give a warm welcome to tonight's speakers, Riki Polygenis, Guay Lim, and our moderator, Dr Jim Minifie. I'd also like to welcome Grattan Institute members and staff and the Friends of the Library who may be here tonight. We're delighted to present *The Policy Pitch* series in partnership with Grattan Institute.

This seminar brings together three leading Australian economists for a discussion about the low growth problem and Australia's prospects and policy priorities. Uncertainty in Australia's economy and seismic shifts in workplace skill requirements mean a smart and adaptable workforce will be needed to ensure a solid position in the global economy. To that end, libraries will be among our most valuable public resources. Libraries allow free and open self-directed learning in a supported and resource-rich environment, which is a potent combination for rapid and diverse skills development. Part of preparing for the future is to have some insight into what it may look like and Riki, Guay and Jim will give us some of those insights tonight. What should Australia do to avoid the slow growth trap? I'm looking forward to hearing their answers so I'm pleased now to introduce Jim Minifie, tonight's moderator, who will introduce the panel and lead the discussion. Jim is the Productivity Growth Program Director at Grattan Institute. He's a leading economist and writer with a strong grasp of the Australian policy landscape. His research focuses on developing policy to raise Australia's living standards by improving productivity and accelerating the spread of innovations. Please join me in welcoming Jim.

JM: Sarah, thanks very much. Good evening everybody, it's really my pleasure to introduce our two speakers. Our format for the night is that Riki and Guay are going to make brief presentations, then we'll break for a discussion and we've got plenty of time at the end for questions. I just wanted to start, Riki, by introducing you. I've known Riki for a long time. She's the Head of Australian Economics at the National Australia Bank (NAB), prior to that she was at the ANZ for many years and prior to that the Reserve Bank. Riki is a very well-recognised commentator on some of the topics that we're going to cover tonight. Let me also introduce Guay Lim. Guay is at the Melbourne Institute at Melbourne University, she's a Professor effectively of macroeconomics there and her research covers a huge range of topics, everything from macroprudential issues, labour markets, macro modelling and forecasting, and so forth. So I can't think of two better people to introduce the topics we're going to talk about tonight. Without further ado, if I could invite you up Riki for your brief presentation. Thank you.

RIKI POLYGENIS: Good evening, thank you. Dynamism or descent is a huge topic at a time in which structural and cyclical forces are colliding, both locally and internationally. My opening remarks today will look at Australia's economic performance since the Global Financial Crisis (GFC) and touch on some of the factors which helped us ride that wave, and referencing some of the key features which may or may not be at our disposal going forward. First off, despite the talk of doom and gloom for the Australian economy in the press which we hear every day, it is important to recognise that Australia's economic performance has actually been pretty good.

If you look at this chart of real GDP growth rates, it's indexed I should say, you can see that since 2006 the Australian economy has grown by more than 30% or an average of about 3% a year, which is just below its historical average growth rate of 3.25%. By contrast, many other large and advanced economies have grown by a much reduced rate. The US has grown by approximately 15%, it did suffer a recession through the GFC and has recovered, and the Eurozone and Japan have expanded by just 10% and 5%, respectively. Our latest national accounts figures for the June quarter showed the economy was growing at about 3.3%. So what of all the talk of income recession that you might have heard about? That's because real GDP has been growing at a different rate to measures of national income. Here on this chart you can see real GDP growth in grey and the red line there is real net national disposable income per capita - that adjusts for the terms of trade effect, so the significant increase and decrease we've seen in commodity prices in particular, as well as foreign income and a few other things - you can see that that has actually been going backwards for 11 out of the past 12 quarters, although there was some bounce in the latest data. But a lot of that decline was because the boom that we saw in commodity prices has now unwound, globally there's been a pickup in commodity supply at the same time as global commodity demand has come off, so to some degree that was inevitable. In my view, I like to call that the income recession that we had to have, channelling Paul Keating.

Returning now to what helped us get through the GFC. We can see here that a lot of that was to do with the surge in mining investment which, in turn, was thanks at least in part to the Chinese Government and their stimulus efforts in the aftermath of the GFC, because commodity demand really did surge at that time. Mining investment went from around 2% of GDP in the early 2000s to a peak of 9% of GDP in 2012 and 2013. It's now come off to around 3.7% of GDP and is about 70% of the way through the adjustment back down to where we think it'll settle at about 1.5% to 2% of GDP. This increase in capital expenditure did, to some degree, come at the expense of investment in non-mining areas of the economy, and you can see there that non-mining investment has fallen as a share of GDP. It also led to an increase in Australia's capital-to-labour ratio and, to some degree, more recently in our labour productivity, so output per hour and that's because of this capital deepening or increasing investment. The main point to make there is that this hasn't led to a rise in multifactor productivity. So you may have seen that the Productivity Commission yesterday put out a briefing paper asking for submissions around how we can improve Australia's growth prospects going forward and they did highlight that multifactor productivity has actually been stagnant since around 2004.

