AUSTRALIA AND BRITAIN –
PREVIOUSLY PARALLEL PATHS NOW DIVERGING

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by

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There are some striking parallels between political and economic developments in Britain and Australia over the past twenty-five years, despite their respective locations at opposite ends of the globe.

Both countries undertook substantial economic reforms in the 1980s, in response to decades of economic underperformance which saw their average standards of living decline relative to those of countries with which they had typically compared themselves. In the early 1990s, the Prime Ministers who had led those reforms were both overthrown by their respective Treasurers, who each went on to lead their parties initially to unexpected election victories, but then to substantial defeats from which neither of their parties have subsequently recovered.

Australia and Britain both experienced severe recessions in the early 1990s, but these were followed by prolonged periods of strong economic growth, accompanied by low and relatively stable inflation and interest rates. After incurring large budget deficits in the early 1990s, both saw a return to fiscal surpluses by the end of the decade. Despite this, and notwithstanding the attraction which both countries had in the 1980s to the so-called 'twin deficits theory' purporting to link budget deficits to deficits on the balance of payments, both experienced a substantial deterioration in their current account balances: to the point where in recent years Britain and Australia have been running the second- and fourth-largest current account deficits in the world, in absolute terms, in the last three years.

Reforms continued in both countries during the 1990s, and in each possibly the most important reform – at least from the perspective of economic policy-making – was the granting of formal independence to their respective central banks, ending decades of political interference in the setting of interest rates, and ushering in more credible frameworks for the administration of monetary policy which in turn contributed to the lower and more stable inflation and interest rates which both have since enjoyed, in marked contrast to their common experience in the 1970s and 1980s.

The emergence of low and stable interest rates combined with sustained growth in real labour incomes, innovation in both countries' mortgage markets, and high levels of immigration, resulted in both countries experiencing housing booms of unprecedented magnitude, breadth and duration. These booms came to an end at roughly the same time in both countries – towards the end of 2003 and the early part of 2004 - although (in contrast to some of the gloomy predictions made towards the end of the boom) house prices have plateaued[1] rather than declined precipitously, as they did at the end of the late 1980s property booms in both countries.

And of course in both countries the Prime Ministers who led their respective parties to major electoral victories in the second half of the 1990s have attained milestones of incumbency matched by very few of their predecessors. And in both countries one of the on-going political fascinations is the frustrated aspirations of Treasurers who could have been Leaders of their respective parties in the mid-1990s and who now feel that their time has come.

Yet in some other very important respects the course of events in Britain and Australia has begun to diverge in recent years.

[1] Albeit that house prices are continuing to rise in Perth, Darwin and some other mining centres in Queensland and Western Australia.

Britain's economy has slowed significantly since the property market peaked. UK real GDP grew by just 1.8% in 2005, the slowest since 1992; while recorded unemployment rose by an average of 7,000 per month last year, the first year in which unemployment has risen since 1992. In response to this slowdown, the Bank of England cut interest rates last August.

Britain's fiscal position has also deteriorated significantly, partly as a result of conscious policy decisions by the Blair Government (in particular, to boost spending on the National Health Service) but also in response to the slowdown in economic activity. Britain's fiscal balance has swung from a surplus of 1.5% of GDP in 2000 to a deficit of 3.6% of GDP in 2005. According to the IMF, the *structural* deterioration in the UK's fiscal position has been equivalent to 5.0 percentage points of GDP over this interval, a full percentage point of GDP more than in the United States during the same period.

By contrast, although Australia's economy also slowed somewhat in the aftermath of the end of our property boom, it was 'only' to 2.5% in 2005, and all the indications are that it is picking up once again in the first half of 2006. The Reserve Bank of Australia raised interest rates in March last year, and is poised to raise them again sometime this year (although I'm not convinced that they will do it next week, as the financial markets seem now to be predicting).

And of course Australia's budget remains in surplus, of the order of about 1% of GDP.

So what is the reason for this difference in the recent economic experience and the economic prospects for two economies whose experience over the previous two decades or so had been so uncannily similar?

The answer, in a word, is *geography*; and in another two, *resource endowment.*

Britain's economic fortunes have, over the past thirty years or so, become increasingly intertwined with those of its fellow members of the European Union. While this is entirely natural and logical – indeed it would be strange if this had not been the case – the problem it poses for Britain is that the European Union has become increasingly sclerotic, unable to contemplate let alone undertake the reforms required to address deep-rooted structural problems which have undermined its long-term economic performance and prospects.

