RESERVE BANK OF AUSTRALIA

Economic Opportunities and Risks over the Coming Decades

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Talk to 2003 Melbourne Institute Economic and Social Outlook Conference Dinner
Melbourne - 13 November 2003

In keeping with the theme of this year's conference, I have chosen a subject which has a long-run focus. No doubt this will disappoint some who were hoping that I would deal with the 'here and now' of Australian monetary policy. But I should point out that within the last week or so we have put out both a press release and a detailed quarterly report on monetary policy and in a few weeks time I will appear before a Parliamentary Committee for three hours of grilling on the same subject. I think we keep the public well informed on the evolution of our thinking on monetary policy, and therefore do not feel the need to deal with it every time I speak in public.

My talk tonight will bear a family resemblance to the talk I gave 18 months ago at the first of these conferences jointly organised by the Melbourne Institute and *The Australian* newspaper. As in that talk, my approach will be to start with the world and work back to Australia's place in it. I should say at the outset that I have always been an optimist when I consider Australia's place in the world. That is, I think that the opportunities before us outnumber the risks and I think that Australia is in a much better position than nearly all of the other countries I could name. It does not mean that success will fall in our lap – we will still have to make a lot of hard decisions, many of which will not be particularly popular, but this will be nothing new.

Optimism is not the normal Australian position when viewing our place in the world. There has been an abiding gloominess amongst most observers who were pre-occupied with the view that we as a country were slipping down the international rankings, and that this would continue. This pessimism was particularly rife in the 1980s, re-emerged briefly during the 'tech boom', but fortunately there is less of it now. The fact that we have had more than a decade of good economic performance, notwithstanding a difficult international environment at times, has helped build confidence in our ability to make our way in the world.

Let me say a few words about international rankings. There are several organisations that publish rankings of countries according to income or GDP per capita. That is, they rank countries from the richest down to the poorest. In the past, I have been critical of these rankings because there are so many statistical assumptions that are involved in their construction that the results are very approximate, and therefore cannot form the basis of policy interpretation or aspiration. To illustrate this, Table 1 shows the rankings for the year 2000 as calculated by three separate organisations – the World Bank, the OECD (Organisation for Economic Co-operation and Development) and Penn World Tables (University of Pennsylvania). As you can see, there is a good deal of similarity between the three rankings, but Australia's position is variously recorded as seventh, tenth and twelfth out of 22 countries.

Table 1
GDP per capita rankings - OECD countries, 2000

	Penn World Tables	World Bank	OECD
1	United States	United States	United States
2	Norway	Switzerland	Norway
3	Canada	Norway	Switzerland
4	Denmark	Iceland	Denmark
5	Switzerland	Belgium	Iceland
6	Ireland	Denmark	Ireland
7	**Australia**	Canada	Canada
8	Iceland	Japan	Netherlands
9	Japan	Austria	Austria
10	Netherlands	Netherlands	**Australia**
11	Belgium	Ireland	Belgium
12	Austria	**Australia**	Japan
13	Sweden	Germany	Germany
14	Finland	Finland	Finland
15	United Kingdom	France	Italy
16	Germany	Sweden	Sweden
17	France	United Kingdom	United Kingdom
18	Italy	Italy	France
19	New Zealand	Spain	New Zealand
20	Spain	New Zealand	Spain
21	Portugal	Portugal	Portugal
22	Greece	Greece	Greece

PPP weights
Sources: Penn World Tables; World Bank; OECD

Notwithstanding these reservations, it should be pointed out that the period when Australia was slipping down the rankings appears to have ended (Table 2). Using the Penn World Tables, Australia has moved up from tenth in 1990 to seventh in 2000, while the World Bank numbers show it moving up from sixteenth in 1990 to ninth in 2002. I do not wish to make much of this, given my reservations about these rankings, but at least it should put a stop to stories about how we are falling behind.