Other things that have allowed the Australian economy to adjust include the exchange rate. I won't go through all the numbers here, but you can see the dramatic rise in the Aussie dollar on the left-hand side there which has mirrored, to a large degree, the rise and the fall in the Terms of Trade. You can see also on the right-hand side that interest rates rose at the height of the mining boom but then have fallen since that time, helping the economy to adjust and allowing the non-mining sector to recover. But I guess a lot of that increase in the Aussie dollar did arguably lead to a hollowing out of Australia's industrial base or what some people called "the Dutch disease" as well. So you can see here, this is a chart from the NAB survey, we put another update out today which showed a bit of a fall in business conditions which we're watching quite closely at the moment. The main point to make here is that between around 2010 and 2013 conditions were actually deeply negative in a number of industries including construction, manufacturing, wholesale trade and retail. That has since improved as the Aussie dollar as depreciated, but in some industries, like manufacturing, of course that offshoring process can't really be reversed. The other way that the economy adjusted was through a relatively resilient but also flexible – and some of you might find that controversial - labour market.

What we saw actually was quite a large drop in hours worked at the height of the GFC which hasn't been recovered. In actual fact, hours worked dropped again over the past year. So average hours worked in September 2008 was 35.8 hours a week, that dropped to 35.2 hours a week in late 2009 and the most recent data shows that it's dropped to 34.8 hours. So while that did prevent a rise in unemployment, what we've seen through this period is a rise in the underutilisation rate, particularly the underemployment rate, that means the number of people who would like to work more hours. That's partly because the industry mix of growth is changing, so we're seeing stronger growth in industries where there's a higher rate of casualization, like health and hospitality, but that's not the full story of course because there are many other workers who would like to work more hours. So that suggests to us that there is still spare capacity in Australia's labour market. If you take those numbers forward, we don't forecast the underutilisation rate but for the unemployment rate we're expecting it to remain where it is, between around 5.5% and 5.75%, over the next few years, which is still above where full employment is considered in Australia at around 5%. So that does suggest that we're not going to see much upward pressure on wages and that's going to be a constraint on household incomes and therefore household consumption growth going forward.

In terms of the new term outlook for GDP, our forecasts are pretty benign actually. We've got real GDP growth of 3% in 2016 as a whole, followed by 2.8% in 2017 and 2.6% in 2018. By 2018 that's reverting to around where we now see Australia's potential growth rate of around 2.5% and at that time we won't be getting as much contribution from net exports. At the moment these real GDP numbers are being inflated by the very strong contribution from mining exports following the mining investment boom, particularly at the moment in LNG. By 2018 we're also not going to have as much dwelling construction either because we believe the dwelling construction cycle will have peaked, and we're getting moderate rates of household consumption growth and non-mining business investment growth at that point in time. I should say also that I haven't shown forecasts of national income growth, but for the most part it will be growing pretty much in line with real GDP, except in 2017 where we're going to get a bit of a boost to income growth actually because of the recent surge in coking coal prices, which will probably be unwound by the time we get to 2018.

So dynamism or descent, where do I stand on this issue? Well, I think it's neither really. It looks to me more like a slow and hopefully steady grind. There are reasons to be optimistic: 25 years of uninterrupted economic growth hasn't happened by accident, much of the flexibility exhibited by the economy still exists and we still have a flexible exchange rate and a more flexible labour market. We have strong ties with emerging Asia, our connections through trade and also through people, strong migration, and also access and exposure to countries where population growth will be very rapid, like in the Mekong Delta and India. Equally though, it is difficult to envisage the pickup in productivity growth or growth in labour force participation necessary to return Australia's potential rate of growth back to where it was in the past. I mentioned earlier that we now see potential growth for Australia at about 2.5% and that's actually down from pre-GFC estimates of 3.25%. Our numbers are also a little bit weaker than where the Federal Treasury's estimate is at the moment, they're at 2.75%, and it is worth noting actually that they're expecting above potential growth in their Budget estimates going forward, so above 3%. In terms of the composition of these figures, it's hard to see a much larger contribution from labour coming through because we have an ageing population who have a lower rate of participation in the labour market. There are some policies that we can do to help address or improve female participation in the labour market and the participation of older workers which will be welcome, but there are still going to be limits on how much we can grow that component.

When you look at potential growth in this framework, stronger productivity growth is the main area which we can affect, but to get the same rates of productivity growth we've seen in preceding decades we really need to see the same pace of economic reform. That implicitly is what's being assumed when you see forecasts elsewhere and that is going to be quite challenging because a lot of the reforms that need to take place now are more micro in nature, microeconomic reforms, or they involve politically challenging taxation reform and co-ordination across the states and territories. I am a bit more optimistic on the infrastructure front. I do believe that there is a lot of private investor capital looking to invest in infrastructure at the moment because they want long term, safe investments. In a global environment where very low yields are on offer, infrastructure projects do offer that for investors and surely as an economy we can come up with some projects which have a higher rate of return to the economy or society than the current 30 year bond rate of 3.3%. So, to me, that really needs to be an area of focus, but, even still, you come up with numbers which are not terrible but are a little bit slower than what we've been used to in the past. The other point that needs to be made is that we do have less flexibility in terms of fiscal and monetary policy going forward. The RBA cash rate is now at 1.5% and the broad consensus is that 1% is around the floor for the cash rate in Australia as a small capital importing economy. Perhaps we could go down the path of a quantitative easing program, asset purchases or even helicopter money, but I think we would need to see a much more substantial slowdown than what's in our forecast for the RBA to go down that path.

