15-16 March 2014
The Australian Financial Review | www.afr.com AFR

Treasurer Joe Hockey has taken a cautious approach to recent economic indicators. PHOTO: CHRIS PEARCE

Required: early action on all fronts

Comment

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2
$ billion
net annual cost over the forward estimates of the policy changes implemented by the Abbott government so far

10
$ billion
minimum additional annual cost to the budget of replacing the carbon laws and introducing paid parental leave

Some economic commentators saw the glass as half full when recent numbers on gross domestic product and retail sales were surprisingly strong, and as a bit more than half full with Thursday's employment numbers. Treasurer Joe Hockey was more cautious and wise. With good advice from Treasury, he was aware of the risks involved in growth coming overwhelming from resource export volumes, de facto budget stimulus and housing and consumption expenditure.

What is the trajectory of the economy under current policy settings? Are we putting in place policies that can restore and maintain full employment while placing the external and public budget accounts on a sustainable basis for stable growth in future?

Economic output has been growing at lower than sustainable rates since resource prices and the terms of trade reached a peak and began to fall in the second half of 2011. Since then, employment has grown more slowly than has the adult population; so participation rates fall and unemployment rises. Thursday's February improved labour force data does not yet represent a trend. Real incomes per Australian have been falling since the peak of the resources boom in late 2011. Wages have increased more slowly than consumer prices over the past year for the first time that workers can remember.

The budget and current account deficits remain at several per cent of GDP despite historically high terms of trade and historically low interest rates. The budget is still supported by extraordinarily high business investment driven by the resources sector.

The challenges are daunting.

By the December quarter of last year, the terms of trade were less than halfway into the huge adjustment from the giddy heights of 2011. The fall in iron ore and base metal prices so far this year has large implications for government revenue, and may end the flirtation with what is left in the pipeline of new mine developments. The economy has just stepped off the edge of the resources investment cliff and it is a long way down to the bottom. The emergence of an eastern Australian LNG export industry is lifting domestic gas prices several fold over a few years, raising costs for industry and households at a time when competitiveness and living standards are under pressure.

The budget is a much bigger challenge than generally understood. The deficit is large now, and that's before the fall in the terms of trade and business investment have done their worst. The servicing of increasing debt becomes more difficult with the rise in interest rates that eventually follows economic recovery in the rest of the developed world. (New Zealand raised rates this week.)

Structural changes in the budget must be made, and they'll put downward pressure on economic activity.

Corporate tax revenues from resources are declining with capital deductions from the boom in resources investment – and will do so for several years. The policy changes implemented so far by the new government have accumulated to something like a net $2 billion a year over the forward estimates, if we exclude the capital contribution to the Reserve Bank. If other policies are implemented as announced, the replacement of the carbon laws and introduction of paid parental leave will lead to an additional budget deterioration of $10 billion a year or more. Other new policies would lead to further deterioration.

This challenge must be managed alongside gradually increasing pressure on the budget from commitments such as the Gonski education measures and the National Disability Insurance Scheme.

Then the government wants to add about $10 billion in today's dollars a year to defence. On current policies, the ageing of the population will add between a 10th and a fifth of a percentage point of GDP to public deficits every year until the middle of the century. And the corporate tax base continues to be corroded by the globalisation of tax evasion and avoidance.

Sooner or later structural changes in the budget must be made and, whether they come from removing tax concessions or reducing expenditures, they'll put downward pressure on economic activity.

There is some uplift from export volumes – growth a bit over 6 per cent in the year to December. This comes mainly from resources. The lift in farm exports over the past year was driven by an exceptionally good season, to be followed by much worse if El Nino conditions in winter and spring follow the hot and dry summer and early autumn. Resource exports contribute much more to output as measured in the national accounts than to domestic economic activity, incomes and employment. Housing, consumption and the loosening of the budget since the change of government have contributed to recent growth in domestic demand but can't do this at current rates for long without exacerbating vulnerability to future shocks.

The optimists see in all of this a rebalancing of the economy. The cautious point out it's unlikely to be a sustainable rebalancing until there's a return to substantial expansion of investment and output in trade-exposed industries beyond resources.

