# EUROPE, AUSTRALIA AND ASIA: SOME OBSERVATIONS

*Address by Mr GR Stevens, Deputy Governor, to the European Australian Business Council, Sydney, 11 August 2006.*

The first Europeans who are known to have had any significant contact with Australia were the Dutch, but they didn't see much they thought to be of value. Long before James Cook set off in 1768 to view the transit of Venus in Tahiti and then continued across to explore New Zealand and the east coast of Australia, Dutch seafarers on their way to Java for the spice trade encountered the coastline of the 'missing continent'. Historians say that Willem Janszoon, in the ship Duyfken, made landfall on the western shore of Cape York in November 1606. This year, then, marks the 400th anniversary of that event, and it is being marked by various cultural exchanges between the Netherlands and Australia.[1]

Finding the terrain and the existing inhabitants inhospitable, Janszoon didn't stay long. Cook landed at Botany Bay in April 1770, but the first serious attempt at settlement by the English was not until 1788. Even then, the main attraction of the place was presumably its remoteness. The agricultural and mineral potential which was later to help make Australia a wealthy nation was at that stage unknown, or not valued. As it happened, the first fleet preceded the arrival of the French explorer, La Perouse, by less than a week. So but for a week or two, we might not have taken up cricket. As it was, La Perouse soon left and vanished in the Pacific near the Solomon Islands shortly thereafter.

However that may be, the historical links of modern Australia with Europe are everywhere. While modern Australia had an inauspicious start as a prison, the numbers involved in that venture were tiny in comparison with the countless numbers who came voluntarily from Europe over the ensuing two centuries, in search of a better life. For over a century and a half, Australians looked mainly to Europe as the source of technology and capital as well as people. While Australians, as a nation of immigrants, are from all over the world, the importance of Europe as a source of people, culture and values is immense.

That is a heritage we share, of course, with many other countries. The Europeans had colonies all over the world. But in some cases, when the colonial period ended the former colonies went on to become vibrant, affluent societies – not without their problems, but successful nonetheless. In other cases, success was elusive. Presumably the reasons for the differences are complex (and are beyond today's discussion) but have a lot to do with success in building institutions, a theme to which I will return directly.

1 *See < http://nederland-australie2006.nl>.*

For the past 50 years or more, however, Europe and Australia, while not disengaging with each other, have perhaps been preoccupied with other matters.

Europe has been building the European project. On the economic front, the movement towards a single market and, ultimately, a single currency for the euro area was an ambitious undertaking. This had social, political and strategic dimensions, as well as economic ones. Indeed, one of the mistakes outside observers made in the lead-up to the adoption of the euro was to think about this in purely economic terms. This was a misunderstanding because the project was not just about economics, where the case for a single currency was probably, at best, an on-balance one. It was also about the broader needs for integration in a continent with its own particular history. Project Europe remains in many ways a work in progress, but much has been achieved.

Over that same period, of course, Australia has been on its own journey. The changed focus towards the United States in a strategic sense occurred out of necessity in the 1940s. Business ties across the Pacific grew rapidly after the war but Australian eyes also turned north. The visionary opening-up of a very important trade relationship with Japan in the 1950s, which fostered the rise of the mineral sector, and the growing trade with the rest of Asia, not least in recent years China, mean that five of every eight dollars of our trade is with the Asia-Pacific region, compared with one in six 60 years ago. Europe is still, and will remain, a major trading partner for Australia, of course, but there is no doubt which way the trends have been going (and they have been going that way for Europe too). A much bigger proportion of our immigration is also from the Asia-Pacific region than was once the case, and the general intensity of economic, official and personal engagement with the countries in the region has exploded. To this we would add that the path of unilateral opening-up of the economy, with extensive financial, goods, services and labour market liberalisation, has seen a significant degree of structural change, which has been pretty successfully managed.

So one might be forgiven for asking, after all this, whether Europe and Australia have anything to offer each other, and whether they have much in common. I think they do. An Australian, in a country with many important elements of European heritage but positioned in the Asia-Pacific time zone, would I think pose four questions.

First, what observations, based on experience, would a European have to offer Australia? Second, what has Australia, based on our experience, to say to Europe? Third, what has, in the opinion of one Australian, European experience to offer to Asia? And finally, what has Asia to say to Europe?

Let me be clear that I am sticking to the macroeconomic and financial sphere; I will not venture into political issues, agricultural policies, nor into climate change – where Europe and Australia probably do have things to say to each other, and where both would want to think about the impact of Asia over time. I will stick to my own field of expertise.

For Australia, Europe has offered some lessons in the importance of sound macroeconomic policies – both of the positive and negative kind. In the monetary sphere, the example was positive. The Deutsche Bundesbank was in the post-war period the epitome of the commitment to price stability. All countries struggled to contain the inflation outbreak of the 1970s but the Germans (and the Swiss) did better than most. This was not costless in terms of lost economic activity, but I do not doubt that the long-run pay-off in price stability was worth it. It was not just because Germany was the biggest country in Europe that the deutschemark became the anchor currency of European monetary arrangements. It was also because German monetary management had offered a commitment to stability in a time of global instability. The other countries of continental Europe – even pretty big ones – saw advantages in pegging to the deutschemark and ultimately in adopting the euro and joining the ECB, which in many respects was conceived in the image of the Bundesbank.

