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Issues facing Australia's economy – a viewpoint

by Ian McAuley

Australia in the world

With just 0.3 percent of the planet's population, Australia accounts for two percent of the world's measured economy – twelfth behind the large economics of the European Union, the USA, Japan, and, more recently China, Brazil, Russia and India – the "BRICs". With an open economy Australia is subject both to global developments and to the ideologies which govern public policy.

We tend to think that the present turmoil is unusual, but over the last 250 years, about the same period as European settlement in Australia, the world has seen many economic upheavals – industrialization in the "west", waves of openness and of isolation, depressions, fashions of central planning and of unregulated market forces, mass migrations, war damage and postwar reconstruction, and the spread of information technologies, to name a few.

The postwar order of the second half of the twentieth century was supposed to bring an era of peace and growing prosperity. It was a period of economic domination by the "G5" – the USA, Japan, Germany (West Germany as it was then) and France – which in 1970 collectively accounted for 64 percent of the world economy and which could set the rules of international trade and finance. Economic openness was to give the poorer countries the opportunity to develop, through foreign investment from the "developed" countries, and through finding markets in the more prosperous countries.

In spite of setbacks, the model worked up to a point. The proportion of the world's population living in poverty has fallen, and there has been strong development in the BRICs and other countries. By 2010 the convergence between the "developed" and the "developing" countries was well underway. (In the comparatively stagnant period since 2008, three quarters of the world's economic growth has been in just two countries – India and China.)

There are now significant instabilities. Much of the growth of the "developed" world has been unsustainable for two reasons. First, it has been based on debt, and second, it has been based on over-exploitation of natural systems, most notably (but not solely) the atmosphere's capacity to absorb greenhouse gas (GHG) emissions. In short, we in the developed world, including Australia, have been living beyond our means.

Over-reliance on debt was the driver of the 2008 global financial crisis (GFC). In the 1980s, particularly in the USA and the UK, there was an ideology favouring market deregulation, including deregulation of financial markets, which, following the 1930s Depression, had been largely constrained to providing a service to the real economy – the economy where people produce and exchange real goods and services.

The financial sector took on a life of its own, grossly inflating values of assets (listed companies and real estate) and eventually, as they developed "derivative" products, losing any connection to real assets. Governments, too, got onto the debt bandwagon, using debt to cover the gap between what they raised in taxes and what they spent on welfare transfers and public goods. In many countries that gap was up to ten percent of GDP, year after year.

Where there are borrowers there are lenders. While the borrowers were in the "developed" countries, the savers were in the "developing" countries, as well as Japan and the oil exporters. It defies the rules of economics that poor people should lend to rich people to buy their goods and services, but this was a convenient model for China, in particular, at its stage of development. China was industrializing and needed markets for its produce.

The GFC was not just a normal downturn in the business cycle. Rather, it was the bust of a long boom which had been driven by irrational exuberance. There are technical problems in Europe to do with its lack of fiscal unity and

there are political problems in the USA where Congress has been blocking sensible fiscal policy which would see tax increases playing their part in reducing government debt. But these are against the backdrop of much greater problems – the simple fact that people cannot go on consuming more than they are producing, and the difficulty of bringing the finance sector back under control. Having been so privileged the sector is able to blackmail governments, with the threat that if financial institutions fail the world would face even worse problems than they have already inflicted.

The manifestation of these problems is not only what may be another deep recession in the USA and much of Europe (the feeble recovery from the GFC was no more than a "dead cat bounce"), but also a loss of confidence in the whole financial system – a system which is supposed to provide the means for investment to be allocated to productive ends. It isn't working.

