The Australian Economy and Challenges of Change

Address to the China Advanced Leadership Program (CALP)

John Fraser | Secretary to the Treasury | 25 November 2015

Introduction

Over the past three decades, one of the most profound shifts in the global economy has been the rapid economic growth of China.

It has transformed global trade and investment flows and lifted over 700 million people out of poverty in China. And there are 15 cities with over 10 million people.

This growth has had singular implications for Australia and, over the same period, our relationship with China has strengthened considerably.

We are very different countries. For one thing, our entire population of almost 24 million is less than Shanghai's.

We have three people per square kilometre of land area compared with China's 145.

We are also different economically, politically and culturally.

But an important similarity between Australia and China is the ambitious program of economic reform both countries have followed over the past 30 years.

Though the starting point and the policy framework for reform were very different, both countries shared the objective of enhancing the wellbeing of their societies.

On that score, both have been very successful. Both are now more diverse, more outward-looking and provide more opportunities for their people and businesses.

The results have been impressive, even remarkable in China's case. China's per capita GDP has increased more than 17 times since 1980.

Australia's has almost doubled in the same period, a successful outcome for an already high-income country.

Common threads ran through our reform programs.

There was a focus on greater exposure to global markets and more competition in domestic markets. As a result, there has been a greater role for prices to determine the allocation of resources.

In Australia this was most evident in financial and labour markets. We floated the exchange rate and let interest rates be determined by the market.

We also let wages be negotiated between firms and workers rather than be set by a central wage-fixing tribunal.

Both countries also shifted the provision of some services from public entities to the private sector. This is ongoing, particularly in China.

And policy makers have developed more robust frameworks to manage the economy.

Both countries have become closer in trade, investment and foreign relations. The recent China-Australia Free Trade Agreement (ChAFTA) is the latest example of this.

One reflection of the importance of China to Australia is that Treasury has devoted more resources to understanding China's economy and engaging with Chinese officials and businesses.

We have two people in Beijing and a dedicated China Policy Unit in Canberra.

In addition, Treasury and the National Development Reform Commission meet annually to discuss the economic challenges facing both countries.

There is no doubt that Australia's future prosperity will be influenced by the success of China.

Crucial as China is to our economy, most of Australia's future success is in our hands. It will be determined by Australia's businesses, employees and policy makers.

Put simply, what we do in Australia is central to improving our productivity performance.

Today, I would like to reflect on our successes and talk about current conditions in the Australian economy and some of the challenges we face.

The challenges are not unique to Australia and many will resonate with the China experience.

A theme running through these observations is the importance of resilience.

Businesses and policy makers do not know the future.

Promoting a flexible economy with a robust financial system and sound policy anchors will leave us better-placed to confront the challenges and inevitable shocks that come our way.

This has been Australia's experience of the past few decades and one of our great successes.

The Australian Economy

The Australian economy grew a bit below trend at 2.3 per cent in 2014-15.

The Budget forecasts that growth will pick up a little to be 2 ¾ per cent in 2015-16.

We will publish our review of these forecasts soon.

There have recently been more promising signs in the economy.

We have had good news on the labour market and firms are reporting better business conditions.

But we are still waiting for clear signs of a recovery in non-mining investment. So it is too early to say that stronger growth is ahead of us.

We are in the midst of a challenging domestic and global adjustment.

The huge mining investment boom that has greatly expanded our export capacity is receding.

Mining investment rose to a peak of 7.5 per cent of GDP in 2012-13 from 1.7 per cent at the start of the mining boom in 2002-03.

It is now 5.6 per cent of GDP and will decline further.

While weaker mining investment is a drain on growth, the boom has left us with much higher capacity in the resources sector.

As a result, the volume of resource exports has increased from 6.1 per cent of GDP in 2004 to 11.5 per cent in 2014.

However, the prices of our main commodity exports have fallen sharply from historically high levels over the past few years.

Since the peak in 2011, Australia's terms of trade have fallen by around 30 per cent, as commodity prices have fallen.

Falling commodity prices mean that Australia's income is growing more slowly than previously.

Our per capita income has not increased for three years.

This is a major constraint on our economy and it is occurring against a backdrop of softer domestic spending.

Households have been strengthening their balance sheets through higher saving. Businesses are more reticent to invest. Governments are focussed on fiscal consolidation.

The world economy is also still fragile.

The IMF has downgraded its outlook for global growth for the fifteenth time in the past four years, cutting its forecasts for 2016 from 3.8 per cent to 3.6 per cent.

The United States economy is performing well.

