



COMMONWEALTH OF AUSTRALIA

Official Committee Hansard

SENATE

ECONOMICS REFERENCES COMMITTEE

**Reference: Possible links between household debts, demand for imported goods
and Australia's current account deficit**

MONDAY, 15 AUGUST 2005

CANBERRA

BY AUTHORITY OF THE SENATE

INTERNET

The Proof and Official Hansard transcripts of Senate committee hearings, some House of Representatives committee hearings and some joint committee hearings are available on the Internet. Some House of Representatives committees and some joint committees make available only Official Hansard transcripts.

The Internet address is: **<http://www.aph.gov.au/hansard>**

To search the parliamentary database, go to:
<http://parlinfoweb.aph.gov.au>

SENATE
ECONOMICS REFERENCES COMMITTEE

Monday, 15 August 2005

Members: Senator Stephens (*Chair*), Senator Brandis (*Deputy Chair*), Senators Chapman, Lundy, Murray and Webber

Participating members: Senators Abetz, Barnett, Bartlett, Boswell, Brown, George Campbell, Carr, Colbeck, Conroy, Coonan, Eggleston, Chris Evans, Faulkner, Ferguson, Ferris, Fielding, Fifield, Forshaw, Kirk, Lightfoot, Ludwig, Mason, McGauran, Payne, Robert Ray, Sherry, Stott Despoja, Watson and Wong

Senators in attendance: Senators Brandis, George Campbell, Murray, Stephens and Webber

Terms of reference for the inquiry:

To inquire into and report on:

Possible links between household debt, demand for imported goods and Australia's current account deficit, with particular reference to:

- (a) current levels of household debt and whether these are historically high (as a proportion of household income or otherwise);
- (b) the factors, including the lending policies of banks and other financial institutions, that contribute to household debt levels;
- (c) the extent to which demand for imported goods contributes to household debt levels;
- (d) the extent to which demand for imported goods by Australian households contributes to the current account deficit;
- (e) risks for households and the economy of high household debt levels;
- (f) whether there is a case for addressing the lending policies of banks and other credit providers and if so, what practical options are available;
- (g) whether there are other measures that might be taken in place of possible restrictions on lending practices which would be as effective;
- (h) whether any Commonwealth social and economic policy settings should be changed as a result of matters identified above;
- (i) whether there is a need for any other form of regulatory intervention in relation to this issue; and
- (j) any related matters.

WITNESSES

GARNAUT, Professor Ross Gregory, Professor of Economics, Division of Economics, Research School of Pacific and Asian Studies, Australian National University.....	1
GRUEN, Dr David William Roy, Chief Adviser (Domestic), Macroeconomic Group, Department of the Treasury	1
HAWKINS, Mr John Robert, Manager, Domestic Economy Division, Department of the Treasury	1
PEARSON, Mr Anthony George, Head of Australian Economics, ANZ.....	1
POTTER, Mr Michael, Director of Economics and Taxation, Australian Chamber of Commerce and Industry	1
SIMES, Dr Richard Mark, Private capacity	1

Committee met at 2.04 pm

GARNAUT, Professor Ross Gregory, Professor of Economics, Division of Economics, Research School of Pacific and Asian Studies, Australian National University

GRUEN, Dr David William Roy, Chief Adviser (Domestic), Macroeconomic Group, Department of the Treasury

HAWKINS, Mr John Robert, Manager, Domestic Economy Division, Department of the Treasury

PEARSON, Mr Anthony George, Head of Australian Economics, ANZ

POTTER, Mr Michael, Director of Economics and Taxation, Australian Chamber of Commerce and Industry

SIMES, Dr Richard Mark, Private capacity

CHAIR (Senator Stephens)—I would like to welcome you all to this roundtable forum on the current account deficit. Chris Murphy from Econtech was also to have joined us but has had to tender his apologies today because of illness. This is probably the final hearing that we will have in this inquiry. We have had many issues raised and now we think it is an opportunity to explore those issues a little more.

Despite the hand wringing and dire forecasts we seem to see in the press, there seems to be a widespread view among economists that the current account is not that important unless it betrays deeper structural problems within the economy. We know that current account deficits are not necessarily a bad thing and that benefits can flow from them and from external debt. We are all familiar with the notion that they provide the means for the efficient movement of capital to where it is needed—for example, the inflow of capital allows us to develop resources, provide export income and employment opportunities. Nonetheless, Australia's deficit has grown to over seven per cent and there are some warnings around that perhaps all is not well. Some of the banks are forecasting a drop in the currency, which may be a good thing for exporters but perhaps not such good news for consumers already contending with record prices for oil.

The deficit we see today is unusual in that it has been attributed to the household sector investing more than it saves, a trend that has become quite pronounced in recent years. It has been accompanied by large increases in house prices, which is where most of the money has been spent. Nonetheless, it is private sector debt—and as former Secretary to the Treasury Ted Evans so aptly put it, it is a 'consenting-adults deficit': the foreign lenders who are providing the money seem to be more than willing to lend as much as is required and, if they get concerned, presumably the deficit will self-correct if the currency falls. But are things getting out of hand? Does a current account deficit that has now climbed to seven per cent of GDP indicate that there are some structural issues in the economy that we need to be concerned about, particularly in relation to household debt, which is the main theme of this inquiry? Are there other matters we should be mindful of, for example in relation to exports? This is the theme for the roundtable today.

Before we start, I would like to get some housekeeping matters out of the way. This forum format is a bit different to the question and answer sessions that those of you who have appeared before committees before may be used to. The reason for this is to try and encourage a free exchange of views between participants, as well as between senators and participants. Nonetheless, these are public parliamentary proceedings, which means that all participants are protected by parliamentary privilege, and there will be a transcript produced by Hansard.

During the week I know that the secretariat will have sent you a set of questions which are intended to stimulate some discussion, but you should not feel confined by them. To kick things off I would like to pose the first of the questions, and that is: Should we be concerned about a current account deficit of about seven per cent of GDP? Does this indicate emerging structural problems in the economy? What, if anything, should be done and what is the outlook for the future? Perhaps we can start with Treasury—Michael is sneaking away! Perhaps we can start with you, David, and whether or not you believe there are structural issues emerging.

Dr Gruen—Let me start by saying a few things. I do not think there are any magic numbers in this business. The Australian current account deficit has cycled between about two and seven per cent of GDP for 20 years now and has averaged just under five per cent of GDP for 20 years. It is true that the current ratio to GDP is higher than at any other time in that period, but not much. There have been previous peaks that were, I think, 6.6 per cent and several times when it was six per cent of GDP. Just a few years ago it was two per cent of GDP. So in the last several years we have seen both the highest ratio to GDP and the lowest. My characterisation of the situation would be that we have seen quite big cycles in the current account but no obvious trend over that period. As I say, it has been around five per cent—I think the average is $4\frac{3}{4}$ per cent—of GDP for 20 years and there have been quite big cycles around that.

As a consequence of that, net external liabilities as a proportion of the size of the economy have been gradually rising. But, again, that has been true for 20 years, and I do not think there are any magic numbers here. At some point, net external liabilities to GDP have to stop rising. They cannot go on going up forever, but it is far from obvious how much further net external liabilities to GDP could rise. I do not think it indicates emerging structural problems in the economy. In the broad, I think it is a continuation of something that we have seen for an extended period.

CHAIR—Professor Garnaut, do you have any comments to make about that, given your comments in the 2004 Melville Lecture?

Prof. Garnaut—Yes. Having a current account deficit of seven per cent of GDP does not prove that you have a big problem or crisis coming, but it should be a warning bell that you should look very carefully at what is generating it and at whether or not the things that are generating it are sustainable. It is an unusual figure for Australia and very unusual in the world, especially amongst developed countries. In developing countries where numbers above that have arisen they have usually been followed by crisis. There are lots of different features in Australia, but when you see an unusual number like this it should get you thinking. In earlier periods of Australian history it has been very rare that we have had the current account deficit this high. I do not think it has ever been quite as high as in the March quarter of this year, at least not since quarterly national accounts have been kept. Since we have kept quarterly data like that, in earlier periods when it has gone up to that level it has been followed by quite severe adjustment

problems. That does not prove that it is a problem now but it should get us thinking. I suppose that is why this Senate committee is holding these hearings.

And what should you think about in those circumstances? It is all to do with whether or not the underlying forces that are generating and sustaining the deficit are themselves sustainable, and with whether or not there are self-correcting forces in them. There are a couple of features of that big number—or all those big numbers last year and the big number in the March quarter of this year—that make that big number even more unusual. One of those is that it has occurred at a time of historically extremely high current account deficits—prices for our exports relative to our imports. Other periods of peak current account deficits—they have never been quite this high before, but at other times they have got close to it—have usually been times when export prices have been relatively low. But at this time they are unusually high.

A second feature that should cause us to think a bit harder is the historically very high and, I think, unprecedented levels of net external liabilities and net external debt as a share of GDP. These are occurring at a time of unusually low global interest rates so that the financing demands of the large external liabilities are less severe than they would be in normal times for international interest rates. If international interest rates were near the average of the last 20 years, rather than historically extremely low, then that would add possibly a couple of per cent to the current account deficit. That is another reason why the seven per cent is even more unusual than it might look at first sight.

Senator BRANDIS—When economists are assessing the current account deficit, is there a measure by which, for example, they adjust for the terms of trade to achieve an historically truer comparison?

Prof. Garnaut—It is not a sum that is done routinely, but it can easily be done, although the adjustment that has to be made is quite complicated because if our terms of trade return to the normal levels—well, let us not call them ‘normal’ but ‘average’ levels—of the last 20 years, then some of the liability side of our current account would be eased. There would be fewer payments of dividends by foreign companies operating in Australia and so on. There are swings and roundabouts, but you can work through all of that and can make an adjustment for that.

Senator BRANDIS—Thank you.

Prof. Garnaut—I think they are all reasons for caution at this time. Then we have to ask: what has generated this large current account deficit; what is allowing us to finance it, apparently without great strain at the moment; what is going to change about the circumstances that generated it; and might anything change about the external circumstances that are allowing us to fund it at the moment? The biggest single cause of a large current account deficit is the decline in household savings, which I think most economists, if not all, who think about these things would attribute above all else, directly and indirectly, to the extraordinary wealth effects of our housing boom, which is large by our historical standards and large by world standards. It led Australian households—more in Sydney than anywhere else, but to some extent everywhere—to think that they were very wealthy and very comfortable, and that they could comfortably go through a period of higher consumption expenditure and low, zero or negative savings. There have been some quarters in which household savings have been negative recently.

I think it is obvious that that is not sustainable. You cannot have your households dissaving forever, with that being balanced by ever-increasing asset values—in this case, bubble housing values. We are going through an adjustment now, as the housing boom has reached a plateau. It is a different story in different parts of Australia—a very interesting, uneven story across Australia—but on average house prices have eased. Over time, one would expect that to significantly bring down consumption and raise saving rates. We have been able to finance the large current account deficit because the international financial markets, the various sources of capital—equity and debt—and other instruments of capital transfer have not formed a view that the Australian deficit is unsustainable. That is a comfort.

The issue to think about there is a cautionary point: the views of international markets can change rather quickly. I am not seeking to draw a parallel between Australia and any of the East Asian countries that went into crisis, but until right on the point of the crisis, in the main, those economies had consenting-adult deficits, mainly driven by debt-funded assets booms in the private sector. We are taking comfort from the consenting-adults view of debt and the fact that it is in the private sector. There have been lots of circumstances in other countries where that has looked like a comfort for a while and then quite quickly has ceased to be a comfort. Even in our own history, the most severe depression we ever had, in the 1890s, followed the deflation of a private sector asset boom: the great housing boom of the late eighties, which extended into 1890 and then collapsed, which was greatest in Melbourne but had Australia-wide ramifications in the early 1890s. It was not principally a problem of government debt, and yet the consequences were severe.