I think there's also less room to move on fiscal policies. Everyone is well-aware the Budget's not expected to return to surplus until 2021, and it's a wafer thin surplus at that, but in a crisis we probably could see a bit more fiscal stimulus because general government debt, at least for the

Commonwealth, is around 18% of GDP at the moment; that compares to the advanced economy average of around 75% of GDP. So while we might suffer a little bit on our AAA credit rating, the government does have some room to move in the event of a crisis, although it probably cannot justify further stimulus to the economy just to help rectify below-average rates of growth. I'll let the other speakers touch on the policy options at our disposal but, to me, the outlook is one which is not terrible. It is positive, but it is where growth is a little bit lower than what we've become accustomed to and income growth is also a little bit lower than what we've become accustomed to. Thank you very much.

GUAY LIM: Good evening. I'd just like to make a few points before we begin our discussion and open it up for questions from the floor. My first slide is to reinforce the point that Riki has just made, mainly that the rich world has stagnated, it's not growing, and that the IMF expects it to continue to experience slow growth.

If you look closely and carefully at that graph what you see is that Australia isn't doing too badly. We are above the Western countries, the US and Euro, but of course our growth is below the Asian countries. What's happening in China is that it's rebalancing. The government is adopting reforms to ensure that they have sustainable growth into the future, and that means they want to move away from high investment type growth to more a consumption-led growth. Australia has escaped the recession, but we should expect growth to remain low for a very long time. The first point I want to make is that we can no longer rely on growth from external economies to stimulate our growth. We're not going to get it from trade. If we are going to grow it has to be home-grown, we'll have to find ways of growing our growth ourselves, which then leads me to the question of policy. When we think about policy we traditionally think about monetary policy, fiscal policy and the rest. Now, as Riki has said, with the monetary policy we're kind of at a low level and the reality is that if the government were to reduce the rate further it's quite unclear that it will stimulate further spending. We've reached a point where perhaps what will happen is that any further reduction in the rate will lead to a house price asset bubble, rather than to genuine change in spending, growth and jobs. Riki has also touched on the constraints of fiscal policy and I know we have read a lot about it so I can skip that point, which means that we're now left with the policy arm that we generally call structural reforms, basically micro type reforms. Before we go into a discussion about micro reforms, I'd like to talk about three big picture mantras about growth.

The first is growth and innovation. There's a general belief that we need to innovate to stimulate growth. That's true and we look at this picture which is some research that we're doing at the Melbourne Institute. We're looking at all the components that are classified under innovation, which includes R&D, trademarks, patents and improvements in business practises, and we put them altogether and get an index so that we can see the general pattern of innovation in Australia. Well, as you can see, it used to be here on a downward trend, which is fine and perhaps that's the reason why we have slow growth. However, if you look at the data more closely you'll soon realise that innovation in Australia is not the big bang type. As Robert Gordon, an American economist, said, the big bang radical innovations came out - and I like the way he classified them - steam, electricity, electronics, and out of these big radical changes there were more incremental innovations. Australia is very, very good at applied and translational innovation and we've been extremely good in applying that especially to our natural resource industries. So when we talk about growth in innovation it's a wonderful mantra and it gets lots of people very excited, but to be realistic we need to be talking about growth in productivity or translational innovation, incremental innovations.

The next point I want to talk about is growth and jobs. Again, there's a belief that all we've got to do is grow and if we grow, jobs will follow. That might be true for the US; I was quite surprised when I did a scatter plot to compare growth in the US with changes in employment and unemployment, you can definitely see a pattern there that if the US economy grows, jobs seem to follow and unemployment seems to fall, except perhaps recently. But it's not the case for Australia. I was also quite surprised to find that when you look at the data you get a scatter plot and it's not clear that just because we grow we're going to create jobs. Part of the reason why that doesn't follow is because the sector that was growing most in the last 10 to 15 years was the mining sector and the mining sector is not a labour-intensive sector. So for us to talk about growth and jobs we need to ask the next question: where is it coming from? The third point I want to make is about growth and inequality. There is, again, a general belief at the moment that if we grow we will only create more inequality. There is some evidence that it is possible that if you grow the rich could get richer and we could leave some people behind. I think that is just a case for being very careful about how we grow and where we grow and the way we structure our growth. If this is to happen that level of inequality, although it's deteriorated a little bit, is not ridiculous but, on the other hand, it is an important message that we need to pay attention to.

So bearing in mind those three points - that when we talk about innovation we need to think about productivity; when we talk about jobs we need to be worried about the sectors that we are talking about and where the growth is coming from; and, thirdly, that when we talk about growth we need to be aware that we do not want to create a class of disadvantaged people in Australia - I think that if we were to discuss growth and how we grow out of our current stagnant or slow growth stage we should be talking about various types of micro reform and, for me, it's convenient to think about grouping them according to three categories. First of all, we should think about markets. One of the ways to grow is if demand is growing, and if we can't grow demand ourselves, because the population is limited, we can always consider changes in our immigration policy. On the other hand, we can also think about creating new export markets: is there demand for Australian type products, especially in the growing emerging economies? The next think to think about is work incentives and participation. If we want growth and we want growth for all and for everyone to benefit, we need to think about growth as improvements in human capital, and that means having structures and reforms in place that improve the quality of education and training, healthcare and housing.

