Australia after the boom

By CEDA Chief Executive Professor the Hon Stephen Martin and CEDA Chief Economist Nathan Taylor.

This document is based on discussions at the CEDA Council on Economic Policy meeting held 18 July, 2013. This document represents the views of the CEDA CEO and Chief Economist but does not necessarily reflect the views or opinions of any individual in attendance unless specifically cited.

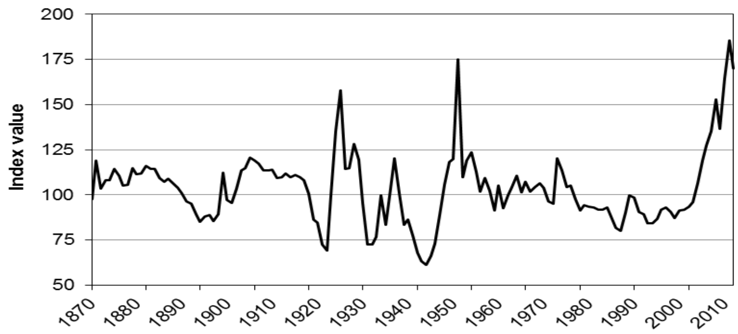
Over the last 22 years Australia has achieved something that no other industrialised country has ever been able to do: avoided a serious economic downturn and experienced continuous economic growth. This has not been through chance alone as good economic policy settings have allowed Australia's economy to respond to regional economic crises, the quadrupling of oil prices, the developed world enduring a deep recession, while the domestic economy digested the most sustained and pronounced mining boom the nation has experienced.

CEDA's Council on Economic Policy (CCEP) meeting in July 2013 discussed how Australia should respond to the terms of trade normalising if it is to avoid the worst recession since Federation.[i] Professor Ross Garnaut presented on ***Monetary and Exchange Rate Policy after the China Boom*** and Professor Warwick McKibbin commented on ***Current Australian policy***. How Australia responds to the issues presented will critically determine the nation's future prosperity.

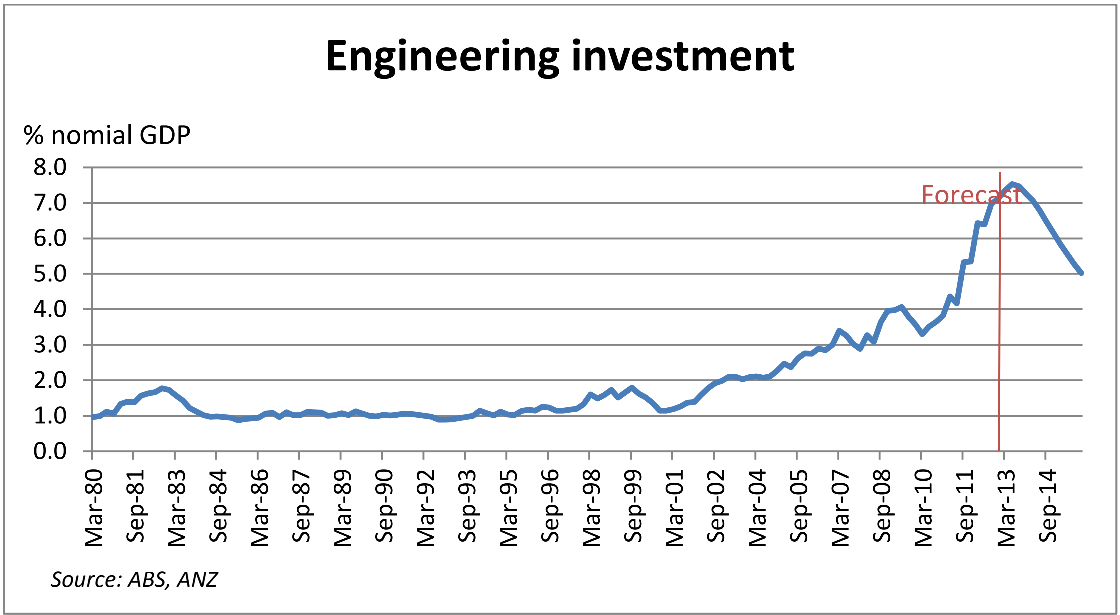
The Chinese influence

Chinese economic growth has had a substantial influence on Australia's economic performance over the last decade. However, recent decisions by the Chinese government to rebalance their growth profile will fundamentally change Australia's economic fortunes.

