AUSTRALIA AND BRITAIN – HOW THE CHINA-DRIVEN COMMODITIES BOOM IS CAUSING THEIR ECONOMIC CYCLES TO DIVERGE

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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 replaced 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 has yet recovered.

In both countries the Prime Ministers who led their respective parties to major electoral victories in the second half of the 1990s went on to achieve milestones of incumbency matched by very few of their predecessors. And in both countries one of the on-going political fascinations has been aspirations of Treasurers who could have been Leaders of their respective parties in the mid-1990s and who have made no secret of their belief that their time has come.

In Britain's case, Gordon Brown's aspirations to move from Number 11 Downing Street into the adjacent Prime Minister's residence have recently been fulfilled, and the transition has been accompanied by a sharp rebound in Labour's standing in the opinion polls, which if recent speculation is correct may prompt him to seek a mandate for his own leadership by calling an early election. On the other hand, here in Australia, if opinion polls are to be believed, Peter Costello's ambitions for higher office may go unfulfilled.

Of course the key qualifier here is 'if opinion polls are to be believed', because the Howard Government has a track record both of 'coming from behind' in elections, as it did in both 2001 and 2004; and in retaining government despite failing to secure a majority of the overall vote, as it did in 1998. It would thus be premature to conclude that the transition from Tony Blair to Gordon Brown will not have its parallel in Australia.

Over the past five years, the governments of both countries have consciously eroded civil liberties which our grandparents were willing to die for, ostensibly in order to secure their respective populations from a threat (Islamist terrorism) which in my opinion (though obviously not in theirs) represents less of a threat to our existence than fascism or Nazism did in the 1940s or Soviet Communism (and the risk of nuclear annihilation) did during the Cold War[1].

The strong parallels between the Australian and British political cycles are also apparent when we turn to economic cycles. 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.

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[1] For a detailed historical account see A.C. Graying, *Towards the Light: The Story of the Struggles for Liberty and Rights That Made the Modern West* (Allen & Unwin, 2007), especially the first and final chapters.

Major economic 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 rather than declined precipitously, as they did at the end of the late 1980s property booms in both countries.

Both countries avoided recession in the aftermath of the 'tech wreck' at the beginning of this decade – and were among the few Western economies to have done so.

And of course both Britain and Australia have been affected by the meltdown in the US sub-prime mortgage market and the consequent increase in 'risk aversion' on the part of credit market participants.

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

Australia's economy has continued to record relatively strong growth, averaging 3.5% per annum so far this decade, while Britain's growth rate has slowed to an average of 2.6% per annum over the same period. Indeed, during 2005, Britain's growth rate dropped to less than 2%, prompting the Bank of England to cut interest rates in August of that year, although with the benefit of hindsight that move was arguably a mistake and was reversed a year later, followed by four further rate increases. By contrast, the Reserve Bank of Australia has continued to tighten monetary policy, including this year which is the first time in living memory that the Reserve Bank has increased its cash rate in an election year.

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 swung from a surplus of 1.7% of GDP in 2000 to a deficit of over 3% of GDP in 2005, and is still running at around 2½% of GDP this year. According to the IMF, the *structural* deterioration in the UK's fiscal position has been equivalent to 4 percentage points of GDP over this interval, 1½ percentage points of GDP more than in the United States during the same period.

By contrast, Australia's budget remains in surplus, to the tune of 1¼-1¾% of GDP in recent years.

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 one 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.

Although China's economy will almost certainly experience cyclical fluctuations in its growth rate – and indeed may do so over the next couple of years as result of the recent sharp upward trend in its inflation rate – I see no compelling economic reason why it cannot achieve economic growth averaging somewhere in the range 7 to 10% 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 (properly measured, by GDP at purchasing power parities rather than at market exchange rates) sometime between 2013 and 2018[2]. 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.

And, looking much further out into the distant future, I suspect China will one day to the United States what the United States did to Britain between 1914 and 1956 – that is, use the financial leverage which it is now accumulating over the US (by financing a large proportion of the latter's current account deficits) to engineer a greater role for its own currency in the global financial system, with a view to having it eventually rival the US dollar as a reserve currency, and to move the world's financial capital from New York to either Shanghai or Hong Kong.

This, after all, is how the US dollar supplanted sterling as the world's reserve currency over the first half of the 20th century, and how New York took over London's previously pre-eminent role as the world's leading financial centre – although partly as a reaction to Sarbanes-Oxley, the Patriot Act and other regulatory excesses in the US, London has in recent years been reclaiming some of its earlier status as the world's premier financial centre.

While that day is more than 50, and maybe as many as 100 years away, for now 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.

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[2] For more details, see my *China and India in the World Economy*, Paper presented to the International Conference of Commercial Bank Economists (Costa do Sauipe, Brazil, July 2005), available at http://www.anz.com/business/info_centre/economic_commentary/ICCBEChinaIndia.pdf.