Australia's performance – a snapshot of success

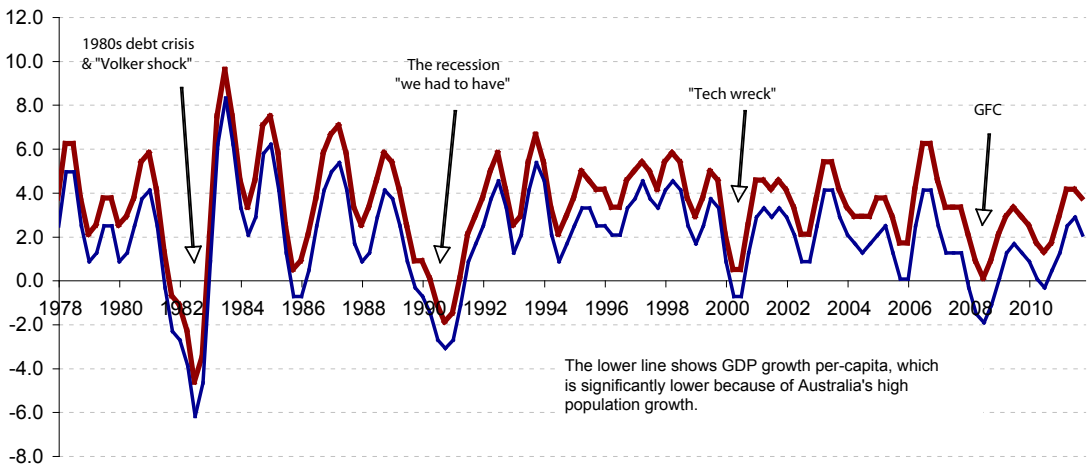
Through a combination of luck and good public policy, Australia has avoided the economic pain afflicting almost every other old industrialised country. The luck is mainly China's demand for Australia's minerals. Good management has also played its part. The economic reforms of the last twenty years of the twentieth century – tariff reductions, tax reform, and competition measures – gave the Howard Government a strong revenue base, allowing it to accumulate a significant budget surplus. Our financial institutions are well-regulated. The present Government's response to the GFC was timely and effective. All this has meant that Australia was one of the very few "developed"countries to avoid a recession when the GFC hit.

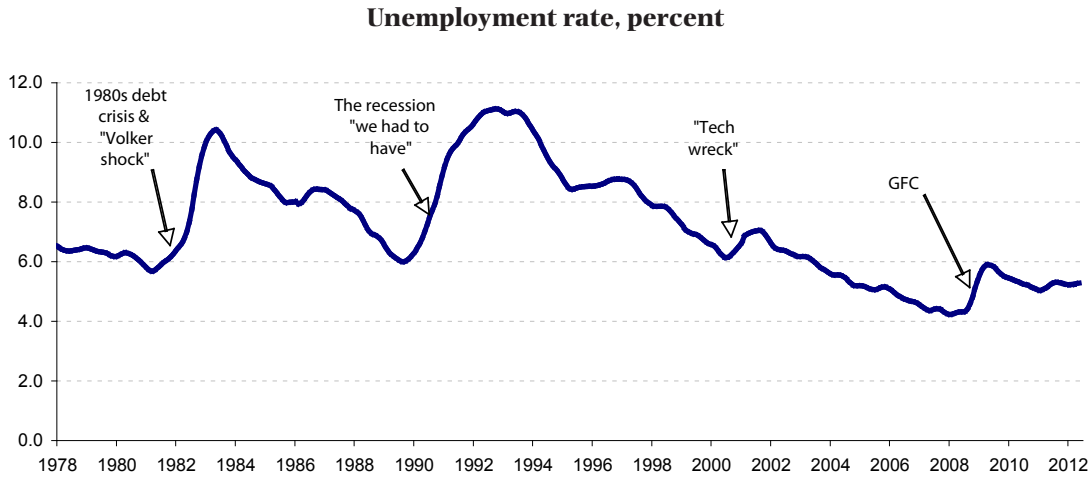
While the USA and most of Europe have been either in recession or limping along with poor growth and high unemployment ever since the GFC, Australia's economy, by the conventional indicators of GDP growth, inflation and unemployment, is in remarkably good shape. The GFC had its effects, but these were mild and we recovered much faster than we had from earlier shocks. Inflation is low and interest rates are near their historical low levels – only those countries desperately trying to re-start their economies with easy monetary policies have lower rates.

In terms of per-capita income, Australians are among the world's most prosperous people. Australia ranks among the top ten countries by the various income measures used by international agencies. The UN's Human Development Index, which includes indicators of education and health as well as material living standards, ranks Australia second in the world (pipped by Norway in the top spot).

Gross indicators, however, are like high altitude aerial photographs in that they do not reveal detail. Not all sectors of the economy are travelling well. In the fast lane are the mining sector and industries supporting it, where the

Australia's GDP: annual percentage change





main problems are labour shortages. In the middle lane, relatively unaffected, are naturally-protected sectors, such as professional services, health and recreation. In the slow lane are trade-exposed industries, such as manufacturing, airlines and tourism struggling to cope with a high Australian dollar, and industries such as construction deprived of finance in a world of scarce credit. And in the breakdown lane are industries bearing the weight of structural change, such as department store retailing, bookshops and the print media.

Such variation leads to regional imbalances. For example, of 65 000 new jobs over the year to July 2012, 42 000 were in Western Australia, while jobs were actually lost in South Australia and Tasmania. In mid 2012 state unemployment rates varied from 3.5 percent in Western Australia to 6.1 percent in Tasmania.