Uninhibited investment expansion in China from 1985 to 2011 has underpinned a surge in commodity prices. The economic growth experienced in China has been unprecedented in world economic history. It was also very advantageous for Australia as this phase of China's growth was resource hungry. Chinese demand has represented a high proportion of world growth in demand for metals and energy minerals since 2001 and the whole of global growth in some metals since the Great Crash of 2008. The consequence of China's rapid industrialisation has been the most prominent and prolonged improvements to Australia's terms of trade on record.



Index values, 1870–2012, year ended June (1901–2000 average = 100),
Source: Reserve Bank of Australia



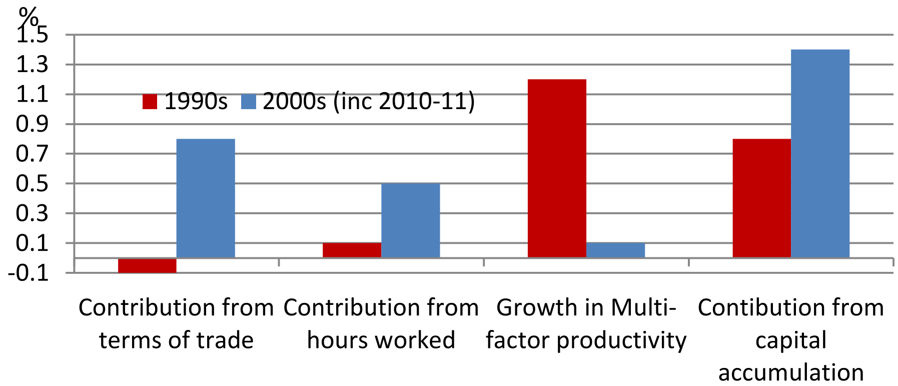
The uninhibited investment expansion phase of China's growth ended in 2011. The new phase of economic growth in China is an attempt to transition it towards a modern economy with a balanced domestic demand profile. This changed policy has already had an influence with commodity prices having fallen significantly from their peaks, although they remain at relatively elevated levels. As commodity prices decline further there is a significant potential to overshoot their price while higher cost producers are weaned out of the market. Australian businesses have already planned for declining commodity prices, as reflected in investment plans.

'Peak construction' marks the beginning of the end of a critical phase of the current mining boom, with serious consequences for the Australian economy. There are three distinct phases to an economy's response to a resource stimulus. The first is a price phase, when terms of trade improvements dominate; the second is a construction phase, when high levels of business investment occur to take advantage of the terms of trade; while the final phase is one of production as the earlier business investment comes on stream. While these phases can occur simultaneously, they have a very different influence on the Australian economy.

Australia's prosperity has been supported by high prices for resources and record levels of business investment. The first two phases of the mining boom have provided high levels of income and employment for many people with substantial benefits for all Australians. However, with a high level of foreign ownership over Australia's resource companies in a highly capital intensive industry, the main benefits to Australian incomes come from royalties and taxation. Together these will be much lower in the production phase than during the terms of trade and investment phases, because tax deductions from the investment phase and lower profitability from lower prices and higher costs will reduce the corporate tax take. The production phase of the mining boom will not have the same level of benefit to the nation's citizens.

The chart below outlines how significantly the terms of trade and construction phase of the mining boom have contributed to gross domestic income per person in the 2000s compared with the 1990s.

