

THE ECONOMIC OUTLOOK AND CHALLENGES FOR THE AUSTRALIAN ECONOMY

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It is traditional to start the New Year with optimism and a fresh outlook.

In 2010, Australians have earned a bit of optimism, after a difficult 2009.

Twelve months ago, along with the rest of the industrialised world, we were facing one of the most turbulent times for our economy in many decades.

Today, the threat of high unemployment and recession has receded.

With this more positive outlook we have an opportunity to think about some of the challenges further ahead.

While these challenges do not have the immediacy of those we have had to deal with over the past 12 months, they are no less confronting.

Short-term economic outlook

But first, a brief recap on the short term economic outlook.

As you know, the Australian economy has performed better than anybody expected through the global downturn, growing by 1.2 per cent in the 2008-09 financial year. The labour market has also shown remarkable resilience, with the unemployment rate falling in the months of November, December and January, after hovering around 5¾ per cent since early 2009. Last month's unemployment rate of 5.3 per cent is lower than any major advanced economy, with the exception of Japan.

The Australian economy's resilience during this episode reflects, among other things, large and timely fiscal and monetary policy responses; solid demand from some of our major trading partners, particularly China; strong population growth helping to support demand in the domestic economy; and the underlying strength and robustness of our financial sector.

These factors together have inspired confidence locally, with measures of consumer and business confidence rebounding strongly.

More generally, the Australian economy's resilience owes much to decades of economic reform – in economic policy, regulatory frameworks and governance. These have increased the flexibility of the economy, and strengthened its ability to withstand shocks.

The United States has not fared so well. As you know, economic conditions remain difficult there. Since the recession began in

December 2007, more than 8.4 million people have lost their jobs, and the unemployment rate has risen significantly, standing at just below 10 per cent in January. While consumer confidence has begun recovering, and there are signs of output growth resuming, GDP is still around 2 per cent below its pre-recession level and the medium-term outlook remains challenging. Other advanced countries are in similar circumstances.

The medium-term outlook for Australia is much more favourable. Here, a sustainable recovery appears to be underway. Even so, global financial markets remain fragile and the continuing international fragility in financial systems and real economies argues for some caution.

Challenges ahead

I now want to turn to some challenges just over the horizon.

As you would be aware, the Australian Government recently released the 2010 intergenerational report, *Australia to 2050: future challenges*.

Australia's population is projected to reach nearly 36 million by 2050 – an increase of around 14 million.

This considerably larger population will also be much older than today's. The proportion of people of traditional working age (15 to 64 years old) will fall, with only 2.7 people of traditional working age to support each Australian aged 65 years and over by 2050. This is

about half the number of workers supporting those aged 65-plus today.

The intergenerational report identifies three challenges.

The first challenge is that an ageing population implies slower economic growth. As the proportion of the population that is of traditional working age falls, the labour force participation rate is projected to fall (from above 65 per cent today, to below 61 per cent over the next 40 years), dampening workforce growth.

Population dynamics explain one-half of the 0.4 percentage point gap between annual growth in GDP per capita over the next 40 years relative to the past 40 years – the other half being due to a technical assumption relating to productivity growth.

The second challenge is that working Australians will need to support an ageing population that, in part due to continuing technological advancements, is likely to be living longer. Men aged 60 in 2050 are projected to live an average of 5.8 years longer than someone aged 60 today, while women aged 60 in 2050 are projected to live an average of 4.8 years longer.

This is great news for Generation Y, but a sobering statistic for future budgets.

The greater publicly funded health, aged care and related expenditures to support Generations X and Y in their retirement years will need to come from a relatively smaller number of workers

than we have today. On a “no policy change” basis, a significant fiscal gap is projected.

The intergenerational report shows how the Government’s fiscal strategy to constrain real expenditure growth contributes to reducing, without wholly eliminating, the projected fiscal gap.

The third challenge identified in the intergenerational report concerns the impact of climate change on ecosystems, water resources, agricultural production and weather patterns.

Against these challenges, there are three topics I want to say something about today:

- Promoting economic growth by improving productivity and workforce participation;
- The implications of a growing population, particularly for infrastructure investment; and
- Medium-term prospects for capital flows required to finance national investment.

For obvious reasons, I won’t be saying anything about climate change on this occasion.

I’m sure all of you will have heard of the 3 Ps – population, participation and productivity. These are the “supply-side” components of real GDP, and real GDP per capita – they are the structural drivers of economic growth.

To recap, in explaining GDP per capita:

- Population is the proportion of people of working age (15 and over);
- Participation is the average number of hours worked by each of these working age persons; and
- Productivity is average output per hour worked.

