

Discussion

1. Chris Richardson

The immediate – indeed striking – observation on reading the valuable conference paper by Kearns and Lowe is just how remarkable a decade Australia had in the 2000s compared with our rich world peers. If this were a paper reviewing the experience of the past decade in almost any other western nation, it could be rapidly summarised as ‘bad stuff happens’.

Yet the point driven home by Kearns and Lowe is that, although we had our share of challenges to climb, by and large the 2000s were a decade in which ‘bad stuff didn’t happen’ in Australia. Or, as the authors put it (at p 78), ‘[o]n many levels the 2000s were a successful decade for Australia’.

That means a key task for Kearns and Lowe – and the Conference as a whole – is to discern how and why the Lucky Country got lucky again, and the implications that may have for the coming decade.

The authors tackle that task by telling us:

- *what happened*: increases in housing and commodity prices, as well as wealth and business investment, falls in unemployment, productivity growth and saving rates; no wage breakout; the financial crisis; the Australian dollar’s surge, the ups and downs of the cash rate, and the ‘two speed economy’;
- *why it happened*: the impact of China and other emerging economies on the terms of trade; shifts in interest rates and the degree of competition in financial markets; as well as reforms (and, in some cases, the lack of reforms); and
- *some possible implications* for monetary, fiscal and structural policies.

Their analysis makes sense at each of these steps.

What happened

The authors (at p 74) identify what they see as ‘the two driving forces for the two halves of the decade: the changes to household balance sheets and the impact on Australia of rapid development in Asia’.

Although that’s true in terms of the chronology, I would divide the last decade differently. While it makes sense to place Asia’s rapid development at the heart of Australia’s performance last decade, I’d see the global financial crisis (or, as the Reserve Bank sometimes calls it, the North Atlantic financial crisis) as the other key development of recent times.

Indeed, I think the surge in the terms of trade in the second half of the decade was an important reason why the housing price hike in the first half of the decade didn’t lead to as many problems as it might – the boost to nominal incomes ‘forgave’ some of the earlier enthusiasm in housing prices.

Or, to put that differently, it made sense the Conference opened with a paper on the rise of Asia (Huang and Wang) and then followed it with one that looked at the financial crisis (Bayoumi and Bui). The first of these provided Australia with an opportunity, while the second provided challenges.

Why it happened

The authors identify other important drivers of the past decade, and I broadly agree with them.

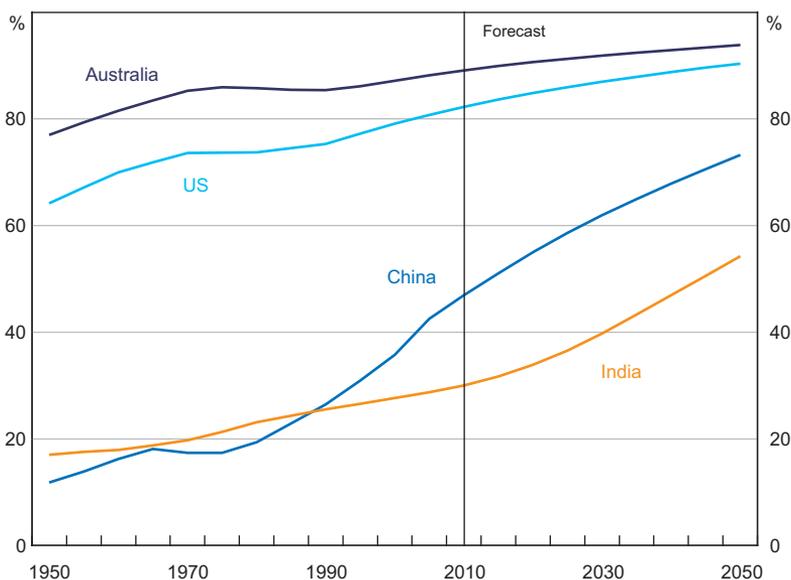
However, and having differed from Kearns and Lowe by giving second place to the financial crisis rather than the housing price boom in an assessment of developments over the past decade, I do think that Asia's development – and in particular, its impact on Australia's terms of trade – was the single most important factor in explaining the performance of Australia's economy in the 2000s.