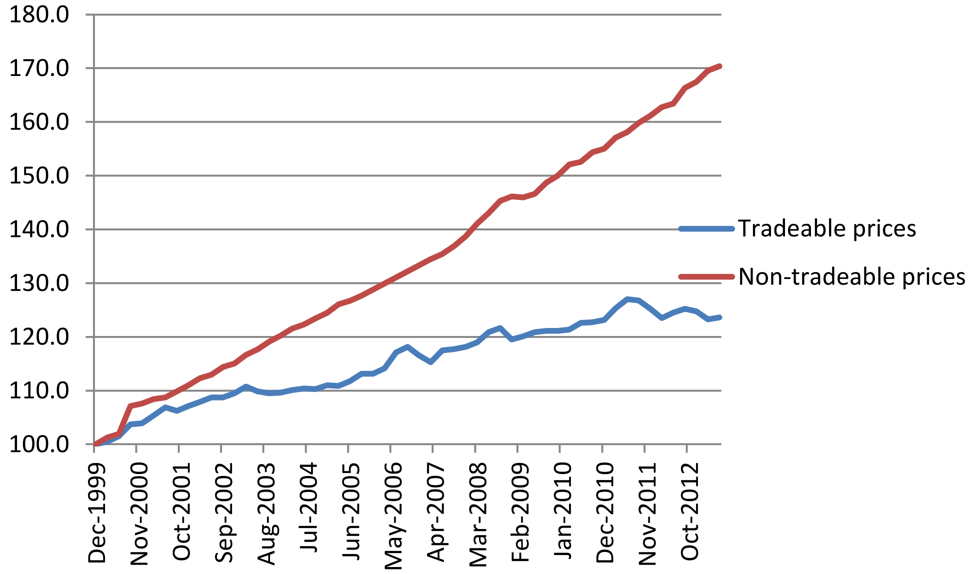
Contributions to GDI per capita growth



Source: Productivity Commission presentation to CCEP

If Australia is to experience ongoing economic prosperity it needs to find new sources of employment and income. As the influence of the mining boom on national wealth fades, the nation will be faced with the prospect of uncompetitive industries operating in a more difficult international environment. Many of the productivity gains and expanded export opportunities developed during the 1990s have declined. Further, the parts of the economy not exposed to international competition have experienced rapid price rises, undermining the competitiveness of trade-exposed sectors.

Tradeable versus non-tradeable prices,
Accumulation index, Dec 1999 = 100



Source: ABS, Cat No. 6401.0

The tourist sector provides an excellent example of how the terms of trade have influenced the Australian economy more broadly. During the reforms of the 1980s and 1990s, the sector became a major domestic employer and a significant source of foreign income. However, the mining boom, and the consequential high Australian dollar, made the nation a relatively expensive destination for both domestic and international tourists. Not only did foreign tourists go elsewhere, Australians also took more overseas holidays. The large level of mining investment also crowded out many of the goods and services that underpinned the success of the tourist sector. For example, with full employment in the economy, the cost of labour became prohibitive for many tourism operators. The consequence was a significant decline in the tourism sector.

Australia needs to regain its international competitiveness in enough sectors to replace the fading influence of mining. It will take time for the Australian economy to regain its international competitiveness as you "cannot fatten the pig on market day".[ii] The improvement in competitiveness can come about through a depreciation of the nominal exchange rate or a fall in input costs. The latter is a real depreciation whereas the former may not translate into a depreciation of the real exchange rate.

Productivity improvements matter, but they matter over the longer term. The immediate challenge for Australia's economy as it undergoes the biggest downward adjustment of relative costs since Federation, is how to avoid deep recession through adjustment. Improving the productivity of the economy will not, in itself, be enough but it is the main story in the medium and longer terms.

