

BETWEEN LUCK AND VULNERABILITY? AUSTRALIA IN THE GLOBAL ECONOMY

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Introduction

If something can't go on for ever, it won't¹

The recession that Australia faced in 2009 must have been the most anticipated economic crisis in Australian history. Although the worst global economic downturn since the Great Depression caused problems for the Australian economy, it appeared by late 2009 that Australia had avoided a severe downturn and outperformed the rest of the developed world.² One year earlier, it seemed certain that the Rudd Labor government had inherited an unfortunate Labor tradition of coming into office just as good times were replaced by bad. James Scullin had to deal with the Great Depression; Gough Whitlam tried to spread the luck of the post-war boom just at the point the luck ran out; and Bob Hawke took over at a time when it was increasingly obvious that Australia's problems were structural, rather than just cyclical. Determined to replicate the excellent record of the Hawke government, rather than the ignominy of Scullin's or Whitlam's, the Rudd government quickly embarked on a resolute program of government spending to stimulate the economy. The Reserve Bank of Australia (RBA) added monetary easing to this fiscal stimulus by cutting interest rates by 4.25 per cent between September 2008 and April 2009.

This prescient action helped Australia to avoid a technical recession, which is two quarters of GDP contraction in a row. Australia also benefitted from the Chinese government's huge fiscal stimulus, which helped to underpin continuing Chinese demand for Australian resources. Indeed, government actions throughout the world probably helped the world economy avoid a severe depression. Despite Australia's relatively good fortune, the global downturn was the world's worst crisis since the Great Depression of the 1930s.

As the news from the rest of the world started to improve, some Australian policy-makers and business figures argued that despite the chaos in much of the world economy, the real problem for Australia's future would be dealing with the politics of prosperity caused by the rise and

¹ Herb Stein, chief economic adviser to President Nixon

² See Ken Henry (2009) "The Shape of Things to Come: Long Run Forces Affecting the Australian Economy in Coming Decades", *Address to the Queensland University of Technology Business Leaders' Forum*, 22 October 2009 <<http://www.treasury.gov.au/contentitem.asp?NavId=008&ContentID=1643>>.

rise of Asia.³ Secretary to the Treasury, Ken Henry, argued that “China and India are only in the early stages of catching up with the living standards of the developed world and this process could have a very long way to run.”⁴ The Chairman of Australia’s biggest company BHP-Billiton, Don Argus argued on the same day “I believe we stand at the threshold of an era of unprecedented growth due to demand generated by China and, in the future, India.”⁵

Australia’s perceptions of their position in the world have often oscillated between optimism and pessimism, frequently driven by the vagaries of the global economy. Today, Australians once again believe they are living in a ‘lucky country’. When Donald Horne wrote *The Lucky Country* in 1964 he could not have imagined how iconic the phrase would become or how completely the ironic intent of his title would disappear.⁶ Nevertheless, his argument that Australia had succeeded because of its luck rather than its industriousness or innovation did not deny the fact that Australia was, indeed, lucky. While resource riches have been a curse for many countries, this has certainly not been the case for Australia. Prosperity in Australia has been built upon the foundation provided by its farms and mines.

But resource wealth has never been, nor will it ever be, enough. It has to be converted into widespread prosperity through political action and the construction of appropriate institutions. Eminent economic historian Ian McLean argues that:

The institutional framework is seldom offered as a reason for our economic success because it is taken for granted. Yet many growth economists now believe that, perhaps more than any other factor, appropriate institutions are the key to explaining why some countries are rich and others poor.⁷

By ‘institutional framework’, McLean means things such as the form of land ownership in colonial Australia such as the family farm, the development of educational and research facilities, right through to the political system itself. Why is it, for example, that the fortunes of Australia and Argentina diverged so significantly over the twentieth century given their similar positions in the 1890s? Both widespread prosperity and narrow opulence are shaped by political institutions. It is the political process in Australia, as flawed as it inevitably has been

³ Glen Stevens (2009) “The Road to Prosperity”, *Address to the 2009 Economic and Social Outlook Conference Dinner: The Melbourne Institute and The Australian*, Melbourne, 5 November <<http://www.rba.gov.au/Speeches/2009/sp-gov-051109.pdf>>.

⁴ Henry, “The Shape of Things to Come”. See also Tom Conley (2009) “China and India at the End of the Rainbow” *Big P Political Economy Blog Post*, 23 October <<http://tomjconley.blogspot.com/2009/10/china-and-india-at-end-of-rainbow.html>>.

⁵ Cited in Alan Kohler (2009) “Oracles of the Economy”, *Business Spectator*, 23 October <<http://www.businessspectator.com.au/bs.nsf/Article/Don-Argus-Ken-Henry-Ross-Garnaut-economy-BHP-Billi-pd20091023-X3RKZ?OpenDocument>>.

⁶ Donald Horne (1964) *The Lucky Country: Australia in the Sixties*, Melbourne, Penguin.

⁷ Ian McLean (2004) “Australian Economic Growth in Historical Perspective”, *Economic Record*, 80(250), p. 340.

and remains, that has ensured that the benefits of growth have been spread across Australian society.

Horne may have been too harsh. The spreading of luck in Australian economic history had much to do with the preference of policy-makers, supported by the population, to spread the benefits of abundance. There was a deliberate attempt to build an Australian model that has been called variously: the “Australian settlement”, “the historic compromise between capital and labour” and the “protectionist policy structure”.⁸ The model was built upon the realisation that resource wealth by itself would never be sufficient for longer-term prosperity. From the 1970s, however, this understanding was increasingly matched with an assessment that protectionism and insularity were no longer viable for an Australia wanting to maintain a high standard of living. The economic crisis of the mid-1980s, reinforced these twin understandings of Australia’s predicament as Labor Treasurer in the Hawke government, Paul Keating, treated Australians to a new label for Australia, the ‘banana republic’. Australia, Hawke and Keating argued, could never again rely on protectionism or resource wealth. The solution was to liberalise and globalise the Australian economy.

But things change. And then they change again. Globalisation of the Australian economy, continuous years of growth, and the rise of China undercut the pessimistic view of Australia and its position in the world. The Howard Liberal-National Coalition government presided over the longest period of economic growth in Australian history and the China boom of the 2000s weakened arguments that Australia needed a more diversified economy. Optimism about the benefits of liberalisation became almost universal among policy-makers and commentators, but pessimism about Australia’s economic structure almost entirely disappeared. The lucky country epithet was completely shorn of irony or paradox.

This paper argues that Australians should be aware, however, of the lessons of Australia’s economic history, that booms are often followed by periods of gloom. Booms do not solve the fundamental recurring problem of Australian economic history: vulnerability to changes in international demand and international financial sentiment. An over-reliance on resource wealth is still a precarious path for Australia’s future, just as it has been throughout Australian economic history. This is especially the case if growth is supported through high levels of unproductive debt. Australia is more indebted than it has ever been in its history. Australia will remain vulnerable even if China continues to grow into the indefinite future. And it continues to be vulnerable in a world where financial markets continue to be unsettled. With rising concern about global warming it is perhaps more urgent than ever to increase the diversity of

⁸ ‘Australian settlement’ comes from Paul Kelly (1994) *The End of Certainty*, Second Edition, Sydney, Allen & Unwin; ‘historic compromise’ from Francis Castles (1988) *Australian Public Policy and Economic Vulnerability*, Sydney, Allen & Unwin; and ‘protectionist policy structure’ from Tom Conley (2009) *The Vulnerable Country: Australia and the Global Economy*, Sydney, University of New South Wales Press.

Australia's productive capacity and export profile. If the more dire consequences of warming occur, Australia needs to be prepared to adapt.

