ECONOMIC CHALLENGES FOR THE NEW LABOR GOVERNMENT

Talk to the NSW Branch of the Fabian Society

Gleebooks, Sydney

20th February 2008

by

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From a short-term perspective there's little doubt in my mind that the biggest economic challenge facing the newly-elected Rudd Government is that posed by the acceleration in inflation over the past six months, and the prospect (foreshadowed in last week's Reserve Bank *Statement on Monetary Policy*) that, on unchanged policies, inflation will remain above the top end of the Reserve Bank's 2-3% target band through until mid-2010 – that is, for more than two years.

They key phrase here is 'on unchanged policies', because the underlying message in the Reserve Bank's Statement is that confronted with such an outlook, policies will *not* remain unchanged. The Reserve Bank says, quite explicitly, that 'a significant moderation in domestic demand will be needed if inflation is to be satisfactorily reduced over time'. Implicitly, the Reserve Bank appears to be saying that if other influences – such as a slowdown in the global economy, a tightening in the availability (as distinct from the price) of credit as a result of developments in the global financial system (about which I will say more later), or appropriate changes in other instruments of economic policy – do not produce this 'significant moderation in domestic demand', then the Reserve Bank will seek to achieve that end through further tightening(s) of monetary policy.

Some people may argue that the Reserve Bank should not be so alarmed about the prospect of inflation exceeding 3% for another two years. Some argue that the inflation target should be revised to, say, 4-5% per annum. Personally, I think that flies in the face of a good deal of historical evidence suggesting that, once inflation does get entrenched above 3% per annum, it tends to acquire a self-perpetuating momentum and can only be brought back down again at very high cost in terms of economic activity and employment.

But, as a practical matter, the 2-3% target has been agreed between the Reserve Bank and successive elected governments, and I take it as given that the Reserve Bank will do what it thinks it needs to do in order to achieve it – not at *any* cost, to be sure, but it will be willing to raise interest rates further (which will have some cost, and carry some risk) in order to achieve it over a reasonable time frame.

It's perhaps also worth noting that the 2-3% target is expressly a *flexible* one. It does not require the Reserve Bank to keep inflation between these two integers at all times and in all places. Rather, it quite specifically asks the Reserve Bank to keep the inflation rate at between 2 and 3% per annum 'on average over the course of the cycle', whilst leaving the definition of 'the cycle' open to interpretation. This is a less dogmatic formulation than that which used to be pursued, for example, by the Reserve Bank of New Zealand, or that of the European Central Bank.

Inflation is not an elevated concern at present because the inflation rate has, for the moment, moved above 3% per annum; it is an elevated concern because there is a significant risk that it will stay above that level for an extended period.

It's true that monetary policy is a 'blunt instrument'. Its impact falls disproportionately on those households with a mortgage – roughly 38% of all households – and on those businesses with relatively high levels of debt. Those with no debt (because, for example, they have already paid off their mortgage, or because they are renting) are, at least in the first instance, relatively untouched by rising interest rates – although they may well be affected in a number of different ways by the 'second-round' effects of higher interest rates as those who are directly affected adjust their behaviour.

Because of the way in which the exchange rate of the Australian dollar is influenced by the spread between Australian interest rates and interest rates in other countries, tighter monetary policy also impacts relatively more severely on those sectors of the economy which depend on exports for a large proportion of their revenues (and in current circumstances, in particular on those for whom higher commodity prices do not provide some offsetting benefit), and on those who compete with imports in the domestic market.

But it's also true that monetary policy is the only instrument which the Reserve Bank has available to meet its inflation target.

Some might argue that the Bank should be using other instruments instead of relying solely on interest rates. Those alternative instruments presumably include various types of regulation designed to limit the supply of credit in some way, either in aggregate or to particular sectors or for particular purposes, rather than relying solely on adjusting the price of credit.

History strongly suggests that quantity-rationing is no less blunt an instrument than price-rationing, and more easily evaded in ways that ultimately expose borrowers to even greater risk. Partly for this reason, history also suggests that quantity-rationing has not been very effective in keeping inflation under control, and certainly has not previously done so at less cost in terms of activity or employment than price-rationing (ie, the use of interest rates). Australia's three largest 'inflation break-outs' (in 1951, 1974 and 1981) all occurred while the Reserve Bank had at its disposal, and made use of, precisely such tools.

It might also be argued – albeit only with the wisdom of hindsight – that the Reserve Bank has made some mistakes in handling the one instrument which it now has at its disposal.

Such criticism can, however, only be along the lines that the Reserve Bank should have raised rates by more, and sooner, than it actually did.