Table 2
GDP per capita rankings - Penn World Tables

	1960	1980	1990	2000
1	Switzerland	United States	United States	United States
2	United States	Switzerland	Switzerland	Norway
3	New Zealand	Canada	Canada	Canada
4	Denmark	Norway	Japan	Denmark
5	**Australia**	Iceland	Denmark	Switzerland
6	Sweden	Denmark	Iceland	Ireland
7	Canada	Sweden	Sweden	**Australia**
8	United Kingdom	**Australia**	Norway	Iceland
9	Netherlands	Netherlands	Finland	Japan
10	Norway	France	**Australia**	Netherlands
11	France	Belgium	France	Belgium
12	Belgium	Austria	Belgium	Austria
13	Finland	Germany	Austria	Sweden
14	Iceland	Japan	Netherlands	Finland
15	Austria	Finland	Germany	United Kingdom
16	Italy	Italy	Italy	Germany
17	Ireland	United Kingdom	United Kingdom	France
18	Spain	New Zealand	New Zealand	Italy
19	Japan	Greece	Ireland	New Zealand
20	Greece	Spain	Spain	Spain
21	Portugal	Ireland	Portugal	Portugal
22		Portugal	Greece	Greece

Table 2 (continued)
GDP per capita rankings - World Bank

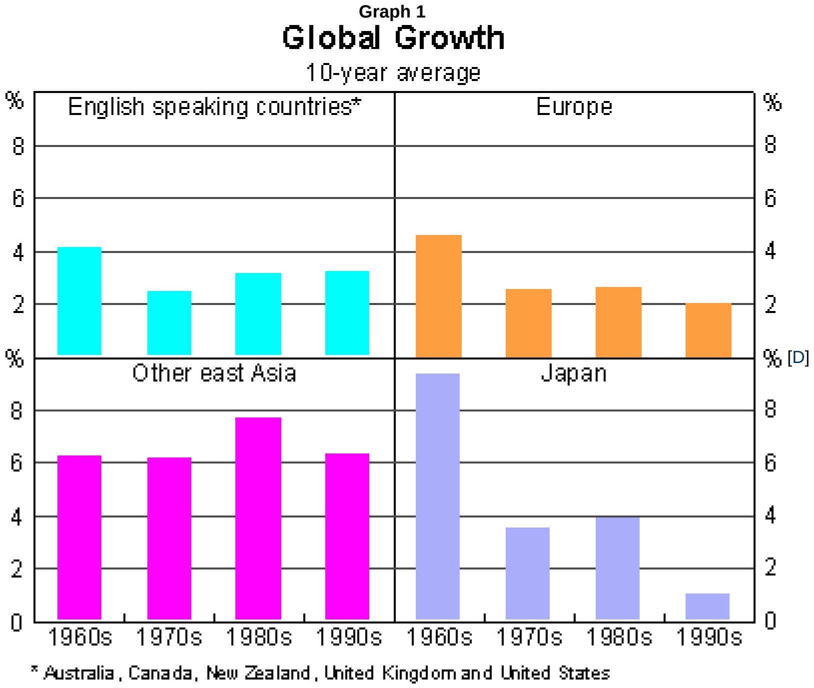
	1980	1990	2002
1	Switzerland	Switzerland	Norway
2	United States	United States	United States
3	Norway	Norway	Ireland
4	Iceland	Iceland	Denmark
5	Denmark	Denmark	Iceland
6	Canada	Canada	Canada
7	Austria	Japan	Austria
8	Germany	Austria	Switzerland
9	Belgium	Germany	**Australia**
10	Netherlands	Belgium	Netherlands
11	France	France	Belgium
12	**Australia**	Netherlands	Germany
13	Sweden	Italy	France
14	Italy	Sweden	Finland
15	Japan	Finland	United Kingdom
16	Finland	**Australia**	Japan
17	United Kingdom	United Kingdom	Italy
18	New Zealand	New Zealand	Sweden
19	Greece	Spain	Spain

20	Spain	Ireland	New Zealand
21	Ireland	Greece	Greece
22	Portugal	Portugal	Portugal

As I said earlier, I think we are well placed for another good performance over the coming decade for two broad reasons.

First, our geographic position. When we look at the major regions of the world over the past four decades, we note from the right-hand panels of Diagram 1 that both Continental Europe and Japan show a distinct downward trend in their growth rates as we move forward from decade to decade. For the English-speaking countries, this has not been the case; even though they have not regained the growth rates of the 1960s, the three decades after that show, if anything, a slight upward trend. The thing that stands out about East Asia is just how fast growth has been in each decade (greater than 6 per cent per annum), and again there is no sign of a downward trend.