That's why I'll concentrate on Asia's impacts here in these comments.

Of course the rise of Asia is merely a continuation of an old story for the world economy as the two great trends of urbanisation and industrialisation are continuing to transform the global landscape. As Figure 1 shows, there are enormous numbers of people moving from the country to the city in the emerging world, and the pace of that urbanisation is unlikely to slow any time soon.

People are moving from the country to the city so that they can move from farms to factories. They want to do that because the wages they can command in the latter – even allowing for the impact of the higher cost of living in cities – is a considerable improvement on the purchasing power of their farm earnings.

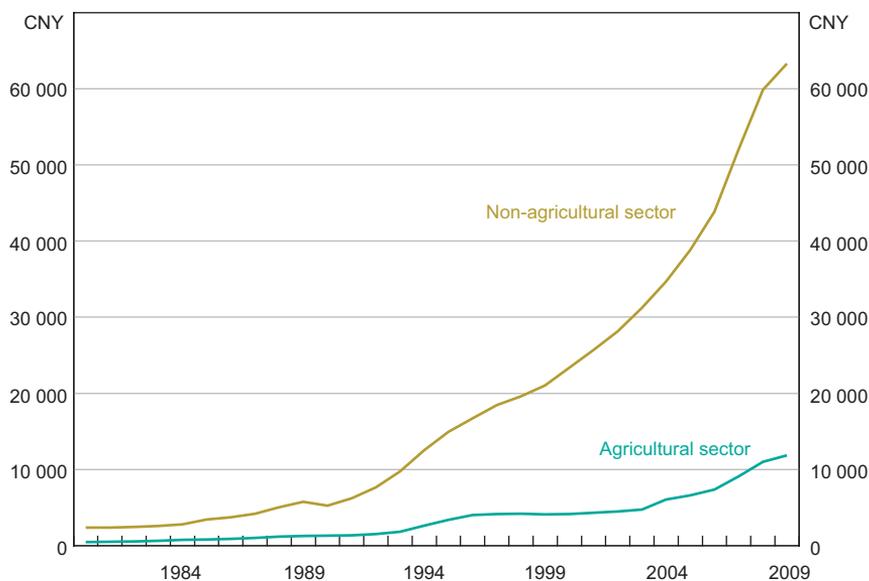
Figure 1: Share of Population Living in Urban Areas



Source: United Nations, 'World Urbanization Prospects, The 2009 Revision' database

That process also provides emerging economies with substantial productivity momentum: Figure 2 shows that output per worker in a Chinese factory is more than five times that on a Chinese farm.