Senator MURRAY—You are discussing market reaction to the phenomenon rather than a policy change by government designed to influence the outcomes. Economists so far have taken the view that the market will adjust for the circumstances, perhaps with currency reductions and falling house prices. Obviously the Reserve Bank itself is attending to a policy lever—but that is not government action; it is mostly market focused. It seems to me that, if there is to be a crisis of any kind at some time in the future, it will have one of two variants: it will either cause a market shock, which you ride and then emerge out the other end, or it will initiate a structural change. If the market shock is to be addressed to the household sector, there is a natural cushion there: because one-third of households are mortgage free often they effectively operate as lenders of last resort to the highly geared children. So, where the stresses and strains are highest, there is an extra financial lender, if you like, which is the mums and dads who are sitting on assets—and are not as reliant on asset appreciation, incidentally; they are actually free of debt and that gives them a capacity to assist with market shocks. I see the situation as requiring market reaction of some kind in the future. I am more interested in knowing what that is likely to be and how Australia is likely to cope with it.

Prof. Garnaut—If one thinks of the things that could bring what are currently happy circumstances to an end, I think the outstanding possibility is a retreat of the terms of trade towards more normal levels. This is the way that the boom of the late sixties and early seventies ended. This is the way that the resources boom of the Fraser era ended. This is part of the story of the boom of the late eighties which gave rise to recession. On each occasion, there was a large and fairly sharp fall in the terms of trade. I do not think there is any doubt that, if within a relatively short period we got an adjustment in export prices similar to that which has occurred a number of times in modern Australian history, we would have a very difficult adjustment

problem. The question then is: what is the likelihood of this occurring? We never know until history has told us.

Senator MURRAY—And that would be currency driven, not demand driven.

Prof. Garnaut—It would be both. If over a short period you had a return in average export prices or average terms of trade to the levels of the last 20 years, it certainly would take the currency down quickly. It would take government revenue down. It would reduce levels of investment because the sector of the economy which is experiencing a very high proportion of Australian investment growth at the moment is the resources sector. That would stop pretty quickly. It has with each of the other episodes that I have talked about. I am not predicting a large and sudden retreat of the terms of trade, but one has to recognise that it is historically normal to get these corrections, so it is one of things that we should turn our minds to. If that were accompanied by a lift in global interest rates, increasing the cost of servicing our external debt, it would put an additional burden on our external accounts.

A very high proportion of our current account deficit in recent years has been funded by our banks borrowing abroad to lend, especially to households. If you had a sudden large fall in currency and an associated significant increase in international interest rates, there would be two mechanisms through which the cost of borrowing to the Australian economy and to firms and households within it would rise rather sharply. If we had a large and sudden fall in the currency, probably the rate of inflation in Australia would rise above the band that the Reserve Bank works within, and the Reserve Bank would be required to ask for some time to adjust—ask for some time for forgiveness, if you like—for the rate of inflation rising above the band for a period or it would need to adjust and tighten monetary policy to bring the rate of inflation of non-tradable goods and services down quickly to compensate for the very large increases in tradable prices. In those worst of adjustment circumstances, the mechanism would be a combination of rising cost of borrowing and of falling currency and declining rates of investment and expenditure within the Australian economy.

CHAIR—Dr Simes, do you have anything more to add to that or a different view, perhaps?

Dr Simes—Can I go back to one of your starting points. You mentioned that, unless the current account deficit is seen as reflecting structural issues, a lot of people are saying it is not a problem. That tends to lead you down the path of looking for those structural problems that might be there. I think that is the wrong way to go about it, because it is always going to be very difficult to identify those structural issues. It is no different from when, in a recession, unemployment goes up. You cannot go back and work out all the precise causes; you can instead respond to it. To me, a high current account deficit is a signal of something not quite right and it is something that, for various reasons that Ross has alluded to, you should be cautious about. You can act directly based on that signal. That is the first point.

David mentioned that we have had a deficit of $4\frac{3}{4}$ per cent for 20 years or so. My calculation for up until recently was $4\frac{1}{2}$ per cent, so I guess that is the same. Twenty years is, by itself, important. The current account deficits around the world are more spread today than they have been for quite a while. The dispersion there is fairly unique. In fact, I think Australia is the only country that I know of that has had a deficit anywhere near this level for that long. So it does cause greater concern down the track. My assessment of the numbers is that, after some of the

things in the system work their way through, we are probably looking at the average of the current account deficit to GDP increasing from around 4½ per cent to maybe between five and six per cent. That is taking the cycles out.

You cannot say that definitively because you do not know what is going to happen to the exchange rate down the track. That is the major mechanism that would affect that average. But, without a big change in the exchange rate long term, it does look, in my judgment, as though, if anything, things have got a bit worse and that should be a worry. At the same time, I do not see a crisis situation. How might the current account come back? In a temporary way, the way that it normally comes back is a slowdown in economic demand and activity in the country, and that might be induced, as Ross said, by a switch in the terms of trade, or it could be house prices or whatever. In the short term it can come back.

The other mechanism that might have an effect is foreigners withdrawing capital. That would lead to the exchange rate falling, and it could fall fairly sharply. Would that lead to recession or to the Reserve Bank having to tighten monetary policy significantly? I would hope not, because of the strength of the financial sector. We saw that in the Asian financial crisis and the direct effects on higher import prices. The Reserve Bank at that time was happy to look through those and look at the second-round effects to see whether there was going to be any impact on inflation. Because of that, it was prepared to not tighten in response to the falling currency. That basically meant that we had the ability to ride out those shorter term things. The current account is an issue and something we should be acting to address, but we can do it over the medium term, and we should be looking at medium-term policy changes either related to savings or to exports. I could talk about those, but that is a starting point.

CHAIR—Mr Pearson, what do you think is the view of the banking sector, given the comments in the June economic update?

Mr Pearson—I have a couple of observations. There has been a presumption in the discussion so far that the capital account has been driving the current account. But we have made some observations that over the last 20 years there have been a number of cycles in the current account, from peak to trough and trough to peak. Another presumption has been that household borrowing was the principal driver of the current account deficit. But, if you were to line up a chart over the last 20 years of the cycles and the current account and stick that against household borrowing—the relationship is not precise—you would see that household borrowing has accelerated since the late 1980s and we have had peaks within a number of cycles in the current account over that period.

I wonder whether we could also look at the problem more from the perspective of the trade side, the imports and exports side. If you look at that, you will find that there has been an acceleration in import growth since 2001, particularly in volume terms, but in particular there has been flatness in the volume of exports. I am not sure that you could ascribe the flatness in exports to household borrowing, for example. So I wonder, in terms of causation, whether the line of thinking we have been following is the whole story. I think we need to look at the trade side.

Looking at the export side, we know that drought impacted on rural exports for a while. That may now be breaking. There has been flatness in services exports, which has been a concern, and

we can talk about the reasons for that. Heavy mining exports have started to come good, as we well know, from the strong global growth story. But I wonder if you could explain a lot of the recent blow-out, just taking the last cycle where it has been heading towards seven per cent of GDP, more from the trade side than from a capital flow side. If you do that, then the prescriptions you might come up with from a policy point of view are quite different.

Senator MURRAY—There is also a market reaction to that, and it is exhibited by a wide range of people, from farmers saying, ‘Buy Australian; don’t buy foreign,’ to people saying to governments, ‘Build your ships in Australia; don’t buy foreign ships.’ There is a kind of market sense that self-sufficiency and self-help will assist a situation of being exposed to external risk through excess of imports. How conscious that is I do not know, but it does seem to be a market reaction which is increasing.

Prof. Garnaut—In the political market.

Senator MURRAY—Yes. That in a sense is a response. I recall sitting through the mid- to late-nineties, when governments were very big on buying where you had the best value. They were not at all espousing what they are now espousing, which is that wherever possible you should buy Australian.

Prof Garnaut—If that is becoming a big issue, perhaps it would help if each member here made a very clear statement that it would not help. I am very happy to start with that. Protectionism would not help the current account deficit.

Senator MURRAY—I understand your reaction.

Senator WEBBER—This is where George comes in.

Senator GEORGE CAMPBELL—It is not so much that; it is very important these days to define what is Australian and what is not Australian. One of the factors, particularly in the manufacturing sector, or in ETMs, is the currency fluctuation. We have had our dollar float somewhere between 49c and almost 80c in a period of 2½ years. It is very difficult for any economy, particularly smaller businesses, to absorb that sort of shift without it having a major impact upon business. It is creating a shift in the share of the end product that is coming from imports as opposed to what is being locally produced. In reality, if the dollar goes up, the level of imports in products here also goes up. When the dollar comes down, the level of input from locally introduced components goes up. The problem is that the gap has been so wide and the fluctuation has been so big. It has been very difficult to get stability into that. That is having a major impact upon the decline in the export of ETMs in particular, which have declined from about 18 per cent to 3.4 per cent in the last figures that I saw.

Dr Gruen—In the last few years, we have been through a very unusual set of macroeconomic circumstances—namely, this huge rise in the terms of trade. To my mind at least, the way we now cope with huge rises in the terms of trade—which is to let the exchange rate adjust via the market—may well have implications for the manufacturing sector which, looked at in isolation, are perhaps not what the manufacturing sector would like. But from the point of view of the economy as a whole, this is a huge advance on the way we used to operate big terms-of-trade rises, which was not to allow the exchange rate to adjust and stabilise the macroeconomy. To a

considerable extent, one of the reasons why the economy as a whole has been as stable as it has is that we have allowed the exchange rate to play the role of a shock absorber.

The recent period which you talked about, moving from US49c to something close to US80c, is not very usual. We have been in an extremely unusual circumstance of going from being viewed as the old economy in 2001 to this huge rise in the terms of trade, and the currency has gone with it. Given that the terms of trade are something that we get dealt largely by the rest of the world, allowing the currency to move with them may have sectoral implications that some people would not like but, in terms of the stability of the overall economy, it is a huge advance on the last time we had a huge terms-of-trade rise like this, which was in 1973-74. The Australian economy did not cope well with that. We ended up with a big rise in inflation and a lot of other things as well. Nothing has only good sides, but my judgment is that this is a much better way of allowing the economy to adjust than the alternatives.

While I have the floor, I will make a couple of other comments. In terms of servicing the foreign debt, I do not think that global interest rates are all that relevant. The ABS did a survey in 2001 of the hedging practices of Australian companies. They have just redone this survey and the results will be published later in the year. When the first survey was done, the ABS was given the answer that 77 per cent of the value of foreign currency denominated debt was hedged back to Australian dollars. That is more than three-quarters. If you hedge foreign currency debt back to Australian dollars, you effectively pay Australian interest rates. I do not know the results of the more recent survey, but, if that is a reasonable reflection of the situation as it is now, the servicing of Australia's foreign debt is largely in Australian interest rates, and a change in global interest rates has a relatively small effect on that.

Another thing came up, which I think was talked about by a few people. If you look at the savings-investment balances for the various parts of the economy, which was something that we put in the Treasury submission to the inquiry, it is very striking that over the last few years the household sector is the sector which has invested very substantially more than it has saved. In an arithmetic sense, it is extremely unusual. In the last 25 years it is only in the last couple of years that the household sector has run a savings-investment imbalance of the order of the size of the current account. I think it is reasonable from that perspective to say that it is the household sector where, if you like, you can explain why the current account has been as large as it has recently. I think it is reasonable to say that that is largely a consequence of savings-investments decisions by the household sector.

Mr Pearson—Is that a consequence or a result?

Dr Gruen—I think it is a consequence.

Mr Pearson—So you are saying it is not a driver.

Dr Gruen—No, I am saying it is a driver. I think it is a driver—absolutely. I think the outcomes on imports and exports are a consequence of the macroeconomic policy that needed to be run to keep the economy stable through that period—in other words, the economy was growing quite strongly and we did not need the sort of stimulus the US economy needed from very low interest rates, so we ran reasonably high interest rates through that period and we got an outcome for net exports which was a consequence of what was happening to the exchange rate.

That would be my explanation for what was going on. But that is also relevant to the fact that there are self-correcting forces operating.