To these well-known vulnerabilities we can add a third, vulnerability to rising inequality. Australia cannot control what happens in the rest of the world – we are a minor player in the global economy – but we can control the way we adapt to global events and developments. A fairer society is more likely to continue down the path of economic dynamism and continuous adaptation and less likely to see globalisation as a byword for rising inequality and a process that needs to be resisted. Embracing the outside world stimulates competition and underpins expansive growth, but it does not need to come at the expense of the weakest elements of society. Governments should foster the politics of the positive sum game. Both good and bad things can come from political processes but we cannot remove politics from the equation. It is worth remembering that Australia is a wealthy and relatively equal country because of political interventions, not despite them, as many economists would have us believe. Australia needs to utilise its luck to lessen its vulnerabilities.

Vulnerability in Historical Perspective

Before looking at Australia's current position in the world economy, it's worth getting some historical context and briefly considering Australia's past swings between boom and gloom. Australia's reliance on foreign labour, capital and markets for exports has shaped the cycle of boom and bust in Australian economic history. The establishment of a natural resource-based economy in the first half of the nineteenth century, through state support for private initiative, set the scene for Australia's future economic development.⁹ Australia had an abundance of land and this fitted well with an emerging global trade system wherein industrialising countries in Europe, which were population rich but land poor increased their manufacturing output and imported raw materials and foodstuffs from Latin America, Africa, Asia and Australasia.¹⁰ From the first pastoral boom in the 1820s and 1830s, through the gold rushes of the 1850s, Australia's natural resource comparative advantage was a significant factor in the generation of export wealth.¹¹ Together, wool and gold accounted for between 55 and 75 per cent of Australia's exports before 1913. After World War I, gold declined in importance, "whereas

⁹ W. A. Sinclair (1976) *The Process of Economic Development in Australia*, Melbourne, Longman Cheshire, p. 2.

¹⁰ David Meredith and Barrie Dyster (1999) *Australia in the Global Economy: Continuity and Change*, Melbourne, Cambridge University Press, p. 36.

¹¹ Brian Pinkstone (1992) *Global Connections: A History of Exports and the Australian Economy*, Canberra, AGPS.

wool continued to dominate Australia's export trade right up to the 1960s when it still accounted for between one-third and one-quarter of the country's export trade by value".¹²

The boom times between 1861 and 1891, like all boom times, disguised Australia's economic vulnerability.¹³ The end of the boom was a fortuitous time to measure Australia's fortunes, leading to the claim from Australian statisticians "that Australia was the wealthiest place in the world per head of population".¹⁴ The 1890s revealed how external developments could exacerbate domestic economic problems. During the 1880s, servicing Australia's debt increased from 15 to 40 per cent of export earnings.¹⁵ And when the British bank Barings nearly went bankrupt through bad deals in Argentina, British investors did the sort of wholesale reassessment of developing country investments that has been common in recent years at times of crisis. The substantial decline in the demand and price of commodities, and the decline in foreign sources of capital, intensified the problems caused by over-expansion in the wool industry, property speculation (especially in Melbourne), banking collapse and over-investment by colonial governments in infrastructure.¹⁶ The severe drought from 1895-1903 added to the colonies' woes and delayed recovery.

Despite the depression, the view remained that Australia was "a fundamentally prosperous economy"¹⁷ and in their attempts to establish the policy principles for the new Federation, Castles maintains that policy-makers

set out to defend the economic structure as it presently existed ... by offering all major economic sectors institutional guarantees that the economic prosperity that they now enjoyed, or rather had enjoyed before the onset of the depression, would be the first priority of public policy.¹⁸

Both boom and gloom, therefore, helped to create the conditions for protectionism. Castles suggests that there were four main components of the protectionist policy structure: protection of manufacturing industry, the conciliation and arbitration of industrial disputes, the control of immigration, and a residual system of income maintenance for those outside the labour

¹² A. G. Kenwood (1995) *Australian Economic Institutions Since Federation*, Melbourne, Oxford University Press, p. 16.

¹³ Rodney Maddock and Ian W. McLean (1987) "The Australian Economy in the Very Long Run" in Rodney Maddock and Ian W. McLean (eds), *The Australian Economy in the Long Run*, Melbourne, Cambridge University Press, p. 11-12; Kenwood, *Australian Economic Institutions Since Federation*, p. 3.

¹⁴ The development of statistics in Australia was the most advanced in the world, but there may have been a bit of propaganda surrounding the claim. Doomers in the 1980s regularly trotted out the declaration to show how far Australia had fallen. Meredith and Dyster, *Australia in the Global Economy*, p. 60.

¹⁵ Meredith and Dyster, *Australia in the Global Economy*, p. 60.

¹⁶ Maddock and McLean, "The Australian Economy in the Very Long Run", p. 11-12; Kenwood, *Australian Economic Institutions Since Federation*, p. 3; Pinkstone, *Global Connections*, p. 353..

¹⁷ Francis Castles (1988) *Australian Public Policy and Economic Vulnerability*, Sydney, Allen & Unwin, p. 93.

¹⁸ Ibid.

market.¹⁹ Protectionism supported the creation of a manufacturing sector of greater size and importance than would have been possible if Australia had adopted a policy of free trade, providing a fundamental source of employment and helping to establish a more diversified economy.²⁰ High wages and controlled white immigration provided a compromise between the demands of labour and the desires for a larger population. High levels of employment meant that policy-makers deemed only a residual welfare state as necessary. Kelly adds Imperial benevolence – Australia’s reliance on ‘great and powerful friends’ – as an integral addendum to the structure.²¹

In the period from 1900 to 1914, increasing demand for Australia’s exports underpinned economic growth, the repayment of foreign debt, and rising living standards.²² The recovery was not dependent on foreign investment and immigration,²³ rather it was bolstered by gold discoveries in Coolgardie and Kalgoorlie, and development in Western Australian generally.²⁴ Australia maintained a trade surplus for most of the period and capital flowed out of the economy to repay the debts incurred in the 1880s.²⁵ State and federal governments were actively involved in diversifying the economy, with shifts towards manufacturing, mining, services and non-pastoral land use dominating government efforts.²⁶

Once again, however, good times were not to last as the world descended into depression during the early 1930s, exposing Australia’s dependence on primary commodity exports and reliance on foreign capital. Rising agricultural protectionism, falling population in Europe and surplus production caused lower demand and prices for Australian exports in the mid-to-late 1920s. While the 1890s depression had been vastly more severe in Australia than in the United States, Canada or the United Kingdom, the 1930s Great Depression was severe everywhere.²⁷ Still, Australia was one of the worst affected countries. Australia’s terms of trade deteriorated and increased recourse to foreign borrowing in the late 1920s accompanied the decline of Australian exports.²⁸ Public debt during this period was high – about 128 per cent of GDP – because of government efforts to develop the economy through the provision of infrastructure and support.²⁹ Rolling over debt was no longer possible after the crash of 1929 and debt

¹⁹ Ibid.

²⁰ Hugh Stretton (1987) *Political Essays*, Melbourne, Georgian House, p. 37.

²¹ Paul Kelly (1994) *The End of Certainty*, Second Edition, Sydney, Allen & Unwin.

²² Alan L. Lougheed (1988) *Australia and the World Economy*, Melbourne, McPhee Gribble/Penguin, pp. 10-15.

²³ Meredith and Dyster, *Australia in the Global Economy*, p. 62.

²⁴ Sinclair, *The Process of Economic Development in Australia*, pp. 151-55.

²⁵ Lougheed, *Australia and the World Economy*, p. 15.

²⁶ N. J. Butlin, A. Barnard and J. J. Pincus (1982) *Government and Capitalism: Public and Private Choice in 20th Century Australia*, Sydney, Allen & Unwin, pp. 53 & 60.

²⁷ Lougheed, *Australia and the World Economy*, p. 26.

²⁸ Meredith and Dyster, *Australia in the Global Economy*, pp. 114-9.