Graph 1



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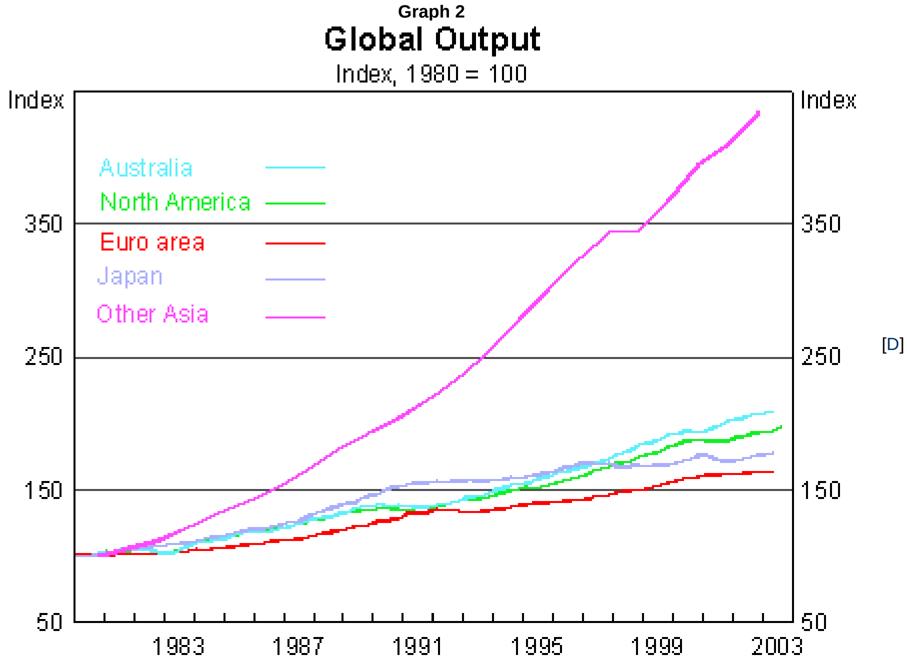
Over any measure, say, 20 years, 10 years or even five years, Asia is the fastest growing region in the world, despite what we can now see was a relatively brief setback during the Asian crisis. And there is no reason to believe that it will not continue. In fact, there is reason to believe that it will become more pronounced. Over the past few decades, a number of smallish Asian countries learned how to grow quickly, and now we are seeing the two truly huge countries – China followed by India – achieve the same sort of consistent high growth rates.

Graph 2



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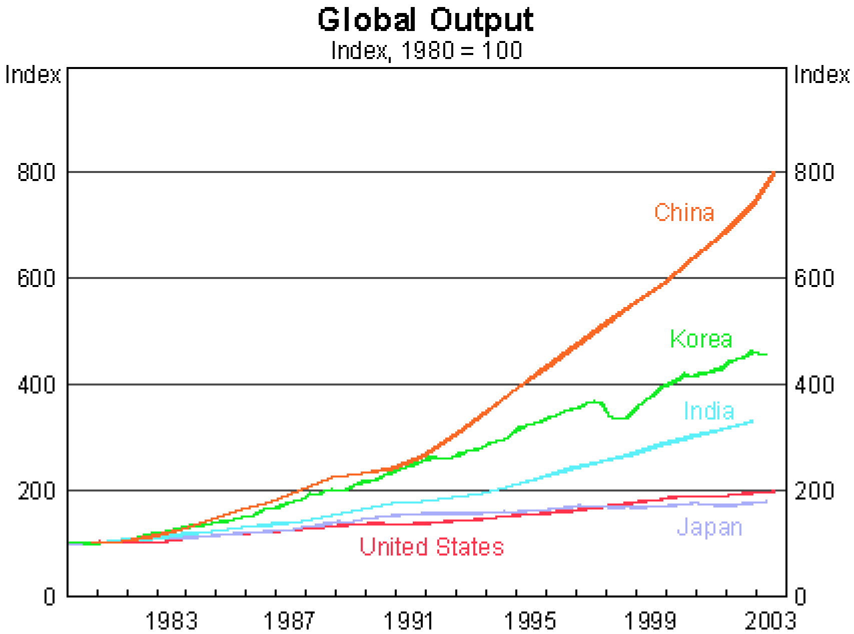
Graph 3



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A lot of countries are terrified by this, as they see China and India threatening their own industries. Other countries see themselves in a position to benefit from this growth, and Australia surely has to be one of them. The potential benefit comes from the fact that China and India will not only be large exporters, but will be large importers as well. For example, over the past year, Chinese imports rose by 40 per cent.