The last point I would like to make is that when we talk about productivity, which we are going to talk about a lot later on, it's useful to remember that it's is mainly driven by companies, the enterprises, but we need to have a form of structure where in some way the gains from productivity are shared equally between the employers and employees. The government can do something about that in terms of their investment in infrastructure, the broadband network and transport networks because all of this will help reduce costs and increase profits, and hopefully that means increased wages, more employment and we'll all be happy. So in short, for me, the question is not that slow growth is inevitable; I think we're in for a period of slow growth. The question is also not can we avoid it, but rather that in the next few years what we can sensibly do about sharing the limited pie? We need to ensure that we remain productive; we need to ensure that there are equal opportunities for all; and we need to ensure that we, and especially the government, are spending money on infrastructure such as the broadband network, things that will ensure that we have a strong base for building to have a great future. Thank you.

JM: Let me just start with a question about why we're even talking about growth, which came up in some of the preliminary questions submitted before the event. We live on a finite planet, we're clearly running out of space around climate change and there are a number of other physical constraints. Is growth in GDP even the right measure? Why do we make such a big deal about it?

RIKI POLYGENIS: Well, I think, for starters, one of the benefits of looking at GDP is that it is something that can be easily quantified and is not subjective. I would love for there to be measures where we can include happiness and environmental costs and can incorporate a lot of those things into our metrics, but there needs to be a framework and it needs to be an internationally recognised framework so that the whole profession of economics can adjust to that it. I guess the other issue is that a lot of those other measures are a bit more subjective rather than objective, whereas a measure like real GDP is quite objective and quantifiable. I think there are some challenges. That doesn't necessarily mean that we shouldn't try through to incorporate other things into our way of thinking and I think the profession is evolving very slowly towards that.

JM: Guay, any thoughts?

GUAY LIM: I tend to think that there is growth and there is tremendous growth. If we think about growth, there's growth per capita, so if the population is growing at 5% then you'd like there to be GDP growth of 5%, so that's growth that just keeps us at the same standard of living. Sometimes I think we get distracted because we talk about growth and we don't actually think about growth relative to what is being useful. So if we want to maintain our standard of living and if rate of population is growing at 2% at the minimum we have to talk about growth of 2%. However, we all desire to improve our standard our living, so if we want a little bit more then we have to talk about the 2% plus a bit more.

JM: And I guess you could add to that that when you've got productivity growth, if the economy doesn't outpace population and productivity growth then you're going to have declining employment.

GUAY LIM: Absolutely, yes.

JM: All I would add is that there's no question where you've got costs that are being imposed on other people. So, for example, if you go to China, one measure of the cost of air pollution is that it's about equivalent to 10% of GDP when you look at the morbidity and mortality that's associated with that. So there may be some relatively simple modifications without waiting for full infrastructure that can give you a feeling for whether you're heading in the right direction, because you can imagine in the worst case that you might be having a form of growth that is really detracting from welfare. Can I just move on, what I thought we could do at a high level is, first, try to draw the right lessons out of a stagnation that parts of the rest of the rich world have fallen into, then have a bit of an examination of Australia and then look at some policy issues. So Guay, if I could start with you. As a macroeconomist, did the GFC take you and your profession by surprise?

GUAY LIM: Oh yes.

JM: What lessons have you drawn from it?

GUAY LIM: I think the development of financial derivatives and the way it was being priced at the end of the day was the key, because a lot of people did not understand that there was a lot of risk and while there was supposedly a lot of on paper risk-sharing around the world, in actual fact the people who were evaluating the risk really had no idea what they were doing. So in one sense, when that collapsed perhaps the greatest shock to the profession was that a financial collapse could lead to real outcomes. A lot of the times we've had collapses in the share market, Black Octobers, the share market rises, collapses, you all worry about it and then it's over and done with. However, this one was prolonged and I think that really shook the profession.

JM: Larry Summers three years ago put forward the view that a concept that had been introduced in the wake of another financial crisis in 1929 and another prolonged recession, The Great Depression, could be relevant now. The view he put forward was that while the downturn might have started as a cyclical one, over time it seemed to develop into a syndrome where, at least for some of the economies, you had an excess desired savings rate compared to investment leading to very low interest rates and you had persistent low investment in the real economy leading, in turn, to essentially a structural failure of the economy to renew itself and to generate growth. Again, speaking as a non-macroeconomist, is that a view that's got some traction inside the profession of macroeconomics or is it really just a rhetorical device?

RIKI POLYGENIS: I think there is probably some truth to what Larry Summers is saying. I think that we have seen lower rates of investment since the GFC, but that perhaps is just a natural consequence of the magnitude of the decline that we saw and the uncertainty that many businesses and households are feeling in the aftermath and it may also be that that is occurring at a time when we're also seeing some very large demographic shifts and an ageing of the population as well, which is accentuating those factors. I'm not personally convinced that it's an intractable situation though and it may just mean that we're seeing a much more prolonged cycle than we've seen in the past. So to some degree I agree with his argument, but it might be exaggerating the story a little bit, in my view.

GUAY LIM: I'm going to go off on a slight tangent. I think when the crisis hit macroeconomists in Australia were asked the key question, why didn't we have the collapse in Australia? Financial markets are integrated around the world, Australian banks borrow money from overseas, we understand derivatives and we have derivatives too, but what is it about the Australian financial system that somehow insulated it from the collapse? So yes, the American system collapsed partly because there were a lot of tentacles around the world, there were lots and lots of linkages, so if one arm of the system collapsed the rest collapsed. We're part of the system but we didn't collapse, so the question that we asked was what was in the Australian financial system that prevented the collapse? Is it by some strange code of our four banks that somehow the way they were structured protected our system?