By contrast, Australia's geographical location and its bounteous endowment of natural resources have made it almost uniquely well placed to benefit from the rapid growth and industrialization of China.

At this point let me recite a couple of facts. Properly measured – by gross domestic product converted into US dollars at purchasing power parities rather than at market exchange rates – China is already the world's second largest economy and has been since 1994. [To understand how misleading comparisons based on GDP at market exchange rates can be, recall that the Australian dollar has risen by around 50% - from US50¢ to around US75¢ - over the past five years. This would imply that Australia's GDP, converted to US$ at market exchange rates, has grown by around 50% plus the roughly 3% per annum by which it has grown in real A$ terms over that interval. Does anyone seriously suggest that this measure constitutes a sensible basis for undertaking comparisons of changes in the size of Australia's economy with that of, say, the US, over this period?]

Although China's economy will almost certainly experience cyclical fluctuations in its growth rate[2], there is no reason why it cannot achieve economic growth averaging somewhere in the range 6 to 9% per annum over the next decade and possibly the decade after that as well.

As a result, China will almost certainly move past the United States to become the world's largest economy sometime between 2013 and 2018[3]. Of course China will still be a relatively poor country – with five times the United States' population its per capita GDP will still be only about one-fifth that of the US (compared with about one-seventh today). But it will have reclaimed the position in the global economic pecking order that it (or India) occupied throughout most of recorded human history, until some time in the latter part of the 19th century when it was overtaken by the United States[4].

China is for the most part a net importer of commodities and a net exporter of (a growing range of) manufactured goods. And it is now large enough a participant in global markets for the things that it exports and imports to be exerting significant upward pressure on the prices of the former and downward pressure on the prices of the latter.

Australia, by contrast, and somewhat unusually for a 'First World' economy, is the exact opposite – a net exporter of commodities and a net importer of manufactured goods (and services). Nature has richly endowed this country with many of the things which China needs and cannot produce for itself; while we have, through our own far-sighted program of unilateral trade liberalization over the past two decades, relatively fewer of the industries which are increasingly vulnerable to competition from their Chinese counterparts than the United States or Europe (or, for that matter, other Asian economies).

China has thus almost single-handedly reversed one of the most relentless and detrimental long-term trends in Australia's economic experience – namely, the persistent tendency for the prices of Australia's exports to decline, either in absolute terms or relative to the prices of our imports (which economists refer to as the 'terms of trade').

The decline in Australia's terms of trade – apart brief interruptions in the early 1920s, the early 1950s and the mid-1970s - was, together with our own economic mismanagement over most of this period – the main reason for Australia slipping from having (along with New Zealand and Argentina) the highest standard of living (as measured by per capita GDP) in the latter years of the nineteenth century[5] to ranking only 19th on that score by the end of the 1990s, when we were routinely being reminded by the likes of Lee Kuan Yew that we were well on the way to becoming 'the poor white trash of Asia'.

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[2] In my view China may well experience a downturn after the Beijing Olympics, if the excess liquidity generated by China's foreign exchange interventions re-ignites the boom in China's urban property markets and thereby to further social unrest, forcing the Chinese authorities to take policy actions to 'prick' the real estate 'bubble'. See for example my *China and the Australian Dollar*, Address to a dinner hosted by the Australia-Japan Roundtable (Melbourne, 9 August 2005; available at www.anz.com/Business/info_centre/economic_commentary/Chinaandthe.pdf), p. 10.

[3] See my *China and India in the World Economy*, Paper presented to the International Conference of Commercial Bank Economists, (Salvador, Brazil, 7 July 2005; available at www.anz.com/Business/info_centre/economic_commentary/ICCBEChinaIndia.pdf), p.2.

[4] See Angus Maddison, *The World Economy: A Millennial Perspective* (OECD Development Centre, Paris, 2001), Table B-18.

[5] Nicholas Crafts, *Globalization and Growth in the Twentieth Century*, IMF Working Paper No. 00/44 (Washington DC, March 2000).