Having lived in the United States in the late 1970s and again in the latter half of the 1980s, I remain resolute in my view that its very flexible labour and product markets are a major source of strength.

The performance of other major developed economies is more mixed. The scars of the global financial crisis still linger.

Business investment is subdued in many developed economies and, of more concern, indebtedness in developed and emerging economies is still high.

Indeed, it is higher than before the crisis.

Global debt has risen by $US57 trillion, 17 percentage points of GDP since 2007. Indebtedness in China has also risen sharply.

The Chinese economy also continues its transition to a lower and more sustainable growth rate.

In light of these constraints the Australian economy is doing relatively well. This good performance reflects the dividends of past reforms.

Just as the exchange rate, interest rates and wages adjusted to help cushion the inflationary consequences of the mining boom, they are now absorbing the contractionary effects of its end.

The Australian dollar has fallen by over 23 per cent in trade-weighted terms from its recent peak in 2013.

This is helping to offset the impact of the decline in commodity prices and is supporting a transition to other sources of growth.

However, a weaker exchange rate is not a panacea for Australia's long-term challenges.

It will help our adjustment in the short term but stronger growth in the long term requires ongoing reform.

Lower inflation has allowed the Reserve Bank of Australia to reduce the cash rate to 2 per cent. This too is supporting growth.

And wage growth has slowed to very low rates, helping company profits and supporting employment growth.

Australia has managed this commodity price boom and downturn better than earlier ones because financial, product and labour markets are more flexible and because our macroeconomic policies have appropriate medium-term anchors.

Australia is also faring much better than other commodity exporters.

Economic conditions in some other prominent commodity exporting countries such as Canada, Norway, Brazil, Russia and South Africa are now weaker than in Australia.

Growth in Canada, Norway and South Africa is expected to fall to around 1 per cent this year.

The Brazilian and Russian economies are in recession, though not solely due to weakness in their commodity prices.

Challenges

Nevertheless, the adjustment to lower mining investment and commodity prices represents our major short-term challenge.

I am confident that we will make this adjustment.

As I noted earlier, there are more positive signs in the economy.

Our exporters are also benefiting from the lower exchange rate. Service exports, including tourism and education have picked up.

Service exports to China have grown from 7.1 per cent of our service exports 10 years ago, to 13.6 per cent today.

China is now our second largest source of tourists and our largest source of overseas students.

Part of China's dramatic transformation has included the rise of its middle class.

While estimates vary, it is thought that today the Chinese middle class is around 400 million people - around 17 times Australia's population.

China's rising middle class, which is expected to grow to around 1 billion by 2030, represents a tremendous opportunity for Australia.

We can expect that Chinese demand for better-quality housing, food and tourism and better access to a range of education, health, financial and other professional products and services will strongly increase.

Australia will need to remain flexible and deliver the types of services Chinese consumers will demand.

The Australian economy is on the right path but demand and growth are not as strong as we would like.

I would now like to talk about some of Australia's challenges, past and present.

Many of the challenges I canvass today will be familiar to you.

China is also facing them.

Financial Reform

Financial reform has been a key part of Australia's success.

I believe that Australia's experience has important lessons for China.

Financial reform in Australia followed two streams.

In the early 1980s Australia had a highly regulated financial system.

The exchange rate was managed, capital controls were in place, bank interest rates were regulated and there was limited competition in the domestic financial system.

During the 1980s, the first stream of financial reform focussed on freeing up markets as well as introducing more competition into the financial system.

The exchange rate was floated, capital controls removed, banks were free to set interest rates and the financial system was opened to more competition.

In time, these changes had a profound and positive impact on Australia.

They allowed markets to adjust to absorb shocks and they greatly enhanced the conduct of monetary policy.

China is also grappling with similar financial reforms, allowing more flexibility in its foreign exchange and domestic interest rate markets.

China's recent deposit rate liberalisation marks a further step in this direction.

Along with better resource allocation, China's interest rate liberalisation will enhance the conduct of monetary policy, bring market discipline to commercial banks, as well as further develop China's domestic capital markets.

The second stream of reform in Australia recognised the need for strong financial institutions with rigorous prudential oversight.

This followed hard lessons which were learned during our own financial crisis in the early 1990s and the failure of a prominent insurance company in the early 2000s.

In hindsight, these events taught us that building a strong regulatory framework and developing well-managed financial institutions must go hand in hand with market-opening reforms.

Following the financial reforms of the early 1980s, Australia experienced a period of rapid growth in corporate debt, funded by local banks.

This borrowing was excessive and many investments it funded were poor.

Lending behaviour of the banks was also too lax.

