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KGB: Ross Garnaut

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Economist Ross Garnaut tells *Business Spectator's* Alan Kohler, Robert Gottliebsen and Stephen Bartholomeusz:

-- *A dollar range around 60-80 US cents is necessary to keep Australia competitive*.

-- *Many business community expectations of the Abbott government are "completely unrealistic", and the Coalition won't be able to accomplish achievements on par with Bob Hawke and Paul Keating without disappointing its strongest supporters*.

-- *It makes no sense to have interest rates so much higher than other developed countries when our growth, in fundamental terms, is lower -- and the housing market's strength is a bad reason to avoid cutting rates*.

-- *Why he was right, despite appearances, about China's energy demand and its effects on Australia*.

-- *Australia is headed for an inevitable serious economic adjustment, and any boost from the new phase of Chinese investment is unlikely to be big enough to counteract Australia's resources retreat*.

Alan Kohler: Ross, welcome to *Business Spectator*. Thanks for joining us.

Ross Garnaut: Yeah. Good to be with you.

AK: Perhaps we should start by just summarising what you say in your book, *Dog Days*, which is your new book and which you seem to have finished after the election. You wrote the conclusion after the election, at least.

RG: Yes.

AK: Now, the dog days are after the salad days, which is after the reform era. At the risk of oversimplifying your conclusion, you're saying that Australia needs a real depreciation, a short-term reduction in living standards, because of the dog days. Without that, there'll be a deep recession later on. Does that about sum it up?

RG: Yeah. That's an important part of the story. We've got a cost level in Australia that's way out of line with the rest of the world. Our real exchange rate appreciated 70 per cent from the average of the first twenty years of the flow, from 1983 to 2003 to early this year.

No other developed country, certainly not us in earlier periods of history, ever had that sort of an appreciation of the real exchange rate. That's a really a huge hit to competitiveness, and that was driven by the resources boom and spending the fruits of the resources boom as it arrived. That's why we have a big increase in costs.

If you have a huge increase in the terms of trade, like we had, and you spend it more or less as it arrived and we have right from the start, from 2003, then you're going to get an appreciation of your real exchange rate, whether that comes from the actual exchange rate going up or whether it comes from inflation. This time we've had more of it from the exchange rate going up than from inflation. In other periods of history we got more from inflation. But the effect on competitiveness is the same, however you get it.

As a result, everything is becoming uncompetitive in Australia except for those big, higher grade ore deposits that are at the heart of the resources boom. Even secondary resource projects are no longer competitive. Our LNG is no longer competitive with North America, with the Middle East, with the other places.

AK: We've done a few long-term contracts with LNG, though. I mean it's not as if they were out of the game.

RG: Yeah. And they're great if they survive the competitive pressures from others offering a product at lower prices. But we won't get new contracts, so that's what we've got to adjust to. I don't see a way out of maintaining its high levels of employment in Australia that maintains the economic growth without a big, real depreciation.

Now, a real depreciation can come through a number of ways. If the dollar goes down, you can get it quickly, but that only becomes a real depreciation if you avoid the cost effects of the depreciation – a depreciating dollar falling through all of your domestic costs. You don't have to have such a big reduction in living standards if you're getting faster productivity than the rest of the world, faster productivity growth than the rest of the world.

There were five years in the '90s when we had 2.5 per cent per annum growth in total factor productivity and we were about a percentage higher than most developed countries during that time, but even in those great days, we only clawed back a percentage point a year in productivity. You're whistling in the wind if you think you can make up the sort of disparity in cost levels that we've got entirely through productivity growth. You'll get there, but it'll be a multigenerational task, so it's got to come first of all from the exchange rate adjustment supported by as much productivity growth as you can get.

Both the maintenance of a real depreciation and the productivity growth are really hard. We don't have a good record over our history since Federation in either of these things, and any government trying to do this now has to deal with the fact that we've got a political culture at the moment that's completely…

AK: The thing is that you were involved in the first couple of years of the reform era as economic adviser to Bob Hawke, but is there anything in the current Coalition government that makes you think that they can achieve what Hawke and Keating achieved?

RG: A reason for hope is that before Hawke and Keating and others in that very strong government got to work, no one would have expected it either. And they only got there by being prepared to disappoint their strongest supporters. Abbott and his government won't get there unless they're prepared to disappoint their strongest supporters.

A lot of the expectations of the business community are completely unrealistic. Over what I call the great Australian complacency of the 21st century – again, beginning earlier in the century with the early days of the resources boom -- we've developed a business culture in which monopoly is the main game and in which any government that seems to tackle these entrenched areas of monopoly, guaranteed rates of return, cosy arrangements of all kinds, the things you've got to tackle if you're going to get productivity growth, it's seen as sovereign risk to take on any of these things, to change established arrangements that are favourable to business. So the political culture is a really difficult one.

I think that Tony Abbott probably has got what it takes to take them on, but the new government has to realise that we've got a big job as a country. We can't do it unless a lot of the expectations of the government's strongest supporters are broken.