²⁹ Meredith and Dyster, *Australia in the Global Economy*, p. 111.

servicing as a percentage of export grew steadily during the 1920s, reaching a peak of 50 per cent in 1931 and remaining over 30 per cent for most of the 1930s.³⁰ Unemployment reached nearly 30 per cent in Australia and governments were unable to find a way out of the downward spiral. Australia, however, did recover slightly from 1932, doing better than other primary producers around the world because of its more developed manufacturing and services sectors and superior infrastructure and education levels.³¹

The Depression undermined the established economic order and, in those countries that did not succumb to authoritarianism, it led eventually to new ideas about how states could protect populations from the vagaries of impersonal market forces. Unfortunately, such shifts were fleeting at best and economic malaise soon descended into total war. The war, however, showed how state planning could deliver beneficial economic results: full employment with low inflation. It also provided an impetus to the development of the manufacturing sector when supply lines were cut.

By the late 1940s, Australia once again boomed because of international demand. The Korean War sparked massive US demand for Australian wool and by mid-1950, the price of wool had increased by 50 per cent on the previous year and together with increased demand for metals led to exports reaching 30 per cent of GDP (compared to a low point of 12.2 per cent in 1969 and 20.7 per cent in 2008). This boom involved the largest increase in the terms of trade in Australian history but the fall was just as spectacular. The following recession was severe.³²

Once again the Australian economy recovered and the following ‘Long Boom’ was stimulated by international demand and the inflow of labour and capital. Protectionism provided an institutional – political and economic – strategy for distributing Australia’s resource wealth and developing a more diversified economy. The problem was that the diversity it encouraged created inefficiencies and was not sustainable. Australia’s growth performance during this period was well below the average of developed countries. Still, manufacturing became a significant export earner for the first time in Australian history.

From the 1960s, however, a series of technological and competitive pressures eventually undermined the post-war expansion of manufacturing.³³ Mineral and fuel exports increased from 3 per cent of merchandise exports in the early 1950s to over 30 per cent by the mid-

³⁰ E. A. Boehm (1993) *Twentieth Century Economic Development in Australia*, Melbourne, Longman Cheshire, p. 32; Lougheed, *Australia and the World Economy*, pp. 20-22 & 27-29.

³¹ Meredith and Dyster, *Australia in the Global Economy*, p. 135.

³² Rodney Maddock (1987) “The Long Boom 1940-1970” in Rodney Maddock and Ian W. McLean (eds), *The Australian Economy in the Long Run*, Melbourne, Cambridge University Press, pp. 98-9; Boehm, *Twentieth Century Economic Development in Australia*, p. 34; Pinkstone, *Global Connections*, p. 158.

³³ Bell, *Australian Manufacturing and the State*, p. 43.

1970s.³⁴ An over-valued dollar, resulting from increases in foreign earnings from the mining sector and foreign investment in mining company shares, also contributed to manufacturing decline. And policy-makers were often ambivalent about its future, given mining's meteoric rise.³⁵ Capital inflow fuelled the share market boom of the early 1980s and caused considerable problems for macroeconomic management. The growth of mineral exports helped reduce Australia's reliance on agricultural exports, although agricultural exports still averaged around 50 per cent of merchandise exports between 1970 and 1975. Australian trade shifted away from Britain and Europe to Japan and the US. By the early 1970s, Asia accounted for half of Australia's exports.³⁶

The 1970s were a time of turmoil for both Australian politics and the Australian economy. The Whitlam government's ambitious social democratic program assumed continuing prosperity, but as the mid-1970s mining boom turned to gloom and as stagflation beset the global economy, conditions for social reform became less favourable.³⁷ The world economic downturn would have made managing the economy difficult for even the most economically competent and politically united government. Unfortunately, the Whitlam Government was neither. Loose fiscal policy and a wages explosion (average wages increased by 30 per cent in 1974) exacerbated international inflationary pressures.³⁸

Whitlam's successor, Malcolm Fraser and his Liberal-Country Party Coalition government, continued to believe that the rural and resources industries would provide for Australia's future.³⁹ He and many others saw the resources boom of the late 1970s as the solution to Australia's economic woes. In the lead up to the 1980 election, Fraser argued:

In my policy speech of 1977, I said Australia could look forward to \$6000 million in development. Some amazement was expressed in this – even disbelief ... And now prospective development is \$29000 million. This development promises to be as important to Australia and individual Australians as anything in the last 35 years ... The benefits of this will be felt nationwide.⁴⁰

Unfortunately, the mooted boom failed to bring the economic windfall that some believed would present Australian policy-makers with the 'problem' of working out what to do with

³⁴ Pinkstone, *Global Connections*, p. 388.

³⁵ Bell, *Australian Manufacturing and the State*, pp. 122-123.

³⁶ Dyster and Meredith, *Australia in the International Economy*, p. 250.

³⁷ Castles, *Australian Public Policy and Economic Vulnerability*, p. 21.

³⁸ Dyster and Meredith, *Australia in the International Economy*, p. 269. Barry Hughes (1978) "The Economy" in Alan Patience and Brian Head (eds) *From Whitlam to Fraser: Reform and Reaction in Australian Politics*, Melbourne, Oxford University Press, pp. 10-15.

³⁹ Paul Kelly (1984) *The Hawke Ascendancy*, Sydney, Angus and Robertson, ch. 3.

⁴⁰ Fraser, cited in Kelly, *The Hawke Ascendancy*, p. 93. See also Robert Birrell, Doug Hill and John Stanley, (eds) (1982) *Quarry Australia? Social and Environmental Perspectives on Managing the Nation's Resources*, Melbourne, Oxford University Press, p. xi.

excessive trade surpluses! This optimism was widely held with the OECD rating Australia as having the best prospects of all developed countries in 1981.⁴¹ John Stone, Secretary to the Treasury, suggested that, faced with an appreciating currency because of the boom, Australia would need to lower protection levels so that the burden of adjusting to the boom would fall on the inefficient manufacturing industries. This would allow imports to flow into the Australian economy, lower the trade surplus and reduce pressure on the currency. The obvious political difficulty of this strategy was evident in Fraser's equivocations over reducing protection. The failure of the boom to eventuate rendered the debate meaningless.⁴² Fraser and Stone, as well as many other policy-makers, failed to realise the extent of Australia's structural economic problems.

The recession of the early 1980s was a turning point for the Australian political economy. The Hawke government's decision to float the dollar and liberalise the financial sector was the beginning of the end of the old Australia. Once again Horne's famous phrase was trotted out but this time it was in commemoration rather than celebration. Resource optimism turned into resource pessimism and the perception was that Australia had a 'third world' economy inappropriate for the late twentieth century. In sum, resources were now seen as unstable foundation for first world standard of living.

Nothing can represent this decline better than a graph of the 'terms of trade' – the average price level of exports versus the average price level of imports – from the early 1970s to the mid-1980s. The terms of trade effectively reflects the capacity of a given quantity of exports to pay for a given quantity of imports, and provides an important indication of the strengths and weaknesses of economic structure. Because the terms of trade is a ratio, increases can be a result of export prices increasing at a greater rate than import prices, or export prices increasing while import prices are declining, or export prices declining at a slower rate than import prices. A rising or falling terms of trade indicates the possibility of improving or declining living standards, because if what we sell earns relatively more than what we buy, we will be relatively wealthier. Improvements in the terms of trade are not reflected in GDP figures, but improvements do contribute significantly to increases in national disposable income.

As chart 1 shows, Australia's terms of trade went into freefall after the short-lived mineral booms of the mid-1970s and early-1980s. After gradually climbing from late 1982, it again plummeted over 1985 and early 1986. The current account deficit (CAD) went from a small

⁴¹ See Richard E. Caves and Lawrence B. Krause (1984) *The Australian Economy: A View from the North*, Sydney, Allen & Unwin, p. 11.