Even the resource-rich states have not had an easy run. Queensland has difficulties in providing public infrastructure to support its rapid population growth, and in mining regions in many states there are severe housing shortages.

Overshadowing this strong economic performance is a degree of fear and uncertainty – both business confidence and consumer confidence are low, and there is a general notion that people are facing difficulties in keeping pace with the cost of living. There is no objective evidence, however, to support such widespread nervousness. For most Australians incomes are running well ahead of inflation, and people's jobs are no less secure than they have been in times past.

There are many possible explanations for this nervousness. Jobs are being lost in industries once considered as "safe", such as banking, retailing and journalism, and are reaching into "white collar" occupations. Many people, in the long boom, became over-committed to debt, and are now more cautious and more aware of the consequences of losing their jobs. Housing prices, which at one stage were the highest in the world, are coming down – a welcome development for those seeking to buy but unsettling for those who unwisely used rising house prices as a line of credit. And there is a destructive political atmosphere, with many voices deliberately trying to discredit the Government's economic management.

A more general weakness in the Australian economy is that the benefits of economic growth are not being shared equitably. Up to around 1975 Australian incomes tended to converge – we were indeed living up to our image of egalitarianism – but from about 1985 income disparities have been widening again, and as income disparities have widened, so too have disparities in wealth. While we have maintained a fairer distribution than the USA (where all the benefits of economic growth have been appropriated by a wealthy minority), we have lost much of the social capital that accrues when people feel that the fruits of their labour will be fairly distributed.

Longer term – structural issues

A period of prosperity, as Australia has enjoyed, carries long-term costs, particularly when it is based on conditions which are unlikely to be sustained in the future.

It is questionable whether Australia is well-equipped to sustain its high living standards once mineral commodity prices fall, and once we have to take into account the costs of depletion of our environmental capital.

We have been getting away with low taxes. For many years, contrary to popular opinion and partisan rhetoric, Australia has been one of the world's most lightly taxed industrialised countries. We have managed, in part, because of an age structure kept young through immigration, thus helping keep expenditures on health care and age pensions in check. Unemployment has been on a downward trend for twenty years, thus reducing demand for unemployment benefits while providing more income tax revenue. We have also managed by constraining public expenditure, particularly in areas which are important for our long-term prosperity – education, infrastructure and environmental protection and restoration. Like the Mediterranean countries we have been increasing "middle class welfare", using public revenue to keep people's incomes rising faster than our productive capacity – an inherently unsustainable situation.

There has recently been some turnaround in these trends, but shortcomings remain. Government expenditure on education, for example, steadily fell to a low point of 4.7 percent of GDP in 2007-08; by 2010-11 it had been restored to 5.4 percent of GDP. We still have a task to catch up with countries which have invested more heavily in post-school education. Even though our population growth has been high, putting strain on our physical infrastructure, our public investment in infrastructure has been low in comparison with other countries. Public sector capital investment was on a steady decline over 50 years until 2005. It has picked up in recent years, most recently as a result of GFC stimulus spending, but there are still substantial deficits in road and rail transport, including urban public transport, energy, and water infrastructure.

The commodity boom will end. Even if China's strong growth continues, its economy is likely to be less demanding of minerals and coal, and in any event, there are many other countries with mineral resources. Mineral prices have long cycles – high prices encourage the development of new mines, which, once developed, can stay in production at low cost, keeping prices suppressed for many years.

A great challenge to the Australian economy is its dependence on coal as a domestic energy source and as a source of export revenue. By most measures Australia is the world's largest per-capita contributor to greenhouse gases (GHG). The recently-introduced carbon price, combined with the rapidly falling prices of alternative energy technologies, will go some way to reducing those contributions, but we remain the world's largest exporter of coal – mainly steaming coal – contributing to other countries' GHG emissions. Even if there isn't concerted global action to price carbon, coal could become worthless once alternative energy sources become economic.

This is in addition to other environmental challenges, because since 1788 we have been drawing down the capital of the continent's natural resources, particularly soils, water and the ecosystems they support. Above-average national rainfall since 1995 has temporarily pushed aside concern about water resources, particularly the problems of the Murray-Darling basin, even though the last few years of high rainfall have simply been manifestations of regular cyclical changes in sea temperatures. They are not a return to "normal" conditions, and indeed the models of climate change suggest that much of the country will become more arid.