In my book *Dog Days: Australia After the Boom*, I identified five possible approaches to restoring full employment and robust growth: Business as Usual; Austerity; Budget Stimulus; Productivity Growth; and Real Depreciation.

Dog Days favoured Real Depreciation supported by Productivity Growth as the best strategy to restore high employment and sustained growth. A real depreciation of 20 to 40 per cent from the levels of March 2013 would be required. And for the fall in the dollar to lead to a sustained improvement in competitiveness, the price effects of currency depreciation cannot be passed through into domestic incomes and profit margins. Depreciation of the currency would be secured in the first instance by easing domestic – relative to international – interest rates, alongside tightening of lending to the housing sector to avoid overheating. Accompanying real depreciation with far-reaching productivity-raising reform would ease the impact on living standards. Real depreciation is more likely to be politically feasible and economically successful if the necessary expenditure restraint is shared equitably across the community.

For the time being Australia has Business as Usual with a bit of Budget Stimulus. There is support from Real Depreciation, with action on Productivity Growth confined to the helpful but highly selective withholding of fiscal support from some commercial enterprises under stress. The Treasurer has foreshadowed stimulus from increased infrastructure expenditure but this could raise productivity growth only if projects were subject to objective independent evaluation of economic value.

On structural reform, we have been warned action will be delayed and slow.

Early reliance on domestic demand from housing, consumption and government deficits to support rising economic growth is unlikely to be consistent with sustainable external accounts in the years ahead. Growth in export volumes at around 6 per cent a year is actually a step down from the average rate of growth in export volumes in the two decades before the resources boom. It sits alongside a powerful secular tendency for the import share of expenditure on goods and services to rise with deepening integration into the international economy. The overwhelming concentration of export growth in resources limits its contribution to current external payments as well as to domestic economic activity, so growth in export volumes is smaller than it looks. Lower terms of trade and higher interest rates will increase the current account deficit, which then has to be financed at what may be an unpropitious time.

Later weakening of the current account at a time when capital flows less enthusiastically into Australia will place downward pressure on the exchange rate. That will provide another opportunity for Real Depreciation. But by then the task will have been rendered more difficult by the closure of potentially economically viable capacity in import-competing and export industries that have been rendered uncompetitive by an overvalued exchange rate, and by the accumulation of larger stocks of public and external debt.

While the currency depreciation through the middle months of 2013 fell well short of what is eventually required, it helps. The fall in the dollar so far has contributed to a real depreciation. Pass-through of the price effects of depreciation into wages has not been an issue, yet. But prices of goods and services that are not exposed to foreign trade (electricity supply, transport, wholesale and retail trade) have continued to increase by 3 to 4 per cent a year. This corrodes the improvement in competitiveness from the fall in the dollar.

With wages growing slowly, the persistence of high inflation in industries without exposure to foreign trade is the result of business practices and regulatory arrangements that are in urgent need of reform. So far we have seen few signs of life in investment in trade-exposed sectors outside resources. And we will see few signs until Australia's competitiveness has improved much more through real depreciation. Productivity growth helps. But our cost structures moved so far out of line with other developed countries during the resources boom – a real appreciation of around 70 per cent from early in the century to early 2013 – that it would take more time than we have to restore competitiveness through superior productivity growth alone.

From the end of the 1990-91 recession to the end of the century, Australia's productivity growth was at the head of the world league table, and yet the improvement against the average of other high-income countries was never more than a percentage point a year. To bridge the competitiveness gap that emerged by early 2013 through productivity growth alone would take many decades.

Early action on the revenue and expenditures sides of the budget would be helpful to real depreciation as well as important in the necessary budget adjustment. Early progress on raising productivity would allow Australians to retain as much as possible of the increases in living standards that have accumulated in nearly a quarter century of continuous economic growth. These are large and important matters requiring leadership to explain. The community needs to know the nature of the problem and understand the policies that will share the burden of adjustment equitably. Successful adjustment will require the removal of taxation and regulatory advantages that are highly valued by vocal supporters of the government.

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