Australia's Economic Policy Challenges

Address to the Committee for Economic Development of Australia (CEDA)

John Fraser | Secretary to the Treasury | 27 February 2015

Introduction

Lee and Nick, thank you for that kind introduction and for hosting today's event.

Over the past two decades, I have observed the performance of the Australian economy and the debates about fiscal policy and structural reform largely from afar.

My outsider's perspective was that, while our economy was performing comparatively well and our levels of government debt were well below those of most other advanced economies, this owed much to the hard decisions on structural reform made through the 1980s and 1990s, the fiscal repair of the late 1990s and the good fortune of being endowed with commodities that have been in high demand by China since the early 2000s.

Now, there is a real question as to where our future prosperity will come from as the growth dividend of past reforms fades and growth in demand for our natural resources eases, especially against the headwinds of a weak global economy and an ageing population.

It is hard not to think that the proceeds from the resources boom may have led to reform complacency and, just as importantly, those proceeds financed government decisions that are now harming the structural integrity of the budget.

More than ever Australia's future economic prosperity lies in our own hands.

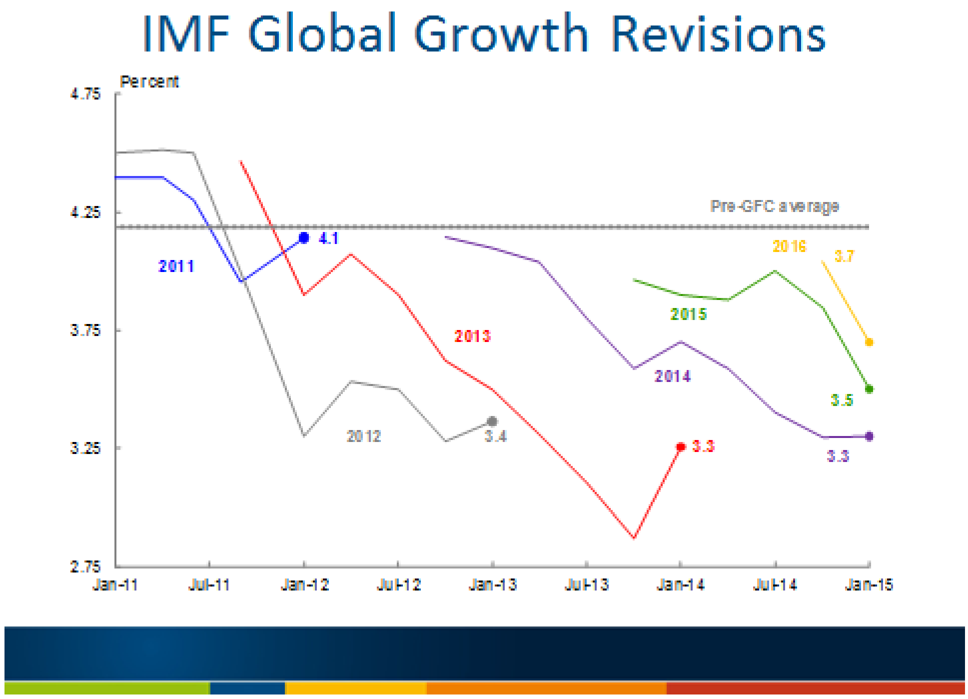
Economic Outlook

I'll start by providing you with my assessment of the current economic backdrop, both globally and domestically.

Seven years after the collapse of Lehman Brothers and the attendant ravages of the global financial crisis, the global economic environment remains very challenging.

Indeed, the period of weakness following the crisis has significantly exceeded the average experience since World War 2 between the depths of a recession and the subsequent cyclical peak, highlighting the severity of the damage.

We have seen hopes for a return to stronger global growth dashed by a series of setbacks, evident in the long succession of downgrades to the IMF's global growth forecasts shown in this chart.



For most major advanced economies, extremely easy and, frankly, experimental monetary policy settings have failed to generate a significant recovery in household spending and business investment.

The US, which was at the epicentre of the crisis, is now emerging as a bright spot in the global economy.