The countries that are threatened have one or both of the following characteristics:

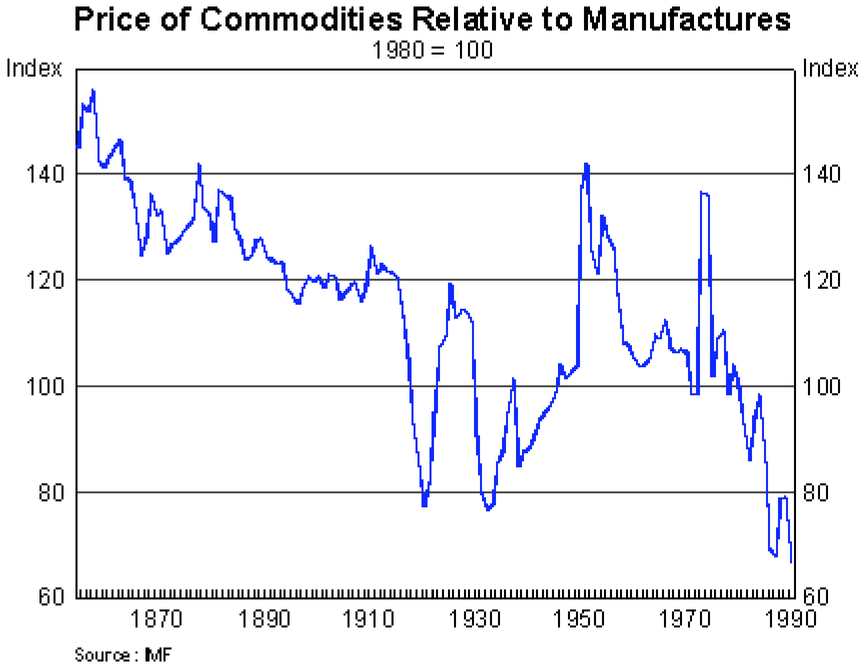
- they have large manufacturing sectors, often propped up with various protective devices; and
- they have relatively rigid regulations which make it difficult to shift resources (mainly labour) from the declining sectors into the potential growth sectors.

Large parts of the world's manufacturing industry are being effectively transferred to China, so in other countries new jobs will have to be found for the people so displaced. The test these countries face is whether they can rise to the occasion or whether they will simply try and prop up yesterday's industries. (As an aside, I am relieved that we are not having to face the coming challenge with the sort of heavily protected manufacturing sector and centralised wage system that we had a couple of decades ago. I am sure we would have failed the test.)

My second cause for optimism is related to the first. For most of the 20th century, as the new post-colonial countries were opened up, there was a massive expansion in the supply of resource-based products like the ones we have traditionally produced and exported. In resource-based, I include both agricultural products and minerals and metals. The prices of these products trended downwards relative to the prices of the things that we tended to import like manufactures and services. In economic parlance, the terms of trade moved against us decade by decade, and this held back the growth in our real incomes (Graph 4). Incidentally, this was the principal reason why we slipped down the international league table of income per head.

I think this long trend has at last turned – by my estimate, since about the middle of the 1980s. Now the massive expansion in capacity around the world is in manufacturing (mainly Asian manufacturing) and the greatest downward pressure on pricing is occurring there. Thus, our export prices are now doing better than our import prices, and our terms of trade has risen on average over the past 15 years (Graph 5). The mirror image of this is to be found in China's terms of trade which has fallen by 30 per cent between 1978 and 2001.

Graph 4



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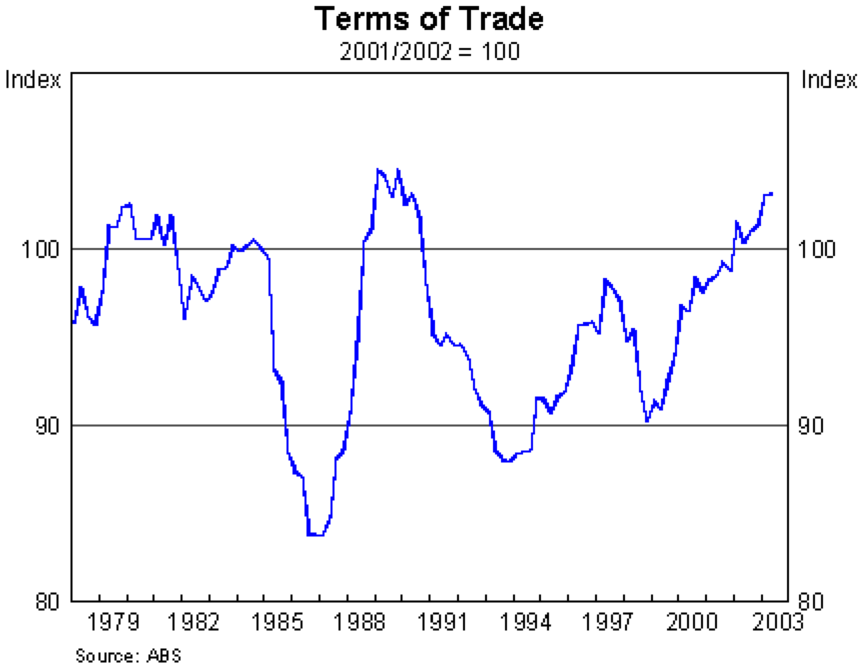
Graph 5