Perhaps, with the benefit of hindsight, the Bank shouldn't have tied changes in the cash rate so closely to the quarterly CPI releases. On at least two occasions last year, Glenn Stevens went to some lengths to dissuade people from thinking that the Reserve Bank would not be prepared to raise interest rates during an election year, saying that it was wrong to imagine that the Bank 'went to sleep' one year in every three. However by the middle of last year the belief that the Bank 'went to sleep' two *months* in every three had become almost the conventional wisdom (wisdom which the minutes of this month's RBA Board meeting released earlier this week suggest is about to be challenged).

Second, the Bank should perhaps have been willing to raise rates by increments of more than a quarter of percentage point. In 1994, the Bank raised rates 2¾ percentage points in three months – and stopped what looked like a worrying rise in inflation in its tracks. Mindful, perhaps, of the greater risks stemming from the significant increase in levels of household indebtedness since then, the Bank has taken more than five years to raise rates by the same amount in the current cycle. The series of quarter-of-a-percentage-point increments has clearly lacked the 'shock value' of the 1994 episode.

In making such criticisms, however, it should be acknowledged that the Reserve Bank cut rates by less at the beginning of this decade, and began raising them sooner, than any other major central bank in the developed world (with the exception of its counterpart in New Zealand).

It should also be acknowledged that no other central bank, including the RBNZ, has faced as much criticism – including from other economic policy-makers – of nearly every decision to raise rates as has the Reserve Bank of Australia.

Finally, it should also be noted that no-one else foresaw the magnitude or duration of the commodities boom which has been a key factor in prolonging the economic expansion which began more than 16 years ago to the point where, in the Bank's assessment, 'capacity constraints' are contributing as they are to inflationary pressures.

Nonetheless, because monetary policy does concentrate the burden of dealing with rising inflation on a minority of Australians, it is reasonable to ask whether other instruments of economic policy could not, in the circumstances in which we actually find ourselves today, play a greater role in containing and reversing inflationary pressures.

In raising that question, I do not mean to imply that monetary policy shouldn't have been, or shouldn't continue to be, the principal tool for keeping inflation under control. Apart from anything else, of all the macro-economic policy instruments available in a market economy it is the one which can be most readily and flexibly adapted to changing circumstances.

Nonetheless, I believe that the role played by fiscal policy in recent years has contributed to the inflationary pressures which have built up in the Australian economy, and thrown a greater burden on monetary policy than would otherwise have been necessary. And unlike some other more recent converts to this view, I don't say that only with the wisdom of hindsight.

For some years now, I have been drawing attention to the way in which fiscal policy has, by recycling part of the income thrown off by rising commodity prices from the business sector to the household sector, unnecessarily boosted domestic demand. After each of the last four Budgets, I have drawn attention to the fact that nearly all of the upward revisions to estimates of revenue, most of which came from upward revisions to projections of company tax collections, had been used to fund cuts in personal income tax cuts and increases in a wide range of other personal benefit payments, so as to leave the projected Budget surpluses at around 1% of GDP.

Shortly before the 2007 election I estimated that, since the 2003-04 Budget, so-called 'parameter variations' (86% of which were upward revisions to revenue) had added some $457 billion to the resources available to the Commonwealth Government over the nine years to 2010-11; and that, of this amount, $435bn had been or would be spent or given away in tax cuts, and only $22bn 'saved' in the form of higher-than-previously-forecast Budget surpluses. And of this $435bn, at least $270bn had taken or would take the form of personal income tax cuts (including those foreshadowed by the Coalition on the first day of the election campaign, all but $3bn of which the Labor Party then pledged to match).

And although most economists accepted the former Government's contention that because the Budget remained in surplus, and because the surplus did not change much as a proportion of GDP from year to year, the impact of fiscal policy has been, at best, broadly neutral. My argument has always been that fiscal policy should have been doing more than that. It should have been exerting at least some restraining influence on domestic demand by allowing the so-called 'automatic stabilizers' (the natural tendency for revenue to rise as a share of GDP as the business cycle continues and resource utilization increases) to operate.

I've also argued that, because the corporate sector typically saves the equivalent of 3-4% of GDP while the household sector, until very recently, dis-saved the equivalent of about ½% of GDP, a policy of redistributing income from the corporate sector to the household sector through the budget must inevitably boost total aggregate demand – as it has done in recent years.

While it would have been politically naïve to imagine that all of this $457bn should or could have been 'saved' in the form of bigger budget surpluses, I did say, and I still do, that a lot more of it should have been saved than actually was.