A deep recession ensued as monetary policy was tightened significantly in the late 1980s.

The recession was exacerbated by the weaknesses in the financial system at the time.

Many firms failed and Australia's major banks were severely stressed.

The unemployment rate rose from a low of 5.8 per cent prior to the recession and peaked at 11.1 per cent in 1992.

It took eight years for the unemployment rate to return to around its pre-recession lows.

Financial recessions are very costly.

In hindsight, the behaviour of banks was inappropriate and Australia's prudential regulatory system was not strong enough.

Following this, a consistent thread in Australia's financial reform process has been the strengthening of the policy architecture around the financial system.

We have held two major inquiries into the Australian financial system, the Wallis Inquiry in 1997 and the recent Murray Inquiry.

Both emphasised the need for strong prudential oversight and sound, well-managed financial institutions.

Since that time we have established a central regulator of our financial services industry, the Australian Prudential Regulation Authority (APRA).

And we have developed an environment of close co-operation and co-ordination amongst regulators, through the Council of Financial Regulators (CFR).

The Council includes all the major financial regulators APRA, the Reserve Bank of Australia, the Treasury and the Australian Securities Investments Commission (ASIC).

This stronger and co-ordinated focus on prudential regulation of the Australian financial system has served us well since then.

There are a number of clear examples of this.

In the early 2000s Australia experienced a period of rapid credit growth and house price appreciation.

This led to heightened supervision and stress-testing of the banks by APRA and tighter monetary policy by the RBA.

This left the Australian financial system and economy well placed to deal with the consequences of the global financial crisis later in the decade.

More recently, Australia has again seen strong house price gains in some large cities and a large increase in borrowing by investors.

APRA has again tightened its supervision of the banks, focussing on banks' lending to investors.

This appears to be having the desired effects. Investor financing has slowed and the housing market has been more moderate.

Financial reform has had a profound and positive impact on Australia.

Australia is a more resilient economy because of it.

But our experience does highlight that the combination of a more sophisticated, market-based financial system and more leveraged household and corporate sectors demand stronger and more nimble prudential oversight.

I will now turn to a long-run challenge, demographics.

Demographics

Our population is ageing.

This will result in a much smaller share of people of traditional working age, between 15 and 64 years of age.

In 1975 there were 7.3 people in this age group for every person aged 65 and over. Today that number is 4.5 people.

The Government's Intergenerational Report estimates that by 2055 that number will be 2.7 people.

Put simply, Australia will have far fewer workers to support the demands of the population.

The Intergenerational Report estimates that as a result of an ageing population, economic growth over the next 40 years will be slightly slower than the past 40 years.

The projections are for growth of real GDP per person of 1.5 per cent per annum in that time, against 1.8 per cent per annum in the past 40 years.

China too is experiencing these challenges.

Faced with this population profile, growth in Australia and China will have to rely far more on productivity gains in the future.

Tax reform

Australia can improve its tax system to encourage work, promote new investment and reward successful innovation.

It must also recognise that capital and labour are mobile. We must have an internationally competitive tax system.

Our current tax system is a little unusual by the standards of developed economies.

The overall tax burden is not high.

Taxes in Australia as a share of GDP were 27.3 per cent in 2012. [1] This compares with an average across OECD countries of 33.7 per cent.

However, the distribution of that burden is biased towards taxes on income.

Indirect taxes, such as our Goods and Services Tax make up almost a third of Commonwealth tax receipts, while personal and company tax make up around 50 per cent and 20 per cent respectively.

And tax rates on income are high by international standards.

Our top marginal tax rate (including levies) on personal income is 49 per cent. By contrast, New Zealand's is only 33 per cent; Singapore's is 20 per cent.

Our top rate also kicks in relatively quickly compared with other OECD nations, at AUD $180,000. That is only 2.3 times the average full-time wage.

In the UK the top rate is payable at 4.2 times the average wage, and in the US it occurs at 8.2 times.

[1] Includes Commonwealth, state and local taxes

Furthermore, our company tax rate is 28.5 per cent for small companies and 30 per cent for others.

By way of comparison, companies operating in our near neighbour, Singapore, pay 17 per cent tax.

In its latest budget, the UK Government committed to reducing the company tax rate from 20 to 18 per cent by 2020. And other economies are likely to follow.

Individuals can also claim tax deductions to help fund their retirement savings and retirement income streams.

They can also claim deductions when they borrow to acquire assets for investment purposes.

Some of these deductions accrue more to higher income households.

The Government is reviewing Australia's tax structure.

An active debate is underway, focussed on delivering a tax system with a broader base, lower personal and corporate tax rates and more targeted deductions.