Figure 2: China – Output per Worker
Current prices

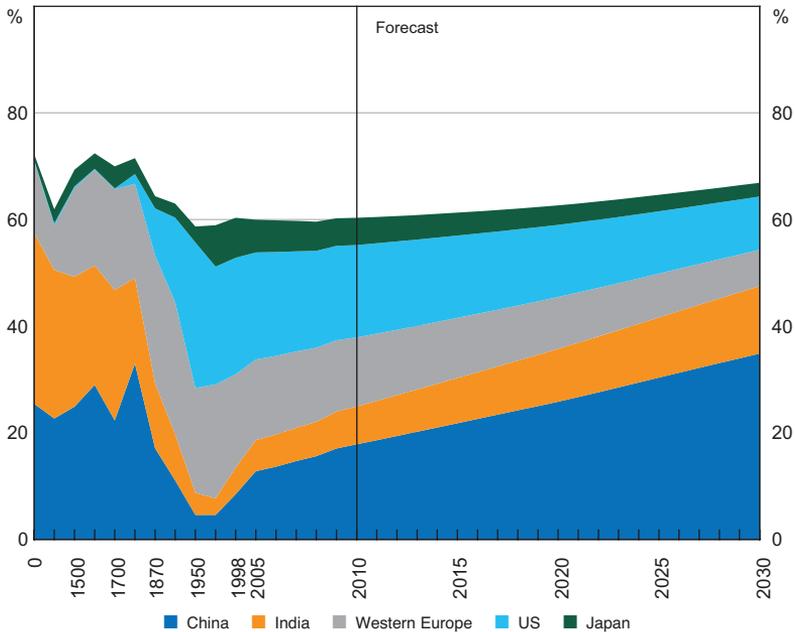


Source: Thomson Reuters

Or, more broadly, the twin drivers of urbanisation and industrialisation are the trademarks of a global industrial revolution in which three billion people are changing the way they live and where they work in a way that is reshaping the global economic landscape at a truly frantic pace (see Figure 3).

It is worth stressing the centrality of the Asian development story for Australia. For us, Asia's impact comes as a profound global demand shock for our exports of industrial inputs such as coal and iron ore. Kearns and Lowe dramatically illustrate the impact of that when they point out that iron ore's share by value of Australian exports leapt from 3 per cent in 2003 to 17 per cent in 2010.

Of course the reason that iron ore values grew as much as they did was because prices shifted so sharply. In turn, the main impact for Australia came from commodity prices rather than through quantities because it simply takes longer for supply to respond in mining markets than in most other markets. (The common assessment is that the response takes about a decade, and I'd date the surge in China's commodity consumption as beginning in 2003, so it's no surprise that global mineral supply has yet to really hit its straps.)

Figure 3: Share of World Output

Sources: The Conference Board, Total Economy Database™; Deloitte Access Economics; Maddison A (2009), 'Statistics on World Population, GDP and Per Capita GDP, 1–2008 AD'

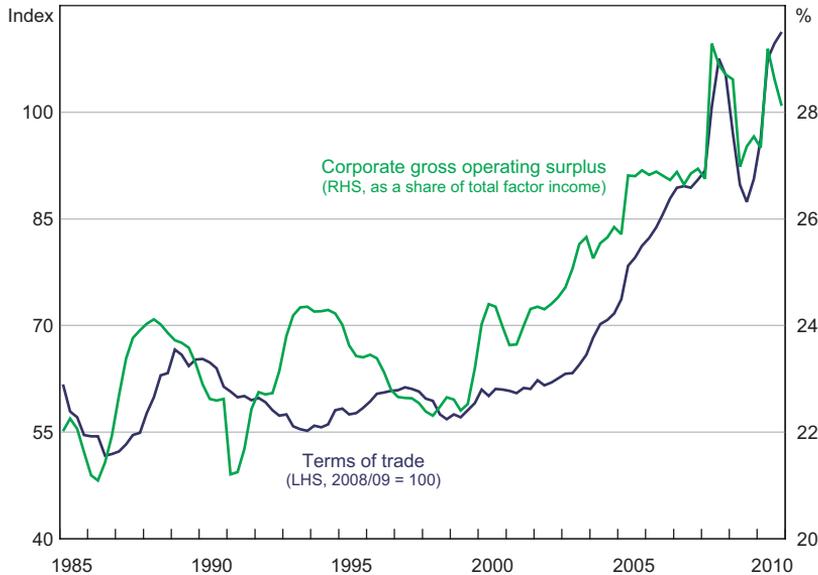
The centrality of the terms of trade effect

Figure 4 shows the remarkable climb in the terms of trade which occurred through the past decade.¹ That same figure also includes a measure of the profit share. Although profit shares moved up in much of the world over the past decade, the equivalent move in Australia was strong and closely tied to the shift in the terms of trade.

That is no surprise. In simple terms, a China boom is a commodity price boom is a terms of trade boom is a profit boom.

Moreover, the shift in the terms of trade also invoked a series of other key responses in Australia's economic performance in the past decade. For example, as alluded to above, arguably one of the reasons why the upswing in Australian housing prices in the first half of the past decade didn't then prove problematic in the second half of the decade was that the lift in national income due to the lift in the terms of trade helped to 'forgive' the earlier upswing in housing prices.

