Gala Address to the Melbourne Institute Economic and Social Outlook Conference

SUSTAINING GROWTH IN LIVING STANDARDS IN THE ASIAN CENTURY

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SUSTAINING GROWTH IN LIVING STANDARDS IN THE ASIAN CENTURY

Introduction

Thank you for inviting me to be here with you today at this, the seventh Economic and Social Outlook Conference. I would like to congratulate the Melbourne Institute and The Australian for what is, without doubt, Australia's pre-eminent economic and public policy event.

A consistent theme of past conferences has been the importance of continued policy reform to improve the opportunity for all Australians. This year's topic, *Growth Challenge – riding the resources boom to lasting prosperity*, is firmly in that tradition.

Tonight I wish to discuss some of the challenges to securing long run prosperity, but before I do I would like to make a few remarks on the sources of prosperity.

The sources of prosperity

Our prosperity is a function of the ingenuity, innovation, skills and flexibility of our people combined with the quality of our national institutions. Without these, our rich resource base would leave us no better off than many other countries around the world, equally endowed with great resource assets but unable to convert the opportunity into sustained benefits for their populations.

It is the choices that we make as a nation today that will determine our living standards into the future, in the same way that it is past decisions that have determined the society and economy we live in today.

It was the flexible, adaptable economy built by two decades of structural reform that gave us the opportunity to minimise the damage of the Global Financial Crisis.

It was the results of many years of sound macroeconomic policy, in particular our robust monetary policy framework, our fiscal framework and low government debt that provided the scope to respond to the GFC.

And it was the strength and quality of our leadership and our institutions that saw us act quickly to deliver the macroeconomic response in the face of global and regional crises.

It was a combination of decisions made over a quarter of a century that means Australia, in contrast to the major developed economies, is experiencing solid growth, low unemployment and increasing living standards. It is why we not only survived the GFC but coped with the Asian financial crisis of 1997-98 and avoided the early 2000s tech-wreck recession that afflicted many other developed economies.

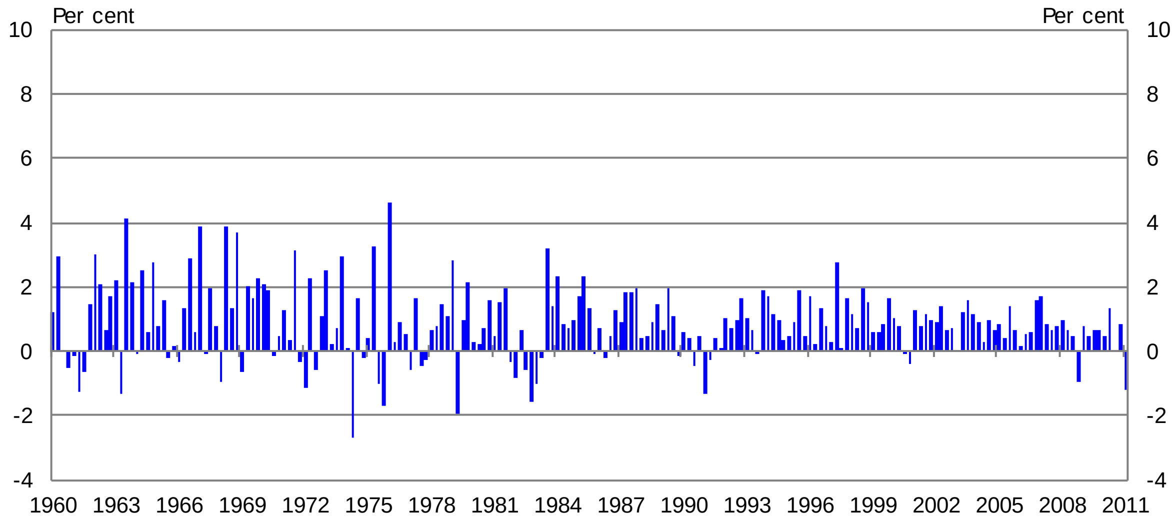
And it is why the sub-text of this Conference is “securing prosperity”, not “how to create growth” or “how to reduce high and sustained unemployment”.

Daily we are reminded of the many vulnerabilities and uncertainties in the global economy. This places a premium on good policy and a flexible economy to allow us to withstand shocks from any source.

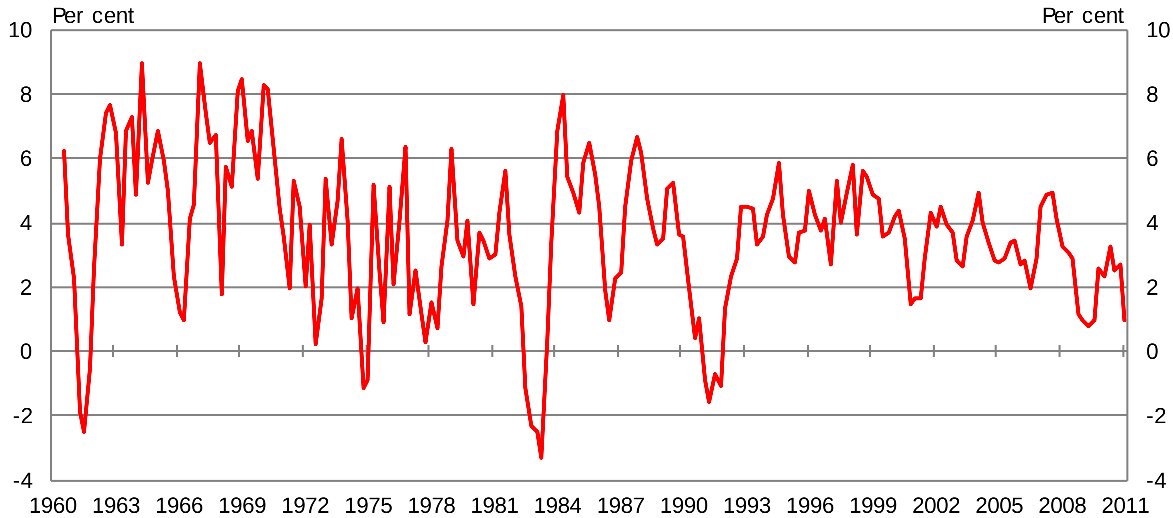
Indeed, the stability and resilience of the Australian economy in the last two decades is unusual, both with respect to our own historical experience and with that of other advanced economies (Chart 1).