The Australian dollar

The magnitude of the mining boom determines the size of adjustment the Australian economy will have to make. The improvement in Australia's terms of trade from China's economic growth is both longer and more pronounced than any in recorded history, lifting Australia's real exchange rate to an incredibly high level. To provide some context, when the effective exchange rate appreciated by 16 per cent from June 1970 to its peak in 1974, it brought about a disastrous end to Australia's post World War II economic boom.[iii] In comparison, in March 2013 the Australian dollar's real exchange rate was 51 per cent higher against the US dollar, 40 per cent higher against the UK Pound and 64 per cent higher against the Japanese yen, than the Australian dollar's post-float average. These are the developed economies Australia will be competing with to find sources of non-resource based revenue, such as education, other services and high-value manufacturing.

The CCEP also discussed how there has been a mismatch between the decline in the terms of trade Australia has experienced and its real exchange rate. This is potentially explained by a preference shift among international investors for Australian denominated (AUD) assets. Professor McKibbin suggested that a one per cent shift in international preferences for AUD assets would result in a 10 per cent shift in the real exchange rate. Given the financial uncertainty experienced in much of the rest of the world, and how Australia's financial assets may represent a proxy for the Chinese economy, it is plausible that there has been at least a short term shift in international portfolio preferences for AUD assets.

The consequences of this elevated real exchange rate for Australia are pronounced. There are already signs that Australia is in the grip of a pronounced economic downturn. While unemployment is still at a relatively low level, the amount of hours worked per person older than

15 peaked in November 2011. By this measure, by June 2013, the total decline in the strength of labour market from the height of the China Resources Boom in 2011 was almost half the amount that it declined during the 1990s recession.

According to Professor Garnaut, the danger is that Australia's macroeconomic policy makers may be complacent in their belief that the economy's automatic stabilisers, such as a floating exchange rate, will be enough to avoid a recession. The magnitude of the changes involved may require a more active macroeconomic policy response, to ensure an early and large fall in the dollar and its effective translation into a real depreciation.

The immediate policy challenge

While it was agreed that the national reform agenda needs to be reinvigorated, a number of alternative short term responses were also discussed. These included:

- A significant real depreciation of the exchange rate: while this would have a negative influence on the living standards of Australians, it was suggested that a real depreciation of at least 20 per cent would be needed to avoid a major recession. The nominal depreciation would likely need to be larger; and/or
- Sterilise the terms of trade stimulus. During discussion it was observed that Norway managed to sterilise its terms of trade boon via a sovereign wealth fund. While it is too late for Australia to adopt such a strategy, it could sell AUD assets while interest rates are low and use the funds to invest in physical infrastructure. The opportunity to sterilise the terms of trade is rapidly diminishing.

These recommendations represent bold approaches to the challenge of a high real exchange rate, and they were not unanimously endorsed by the CCEP. In particular there was concerns expressed that reducing interest rates to depreciate the AUD could result in a misallocation of resource and potential asset bubble emerging. In contrast, there was broad agreement that the major supply side constraints need to be addressed to improve Australia's long term international competitiveness. These included the nation's high labour costs, driving down the regulatory burden and addressing the rising cost of energy and other utilities.

Australia is facing a simple choice. Make difficult decisions in the short term to manage the real exchange rate adjustment that needs to occur while implementing substantive economic reforms to underpin the longer term competitiveness of the economy. The alternative is to experience a very substantial economic recession.

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[i] Attending the CCEP meeting on 18 July 2013: Professor Glenn Withers AO (Chair), Percy Allen AM, Sarah-Jane Derby, Dr John Edwards, Dr Vince Fitzgerald, Professor John Freebairn, Professor Ian Harper, Professor Paul Johnson, Professor Stephen King, Professor the Hon. Stephen Martin, Professor Warwick McKibbin, Professor Graeme Samuel AC, Professor Paul Simshauser, Nathan Taylor and Professor Kenneth Wilshire AO. Professor Ross Garnaut presented to the CCEP and Professor Warwick McKibbin responded.

[ii] Garnaut, R., *Ending the great Australian complacency of the early twenty first century*, page 11.

[iii] Mclean, I., 2012, *Why Australia Prospered: The shifting sources of economic growth*, Princeton University Press, Princeton New Jersey.