While the US economy is still operating below its potential and a sizable percentage of the population remains disconnected from the labour market, there are reasons to be cautiously optimistic that the US economy may have turned the corner and that sustained strong growth will start to reduce excess capacity.

To my mind, this owes as much to the remarkable flexibility of labour and product markets in that nation as to policy interventions since the global financial crisis.

Growth is becoming increasingly broad-based and the labour market continues to strengthen.

If this continues, the conditions will be in place for the Federal Reserve to continue unwinding monetary stimulus.

While the adjustment period may present its own challenges, this would start to reduce the serious risks inherent in a prolonged period of very low interest rates.

Unfortunately though, downside risks continue to dominate in other major economies.

Despite the benefits of the fall in oil prices over the past year and very low interest rates, persistent economic weakness continues to plague large parts of Europe and Japan.

Key for Australia, the IMF also recently downgraded its outlook for China's growth to reflect its ongoing transition to more moderate but sustainable growth.

This brings the IMF's forecasts for China in line with those published in the Mid-Year Economic and Fiscal Outlook in December last year.

Recent Chinese data support this revised outlook.

Although there are concerns about the extent of China's slowdown and the potential risks arising from the rapid expansion of credit over the past decade.

The moderation in China's growth prospects was one factor driving the rapid reduction in prices we receive for our key commodity exports through last year.

Subdued growth prospects leave the global economy vulnerable to a range of potential shocks.

Stress testing highlights the vulnerability of some financial institutions in Europe.

Recent developments with regards to Greece are a reminder that the structural shortcomings of the Eurozone also remain a significant threat.

And geopolitical risks loom large in many parts of the world, most notably Eastern Europe, the Middle East and Asia.

That said, the Australian economy has performed well by the standards of our peers since the global financial crisis.

There are few, if any, developed countries that would not trade their circumstances for our own.

We avoided the increases in unemployment and substantial loss of productive capacity experienced by most other developed nations.

But we did not emerge from the global financial crisis unscathed.

Our economic growth has been below its long run average in 5 of the past 6 financial years, weighing on job creation and contributing to a gradual upward drift in unemployment.

Critically important for Australia’s near term growth prospects is that we must now secure stronger growth in non-mining business investment as the resources investment boom fades.

Cheap credit, lower fuel prices and the depreciation of the exchange rate will assist, although weak demand is weighing on confidence and current investment plans.

This is reducing the preparedness of businesses to invest in future capacity and take on additional workers.

Treasury’s forecasts are for the Australian economy to grow at a below-trend rate over the next two years, making significant inroads into unemployment difficult.

In my view, one factor not fully recognised as constraining growth - both in recent years and in the future - is the tighter regulatory requirements on major global and some national banks, as well as the more conservative risk appetites of global financial institutions.

During the 1990s and first half of the 2000s, the balance sheets of global financial institutions expanded at a rapid pace.

This was an important driver of the strong growth in real GDP and employment experienced by most major advanced economies prior to 2008.

But at the same time, it also drove a significant increase in private sector indebtedness and far greater risk in the financial sector.

This was unsustainable.

The tighter regulatory and capital rules introduced since the global financial crisis will lead to a more stable financial system over time but they have resulted in financial institutions becoming more circumspect.

This has made it more difficult for businesses to gain access to bank balance sheets, weighing on investment to the detriment of potential growth.

In a world where many economies have struggled to generate growth, we have also seen countries seemingly engaging in the zero sum game of competitive currency depreciation.

The US is an example of an economy that appears to have benefitted from exchange rate depreciation in some past episodes.

The flexibility of US product and labour markets has meant that the relative price signals sent by a decline in the exchange rate have been effective in shifting resources to export and import-competing industries in support of stronger growth.

Similarly, with the euro, Germany has also benefitted from being a member of a currency bloc with weaker peripheral economies that suppress Germany’s effective exchange rate.

The flip side though is that Germany’s participation in the currency bloc may have supported the euro to the detriment of the peripheral economies.

While a lower exchange rate can support growth, currency depreciation is not a badge of honour.

In Australia’s case, we have benefited enormously from our flexible exchange rate.