Robert Gottliebsen: But you're talking about a fall in the dollar of, say, 50 cents, 40 cents. Is that what you're thinking?

Ross Garnaut: Oh, I say 20-40 per cent from the levels earlier this year. Now, I've been talking in these terms…

RG: So, you're talking about 60 cents, roughly?

RG: A bit over 60 to a bit over 80 is the range. And why I give a range is that you don't really know how much is required until you see the market response. You know, if we got down to 80 cents and suddenly found that you were getting the investment in tradable industries, export and import competing industries other than big resources, then you'd say well maybe 80 will do it. But you don't know till you're into that process. At the moment all of our tradables industries, other than the big, high-grade ore deposits, are dead in the water.

Stephen Bartholomeusz: Ross, getting back to the exchange rate, there's another dimension which is beyond our control and that is that we're confronted by all of these desperate devaluations, I think you refer to them, by other developed economies much larger than ours. How do we deal with that? What happens if and when they start to unwind? How does that impact us?

RG: I'll come to the end of the story first. If and when they start to unwind, helps us because our dollar will fall and will probably fall big time. But whenever you've had the United States Federal Reserve put its toe in the water over unwinding, it's triggering negative market reactions and they pull their toe out again. So, we can't take unwinding for granted. The US economy is still pretty weak.

Obviously you can't continue with quantitative easing forever. It's got to come back with the timing of that and the vigour of the reversal of the policies and the effects on the economy of the United States as long term interest rates start to rise again after this long period of very low rates are all uncertain.

It's great for us if the US and Japan and to a lesser extent Europe and the United Kingdom start the unwinding of monetary policy and that pushes our dollar down, that takes the first step in the job for us. It still leaves us with all the problems of turning that into a real depreciation, but that's the start.

The bigger challenge is if that doesn't happen soon. I don't think it makes much sense for us to have interest rates a couple of percentage points higher than other developed countries when our growth is now, in fundamental terms, slower than other developed countries. In real output per worker or real output per adult Australian, we're growing more slowly than Japan or the United States.

AK: So, you'd see our interest rates lower?

RG: Yeah.

AK: Even a couple of percentage points lower?

RG: In these circumstances where other countries have lowered their interest rate to extreme levels, now whether they should have done that is another question, but we've got to deal with the world as it is. Given they're doing it and given the weakness in our economy and I think there's a lot of weakness there, then that's what we should be doing. Now, the argument against it is we're on the verge of a housing boom.

A couple of days ago I read Bernanke's reflections on his period as governor – a series of lectures he gave a little while ago – and he was asked whether the United States should have raised interest rates early in the century to stop the housing boom. His answer to that was no, because the rest of the economy didn't need higher interest rates.

What we should have done was something specifically to kill the housing boom. You don't change the whole economy with changes of interest rates to deal with the housing situation. His answer then can be turned into reverse to the current situation. If worries about a housing boom – we're not quite there yet, but we probably will get there if we lower interest rates a lot further – if that's the reason for not lowering interest rates, then we should be doing something specifically about housing.There are lots of things we can do. That goes under the general heading of macroprudential analysis there. Just about everyone else is having a crack at this now, but we're not.

The first thing I'd do, and I say this in *Dog Days,* is take away the privileged treatment of housing for prudential purposes so that banks only have to put away half the weight for half the capital for housing lending as for the least favour to the other lending.

What's the case for that if the reason you're not lowering interest rates is you're worried about risk in the housing sector It's a prudential reason that you have a lower capital liquidity requirement. Then there are all the other ways in which we privilege housing and we give privileges to treatment of housing for tax purposes and so on.

If that's our reason for not lowering interest rates, it's a bad reason. We should be lowering interest rates to get down the dollar and doing something specifically of a macroprudential kind about the risks in the housing sector.

RG: Can I take you into China? I think it was last February, you and others were suggesting that we would have a China that would be much less energy intensive and as a result both there'd be less demand for our iron ore and our coal and perhaps even our LNG, but in the rest of the year in 2013, demand rose in the case of iron ore. Why were you wrong?

RG: On energy?

RG: On less-energy intensive industries and therefore the demand.

RG: On energy, I was dead right. There's been no growth in thermal demand for coal since not long after the GFC. All that huge expansion of Australian and global capacity in thermal coal production is just lowering the price.

That's what the trade tax used to teach students was "immiserising growth". The more you produce, the poorer you are. If we get Galilee Basin going, the Chinese market won't grow to take it. We'd just have to sell it at lower prices, dump it and that makes life miserable for everyone else who's already producing coal. That's the energy story there.

China's growth in energy demand has slowed with the new pattern of growth, and the composition of energy use has changed radically as a result of their giving higher priority to environmental amenity, both domestic environment – cleaning up their cities – and their contribution to the international environmental problem. That's effectively leading to a cap being put on emissions from thermal coal after a long period in which you had double-digit annual growth in thermal coal demand. It was China that made the difference in the world markets and it set the price of coal sky high for a while.