⁴² INDECS (1982) *State of Play 2*, Sydney, Allen & Unwin, p. 75; Robert Birrell, Doug Hill and John Stanley (eds) (1982) *Quarry Australia? Social and Environmental Perspectives on Managing the Nation's Resources*, Melbourne, Oxford University Press.

surplus in 1973 to a deficit in 1974 from which it continued to worsen until the crisis of 1986. The current account is made up of the balance between exports and imports and the flow of interest and dividend payments to and away from Australia. The CAD became the fundamental policy problem for policy-makers for the rest of Labor's period of office. The implications seemed clear: Australia was in almost terminal decline and external vulnerability was once again the fundamental issue of public policy. Keating's banana republic warning was the public manifestation of crisis and is worth quoting at length:

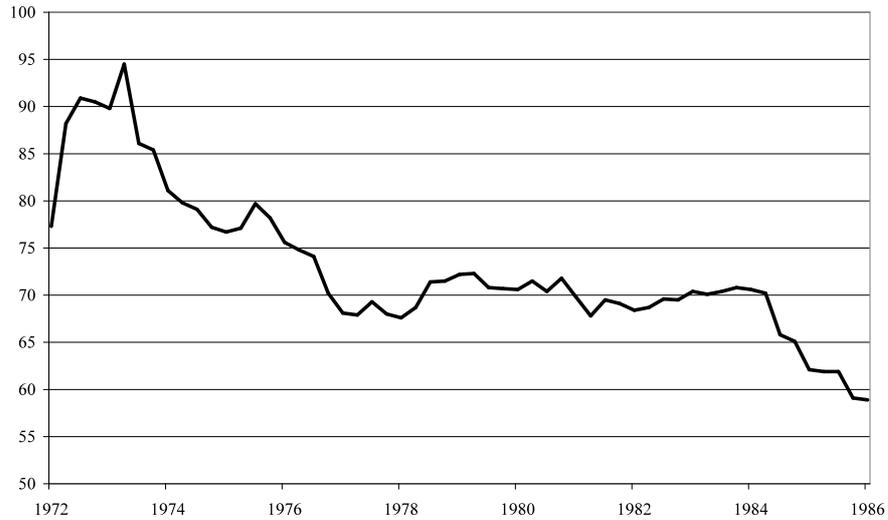
We took the view in the 1970s – it's the old cargo cult mentality of Australia that she'll be right. This is the lucky country, we can dig up another mound of rock and someone will buy it from us, or we can sell a bit of wheat and bit of wool and we will just sort of muddle through ... In the 1970s ... we became a third world economy selling raw materials and food and we let the sophisticated industrial side fall apart ... We must let Australians know truthfully, honestly, earnestly, just what sort of international hole Australia is in. It's the price of our commodities – they are as bad in real terms since the Depression ... If this government cannot get the adjustment, get manufacturing going again and keep moderate wage outcomes and a sensible economic policy, then Australia is basically done for ... If in the final analysis Australia is so undisciplined, so disinterested in its salvation and its economic well being, that it doesn't deal with these fundamental problems ... the only thing to do is to slow the growth down to a canter. Once you slow the growth under 3 per cent, unemployment starts to rise ... Then you are gone. You are a banana republic.⁴³

⁴³ Paul Keating speaking on a wall phone in the kitchen of a function centre to radio personality John Laws on 14 May 1986, cited in Richard H. Snape, Lisa Gropp and Tas Luttrell (1998) *Australian Trade Policy: 1965-1997*, Sydney, Allen & Unwin, pp. 84-5.

Chart 1

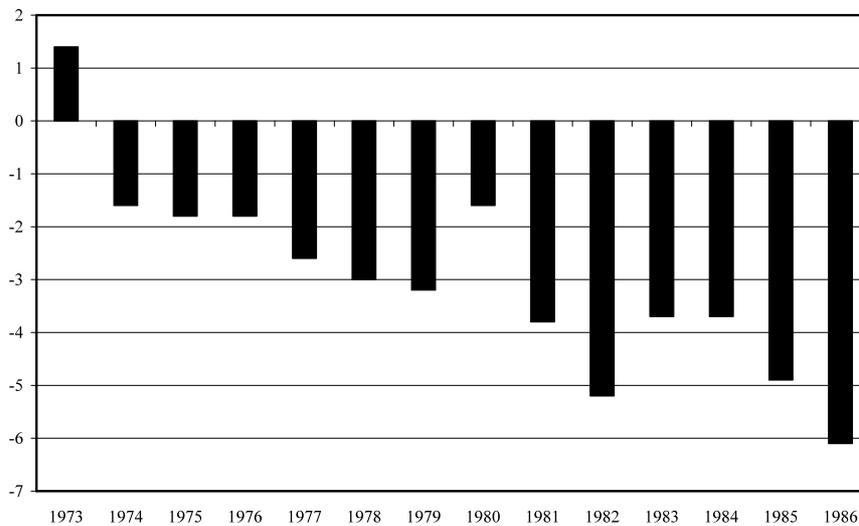
Terms of Trade

1972-1986
2006-07=100



Source: Treasury

Chart 2
Current Account Deficit
1973-1986



Source: RBA

Most policy-makers believed that a high CAD was unsustainable and indeed recent years have been the first time in Australian economic history that policy-makers believe that they are not constrained by the balance of payments. The CAD gradually improved in 1987, but the loosening of monetary policy in response to the stock market crash of October 1987 led to a lending boom, an expansion of demand and a substantial worsening of the deficit over 1988 and 1989.

The severity of the early 1990s recession had much to do with the zealotry of Keating and his coterie of economic advisers. With news of the recession, Keating made possibly one of the stupidest political remarks in Australian history when he said, “It is a recession that Australia had to have”. But he said it, because he meant it. Keating and his advisers truly believed that a recession would be good for the economy because it would ‘fix’ the CAD, kill inflation and set up Australia for long-term growth. There’s no doubt that it helped to quell inflation and since the recession Australia has not had two consecutive quarters of GDP contraction. But it certainly didn’t fix the CAD. In the lead-up to the 1996 election, the John Howard-led opposition increasingly exploited the recession, the worsening CAD and the growing level of foreign debt, arguing that Labor had solved none of Australia’s economic problems despite its long hold on government.

The Howard government may have taken office at the most opportune time in Australian history. But it wasn’t all plain sailing. The government faced the Asian crisis in the late 1990s. And in 2000 and 2001, at the height of the technology boom many commentators, attempting to justify the collapse of the value of the dollar, derided Australia as an ‘old’ economy with an archaic economic structure.⁴⁴ These statements were the residue of the mid-1980s anxiety about Australia’s primary commodity dependency because, soon after, commodity prices went on to rise almost continuously until 2008. In hindsight, the lack of a widespread technology boom in Australia was an advantage because, as former Reserve Bank Governor Ian Macfarlane points out, “We didn’t have the boom, so we did not have the bust”.⁴⁵ While the technology boom and bust led to a recession in many OECD countries, in Australia a housing boom turned into a resources boom built upon growth in Asia and particularly China.

From Doom to Boom

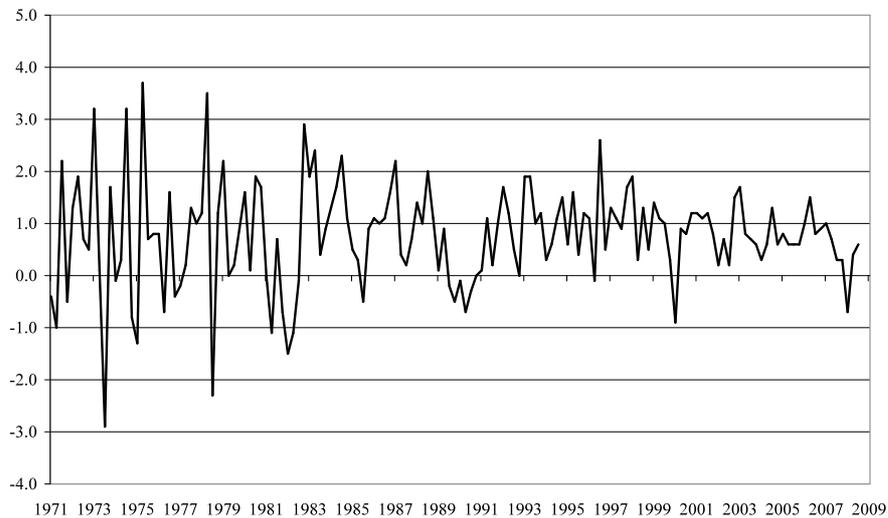
Chart 3 plots quarter-by-quarter GDP growth from 1973 and shows that the recession of the early 1980s was more severe than the recession of the early 1990s. It also shows the poor performance of the economy from the early 1970s to the early 1990s. From that point until 2009, Australian economy has experienced a record 18 years without a technical recession. In terms of GDP, the story of Australian growth between 1991 and 2009 has been a truly amazing one. The economy expanded by around 80 per cent and this continuous growth had a beneficial