¹ Given falling levels of labour productivity in mining, Australia's factoral terms of trade have performed relatively worse than the (usually reported) net barter terms of trade seen in Figure 4. Note that, given the focus of the Conference, this and some of the other figures have been truncated to end at December quarter 2010 or 2009/10.

Figure 4: Terms of Trade and Profit Share

Source: ABS

Similarly, a little remarked upon linkage – though Borland in this volume correctly identifies its importance – is that the profit boom which accompanied the rise in the terms of trade also shifted the relative price of labour and capital. Hence, as is usually the case when real unit labour costs fall, the profit boom of the 2000s was associated with faster-than-average employment growth (one of the many reasons why measured labour productivity underperformed last decade – though far from the only reason).

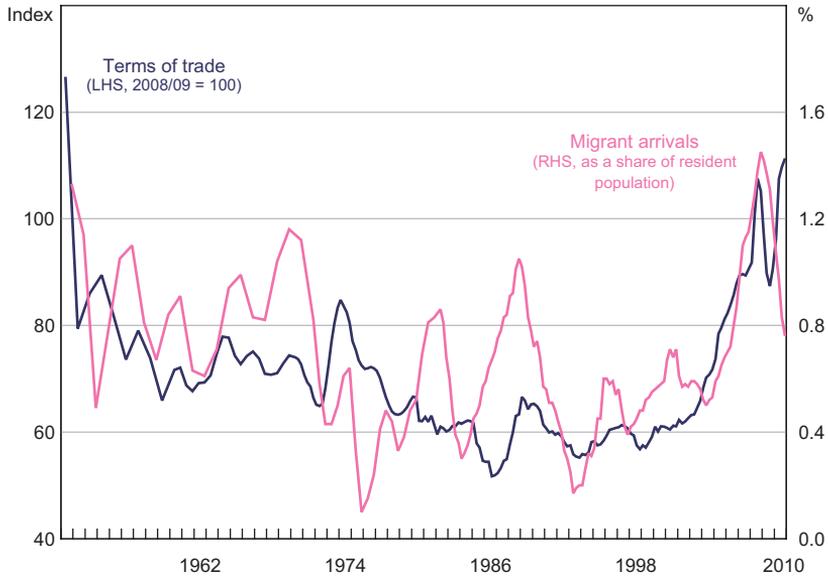
Moreover, it is also arguable that shifts in the terms of trade are correlated with the relative pace of migration to Australia. Such a ‘migration equation’ is shown in Figure 5, which points to the historical similarity between the terms of trade and the pace of migration.

Hence the hand of the terms of trade is evident in many of the standout features identified by Kearns and Lowe as key characteristics of Australia’s economic performance through the 2000s.

To that list I would add one final important linkage – the impact of the terms of trade on the Australian Budget.

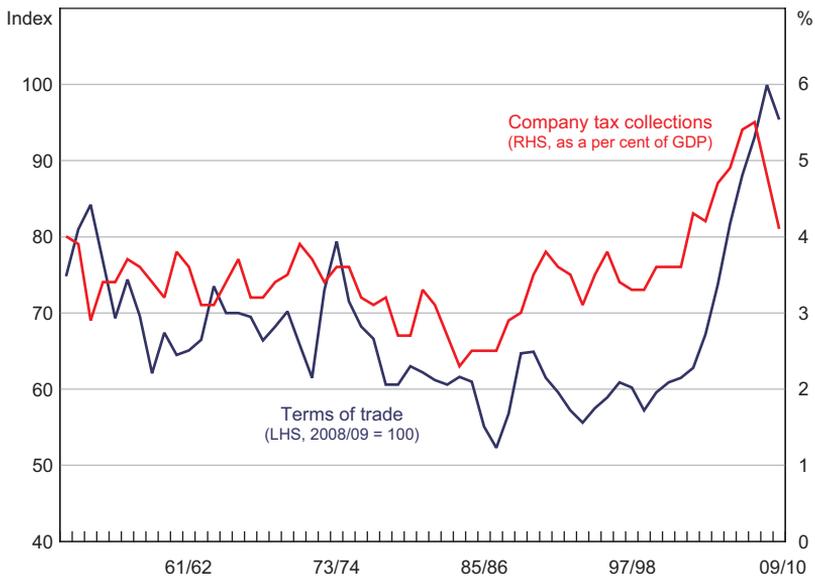
Figure 6 shows the relatively close link between the terms of trade and company tax collections as a share of GDP. Although this linkage broke down in 2009/10 (as the global financial crisis led to reduced collections of capital gains tax as well as the impact on company tax collections of accumulated corporate losses racked up through the crisis), the latter gap between the terms of trade and company tax collections is likely to prove temporary rather than permanent.

