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A TIME FOR PRUDENCE

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Australia has done well to hold up economic activity through what for the rest of the developed world is the deepest recession since the Great Depression. I give high marks to the Government's immediate policy response: the early and decisive reduction of interest rates, expansion of government expenditure and the Commonwealth guarantee of the banks' wholesale borrowing. The successful management of the Great Crash leaves a heavy economic policy agenda. These remarks are mainly directed to the macro-economic dimensions of that agenda.

The Great Crash of 2008 (Garnaut with Llewellyn-Smith, 2009) noted that countries with larger current account deficits before the Crash would have additional adjustment problems beyond those with surpluses; and that commodity exporting countries which had spent most of the proceeds of the exceptionally high terms of trade before the boom would face greater adjustment challenges than those who had prudently saved a larger proportion of the exceptional income from high export prices. It noted that at their boom-time peaks, Australia's Current Account Deficit as a proportion of GDP reached 7.4% of GDP (March Quarter of 2008), and that terms of trade were about two thirds higher than in 2008 than in 2003—and they were higher still compared with an extended period in the late twentieth century..

Current account deficit countries would face greater challenges than surplus countries because the established private mechanisms of financial intermediation had been seriously damaged by the Crash and would not quickly be put together again in their old forms. It would therefore either be necessary or judged to be prudent to run lower deficits after than before the Crash. The other side of this coin was that surplus countries were likely to find it necessary or judge it to be prudent to reduce their own imbalances. Lower global imbalances would be a feature of the new world order than of the pre-Crash order.

The Great Crash of 2008 sparked some commentary about how current account deficits don't matter, and that our terms of trade will remain extremely high or go even higher because China's rapid economic growth can be expected to continue. Here I will look briefly at the hard times ahead in macro-economic management, associated with funding the current account deficit and changes in the terms of trade, with the relationship between macro-economic stability and productivity growth, and the interaction of these economic realities with some implications of the climate change agenda.

I am sorry to take a prudent Treasury view of the period ahead in these difficult times, when it is more satisfying to linger on how well we have done. But the challenges facing us are large enough for someone to make the case for

prudence.

None of these are new themes for me at these Outlook Conferences and elsewhere. For earlier and more detailed statements of my views on the central macro-economic relationships you can look at my Sir Leslie Melville Lecture in 2004, and my papers to the Outlook Conferences in March 2005 and October 2006, and my address to the 2005 Economics Society annual dinner in Canberra (published in the December 2005 issue of the Oxford Review of Economic Policy). (All are available on www.rossgarnaut.com.au, under the Australian Economy tab).

I draw attention to two earlier remarks. First, my commendation during the boom of E.O.G. Shann's cautionary comment in 1927 that although the times were prosperous, things felt to him as they must have felt to Australians in 1889 before the 1891 Great Depression. I called the lecture "The Boom of 1989 and Now", after Shann's "The Boom of 1889 and Now".

Second, my definition of the task of macro-economic policy at the 2006 Outlook:

"Macro-economic policy is about balancing growth in domestic incomes and expenditure and therefore economic activity in relation to the rate of increase in the productive capacity of the economy." The objective is to avoid the need to reduce the rate of growth in domestic expenditure sharply, or to reduce at all the real level of per capita domestic expenditure and the real wage levels that are necessary for full employment. It is always difficult to reduce real per capita domestic expenditure, and real wages; imperfect management of the difficulties can lead to economic instability, loss of productivity growth and unemployment.

If the objective of macro-economic policy is to avoid the need for sharp changes in the trajectory of growth of real expenditure, then we haven't done well. The need for adjustment arises from the excessive levels of expenditure growth in the half dozen years of boom before the Crash. That follows more or less by definition from the need to move from years with some of the most rapid expenditure growth in Australian history, to a long period when expenditure growth needs to be more constrained than it has been over a comparable period probably since the 1930s.

When is a current account deficit excessive? A view developed in the 1990s and in the early twenty first century boom that no deficit was excessive if it had its origins in the private sector. There are two things to say about that.