JM: There's a very good economist in some of these banks I understand.

GUAY LIM: Yes.

RIKI POLYGENIS: We'll take all the credit!

JM: The conventional wisdom seems to be that Australian banks did not own those toxic assets, and so while we were hit on our liability side, not on the asset side and obviously China came at the right time.

GUAY LIM: China came at the right time and our flexible labour markets helped and the government, we'll have to give them a bit of credit.

JM: So do you think the conventional view that we had those three factors that protected us is about right?

GUAY LIM: Yes.

JM: Is there any relevance then? I mean, this is all now seven/eight years ago, why are we still talking about it? From my point of view, I look at the persistent very low interest rates and I worry about whether we've got policy room if there were another global crisis or some type of a major slowdown in China. So to my mind I feel that, in a Rip van Winkle sort of way, the Australian economy is now finally, with the resource investment coming off, potentially confronting some of the syndrome that the rest of the rich world faced eight years ago. We dodged that bullet, but are we now coming back into the firing line?

RIKI POLYGENIS: I think it is true to some degree that cyclical factors can become a little bit structural in nature. I think in Australia we've seen very high rates of capital investment in the mining sector, but not necessarily in the non-mining economy and not necessarily in infrastructure and that will impede future rates of growth. There can also be a loss of skill in the labour market which then impedes on future rates of growth as well, and there's something that's often called hysteresis in the labour market which is when unemployment rates go up too high and if there's long term unemployment then there's a loss of skills. So I think that it is true to some degree that the supply side of the Australian economy might not be growing as quickly as in the past and that is something that the rest of the world is experiencing as well which is overlaid with the ageing of the population. So to some degree I think that's the case.

JM: The other side of the slowdown really feeds into a discussion about technology and growth, whether there has been, Guay as you put forward, a slowdown in the rate of innovation or at least in the rate of innovation being realised in what firms are really doing. There seems to be two schools of thought, one of them is very optimistic, associated with people like Andrew McAfee, the fourth industrial revolution and the new machine age and so forth, and quite bullish about the prospects that robotics and AI and so forth are going to transform our economies and lead to a big improvement in living standards. Then you mentioned the Robert Gordon view, which is more pessimistic and says some combination of demographics and the fact that these really big waves from the mid-century just aren't being replicated in the next round of technology. Do you look at those two issues and come down more on the side of Gordon or more on the side of the optimists?

GUAY LIM: Well, I'm optimistic. I'm optimistic because I've lived long enough to see big events and big changes and I'm constantly surprised at how creative people can be. So in that sense I'm optimistic, but I'm a cautious optimist. I think that we don't sit around and wait for the big bang. In the meanwhile, while we're waiting for some great things to happen, there are things that we can do to secure our future and I think it would be wonderful if the whole reform package moved in that direction.

JM: If we turn then to some of those policy opportunities. There'd be one view of what macroeconomists learnt from the GFC and subsequent great recession which would say actually, we had some more firepower in monetary policy than we had thought about for a long time, there'd been maybe 25 years where we just thought about short-run interest rates, and people rediscovered some tools like buying assets or setting forward guidance or thinking about nominal GDP rather than just the price level. I guess one of the other thoughts was potentially that activist fiscal policy, the tax and spend side, might have some more legs. How are those debates playing out both in the practitioner community and the theorist community?

RIKI POLYGENIS: As a practitioner, I think one thing that's become clear is that monetary policy does have its limits and I think perhaps there's more acknowledgement that there has actually been an overreliance on monetary policy. I guess there is some scepticism that quantitative easing has actually produced the benefits that it was intended to, particularly the pickup in investment in a lot of advanced economies that was hoped for. I mean, it has come through now in the US but quite late in the cycle and it has been largely absent from many other recoveries around the world, including Australia.

There are also question marks over whether zero or negative interest rates have more costs than benefits. So of course low interest rates are negative for savers and for retirees, for instance, but also it does appear to be leading to some stress, not in Australia but in parts of Europe, where interest rates on lending products are now negative, that it does lead to some marginal pressure for the banking sector in most places. Then there are counterintuitive things, like at the moment, for instance, there's a lot of pressure on companies to delivery high dividends. So if you look in Australia and the speculation in the last couple of weeks as the major banks have been reporting their profits, a lot of the speculation is around whether they're going to maintain their dividend or not. If companies are paying out very high dividends they're not reinvesting in their business, so that might be another unintended consequence where you've got very low interest rates around the world, you've got a lot of people who are trying to search for that yield and don't have many options, so that is leading to some unintended consequences which may actually be stymieing investment. The other thing that makes me nervous is that it can cause excessive risk-taking behaviour, like we saw in the lead up to the GFC as well.

I think in terms of fiscal policy though most private sector economists, in the Australian context at least, still believe that we don't have a lot of flexibility because it's still quite a strong imperative to return the budget back to balance.