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A lot of people would object to this line of reasoning as they would say that I seem to be accepting that we will remain a quarry and a farm. That is not true. I thoroughly applaud our success in broadening our export base into elaborately transformed manufactures and services, and will have more to say about this later. But with the best will in the world, most of our exports will still be resource-based in a decade's time and probably two decades' time. It has taken 20 years for the resource-based share of exports to fall from 70 per cent to 60 per cent, so you can see that change is relatively gradual in this area. We should assume that over the next decade or so we will still be a major exporter of resource-based products, but we should take comfort from the fact that this will not be the disadvantage that it once was.

What are our advantages and disadvantages?

Apart from being in the right place and producing the right output, what are our advantages compared with other countries?

First, we should compare ourselves with other developed countries with a similar level of income per head; these are mainly European. Compared with this group, I think we have two big advantages – flexibility and demographics. Certainly, our institutional framework in goods, labour and financial markets means we can adjust to change better than virtually all of the European competitors, even if we are only on a par with the British and Canadians, and less flexible than the United States. On demographics, our population is aging less quickly than virtually any other developed country, thanks to our high level of immigration. But even though we are better off than others, we should not delude ourselves into thinking that we do not have some big challenges facing us brought about by an aging population, a subject to which I will return.

Second, if we compare ourselves with the countries of Asia, we have three clear advantages:

- we have a better legal and regulatory infrastructure;
- we have a less-polluted physical environment; and
- a higher proportion of our labour force is skilled.

Against this, we have less flexibility in the labour market and a more expensive social welfare system. While the latter makes for a better and fairer society, it has to be financed by relatively high taxes, a combination of factors which means that our savings rate is low by Asian standards. This means that we will continue to rely on foreign savings to augment our own, and hence we need to remain an attractive place for foreigners to invest.

Against this background, what should we do to maximise our advantages? First, I think there will be a huge premium on flexibility. The countries that can adapt to the emergence of China and India and other parts of Asia will thrive, while those that go into defensive mode will stagnate. I think that the market by itself will probably do quite a good job of handling the challenge, although at times it may need assistance. The main risk is that there will be public pressure put on the Government to prevent the changes which may be painful in the short run, but which will be in our long-term interest.

Secondly, there will be a premium on moving up the skill spectrum. This can be seen most clearly in manufacturing where the mass-production of standard items will become dominated by the big Asian countries, and we must find other avenues which are opened up by the possession of more specialised skills. This is more complicated than it sounds. Some people think that China is only going to dominate low-tech things such as textiles, clothing and footwear, basic utensils, consumer electronics, etc. But they could dominate a lot more than that; they could dominate anything that can be produced on a large scale, even if it is technologically sophisticated, such as cars and semi-conductors. What we will need to be good at will be in producing things that are specialised rather than mass-produced, skill-intensive and which, in many cases, may be difficult to identify other than by trial and error. They will include both manufactured goods and specialised services for export, but will also involve using the best applied science available to increase productivity in our traditional resource-based industries and in those parts of the economy not involved in international trade such as construction or domestic transport.

There are no short cuts here. The thing we know is that profitable opportunities will only be found if we have a culture of inquiry and innovation. This in turn can only happen if we have a vigorous educational and scientific environment where excellence is valued and rewarded.

An illustration of this is if we think back to the discussions in 2000 at the height of the technology boom. There was a widely-held view at that time that the countries that would get ahead were those that manufactured IT and telecommunications equipment, and that if you did not do so you would fall behind. There was even the suggestion floated in this country that we should entice Intel to open a chip factory here. In fact, all the research that has now come to light shows that it is the application of the new technologies which leads to the big increases in productivity, not the manufacture. In fact, manufacturing often takes place in a huge foreign-owned factory, using orthodox mass production techniques, with very little spin-off to the rest of the economy.