Chart 1: Growth in real GDP

Quarterly



Year ended



Source: ABS Catalogue Number 5206.0 and Treasury

The 20 years of economic growth commencing in 1991 is unique among developed economies over this period and is one of the longest periods of growth Australia has recorded.

A consequence of this is that around a half of the current workforce has never experienced a major slowdown in activity in their working lives.

Opportunity beckons

Looking to the future we face a number of challenges that, if handled well, will further build and sustain our modern prosperity. If handled badly, future generations will pay the price for our mistakes, our lack of courage and the short-termism of our vision.

The shift in global economic weight, an ageing population and an industrial structure and environment vulnerable to climate change, pose challenges – but they also bring with them significant opportunities.

Global economic transformation

Let me start with what is clearly our greatest economic opportunity, the emergence of fast growing developing economies across the globe, but particularly in Asia.

Together, China and India account for around one-third of the world's population, yet in 1990 they accounted for less than 10 per cent of the world's GDP. Economic reforms and opening to the rest of the world that commenced in both countries in the later part of last century has seen them move to around 20 per cent of world GDP today, in a period when world GDP itself nearly doubled. On some projections, China and India are expected to comprise around one-third of world GDP by 2030.

Australians know intimately one of the consequences of this massive shift in the centre of economic gravity back towards Asia – the industrialisation and urbanisation underway in a number of countries in the region, but particularly in China, has driven our terms of trade to 140 year highs.

Some suggest that as a result we should take action to reduce our so called "dependence on China".

While the share of our exports going to China has risen sharply, its importance to us as an export destination is not much different to that of Japan even today, and is well shy of the historical importance of the United Kingdom. Moreover, even if we redirected all of our exports elsewhere, China's emergence would still be impacting on our economy as global commodity prices would still be determined in global markets. The critical issue here is that China is now so big that it shifts global demand for resources and global supply of manufactures.

As such, we are "dependent" on China in much the same way that we are "dependent" on the United States – the global economy is so integrated that what happens elsewhere impacts us directly. The ever-unfolding European sovereign debt crisis should be making that clear if the GFC did not!

A more legitimate concern is the fear that China's growth "can't last" and that, as a result, we should be saving the proceeds of the boom and the high terms of trade.

In a recent speech I noted the importance of running tighter fiscal policy and boosting national saving if the economy unfolds as we anticipate in 2013-14 and beyond, and I will not revisit that here.[1]

But let's look at whether China's growth is likely to be ephemeral.

It is clear that a loss of growth momentum in China, or India for that matter, poses a source of risk to the global economy and hence to Australia. In that respect they are no different to other large and systemically important countries. Recall that we used to say "if the US sneezes Australia catches a cold".

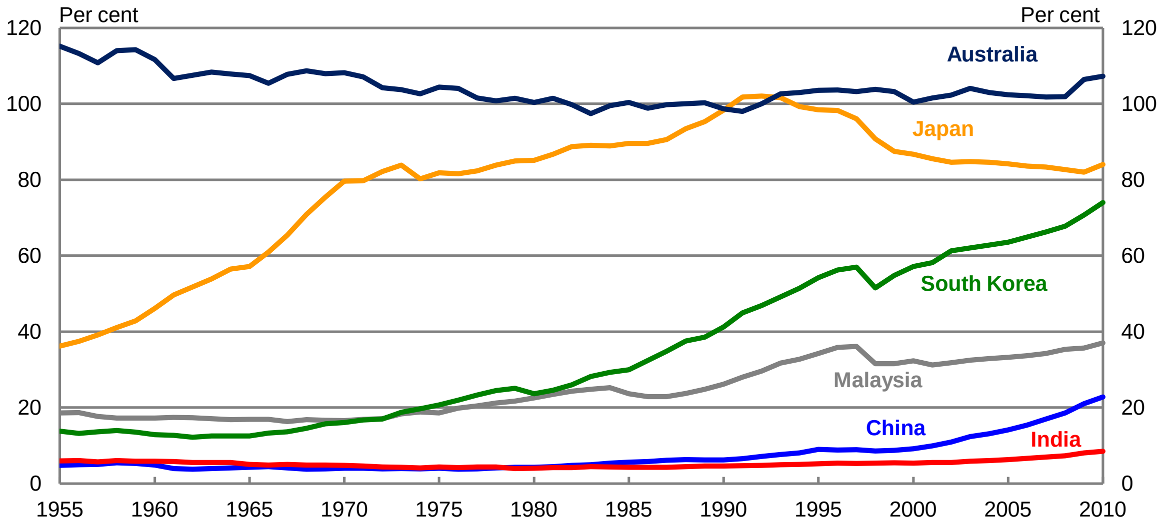
[1] Parkinson, M., "Opportunities, Challenges and Implications for Policy". Annual post-Budget address to the Australian Business Economists, delivered on 17 May 2011.

In the case of China, the challenges of managing the economy are more marked than elsewhere as the authorities continue the transformation towards greater reliance on market-based policy instruments.

This heightens the risk of policy mis-steps in China and reinforces the need for good policy in Australia.

But short of major social dislocation or global geo-strategic tensions it is hard to believe that the industrialisation and urbanisation currently underway in both countries does not have many years to run. Let me be clear, I am not suggesting that China's growth path will be without volatility, but rather that viewed through the prism of history, this will look like cycles around a strong trend in growth. This means the impacts on Australia will be sustained and profound.

Chart 2: GDP per capita
(Per cent of OECD -15 average)



Note: OECD-15 = Australia, Austria, Belgium, Denmark, Finland, France, Iceland, Ireland, Netherlands, Norway, Sweden, Switzerland, UK, US and Canada.
Source: The Conference Board Total Economy Database and Treasury.

China is further down the development path than India but still has a long way to go to converge to income levels of other countries (Chart 2).

But China is also a demographically older society than India. Indeed, it is less than a decade ago we were wondering whether China would get rich before it got old. I think we know the answer to that question now – while still home to many desperately poor people, China has been rapidly approaching upper-middle income status and will shortly become the largest economy in the world. If India can maintain its growth momentum and grow its human capital base, it will also benefit from a significant demographic dividend – that is, India's working age population is growing as a share of its total population.