Now it's made the difference in sending it low. There are very few coal producers in Australia who are making money now. If you've got boards of directors who care about their shareholders, they'll be wishing that they hadn't made the investments they've been making for the last couple of years. There are a couple who are still threatening to make more investment.

Iron ore is different. I've always said that you're going to get a moderation of iron ore demand, but not the end of growth, as is the case for thermal coal. For iron ore, you actually got quite a step back in absolute demand for a while last year, and then that's recovering again this year.

I doubt very much that the current prices in the $130s are sustainable. They'll come down again as a result of two things: a big increase in global supply and the moderation of growth in China – still some growth, but a fraction of what it had been for a long time.

LNG is different again. Total demand for gas in China will grow quite strongly because there is a shift going on from high emissions like coal to low-emission forms of energy use. Gas is one of the favoured forms.

RG: Nuclear too?

RG: Nuclear too. In numbers of megawatt hours, it's hydro first, wind second, nuclear third, but gas is still a worthwhile contribution and solar is rising most rapidly from a low base. And we'll see demand for uranium out of this because that's part of the story. But gas demand will grow; supplies will grow too.

You have the recent agreement on the pipeline from Russia, the pipeline from Central Asia. You have a big effort in investment in exploration for gas in China. They're trying to apply new unconventional technologies for shale and coal gas in China. We're not very competitive in LNG now with the high, real exchange rate compared with the Americans, the south-east Asians, Papua New Guinea, Middle East. So, the problem with LNG won't be Chinese demand; it's whether we're competitive.

SB: Ross, at the core of the book is this view that whatever happens, we're in for some enduring economic pain: either a recession today or something worse tomorrow.

RG: No, not recession today – pull in the belts today or something worse tomorrow. We might be able to avoid a recession if we quickly pull in our belts.

SB: It's fair that in your mind is there a scenario where we can avoid pain at all?

RG: No, I don't think so. We spent too much during the boom. The big part of the boom was the high terms of trade, which started in 2003. It just kept lifting to 2008. We had a bit of a dip after the great crash, and it lifted again in 2010 and 2011.

It's been heading down since then and it's got further to go. On top of that, we've had the investment phase, which is nowhere near as powerful as a terms of trade lift when you're spending the terms of trade that comes in. Then we'll get an export growth phase, but that's much less powerful again.

The peak of the boom was 2011. We simply can't support the expenditure and expenditure growth that we've became accustomed to at that time. There's got to be an adjustment to that. That's why our real exchange rates rose that high, exacerbated by the unusual monetary policies of other countries, which we should counteract.

RG: Ross, is there a chance you're really wrong in this form? In this scenario, that because of the changes in China, we're going to see a massive rise in Chinese external investment? That's a question, not a statement. A lot of that's going to come into our markets. They'll buy our businesses, they'll buy our real estate, agriculture, all those things and that'll keep the dollar high.

RG: A new massive source of foreign investment could add a third boom to the two we've had. We had the housing and consumption boom, which we would have had a big dump after, if it hadn't been for the resources boom. We've had the resources boom and it's on its way down. It is possible we could get quite a big boost from this new phase of Chinese investment. It's pretty big in real estate at the moment.

RG: Yes.

RG: But it's unlikely to be big enough to counteract the retreat of resources, just the numbers don't seem to be there. If it were, it would hold up the external account for a while, allow us to keep on spending. That doesn't last forever, so we'd get an even bigger dump later on.

AK: Ross, when I asked you before whether the Coalition… whether you see anything in the current Coalition government to remind you of the reform era before, you focussed on the fact that in your view they've got to disappoint their greatest supporters and therefore, in the case of the Coalition, attack the monopolies and cartels.

RG: Yes.

AK: Do you think that that's the main thing that's required now or do they need to disappoint the unions as well?

RG: Oh, they need to disappoint the unions, but that's easy for the Coalition.

AK: In fact, they've said they won't do it until the next election. In many ways, it's harder or at least less likely for the Coalition to do that than it was for the Labor Party because they were able to reduce real wages through the Prices and Incomes Accord with the union movement.

RG: Yes. Whoever is in government, you can't get those sorts of adjustments in the labour market without a political program that gives everyone a clear view of the adjustment the economy's got to make in everyone's interest. There has to be a wide view in the community that what's being done is fair. And the opposition when it was the opposition – now the government – supported business in resistance to taking away cosy arrangements, even when taking away those cosy arrangements was necessary for economic efficiency.

RG: What would you say is a good example of a cosy arrangement?

RG: The guaranteed returns at unrealistically high levels in infrastructure for utilities, that's one. Another one: the extraordinary margins, by far the highest in the world, in Australian banking and in Australian retailing. The resistance to taxation of rents where we all know that that's the one way in which you can get revenue to repair a budget without actually damaging investment, if you do it in the right way. Those are a few examples.

AK: We'll have to leave it there, Ross. Thanks very much.

RG: And more of it in *Dog Days*, Alan.

AK: Yes. *Dog Days*.

SB: Thanks, Ross.

RG: Thanks, Ross.

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