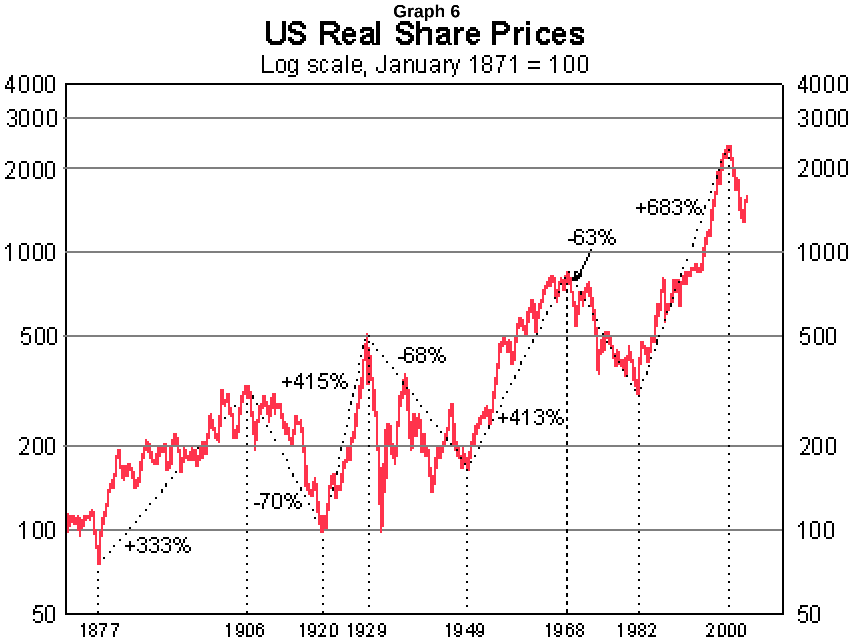
My third theme is demographic. All around the developed world, populations are aging and the growth of working-age populations is slowing or, in some cases, falling. More retired people are being supported by fewer working people. We should be looking ahead and encouraging higher labour force participation by older workers. The Intergenerational Report produced by the Government will be a very useful document on which to base thinking on policy options.

If we are not careful, there is a potential for conflict between generations. The young may resent the tax burden imposed on them to pay for pension and health expenditure on the old. This will particularly be the case if they see the old as owning most of the community's assets. Housing is the most obvious example, where people of my generation have benefited from 30 years of asset price inflation, while new entrants to the workforce struggle to buy their first home.

At the same time, people – retirees in particular – are likely to be feeling less secure as they may be disappointed with the rates of return they are receiving on their savings. It seems to me that the community has not yet come to terms with the fact that nominal rates of return on financial and real assets are likely to be much lower over the coming decade or so than over the previous two decades.

Returns were held up first by inflation (although, to some extent, this was illusory) and then by an asset price boom that lasted from 1983 to 2000 – the final instalment of which reached bubble proportions in many countries. We are presently witnessing the unwinding of this unsustainable situation. A good illustration of the long swings in rates of return is illustrated below by the change over the past 130 years in real equity prices in the United States.

Graph 6



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The potential for intergenerational conflict exists in all countries, and their future economic success depends in some sense on how they handle it. The countries that will do worst are those where the population is aging the fastest, and those where their governments have given the most generous promises. Again, we are looking mainly at Europe to find this combination of problems. But even in Australia, the conflict could become a problem and lead to all sorts of behavioural changes. At the very least, we should question the assumption that age and poverty are positively related and that concessions to alleviate the latter should be directed at the former.

In fact, I think we will have to go further and be pre-emptive in conditioning the public, particularly the grey-headed part, to accept that policy must be forward looking and directed to ensuring a vigorous Australian economy and society 20 years hence. This will mean giving priority to tomorrow's working-age population, rather than satisfying the demands of yesterday's.

Last time I spoke at this forum, I ended by making a plea for raising the priority attached to improving the level of excellence in tertiary education. Although I am not an expert in this subject and was merely quoting others more expert than myself, I was surprised at the favourable public reaction my observations received. I can think of no better way of ending this speech than again stating my view that an improvement in the quality of tertiary education is probably the best investment we can make in our future.