First, we need to qualify the "current account deficits don't matter" position when there are temporarily high terms of trade (or levels of private investment). If you spend the proceeds of high terms of trade—and a large part of the national

gains go directly to Commonwealth and State government revenue—domestic expenditure and costs including wages are likely to be pushed to levels that are so high that they need to be reduced when the turns of trade fall. Avoiding the need for such adjustments is the essence of macro-economic stabilisation policy.

If the governments save that part of the additional revenue from high terms of trade that is clearly temporary, the current account deficit will be correspondingly lower or the surplus higher.

Where will the terms of trade be on average in the years ahead? Will the giddy heights of the recent boom become the norm, driven like the boom itself by sustained strong growth in China? There was a period of much lower metals and energy prices after the Crash, but recent levels have been much closer to the boom-time peaks.

I have followed the economies of China and the other large Asian economies as closely as any Australian since I put these issues on the Australian and international policy agendas a quarter of a century ago. It is likely that Chinese growth will be sustained at high levels for many years yet. I also have positive expectations for India and Indonesia. These are the three most populous developing countries. This is likely to keep average commodity prices above those of the last quarter of the twentieth century, as prices must be high enough to meet the full investment as well as recurrent costs of new capacity.

But average prices will not be as high as those immediately before the Crash, which were the result of markets being taken by surprise by the growth of demand in China. Expectations have caught up. A process of capacity expansion is occurring in the big Asian developing countries themselves, in Australia, in Africa, in Latin America and in Central Asia, to name only the most important loci. Much is being supported by Chinese investment. Average commodity prices over the years and decades are likely to be well below the boom-time peaks, and below current levels. In addition, China and the other large Asian developing countries are market economies with a business cycle, and there will be fluctuations around average price levels. The September Quarter of 2009 may have seen the highest growth of import demand for minerals and energy for many years, as the expansionary fiscal and monetary took root and generated temporarily exceptional growth, and this was reinforced by the rebuilding of stocks after the disinvestment in the aftermath of the Crash. It would be imprudent to build policy around an expectation of return to pre-Crash prices, or even around the holding of prices at current levels. The costs of raising expenditure to excessive levels when price expectations turn out to be too high, are much larger than the costs of the opposite error. This is a point to

which the Governor alluded at dinner last night.

Second, we need to consider the possibility of difficulties in funding the current account deficit after the Crash.

Much of the external deficit in the early twenty first century was funded by wholesale borrowing by the banks—to an extent that has no near comparator in Australian history or the experience of other countries. When the Crash descended, the banks were unable to roll over old or secure new foreign wholesale debt. They were saved from crisis by the Rudd Government's wholesale guarantee. The ABA's statement in response to the publication of The Great Crash of 2008 confirms rather than challenges this point. From December last year to August 2009, the Commonwealth guaranteed $135 billion of bank wholesale debt. The amount has continued to grow since August. The guarantee was appropriate in response to the banks predicament in late 2008. But it would be dangerous for the guarantee to continue much longer, or for banks to be left with an expectation that they will be bailed out again by a government guarantee if they are unable to fund their liabilities fully on their own balance sheets in future. That expectation would remove from banks' commercial calculations the normal market discipline; the moral hazard would distort commercial decisions. The continued weakness of the North Atlantic banks, failure to change fundamentally the conditions that generated the crisis in the developed countries of the North Atlantic, and the vulnerability of many financial institutions in many countries to weakness in United States bond markets together make provision for recurrence of crisis in wholesale funding markets a matter of ordinary prudence. If private Australian borrowers can find safe ways of funding a current deficit on the scale that preceded the crash, well and good. New and stronger financial institutions—for example, deeper Australian corporate bond markets linked to international bond markets—could expand the limits of prudence. But it is likely that prudent funding of private liabilities, and prudent regulation of the banks, would make it more difficult at least for a time to fund liabilities in the manner of the early twenty first century.