In the latest statement on monetary policy released, I think in the last week or so, by the Reserve Bank, they do their latest update on what has been going on with house prices. Their latest estimate, which adjusts for composition in all of the state capitals—on page 36—is that in the 18 months to the December quarter 2003 house prices in Australia went up 29 per cent. Over the last 18 months they went up by exactly nothing. This is the best quantitative estimate we have of something we are all aware of, which is that in terms of prices we have had 18 months of no growth in house prices. I think—I am not predicting the future—the consequences of that for the savings and investment balance of the household are going to be very substantial. So I think there are self-correcting forces in play in the Australian economy which should move us in the direction of smaller current account deficits. There will be other changes that will accompany those things in terms of wider macroeconomic consequences. That seems to me to be a very substantial self-correcting development that has been going on for 18 months, but it will play out over an extended period.

Senator MURRAY—Looking at your chart 3 on net lending, it seems to me that public corporations and governments made very strong efforts to improve their balance sheets, their financing and their disciplines over a period of well over a decade. Private corporations as well improved their situations but not as markedly over the same period. Is it likely that the current account deficit cautionary signals, to use the professor's language, will diminish because households will come back and, since there is no sign of governments, public corporations or private corporations getting into any debt trouble or moving into more difficult credit areas, you will have a natural move back into a more manageable situation?

Dr Gruen—Certainly my expectation would be that, as a consequence of the adjustment we are having in the household sector, the household saving and investment balance will do precisely what you have said. What will happen to private corporations, I do not know. Their normal pattern over this 25-year period has been to be in deficit, so they might go back to that.

Senator MURRAY—One of the dangers with the household sector having to cope with this adjustment is that the shock is so considerable that it causes a lot of social and economic distress. That is why I drew attention to the third of households that do not have mortgages and are not financially stressed. In my view, they therefore provide a cushion, because of their children, by and large, for the third who are financially stressed. That will allow the market adjustment to be managed, because they are economic lenders of last resort: they will do it on emotional and moral grounds, not as cold-hearted, financial beings. My sense of things is that, if you are right, the adjustment should be able to be accommodated. I put the proposition deliberately to you, gentlemen, because you are more skilled in interpreting these things than I am.

Dr Simes—My view is that it is not only the fact that you have a large proportion of the population who are not in debt and who can support the others; it is also that the financial sector is attuned to providing credit et cetera in a fairly smooth way. Given that most of this debt is secured against a house and is being serviced by regular income, the real problem is only going to arise if you have a sharp lift in unemployment, not just if house prices fall. Coming back to your starting point, I think that access to credit in the financial sector will be a more important

reason for it to be handled in a smooth way rather than borrowing off your parents or something more indirect like that.

Senator MURRAY—You have to fear high interest rates because they would create conditions where unemployment will rise.

Dr Simes—Yes. You are going to fear high interest rates if you have a price and wage system that is basically propagating a shock through that like we had in the past. I think the risk of that is low.

Senator MURRAY—Or if foreign investment is withdrawn?

Dr Simes—If foreign investment is withdrawn, the adjustment will be through the exchange rate—that is, foreign money will be available at a price and it will be the exchange rate that does the buffering, as we saw in the Asian financial crisis, if you like. That will be manageable unless you have a system in the price-wage interactions where it is going to get into ongoing inflation, and that is hard to see in the current structure of the economy or for the next five years. You could not rule that coming back into play at some point, but it is a long way off.

Prof. Garnaut—I do not want to unnecessarily prolong the last part of the discussion, but I think David's comment should be taken a little further. He talked about the adjustment in household expenditure and savings that is likely to take place as a result of the end of the housing boom and for something substantial to happen there. We have to ask whether some other unusual elements of Australia's situation at the moment are sustainable. The very high terms of trade, which are driving very high levels of resource investment, raise very important questions and require a lot of analysis, and the answers are not all that clear. If there were a downturn in export prices then that would very quickly affect business savings, because a lot of the very high profitability of Australian business—high cash flows, high savings over the last few years—have been on the back of the high minerals and energy prices. A fall in export prices would flow quite quickly into government revenue, both state and federal, both of which have been buoyant to an extraordinary degree in recent years. A great contributor to that buoyancy has been the high minerals and energy prices. So then you are left with a whole lot of adjustments going on at once.

There is a sense in which there cannot be a long-term current account deficit problem because in its nature it is self-correcting. Indonesia and Thailand had current account deficits in 1996 that some people thought were worrying. They had large current account surpluses by late 1998 and 1999, so there is a sense in which there was no current account deficit problem because it was self-correcting. The problem was the consequences of the adjustment that the economy had to go through. So the issue we are talking about is not really a problem of whether the current account deficit will adjust or whether in the end whatever deficit is there will be financed—by definition it will be. The question is: what will the process of adjustment be, and what stress will that place on government budgets, on unemployment and on economic activity—or, to put it another way, will it give us a recession like similar adjustments have in the past? So the questions in the end become ones of vulnerability to circumstances changing and forcing adjustment and of our capacity to handle without excessive pain the adjustments that will be necessary.

Mr Potter—First, a couple of measurement issues which are technical but important in regard to the terms of trade and the current account deficit. There are a number of ways of looking at this. The headline number for the current account deficit which is reported adjusts for prices, so it is a current account deficit in terms of volumes. It does not take account of the price effects. That is normally the right thing to do, but in the current circumstances we may be getting a misleading picture of where the current account deficit is because we have had such a large movement in the terms of trade. In one sense—this is only in one sense—the terms of trade are not quite as bad as we think they are because we are getting a lot more for our exports and we are paying less for our imports. The headline figure for the current account deficit takes that out automatically.

Dr Gruen—What do you mean it takes it out?

Mr Potter—The current account deficit is a volume.

Dr Gruen—No, it is not.

Mr Pearson—No, it is not.

Dr Gruen—It is a values measure.

Mr Potter—No, it is not.

Mr Pearson—Net export volumes go into GDP.

Mr Potter—The one which is used for the national accounts; all of the national accounts figures are volume.

Dr Gruen—No, it is a values measure.

Mr Hawkins—Net exports in the national accounts sense is a volume concept but not the current account.

Dr Gruen—Not the current account.

Mr Potter—Sorry, I was using the wrong term there. I meant the net exports figure in the national accounts. The net exports figure in the national accounts is entirely a volume measure, so it does not affect the terms of trade. So our net exports may not be quite as bad as people think they are. You are correct that the current account deficit incorporates both the volume and the value measures.

We have talked about household savings. The household sector has been a dissaver, if we talk about the cash-flow measure of savings. Household wealth has been increasing substantially, largely because of housing prices. We have to ask: is an increase in household wealth similar to an increase in household cash income? If you think it is, then households have substantial savings at the moment. If you think they are separate and distinct and that there is a big difference between cash income and changes in wealth, then households are dissaving. But if you think there is a degree of similarity between an increase in wealth and an increase in cash

income, then households are going through substantial saving at the moment. That debate might be worth having. I would not want to take either side on that one.

Going back to the cash measure of household savings, Professor Garnaut said that household savings had gone into negative territory largely because of the increases in house prices. It is also caused by financial deregulation. Financial deregulation has meant that households are more able to withdraw money from house prices—house equity withdrawals, for example. That is also important.

On the East Asian economic crisis, Professor Garnaut said that it was a sort of ‘consenting-adults’ perspective whereby it was the private sector lending to the private sector. I had the idea—Professor Garnaut may want to respond to this—that there was an impression held by the market that some of the lending to the private sector had government backing, and so there was some government ‘interference’, for want of a better word, in that sector. So I am not sure that the idea it was a consenting-adults current account deficit in the East Asian economic crisis is correct. We can pretty much be certain that the terms of trade will fall. The question is: to what level? Treasury, in their budget, forecast that the terms of trade would fall back to a historically normal level by 2009, I think it was.

Mr Hawkins—It was a technical assumption to be cautious rather than a forecast.

Mr Potter—Okay. It was not a forecast. What was the word you used?

Mr Hawkins—An assumption.

Mr Potter—That is reasonable, and is generally supported by other people who look at this issue. On the risk of the housing sector falling, we have seen a reasonable adjustment to housing prices. This was brought up in the Reserve Bank’s statement of monetary policy. APRA, the prudential regulator, did an analysis last year some time of what would happen to banks’ balance sheets if there were a substantial fall in housing prices—I think they said by 20 per cent. They said it would have a very limited effect on banks’ balance sheets. That suggests that the risk from the housing market, on its own, is limited. Others may want to comment on that issue.

First, on the important issue of whether it is a current account deficit or a capital account surplus, it is absolutely valid to say that we need to look at both. We cannot look at one in isolation from the other. It might be worth while—I do not know if this is the right time—for people to comment on the fact that we have a lower current account deficit than the US as a percentage of our economy. Yet people are complaining about the US one but not the Australian one.

Prof. Garnaut—Michael addressed a question to me about the origins of the East Asian financial crisis. Relatively little of the private debt of East Asian economies that entered crisis was government guaranteed. There were a lot of foreign lenders after they got into trouble who—

Dr Gruen—Tried to make their case.

Prof. Garnaut—Yes.

Mr Potter—I guess that was my point—that it was an implied guarantee rather than an actual government guarantee.

Prof. Garnaut—If I can be allowed a little anecdote, during the Asian financial crisis I happened to be in the office of the deputy managing director of the IMF in Washington, Stan Fischer, when representations were being made to him by the leading banks of the United States, who had lent money to a South China government corporation called GITIC, the Guangdong International Trust and Investment Corporation. Their representation was that the IMF and Western governments should intervene to make sure that their debt was repaid because they had presumed a government guarantee. All the documentation—and the Chinese government made this very clear—not only did not presume a government guarantee but said very explicitly that there was no government guarantee. But the banks said, ‘But we were lending to an agency that was somehow connected to government so we think we were reasonable to presume a guarantee and therefore the IMF and Western governments should intervene to make sure that we are repaid.’

Similarly, one of the most successful of the Hong Kong finance firms through the 1990s which went bankrupt during the financial crisis because South-East Asian loans went bad on it had lent a lot to associates of the Suharto family in Indonesia. It tried to argue that because it was lending to the daughter of the President there was an implicit government guarantee. This was all special pleading and just part of the way consenting adults try to push responsibility elsewhere when they get into trouble.

Dr Gruen—People did not realise the Asian crisis at the time because most of the economics profession continued to have extremely rosy expectations for the region before the crisis and it came as a rude shock to everyone when the Asian countries went into severe recessions. We discovered that they were running either fixed exchange rates against the US or effectively fixed exchange rates against the US. It was perhaps not realised that the financial health of most of the economies, not only the financial system but also the non-financial system, was inextricably tied to this exchange rate policy. In other words, once the currency depreciated significantly, the unhedged foreign borrowings in the companies and the financial system bankrupted large parts of the economy. I do not think it is at all surprising that the public sector felt some need to respond to what was an evolving disaster so they got involved and that ended up putting a lot of the costs onto the public purse. There is no question that that happened.

That leads to the question: are there things in the Australian private sector which if circumstances changed could lead to some sort of contingent liability for the public sector? In the aftermath of the Asian crisis people have looked much more carefully at that issue. Certainly, on the exchange rate no-one could make the argument that they do not realise the Australian dollar goes up and down. It has gone up and down ever since it was floated. No-one is going to make that mistake.

There has been much more careful analysis by regulatory authorities of the sorts of liabilities in the private sector that could ultimately cause systemic problems. The lesson from the Asian crisis is that those are exactly the sorts of things you have to look at carefully. That is precisely what we have done. We have looked carefully at the sorts of shocks that could hit the Australian economy, like the one Michael Potter was talking about earlier of a significant fall in house prices. I think the number might have been 30 per cent—the test that APRA applied. That is

precisely where one does need to look. If one is going to have a consenting-adults view about the current account it is extremely important to take a view about possible shocks that could lead to systemic problems. In the Asian crisis case economists were not very good at predicting it. With the benefit of hindsight, we are much better at predicting things.

Senator WEBBER—I reckon even I could manage it with the benefit of hindsight!