⁴⁴ David Hale (2000) “Aussie.com”, *The International Economy*, May; Dennis Shanahan (2000) “Treasurer Trades Old for New”, *The Australian*, 16 March; Mark Vaile (2000) “Australia and the Knowledge Economy”, *Speech to the Economist Intelligence Unit*, Canberra, 31 October <http://www.trademinister.gov.au/speeches/2000/001031_eiu.html>

⁴⁵ Macfarlane, *The Search for Stability*, p. 94.

effect on employment growth and government finances, although Rudd government stimulus measures have recently dented Australia's budgetary position. Chart 3 also shows that the variability of growth moderated over the 1990s and 2000s. The downturn of 2001 avoided a two-quarter slip into negative territory, making this the first international recession that Australia had managed to avoid. Failing to record a recession in the global crisis of 2008-09 makes it two in a row. Without policy stimulus, however, Australia would have had a recession.⁴⁶ This above average performance is a remarkable turnaround from the post-war period. Chart 4 shows that Australia underperformed the OECD average during the 1970s as it had done during the 1950s and 1960s, but during the 1980s Australia switched direction and the margin in favour of Australia has been growing ever since.

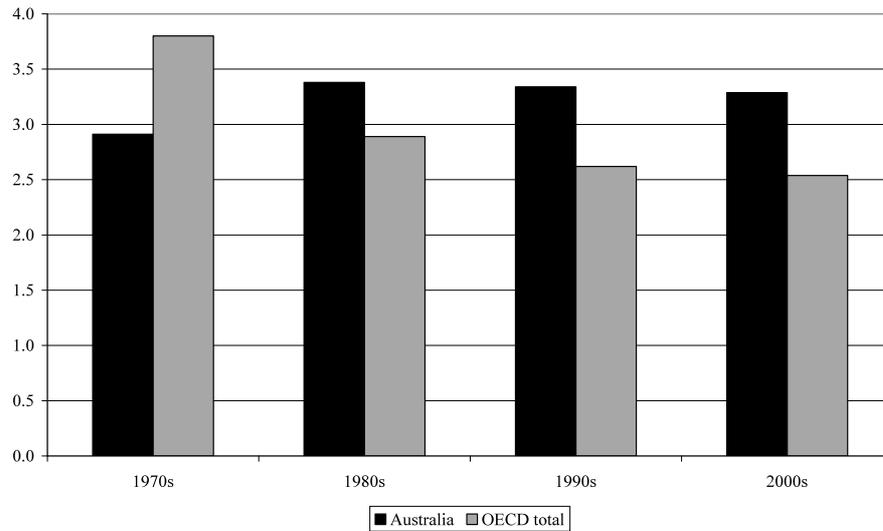
Chart 3
GDP Growth Seasonally Adjusted
Quarterly Changes 1973-2009



Source: ABS

⁴⁶ Wayne Swan and Lindsay Tanner (2009) *Mid-Year Economic and Fiscal Outlook 2009-10*, Canberra, Commonwealth Government <<http://www.budget.gov.au/2009-10/content/myefo/html/index.htm>>.

Chart 4 **GDP Growth**
Australia and the OECD



Source: OECD *Factbook 2009: Economic, Environmental and Social Statistics – Macroeconomic trends - Economic growth - Evolution of GDP*
<http://titania.sourceoecd.org/v1=5198737/cl=19/nw=1/rpsv/factbook2009/02/02/01/index.htm>.

Fundamental to the booming economy has been the mining sector and Asian demand for minerals. Revenue from the mining sector increased from an average of 7 per cent of GDP for most of the 1980s and 1990s to 11 per cent in 2008. Royalties and taxes boomed as well. Together they contributed more than one per cent of GDP in 2005-06 and probably more in following years. Despite this largesse, the percentage contribution of mining and, indeed, agriculture to GDP shown in table 1, would probably surprise most Australians.

Table 1**Employment Industry Contribution to GDP and**

Industry	1990	1996	2002	2008	Share of Employment
	Percentage of gross value added at basic prices				
Agriculture, forestry & fishing	4.9	3.8	4.4	2.5	3.5
Mining	4.9	5.0	5.3	8.3	1.7
Manufacturing	15.8	14.6	12.1	10.5	10.1
Electricity, gas & water supply	3.5	2.8	2.5	2.4	1.0
Construction	6.9	6.0	5.9	7.9	9.3
Wholesale trade	5.4	5.6	5.2	4.9	4.2
Retail trade	6.6	6.9	6.5	5.8	14.4
Accomm., cafes & restaurants	1.9	2.2	2.4	2.1	4.9
Transport and storage	5.6	5.5	4.8	5.1	5.0
Communication services	2.8	3.3	3.0	2.3	1.9
Finance & insurance	5.1	6.1	7.5	7.8	3.6
Property & business services	10.6	11.1	12.6	13.0	12.2
Government admin & defence	4.2	4.3	4.2	4.1	4.6
Education	4.5	4.7	4.7	4.4	7.2
Health & community services	5.5	6.1	6.2	6.3	10.7
Cultural & recreational services	1.2	1.4	1.5	1.6	2.7
Personal & other services	1.8	2.0	2.1	2.0	3.9
Ownership of dwellings	8.7	8.7	9.0	9.0	..
	100	100	100	100	100

Source: ABS

Agriculture's decline has been most severe, down from 30 per cent of GDP in 1951 (20 per cent in 1901). Mining's share of GDP was 2.6 per cent in 1951 and manufacturing peaked at just under 30 per cent in the early 1960s. After remaining static for the 1990s, mining's contribution grew significantly over the 2000s. We should interpret these figures with some caution, because many of the service industries listed are reliant on their role in relation to agriculture, mining and manufacturing. The services sector as a whole is the most important to employment, with 85 per cent of the workforce employed. Mining contributes less than 2 per cent to employment, despite contributing over 8 per cent to GDP.

The contribution of mining and agriculture is vastly more important when it comes to exports. Australia has always been reliant on exports of primary commodities, but there was a rapid growth in exports of elaborately transformed manufactures (ETMs) from the late 1980s and into the 1990s. In the early 2000s, however, ETM exports went into decline and Australia reinvigorated its dependence on commodity exports. Exports of primary commodities increased from 56.1 per cent of merchandise exports in 2003 to 68.5 per cent in 2008. Manufacturing exports declined from 31 per cent in 2003 to 21.2 per cent in 2008. ETMs

declined from 21.8 per cent to 13.9 per cent.⁴⁷ Manufacturing exports still grew during this time, but their growth was dwarfed by the growth in mineral and fuel exports.