Since the late 1980s, and especially since the mid-1990s, this century-long downward trend has been thrown into reverse, such that by the end of last year Australia's 'terms of trade' were more favourable (ie, the prices we were receiving, on average, for our exports were higher relative to the prices we were paying, on average, for our imports) than at any point since the March quarter of 1974. And in all likelihood when the figures for the March quarter just gone are released in early June, they will show Australia's terms of trade as more favourable than at any time since the Korean War wool boom of the early 1950s.

This is no mere statistical abstract. The improvement in Australia's terms of trade represents a boost to Australia's national income which is not captured by movements in real GDP – which, by definition, are stripped of the impact of changes in prices (including of imports and exports). The improvement in Australia's terms of trade so far this decade has lifted Australian real per capita gross disposable income by over $2,600 per head.

The 'China effect' has thus helped to sustain growth in the Australian economy beyond the end of the residential property boom – in contrast to the experience in the UK; and in contrast to what I expect will be the experience in the United States when its housing boom comes to an end, as I suspect it will later this year.

It has done so not only by raising the incomes of commodity producers themselves.

It has also done so by boosting the tax revenues of the Federal Government (which through the company income tax system takes 30 cents of every additional dollar that higher commodity prices adds to the profits of companies such as Rio Tinto or BHP Billiton), which in turn has handed almost over every additional dollar it has thereby reaped to households in the form of tax cuts or increased cash benefits (more on that anon).

And it has done so by exerting downward pressure on the prices of imported consumer goods, thereby helping to keep inflation and interest rates lower than might otherwise have been the case given the high levels of resource utilization at which the Australian economy has been operating in recent years.

And it has done so by stimulating a significant increase in capital expenditure by the resources sector and in its associated infrastructure, and will continue to do so this year with an increase in the volume of resources exports.

The only real downside from the 'China effect' is that by keeping the exchange rate for the Australian dollar higher than it might otherwise have been (especially given the dramatic contraction in the interest rate differential between Australia and the United States since mid-2004), the international competitiveness of Australia's trade-exposed manufacturing and services sector has been eroded. In effect, these sectors have been 'squeezed' to make room for an expansion in Australia's resources sector in the context of greatly diminished 'spare capacity'[6].

Thus Australia, unlike the UK to some extent, finds itself at a very auspicious point in the business cycle with low unemployment by the standards of the preceding decade or so; rising real incomes; record corporate profits and share prices; and buoyant government revenues keeping budgets in surplus.

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[6] For an excellent analysis of this see David Gruen (Chief Adviser (Domestic), Macroeconomic Group, Australian Treasury), *A Tale of Two Terms-of-Trade Booms*, Address to Australian Industry Group *Economy 2006 Forum* (Melbourne, 1 March 2006, available at www.treasury.gov.au/documents/1077/PDF/AIG_March_06.pdf).

The only arguable 'black spot' on our contemporary economic report card is that, despite the currently highly favourable conjuncture of export and import prices, Australia is still running a current account deficit in excess of 6% of GDP – in large measure because buoyant domestic demand is spilling over into imports.

The striking thing about this is that we have been here before – in 1960, in 1973, in 1981 and in 1989. With the exception that inflation and interest rates are much lower than they were in 1981 and 1989, the description I've just given of the current state of the Australian economy also accurately summarizes the condition of the Australian economy on each of those four previous occasions.

And yet within less than two years of each of those four occasions, Australia found itself in one of the four serious recessions we've experienced in the last fifty years.

That hasn't happened by accident; or because there is in economics some equivalent to Newton's Law of Gravity which says that what goes up most come down.

It has happened because whenever the Australian economy has previously enjoyed such a felicitous combination of circumstances, governments and their agencies have made three fatal policy mistakes.

The first has been that of allowing wages growth significantly to exceed productivity growth as 'bargaining power' in the labour market has swung from employers to unions.

That mistake seems unlikely to be made on this occasion – partly because the Industrial Relations Commission, which in its various incarnations has played such a crucial role in making it in previous cycles, is being 'put down' as part of the Government's industrial relations reforms; and partly because structural changes in the labour market – highlighted by the fact that there are now more owners and managers of businesses than trade union members in the labour force, and more direct owners of shares than trade union members in the adult population – have helped to cement an understanding that pushing for wage increases which are not underpinned by productivity gains is a sure route to widespread job losses.

