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Australia needs to invest away from resources

Australia is in desperate need of infrastructure spending. *AFR*

by **Ross Garnaut**

Monetary policy in Australia's current economic dog days has to take account of a new reality: in the middle of the second decade of the 21st century, a cash rate of 2.25 per cent, set by the monetary authorities, is relatively high by developed country standards. And it may be high relative to long-term rates set by the market in future.

After Tuesday's decision not to cut the cash rate, Australia has much tighter monetary policy than the weighted average of developed countries despite slower growth in incomes and output per work-age person. It is tight money when Australian cash rates are much higher than those of all larger developed countries. It is tight money when our cash rates are about as high as our own long sovereign bond yields and much higher than bond yields in other developed countries.

The boost to Australian incomes from the resources boom went into reverse in the third quarter of 2011. Since then, employment has grown less rapidly than the work-age population, real national income per person has fallen and every six-monthly revision of forward revenues by the Commonwealth Treasury has downgraded the preceding estimates.

To avoid a long period of weak employment and sagging real incomes and the possibility of deep recession, we need to restore strong investment and output growth in trade-exposed industries outside resources.

My book *Dog Days: Australia After the Boom* describes five possible approaches to restoring full employment and growth after the end of the China resources boom. I favour real depreciation supported by public investment in productive infrastructure and uninhibited productivity-raising reform. I caution against both austerity and fiscal stimulus.

What we have mostly had so far under the Abbott government is the rhetoric of austerity and the reality of fiscal stimulus.

Depreciation

A large, real deprecation of the Australian dollar is the key to restoring investment and output growth in the trade-exposed industries outside resources. Firm fiscal policy without tight money is the way to secure nominal depreciation – the first step towards real depreciation.

I said in early 2013, when our dollar was worth $US1.05, that we needed a real depreciation of 20 to 40 per cent. Despite today's exchange rate of 75¢ against the US dollar, we have barely reached the closer bound of the required change. The currencies of most other countries have also lost value against the US. The slow response so far of investment and output in the trade-exposed industries suggests we may need a fall to near or beyond the more distant bound.

Unusually low Australian wage growth has converted much of the nominal into real depreciation. Much, but not all, since prices have kept rising rapidly for products of many of the non-traded service industries and utilities in which monopoly and regulation allow boom-time profit margins to be maintained despite weak demand. Think of banks, health insurance, pharmaceuticals, school and childcare fees, retail electricity and gas prices, airport and air-travel costs and road tolls.

Unprecedentedly low long-term interest rates are a feature of the contemporary world economy. On Easter eve, yields on 10-year sovereign bonds were 1.83 per cent in the United States, 1.59 per cent in Britain, 0.19 per cent in Germany, 0.34 per cent in Japan but 2.28 per cent in Australia. Real sovereign rates have been falling for a quarter of a century and have never been so low.

Economic fundamentals and not monetary policy are responsible for the low, long-term interest rates.

The developed world has entered a time when plans for domestic savings are exceeding plans for investment. (For these purposes, we should include China in the developed third of global population, but the statement holds without China). US long-bond yields have moved even lower since quantitative easing was brought to an end. The one certain economic consequence of quantitative easing has been to promote capital outflow and a lower exchange rate in the countries in which it has been applied.

Here to stay

We have entered a world of capital abundance and low interest rates foreshadowed nearly a century ago by John Maynard Keynes. Keynes's anticipation of "the euthanasia of the rentier" is at odds with the views of Thomas Picketty, the author of the most widely read economics book since Keynes (*Capital in the 21st Century*). The contemporary evidence suggests Keynes was right and Picketty wrong on long-term interest rates.

The value of housing, shares and other income-generating assets have risen in the 21st century because interest rates fell.

That's not to say that there is no bubble in Sydney and Melbourne housing – just that there would have been large increases in house prices without a bubble. If there is a housing bubble, the right response is housing sector measures, like the Murray inquiry's suggestions on higher capital adequacy requirements.

Getting through the economic dog days without deep recession and dislocation requires us to join the developed world's acceptance that times have changed. Global abundance of capital and low long-term interest rates are here to stay.

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