Table 2
Australia's Merchandise Exports by Broad Category
(Percentage share)

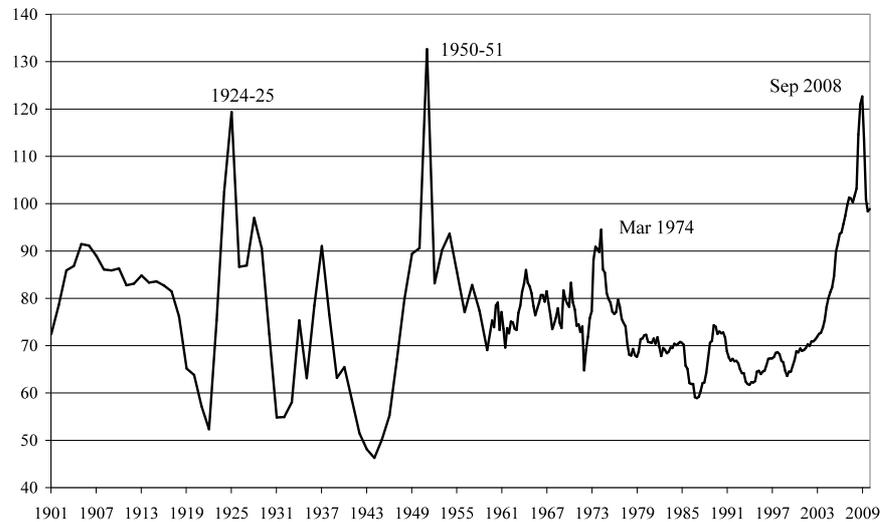
	2003	2004	2005	2006	2007	2008
<i>Total primary products</i>	56.1	59.8	63	62.2	60.2	68.5
Unprocessed food	6.3	8.2	5.4	5.1	3.5	4.2
Processed food	11.9	12.5	10.7	9.4	9.1	7.3
Fuels	19.8	20.3	25.6	24.0	22.7	31.8
Minerals	13.4	14.2	17.5	20.3	21.5	22.8
Other Primary	4.7	4.6	3.8	3.4	3.4	2.4
<i>Total manufactures</i>	31.0	28.9	26.6	25.6	26.9	21.2
STM (excl nickel)	9.2	8.6	7.9	8.9	9.3	7.3
ETM	21.8	20.3	18.7	16.7	17.6	13.9
<i>Other (including non-monetary gold)</i>	12.8	11.3	10.4	12.2	13.0	10.3
Total Merchandise Exports	100	100	100	100	100	100

Source: DFAT

Considering the increase in export values for primary commodities it is not surprising that concerns about Australia being too reliant on resource exports and dependent on manufactured imports almost disappeared. The best indicator of this change in fortunes is once again the terms of trade. To place the recent boom into context, Chart 5 shows the terms of trade since Federation. It clearly shows the extent of the latest boom. Chinese demand has sustained the boom for longer than earlier ones, giving rise to a view that China's continuing expansion could nourish it for even longer.

⁴⁷ DFAT (2009) *Composition of Exports*, Canberra, Commonwealth of Australia, p.49 <http://www.dfat.gov.au/publications/stats-pubs/cot_fy2008.pdf>. Non-monetary gold makes up more than half of the 'other' category in merchandise exports.

Chart 5
Terms of Trade
1901-2009
2006-07=100



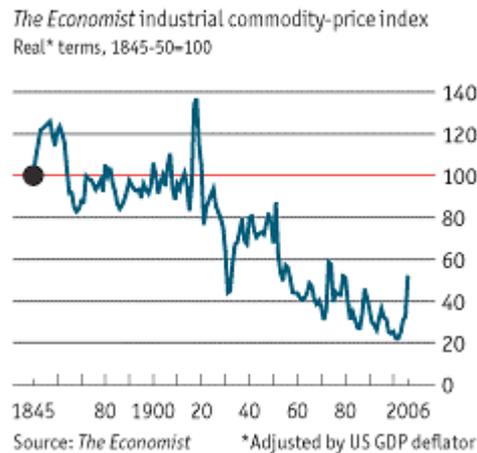
Source: Treasury

Many commentators and policy-makers believe that the concerns of the 1980s and early 2000s are no longer an issue for Australia – that the long-term decline in the terms of trade has been permanently reversed. Former Treasurer, Peter Costello, for example argued in 2007 that “our terms of trade will moderate, but will not be in long term decline, which was the story of the 20th century”.⁴⁸ To argue that Australia’s terms of trade will remain at these levels would require a shift away from the variability that is evident from Chart 5. If we consider the longer-term there is some cause for concern.

⁴⁸ Peter Costello (2007) “Ensuring Australia’s Economic Prosperity: The Intergenerational Report”, *Address to Australian Business*, London, 10 April. <<http://www.treasurer.gov.au/tsr/content/speeches/2007/004.asp>>

Chart 6

The Long-Term Decline of Commodity Prices



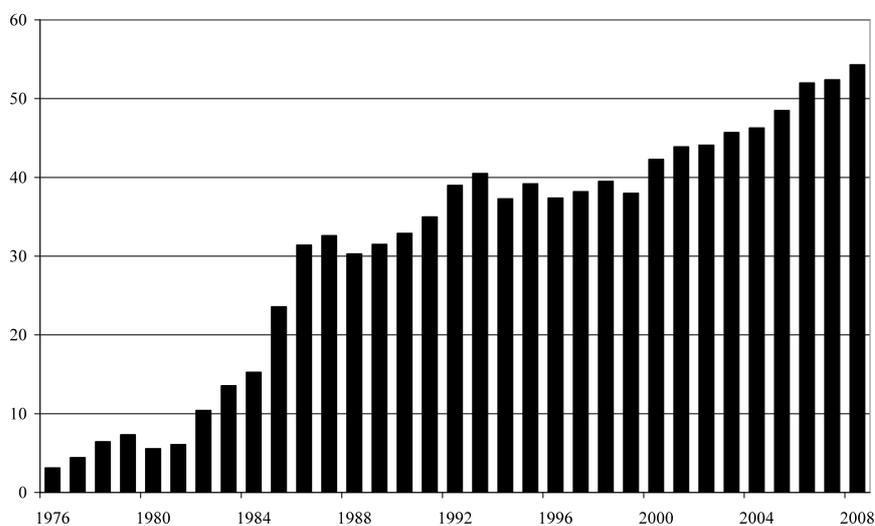
Warning about Australia’s vulnerability to a return to lower prices for commodities should not be construed as a necessarily negative outlook on Australia’s prospects. Over the medium term, there is much to be confident about given Australia’s efficient mining operations. Economic weight has shifted to Asia and because much of Asia is in a developmental mode it will require considerable resource-intensive development. When starting from a low base growth can be very rapid indeed. Asia’s share of world GDP was only 7 per cent of GDP in 1990 (at market exchange rates), increasing to around 15 per cent by 2008. Growth in East Asia has averaged 7 per cent a year during this period compared to 2 per cent for the developed world. As far as industrial production goes Asia has done even better, especially China. In 1990 China’s share of industrial production was 2 per cent, in 2008 the figure was 13 per cent.⁴⁹

The major short-term issue is whether commodity prices will stay high or whether they will revert to the long-term trend decline. Even if Asia continues to expand without major reversals or periods of stagnation, it’s likely that resource prices will decline as their supply increases. The most important growing market for Australian resources – China – is actively seeking to diversify its sources of supply. And it’s also possible that technological change could undermine demand, as happened to Australia’s pre-eminent export until the 1950s – wool. Wool is now Australia’s 26th most important export. Coal is currently our most important export, but it is possible that climate change could force the development of alternatives to the burning of coal for energy.

⁴⁹ Philip Lowe (2009) “The Growth of Asia and Some Implications for Australia”, *Talk to Citi Australia Inaugural Australian Investment Conference*, Sydney, 19 October <<http://www.rba.gov.au/Speeches/2009/sp-ag-191009.pdf>>.

Another major policy concern of the late 1980s and early 1990s was foreign debt. It seems, however, that concern about has lessened as the debt has risen and, as Chart 7 shows, it has risen almost continuously from the mid-1970s. High levels of foreign debt are not a new phenomenon for Australia, although previously they have been associated with particularly bleak periods of its economic history. Before the 1980s, the highest debt levels were recorded during the depressions of the 1890s (34 per cent of GDP) and the 1930s (39 per cent of GDP).