Figure 5: Terms of Trade and Net Migration



Note: Quarterly data from 1970 for terms of trade and from 1982 for migrant arrivals
 Sources: ABS; Deloitte Access Economics

Figure 6: Terms of Trade and Company Tax Collections



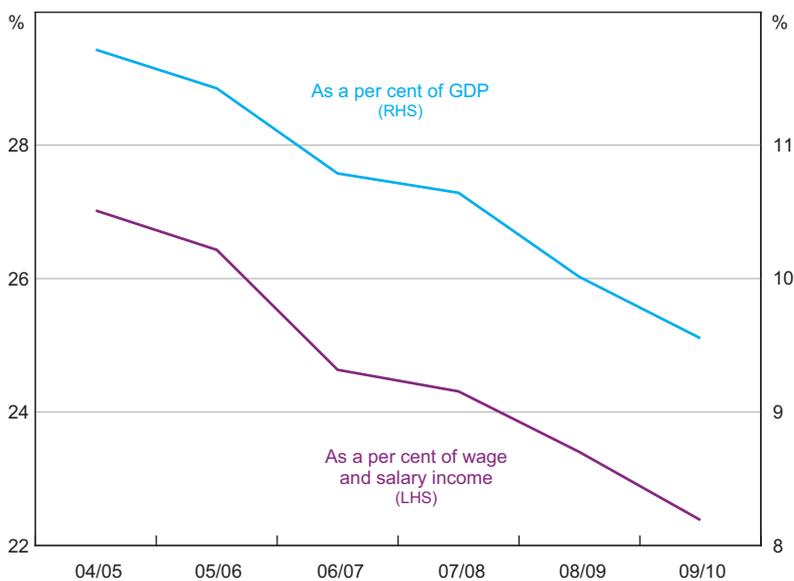
Note: Removes 'doubling up' of company taxes in 2000/01
 Sources: ABS; Deloitte Access Economics; Foster R (1996), 'Australian Economic Statistics 1949–50 to 1994–95', RBA Occasional Paper No 8, rev 1997; RBA

Fiscal implications

What to do with that terms of trade-driven surge in fiscal revenues? As Kearns and Lowe note, 'one form of possible risk mitigation is for the nation to save a significant share of the benefits of the resources boom, and then to only gradually increase spending if the outcomes are as positive as expected' (p 98).

Unfortunately for the nation, the surge of national income and the resultant impact on tax collections was not treated in a risk-averse fashion by Canberra. Rather, the lift in profits (and hence revenues) was recycled into eight personal income tax cuts (see Figure 7) as well as into an increase in spending on family benefits and the like.

Figure 7: Average Rate of Personal Income Taxes



Sources: ABS; Deloitte Access Economics; RBA

The key conclusion – the rise in risks and returns

What next? Kearns and Lowe reach an unassailable conclusion when, at p 96, they note that 'the economy looks to have moved out along the risk-return frontier'.

I think there could be no better summary of what happened to Australia over the past decade. As argued above, the key story of the last decade as far as Australia was concerned was a profound demand shock, having its particular impact on prices (the terms of trade) rather than quantities.

To the extent to which China's 'entry' into the world economy through the 2000s reflects the removal of barriers that constrained its development, Heckscher-Ohlin would suggest that some part of the resulting terms of trade improvement to Australia is a permanent gain.