These are momentous developments in the global economy, but they raise significant issues for Australia.

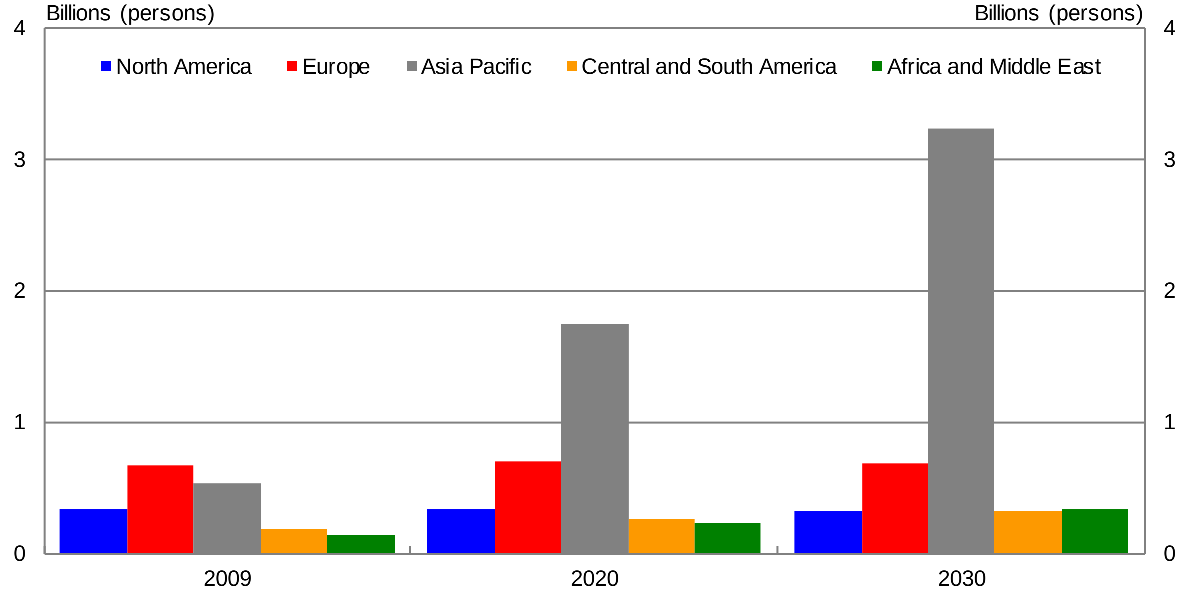
As I noted earlier, Australians appreciate the positive impact of the rise of China and India on demand for our commodities and the resulting impacts on mining exports, investment, profit and employment, and on our national terms of trade.

We are also gradually coming to realise the negative implications in terms of the structural adjustment being forced on parts of the non-mining sector by the sustained increase in the exchange rate.

As urbanisation and industrialisation in China and India continue over the decades ahead, commodity prices, our terms of trade and, hence our exchange rate, are likely to remain well above historical levels.

What we have still not begun to appreciate, though, is the implications of the emergence of a massive new middle class in Asia arising from the success of China and India in lifting hundreds of millions of people from poverty (Chart 3).

Chart 3: Projections of the global middle class by region



Source: Kharas, H and Gertz G, 2010, 'The New Global Middle Class: A Cross-Over from West to East' in C Li (ed), China's Emerging Middle Class: Beyond Economic Transformation, Washington, DC, Brookings Institution Press.

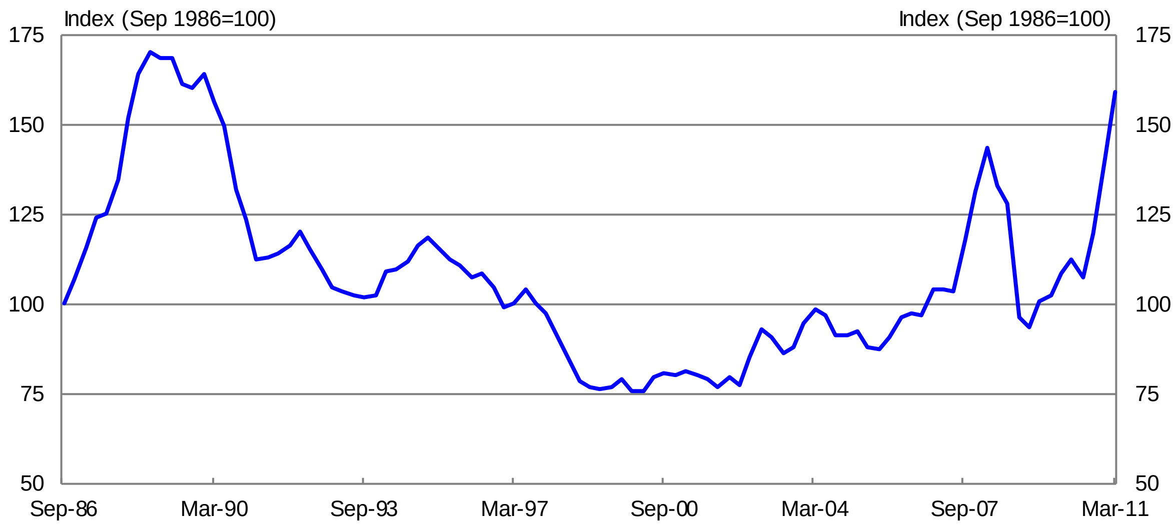
This poses a source of new opportunity for Australia – a massive potential market for our exports, especially knowledge based exports like education and high-end manufacturing; services like tourism; and rural commodities.

But these opportunities will not fall into our lap – there is nothing pre-ordained that says Australia will be the beneficiary of these developments. To take advantage of them requires a significant change in the structure and mindset of Australian business, longer-term vision on the part of investors, and sustained improvement in the skills sets of Australian workers.

In education, we will be challenged by the rapid growth and improvement in the quality of competitor institutions elsewhere in Asia and in the rest of the world. In tourism, we have to build on our natural advantages, not just rely on them. And I am continually surprised that Australian investors have not yet realised the potential benefits of this new middle class for our agricultural industries.