It has served as an important shock absorber and was a key reason why the most recent commodities price boom did not generate the kind of macroeconomic instability that we saw when the terms of trade peaked in the 1970s.

But we cannot rely on a lower exchange rate to solve our growth challenges.

As evidenced in the 1980s, a lower exchange rate must go hand in hand with good structural and fiscal policy.

We need to start now - not leave it to the next generation to pick up the pieces and face even tougher choices in the years ahead.

Fiscal Repair

An immediate priority is to repair the fiscal position.

Since 2007-08, the Australian Government's fiscal position has deteriorated from surpluses in the order of 1½ per cent of GDP to deficits in the order of 3 per cent of GDP.

Commonwealth Government net debt has increased from negative 3.8 per cent of GDP to positive 12.8 per cent of GDP in 2013-14 and continues to rise.

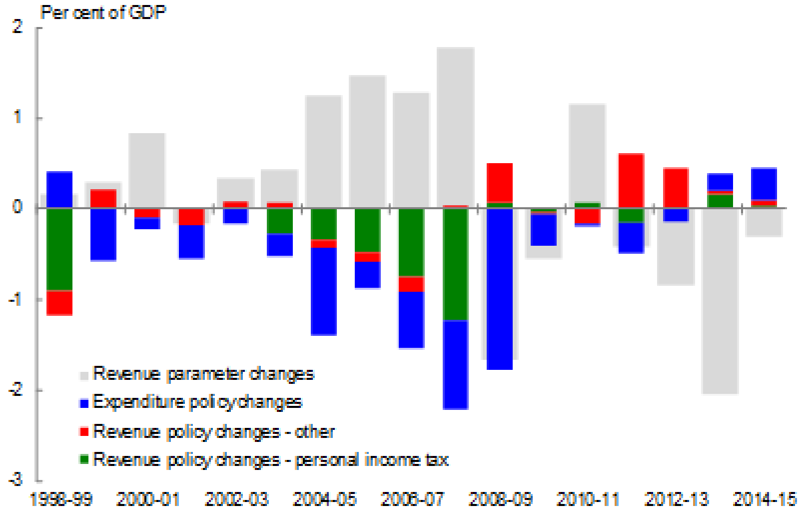
Net debt is approaching the levels that we last saw after the recession in the early 1990s, which at that time was the highest we'd seen in Australia since the years following World War 2.

Importantly, this debt is currently being serviced with interest rates at a little under 3 per cent.

The debt burden is growing with each budget deficit and will grow even faster when interest rates rise.

The start of the structural deterioration in the Commonwealth's budget position began before the global financial crisis.

Net impact of unexpected revenue windfalls, spending decisions and tax cuts



This chart shows the impact on the budget bottom line of unexpected revenue parameter changes (the grey bars), personal income tax cuts (the green bars), other revenue policy changes (the red bars), and new expenditure decisions (the blue bars).

The grey bars above the line show that the Government received positive revenue surprises at successive budget updates from around 2002-03 to 2007-08, primarily due to the terms of trade persistently exceeding Treasury's forecasts.

The green and blue bars below the line show that these positive revenue surprises were largely handed back through personal income tax cuts or spent.

In real terms, Commonwealth Government spending grew at an average annual rate of around 3½ per cent between the start of the terms of trade boom in 2003-04 and the start of the global financial crisis in 2007-08, while taxes fell as a share of GDP.

Some of the proceeds of our once-in-a-generation commodity price boom were used to pay down debt and set against future liabilities through the creation of the Future Fund.

There was also some increase in infrastructure investment.

But a very substantial amount was spent, including on untargeted transfers (so called middle class welfare) without sufficient regard to the future prospects for servicing those ongoing transfers.

Generous income testing arrangements for Family Tax Benefits in the early 2000s and access to million dollar contributions to tax-preferred superannuation through 2006-07 were notable examples of middle or higher income welfare that contributed to the problem.

It is my strong belief that as a society we have a moral obligation to assist the worst off, including the disabled and those who are not in a position to provide a basic standard of living for themselves and their families.

The tax and welfare systems are a means of doing this but we must ensure that fiscal transfers are well-targeted.