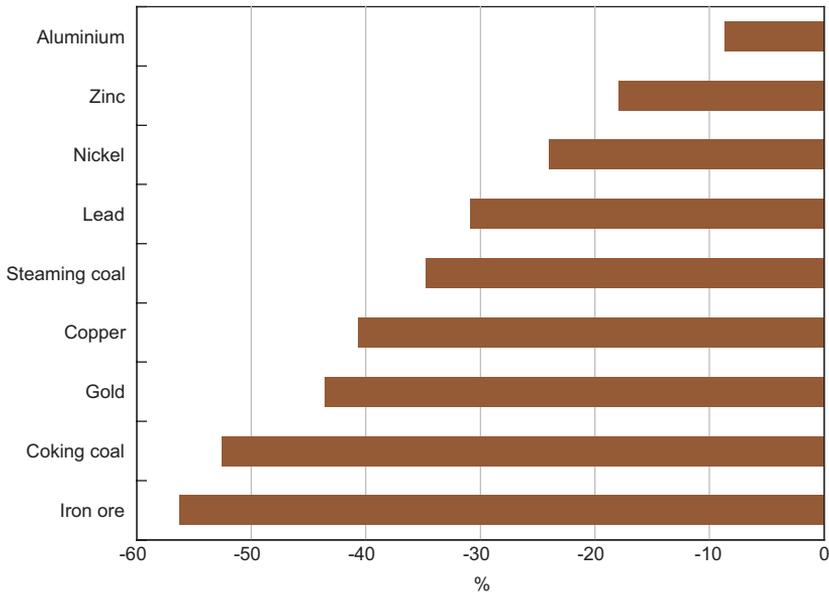
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Yet that also begs a related question. If Kearns and Lowe are correct that average returns in Australia have risen, is there a chance that the coming decade will see the associated increase in risk coming home to roost?

After all, if the story of the past decade for Australia was the impact here of a profound global demand shock, surely there's a chance that the story of the coming decade will be a supply driven one. All around the world – everywhere from West Africa to Mongolia – the soil is being shifted faster as miners leap to feed extra supply into the magic margins of the moment.

Figure 8 is drawn from a July 2011 survey undertaken by Consensus Economics. It points to the difference between current commodity prices and those expected towards the end of this decade, with that shift measured in real terms. If the forecasts in Figure 8 prove correct – remembering that such falls in prices imply even larger falls in profit margins, especially to the extent that long-run marginal costs are rising – then it may be that the matching Reserve Bank conference in a decade's time will once again be noting that Australia has indeed moved out along the risk-return frontier, but that our subsequent experience saw those risks eventuate in a way that the past decade did not.

Figure 8: Forecasts of Real US\$ Commodity Prices for 2017–2021
Percentage change from July 2011



Source: Consensus Economics, *Energy & Metals Consensus Forecasts*, July 2011

To summarise, the 2000s in Australia were in many ways a ‘China’ story of the implications for this nation of leaping mineral demand. But what if the 2010s are a story of rising global mineral supply – with a bigger negative effect on margins than widely recognised?

If so, then the ‘what happened’ summary in a decade's time may read differently, with risks dominating returns; with the performance of commodity prices, housing prices, wealth and

business investment all under pressure relative to the experience of the 2000s, albeit with a lower Australian dollar and lower interest rates taking pressure off ‘two speed economy’ effects at the sectoral level.

Moreover, that ‘what happened’ summary in a decade’s time may be affected by the risk that:

- the prosperity of the 2000s left Australia as an underachiever on reforms – and hence as a continuing underachiever on productivity gains in the 2010s; and
- the prosperity of the 2000s left us too sanguine on the structural budget deficit, and made us ‘late’ in tackling intergenerational-style fiscal challenges.

Let’s hope that’s not right.