The second mistake which Australian governments have always made at this stage of the business cycle is that of failing to permit the Reserve Bank to raise interest rates 'a little bit' in the early stages of a cyclical acceleration in inflation, and thus ultimately forcing the Bank to raise interest rates to recession-inducing levels in order to get inflation down to tolerable levels once more.

I say *governments* have made this mistake – rather than the Reserve Bank itself - because until the early 1990s *de facto*, and 1996 *de jure*, the Reserve Bank used to have to go cap in hand to the Treasurer of the day in order to get his permission to raise interest rates; and the Treasurer of the day, being a politician, was always reluctant to give that permission if an election was in the offing[7] or until inflation had itself become a serious political issue. The problem with that, of course, is that the nature of the inflationary process is such that if you (force the central bank to) wait until it is a serious political issue before doing anything about it, it is inevitable that inflation will rise a lot further – and the costs of bringing it down will be much higher – than if you 'nipped it in the bud'.

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[7] And not necessarily a Federal election; Treasurers' decisions about RBA requests to raise interest rates have been influenced by the imminence of by-elections or State elections.

It's therefore fortunate that, as a result of what I regard as the single best decision Peter Costello has made as Treasurer, the Reserve Bank no longer needs his blessing before raising interest rates.

That's just as well, because judging by everything that the Treasurer and most of his Ministerial colleagues[8] have said about the Reserve Bank every time the Bank even muses about raising interest rates, let alone actually does it, one would be entitled to think that if it *was* still up to them the present Government would make the second of the mistakes which previous governments have made at this stage of the cycle.

Australia is the only country in the western world (with the partial exception of Japan) with an independent central bank where the government regards central bank independence as giving it a remit to criticize the central bank whenever it makes a monetary policy decision that it (the government) regards as politically unpalatable. Not even in New Zealand – where perhaps some criticism from the government of that country's central bank's enthusiasm for raising interest rates might be considered justifiable by an objective observer – does one ever see or hear a word of official censure of the decisions of the central bank. Not even President George W. Bush – who has accumulated a substantial track record of elevating political considerations above conventional economic wisdom – was prompted to criticize the US Federal Reserve for raising interest rates three times during the 2004 election campaign, nor 12 times subsequently.

Nonetheless, and to its very great credit, the Reserve Bank has not been dissuaded by this overt political pressure from pursuing what it considers to be the correct course of action, and it has raised interest rates five times (albeit by only 1.25 percentage points in total) over the past four years with a view to maintaining inflation within its 2-3% target range.

And so the likelihood that the second of the mistakes which has always been made at this stage of previous business cycles will be made in this one is minuscule.

The third mistake which Australian governments have always made at this stage of the business cycle is that when, as now, their coffers are overflowing with tax dollars, they just can't help themselves from spreading it around in the form of tax cuts or increases in spending – even though this is precisely the stage of the business cycle when fiscal stimulus is least needed and most risky.

I suppose that mistake will always be a significant risk for as long as we are governed – as I hope we always will be – by people whom we have the right to dismiss from office at regular intervals if we collectively disapprove of their performance in it, and who therefore perceive it to be in their interests (of avoiding that fate) to ingratiate themselves with voters in the most tangible means possible.

This third mistake is one which, unlike the first two, is *not* being avoided by the present Australian government.

The China-driven resources boom has substantially increased the revenues being collected by the Federal Government. For example, when the Government first made an estimate of total tax revenues for the current (2005-06) fiscal year, in the 2002-03 Budget Papers, they were projected at $187.6bn.

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[8] With the notable and honourable exception of the Finance Minister, Senator Nick Minchin.

By the time of the most recent estimate, made in last December's *Mid-Year Economic and Fiscal Outlook*, that estimate had been revised up to $203.8bn, an increase of $16.2bn (or 8.6%). $14.9bn (or 92%) of that upward revision was attributable to the estimate for company income tax collections, which were revised up from $33.9bn to $48.7bn (or by 44%) between the 2002-03 Budget and the December 2005 MYEFO.

Similarly, the estimate of total tax revenues for the forthcoming financial year, 2006-07, has been revised upwards from $193.1bn when it was first published in the 2003-04 Budget Papers to $212.9bn in last December's MYEFO, an increase of $19.8bn (or 10.3%), $14.4bn of which is due to upward revisions to the estimate of company tax collections.