Australia failed this inflation test in the 1970s, and took until the early 1990s to beat inflation decisively. We learned that lesson and have for the past 15 years had an average inflation rate very similar to what the Bundesbank delivered though the 1950s and 1960s.

The negative example from Europe is public finances, where several countries have large public debt burdens as a result of insufficient fiscal discipline over many years. With that background, the countries of the euro area have had to adopt the Stability and Growth Pact, under which they commit to limit budget deficits in order to maintain future discipline and assure long-run solvency. All of this means that there is very little fiscal flexibility to handle new adverse circumstances that might come along – such as a recession, for example. The problems will not get any easier as population ageing proceeds. A contrast to this is the Australian Government's fiscal position, which would allow considerable flexibility were a serious adverse macroeconomic shock to materialise.

What Australian experiences are relevant for Europe?

Apart from the longer-run flexibility afforded by strong fiscal discipline referred to above, I think here I would point to the importance of supply-side enhancing structural reforms. In our economy, these have had a tremendous pay-off in overall living standards, even though painful adjustments have had to be made. It has been a very long process, and we could not claim to have done all things in exactly the ideal way, but there is little serious debate now over the proposition that these reforms were very positive. The arguments are over the pace of ongoing change, and how to balance economic efficiency with social values of egalitarianism and so on. What was impressive about the Australian experience was the way in which the intellectual battle was won in favour of liberalisation to the extent that, through the crucial years of the 1980s and 1990s, there was bipartisan political support for the broad direction of the reforms.

Of course, excesses occurred. Particularly in the case of financial liberalisation, which lifted balance-sheet and liquidity constraints on behaviour, there were problems of over-exuberance by lenders and borrowers at times. There were some painful lessons learned by corporates and banks at the end of the 1980s boom.

More recently, the action has been in household balance sheets. I suspect many Europeans would look at Australian households' apparent fondness for consumption over saving, the low saving rate as measured, the persisting largish current account deficit and so on, and conclude that this is no model for anyone.

Yet it is interesting to compare the rate at which the stock of savings owned by Australian households has risen compared with that of Europeans. Research by my colleague Ric Battellino and his staff shows that, despite the much higher household saving rate in Europe, the stock of financial assets owned by Australians is about the same, relative to current income, as for Germans. In fact, the rate of growth of the stock of Australian savings has been higher over the past decade (Table 1).

**Table 1: Average Annual Growth in Net Financial Assets**
Percentage change

| | Total | | Per head of working-age population |
|---|---|---|---|
| | 1986–1995 | 1996–2005 | 1996–2005 |
| Australia | 11.7 | 9.2 | 7.7 |
| France | 5.8[(a)] | 6.8 | 6.1 |
| Germany | 7.1[(b)] | 5.7 | 5.4 |
| Italy | – | 7.2 | 6.8 |
| Japan | 7.7 | 2.5 | 2.7 |
| United Kingdom | 11.9[(c)] | 6.3 | 5.7 |
| United States | 8.2 | 6.4 | 5.0 |

(a) 1995 only
(b) 1992–1995
(c) 1988–1995
Sources: ABS; national sources; OECD

The reason this has occurred is that Australians have a much higher direct exposure to the returns generated by the business capital stock, through their ownership of equities. And a more open, dynamic economy has used its capital and labour much more efficiently than it once did. Hence, the operating surplus of the corporate sector as measured by the statisticians who prepare the national accounts has increased by over 200 per cent over the past 15 years, versus 70 per cent in Germany. The returns on equities are more variable, but higher on average, than the much more conservative assets such as bonds and bank deposits typically held by European households.

In summary, the fruits of a more efficient economy partly have come to Australian households through this channel, as well as via lower prices for goods and services. The result is that per capita net financial wealth in Australia has risen at least as fast as in large European countries, even though Australians save less of their income flow. That said, these same fruits of reform are now starting to become available to Europeans.

So Australia and Europe have things to learn from each other in the economic field (and doubtless elsewhere too), even though we have each been preoccupied with projects closer to home.

So much for Australia and Europe. What lessons might this Australian observer, of both Europe and Asia, draw from European experience for Asia?

To return to a theme I mentioned only briefly at the beginning, it is the importance of institutions – in this case, those institutions pertinent to the regional financial and economic architecture. Europe has invested a great deal in the construction of such institutions. What is striking is the time horizon over which this commitment has been maintained. Such a major journey is not made quickly: the euro was the culmination of a 50-year development phase. It began in the aftermath of war, with agreements among a small group of countries for particular industries, which subsequently became a customs union, and went from there. So there was integration on the real side of the economy going on. The Werner plan for European Monetary Union was adopted as far back as 1971, with a target date of 1980, which was too ambitious as it turned out. But momentum increased in the 1990s, and of course the euro came into being at the beginning of 1999.