Chart 7
Foreign Debt
Percentage of GDP
1976-2008

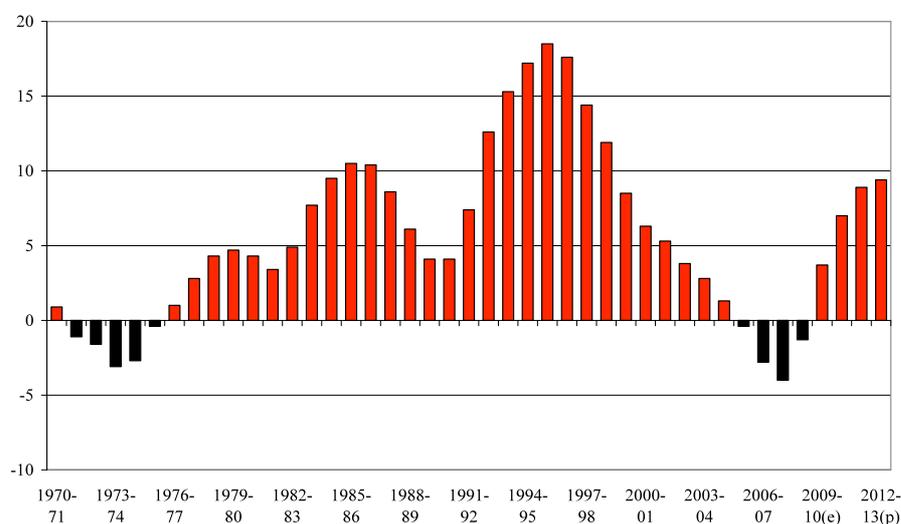


Source: ABS, RBA

Australia's major problem is with private debt, although public debt is also increasing due to government efforts to stimulate the economy. After reaching a high of 18.5 per cent of GDP in 1995–96, Australia's general government net debt fell markedly to a net surplus in 2005–06. Continuous growth and a sustained resources boom can do wonders for a government's fiscal position, but given the revenue that the boom created, greater efforts could have been committed to build up of a true counter-cyclical budget surplus ready for use during a downturn. The political difficulty of such a task should not, however, be under-estimated. The problem is that a growing surplus tends to be accompanied by assertions that the government should limit future revenue by returning surpluses through tax cuts. Governments also fear that if they build up a surplus, oppositions will be able to make electorally popular spending promises. Nevertheless, Norway managed to legislate with cross-party agreement in 1990 for the creation of a sovereign wealth fund to invest surpluses from its resource wealth so that when the oil revenue runs out Norwegians will continue to reap the benefits of resource abundance. Astute public management of national wealth during the good times will enable

Norway to deal more effectively with future vulnerabilities. Throughout the world, public debt is increasing, but some countries are clearly in better positions than others.

Chart 8
Australian General Government Sector Net Debt



Source: MYEFO 2009-10

<http://www.budget.gov.au/2009-10/content/myefo/html/index.htm>

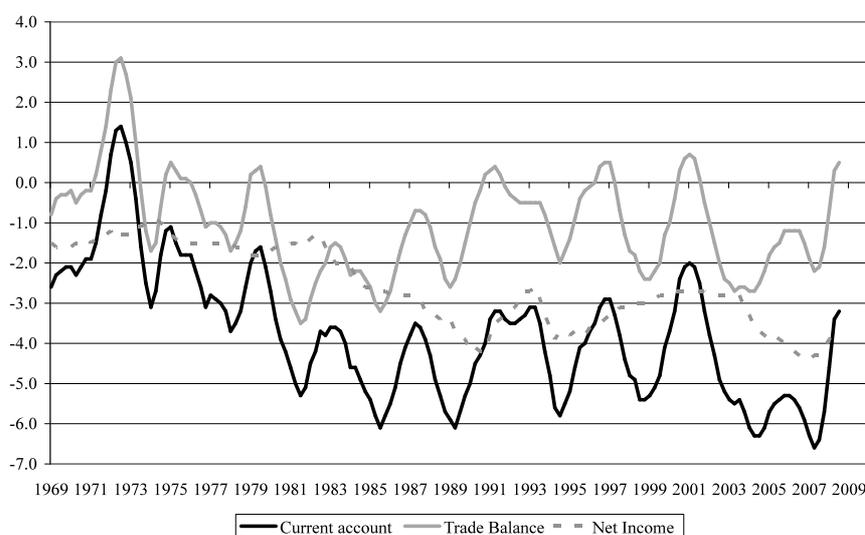
Australia's public debt position is reasonably sound, but this is not the case for many other countries, including the world's two largest economies – the United States and Japan. While much of Japan's public debt is taken up within Japan, this may not be possible if debt continues to expand. The huge government debt of the United States will soak up a considerable amount of global capital, but the United States has the advantage that its debt is denominated in its own currency, which means that any fall in the value of the greenback diminishes the size of its debt.

While the Howard government pared back net government debt to positive territory, private debt increased significantly. Both political parties now appear to accept the 'consenting adults' view of foreign debt – the idea that as long as debt is between private businesses with the aim of creating economic activity it should not be a concern of government policy. Those who are concerned about the increase of debt worry that it has not gone into creating the productive capacity that will earn the foreign exchange to *eventually* lower the level of debt. The persistent warning of analysts that high foreign debt left Australia 'vulnerable to a change in global financial market sentiment' will be tested over the coming years. The main variable here is the danger of self-reinforcing movements of sentiment. If Australia's foreign debt is seen as a problem by those who fund the debt then it will be a problem.

Current account deficits can often provide a marker to spark the concern of investors and analysts when things turn bad. As chart 9 shows, by far the largest component of the CAD is

the net income deficit, which includes interest paid to foreign lenders and dividends paid to foreign shareholders. Running a long-term trade deficit hasn't helped the current account either. Although the CAD improved in late 2008 it needs to be remembered that this was after 17 years of growth and a huge increase in the price of resources. Ultimately, CADs can only be lowered through increasing exports, decreasing imports, increasing saving or decreasing investment.⁵⁰

Chart 9
Current Account, Trade Balance and Net Income
Percentage of GDP
1969-2009



Source: ABS

Australia's two most important economic bureaucrats have both signalled that Australia's CAD will rise as investment flows into the Australian economy to fund what they consider will be a long-running minerals boom. Ken Henry argues that "Australia has a long history of CADs, reflecting the need to supplement the savings of a relatively small population to take advantage of an abundance of investment opportunities."⁵¹ The CAD, as an accounting entity, represents the extent to which investment exceeds saving, which means that it represents either a "deficiency of national saving or an excess of national investment". There are several ways that governments can increase national saving with forced superannuation perhaps being the most direct way. Given that Australia has increased its national saving over the past 20 years, Henry contends that the major cause of the CAD is Australia's high level of investment.

⁵⁰ Tim Colebatch (2009) "Balance of Power", *The Age*, 24 October
<http://www.theage.com.au/business/balance-of-power-20091023-hdgu.html>.

⁵¹ Henry, "The Shape of Things to Come".

RBA governor Glen Stevens also argues that for Australia. Instead, the capital inflow will mean that the risks of investment in Australia's larger CADs will not necessarily be a problem resource capacity will be shared between Australians and foreigners. Nevertheless, given that growing CADs in the past have worried international investors when they have gotten too large, Stevens argues some persuasion might be necessary: "These trends will take some explaining, not least to foreign and international organizations, many of which have a more traditional view of current account positions."⁵²

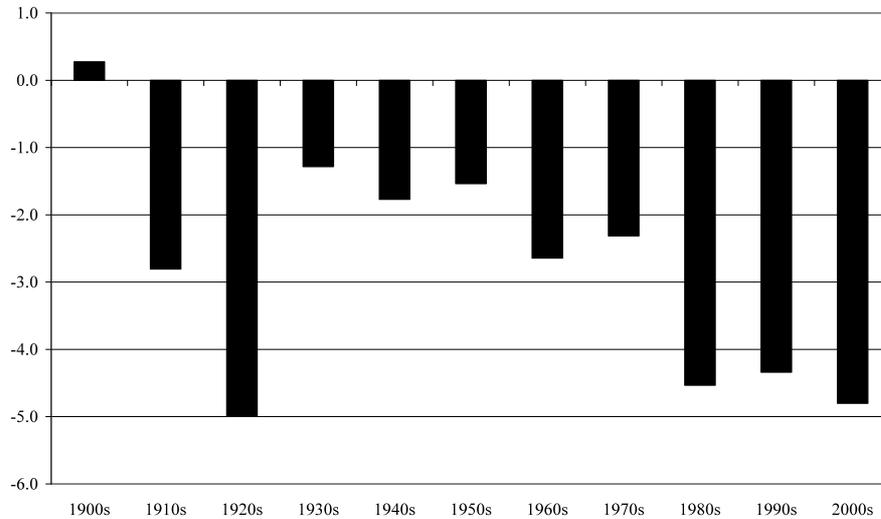
Not everyone agrees. Ross Garnaut argues that failure to deal with Australia's CAD problem has been one of the major shortfalls in economic policy over the past 10 years or so. Garnaut argues that much of Australia's growth rate is unsustainable because it's not possible to keep increasing foreign debt. "Australia has two strikes against it: its huge current account deficits before the crisis, and the deterioration in its terms of trade. They mean that Australia will have to reduce average consumption levels more than most countries if it is to restore full employment on a sustainable basis."⁵³ In other words, Garnaut argues that Australians have been living beyond their means, with living standards bolstered by unsustainable increases in debt.