Dr Gruen—With the benefit of hindsight, that exposed something that was extremely important to look at. It would be fair to say that that is precisely what not only Australian authorities but authorities in other countries have done: they have looked through and thought about potential scenarios in which shocks could lead to systemic problems.

Mr Hawkins—Perhaps I can tie something that Michael and David have said into an answer to your original question about how concerned we should be about a current account deficit of six per cent to seven per cent of GDP. While I would not want to be complacent, and it is admittedly a relatively large number in our historical experience and in the historical experiences of comparable countries, you have to look at the underlying structure and the counterpart savings-investment imbalances to see how dangerous a current account deficit of a particular size is. Similarly, while the net liabilities we have accumulated are large, you have to look at the underlying structure of them before you can make a judgment.

On the current account, our deficit proportionate to GDP is something similar to the US. But there is a very big difference in the counterparts to it. On this graph, we see that in Australia's case the counterpart to our CAD is all in the private sector. In the case of the United States, the counterpart is largely a very large fiscal deficit. That is one reason why in the US there has been a lot of concern about the current account deficit that is not applicable to the current account deficit in Australia.

Similarly, while we have large net external liabilities to GDP, as had some of the East Asian countries, we are much less vulnerable to a large movement in the exchange rate, because, as David commented earlier, we are not in a position where all our debt is in foreign currency and unhedged. A significant amount of our debt is in Australian dollars and a significant amount of the debt that is not is either hedged in financial markets or naturally hedged through the export flows that companies which have borrowed have.

CHAIR—I am thinking about that and the issue of vulnerability. I want to go back to the point that you made, Dr Gruen. It picks up what Mr Pearson said earlier about exports and the other side of the balance sheet, I suppose—about there being a vulnerability in us having such dependence on a limited range of exports. If we are so limited—and we have been talking about the mining sector increasing but services and the rural sector decreasing—is that a vulnerability that we need to be aware of?

Mr Pearson—In terms of vulnerability, my calculation is that mining is about 31 per cent by volume at the moment. It varies from year to year, and obviously it is on a roll at the moment. Rural accounts for about 17 per cent and services account for 23 per cent, and that includes things like tourism, education services and financial services. The balance is manufacturing. It is not entirely mining and rural. Together they make up, in broad terms, around about half by volume, which is still a heap of dependence. But the other half is services and manufacturing.

What has been disappointing is that that other half perhaps has not been performing the way we would like over the past four years.

On that, we have talked a lot about household debt and capital inflows. It does appear that demand for finance from the household sector is waning. We have seen an approximate halving in the demand for household debt for housing, for example, associated with the end of the housing boom. That may lead to some toning down in the pace of growth of imports. We have not seen too much of that yet but we have seen a large inventory accumulation in the March quarter national account figures that might suggest that the stocks of retailers and wholesalers will cause reduced imports going forward. But none of that does anything for exports. I still think we need to focus on, as part of the inquiry, why the exports have been so weak. The whole capital flow and household debt story is almost irrelevant to the export side, and I perceive some problems there.

Dr Simes—I will just respond a little bit to your question too. You have said that this will make us more vulnerable. I do not think that that is really quite the right focus. We are vulnerable more to the exchange rate moving a long way or the economy slowing. Either would see a correction in the current account and that correction would largely come through the import side of the equation—particularly if investment were to collapse. So rather than the lack of diversity in exports being an issue about vulnerability or a short-term issue, it is an issue about what you might want to do about a longer term current account problem, which is a problem in an underlying structural sense.

As Mr Pearson and others have said, you can look at that either from the lending side or from the trade side. If you are going to look at it from the lending side, my response to that is that after we see all these short-term corrections in house prices and net lending coming out of that, and we see the correction in the terms of trade and the like, I think we are still going to see a current account that I would be uncomfortable with. What do you do about it? You can do something on the savings and investment balance. You can look at fiscal policy but I would look more at superannuation and the like.

At the same time, that needs to have an impact on the net trade position—exports minus imports—and the mechanism by which that occurs is largely through the exchange rate long term—other than short-term cyclical changes—which gets back to what Senator Campbell said earlier about how the exchange rate has moved around a long way. I guess my biggest concern over that period was that for three years we had the exchange rate down around the 50c to 55c level, and the response on the export side in particular, but also on the import side, was, in my view, disappointingly limited. With regard to any mechanism that you might want to think of to fix the current account, you need to somehow get into exports and imports through the exchange rate.

With regard to success stories on exports, in particular, in the past I think the classic success was from the mid-eighties to the mid- to late-nineties, where you did have a big increase in the share of exports or the performance of manufacturing and services exports. As you have said, that has stopped today. Why did that come about? There were lots of factors but some of them were the fall in the currency in the early eighties and the fact that tariffs were reduced, which basically meant that the manufacturing firms that were in existence were more internationally competitive. They were forced to be. But also you had some non-industry-specific industry

policies like export programs or engagement with Asia or whatever. The whole atmospherics through those periods were quite different.

If you look at the situation today, we have got a much more open economy—that is, the imports to GDP is much higher than it was then. I think it is hard to conceive of a scenario where we are going to get a lot of mileage from the rural sector. We will get some with the further breaking of the drought and the like. I think it is hard to see a situation where we get a long-term big boost from the mining sector also. A lot of the big boost we have at the moment is coming off the terms of trade. While volumes are going to continue to rise—that is, the lags in the system—if the prices fall you have that offset. So somehow I think the focus needs to come back to if we can we do something a bit more proactive on manufacturing and services. Long term, an exchange rate will solve the problem but my concern is that, as Senator Campbell said, a volatile exchange rate is not always good for these sectors and a bit of easing the transition to this new world might be what is in order. It is a hard ask but I think that that is an area that we should be looking at.

Mr Hawkins—I think your observation that excessive concentration of exports can be a problem for countries is absolutely right. Of course, the classic example would be some of the developing countries where maybe 90 per cent of their exports are copper or something like that. I think Australia is in a fairly good position. This graph shows export volumes, taking out prices. You can see that, over the late nineties, we increased our elaborately transformed manufactures, which is a much more diverse area, but we also have a lot of exports of commodities, services, education, tourism and, increasingly, medical services and so forth. So we are quite a diverse country in terms of our exports, despite the ‘riding on the sheep’s back’ rhetoric. I think that is something that is desirable and helpful for us.

Prof. Garnaut—Senator Stephens, I would like to support your use of the word ‘vulnerability’. I think that is what these issues are all about. That does not mean to say that I do not support Ric’s view that we could be doing things on savings. In particular, I would think that at a time of record high terms of trade—a lot of which are flowing straight through into government revenues—it is wise to save that, to run much higher budget surpluses, until you know whether the improvement in the terms of trade was temporary or not. It could be very helpful then to be able to spend that surplus if it turns out that it was temporary.

On the point of vulnerability, I think that the point has been made by a couple of my colleagues that a more diverse export structure causes you to be less vulnerable. I think that is an important point. I think the changes in the structure of our exports from the mid-eighties until 2000, where there was rapid growth of services and manufacturing exports, were very helpful. Amongst other things, it meant that a given movement in minerals and metals prices was dampened in its effects and it did not have such a dramatic effect on our terms of trade. I think it is pity that we have gone backwards on that diversification.

The causes of the dramatic slowdown in our growth in exports of services and manufactures since 2000 are quite complicated. I think there are many elements to it. I think one of us made the point that it cannot just be the exchange rate because for part of that period, a couple of years, we had the lowest exchange rate we have ever had in nominal and real terms. It cannot be just the drought because the drought has come and gone a couple of times. I know that as a farmer. 2003 was an average sort of season. This year will not be as good, although people are

talking about the drought having ended. During the period, we have had some exceptionally weak periods but the next couple of years, with the drought having broken, are not going to be better than 2003.

There are some specific factors in manufacturing and services that bear very close analysis. It is very important to the diminution of vulnerability in future that we understand that slowdown. My thoughts would go not to new interventions by government to artificially increase incentives to those sectors but to understanding the barriers of various kinds that have emerged to continued rapid growth in services and manufacturing exports. We will find, when we do the microeconomics, that it is different as you move from sector to sector. Our education services were expanding very rapidly—they have slowed down. In some ways, Australia seems to have become a bit less congenial for young people from some Asian countries. There will be different factors in other sectors, but it is very important that we do the work to actually understand them.

Mr Potter—It sounds as though we have gone into a conception regarding policy related issues. I thought I would make a comment on some of the suggestions that have been made. First of all, I agree completely with Professor Garnaut that we should not be looking at things which are industry specific. I understand what you are saying: we should not be looking at industry-specific measures to artificially promote a sector, but we might want to look at industry-specific barriers to those particular industries. I think that is absolutely correct. Separate processes are going on relating to the barriers to export. There was the Fisher inquiry earlier this year, for example, and I think there is a House of Representatives inquiry into rural and regional ports and of course COAG is doing an investigation on the new round of national competition policy. All of those things are going to be very beneficial when looking at reducing the barriers to export.

A couple of points were made about private and public sector savings. With respect to public sector savings, I do not agree that the government needs to be saving a lot more than it is saving now. We think that the government, in a sense, needs to be saving less. It needs to be returning more money to individuals' pockets. A related point is: what happens when the terms of trade come back, and I refer to the budget papers, where Treasury have assumed that the terms of trade come back yet they do not have dramatic tax revenues coming back. They have fiscal surpluses for all of the out years, even when the terms of trade come back.

On super savings, I am not so keen on the idea of having the super system aimed at national savings. We think that super policy should be driven on its own merits, not because of the effect it has on national savings. I will separate it into two issues. You can either have the government investing in people's super—that is one possibility—or increase people's compulsory contributions. On the first one, if the government puts more money into people's super then that actually reduces the fiscal balance, so you may end up with no benefit to national savings. You might have an increase in the amount in people's super accounts, but a reduction in the government deficit and you would only be a little bit better off. On the other hand, you could, for example, increase the compulsory component of superannuation. We do not think that is such a good idea because, in a sense, super is like a payroll tax. I think the last thing that businesses want to have is an increase in payroll taxes.

CHAIR—I am sure, Dr Gruen, you want to respond to some of those comments.

Dr Gruen—I am not sure that I do. I have one comment, which again goes to the overall picture. Despite the fact that we have had weak export growth over the last several years, the economy as a whole has grown quite rapidly over that time, with unemployment coming down reasonably fast. Had we had a substantially faster export performance over that period and the same outcomes in the housing sector, something would have had to give, and it might well have been higher interest rates. It is partly a matter of timing, and I would agree with Professor Garnaut that—I am paraphrasing what he said—at the time when house prices have stopped rising and we are getting an adjustment in the household sector, it has been extremely beneficial that the Australian economy has been supported by rising terms of trade. There is no question that our situation would be made more difficult if we had to do adjustments on more than one front at the same time. I think it is the case that, if net exports had been stronger over the last three years, that would not have been the only difference over that period. You would have also had different macro policy settings. But, in a sense, the economy did not really have room for a substantially stronger export performance over that period or, if it had, you would have had to have made adjustments elsewhere.

Dr Simes—I do not understand that point. I would have thought that we would have liked higher net exports. Even if they would have induced some other offsetting effects, net exports would have led to higher GDP, higher demand and whatever and, if that had been offset to some extent by housing or higher interest rates, the economic outcome overall would have been better than what we had.

Dr Gruen—I guess I am suggesting that that would have to have been completely offset—that you would not have wanted GDP growth any faster than we had it over that period.

Dr Simes—Okay. So do you think we have been capacity constrained through this period?

Dr Gruen—No, I do not mean that. I mean that in order to have the sorts of outcomes that you would have wanted on inflation you would not have wanted to grow any faster.

Prof. Garnaut—I think that means that there have been capacity constraints.

Dr Simes—Yes.

Dr Gruen—No. It is a question of how fast demand can grow.

Mr Potter—But if you have an increase in net exports, that is separate from domestic demand.

Dr Gruen—But it employs resources. We may be saying the same thing. I am simply saying that the outcomes for overall output were quite strong over that period. Unemployment came down quite fast. Had it come down faster, my suspicion is that that would have caused problems for macro policy; that is all.