This is a very promising development and would provide better incentives for workers, local firms and businesses wishing to invest in Australia.

This would be a foundation for stronger productivity growth in the future.

Innovation and Competition

Whether higher productivity growth is achieved will depend on the private sector, through the investment and management decisions of firms and the skills of their workforces.

Creating the right conditions to support businesses and entrepreneurship will be important.

But we will also need stronger demand in lock step with higher productivity growth.

Supporting stronger domestic demand or seeing stronger global demand would help.

The Government is committed to Australia remaining a high wage, prosperous economy that is able to provide an appropriate safety net.

To assist, the Government is developing an innovation and science agenda, which it will announce before the end of the year.

Encouraging more competitive markets is also crucial to driving higher productivity.

This is particularly important in Australia as many of our major markets have a small number of firms.

Australia's retail sector too is dominated by a few large institutions.

It is only in the past few years that disruptive technologies and the entry of more foreign firms have brought more competition to the retail market.

This is enhancing consumer welfare by providing a wider range of goods and different ways of delivering services.

We have completed a major review into competition policy, the Harper Review.

This has made an important contribution to the debate in Australia.

Its 56 recommendations explored many ways to enhance competition in Australia.

If followed, Harper's emphasis on more competition, greater consumer choice and diversity of providers would benefit consumers.

The reforms have the potential to improve the provision of many services provided by the public and private sectors.

As Harper made clear, competition reform requires close cooperation between all levels of government.

Public Finances

I mentioned earlier that debt levels globally are higher now than prior to the financial crisis.

This is true in both Australia and China.

Commonwealth Government gross debt has risen to 22.9 per cent of GDP. Prior to the crisis it reached a low of 4.7 per cent of GDP.

This increase is primarily due to the fact that the Commonwealth Government has run budget deficits since 2008-09.

The deficits reflect policy decisions made before and during the global financial crisis.

Between the start of the commodity price boom in 2003 and the start of the global financial crisis in 2008, policy decisions offset much of the revenue gains that the boom delivered to the budget.

Government spending rose at an average real annual rate of around 3-1/2 per cent during this period.

Taxes were cut while transfer payments and benefits through our tax-advantaged superannuation system were increased, even to middle and high income earners.

During the crisis, the Government significantly increased spending to cushion the economy.

The net impact has been a structural deterioration of the nation's fiscal position.

Australia still has a strong fiscal position by international standards. Indeed, many countries would like to be in our position.

However, our fiscal buffers need to be restored.

Despite the better news in the US the world economic outlook is still uncertain: perhaps tightening of monetary policy in the US will strain markets; perhaps China's growth transition may not be as smooth as I expect; or perhaps emerging markets strains may intensify.

Significant geo-political risks such as those in the Middle East or the once-in-a-generation refugee movements through Europe or Europe's relationship with Russia are possible trigger points for negative spill-overs into the global economy.

The point is we do not know where the next crisis will come from.

What we do know is that starting with a strong fiscal position provides a Government with more flexibility in a crisis.

What is also often forgotten is the social benefit of sound fiscal management. A strong fiscal position provides a sustainable way to support the poorest members of our society.

As a result of the increase in our public debt and the structural nature of our deficits we are no longer in the strong position we once were.

A guiding principle of our fiscal policy since the early 1990s has been the objective of achieving Commonwealth budget surpluses over the economic cycle.

That has served us well and should continue to do so.

But budget repair is hard.

Since the end of the financial crisis, successive Governments have targeted returning the budget to surplus over the medium term.

Some progress has been made.

Policy decisions to restore the budget position have been made. However, some have been impeded by the political process. And lower commodity prices and weaker growth have constrained revenues.

We are headed in the right direction but progress is slow and more needs to be done.

It is also important that this consolidation is done in a way that does not threaten our long-term goal of raising productivity growth.

Hard decisions about Government spending and tax concessions may need to be made.

That brings me to talk about some of the successes Australia has enjoyed as a result of the reform program we pursued over the past 30 years.

Australia's reform success

While I am hopeful that we can embark on another period of economic reform, it is far from guaranteed.

There has been a lack of sustained reform in Australia for over a decade as rising terms of trade provided easy gains to the community.

In this environment, there were few advocates of reform.

However, times have changed.

We know that we cannot solely rely on strong global or domestic demand to enhance our prospects.

Nor can we rely on higher commodity prices.

We need to set the conditions for businesses to flourish.

Fortunately, Australia has a history of making some of its best policy decisions when times require them.

There are many examples of this.