The greatest challenge of the mining boom is that it distorts incentives and fosters complacency. It provides a boost to national income, first in the investment phase and then as projects get under way, but it provides little employment – only two percent of the nation's employment as at mid 2012. The inflow of foreign cash drives up the exchange rate, which is welcomed by those buying imported cars, clothes and appliances and holidaying abroad, but which puts huge stresses on trade-exposed industries. While mining itself is skill-intensive, many other skill-intensive manufacturing and service activities which sustain the competitiveness of other high income countries are under-represented in Australia's economic base. And while mining is offering such high returns to both labour and capital, it is drawing resources away from these other activities.

A boom in national income, when it comes from a narrow base, is hard to manage. It can lead to great financial wealth in the hands of a few people, who use that wealth to buy political influence to protect their own privilege against the public interest. (We have already seen that in relation to the Government's modest mining tax.) Even if income is spread, it can still be problematic, for a boost in income raises expectations, and makes it difficult for

governments to make the tough decisions, particularly tax increases, which would temporarily suppress incomes in the interests of long-term prosperity.

Then there is the global economic environment. There is a strong risk of a deep and protracted recession in Europe and the USA, which will have consequential effects on our region. We cannot insulate ourselves fully from these effects, but we can build up our resilience to minimize the damage.

What we should be doing

Australia's economic debate, if we can dignify it with such a name, has become one of simplified slogans. We have embraced the myth that we are paying too much tax, when the reality is that we are one of the industrialised world's lowest-taxed countries, and are paying too little tax to provide the public services which are so important to sustain our prosperity.

We have become obsessed with reducing public debt, while overlooking private debt and while not realising that the flip side of low public debt is a low stock of public assets. Our nation is like an under-capitalised business.

We have been taken in by the idea that any attempt to break the power of those who would use their financial wealth to protect privilege rather than to invest in the nation's prosperity is "class war". Above all, we have failed to consider the future when the mineral boom ends and we must live on our wits.

We have hung on to an antiquated workplace model which pits labour against capital, and where arguments about productivity are in terms of pay and conditions. We don't have a culture of seeing businesses and government departments as enterprises where people come together to create and share wealth.

There is no shortage of recommendations to improve the situation. Many suggestions for tax reform to remove perverse incentives which favour speculation and protection of unearned income over productive effort, and to account for environmental costs, are in the 2010 Australia's *Future Tax System Review* (the "Henry Review"). Many economists suggest that, like Norway, we should invest our temporary windfall into a sovereign wealth fund, and should upgrade our physical and environmental infrastructure. Such investments would sacrifice some immediate opportunities for consumption in favour of longer-term prosperity. Similarly, while acknowledging progress to date, most economists realise that we have to invest in upgrading our human capital – skills and experience, learned on the job and in classrooms, at all levels from basic trades to advanced post-doctoral research. Apart from some in the finance sector, most would agree that the finance sector has to be restored to its proper place as a service to the real economy, rather than as a playpen for speculators. And we must bear the cost of confronting climate change, rather than considering it as some peripheral "left" issue.

These problems are all amenable to public policy, and like IMF head Christine Lagarde, we can criticise "feeble politicians", or we can criticise mass media which increasingly is trivialising public policy issues and becoming controlled by those who seek to sustain privilege. Yet, we live in a democracy where there are many sources of influence, and even if some, such as old political parties or old media, present roadblocks, there are plenty of other avenues available for public engagement.

Useful sources

On the global economy, there are sources such as the United Nations Development Program **www.undp.org**, the World Bank **www.worldbank.org** and the IMF **www.imf.org**. The OECD has an extensive range of data and research reports relating to 34 "developed" countries, including Australia but excluding countries such as China and India.

The Bureau of Statistics **www.abs.gov.au** maintains a wide set of Australian data, in both snapshot and time series form. The Commonwealth Treasury **www.treasury.gov.au** provides a gateway to Commonwealth Budget papers and to many other official papers. The Henry Review **www.taxreview.treasury.gov.au** has its own website. The Productivity Commission **www.pc.gov.au** undertakes a large amount of economic research, some commissioned by the Government, some on its own initiative.

There are several economic think tanks publishing on a range of issues. Some which are reasonably free of partisan bias are the Centre for Policy Development **www.cpd.org.au**, Per Capita **www.percapita.org.au**, the Australia Institute **www.tai.org.au**, and the Grattan Institute **www.grattan.edu.au**

Two sources specifically mentioned in this brief are Infrastructure Australia **www.infrastructureaustralia.gov.au** and Dan Andrews and Andrew Leigh "More Inequality, Less Social Mobility" in *Applied Economics Letters* 2004 **http://econrsss.anu.edu.au/~aleigh/pdf/InequalityMobility.pdf**

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See also, *The Australian Economy*, an essay by Ian McAuley. **www.australiancollaboration.com.au/economics/the-australian-economy/the-australian-economy-essay/**

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