Mr Potter—That does sound like a capacity constraint argument. It is an argument over terminology, I guess.

Dr Gruen—I am not sure, because in a sense I am saying that it was perfectly possible for unemployment to come down that fast. It is really a speed limit argument, I think.

Senator GEORGE CAMPBELL—Let us talk about this issue of vulnerability that Professor Garnaut raises. I would have thought that, surely, at the end of the day, one of the objectives of any policy setting would be reduced vulnerability. You do that by broadening the diversification of your base, of which export is a part. It certainly was a part of it in the late eighties and in the nineties. A lot of focus was put on it and a lot of resources were put into driving it. It was not in the sense of handouts; it was in the sense of saying, ‘This is an objective. This is where we have to go in the longer term.’ Companies focused externally in terms of where they wanted to go.

It seems to me that over the last period we have dropped the ball in terms of export. It seems to me that it is because there is no overall policy framework that has said that that is an important component of our future economic base and therefore has to be maintained and sustained in whatever way we need to do that. That may reflect our policy settings, assuming that we simply let it go. That may have been because other factors were improving so therefore we were getting the same results without putting any pain into that particular area of the economy.

We know what happened in 1986 with the terms of trade. The terms of trade collapsed. We have similar circumstances again. Are we back in a position where we have to start all over again trying to diversify our economy from a very low base? What would that mean in terms of household incomes? It resulted in a 10 per cent decline in wages at that point in time. So the capacity to consume was reduced as a result of the decline in the terms of trade. That also obviously has an impact on interest rates. The impact again compounds the capacity of households to meet their debt repayments. It seems to me that when you look at the policy settings in these areas it really has to be an all-embracing view rather than riding on whatever may be the popular thing of the day. It is about bringing home the bacon, to use Paul Keating’s language, and hoping to hell that it stays there forever and a day.

Prof. Garnaut—I do not think that what has happened since 2000—the cessation, for a while, and then the very slow growth of exports other than in the resources sector—sets us right back to the mid-1980s. I think a lot of the structural improvements are still there. The manufacturing and service export share has not gone right back to what it was before the big expansion in manufactures and service exports in the 15 years from the mid-eighties.

I do think that a very broad approach to removing barriers to exports of non-traditional products for Australia—exports of manufacturing, including processed metals, and services—is required. But I think the solutions now are very complicated and diverse. I think the objective should be to systematically take every chance to remove barriers to increases in productivity. They are here, there and everywhere. Twenty years ago there were a few very big ones, the removal of which had very large effects. I would include the radical reductions in protection and the deregulation of the financial sector as the biggest of them. There is nothing around now of comparable dimension, but we all know of very large numbers of barriers to productivity improvement. Whereas we could make a lot of headway with hits over the boundary in the eighties, now we have to get them in singles. But I think there are lots of opportunities for doing that.

Dr Simes—I have just one figure. I looked up the tables at the back of the OECD's *Economic Outlook*. They have an export performance table that compares export volumes with the import volumes of major trading partners. Australia's performance has gone down by 22 per cent since 1998. To me that is an export problem.

Dr Gruen—What is this statistic?

Dr Simes—The ratio of our export volumes over import volumes of our major trading partners.

Prof Garnaut—So it is a loss of market share?

Dr Simes—It is a loss of market share of 22 per cent since 1998. My response to that is that we need to be doing something on both the productivity side and the jawboning, or trying to get the culture changed and people focused—

Mr Potter—That could be good though if it is signifying that we are exporting to more countries than we were previously.

Dr Simes—No, I cannot see how it is good.

Mr Potter—You said that it is our exports divided by the imports of our major trading partners. Obviously that means that, to add up to one, the remaining bit is the imports of everybody else in the world. Our exports equal the imports of our major trading partners plus the imports of everybody else. So if our exports, let us say, go up by a certain amount and our imports from our major trading partners go up by a lesser amount then that means the imports of the rest of the world have gone up by more, which means that we are diversifying our exports.

Dr Simes—I do not follow that.

Mr Potter—I am just going off your explanation of the data.

Dr Simes—There is no way that this is a good number.

Mr Potter—But I can see that it could be—

Dr Simes—It is a loss of market share.

Mr Potter—First of all, our exports equal the imports from Australia of the rest of the world.

Dr Simes—Yes.

Mr Potter—So if our exports have gone up by a certain amount and the imports from Australia to a certain proportion of the world have gone up by less, that means our exports to the rest of the world, excluding our major trading partners, have gone up by more.

Dr Simes—No. The way they have done it, that does not come in to it. They have just weighted our trading partners by the weights of our exports to them. You are sort of saying that there are going to be fewer countries that they look at. The way that they calculate it, that will not happen.

Mr Potter—There must be something about their description which I am missing.

CHAIR—You will have to revisit it.

Mr Potter—Yes.

Senator MURRAY—Mr Pearson, on the concept of real time—and I ask you because of the close connection of the banking sector with the business sector—there was a long gestational period and a long public debate. I like the analogy that sixes could be hit throughout the eighties and early nineties. There was a long period of debate but somehow the fluidity and immediacy of world events was not quite at the pace that it is now. Deregulation worldwide of financial markets has made for a much more fluid market and much quicker movements and changes. The rationalisation and harmonisation of major markets' regulation and laws, such as within the European Union and so on, made for much greater trade facilities and so on.

When we are faced with a situation where there are multiple decisions to be made about multiple issues of impediment, productivity or regulatory obstructions, it seems to me we do not have quite the time we had to develop these over some time, and to meet and talk and decide what will be done. There is a need for more urgent action, which I think politically is driving the federal government to be more centralist. I do not think it is necessarily a philosophical change; I think it is a reaction to the need for decisions to be taken more urgently and more decisively than formerly. I might or might not be wrong. It seems to me that if you have got to accumulate a very large score through singles, you have to be very quick between the wickets; your decision making has got to be faster. I really wanted to know whether the mechanisms by which we are resolving these issues are not as fluid and quick as they need to be.

Mr Pearson—You raised a couple of issues there, Senator Murray. I will take them in turn. The first issue was really the process of deregulation and reform, and how quickly that process was put through in the past. Maybe a question there is whether that process is still required, and the answer is unambiguously yes, but I will come back to it. The second thing is the speed of government decision making today. Is that a fair assessment of the two questions?

Senator MURRAY—Yes. Whether the speed needs to be greater than it was in the past is really the point.

Mr Pearson—Okay. On those two questions, I am not sure that the ANZ has got an official view, but I will give you my view on those two issues. On the deregulation process, there was a lot of debate initially, which slowed the process down, as to whether the process of deregulation would work. My personal opinion is that it is unambiguously true that all the deregulatory measures that we took in Australia have worked very well. The fact is that we have an unemployment rate at a 28-year low, which is as far back as the monthly data go, and we have had very strong average periods of growth since the early 1990s recession. There was much fear and debate about each of those reforms—and I am talking about trade reform, labour market

reform, reform of monetary policy, floating of the dollar, reform of fiscal policy and all that sort of stuff, none of which was important in its own right, but as a body of work was unleashing market forces. I think it is unambiguously true that it has worked for Australia. You have only got to compare us with Europe, which has not gone through that process and is locked in the mire, to show the benefits of economic rationalism—and who would want to be an economic irrationalist anyway?

Secondly, do we need to continue that process, and do we have the current structures in place? That seems to be the second element of the question. Yes, we do need to continue that process. It is relentless, because you can never say enough is enough, and everybody out there that we are competing with is going through the same process to a greater or lesser degree. You are getting into some questions of politics rather than economics now, and the relationships between federal governments and state governments and who has power to do what. You have seen some classic examples there with health reform, infrastructure reform on the sides of exports and so on. You are really asking: is the current federal system of government now working and able to make decisions quickly enough? Perhaps that is not really a question that we have come here to look at today. But do we need to speed up our decision making? Yes, we do. We need to keep that process moving, and, given the changes you are going to get through today, each of the subsequent changes to come is going to have a smaller net effect than some of those very large changes that were done in the past. You need to keep a body of changes moving on very quickly.

Senator MURRAY—I have asked the question because, whilst the discussion about the current account deficit may well attend to matters of market reaction and broad macro-economic and market responses, those things which will assist in fixing the current account deficit problem come back to making probably many micro-economic decisions as well, and policy decisions. That is why I asked about the speed in the responsiveness of our institutions and our political system. I do not mean it as a political question, but are we equipped? If we look at what happened, there were a number of things which could be done—and were—by federal governments of both persuasions: lowering tariffs, floating the dollar and all that sort of thing. Then there were a number which required very close intergovernmental agreement—the GST, having a single set of laws for our financial institutions for the first time in 100 years and those sorts of major events. If you now get into the hard and multiple tasks to be done, it seems to me that the ability of governments to interact, and interact quickly and productively, is probably more important than it was, simply because you cannot do the big things. That is why I asked about the institutional mechanisms.

Mr Pearson—It is certainly true that you need to be able to react quickly. Australia, from observation, is highly regarded offshore as a country that is well governed today, and the quality of governance has improved remarkably over, say, the last two or three decades. I think people recognise Australia almost as a model in terms of the quality of governance, particularly the governance of the economy. There is, again just from personal observation, some puzzlement as to why we need so much governance in this country and, to an extent, it does have the potential to slow down the decision-making process. Every time we have to talk about something, it slows down the decision being made. I would be cautious about throwing out the infrastructure we have in place today or modifying it too much, because there is a perception out there that we are well governed, generally speaking, from a macro-economic point of view.

Senator MURRAY—One of the last statements I heard Mr Carr make—and one of my New South Wales colleagues might correct me—was that the federal compact needs to be revisited, because there are real difficulties as to how to address major issues within our economy and within our society. I cannot see that at present we are able to move quickly enough where a non-market response is required. That is my point.

Prof. Garnaut—That is a very important set of points. Federal-state relations are very important to productivity-raising reform in many areas, including efficiency in public expenditure, but also in many regulatory ways. I think change of various kinds has made the old federal-state compact dysfunctional. I think it is in very bad shape. That holds us back in many ways. I do not think incremental tinkering will get us to a workable federal-state system. At the heart of it is federal-state financial relations—

Senator MURRAY—And responsibilities.

Prof. Garnaut—And responsibilities. But those weaknesses, then, have impacts in many other areas, and sorting that out I think is going to be very important to progress in many areas.

Senator MURRAY—Mr Bracks seems to have made the same point just recently, as well, when he spoke about the need to attack over-regulation, which is part of the same—

Dr Simes—The way I see it, it is not so much a need to speed up decision-making times; it is more getting greater clarity in the roles and responsibilities between Commonwealth and state—health is a classic, but it is in lots of others—and also getting clarity on how to regulate firms or companies or whatever that have been delivering services that were traditionally done in the public sector. I agree that the decision-making processes have started in recent years.

Senator MURRAY—I would pick on one of the key future productivity areas—and in fact Senator Campbell has beaten this drum for a long time—as being training, skills and education, in which there seems to me to be the greatest dissonance between federal and state views, systems, institutions, funding and so on. To me that area is far worse than health, because the future of your nation-state is your land and your people.

Senator GEORGE CAMPBELL—That really is your classic example of the dysfunctionality of the way in which the system operates.

Senator MURRAY—At present.

Senator GEORGE CAMPBELL—We made a decision in the late eighties to go to a competency based training system. AiG today are still talking about getting to a competency based training system. That essentially was not undermined—or was not a problem—at the state government-federal government level or at the premiers-Prime Minister level. The problem was that, when you got down to the public servant level and the interrelationships at that level, they boned the whole system. We never got competency based training implemented anywhere.

Senator WEBBER—But that is where the problems are in health too.

Mr Potter—In support of Senator Murray, I would make a couple of points. One is that it is not only talking about the speed of getting things done when you have different intergovernmental systems; there is also an issue about companies and individuals working across state boundaries having to operate through different systems. The classic one for us, of course, is industrial relations, but we have had lots of examples: health, education, training et cetera. Professions would be another one where, with people moving more and more around Australia, they are registered as a particular profession in one state or territory and they may not be registered in another one or they may have different requirements on them. In education, the one which I am aware of is the different starting and finishing ages. I think primary school ends at different times in different states. I am not sure about the training system, but there is a vast range of discrepancies there. This does not mean that the federal government has to take it over, of course. It does mean that we have to have greater working, perhaps through COAG, to get more harmonisation.