Not only did we enter the global financial crisis with a Commonwealth Government budget that was structurally weaker than the budget balance suggested but the pace of Government spending growth has remained high since.

Initially this could be attributed to fiscal stimulus measures.

But while many of these measures were subsequently unwound, growth in Commonwealth Government spending continued apace.

As you can see from the chart, it wasn't until 2013-14 that expenditure policy decisions started to make a positive contribution to the budget bottom line.

Commonwealth Government spending has grown at an annual average of more than 4 per cent in real terms since 2007-08, compared with 3 per cent during the 1980s and 1990s.

As a result, spending in 2013-14 was around 2½ percentage points higher (as a proportion of GDP) than it was 6 years ago.

This strong growth in expenditure highlights that weakness in revenue is only partly to blame for the current state of government finances.

The reality is that Australia has spent its way to a structural budget problem. Government payments are growing faster than government revenues and without action, this trend will continue.

Why do I place such an emphasis on fiscal sustainability?

The importance of fiscal sustainability for Australia was spelt out long ago in a 1993 report to former Treasurer Dawkins on National Savings, prepared with the very considerable assistance of the Treasury.

The argument at the time, which is as relevant now as it was then, is that we cannot continue to finance recurrent expenditure by continuing to increase our debt.

The result would be increasing exposure to external shocks, an erosion of intergenerational equity and a rising premium on our borrowings that would reduce our long run growth potential.

The Report highlighted the importance of public saving to Australia's national savings and the need for a strong government balance sheet given Australia's relatively high levels of private indebtedness by international standards.

This remains the case today.

The Report made an important contribution to the establishment of a medium term framework for setting fiscal policy in Australia, centred on the Commonwealth achieving budget surpluses on average over the economic cycle.

It argued that the States should also run fiscal surpluses on current spending but small deficits overall that they would use to finance productive infrastructure investment.

This remains a sound framework for setting fiscal policy in Australia today.

It supported reductions in government debt during the second half of the 1990s and early to mid-2000s, providing an important buffer when the global economy was hit by crisis.

But seven years after the start of the crisis, our fiscal buffers have been eroded and we need to undertake fiscal repair.

I would also like to emphasise that it would be naïve to rely on a short term boost in economic activity to address Australia's fiscal challenge.

Returning the budget to a modest surplus by 2017-18 (the end of the forward estimates period in the Mid-Year Economic and Fiscal Outlook) would still require real GDP growth to average around 4 per cent over the next five years – compared with Australia's trend growth rate of around 3 per cent.

And this calculation assumes that the measures – or those of an equivalent order of magnitude - announced in last year's budget that remain before the Parliament are implemented.

If they're not, real GDP growth would need to average roughly 4½ per cent to return the budget to surplus by the end of the forward estimates period.

Even putting to one side whether sustained 4 per cent growth is realistic, given the significant headwinds - it's not clear that the economy could sustain the pace of demand growth necessary to return the budget to surplus by the end of the forward estimates period without generating significant inflation or pressure on available skills.

The more sophisticated advocates of the growth strategy argue that spending should be boosted on productive infrastructure investment.

My assessment is that the key to solving Australia's infrastructure challenge is far more to identify projects with a demonstrated high rate of economic return.

Where such projects exist, there is no shortage of private sector financing.

More fundamentally, those that say the government should spend its way to stronger growth in the near term tend to ignore the costs to growth in the medium to long term of higher government debt or higher average tax rates.

My view is that we need to address Australia's structural budget problem through greater expenditure restraint, where the international experience shows what can be achieved over relatively short time periods.

By way of comparison, the UK has reduced their budget deficit by a cumulative 4.6 per cent of GDP since the peak in 2010 to a deficit of 5.6 per cent of GDP.

The US budget deficit has been reduced by a cumulative 7.0 per cent of GDP since the peak in 2009 to a deficit of 2.8 per cent of GDP.

A key difference for Australia of course is that our economy was not as hard hit by the global financial crisis as the US and UK and we are not experiencing the same rebound in our growth.

But it's also the case that the US and UK have been more successful in reigning in the growth of government expenditures than we have been in Australia since the global financial crisis.

