**"Australia's place in the new global economy"**

Address to CEDA State of the Nation 2012

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## INTRODUCTION

Today, as is appropriate given CEDA's mission, I want to focus on how we ensure Australia's long-term prosperity in the new global economy.

In particular I will argue that to prosper in coming decades, we must foster and protect the economic frameworks that have served us so well in the last three decades. The combination of sound macroeconomic frameworks and ongoing structural reforms has been the key to our current success.

The 2012-13 Budget takes this approach. It returns Australia's fiscal policy to a more normal setting, appropriate for an economy forecast to grow around trend. And it does this while making further investments in future productivity and participation.

But there are two current – and contrasting – features of the short-term outlook that warrant comment. These are the strong ongoing performance of the Australian economy, and the serious economic, financial and political turmoil in Europe and its implications for Australia.

## AUSTRALIA WELL-POSITIONED IN A VOLATILE WORLD ECONOMY

**My first key message is that Australia is well-placed to cope with further global turmoil. This is due both to the underlying strength of the economy and to the significant resilience and flexibility we have across all arms of economic policy.**

The Australian economy is growing solidly and our expectation is for it to grow close to trend over the next year.

Importantly, this growth has not been accompanied by signs of emerging economic imbalances. We have close to full employment and aggregate wages and prices are in check. Indeed some imbalances that built up in the previous decade are receding, albeit slowly – for example, household balance sheets are strengthening on the back of higher private savings.

While structural change is painful for some parts of the economy, this is happening in the context of overall economic strength.

In contrast, the international economic outlook is marked by some areas of great weakness, and a high degree of uncertainty. In particular, there are deep-seated and deeply troubling problems in the Eurozone and there is little sign that they will be resolved in the near future.

The Eurozone's malaise reflects entrenched structural problems in a common currency area, compounded by deep weaknesses in the financial system, and in fiscal positions, and a lack of political will or accord to deal with them.  This view underpinned the relatively pessimistic projection of European growth included in the Budget papers.

The Eurozone crisis is unlikely to be resolved for some considerable time to come. While the Greek election has been grabbing headlines and attention, we should not over-dramatize these events, but nor should we believe the election eliminates the risks emanating from Greece or from the Eurozone more broadly. The next challenge is, of course, the orderly creation of a new Greek Government. But even if this is achieved quickly, the key issue remains the absence of political will in Europe to implement policies better suited to the circumstances confronting the Eurozone member countries.  The Treasurer covered these issues in his Ministerial Statement earlier today.

What I would emphasise, though, and as recently discussed at Senate Estimates, Australia is well-placed to cope with whatever emanates from Europe.

Of course we would not be immune to negative impacts via financial, trade and confidence channels, but we have significant flexibility and capacity at our disposal to cope with a range of different global scenarios.

Given the nature of the problems in Europe, any sharp intensification of the crisis would likely be transmitted via the global financial system. As you would expect, a normal part of our role is to undertake contingency planning for a range of events – and a key conclusion of that work is that Australia's financial system is well-placed to deal with shocks emanating from Europe; indeed more so than at the onset of the GFC in 2008.

Our banks are well-capitalised and have sufficient resources to withstand a freeze in international capital markets for several months. They are also well-regulated and, since the GFC, the regulatory framework has continued to be refined. Some 99 per cent of all deposit accounts are protected through the Financial Claims Scheme. So on the direct – and in some ways most dangerous – financial transmission channel, we are well-placed.

Australia is also well-placed to respond to demand and confidence shocks emanating from Europe.

As everyone here knows, our main trade links are with the emerging Asian economies, not with Europe. (In the last two decades, the share of Australia's merchandise exports going to emerging Asia increased from 13 per cent to 42 per cent.[1] Over the same period, the share of Australia's merchandise exports to advanced economies declined from 78 per cent to 50 per cent.) While these Asian economies, and particularly China, have significant trade exposure to Europe, they also have, like Australia, significant policy capacity in the event of a crisis.

In the event that a demand or confidence shock emanating from Europe affects us via our Asian markets, macroeconomic policy is well-placed to respond and we would expect the exchange rate to adjust in ways that help buffer the impacts.

Importantly, as discussed with the Senate committee, any new situation would not be just a replay of 2008. In the event of a new crisis, the mix of instruments the Government might utilize would depend on circumstances, but the crucial point is that Australia has room to respond if necessary.

Obviously, we all need to be both vigilant and agile. However, there is every reason to be confident that Australia is well-placed to respond to economic volatility and to continue its relatively strong economic performance.

## FOSTERING AUSTRALIA'S POLICY FOUNDATIONS

Australia is not in this current strong position by accident.

Rather, this is the product of investments that have been made over the past few decades.

Which brings me to my second key point tonight. **The current Australian economic policy framework has served us well and is the foundation of our current good economic performance. To set Australia up for prosperity over the coming decades, we need to foster and build on this framework.**

Australia's story of structural reform is entering its fourth decade. It has persisted through both good economic times and bad. In fact, many of these policies have been implemented in very difficult economic circumstances.[2]

[1] 1990-91 to 2010-11.