Senator MURRAY—Please correct me if I think I am off beat. But, if you were to say that the view of our roundtable, of you gentlemen, is that the current account deficit can largely be managed through market responses at present but in the longer term you have to address our terms of trade and our ability to produce, compete and export at greater levels, then you have to move from the current account deficit as a kind of arcane discussion on its own into major policy changes for the Australian economy and society. So, at the one level, the immediate reaction is market based, but at a longer term level it is structural and policy based. That is my response to what I hear.

Mr Pearson—Just on that point: I spent last week in Western Australia talking to various businesses there. That is a state that is clearly benefiting from the export boom at the moment, but the consistent theme I got pretty much from every business I spoke to was that, in terms of speed limits to growth, the lack of suitable labour was a very major constraint. That is now leading—and this is a side issue—to some wages pressures in Western Australia that have not appeared yet in the official wage data, but the stop-go man on the road gets \$95 grand a year and—

Senator WEBBER—Or gets \$3½ grand a week up north.

Mr Pearson—Yes, things like that.

Senator MURRAY—And it is having social effects.

Mr Pearson—And it is having social effects, but—

Senator MURRAY—So you are finding that a lot of people are working at such a rate that it is affecting family and community life and so on.

Mr Pearson—I was asked, ‘Why are we running out of labour?’ We have five per cent unemployed, which is over half a million people, who say they would take a job if there was one there. It is still the case that the highest rate of unemployment in this country is up around the North Coast of New South Wales. There are another three-quarters of a million on disability pensions that could perhaps do more work if they would like to. The point was put to me that, if

there are 1.3 million people who perhaps could do more work, why aren't we getting them into the work force, because we need all the help we can get?

Mr Potter—The number which we have used is 1.65 million.

Mr Pearson—I will not split hairs on a couple of hundred thousand people. The issue of training is now very important. It has come to the fore in businesses, particularly those that are feeling constrained in being able to do what they would like to do and expand. That comes right down to skills and getting those people who could do more to do more.

Senator MURRAY—There is an issue of funding. Young people will be prepared to invest in their education, but older people, if you are retraining them, do not want to incur that debt. There is an issue of matching the funding system we have to the ages and interests of people.

Senator GEORGE CAMPBELL—There are several problems in this area. The first is that companies will not train. Companies are not prepared to put the investment into training. That is the reality. Historically, in this country your skills base has always been trained by the public sector—utilities, shipyards, dockyards et cetera. Very little training is done in the private sector. That has been a historical problem. That is partly because we have a lot of small businesses.

The second factor is that we have an attitude now, which I do not necessarily disagree with, of people having to stay until year 12. There are a heap of kids out there in years 9 or 10 who are dropping out. Through training centres, they are being picked up and given the basic skills. They suddenly realise they can become a boilermaker and get a reasonable outcome out of this, and they are going back to school to finish off their year 10 maths et cetera and are getting into the work force. The truth of the matter is that when people come in at that level, they come in as a boilermaker and they are there as a boilermaker until they are 65. A lot of the kids who are coming in at years 11 or 12 are doing their training and, by the time they are 23 or 24, they have either gone on to university, they are into management or they are into the drawing offices. The investment you have put into the skills of those individuals is not lost; it is transferred into another sector of the company.

The fact that that shortage is there—the fact that companies will not train or are not putting the investment into training—is now leading to this argument that you have to cut the training time. Instead of training a boilermaker, we train half a boilermaker. Instead of training a bricklayer to do a chimney, we train them just to lay a brick wall, or we train them in two years to lay pavers. That is deskilling the labour force. It might solve the short-term problem of a shortage of labour on particular projects at any given point in time, but you are moving the mobility out of your labour force. Those people are going to have to move to somewhere else. If there is a shift in the need for skills, you are going to have to virtually retrain them. It has always been one of the benefits of having tradespeople fully rounded in training, because they have the capacity to be mobile in the labour market.

We have a number of huge projects around the country which are going to absorb a lot of metal engineering people. They are paying \$3,500 a week in Karratha. But that takes them out of the general engineering sector, which is servicing the rest of our industries and keeping them running. If the skills are not there to do that, you are in real danger of collapsing your engineering base and a range of those other companies. These are complex issues. Quite often

we look at one dimension and say, 'Here's a way of fixing that.' In fact, you are creating much deeper problems for yourself in the longer term.

Prof. Garnaut—I will have a shot at drawing some connections between the current account deficit, the productivity-raising reform that we are talking about and export growth. There are some qualifications that have to be made to David's point about whether low international interest rates help us, but that is a detail. There is a sense in which this set of circumstances tells us that we are living beyond our sustainable means. That might not be a terrible thing if we are given the chance to adjust gradually and pull in our belts a bit—the household sector spends a bit less, gradually, over a number of years—so we haul things back into a sustainable shape. But, one way or another, we have to reduce the rate of growth of expenditure relative to growth in the productive capacity of the economy. The more we can raise average productivity through productivity-raising reform and the issues that have been raised about better utilising underutilised labour in our economy—and there is a lot of it—and the more we can remove barriers to skills training and so on, the less we have to reduce our living standards to make the adjustment.

Another angle on that same set of issues is that a large current account deficit requires, amongst other things, an adjustment over time. It has to involve some relative shift of resources from domestic sectors of the economy to international sectors, producing exports or import-competing products. The more successful we are in raising productivity, removing barriers to efficient performance of our potential export industries, the less the external adjustment has to take the form of a crude reduction in living standards. I think that is the link between productivity-raising reform in all its forms and the current account deficits. In fact, there are two links—there are two ways of looking at it—between productivity-raising reform and the current account deficit.

Dr Simes—This is related to what Ross is saying. What he is saying is that, the more the benefits from microeconomic reform or whatever, the less pain we have with the adjustment. My understanding of the empirical literature, though, is that we have not seen a direct causation shown between microeconomic reform as such and the current account. You would hope that, given some of the points that Ross is raising, that would be there. We want microeconomic reform, more productivity growth et cetera in any case.

Senator MURRAY—With respect to terms of trade et cetera.

Dr Simes—Yes. Coming back to the current account, we also want to be looking at some specific policies that are going to affect that more directly.

Senator MURRAY—Can you spell those out?

Dr Simes—The areas that I would be looking at are national savings—a combination of fiscal policy and super—and what we were talking about before about exports, which I can expand on if you like.

Senator MURRAY—Can you expand on fiscal policy and super?

Dr Simes—On fiscal policy, I think that in good times—and, as Ross said, we have a lot of revenues coming in because of the terms of trade—we should be trying to have structures and ways to have larger surpluses than we have been having. There is a tendency to try to run surpluses in recent years between, say, at an extreme, \$0 and \$10 billion. As soon as you get too much in the coffers, the view is ‘that’s not our money; we should be handing it back’. My view is that, for countercyclical reasons or the terms of trade or whatever, in good times you do need to bank it and then use it in the poorer times.

Senator MURRAY—Do you not hold to the view that, because of the necessary timelag that results from infrastructure investment, in good times you should invest your surpluses in long-term productivity-contributing areas? That can include fiscal infrastructure and education.

Dr Simes—I am happy to do that. The starting point for fiscal policy has been deficits and debt and the ideal starting point would be balance sheets, if you like—the balance sheet of the general government or you could go beyond that and use the balance sheets of the country. If you put it in that context, instead of parking the money in the bank you park it in a physical investment that meets that end. So I agree that that is a legitimate approach consistent with what I am trying to say. With superannuation, I still think that there is a good argument that, whether through compulsion or through a combination of compulsion and incentives, we should be aiming to have super at around 15 per cent or whatever.

Senator MURRAY—Would that be entirely employer funded or employer and employee funded? Employers say they cannot afford it.

Dr Simes—That is a practical issue. I think that in the longer term it really does not matter. You get the adjustments in the wage settlements and all the rest of it over term, but there is an adjustment issue of how you get it in place. A lot of those increases to get up to nine per cent were done in a way to minimise the adjustment problems by having some help through superannuation increases instead of forgone wage increases et cetera. You had to work through how you get this into place with the minimal disruption on the way.

Mr Pearson—That raises a question: before one mandates an increased super levy, shouldn’t one first remove the impediments to super savings such as the taxes on super and the residual benefit limits? There are many impediments right now that actually limit the amount of super people are prepared to take out.

Dr Simes—We can get into lots of detail about the design. You can do lots of things to raise super. If you prefer, you can do it through the tax side rather than through direct contributions, but the general point here is that for the current account we should be looking at policies that do encourage higher national savings. On the other side of the equation is what you do to address net exports, in effect. If you get the savings and investment balance right, by definition that will have to flow through to the current account and net exports, but that can be done in a hard way. If it is all through the exchange rate and with a big change, which is sort of what we were talking to Senator Campbell about before, that will occur, but—

Senator MURRAY—At a cost.

Dr Simes—At a cost—if you can facilitate it by encouraging exports or adjustments or whatever at the same time, and that is the export culture that we were talking about.

Senator MURRAY—Dr Gruen, is it your view that the ability of the market to adjust to the circumstances we have now buys us time, in effect, to introduce the policy changes you were outlining?

Dr Gruen—I am not certain about the answer to that question. I think one has to be encouraged by the market's view of Australia in a range of circumstances. There was the Asian crisis, when you might have imagined that a country that was running a large current account deficit would be treated with suspicion. We experienced precisely the opposite and were treated as a safe haven. There was the period in 2000 when all things new economy were regarded as the bee's knees and we were very much out of favour. The currency fell, but there was no sign of difficulty in funding the current account. Is it possible at some point in the future that the market will lose confidence in us? I guess you would have to say it is possible, but the experience that we have suggests that, in a range of circumstances where you might have wondered how we would go, we have actually done fine. The adjustment mechanisms which you would hope would help—namely, the exchange rate falling and allowing an improving export position—have done what you would have wanted.

On this business of responding to the current account with savings measures and particularly with fiscal policy, the general government sector in Australia has been in surplus for eight years in a row, with an average surplus of about one per cent of GDP. That is a significantly tight fiscal policy in a world where you have almost no debt. I wonder how far one wants to take this argument. I guess one can always argue that you should have been tighter, but that strikes me as pretty tight. It is not clear to me how much one wants to unwind the private decisions of individuals. You certainly want to look out for vulnerabilities and you certainly want to make the financial system robust to possible shocks. But, as to what extent you want to unwind decisions that are made by individuals with public sector decisions, you may want to do that to some extent—and we have done it to some extent—but how far do you want to push that? I think it is arguable.

Mr Potter—I just wanted to make a couple of observations. First of all, I would fairly explicitly say that I agree with Dr Gruen and I do not agree with Dr Simes. On the current account deficit, the question is whether it is a symptom or a disease. I would say—that is, if you think it is a problem—that it is a symptom rather than a disease. You do not attack the symptom; you attack the underlying disease. If you think the current account is a problem then you should be looking at the underlying problem. We have talked a lot about some policy measures that would go quite some way to improving Australia's international competitiveness and would probably have a good effect on the current account, but we cannot be too sure about that.

I am very reluctant to say that we should be supporting measures which target the current account directly. I have previously said that we do not support increases in compulsory superannuation. I just make the point in passing that we think it is a very good idea to have increases in people's superannuation, but they should be voluntary and it should not be for the purpose of increasing national savings. It should be for improving people's retirement incomes. We do not think that superannuation is a useful tool for targeting national savings. I have also said the same thing on fiscal policy. I will leave it at that.

Prof. Garnaut—I want to take up David’s point about running nationally a fairly firm fiscal position for quite a long time. That is true, but I think we do need to draw a distinction between average and cyclical conditions. I think the average fiscal surplus over the last decade has been fine. I would not want to see the average bigger than that for the next 10 or 20 years. But I think it is helpful to run a bigger fiscal surplus when you have a temporary boost in the buoyancy of economic conditions, at least while you wait to see whether the boost is temporary or permanent.