Over the past five years, general government expenditure has declined in real terms in both the US and the UK.

As I mentioned earlier, this compares with annual growth in real Commonwealth Government expenditure of more than 4 per cent on average over the same time period.

For any realistic assessment of future growth prospects, the only way that significant fiscal repair will be achieved in Australia is committing now to savings measures that build over time to deliver a return to surplus over the medium term.

Long Term Growth Drivers

The Treasurer will have more to say about Australia's fiscal position when he releases updated 40 year projections in the Intergenerational Report (IGR).

This will be an opportunity for a discussion about Australia's medium term fiscal position and the policy changes needed to provide for the sustainable provision of essential government services.

I will spend a few minutes reflecting on the trends that we're seeing in the three drivers of long term economic growth - population, participation and productivity - and the implications for policy.

Before I do, one point to note is that - when we project forward the economy's productive potential - we are presenting one possible outcome based largely on a set of assumptions.

The IGR will present sensitivity analysis showing the impact of changes in the economic assumptions on the fiscal projections, recognising that relatively small changes in important assumptions can have a major cumulative impact over a 40 year period.

These bands of uncertainty don't in any way detract from the IGR projections.

Quite the opposite.

They all highlight the importance of placing our policy frameworks in the strongest possible position to meet whatever challenges the future may bring.

Where we can be confident is projecting long term demographic drivers in the economy and here it is clear that the ageing of Australia's population will weigh heavily on Australia's potential growth rate and long term fiscal position.

Where there is more uncertainty is projecting future trends in productivity.

An assumption that has been used in successive IGRs is that Australia's labour force productivity is assumed to grow at its long run average.

This long run average growth rate includes the period of strong productivity growth following the reforms of the 1980s and 1990s.

We should not take for granted that productivity growth of this order will be repeated, particularly in the absence of a reinvigorated structural reform effort.

We should also not interpret the IGR projections of long term 3 per cent growth as suggesting that this growth will somehow come from the heavens.

For the economy to operate at its productive potential at any point in time requires matching growth in demand.

This can only be achieved if households and businesses are sufficiently confident about the future direction of the economy to increase spending and investment.

And we must also see international demand growth.

With those caveats, the first key driver of economic growth in the medium term is population.

In recent years, Australia's population growth has been amongst the fastest in the developed world, driven by migration.

A growing population can be a source of dynamism for the economy.

It provides a larger domestic market for business, increases the size of the labour force and facilitates the injection of new ideas.

But it also places additional demands on government budgets in areas such as infrastructure, health and education.

I have seen this firsthand in the United Kingdom where the results are very sobering.

The population projections in the IGR will provide a basis on which governments can plan for the future.

The second key driver of medium term economic growth is workforce participation.

Over the next 40 years, Australia's population will continue to age as the baby boomer generation grows older and this will place downward pressure on workforce participation.

This is because, while the labour force participation rates of older workers are rising - reflecting both advances in health and the less physically demanding nature of new jobs being created in the economy today - participation in the workforce still tends to decline as people approach retirement.

This means that, as the population ages, declining workforce participation will be a drag on Australia's economic growth.

It also means that there will be a greater burden on a smaller proportion of working individuals to raise the revenue to support government services.

This highlights the importance of policies that aim to increase labour force participation, where the focus should be on embracing the potential of older Australians and encouraging the participation of younger Australians, particularly women.

The third key driver of economic growth is productivity.

Indeed, just as productivity was the main driver of growth in per capita income over the past 40 years, our success in raising Australia's productivity performance will largely determine Australia's growth and prosperity over the next 40 years.

For Australia's per capita national income to grow at the historical average of 2.2 per cent per annum over the next decade, annual labour productivity growth would need to increase to around 2.7 per cent to counteract the effects of population ageing and a falling terms of trade.

This is well in excess of what has been achieved in the past 50 years - and almost double what was achieved in the past decade.

These statistics really frame the challenges to our economy and need to be taken seriously.

Structural Reform Priorities

We remain the envy of most of Europe and the global economy generally because we completed important reforms in the 1980s and 1990s that drove productivity growth.