With growth in the first 'P' – working age population – slowing, real per capita GDP growth will have to come from the other two 'Ps'.

We can make some gains through increased participation – which I'll talk about a little later – but, of course, the key to higher real GDP per capita growth is higher productivity growth.

Increasing productivity growth

Productivity is driven by 'capital deepening' – more capital per worker – and by something called 'multi-factor productivity', which basically refers to the efficiency with which we organise labour, capital and natural resources in producing output.

Policy, institutional and regulatory frameworks can have a positive influence on both sources of productivity. The strong productivity growth of the 1990s and its observed slowing over the past decade are probably due to the strong productivity enhancing efforts of past reforms.

Appropriate price signals and incentives improve the decision making of firms, both with respect to business investment decisions and the development and adoption of new products and processes.

But not all worthwhile investments need be made by businesses. There are good reasons for governments also to invest directly in infrastructure, innovation and human capital. These reasons include markets for goods or services being incomplete, goods having public good characteristics, and there being positive ‘spillovers’ associated with the production of some goods or services.

Well targeted investments in physical infrastructure can increase productivity by both increasing the capital stock and improving the efficiency of use of the other factors of production.

One of the lessons of our emergence from the recession of the early 1990s is that labour productivity growth will be faster if the factors of production are efficiently allocated. This has important implications for thinking about the consequences of an elevated terms-of-trade due to what looks like a relatively long-lived mining boom. In particular, the shares of the factors of production allocated to the resources sector will need to increase structurally. It is an open question whether, and in what way, there may be a role for government in facilitating this structural adjustment.

Improving participation

In the context of an ageing population, it will be important to ensure that there are incentives for people who are approaching retirement age to remain in the workforce. Australia’s participation rate for

55-64 year olds is currently below that of comparable countries – including the United States, the United Kingdom, Canada and New Zealand – suggesting significant room for improvement.

In addressing the challenges posed by the global financial crisis and global recession, Australian policy makers were well aware of the risk of higher unemployment discouraging workforce participation. Evidence from past recessions here and in other countries shows that when mature age workers lose their jobs they are more likely to withdraw early from the workforce. There is some evidence also that people who retire early – severing all connection with the workplace – find it especially difficult to reintegrate with the labour market at a future point in time. Thus, both cyclical and cross-sectional evidence supports the case for mature age workers maintaining an attachment to the labour market.

According to the intergenerational report, if mature age participation rates for people aged 50 to 69 were to increase from a base case of 62 per cent in 2049-50 to 67 per cent, real GDP per capita would be 2.4 per cent higher in that year.

In addition to the macroeconomic consequences of workforce participation, there are significant wellbeing benefits for individuals who retain a connection to the workforce. These benefits include improved mental health and a considerably reduced risk of social exclusion.

Implications of population growth

Annual population growth has averaged 1.9 per cent over the past three years, up from 1.2 per cent over the preceding decade.

Population and labour force growth are driven by natural increase (that is, the excess of births over deaths) and migration. As the fertility rate drops, the role of migration becomes relatively more important.

At the time of the last intergenerational report in 2007, the total fertility rate was 1.8 births per woman. While it has risen to almost 2.0 in 2010, the 2010 report projects that it will fall slightly to 1.9 by 2013 and remain at that level.

The rate of net overseas migration over the next 40 years is projected to average 0.6 per cent of the population per annum. This is not out of line with the experience of the previous 40 years, though it is somewhat less than the past several years.

As well as boosting the size of the working age population, skilled migration can enhance productivity – by raising the average skill level of the workforce – and participation – since skilled immigrants typically have positive employment outcomes.

Nonetheless, immigration and population growth more generally present policy challenges for Australian governments at all levels, especially in areas such as infrastructure provision.

As our population continues to grow, so does the need to add to the stock of economic and social infrastructure.

Historically, investments in Australia's energy, water, transport and communications infrastructure assets have been correlated with population growth. This is just as well, of course. And it contains an important message for the future; a message to which I will turn in a moment.

But, as the mining boom has highlighted, it doesn't take rapid population growth to demonstrate that a lack of adequate infrastructure can lead to costly bottlenecks and congestion, eroding competitiveness and undermining productivity growth.

Investing in economic infrastructure is a form of capital deepening. It helps raise the productive capacity of the economy for that reason. But it also contributes to productivity by facilitating the production and distribution of goods and services.

It is equally important to ensure that existing infrastructure is efficiently and effectively utilised.

Australia is one of the most urbanised countries in the world; by 2020 more than 90 per cent of Australians will live in urban areas.

In terms of economic activity, Australia's major capital cities account for at least 65 per cent of GDP. So it is likely that the quality of our cities has a significant impact on national productivity growth.