The Governor last night suggested that we could seek to fill the gap with safer ways of funding the deficit—ways that avoid currency mismatches, notably foreign equity. That may be more easily said than done: global direct foreign investment flows have fallen sharply after the Crash. Chinese direct foreign investment is an exception—which raises questions about the economic costs of the recent surge of nationalist sentiment.

To continue my theme of prudence, I should mention one other risk in the outlook. Our private sector and especially our banks have levels of net foreign debt that are high by the standards of Australia in the past or any other

countries at present. This makes our private sector exceptionally vulnerable to any fall in the Australian dollar or rise in international interest rates. There is more danger in such exposures in the post-Crash world. China and other Asian developing countries have substantially reduced their surpluses over the past year; China's expansion has come mainly through increased domestic investment. What if there is a normal sort of recovery in investment and consumption in the big developed countries? What if the Australian is not the only developed economy to respond to massive fiscal and monetary stimulus? What if global US dollar-denominated bond rates behave as we would expect as greatly increased Government borrowing demands in many countries compete with private demand for capital in a market that has much less support from Chinese surpluses--and bond yields rise sharply? In those circumstances the value of the Australian dollar would quickly retrace a fair bit of the ground over which it has travelled since it became clear that Australian interest rates would rise ahead of those in other countries. Our banks' currency exposures may be completely and currency interest rate exposures partially hedged—but only for limited periods. The debt will need to be rolled over at some time in the new market conditions. And will the counterparties to the hedges be comfortable in carrying even larger exposures after than before the Crash? And are the counterparties all impregnable to a bond market sell-off, having accumulated unusually high levels of liabilities in the form of Government securities as part of the response to the Crash?.

Prudence would tell us to be careful about relying on increases in foreign debt at anything like the rates of the early twenty first century. Even if, in the event, the debt can be rolled over without crisis, higher interest rates and foreign exchange losses would lower still further the levels of expenditure that Australia could prudently sustain.

So excessive expenditure during the boom means that we must drastically reduce the rate of expenditure growth, and probably go through a period with no real per capita expenditure growth at all. How long this period will be depends on the rate of productivity growth. The strong Australian productivity growth of the 1990s stopped in the early twenty first century. This required but did not receive corrective policy during the boom –The Great Australian Complacency of the Early Twenty First Century. It must now be restored to the public policy agenda. Productivity growth has been rendered more difficult by the reversal of a quarter of a century of increasing competition in financial services-- more than a reversal, to less competition than before deregulation--and by the proliferation of interventions to secure the economy against crisis. Amongst much else, revival of productivity growth requires reform and heavy investment in transport, communications and other infrastructure, and in education and training. This, in

turn, requires reform of the Federal-State financial arrangements that have systematically diverted investment capacity away from the Governments that are responsible for the vastly over-stretched infrastructure in Australia's largest cities. It represents yet one more reason for caution on current expenditure.

All of this must be managed alongside the increasingly urgent issue of climate change mitigation. As the Minister for Climate Change said this morning, strong global mitigation is of immense importance to future Australian prosperity and security. The Rudd Government's commitment to Australia playing its full part in an ambitious global mitigation effort is strongly in Australia's national interest, and the Government's effective diplomacy has increased the chances of international outcomes that are consistent with Australia's national interest. Costs of Australia playing its full part in an ambitious global agreement will be moderate if economically optimal policies are applied, but high if policy comes to be dominated by re-establishment of old patterns of Australian rent-seeking behaviour.

As the Minister said this morning, playing a full part in an ambitious global effort has a moderate cost. Moderate, but a cost nevertheless. The cost will be much higher if we descend any further into devoting corporate energy and focus to seeking preferment from Government rather than to the achievement of higher productivity. The costs of full Australian participation in a strong global mitigation effort are well worth paying. The mainstream science tells us that this investment in avoiding high risks of dangerous climate change is likely to avoid much higher economic costs in future. But the hard times ahead tell us to be careful not to make the costs higher than they need to be to achieve the mitigation result.

REFERENCES:

Garnaut, Ross with David Llewellyn-Smith, 2009, *The Great Crash of 2008*, Melbourne University Press, Melbourne.