GUAY LIM: It is about instruments and targets. So if you take the interest rate as one instrument, what do you want it to achieve? Do you want it to achieve a level of inflation that everybody can live with? Do you want to use it to stimulate growth? Do you to reduce unemployment? Then fiscal policy, you've got tax rates. What do you want to use the tax rate for? Do you want to use the tax rate to stimulate growth or do you want to use the tax and transfer system to ensure that we have a decent welfare system and that income inequality is something that we can life with?

Because we have to juggle instruments and targets, it is true that the profession came down to a point when we sort of said, "Let's keep monetary policy as *the* instrument to manage the economy, basically to even out the ups and downs, and let's keep fiscal policy as *the* instrument and particularly use the tax and transfer system to ensure that we are happy with our income equality in Australia, that we tax at a decent rate and we hand out welfare payments". That worked for a long, long time, until we hit the zero lower bound as you rightly pointed out. So yes, there's certainly a rethinking about what we should use monetary policy for and what we should use fiscal policy for but, having said that, I think it would be more true to say that the profession is starting to think that it's silly to think that they are separate and that really monetary and fiscal policies should work together. I'm not sure when it will be, but there will be a time when you look at old economic textbooks where that was paramount. Again, I suppose the profession has ups and downs and fads and fashions, and right now a lot of research is devoted to answering the question of how can monetary and fiscal policies work together?

JM: I've got lots of questions about monetary policy, but as a non-expert I'm aware that if there's one part of economics that attracts cranks it's probably that so I'll resist putting some of my own personal views forward, not to deter any cranks in the audience. If I can move on then to one final issue, which is on the micro side of policy, about to what extent policymakers need to do anything more than just try to set up the rules of the game and let private sector decision makers make their call about where to invest and how to behave.

I suppose that view is the conventional, if you like, neoclassical view that you try to build the infrastructure, help people get educated and set up the rules of the game, but there's another view, that I think its proponents would say is a more nuanced one, that says every era of society has got a set of concrete challenges that need to be addressed. I'm talking about people like Mariana Mazzucato who would say the successful state has always been entrepreneurial and has always been active in generating new ideas and innovations that the private sector then takes forward. Or, again, it's now been ten years since the Stern Review and Nick Stern would put the view very strongly, perhaps more strongly now than he would have ten years ago, that the private sector needs some degree of confidence about the policy settings that are going to drive us to a lo w carbon world and a low carbon economy. I think both of those authors would put the view that says actually, an activist state to some extent is the right way to generate growth and where you act, I think the best summary would be Mariana Mazzucato's point, she says growth doesn't just have a rate; it's got a direction as well.

Do you think we need to be thinking from a policy perspective about finding what those directions are and communicating those out to the private sector, or do you just say it's all too complex, we've got to let the magic of the market figure those things out?

RIKI POLYGENIS: I think it's almost a combination of the two, if that even makes sense. We really need to have the right institutional frameworks in place, we need to have a taxation system that does encourage investment in productive assets and there are changes that could be made on that front. But there is also a role for government, in my view, in reducing a lot of uncertainty for business in particular and also for households. There are a lot of challenges that we need to navigate at the moment, the ageing of the population, digital disruption, robotics etc. which could have very disruptive effects on the way that businesses operate and structure their operations. I think there's a role for government in helping business to know about those challenges and look through those challenges as well. You could say that actually, the government shouldn't interfere too much, let the private sector do its job but, in actual fact, I think there's an information asymmetry there and people need assistance in that regard.

GUAY LIM: There are also economies of scale. There are certain activities that are best done by the government. So long as they've got clear direction and we all vote that that's the way we want to go, there are advantages to the government taking on the huge infrastructure jobs, yes.

JM: Let me now segue into questions from the floor, and if I can start with a couple of the canned questions we got at signup. Riki, can I ask you the tough question about Australia's household debt? Just coming back to Larry Summers, part of his secular stagnation thesis was that it was only the big rise in household gearing in the US in the early 2000s, during the Bush era, that sufficed to maintain aggregate demand at a level that was consistent with some degree of economic growth. So his view essentially was it if wasn't for the government attempting to blow bubbles - and I'm being slightly blunt

- that we would've had an earlier slide into stagnation, but obviously that creates its own risks. So where does Australia fit into that framework?

RIKI POLYGENIS: For those in the audience that don't know, Australia has quite a high household debt-to-income ratio by international standards, it's at approximately 180% of GDP. However, it is important to note that just a high debt level in itself isn't necessarily a risk for the economy because the serviceability of that debt is actually quite affordable, at least by Australian standards, due interest rates being so low, so that's the first point to make. I think though from hereon in the higher level of household debt does present a constraint on how fast we can grow household consumption, particularly because it will be more difficult to grow leverage without generating bubbles. From hereon in I think that is the case, but I think that's just a return to a more normal state of affairs than perhaps what we saw through the 2000s as well, because through the 2000s the average household savings ratio was around zero actually, so 0% of household disposable income. Currently it's around 8% of household disposable income, but if you go back into the 1980s and 1990s, particularly the 1980s, then the household savings rate was at that 8% or so mark. So perhaps the era of the 2000s was the unusual period and perhaps that did lead to a build-up of leverage and some risk in the system. I don't think it will continue.

GUAY LIM: I think what puzzles me about the household debt is why there isn't more evidence of the leverage, why are they borrowing more and more when they know that the house values are going up but are likely to collapse eventually? So I am not sure how to read those numbers but, like you, I would say that by itself it's not something to worry about. People draw attention to it and get a bit anxious about it, but the issue has never been just the level of debt, it's always what is it used for?