We tend to focus on the significant increase in non-rural commodity prices, but it is worth highlighting that rural commodity prices have increased significantly in recent years, in part reflecting rising demand from Asia (Chart 4). This growing demand can be expected to continue as incomes rise and will create unforseen opportunities for Australian agricultural producers, notwithstanding the global issues around rising food prices.

Chart 4: Rural commodity price index (Real USD)



Source: Reserve Bank of Australia and Treasury.

Reaping the benefits

So, how do we exploit the opportunities opening up before us?

The first point to recognise is that when we sell resources and energy we are selling non-renewable assets. Yes, we have large supplies, but it is still the case that once sold, those assets cannot yield any further returns for Australia's citizens.

This means that it is critical that society receives an appropriate return on the assets rather than the value being captured solely by the Australian and foreign shareholders of the companies that sell the assets.

Arguably, this is not presently the case.

Second, we need to recognise that not all Australians will automatically share in the benefits.

The rise in commodity prices has boosted mining sector profits and made it easier for miners to pay more for the factors of production they require — predominantly capital and skilled labour.

Non-miners not only find they have to pay more to prevent skilled labour being bid away, those that are exporters or compete with imports also see their competitiveness eroded by movements in the exchange rate in response to the higher terms of trade.

But this higher exchange rate is also one of the ways in which the benefits of the mining boom are spread to consumers – witness the dramatic falls in the prices of imported consumer goods.

The structural adjustment being forced upon the economy by these changes will be dislocating for many firms, workers and regions. The challenge for policy makers is to facilitate as smooth an adjustment as possible for all affected.

Australia's own economic history shows the futility of attempting to stand against such transformative forces, and the importance of focusing assistance on workers, not firms; and in encouraging innovation and investment in skills.

Productivity

The third issue we need to focus on, if we are to take advantage of our economic opportunities, is productivity.

Living standards are ultimately about productivity – how much individuals, businesses and governments produce for each unit of labour and capital. In the long run, productivity growth – producing more from the same inputs – is the only sustainable way for future generations to enjoy higher living standards.

Terms of trade shocks such as we have been experiencing are best thought of as a level shift in living standards – they raise our gross national income and our purchasing power but unless the terms of trade continue to climb we have to rely on productivity growth to drive future growth in living standards.

As you know, the Treasury assumes that the terms of trade will come off only slowly, declining by around 20 percent over the next 15 years.

So while our central scenario is for the mining boom to continue, for resource prices to stay well above historical norms well into the future, and for the growth and development of Asia to continue unabated in trend terms, we expect growth in living standards to slow over time unless productivity growth improves.[2]

Ironically, the policies needed to sustain the growth in living standards are exactly the sorts of policies we need to pursue to deal with the other two big challenges I noted at the outset – an ageing population and climate change.

If we look at the contributions of productivity and the terms of trade to growth in real GNI per capita over the past two decades, it is clear that labour productivity has been the most significant contributor to the increase in real incomes (Chart 5).

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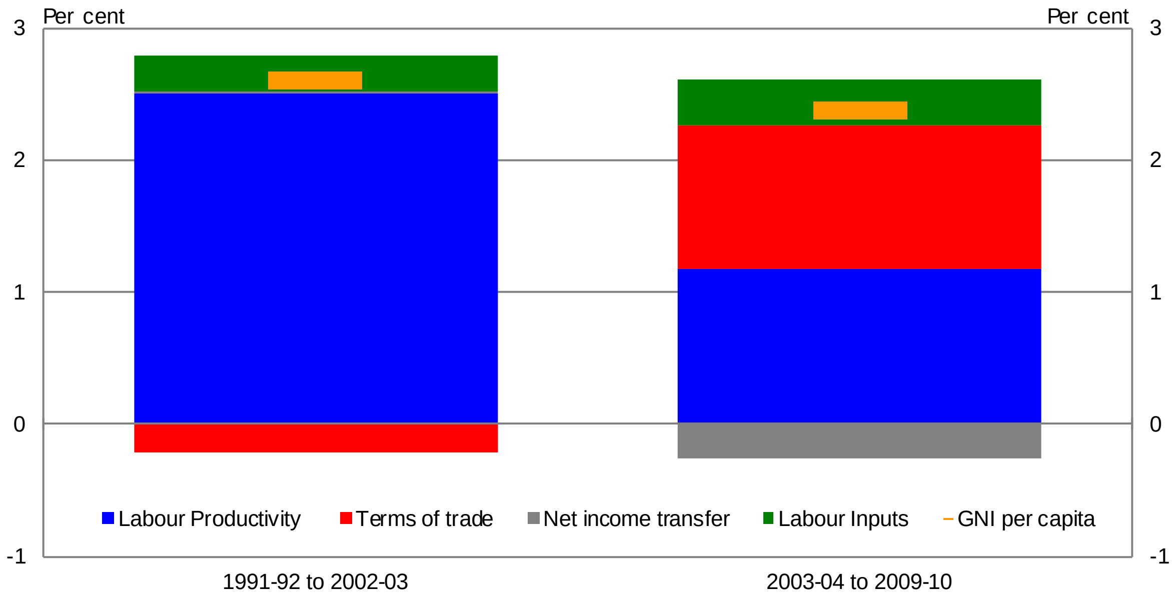
[2] Average living standards can also be boosted by improving participation in the labour force but for today's purposes I will only focus on productivity growth.