2. General Discussion

A number of different issues were taken up by participants during the discussion. First, the question was raised as to whether or not the increase in the terms of trade experienced during the second half of the 2000s was foreseeable. It was highlighted that the rapid growth in China over the past decade was similar to that over the 1990s, suggesting that forecasters could have extrapolated this outcome of rapid growth into the 2000s, particularly as China was still a long way from ‘catching up’ with more advanced economies. Further, it was mentioned that key characteristics of the Chinese economy, such as its high resource intensity and very large population, were well known at the beginning of the decade. One participant pointed out, however, that past episodes, including rapid development in Japan and also strong growth in China in prior decades, did not result in substantial movements in the terms of trade, with large increases only observed from 2003. They argued, therefore, that even given an expectation of strong growth in China, it was not obvious that the rapid increase in Australia’s terms of trade was predictable. It was also mentioned that it took longer than expected for additional supply to come on line in response to the rapid increase in commodity demand (although one participant thought that this was a regular and potentially predictable feature of supply). It was also suggested that there was always great uncertainty in predicting future demand; for example, the development of India is a further source of demand that might not be fully incorporated into projections made today.

Another participant stressed that strong demand in China was not the only driver of the relative price shock experienced by Australia over the past decade. They suggested that global monetary policy, coupled with pegged exchange rates in fast-growing economies like China, had contributed to excess demand and global inflation, and that this monetary effect has tended to be overshadowed by the perceived slow response of supply. Related to this issue, one participant asked if, even given perfect foresight about the commodities boom, policy-makers would have been able to deliver better outcomes in Australia. They suggested that the lack of strict adherence to a single plan enabled policy-makers to be less rules-based, less prescriptive and more flexible, which led to good outcomes overall during the 2000s.

A second key theme during the discussion was how the gains from the mining boom should be best utilised. One participant noted that the consumption-to-output ratio in Australia has been quite flat in recent times, suggesting that not all of the mining boom gains have been spent. It

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was also mentioned by one participant that compulsory superannuation increased during the decade, contributing to national saving, although it was pointed out that this policy was not a direct response to the terms of trade.

It was noted that the issue of what should be done with the gains from the historically high terms of trade depends on both the persistence of the relative price shock and the country's degree of risk aversion. If the increase in export prices relative to import prices is permanent, then it would be optimal to increase consumption today. However, given the uncertainty surrounding the persistence of the relative price shock, it is likely to be optimal to save some of the gains. If individuals are risk averse, then it makes sense to save more now. It was suggested that the risk appetite of society as a whole was something that should be debated.

A third topic discussed was Australia's favourable experience during the global financial crisis compared with most other economies. In the discussion, several factors were mentioned as being important. The profitable opportunities for Australian banks in the domestic market, and their funding structure, reduced their incentives to hold what turned out to be high-risk securities. Memories of the experience of Australian financial institutions during the early 1990s recession were also thought to have shaped banks' attitude to risk. The supervisory role of APRA was mentioned as being key to the resilience of financial institutions in Australia; in particular, the fact that APRA was less rules-based than other institutions. Along with the domestic fiscal and monetary stimulus, the very large fiscal stimulus in China was also seen as a significant factor boosting the Australian economy during the crisis period. The exchange rate was also highlighted as a key shock absorber for the economy.

A fourth issue taken up was weak productivity growth in Australia over the past decade. One participant thought that this should be expected to a certain degree given the downward trend in unemployment, with workers entering employment at least initially having low productivity. Similarly, in Europe and the United States, productivity slows as unemployment falls and productivity improves during periods of increasing unemployment. Another participant made the comment that immigration was an important issue over the past decade that deserved more focus. Alongside higher permanent immigration, increased temporary immigration in the 2000s added flexibility to the economy and added to the human capital stock. The issue of slowing population growth was also raised. It was questioned by one participant how temporary this might be, and also whether the population figures could be influenced by foreign students leaving the country, in which case the slowdown in population growth might be less of an issue for labour supply.

A fifth point raised by one participant was the two-speed economy in Australia, noting that since both households and governments seem to be deleveraging in the current environment, coupled with a high exchange rate, structural change could be quite painful for certain sectors of the economy. The authors agreed that it could be difficult, but that structural change was necessary if relative prices facing the economy were persistent or permanent. Another participant suggested that allowing more capital and labour to flow into the country would enable all sectors of the economy to grow more quickly without necessarily increasing inflation. In particular, growth in the non-mining economy would not have to slow as much to absorb the mining sector.