As Australia's major cities continue to grow and expand, forward-looking urban planning and infrastructure management will be needed to support sustainable urban development and renewal.

Failure to invest appropriately in our cities could be costly, constraining growth through congestion, and imposing other economic and social costs.

Reforms to ensure strategic, co-ordinated planning of future infrastructure, and to encourage the efficient utilisation of existing infrastructure, could play a key role in avoiding these costs and in delivering economic benefits.

Infrastructure planning should also take account of the needs of an ageing population, including thinking about what might be required to facilitate the active workforce participation of an ageing workforce and to supply services to increasing numbers of older Australians.

At present, younger people are attracted to education and employment opportunities in capital cities. Older adults represent a growing proportion of the population outside of the capital cities. If these patterns continue, the older population risks becoming increasingly distanced from both job opportunities and the workforce that will be required to deliver the services it needs.

Capital flows to finance a higher level of national investment

An important issue in thinking about the need for increased public and private investment is what it might imply for the balance

between national saving and national investment, summarised in the current account deficit.

Since the resources boom began some six years ago, the current account deficit has averaged 5¼ per cent of GDP, compared with a 30-year average of around 4 per cent of GDP. That increase reflects a rise in national investment, which has been about 3¼ per cent of GDP higher than over the preceding decade. National saving has been nearly 1¾ per cent of GDP higher, on average, over the same period, funding more than half of the increase in national investment.

The largest contributor to the increase in national investment has been mining investment, which has risen from around 1½ per cent of GDP before the boom to 4¼ per cent of GDP last year. It may rise even further: the Reserve Bank of Australia has noted that investment in liquefied natural gas projects alone could plausibly rise by 2 per cent of GDP within the next few years.

The demand for resources from China and India could see mining investment remaining high for an extended period – possibly for decades.

The other driver of higher investment has been infrastructure. Total investment in infrastructure-related industries – electricity, gas, water, transport and telecommunications – has risen by about 1½ per cent of GDP over the past five years.

Some of this infrastructure investment has been to service the resources sector, but faster population growth has also been a factor.

A useful way to think about what population growth alone implies for investment is to 'back out' the level of investment needed to keep the ratio of capital to output constant. This ratio has been fairly stable at around three over the past 30 years (that is, the value of capital is three times the value of output).

Population growth is projected to ease progressively over the longer term, which – other things equal – would reduce investment needs. However, average population growth over the coming decade is still projected to remain relatively strong, at about 1.5 per cent a year. This is 0.3 percentage points higher than its decade average before the resource boom. Thus, ignoring any change in labour productivity and workforce participation rates, investment would need to be nearly 1 per cent of GDP higher than before the resources boom, in order simply to keep the capital to output ratio constant.

National saving is presumably being influenced by several cyclical factors, including the income effects of the resources boom; the macroeconomic slowdown and asset price volatility; and the change in the stance of fiscal policy. There are also structural factors at play, including population ageing – with implications for both private saving and government budgets.

Projections of national saving are notoriously difficult – and are likely to be especially difficult at the present time. Even so, the pick-up in national investment in prospect is so marked that it seems likely that the current account deficit over the next several years will remain around the high levels of recent years, or possibly go even higher.

As I have noted, Australia's current account deficit reflects high and rising investment – and, in particular, investment to expand the capacity of the traded goods sector. This distinguishes Australia from most other countries with large current account deficits. In the United States and the United Kingdom, for example, rising current account deficits since the mid-1990s have reflected falls in the national saving rate, with the rate of investment being broadly unchanged.

Even so, the global financial crisis has challenged the assumption underpinning the 'consenting adults' view of the current account, emphasising how dependent that view is on the assumptions that global financial markets do not fail and borrowers with sound prospects can always obtain finance.

We now know that those assumptions are not always realistic. Nevertheless, the fact that Australia has come through the demanding stress test posed by the global financial crisis provides grounds for confidence that the risks are manageable. But, consistent with remarks made earlier in this address, it would be

prudent to interpret that experience as emphasising also the importance of maintaining a strong track record in macroeconomic management, structural reform and financial regulation.

It is also worth bearing in mind the point made earlier, that 'capital deepening' from higher rates of investment should contribute to higher productivity and stronger economic growth, which in turn improves our capacity to service the associated increase in external borrowing.

Conclusion

The Australian economy has thus far proved remarkably resilient to the global financial crisis and the global recession. The near-term outlook is positive. Internationally, there remains much to be done to guard against the possibility of another crisis, including in the medium-term. For that reason, Australia's prospects support a somewhat guarded optimism.

Even so, it is timely to reflect on the medium to longer term challenges presented by an ageing and growing population and to formulate policy responses that might meet these challenges in sustainable ways.