[2] For example, the tariff reduction in the early 70s during the global oil price shock; which was started again in 1989 and not slowed during the recession of the early 90s.

Over the last three decades, economic circumstances were not used as an excuse to delay or reverse good economic policies. Indeed much of our current framework was constructed in response to specific challenges or to avert specific problems.[3]

The three pillars of Australia's macroeconomic framework are: a floating exchange rate that acts as a shock absorber for the economy; independent monetary policy focused on managing the level of demand to keep the economy on a stable growth path consistent with low inflation; and fiscal policy aimed at running budget surpluses over the cycle in order to contribute to national saving.

Fiscal policy is critical to ensure the sustainability of the budget position, and is particularly important in the context of demands associated with an ageing population.

These macroeconomic pillars have been underpinned by structural policies that have fostered flexibility and growth. These include the creation of more open and flexible labour, capital and product markets, and policy settings that foster competition. An open approach to foreign investment has also contributed significantly to our economic performance, reducing excessive reliance on foreign debt.[4]

This combination of macroeconomic and structural policies is the reason we are responding so much better to volatile economic conditions than we did in earlier episodes.

A more recent element of our policy framework is the Charter of Budget Honesty, introduced in 1998. The Charter has made fiscal policy significantly more transparent, and most importantly, has led governments to look at policy over the economic cycle.

The Government's response to the GFC was driven by the imperatives confronting Australia, but was entirely consistent with the intent of the Charter which requires governments to specify any actions that are designed to 'moderate cyclical economic fluctuations', and to set out how they intend to reverse these decisions. As you will recall, the Government both responded to the crisis and laid out how it intended to return the budget to surplus. While the Charter wasn't designed

[3] Such as the floating of the dollar in the 1980s, the progressive strengthening of independent monetary policy targeted at an inflation band through the 1990s, and the strengthening of the fiscal framework in the late 1990s.

[4] This combination of policies is more subtle than the textbook dichotomy where structural policy focuses on lifting potential GDP while macroeconomic policy focuses or managing fluctuations around potential GDP. For example, fiscal policy contributes to the supply potential of the economy by enhancing incentives. Monetary policy seeks to keep the economy running as close to potential as possible without stoking inflation. And we can see internationally, and from experience, how large economic disruptions can leave a permanent scar on the output potential of the economy. We also know from experience that low inflation is critical to sustained growth.

with the GFC specifically in mind, the GFC was arguably the Charter's first big test – and it passed.

The next step in increasing fiscal transparency is the imminent establishment of the Parliamentary Budget Office – which we strongly welcome. The PBO will provide independent analysis of the budget cycle, fiscal policy and the financial implications of proposals. The announcement of Phil Bowen as the inaugural Officer is an important step in establishing this institution. There will be further steps to underpin this important reform. Finance and Treasury will be negotiating a Memorandum of Understanding with the PBO to ensure a productive day-to-day working relationship, while fully respecting the PBO's independence. In line with this open approach, the Treasury and Finance will publicly release our costing methodologies, which will assist the PBO but also give the broader community visibility of how we approach issues central to the PBO's remit.

Establishing Australia's current economic frameworks was not easy. Today Australia's macroeconomic and structural policy frameworks should be thought of as assets, forming an important part of the economy's productive base.

It is important that we maintain and build on these assets. In the current environment of volatility and uncertainty, with what can seem overwhelming global and domestic pressures, some have been tempted to suggest dismantling or undermining this framework. I refer to a range of views – from questioning the value of the RBA's current mandate, proposing a return to industry protection or exchange rate intervention, to significant restrictions on foreign investment while ignoring the role of foreign capital in raising Australian living standards.[5]

It is our frameworks that have stood us in good stead through the global financial crisis and recent period of structural change, and they will continue to do so. And if you don't believe this, ask yourself the following question: what would Australia look like today had any one of those policy pillars been missing in recent years?

## ASSURING GROWTH IN AUSTRALIAN WELLBEING INTO THE FUTURE

The success of this framework should give us confidence to build on it as we address the challenges of the next few decades.

**My third key message is that if we can respond to these challenges, our next two decades can be as prosperous as the two just past.** The prospects for achieving this lie in the continuing

[5] In contrast, greater transparency around foreign holdings of agricultural land could help dispel the myths and uncertainties around this issue.

story of structural reform.  While the current frameworks are the result of hard structural reforms in the past, the process of reform is never finished and will evolve with changing times.

I've spoken before about four big drivers of change sweeping across our economic landscape. Briefly, these are:

First, the re-engagement of China and India with the global economy, bringing with them a middle class that will soon outnumber the rest of the world's combined. The middle class in the Asia-Pacific region currently numbers around 500 million and is expected to grow to 3.2 billion by 2030.  These people will want better services, goods and experiences. China's GDP is expected to overtake the USA's in the next five years. The combined GDP of China and India will likely exceed the total output of the G7 by 2025. The economic weight of the world is moving inexorably from West to East.