One was the 25 per cent across-the-board cut in all tariffs by the Whitlam Government in 1973.

This was a period of profound economic distress in Australia, with rising inflation and unemployment.

This move was surprising on many levels but it was a first step on the way to opening up the economy.

The next significant period of reform was in the 1980s.

The Australian dollar was floated, interest rates were set by the market, capital controls were relaxed and the financial sector was deregulated.

During the middle years of that decade the terms of trade fell to record low levels, Australia's foreign debt rose sharply and the Australian dollar fell sharply.

This ushered in further reforms including tariff reductions, the removal of import quotas and the reduction of industry assistance.

A round of stringent fiscal repair was also implemented.

The tax base was broadened via the introduction of a capital gains tax and fringe benefit taxes.

The company tax rate was cut by 10 percentage points to 39 per cent, while personal income tax rates were also reduced across all levels of income.

The early 1990s was a period of reforms aimed at enhancing competition and reducing the role of the centralised wage-setting mechanism.

This continued into the late 1990s and early 2000s, when a broad-based 10 per cent Goods and Services Tax was implemented, the labour market was reformed further and major public sector businesses were sold to the private sector.

These examples show that when faced with challenges, the Australian community is up for the task of reform.

There have been many successes in our period of reform.

One is surely our deeper integration with China and Asia more generally.

This pervades our economy and society.

When Prime Minister Whitlam established diplomatic relations with the People's Republic of China, our bilateral trade was around $100 million, fewer than 500 Chinese visitors came to Australia and there were no Chinese students studying here[2].

In 2014 our bilateral trade was over $150 billion, 840 thousand Chinese short-term visitors arrived in Australia and we had over 150 thousand Chinese student enrolments.

At the policy level, we have much stronger ministerial and official level ties.

The recent Strategic Economic Dialogue (SED) meetings in Canberra exemplify the depth of Treasury's bilateral engagement with China's principal economic agency, the National Development and Reform Commission (NDRC) on key economic issues of bilateral interest.

The SED was established between China and the previous Australian Government in 2013, with the inaugural dialogue first convened in Beijing in June 2014.

The SED is one of the three key top-level mechanisms that underpin Australia's bilateral relationship with China.

However, I should not limit these observations to China.

We have deepened our economic ties throughout the region.

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[2] Parkinson, M. (2012), "Reflections on our shared past and future", Economic Roundup Issue 4.

Asia is our largest trading partner by far.

Within the region we have concluded free trade agreements with ASEAN, China, Japan, Korea, Malaysia, New Zealand, Singapore and Thailand, while most recently concluding Trans-Pacific Partnership negotiations, furthering our integration with several of our existing treaty partners.

Our social ties are also close: over 8 per cent of our population was born in Asia.[3]

Another success of our reform program has been the fact that the gains have been widely dispersed.[4]

While there has been some increase in income inequality in Australia, this increase has been low by the standards of some other OECD countries.

Over the past twenty years there have been good gains in real income across the entire income distribution.

Growth in the income of lower-income earners has been due to more participation in the labour market – through stronger employment and more hours – and also wages gains.

This achievement highlights the fact that well-designed reform programs that expose the economy and labour market to more competition need not adversely affect lower income earners.

The Australian economy has now been growing for 25 consecutive years.

I sometimes think that we take this for granted.

It is a remarkable achievement.

[3] Lowe, P. (2014), "Building on Strong Foundations", Address to the Australian Business Economists, Sydney November 25.
[4] Fletcher, M. and Guttman, B. (2013), "Income Inequality in Australia", Economic Roundup Issue 2.

Nobody could have imagined 25 years ago that this period of sustained growth lay ahead of us.

What is truly remarkable is that we faced two major financial crises – the Asian financial crisis and the crisis of 2008 – and a global recession in the early 2000s, yet did not experience a recession ourselves.

When I think back to the arguments made to reform the economy, they were mainly about allocative efficiency and raising living standards over time.

There was much less focus on flexibility and resilience.

Yet one of the main lessons we have learned is that deep and consistent reform meaningfully enhances an economy's resilience and ability to adjust to the negative events that inevitably and regularly hit it.

Conclusion

Australia is well-positioned to exploit the opportunities ahead of us.

Our relationship with China is strong.

A lot of work has been done on how Governments can reinvigorate the reform process in Australia.

Major reviews of the tax system, financial system, workplace relations framework and competition policy have been conducted or are underway.

Implementation of their major recommendations will provide a foundation for Australia to overcome some of the challenges it faces.

The further successful transition of China's economy will help us.

As will a share of luck but, in the end, we will be the makers of our future success.