RIKI POLYGENIS: There's also some silver lining to that, at least for borrowers, which is that the RBA is very unlikely to raise interest rates in a large order of magnitude because they are mindful of that high level of household debt as well.

JM: In the US they call that the "Greenspan put"; you always get an interest rate cut when you need one, but it is hard at 1.5%. Why don't we open it up to questions? What I thought was we could pick three questions in a row. Normally what people say at this point when they're sitting where I am is you mustn't make a speech, you've got to ask a question, but that seems a bit unfair coming from us, so if you want to make a very short comment that's also fine, but do try to keep them brief.

AUDIENCE: I was wondering if I could try and pin down the economists to be more specific about where they think the growth will come from. I must admit I'm taking a view now that we're not going to see a mining boom like we've previously had because if you take the fossil fuel component out of the Australian mining sector it's just not going to provide the stimulus, so I think we can almost draw a line roundabout the end of that boom and say that's really going to be a watershed in Australian economic history. Given that, I think we're probably risking more of the slow growth trap than we are in terms of growth but, on the other hand, we've also been surprised by where growth can come from. You think when tariffs were being unwound, education services came out of nowhere and surprised people with how strong they were and I guess tourism at some stage has too. My question is would people be brave and really try and pin down specific sectors that might surprise and at least fill in the gap that we're going to lose in the mining sector?

AUDIENCE: You put some charts up earlier on, Riki, which really showed how underemployment is growing and it looks to me like it's as bad as it was the last time we had a recession, particularly for young people. Given that, I'm puzzled that we say that the labour market can't contribute much to increasing our potential growth rate. There's a big emphasis on the ageing population and the impact it's going to have, but how about significantly more emphasis on reducing underemployment and perhaps evening shortening the amount of time people spend in education at the beginning of their careers, because I think there's evidence that that's getting beyond the point of diminishing returns as well?

AUDIENCE: Guay, you mentioned about a big bang event happening. In the 21st century internet access is access to knowledge and I consider it a big bang event which basically has moved an industrial society to a knowledge-based society, so all the instruments and everything that have been devised to measure economic growth which are dependent on the industrial society have to be reassessed or redesigned to base everything on a knowledge-based society moving forward. That's my opinion; I just wondered what your take on that is.

JM: I'm finding these questions a bit hard; do you think we should have any more after this? The first one was around where growth is coming from. So given that we've got carbon constraints and if you look at what we're exporting, essentially we're exporting carbon from the east coast and China mixes that together with the iron ore we export from the west coast, where do we go next for growth?

RIKI POLYGENIS: That's the million dollar question isn't it? I think Australia's showing that it's got some natural advantage, as you already mentioned, in education exports. That's actually now our third-largest export industry after iron ore and coal and there's particularly rapid growth in student arrivals from some geographies, like China. It's the services sectors of the economy that are really outperforming at the moment, you might have seen that in the chart that I showed of business conditions, and that's services sectors that provide services to households but also those that provide services to business as well. I think there are increasingly a lot more export opportunities in that space, particularly given our close engagement with East Asia and emerging Asia, for things like architectural services, a whole lot of technical advice, even healthcare provision. There are a lot of opportunities, exports of Australian wine. I think Australia, if we get the policy right, could still have some advantage in very high-end sophisticated manufacturing, biomedical and that kind of thing.

But I guess one of the things is that you can't always predict which industries are going to pop up in the future. Maybe blockchain is going to revolutionise everything and there'll be a whole industry that emerges around blockchain. I don't know, but it's important that our economy is flexible enough to adjust to those shifts that are occurring at a global level and that we retain the talent and the human capital that's necessary to allow those industries to flourish.

GUAY LIM: I would echo what Riki said. The last time I looked at the data that's where I noticed we were getting our growth. We're basically exporting services, accounting services and healthcare services. I don't think I can add more than what Riki said.

JM: The second question might have been directed to your observation that there might not be a huge amount of growth in labour input available, despite the fact that we do have quite a lot of underemployment, so how do you square those?

RIKI POLYGENIS: A lot of that comes down to the sheer impact that the ageing of the population will have on the figures. So on our estimates, for instance, the demographic drag on the participation rate which, and this is getting a little bit technical, will be approximately 0.2 percentage points a year is actually quite a big drop in the participation rate over time, just from that effect. So while I would encourage policies that do try to address the issues of youth unemployment and unemployment and I'm a very strong believer in supporting ways that we can improve female participation and participation of older workers as well, I guess the sheer maths means that it's very hard to offset that ageing effect. For instance, female participation for Australia overall in the labour market, so people that are in work or looking for work in the labour market as a share of the total population, is actually above the OECD average; we're not near best practice, but it's above the OECD average. However, for women of childbearing age, between 25 and 39, we're below the OECD average.

So there are things that we can do there to reduce the fact that there is a very high net marginal tax rate for women entering the workforce in those age cohorts and there are also other measures that we can introduce around apprenticeships to support youths trying to enter the labour market as well. So there are a whole lot of small reforms that need to take place, but within a co-ordinated approach towards trying to address this issue of lower rates of participation.

JM: I would only add that the underemployment is small relative to those long run trends, so you can get a bit of a one-off from managing that but losing 2% or 2.5% of the workforce every decade does overwhelm that. The final question was around measuring the knowledge economy.