Through all this there was, critically, a degree of political support for European institution building. When we speak here of institutions, by the way, we mean not just intergovernmental or international organisations, though these have doubtless been very important. We mean as well the general pattern of dealings across countries between businesses, governments and citizens over long periods, which build confidence as people understand how their counterparts in neighbouring countries think and are likely to behave.

This is relevant for Asia, when some in the region are talking about integration, even of the monetary kind, as a desirable goal. There are probably economic impediments to speedy monetary integration of that degree, not least because of the very different levels of economic development around Asia, which are greater than those in Europe. There are a number of countries – China not least among them – whose prospective rates of productivity growth over the decades ahead will surely mean a substantial increase in their real exchange rate. But there are others, Singapore or Hong Kong say, which have already largely completed their productivity catch-up with the advanced economies. It seems unlikely that these two – which, of course, have very different exchange rate regimes at present, but both quite successful ones – would easily find an acceptable exchange rate linkage with the others in the near term.

Nor is there a large bastion of economic stability within the region that is the obvious anchor for a currency arrangement, the way Germany was for Europe in the 1980s and 1990s. Once Japan might have been that country. But then Japan experienced a decade of stagnation, deflation and concerns over financial-sector solvency. It is now emerging from that period, something which is of great benefit to the region and the world. But it seems unlikely now that Japan could become the anchor currency of an Asian exchange rate system. The obvious potential candidate in the long run is China, but China does not yet maintain a convertible currency and does not have a 40-year record of economic and monetary stability the way Germany did by the end of the 1990s. And, as noted above, China has its own adjustments to make for some time ahead, in which others in the region might not want to share.

Hence it seems to me that, for economic reasons, an Asia-wide currency is not likely any time soon. But even apart from the economic factors, the institutional infrastructure is not there, and it cannot be manufactured quickly. Institutional capital takes a long time to build – much longer than physical capital. It is not just a matter of writing down a charter for an institution, putting in some money, employing people and having meetings. That is the end of the process; the hard part of the process is the building of relationships, economic and political, and proceeding with domestic development and reform, which will give people the confidence to do the more adventurous parts in due course.

In the interim, there is much value to be gained by pursuing co-operation: working on making the financial infrastructure reasonably consistent, well-understood and easy to use for investors across the region; working on understanding the interactions between the countries of the region, where their interests converge and where they diverge; and working out how to accommodate different positions. This is unglamorous work, but unless these foundations are laid, more ambitious ideas will not get far. That is, I think, the lesson from European experience: it is a long road; there will be many setbacks and persistence will be critical.

What, finally, would be the messages from Asia to Europe?

Here there is a question of acceptance of Asia's growing role in the world economy and financial system, and being prepared to accept some changes to international governance which reflect that. This is NOT an issue of Asia versus Europe – it is broader than that. The developed world in general needs to make some room for the emerging economies to take a place at the table.

But there is a distinctly European flavour to the governance arrangements of some of the key international financial institutions, and a distinct underweighting of Asia. This is not a new point; it is well known, and progress is slowly being made towards a better set of arrangements. It is hoped, for example, that there will be a move to increase, at the margin, the weight of some emerging-market countries (not just Asian ones) in the IMF quota system at the IMF meetings in Singapore next month. But it is important that this be just the start of a broader effort towards more balanced representation.

One of the difficulties in achieving progress in this area is that other countries deal with Europe sometimes as Europe – the EU, or the ECB or some other pan-European body – and sometimes with European countries as individual countries. And, on many occasions, both versions of Europe are at the table. There are historical reasons for this that we can all understand. Nonetheless, the situation can complicate matters considerably.

Perhaps this just reflects the fact that, even though remarkable progress has been made in Project Europe, Europe has not yet reached long-run equilibrium. It is, of course, for Europeans to decide whether there is ever a 'United States of Europe' with a common external face on all international matters as well as a common currency, or whether Europe remains a collection of individual countries, in close relationship but still separate in foreign matters. But it seems to me to be unsustainable for Europe to continue indefinitely to participate in the international bodies in both capacities. To attempt to do so would be likely in the long run to complicate the already arduous process of adaptation to the changing international economic landscape.

At the same time our European colleagues would I am sure say, rightly, that more weight in international governance for other countries or regions brings responsibilities along with privileges. So as the process of opening up and reforming governance structures proceeds, it will be important for those countries that benefit to understand and meet their responsibilities to the international system.

So in brief, Asia's message to Europe – and to other regions – might be: allow us some room at the table in the key international bodies, and help us to understand and live up to the responsibilities that go with that.

## Conclusion

A lot has changed since the early Europeans came across the Australian continent four centuries ago. The dry, strange southern land has become a successful modern democracy and economy – in no small way because of the influx of capital, people, ideas and culture from Europe. Europe, after enduring devastating conflicts, has in the past half century embarked on a project of integration of a size and scope seldom contemplated before, if ever. While this project is not yet complete, it has already achieved a great deal.

Along the way, both of us have become much more aware of Asia, which presents economic opportunities and challenges. Hopefully, we still can learn from each other along the way, and also help our Asian counterparts to play their part in the world economy, to the benefit of all.