Second is the ageing of our population, with the proportion of Australians aged over 65 projected to rise from 13.5 per cent in 2012 to almost one quarter by 2050.

This represents enormous success. But it will also pose a challenge for achieving sustained growth in living standards, and it will exert substantial pressure on fiscal sustainability – the impacts of demographic change first identified in the Inter-generational report in 2002 are now reflected in our budget forward estimates. At the same time there are building pressures across a range of related fronts – health, aged care, disability.

Ageing in the population also means that the median voter is ageing. It is unclear what impact this will have on future Australian policy debates, but the experience in Europe and Japan hardly suggests that ageing populations are enthusiastic advocates of structural reform.

Third is the challenge of environmental sustainability, which includes water and climate change but also encompasses the range of pressures affecting our natural and built environments.

Fourth are the emerging technology trends. We are only just grasping the implications of the digital revolution for business, for individuals, and for governments. And while we can be sure that these will be transformative over coming decades, we don't yet know how!

All of these trends present both challenges and opportunities.

We are now at a cross-roads. An ongoing national conversation about what we can do to meet these challenges is essential – one that asks "How can we build and make best use of the social and economic infrastructure that will turn these sweeping changes to our advantage? How do we turn the challenges into opportunities to grow and prosper? And how can these changes be supported and sustained?"

Let me sketch out some of the broad factors relevant to the policy framework required to address these challenges over the years ahead.

One priority is to continue reforms that further build productivity and participation. The key factors affecting whether Australia succeeds in the Asian Century while also meeting our demographic challenge, start with our domestic policy settings.

- Current economic circumstances bring this into sharp relief – we've seen the peak of the terms of trade. Improving national income and living standards in future, therefore, will rest with productivity improvement and innovation, not with continued rises in the prices for our minerals and energy exports or falls in the price of imports due to a rising Australian dollar.

- The key domestic policy directions are to continue microeconomic reforms to improve the productivity of our economy. This includes governments at all levels working together to reduce inefficiency and remove constraints on innovation – for example by: progressing the Seamless National Economy; appropriate infrastructure investment planning, funding and use, including better price signals; and ensuring effective education and skills systems which focus primarily on improved outcomes rather than simply on funding.

- Governments must help manage sectoral transformations so industries adjust to sustainable futures. This is important both in its own right, but also in the signal it gives business – at the end of the day it is decisions by businesses that are the ultimate determinant of Australia's productivity performance.

- And we must continue to develop our tax system at Commonwealth and State levels to improve efficiency and assist in resource movement across the economy.

A second area of focus must be on maintaining and further developing an open, embracing orientation to our Asian neighbours in all areas of social and economic life.

- This goes to our 'soft skills' as a society – our social attitudes, our curiosity and tolerance. But it also goes to our policy settings – for example, how we would build our skill and knowledge base, and the incentives we provide for mobile factors of production such as skilled labour and capital.

A third area of focus is that we must have a sensible discussion on what we expect governments to provide, and the tax system needed to support these expectations.

- Ageing and rising societal expectations are likely to put enormous pressure on budgets over coming decades. At the same time the taxation base is weaker than we had imagined in the mid-noughties.

- The specific choices will be determined politically and I do not presume that there is any 'right' answer. Yet much of the debate over government provision assumes we can have it all, with people simultaneously believing we can maintain or even reduce taxation levels while keeping the current range of social policy interventions with limited targeting and self-provision – and indeed adding to this with a long list of worthy, but expensive, new proposals.

- The key point is that choices need to be explicitly debated. The examples of the US and Europe, where decisions have repeatedly been put off in good times, are not models to emulate.

The fourth area of focus concerns sustainability. The key is to put in place policies that achieve sustainable outcomes at least cost over time, but that can be efficiently adjusted as circumstances change. There has been much debate on climate and water along these lines, but the same issues arise around urban air quality and biodiversity.

Finally, to take advantage of the opportunities arising from technology we will need to ensure our policy settings foster innovation. Government services are a key opportunity for gain – things like developments in e-health, as well as the push for more streamlined and responsive service delivery. But we also need to be alert to inadvertently blocking innovation as technology outstrips our legal structures around media, intellectual property and copyright.

**Conclusion**

A strong sustained focus on meeting these challenges can ensure our next two decades are as successful as our last two. Bringing the Budget back to surplus is the first step to strengthening our capacity for reform as we prepare for the next wave of challenges.

Everyone would agree these challenges go beyond this Budget, this electoral cycle, this decade. They require sustained attention and a long view of Australia's prospects in the world.

As I've said many times now, we have reasons for optimism, though not for complacency. We have reason to protect and progress our frameworks and institutions – especially when the going gets tough – not to trash them or bypass them in the name of short-term expediency.

We need to continue to make good policy decisions and to maintain sound policy frameworks. And to be prepared for both short-term shocks and long-term shifts if we are to fully grasp the opportunities of the new global economy.