We have had two big boosts to revenue, both state and federal, in the last decade. One was the housing boom, which hugely boosted state government revenues, especially in the big states. They ran fairly close to balanced budgets and all the commentators said that was responsible at the time. But now they have to adjust to actual declines in some of the main sources of revenue, and that generates painful adjustment. Maybe they should just run deficits for a while. That may very well be the economically sensible thing to do. At the federal level a huge boost of revenue came from the terms of trade increase. There was a huge increase in corporate profits from high minerals and energy prices. That comes through state revenues as well. Some of the boost to state revenues ends up in federal coffers under the guarantees for minimum payment under the GST arrangements of half a dozen years ago.

I think we would be less vulnerable to a large deterioration in the terms of trade if, in the early period after a big improvement in the terms of trade, we ran a bigger than average surplus and then ran that down in tax cuts or other productive ways when the terms of trade retreated, or when we had realised that the China boom is not a short-term boost to minerals and energy prices but is there forever. In that case, once we know that—and we do not know it yet—we can absorb it then into our permanently higher expenditure levels. But the prudent thing is to run larger surpluses when you have boosts in revenue that are temporary or that may turn out to be temporary.

CHAIR—You seem to be agreeing, Mr Hawkins.

Mr Hawkins—There is some case for having a larger surplus when times are good and a smaller one when times are bad, but the difficult thing is working out how much larger is appropriate. And, as everyone pointed out, we have run larger surpluses over the last few years than a lot of people would have wanted us to and probably than a lot of people would have expected us to.

Mr Pearson—If I can chime in there in response to both points, we have been running surpluses for eight years and there seems to have been a move away from using a budget as a macromanagement tool. We have not gone from surplus to deficit when the time was appropriate, we have just run surpluses, and I understand the political reasons for that. ‘Deficit’ is almost a politically dirty word in Australia at the moment, but that may not be appropriate. But I think the point is that in the good times you do run much larger surpluses, so of course in the bad times, if you do not, you are almost certainly going to run at a deficit. So the cost of not running a large surplus now with the high terms of trade may well be, in a couple of years time when the terms of trade eases back a bit, that it will be almost impossible to avoid a deficit. So you could almost make a political case, I think, for running those larger surpluses in the good times.

Mr Potter—I would be a bit reluctant to support that. I have indicated that I think the government perhaps is actually taking too much of our money. You have to remember that, when the government is running surpluses, it is taxing more than it is spending. If you look at that from a long-term perspective you could argue that the government is either taking too much of our money or spending too little of it. I think it would be a bit unfortunate if we thought that the surpluses are entirely a macro device and they do not have any micro effects. Taxes do have effects on economic activity. Having taxes too high will distort economic activity. For example, we had Steve Bracks's contribution on the weekend, strongly arguing that we need to address some of the high tax rates which are causing disincentives in the economy. I think it will be unfortunate if we use excess money in the budget to indirectly target a current account deficit when there are much more important things to address—for example, trying to get people to improve their skills, encouraging people back into work et cetera.

Senator MURRAY—The point Dr Gruen made was that governments should be wary of substituting public decisions for private decisions where they can be made in the national interest or are likely to be made in the national interest because of the of the factors we understand. But there are certain decisions which generally speaking only governments can make and assess in the national interest and that is, in my view, major infrastructure projects, for which quite often you cannot assemble the private momentum. The other one is exactly the one you have just mentioned: skills, education and training. Without government entry into gearing up or improving or increasing investment in that sector, it seems the private sector is inadequate, and you can see that. Government have been criticised. They have said, 'We are going to create 24 colleges for tradespeople.' Whether that is right or wrong, that is an assessment by government that private decisions are not resulting in filling that particular hole. I think your theory is right until you assess where the long-term productivity weaknesses for Australia are. To me, that has to reside in those which cannot be dealt with by the private sector. It has to reside in infrastructure and people—training.

Prof. Garnaut—I think Michael misses the point that we are making. Whether or not the cyclical position of the budget should vary with economic circumstances has nothing to do with whether, on average, taxes are too high or too low. I am on record as saying that there are lots of advantages in us, on average, having lower taxes than we have got now. That is not at all inconsistent with our running a surplus in times of temporarily buoyant revenues and a smaller surplus or a deficit in times of temporarily deficient revenues.

Mr Potter—I would agree with that. If the question is about levels and changes, I do not think this is a necessarily fantastic time to be running massive surpluses when we have so many other problems around.

Dr Simes—Can I clarify something that I have been trying to say, because I think Mr Potter and David have slightly different views and I want to be clear about it. I have said that the idea that we should be trying to do something about the current account only if we can detect an underlying structural issue is limited. It is saying that you can do something only if you can identify the disease. I think you will never be able to properly identify the disease. Similarly, David said that we should be looking at what we might be vulnerable to—different shocks and all the rest of it. That is a very useful exercise. But whatever that gives you, you get to the stage—which is where I think we are—where the current account is at uncomfortably high levels and there is a vulnerability. At that time you can take steps to do something about it from a

public policy point of view without getting into this game of trying to undo private sector decisions, because you will not be doing that directly either.

Senator MURRAY—Because you can identify the goods you want. By ‘goods’ I mean public goods—namely, increased productivity and competitiveness and improving your terms of trade and your ability to operate internationally.

Dr Simes—To me the current account deficit and the net external liabilities and the like have got to a stage where I am uncomfortable with them in their own right. Just like in an economic cycle, in a downturn, I would be worried about unemployment—that is a symptom—and I would be trying to do something to correct that directly. So it is not necessarily, as you say, even working out what the public good here is and where the public intervention should be. I think the size of the current account deficit is such that it is symptomatic of an underlying problem and should be a source for doing something about it. Again, because of the robustness of the financial markets and the rest of it, I have tried to say that there is no need to do anything quickly; it is more medium-term structural policies that we should be looking at.

Dr Gruen—I want to make one point on productivity-enhancing reforms. To the extent that everyone around the table has spoken out in favour of productivity-enhancing reforms, I would not want to disappoint anyone: I would do the same. But I think you would want to do that because of their own benefits. Hopefully, if they are done well, they will enhance productivity and improve living standards and perhaps improve the flexibility of the economy. I would not want to use the argument of what they will do for the current account as a justification for doing productivity-enhancing reforms, because one should not be too confident that they would improve the current account. They might well lead to a larger current account deficit. If they make Australia appear to be an even better place to invest, you may well get a larger current account deficit. This is not an original argument. In the early nineties, it was put by Professor Peter Forsyth. He made that point when I think there was a general view that all arms of policy had to work to help reduce the current account. At the time there was also the argument for micro reform and he made the point—which I think is exactly right—that lots of micro reforms will not improve the current account, but they are good anyway.

Mr Hawkins—And you would want to do productivity-enhancing reforms even with a surplus.

Dr Gruen—For their own right.

Senator MURRAY—What you have just discussed is sustainability. The reason money flows in is that your economy is seen to be more and more productive and efficient and a safer place for money to go to. In fact, you have made it more sustainable, and that is an important consideration.

Dr Gruen—Some of that has happened. The reason we were re-rated back up to AAA by the rating agencies, even though the current account deficit remained large, was precisely because their view about the rest of the economy was that it was more resilient and that it was performing well based on a wide range of other factors. My point is simply that productivity-enhancing reforms should be defended for what they will do directly, rather than for what they will do indirectly, to the current account.

Mr Pearson—Treasury representatives have talked a lot about the current account deficit. We all know that it will improve substantially in the June quarter as a result of the strong commodity price rises from 1 April. What are the latest forecasts on that? It has already peaked and it is going to improve. Are we talking about a structural problem in the next two years or are we now going to see a gentle decline as a per cent of GDP? In other words, is the problem going to self-correct, as we have discussed a number of times today?

Dr Gruen—The latest forecasts are the ones in the budget, which you are probably aware of. The Reserve Bank has a forecast for the June quarter which shows a considerable improvement in the current account deficit.

Mr Pearson—I want you to contrast that with what was in the May budget. Has there been any updating of that?

Dr Gruen—No.

Mr Hawkins—MYEFO will be the next time we release a forecast.

Dr Gruen—The May budget has an improvement in the current account deficit from the current financial year to the next financial year in the order of a per cent or so of GDP.

Senator MURRAY—Will MYEFO be September or October this year?

Mr Hawkins—No date has been set.

Dr Gruen—It is not up to me.

Mr Pearson—It is out of our hands.

Senator MURRAY—I tried.

Mr Potter—Following on from what both David Gruen and Rick Simes have said: David has quite correctly pointed out that we have had an improvement in our ratings by international agencies. Dr Simes, why do you think the current account deficit is a problem?

Dr Simes—The starting point is that I would not pay too much attention to Standard and Poor's changing its rating.

Mr Potter—To elaborate a little, you are saying that the current account is a problem and something needs to be done about it. What else, other than the international ratings agencies, can we use to indicate independently that it is a problem? Saying it is at historical highs does not really indicate anything much.

Dr Simes—There is a small risk that there will be a crisis at some point. That crisis would manifest itself with foreign capital being withdrawn, which would then have an impact on the exchange rate which could be quite pronounced, as it has been in the past. Hopefully, we would be in a position to weather that, as we have been in the past. Even so, there will be an impact. Even without that, from a public policy point of view you are interested in maximising your

economic welfare over time. To maximise economic welfare over time, basically you want to maximise the production of the economy over time and who owns that. Why is a larger current account deficit a problem? Unless it is lifting the level of production—unless it is getting into investment and increasing the base—there is an issue for longer-term economic welfare for the next generation et cetera. To me it is symptomatic that we are not optimising our long-term economic welfare.

Mr Potter—Would you say that a current account deficit is fine as long as it is all going to business investment?

Dr Simes—There is no right and wrong level about the current account deficit in the first place. I am concerned that we have been at 4½ per cent of GDP for 20 years, and it looks like it is edging up. I would prefer it to be coming down. A current account deficit at seven per cent or whatever of GDP is not as big a problem, in my mind, if more investment rather than less is being conducted at the same time.

Looking at the amount of investment going into a country, if you look at the volume estimates it is very high; if you look at the value estimates it is highish but not as high. Overall, none of that changes my judgment that the current account deficit is too high today and looks like it is going to settle at an average level which is uncomfortably high over the next, say, five years or whatever, without policy adjusting it or doing something about it.

Prof. Garnaut—If I could come back to consenting adults, I think Michael was making the point that a high business investment contribution to the current account deficit makes it all manageable, and in general that is true. But business can also make mistakes that lead to adjustment problems. The '89 deficit was associated with much higher levels of business investment as a share of GDP than the present deficit is. The private consumption, housing et cetera stories are much bigger in the last few years, relative to business investment, than they were in the late eighties. A lot of the business investment turned out to be crook investment when the cycle turned. So you can still get macroeconomic adjustment problems even when consenting adult leaders of business are responsible for investment.

CHAIR—This afternoon's discussion has been very helpful to the committee in trying to resolve the challenges of our inquiry. We have in general terms touched on all of the questions that were provided to you, except perhaps question 2(b)—the issue of foreign debt. Australia's foreign debt is mainly private debt; it is not public debt. Does that mean that it is not a problem?

Mr Hawkins—There are three aspects that people consider in looking at whether or not a debt is a problem. One aspect is the public-private ratio, and the fact that ours is predominantly private is better than it being predominantly public. The second aspect is the currency in which the debt is denominated. In the classic cases of countries having debt crises, all of the debts have been in foreign currencies. In Australia's case, quite a lot of our debt is in Australian dollars or is hedged one way or another. The third aspect is the maturity structure of the debt. Ours is around the OECD average. It is certainly not all short-term debt, as has been the case in some countries that have had a crisis.

CHAIR—Is it an issue for us that some or a large part of our foreign debt takes the form of either loans or equity transfers so that the assets are transferred overseas? Is that kind of selling off of the farm an issue for Australia's economy?