Chart 10 shows the significant rise of Australia's CAD over the past 30 years. As noted above, in the recovery from the depression of the 1890s growth was funded by domestic saving and capital actually flowed out of the country to pay off foreign debt. This is the only decade in Australian history to record a current account surplus. The highpoint of CADs was associated with the build up of foreign debt in the 1920s, which of course was followed by the depression of the 1930s. But the chart can be interpreted more positively as well in that Australia has managed to run substantial CADs for a long period of time. The (last) 30 year average is -4.6 per cent of GDP and the century average is -2.6 per cent.

⁵² Glen Stevens "The Road to Prosperity".

⁵³ Cited in Tim Colebatch (2009) "Balance of Power", *The Age*, 24 October
<<http://www.theage.com.au/business/balance-of-power-20091023-hdgu.html>>.

Chart 10
Australia's Current Account Balance 1901-2009
Decade Averages Percentage of GDP



Source: Treasury

A major factor in the growth of foreign debt in Australia and the corresponding deterioration in the CAD has come through the huge expansion of household debt, much of which has gone into housing. This has helped to make Australia one of the dearest places in the world to buy a house.⁵⁴ Debt has been expanding almost continuously since the early 1960s to levels never-before-seen in Australian history. Particularly noteworthy, as chart 11 shows all too clearly, is the almost continuous expansion of debt as a percentage of disposable income since the early 1990s recession. At its peak in December 2007, debt reached 160 per cent of income. How this debt unwinds over the coming years will matter a lot to Australian households. After falling slightly in late 2008, debt rose again in mid-2009. Like so many good things in life, increased access to credit is a double-edged sword. Credit and debt are, of course, two sides of the same coin. Once again the question is how high debt can go as a percentage of income.

Chart 11

1979-2009 Household Debt to Disposable Income

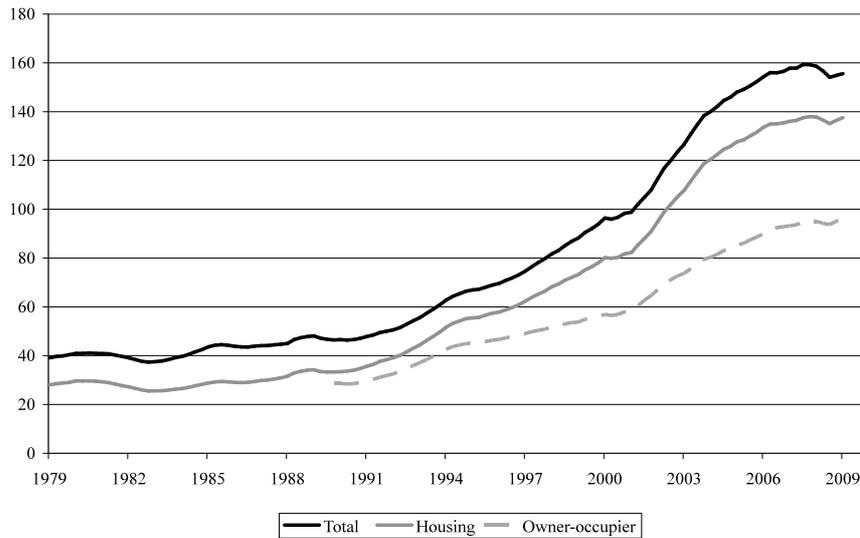
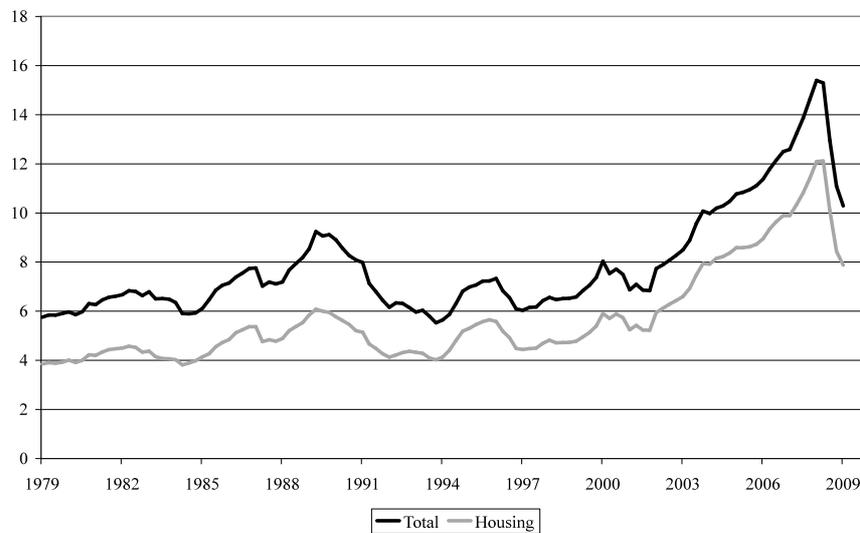


Chart 12
Interest Payments to Disposable Income
1979-2009



Source: RBA

Chart 12 shows the percentage of disposable income spent on interest payments. Despite interest rates reaching unprecedented levels in the late 1980s, interest payments as a percentage of disposable were much higher in the 2000s. The Reserve Bank's 4.25 per cent reduction in interest rates over late 2008 and early 2009 acted to substantially reduce interest payments. Now that interest rates are once again on the rise, interest payments as a percentage of income will also increase.

Luck and Vulnerability

Throughout its modern history, Australia has continually faced three major economic vulnerabilities. Two of these are well recognised and the third has been important but less obvious. These include our vulnerability to:

- changes in international demand for commodities
- changes in international financial sentiment and supply
- rising inequality

The final vulnerability – the dangers of rising inequality – appears to have disappeared from debate. Most commentary on social outcomes now centres on whether outcomes have worsened not whether they've improved despite the fact that we've had 18 years of continuous growth.

Not only is it a poor outcome on its own terms if a wealthy country doesn't provide widespread opportunities across society, but it also matters for productive reasons. It's not productive to have significant sections of the population disengaged and reactionary. And it's not productive to have poor health and education outcomes. Allowing inequality to rise could also have a detrimental effect on Australians' receptivity to the very process that has contributed to our success – globalisation and engagement with Asia. Australia has indeed been a lucky country since the nineteenth century, but it is Australia's institutions and an ethos of egalitarianism that has contributed to the spreading of that luck across the Australian population. While Australia should never go back to protectionism, it should retain some of that spirit of egalitarianism that meant that Australia remained a lucky country for many and not just a few as is the case in many resource-rich countries around the world.

As Australians contemplate the lessons of boom and gloom and consider vulnerabilities it will be worthwhile thinking about why policy-makers thought we were doomed in the 1980s. What they will find is that many of the problems of the 1980s remain. While the economy has been more productive, more efficient and, perhaps most important, less inflation-prone, the trade balance, current account deficit, foreign debt and inequality remain as markers of vulnerability.