Chart 5: Components of real GNI growth



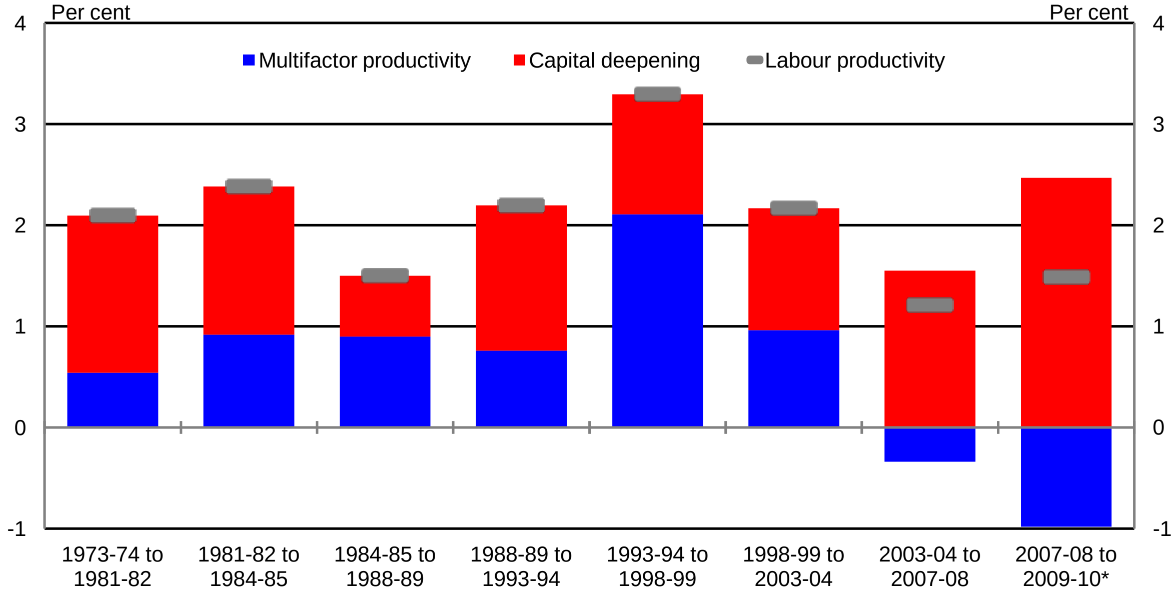
Source: ABS Catalogue Number 5206.0 and Treasury.

Trends in Australia's Productivity

Given the critical role of productivity, it is worth looking at how Australia's recent productivity performance compares against our own history and against developments overseas.

Labour productivity in the market sector grew strongly during the 1990s — over 3 per cent per annum during the 1993-94 to 1998-99 productivity cycle, significantly above the long run average of around 2 per cent (Chart 6).

Chart 6: Productivity growth
(Market sector)



Note: * Denotes incomplete cycle.
Source: ABS Catalogue Numbers 5206.0, 5260.0.55.002 and Treasury.

Aggregate labour productivity growth can be decomposed into two components — the impact of capital deepening (the amount of capital per worker) and how cleverly we combine capital and labour, or multifactor productivity (MFP).

The strong labour productivity performance during the 1990s was driven primarily by multifactor productivity growth which averaged around 1.4 per cent per annum over the decade.

To put the growth in labour productivity into perspective, an Australian worker in 2000-01 produced over 24 per cent more for every hour worked than in 1990-91.

This labour productivity growth resulted in a significant improvement in living standards — with real net national disposable income per capita increasing by over 27 per cent (or around $8,000) over the same period.

It is widely accepted that the economic policy reforms of the 1980s and 1990s transformed the dynamics of the Australian economy, helping drive this surge in productivity growth.

It was these same reforms that provided the macroeconomic benefits of greater stability and resilience that I mentioned earlier in discussing the GFC.

But as the chart 6 shows, there are considerable lags between action and outcome.

More recently, Australia's productivity growth — measured in terms of both labour productivity and multifactor productivity — has slowed, and there is little reason to believe it will improve in the immediate term.

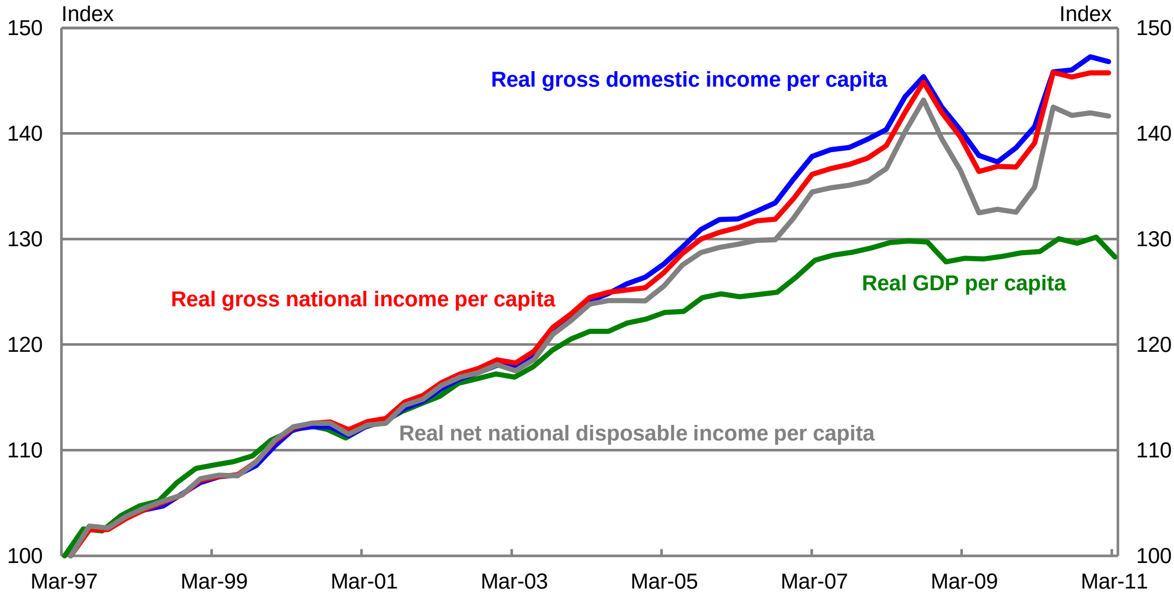
Indeed the rate of improvement in the living standards of Australians, at least that part measured by incomes, has already begun to deteriorate, even with the sustained and unprecedented rise in the terms of trade.

So while increased employment and very strong labour productivity growth boosted national income, notwithstanding a falling terms of trade, between 1991-92 and 2002-03, more recently labour productivity has slowed sharply while the terms of trade have provided a boost to national income of over 1 per cent per annum. At the same time, the transfers of income offshore have increased as rising profits in the resources sector accrue to foreign investors.

As noted, falling multifactor productivity has driven the slowing in labour productivity growth in the market sector. MFP fell by 0.3 per cent per annum in the most recent completed cycle — 2003-04 to 2007-08 – and has fallen by around 1 percent per annum since.

By contrast, the contribution of capital deepening averaged 1.6 per cent a year, reflecting strong business investment as a result of Australia's recent terms of trade boom.

Chart 7: Measures of per capita production and income



Source: ABS Catalogue Number 5206.0 and Treasury.