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's rapid growth and industrialization has 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 to ranking only 18th 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'.

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 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 $3,600 per annum - and in so doing, helped lift Australia's per capita income ranking back to 8th, where it was in the late 1950s and early 1960s. The only countries which now rank ahead of Australia in terms of per capita GDP are the United States and five relatively small countries in western Europe (Luxembourg, Norway, Ireland, Iceland, the Netherlands and Switzerland). Britain, which in 1989 and 1990 was one position behind Australia at 19th, still only ranks 15th.

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, even more so, in contrast to the United States where the end of the housing boom has not only directly slowed overall economic growth by around 1 pc point but has also contributed to a significant upheaval in global financial markets.

The positive impact that China's rapid growth and industrialization is having on the Australian economy goes beyond boosting the profits of mining companies and the wages and salaries of the growing number of Australians who work for them and businesses supplying them, or who live in areas where mining is a major part of the economy.

It has also done so substantially boosted the tax revenues of the Federal Government (about which more 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 in the years ahead 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 agricultural, 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'.

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.

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 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 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'.

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.

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 (2007-08) fiscal year, in the 2004-05 Budget Papers, they were projected at $211bn. By May this year, when the 2007-08 Budget was brought down, that estimate had been revised up to $231bn, an increase of $20bn (or 9.4%). $16.6bn (or 83%) of that upward revision was attributable to upward revisions to the estimate for company income tax collections, which were revised up from $46.4bn to $63.0bn (or by 36%) between over this interval.

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 an amount that I very conservatively reckon to be at least $398bn to the resources available to the Government over the nine years covered by the last five Budgets, compared with the initial estimates made in each Budget.

'Policy decisions' (ie, to increase spending or to cut taxes) taken by the Government over the same period are similarly conservatively projected to 'cost' $388bn[3].

And of this amount some $225bn has been, or will be, handed over to households in the form of cash, through personal income tax cuts and a further $66bn in increased personal benefit payments.

In other words, the Government has spent or given away in tax cuts *almost every single dollar* which 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.

But I do assert that the Government should have saved more of the windfall revenue gains which the commodity boom has delivered to it than it has.

Its reluctance to do so has not been without consequences. By redistributing massive sums from business – which has on average over the last four years saved the equivalent of 4% of GDP – to households which on average over the last four years dis-saved (that is, spent more than they have earned) the equivalent of ½ a percentage point of GDP – the past three Federal Budgets have boosted domestic spending, notwithstanding that their bottom line has been a surplus. And in doing so at a time when the economy is operating at closer to full capacity than at any other time in the past three decades, it has put some upward pressure on inflation and interest rates.

To be fair, in this year's Budget, and subsequently in foreshadowing the final outcome for the 2006-07 fiscal year, the Treasurer has indicated that some of these windfall gains will be invested in funds, the income generated by which will be used for thoroughly worthwhile purposes such as higher education and advanced medical technology.

My point – and I have been making it now for almost three years – is that the Government should have been doing this sooner, and in bigger amounts.

It should for example have been putting money away to pay for some of the costs associated with the ageing of the population, which they have spent the last six years telling us is the biggest fiscal challenge we face as a nation, instead of making those problems worse by making it optional for people aged 60 or more to pay income tax, and making it easier for relatively affluent senior citizens to claim part-pensions and other taxpayer-funded concessions and benefits (as one of the plethora of government advertisements is now reminding them that they can).

Instead of providing for large tax cuts now, when the economy is in no need of fiscal stimulus, it should have been providing for them, preferably in ways which embodied more far-reaching reform of the tax system, at some point in the future when the commodity boom has passed its peak.

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[3] These are conservative estimates because in arriving at them I assume, where necessary, that the bottom-line impact of 'parameter variations' and 'policy decisions' for years beyond the fourth year published in the Forward Estimates in each set of Budget Papers remain unchanged at their fourth year value, rather than escalating from year to year as they typically do in the published estimates for the first through fourth years.

And if it really believed that borrowing by State Governments for infrastructure is putting upward pressure on interest rates – even though the amount which State Governments will borrow this year is less than the amount which the private sector will borrow in the next three weeks – it could have alleviated that pressure by lending that money to the States directly (as Federal Governments used to do before the late 1980s).

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.

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 both the Treasurer and the Leader of the Opposition would presumably regard as impeccable[4].

And lest it be thought that any of the foregoing is meant to imply that I think the Opposition would do any better should there be a change of government later this year, I note that the Labor Party has merely proposed to match the current Government's policy of keeping the Budget in surplus by the amount of 1% of GDP each year - which presumably means that anything in excess of that would be spent or given away in tax cuts, as it has been by the present government.

Nonetheless, since both the present Government and (in the event that there is a change of government at the forthcoming election), the next Government are only making 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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[4] *Genesis* 41: 34-36.