Reform stalled in the 2000s but incomes rose with historic rises in the terms of trade and mining investment.

We need to reinvigorate structural reform to boost productivity growth and sustain increases in living standards.

Boosting productivity will require improvements across all markets – input markets such as the labour market, financial markets, and infrastructure markets as well as final goods and services markets.

Failure to undertake necessary reforms in related markets will mean that the potential benefits of reform in any single market are not realised.

The Government has commissioned a number of policy reviews that will recommend ways to enhance Australia's economic prosperity.

Making the most of these reform opportunities is essential, where three areas stand out as priorities for raising Australia's productivity performance.

The first is tax reform.

Studies have consistently shown that tax reform offers one of the largest policy opportunities to increase incomes and living standards.

And the fact is that the structure of our tax system today looks remarkably like it did back in the 1950s – but our economy looks very different.

That may tell us something.

Tax reform can promote strong investment and encourage workforce participation.

Our company tax rate is high by international standards.

In the context of far more mobile capital, high tax rates are dampening investment and productivity, while continuing personal income tax bracket creep would have negative impacts on workforce participation and incentives.

An important criterion for a well-functioning tax system is fairness, where there are some contentious and important issues that need to be explored.

For example, substantial tax assistance is provided to superannuation savings.

We need to consider whether the level and distribution of these concessions remains appropriate.

These are the types of issues that will be considered in the upcoming Tax White Paper.

A second priority is continuing to modernise the workplace relations system.

Workplace regulation has been progressively and substantially reformed in recent decades.

Many of the fundamental reforms were undertaken in the 1980s and 1990s, in particular the shift from centralised wage fixing to enterprise bargaining.

These reforms have delivered substantial benefits.

But elements of our workplace relations system may need to change to fit the workplaces of our future.

The Productivity Commission's Inquiry into the Workplace Relations Framework to be delivered later this year will be an important opportunity to create a modern system that will support jobs, promote productivity and lift living standards.

A more flexible workplace relations system that supports the economy will help Australia respond to the challenge of lifting productivity growth.

The rise of Asia, the ageing of the population and the transition away from resource-led growth will require significant adjustment.

It is especially important that workplace laws are not impeding workplace transformation.

A third priority area for structural reform is driving greater competition in goods and services markets.

Previous product market reforms, and those associated with the Hilmer review in the 1990s, pushed competition into non-tradable sectors like electricity, telecommunications and rail freight.

These were important changes, contributing to a GDP increase of around 2½ percentage points over the course of that decade.

The proposals in Ian Harper's draft report released in late 2014 provide the opportunity to boost Australia's productivity performance.

The final report will be released in March.

Ian Harper proposes that we apply competition law and a new set of competition principles to all purchasing activities of government such as health, education and aged care.

Even small improvements here, where government has a large footprint and where Australia's population will impose greater demands on health and aged care, can deliver big benefits over time.

The importance of strengthening competition was also a theme of the Financial System Inquiry.

The Inquiry concludes that competition and competitive markets are at the heart of the philosophy of the financial system and the primary means of supporting the system's efficiency.

We must ensure that our banking and financial system more generally are more competitive.

The Inquiry also recognised that, as the financial system becomes increasingly sophisticated and innovative, the importance of receiving appropriate financial advice and access to appropriate and competitively priced products has increased.

These are challenging issues and will require the Commonwealth and the State governments to work together.

Concluding Remarks

We live in a great country.

But we now face challenges generating growth and a budget position that will deteriorate further if not acted upon.

Government debt is not at crisis levels and public debt interest remains low as a share of both nominal GDP and government expenditure.

But no action to stem the growth of government debt and/or any substantial rise in interest rates threaten to make net debt a bigger issue in future.

If we set ourselves on a path of sensible fiscal repair and lay out credible plans for structural reform that address our long-term growth challenges, then the consumer, business and investor sentiment that is critical to lifting economic activity in the near-term will materialise.

We face many challenges that can only be addressed through considered and informed public debate.

It's important that we focus in a mature way on the policies that will maintain Australia's status as one of the world's leading economies.

Thank you for your time today.

I welcome any questions.