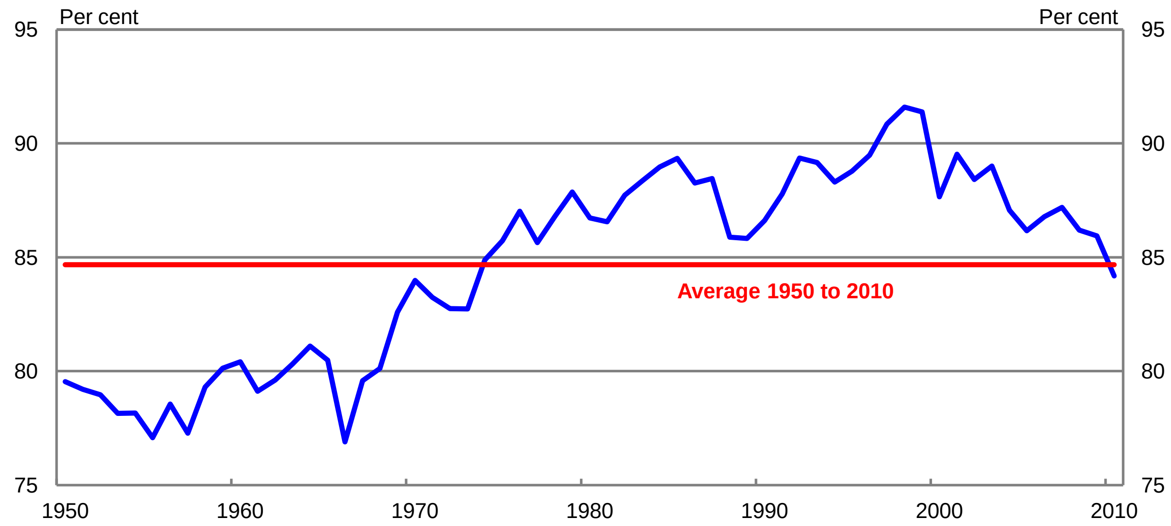
GDP per capita, while slowing since 2008, continued to grow during the 2000s (Chart 7). This is because business utilised increased amounts of capital and labour in production – in fact, since 1999-00 real business investment has more than doubled, while employment has increased by around 25 per cent over the same period. While this may seem odd, it may actually reflect the success of our economy during the period, something I will come back to in a moment.

International comparisons of Australia's productivity

While we have seen a significant slowdown in Australia's productivity performance it is useful to consider our performance against other developed economies, especially against the United States which is typically thought to represent the benchmark for productivity performance.[3]

Relative to the United States, Australia's labour productivity fell from a peak of nearly 92 per cent in the late 1990s to around 84 per cent last year – the lowest since the early 1970s and below its long run average (Chart 8).

Chart 8: Australia's labour productivity level relative to the United States



Source: The Conference Board Total Economy Database, January 2010.

While Australia's recent performance against the United States may to some extent reflect the different economic cycle in each country (with the severity of the US downturn[4] contrasting with the fears of labour shortages in Australia), at least at one level this suggests that all of the improvement in our **relative** productivity due to the reforms of the late 1980s and 1990s has now disappeared.

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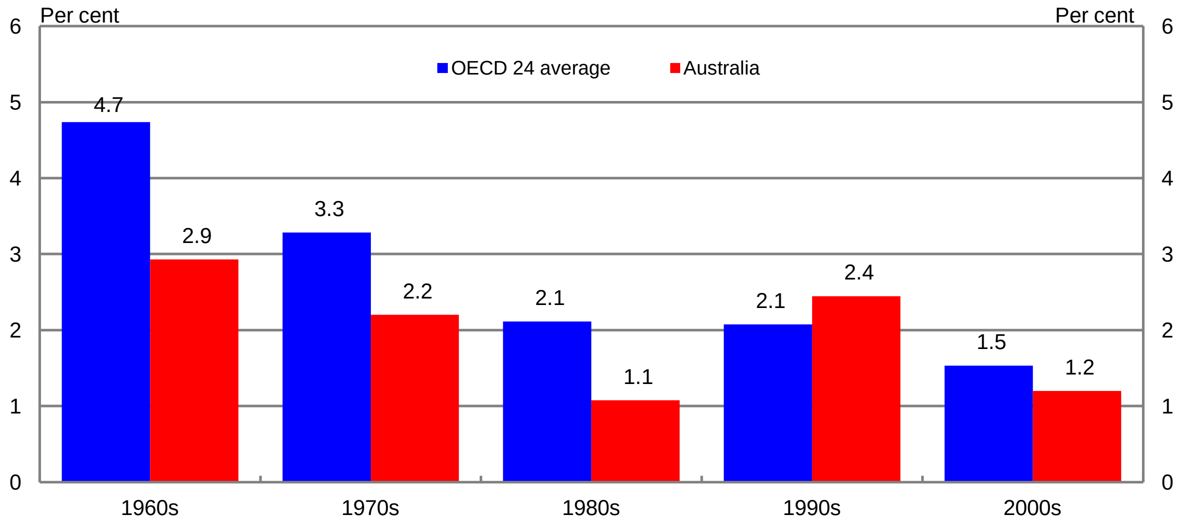
[3] International comparisons should be treated with caution as differences across countries reflect more than differences in the factors typically driving productivity performance — for example, other factors that affect comparisons include the stage of development, geography, policy settings, comparative advantage and measurement issues.

[4] The strong productivity performance in the United States in the last 3 years may partly reflect severe labour shedding in the face of a major and protracted downturn.

It is also worth noting that despite the fall in Australia's relative productivity performance against the United States, Australia's per capita gross national income is at record highs relative to the United States— this reflects Australia's strong employment performance over the past decade and the boost in the terms of trade.[5]

The slowdown in productivity growth this decade is also evident across the OECD, although it is much more pronounced in Australia (Chart 9).