In total, what the Finance boffins call 'parameter variations' (their word for revisions to the Budget estimates that are the result of anything other than a Cabinet decision) since the 2002-03 Budget was handed down have added $97.5bn to the resources available to the Government over successive rolling four-year Forward Estimates periods.

'Policy decisions' taken by the Government over the same period are projected to 'cost' $98.8bn (in terms of revenue foregone through tax cuts or additions to expenditures).

In other words, the Government has spent *every dollar* – plus an additional $1.4bn – that the resources boom has dropped into its lap over the last four years.

Now I'm not so naïve as to suggest that the Government should or could have 'saved' every unforeseen dollar of additional revenue it has adduced since the 2002-03 Budget.

However, had the Government chosen to add, say, half of those windfall gains to its projected surpluses, then it would have been projecting 'underlying' cash surpluses of $28.3bn for both the current and the forthcoming fiscal year, and $22.9bn for 2007-08, instead of the $11.5bn, $9.7bn and $10.1bn which it actually projected in last December's MYEFO.

Those hypothetical surpluses sound like enormous amounts of money – and in an absolute sense of course they are – but as a percentage of projected GDP they would have represented 3.0%, 2.8% and 2.2%, respectively for the years 2005-06 through 2007-08. But they would have been less than the corresponding surplus run by the Menzies Government in 1960-61; not dramatically above the underlying surpluses run by the Whitlam Government in 1973-74 (1.8% of GDP) or the Hawke Government in 1988-89 and 1989-90 (1.75) of GDP or for that matter the surplus run by the present Government in 1999-2000 (2.0% of GDP) – all of which were larger as a proportion of GDP than those currently projected by the Government for the years 2005-06 through 2008-09 (1.2% for 2005-06 and 1.0% for each of the following three years)[9].

The surpluses currently projected for 2005-06 and beyond are also smaller, as a proportion of GDP, than those projected by the governments of other OECD member beneficiaries of current high commodity prices. Norway, for example, will be running budget surpluses of over 16% of GDP this year and next.

[9] Data in this paragraph from Commonwealth of Australia, *Mid-Year Economic and Fiscal Outlook 2005-06* (Canberra, December 2005), Table F1 (p. 253) and corresponding tables in earlier Budget Papers.

Less extremely, New Zealand will be running surpluses of 2.5% of GDP this year and 1.9% of GDP in 2007, while Canada will be running surpluses of 1.3% of GDP this year and 1.1% in 2007. In fact Australia ranks only 11th among the 29 countries classified as 'advanced' by the International Monetary Fund in terms of the size of its general government surplus as a percentage of GDP in 2006[10].

Had the revenue windfalls which have come the Government's way as a result of the commodities boom been used in ways that strengthened the capacity of the Australian economy to withstand the inevitable eventual downturn in commodity prices, then there would perhaps be less grounds for concern at the fact that every dollar of this windfall has been dissipated.

But I have to confess that I genuinely struggle to think of *anything* of lasting value that has been done with it.

And yet the suggestion that the Government should have 'saved' (that is, added to the surplus) a large proportion of these windfall gains, or at least should have used them in a way that contributed positively to the Australian economy's longer-term growth potential, is hardly either novel or radical.

Indeed, the idea that '20% of the produce of the land during the seven plenteous years [should be] laid up ... as a reserve for the land against the seven years of famine which are to befall the land ... so that the land may not perish through the famine' was originally put forward by someone who could perhaps be regarded as the first proponent of counter-cyclical fiscal policy, the biblical prophet Joseph, as recorded in a source that the Treasurer (for one) would presumably regard as impeccable[11].

Mind you, I'm not holding my breath that Joseph's sound advice will have had any bearing on the Budget to be brought down on Tuesday week, either.

Nonetheless, since the present Government is making only one of the three mistakes that previous governments have made at the corresponding stage of previous business cycles, there are good grounds for optimism that the current cycle will not end as miserably as the four previous cycles have done.

I mean no disrespect to say that from an economic perspective (if not a literary or a culinary one) I'd rather be in Britain than, say, France or Italy; but that (again from the same perspective) I'd also rather be in Australia than Britain.

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[10] Data in this paragraph from the IMF's *World Economic Outlook* database, April 2006.
[11] *Genesis* 41: 34-36.