Mr Pearson—Equity and debt are two different kinds of foreign capital inflow. Equity may be 'selling off the farm' but debt is not. If the country needs the finance for development purposes it has a choice of either debt—which has some negative connotations and which has to be serviced irrespective—or equity, which can be 'selling off the farm' but which does not need to be serviced unless the investment is successful.

Mr Potter—Yes. Each of them has costs and benefits.

Mr Pearson—There is no 'right' form of foreign capital inflow. Debt is not 'bad' and equity is not 'good'. Remember, if you go back in the political debate in Australia there was a time when people did not want to have equity, because they thought that was 'selling off the farm', and the alternative was to have debt. Neither is better or worse. They have different servicing obligation characteristics and different ownership characteristics, which are neither good nor bad. They are just different.

CHAIR—Thank you for the clarification.

Mr Potter—I wanted to add one thing about the type of debt and partly also about something that Professor Garnaut talked about previously, the quality of the lending which goes on. I think that is also a very important point: if the people who are borrowing are borrowing for unproductive purposes then that should be a fairly significant concern. Since the problems of the late eighties and early nineties, I think that the lending practices of Australian banks have improved. In fact, I think there is no credible evidence that the lending practices in Australia, particularly from overseas, are going to be causing that degree of problem. So, in that sense, there was a definite problem with the consenting-adults argument, with Bond Corp et cetera, but I think that that is less of a problem now.

CHAIR—Going back to the level of our foreign debt, it is quite significant and, as I understand it, a large proportion of it is short-term borrowing. Is that an issue? Is the fact that we turn over about \$100 billion on terms of less than three months a problem?

Mr Hawkins—My recollection is that about half of them are for less than one year but that that is about average for the OECD economies; there is nothing particularly exceptional about that.

Prof. Garnaut—On the question of the level and composition of debt and whether it is a problem, I think we should not become too complacent about a high proportion of our foreign debt being hedged against currency risk, because there are specific terms to those hedging contracts and when they come to an end they have to be recontracted. And if there is any deterioration in our circumstances—in interest rates, perceptions of capacity to repay the debt of Australian entities or currency risk—then that will affect the terms on which the hedges are rolled over. So that can mean that a problem is phased in, if things turn against us, but it does not mean to say that you avoid the problem altogether.

On the question of debt versus equity, if the concern that we have about an unusually large current account deficit is that, in certain circumstances, it would make us vulnerable to the need for painful adjustment, selling off a lot of equity leaves us less vulnerable than selling off a lot of debt, because if our economy comes upon harder times then the equity that foreigners hold loses value; foreigners share in that adjustment. For example, if we did have a downturn in export prices, if China's growth stayed the same but the investment share of Chinese growth fell—currently the rate of growth of investment in China is about 28 per cent in the year to the June quarter—that is not sustainable. China could keep growing at 9½ per cent per annum but have a real rate of growth in investment of 9½ per cent per annum. That adjustment leaves the same growth, but a large reduction in the investment share of GDP would lead to a large reduction in growth in metals demand, perhaps in absolute levels of metals demand, and that would have a substantial effect on our terms of trade. Terms of trade fall through those processes. If what we have done is sell off a lot of equity then the equity that foreigners own in Mount Isa Mines and other entities will be less valuable and they will take some of the pain of adjustment.

Mr Pearson—On the question of foreign debt, the latest figures up to the March quarter were that there is about \$370 billion of cross-foreign debt in risk liabilities of more than one year's maturity. The total outstanding is about \$690 billion. That is, more than half have more than one year's maturity.

CHAIR—What about the cost of servicing debt? Is that a concern, or should that be a concern, for us?

Prof. Garnaut—That is claim in one way or another on our current incomes. It comes in as a debit in the current account of the balance of payments. If it were much larger, for our overall balances to be sustainable, given a level of production and incomes, we would have to consume less to service it. From that point of view, it is better to have less than more.

Senator MURRAY—But if it is your debt your servicing risk is reduced if you nominate it in Australian currency, isn't it?

Prof. Garnaut—Yes.

Dr Gruen—That is in the short term.

Senator MURRAY—And that is a feature of a lot of the debt at present.

Prof. Garnaut—But a lot is hedged back into Australian dollars, and so it will have to be rolled over on new terms when the current contracts mature.

Senator MURRAY—Is it smooth when these hedging contracts and debt contracts come due? Or are there lumpy periods when you are at more risk than at other periods? For instance, are they congregated around a financial year end?

Prof. Garnaut—I would imagine that it is pretty continuous.

Senator MURRAY—So your risk does not increase at particular times of the year or cycles?

Mr Pearson—The market is pretty deep for foreign currency hedging and the transactions go through all the time.

Senator MURRAY—So there are no peaks and troughs?

Mr Pearson—There may well be peaks and troughs, but I do not think that at any point in time the market becomes particularly illiquid, if that is what you are getting at.

Senator MURRAY—Yes, but also if there is a sudden renegotiation of contracts at a time when it is less favourable for you—does that occur?

Mr Pearson—If you have a contract you do not have an effective date for renegotiation until that first contract is finished.

Senator MURRAY—That is right. I was really looking at the timing of these things.

Dr Simes—Even in countries like Japan, where they have this classic issue that you are talking about, where they have been lumpy—tax has been paid or rolled or whatever—trying to make any money off that is really very difficult. The market is so deep, as Tony was saying, that it is all turn-tacked to be really quite smooth.

Mr Pearson—Even if you are hedging Australian dollar debts, you are operating in a global financial market. You are operating in New York or London or Tokyo; you are not operating in Australia, as such, and the markets are very deep.

CHAIR—You have been very generous with your time and consideration this afternoon. There is time for one final remark from each of you, which would be helpful.

Mr Potter—It has been a very valuable discussion this afternoon, and I thank you for inviting me along. I thank the rest of the panel for their contributions. One of the things I want to leave with the committee is that we do not think that the Australian economy is perfect. There are quite a number of issues around. We have touched on most of those—for example, the capacity constraints and the fact that exports have been reasonably flat until quite recently. Another point I will make is that labour productivity has fallen in the past four quarters, which I think is important, but I would not place too much weight on that because there are some definitional issues in that. There are other things going on, such as oil prices and China.

All of these are important issues that need to be dealt with, but we do not consider that the current account deficit is a problem in and of itself. If it is seen to be an issue, we think it is more a symptom of what is going on in the underlying economy. It could be a symptom of some of those issues that I have just talked about. The two key reasons we think the CAD is not a problem are that, first of all, the rating agencies are saying that Australia is still rated very highly. The second thing is that the risk premium on Australian debt is still within quite manageable levels. I guess the onus of proof really has to be upon those who say the current account is a problem to explain why those measures are wrong and why the market is getting it wrong with assessing Australia's vulnerability.

Prof. Garnaut—When the current account deficit as a share of GDP gets as large as it has recently in Australia, especially when that is at a time of unusually favourable external circumstances—and I have drawn attention to the high terms of trade and the low international interest rates—then it is time to carefully analyse whether we are vulnerable to a deterioration of circumstances. We may be lucky. This may be the first huge increase in the terms of trade in our long history on this island continent which has not suffered a significant reverse, and I hope that that is the case, but we would prepare ourselves better for the possibility of reversal if we were doing a number of the things that have been discussed in this meeting. If, while we are assuring ourselves that the improvement in the terms of trade is permanent, we have governments run larger surpluses, and if, while we are assuring ourselves that the very low international interest rates that Alan Greenspan has described as a conundrum are a permanent feature of the international environment, we are a little cautious in our fiscal policy and if we run hard to remove the many remaining impediments to high productivity, including in the export industries, then the risks of us suffering a very painful adjustment, possibly including a recession if international circumstances deteriorate suddenly, will be significantly less.

Dr Simes—I think I have indicated that I agree with Ross's basic point. We should be concerned about the current account as such. I want to make one comment about the questions you asked about household debt. The level of household debt has obviously gone up. It has been associated with household wealth going up—that is, gearing has gone up a lot. If there is any policy response to it, we need to be careful not to undo something that has been really very positive in the economy—that is, financial deregulation has seen access to credit improve a lot; it has increased not only economic efficiency a lot but also equity. If you go back 20 years or more, access to credit was a big concern from an equity point of view—for example, in the Campbell committee report—and we need to make sure that the benefits are not unwound.

Dr Gruen—I do not have much to add, but I will make one point. It is very hard to determine the extent to which Australia's vulnerability has been raised by the rise in net external liabilities. The extent to which that has made us more vulnerable is not at all obvious—to me, at least. I have certainly been surprised by the extent of resilience in the Australian economy over the last decade or so in a series of circumstances which, before they happened, I would have thought would cause us a lot of trouble but did not. If it is the case that the current account or the rise in external liabilities is a problem, then it is very much a medium-term problem rather than a short-term problem, and that makes me wary of tying macro policy to the current account. It seems to me that we have done extremely well by running macro policy with internal balance objectives, and the last time we used the current account as an excuse for running macro policy was in the lead-up to the early nineties recession, which I do not think was a huge success. So I do not think it is sensible to use macro policy to try and respond to the current account. To the extent that one wants to respond to the current account, I think you have to do as Dr Simes has argued, which is to try and do things to the underlying measures of savings—largely savings in the economy. Again, whether you need to do that is an open question, but, if you want to do something about the current account, that is where you should look.

Mr Hawkins—In a sense you could say that the problem with the current account is something like: you have nothing to fear but fear itself and that the current account becomes a problem if the markets decide it is a problem. I agree with the comments Michael made that the indicators are that at the moment the market is not seeing it as a significant problem in Australia. There are reasons to say that our current account—around six per cent of GDP—is not as much

of a risk as in past instances of current account deficits of that size because of the counterparts in the savings investment and because of the structure of the net liabilities.

CHAIR—Mr Hawkins, you had several very interesting graphs that you provided. If we could have those, that would be wonderful.

Mr Hawkins—Certainly.

CHAIR—Thank you.

Senator MURRAY—Some of them are in your submission.

Mr Hawkins—I think that most of them are in the submission.

Mr Pearson—In summing, up we did not address all the questions that were given to us. A lot of the thrust of the questions as we went through them concerned household borrowing, house price booms—things like that. I just want to put things in perspective a bit in that, particularly in terms of the house price phenomenon in Australia over the last seven years, we have not been alone; we have been part of the global phenomenon. In fact, we have not even been a frontrunner by a country mile. We have roughly doubled house prices over seven years. In South Africa, they have gone up 3½ times. Britain and Ireland have had much bigger house price booms than we have. The global phenomenon we have been part of was because of the very low interest rates through 2000, 2001 and 2002. They were put in place to, in a sense, prevent the possibility of global recession in 2001. So we have been through a very unusual period around the world, and we have been part of that global phenomenon. It has not just been an Australian phenomenon, and I think that is worthy of focusing on.

That global phenomenon is gradually running out of steam. It has pretty much ended in Australia, as we talked about earlier, with the possible exception of Perth. But basically national house prices have, over the last 18 months, been flat and are gradually decelerating generally around the world, with some other exceptions. I am just wondering whether some of these problems that we have focused on as being uniquely Australian and as having emerged recently are in fact part of global phenomena and that they will, to a certain extent, self-correct. I think that global perspective is worthy of some focus.

Having said that, I still believe that the current account deficit in Australia is, in large part, a trade problem, not a capital inflows problem. I believe the capital inflow is a consequence of the trade problem, not the cause of the problem. It appears that, over the last four years in particular, it is the export side that has been particularly weak, rather than that imports have been particularly strong. Imports have certainly been boosted to a certain extent, but the flatness in the volume of exports, I think, is of concern. To that extent, policy measures that could perhaps be directed at that trade side would, I think, help to moderate the current account concerns going forward. But I do believe that in the short term you will find some self-correction as this global phenomenon gradually cools.

CHAIR—Thank you very much. On that note, I thank you all very much for this very interesting afternoon. We will now go back and try to write a scintillating report and quote you all.

Senator MURRAY—The quality of people before us is a credit; thank you very much.

Committee adjourned at 4.49 pm