Chart 9: Labour productivity growth – OECD economies

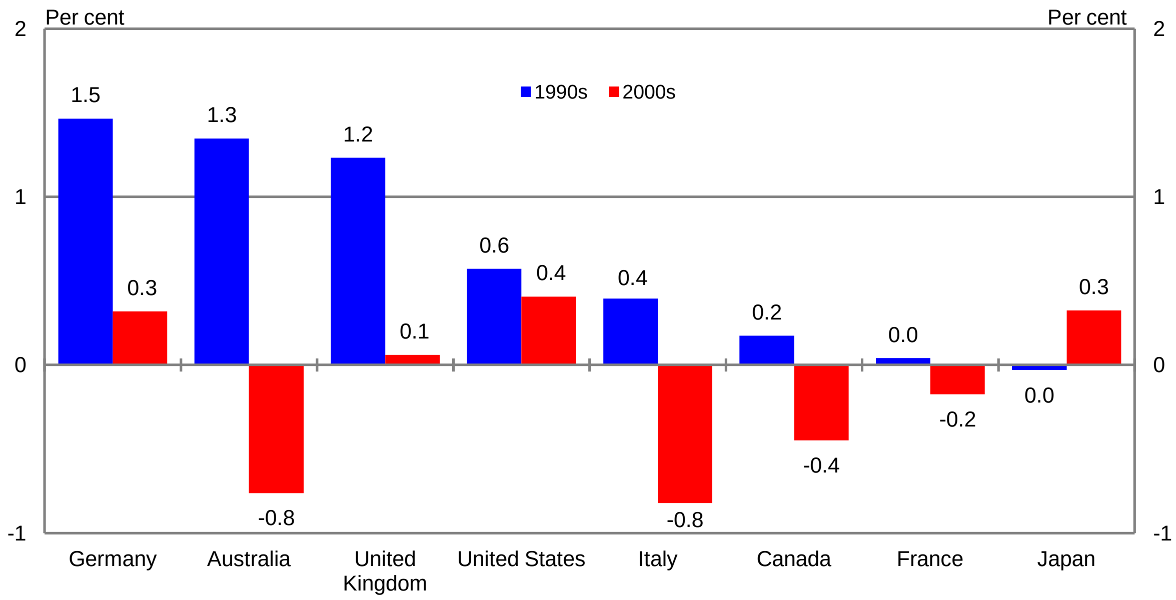


Note: OECD 24 includes the longest standing member countries. To allow for international productivity comparisons, data is based on the OECD Productivity Dataset. There are some differences in productivity estimates between the OECD and those published by the ABS.
Source: The Conference Board Total Economy Database and Treasury.

In particular, Australia has experienced a much sharper deterioration in MFP than most other OECD countries — that is, more of our actual labour productivity growth has come from capital investment, as opposed to the effects of new technology, managerial skills, and process innovation, than other advanced economies (Chart 10).

[5] Data available from 1980 to 2009, World Bank World Databank.

Chart 10: MFP growth – G7 economies and Australia



Note: To allow for international productivity comparisons, data is based on the OECD Productivity Dataset. There are some differences in productivity estimates between the OECD and those published by the ABS.
Source: The Conference Board Total Economy Database and Treasury.

It is also useful to consider how Australia's productivity performance has compared internationally over a longer time period (Chart 9).

The 1960s have often been referred to as the golden age of economic growth in Australia. GDP per capita growth averaged over three per cent per annum over this period, buoyed by strong labour productivity growth.

What is often not realised, however, is that growth in GDP per capita was significantly stronger across the OECD than in Australia. So while Australia was experiencing strong productivity (and output) growth the rest of the developed world was growing at an even faster rate.

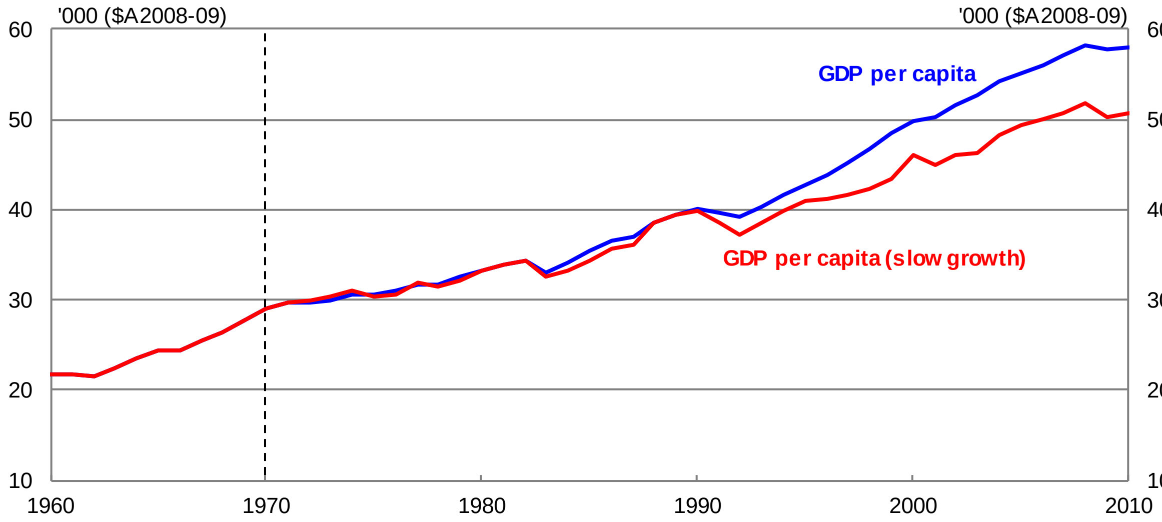
What also stands out when examining the decade long averages is that the 1990s was the only decade in which our labour productivity growth exceeded that of the OECD.

With the passage of time, it can be easy for people to forget just how concerned with our relative economic performance were Australians in the 1980s. As

Singapore's then Prime Minister, Lee Kuan Yew, so colourfully put it, we were on track to be the poor white trash of Asia. Equally, it is easy to underestimate the significance of the economic reforms of the 1980s and 1990s on the living standards we enjoy today.

If Australia had continued to under-perform in respect of its labour productivity over each of the last four decades by the same relative margin that we under-performed in the 1960s, our per capita GDP would now be around $7,000, or around 12 per cent, lower (Chart 11).

Chart 11: GDP per capita different labour productivity scenarios



Note: Slow growth scenario is based on the assumption that Australia continued to under-perform in respect of its labour productivity over each of the last four decades by the same relative margin that it under-performed during the 1960s.
Source: The Conference Board Total Economy Database and Treasury.

Why has Australia's productivity performance declined?