GUAY LIM: I believe you thought that was another big bang. I think it is true that there's more knowledge out there, but whether we've all become more knowledgeable is, for me, another question. Has it just become easier to access knowledge? I just have to do a Google search and I find out lots of things, but I'm not sure I'm particularly smarter or I actually know more. I think in the old days, when I had to use a pen and paper to solve something, I think I actually learned something and there are times when I wonder whether my students actually learn anything because it's so easy for them to get something off the web. However, I take your point that the way we measure GDP may not fully reflect the way we live our lives and that, by the way, is an interesting research project that a number of people are exploring, how to expand our definition of GDP so that it's beyond measuring things that rated to measuring other things that are more important in our lives. Perhaps I could leave it as that and draw your attention to some literature where people are actually trying to do a better job of measuring that activity.

JM: Do you think that we're missing more of the value from, heaven forbid, Facebook than we did from *I Love Lucy*, *The Saturday Evening Post* or a Jane Austen novel? Is the problem really getting worse or is it just that, well, there's always stuff you don't measure?

GUAY LIM: Yes, that's right, absolutely. I think that to the extent that you need to formulate policies, you need something concrete, you need benchmarking, and even as an imperfect measure, as long as we know what we are benchmarking and the sense in which it's imperfect, we can make adjustments. So, for better or worse, at this stage GDP as measured is our way of keeping track of our performance.

AUDIENCE: Just wondering if you want to ponder any black swan events or things that could disrupt the economy in ways that haven't been put up on the slides?

AUDIENCE: I'd like to know your feelings about foreign direct investment, whether it's in property, farming or mining, how that impacts on us and what's the likelihood of that continuing, because I understand that's quite high relative to a lot of countries? Also, the impacts of some of these industries that are closing down, like car manufacturing, some of the power stations and even the difficulty of some of the agricultural companies, like Murray Goulburn, are having, and whether you think we could ever have a BREXIT type of situation or even what we've got in America with Donald Trump appealing to the people who are losing jobs to either automation or going overseas?

AUDIENCE: My question relates to what we may do here to improve our own economic efficiency, our resource efficiency and our productive efficiency. We know, for example, that we can't continue to emit carbon as we have; we know that 30% reduction can be obtained by efficiency measures, such as improved insulation, improved building efficiency, vehicle efficiency and so forth; and we also know that the linear system that we have in our economy is not sustainable, it is one planet and there is considerable advantage in things such as food organic recycling in order to produce better compost; we know that there is material scarcity, not just in precious metals, but in such things even as phosphate which is going to have a significant impact upon food production around the world. So my question goes to the heart of what are the policy instruments and mechanisms that we should be putting in place for major reform to move from a high consumptive linear economy to a far more efficient circular economy that's fit for one planet?

JM: Three fascinating questions. We don't have long and we're not going to be able to completely get all of our thoughts across, but the first one on black swans. Riki, have you got a list of things you keep in the back of every presentation, if the audience can take it?

RIKI POLYGENIS: Yes, there are all sorts of those at the moment. There's the possible breakup of the Eurozone after BREXIT, there is of course geopolitical risk around Donald Trump, for instance, becoming the US President. More broadly, there's been a rise in both extreme left and extreme right-wing political parties; there's the impact of climate change and, perhaps associated with that, possible refugee crises; there's still a very high level of public sector debt, particularly across the advanced world, so in the event of a crisis, perhaps globally a lot more so than in Australia, there's less ability to cope with that. The list goes on and on.

GUAY LIM: I'll take the next question about foreign direct investment. There is a difference between foreign direct investment and equity investment. If those rules are properly obeyed then it's one thing to accept foreign money, to invest in our country and create jobs and growth here, as opposed to someone coming in and taking over, basically taking ownership of the land or the plant or whatever. So I think we need to distinguish between when it's just straight money coming into the country to be used for investment here to support growth and jobs here, as opposed to ownership.

The question of jobs going overseas is interesting because the nature of jobs is such that there are some jobs that are outsourced. When I first heard that accounting jobs were being outsourced to the Philippines it was horrifying. It's never a substitute for the personal relationship, that's one thing, and the other thing is perhaps it's time to be creative. If some types of jobs are no longer available because it's more efficiently done elsewhere, perhaps we as a nation need to think we're a clever nation, so what other things can we do that will be our thing? The case in point is the way we're exporting certain types of educational services and, dare I say it, consulting services as well.

JM: The final question was around policy instruments to shift the basis of the economy to become sustainable and I suppose the conventional economic view there doesn't have to be totally at odds with a sustainable view of the world. So you'd say, first, you need to internalise costs so that people who are making decisions that are imposing costs on other people or on future generations bear those costs and change their behaviour, and that means some combination of a collective system for managing property rights or imposing private property rights and developing price mechanisms. But then I think there's a huge area where traditionally economists might say that regulation is going to be more costly than prices but, in fact, as a practical matter, heading in that direction can add value as well.

I'm aware of time and I'm happy to have a further discussion on that point after the event, but we've come right onto our closing time. I've found the issues that you raised, Guay and Riki, really fascinating. Thank you so much for taking all of us through based on your expertise and experience. I hope the group has found it as illuminating as I have and thanks so much for joining us.

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