So why has Australia's productivity performance declined over recent years?

Some of the slowdown in productivity may reflect an economy approaching full employment. Capacity constraints within the economy, following a long period of uninterrupted growth, may have made it more difficult to raise productivity.

With unemployment rates reaching record lows, businesses may also have employed individuals with lower skills and productivity — if so, this would be a welcome development, helping marginalised people get a closer attachment to the labour force and be a sign of our economic success.

But it is also possible that firms have focused on meeting expanding demand rather than more cost-effective means of production in response to higher prices and profits coming out of the mining boom. Again, this is not necessarily a bad thing.

An examination of market sector MFP by industry indicates that the mining, agriculture and electricity, gas and water industries have played a significant role in the recent slowing in our productivity growth.

This is not surprising. To take the mining sector, the very large investment underway has not yet been fully reflected in increased output. In part, this is likely to reflect lags between the time when investments are made and when capital comes on stream. Similarly, higher prices have made deposits that are more difficult and costly to extract and lower grade resources, economically viable. While this boosts income and profitability, it also reduces measured productivity.

Nevertheless, even allowing for the special factors in these sectors, it is clear that the pace of productivity growth in Australia has slowed since the rapid surge, particularly in MFP, in the 1990s.

There is also good reason to believe that part of the explanation is the fading effect of previous reforms and the lack of significant new productivity enhancing reforms since the turn of the century.

The time lags between action and results are often long and variable, meaning that the root causes of Australia's present productivity performance are embedded in the decisions of the last decade.

That said, failing to tackle this situation will cement poor outcomes in the future.

As I highlighted earlier, Australians have not yet felt the consequences of this decline.

Slowing productivity growth has been offset by a rapid increase in our terms of trade which has made us wealthier.

Making the most of the current boom and sustaining growth in living standards

So what policy principles might help us make the most of the current resource boom, help us to withstand and capitalise on whatever the global economy may send our way, and work to sustain growth in living standards as we move through the Asian century?

First, we need to ensure we do not unwind the policy reforms that have delivered the adaptable, flexible economy of today.

Second, sound fiscal policy settings need to be continued in order to ensure that Australia takes advantage of the opportunities presented by the rise of Asia and effectively manages its risks.

- One facet of this is to ensure we are well placed to cope with increased macroeconomic volatility.

- Allowing the budget balance to improve will provide the necessary fiscal space to run deficits during periods of weak growth should global developments become rocky. In this context, there is the added benefit of relieving, even if only at the margin, some of the pressure that higher factor prices, higher interest rates or an even higher nominal exchange rate exert on the traded sectors of the economy.

- Another facet of a sound fiscal framework is to have the settings and institutions, whatever the form, in place that invest the income surge from the mining boom to ensure its benefits are smoothed over time and also spread across the population.

Third, the increase in the terms of trade is only the first manifestation of Asia's rise – while the higher level will be long lived, the terms of trade will not rise perpetually. So while the current strength in the terms of trade provides a step increase in living standards, future growth in living standards will be dependent on productivity growth. Actions that resist long term economic forces and act against productivity growth should therefore be avoided, including protectionist policies — overt or disguised — which prop up declining firms and sectors.

Fourth, we should ensure that the income boost delivered to us through the terms of trade does not make us complacent about the need for further microeconomic reform. Productivity growth, after all, will be the key means to improving our living standards into the future.

- We need to continue with reforms that increase the flexibility of the economy and its productive capacity in order that people and business are able to embrace change, adapt and innovate.

- There has been a lot of talk about the need for a new microeconomic reform agenda. Whether one describes it as a new reform agenda or a continuation of the existing agenda, one of the challenges we face is the assumption that the most urgent reforms are a continuation of those of the past.

Microeconomic reform needs to be broader than this.

We do ourselves, and the nation, a disservice if we target reform efforts only on the same areas as we have in the past. It is in the areas we have not yet focused on that the largest gains are most likely.

- Reforms to improve the productivity of the growing health and education services sectors, and make them more responsive to market signals, make sense. This is particularly important in the areas of vocational training and tertiary education.
- Tax reforms that improve resource allocation and labour mobility, make sense — especially to state taxes like stamp duty and property taxation.
- Appropriate policies to mitigate climate change at minimum cost also make sense.

At the same time however, it will be important to ensure that the vulnerable and disadvantaged are not left behind as the economy advances.

All of these reforms I have listed are fairly straight forward. What has proven to be difficult in the past, and will continue to be difficult in the future, is communication of the need for, and benefits of, action. This is especially so when so many Australian workers have never experienced anything other than sustained growth.

How then do we move forward?

Lessons from previous microeconomic reform agendas

The successful reform processes of the 1980s and 1990s were characterised by some common themes that all of us in this room should keep in mind as we strive to improve Australia's future productivity performance.

First, consensus on the need for reform is important.

- By the 1980s, a general agreement had formed among academics, policymakers, and commentators.
- The government of the day then identified, prioritised and built community support for particular initiatives — building on the work the Government already has underway, there is a growing community awareness today of the need for a reinvigorated microeconomic reform agenda, but this is easily undermined by populist media campaigns such as we have seen recently.

Second, reform efforts require careful prioritisation and sequencing of the reform.

- Prosecuting reform on too many fronts at once risks losing focus and/or spreading efforts too thinly to deliver on the reforms as well as fracturing any community consensus for reform.

Third, the 1980s and 1990s highlighted the need for perseverance.

- While some of Australia's earlier signature reforms could be implemented quickly, many (such as the national competition policy) took considerable resources and time.
- None were straightforward. Nearly all faced high political hurdles.

- And the time lags between action and outcome sometimes led people to doubt the efficacy of the decisions taken.

- No one should expect the future to differ from the past in this respect.

Fourth, we need to accept that reform is a continual process.

It is all too easy to justify why now might not be the right time for reform.

So let me put this another way. When **would** be the right time for reform? When the commodities boom and terms of trade shock has ended? When there are no global risks? When the economy is not being affected by long-term forces such as demographic change or climate change?

If we followed this logic there would never be a right time for reform, never a right time to cement prosperity!

It is exactly because the economy is undergoing a structural shift, because it is being affected by long term forces, that we need to continue our ongoing efforts to deliver the structural reforms that will ensure a better life for current and future Australians.

Thank you.