I didn't, and don't, suggest that these larger surpluses should have been piled up in cash at the Reserve Bank, or in the Future Fund established by the previous Government to defray the unfunded liability for public service pensions. But I have said that it would have been politically 'saleable' for the previous Government to have – as it would be for the new Government to – allow windfall revenue gains associated with the commodities boom, and with stronger-than-expected economic growth more generally, to be reflected in larger budget surpluses, and for those surpluses to be allocated to 'buckets' or 'pools' to be drawn down over subsequent years, as economic conditions allowed, in order to meet longer-term goals that had hitherto been put into the 'too hard' or 'too expensive' baskets; goals such as:

- meeting the fiscal costs associated with demographic change;
- ameliorating the costs of the climate change which will inevitably occur, and cushioning the impact of the measures required to prevent further climate change;
- education and skills formation;
- reducing Indigenous disadvantage;
- improving and extending economic and social infrastructure;
- improving water security, and addressing salinity and soil degradation; and
- providing for tax cuts at a stage of the economic cycle when some form of fiscal stimulus might actually be appropriate.

Imagine what a difference we could have contemplated making in each of these areas if, say, half of the $457bn of 'parameter variations' which have accrued or will accrue over the nine years to 2010-11 had been dedicated in this way.

In reality, of course, much of this enormous sum has already been dedicated to personal income tax cuts and to spending decisions which have had the effect of boosting domestic demand, in circumstances in which domestic demand was already being boosted by the commodities boom, the lagged effects of earlier easy monetary policy, and rising asset prices.

And much as I wish it were otherwise, I accept that it would be politically impossible to walk away from the pledge to match all but $3bn of the $34bn of tax cuts promised by the Coalition during the 2007 election campaign. But since there is now almost certain to be another round of upward revisions to forward estimates of revenue in the forthcoming Budget cycle, I sincerely hope the new Government will learn from the experience of its predecessor rather than repeat it.

There is another important respect in which fiscal policy decisions have added to the burdens shouldered by monetary policy, and here I suspect I may have more common ground with my co-panellists than in what I have been saying so far.

There's no doubt in my mind that some specific decisions of the previous Government induced people to take on more debt than they might otherwise have done. I'm referring, in particular, to the 1999 decision to halve the rate of capital gains tax, and to last year's decision to remove income from superannuation funds by people aged 60 and over from the tax system altogether.

I can't think of any sound principle of economics or public finance which says that income from speculating should be taxed at a lower rate than income from working – especially when increasing the proportion of the population who are working is supposed to be a policy objective. Yet that is the result of the decision made by the Howard Government, with the support of the then Opposition, in 1999. And in conjunction with the continued availability of 'negative gearing' on a scale unmatched in any OECD country of which I am aware other than New Zealand, this contributed significantly to the ensuing property boom, bringing aspiring landlords into competition with would-be homebuyers for a limited stock of housing, very much to the detriment of the latter.

And I think it is little short of astonishing that, having spent five years telling the Australian people (correctly) that the ageing of the population constituted the biggest medium-term fiscal challenge facing the nation, the Howard Government would make that challenge significantly worse by in effect making it optional for anyone over the age of 60 to pay tax, making it easier for quite affluent people in that age bracket to claim taxpayer-funded concessions and benefits, and as a result of one particular aspect of that decision (allowing people to contribute up to $1 million to superannuation before 30 June last year), encouraging another round of borrowing to acquire assets.

These two decisions were part of a more general pattern under the Howard Government of using the income tax system to favour particular categories of income, particular types of expenditure, particular groups of taxpayers, and particular forms of economic organization, over others. It stood in marked contrast to the principles which informed their reforms to the business income and indirect tax systems, and the earlier personal income tax reforms of the Hawke Government, which were based on the notion of broadening the tax base and lowering rates of tax, thereby simultaneously enhancing equity and efficiency whilst also reducing complexity and incentives for avoidance and evasion.

I would urge the new Labor Government to look seriously anew at reform of the personal income tax system with a view to reversing this trend.

It hadn't been my intention to suggest that dealing with inflation was the only economic challenge facing the new Labor Government. It isn't; it isn't even the only significant short-term challenge which they face.

Another significant challenge stems from the unravelling of the global credit market bubble which developed in the aftermath of the collapse of the 1990s equity market bubble, in an environment of unusually low interest rates; a flood of money from developing to advanced economies, the obverse of the usual flow of capital from rich countries to poor ones; and a wave of 'financial engineering' which foisted an extraordinary amount of complex investment products which what turned out to be poorly understood risk characteristics on a wide range of unsuspecting borrowers and investors.

It is already apparent that the deflating of this bubble is causing significant stresses in the global financial system, and may well push the United States and perhaps other advanced economies into recession.

Australia is far from immune to the stresses in the global financial system, as we have already seen; and although our business cycle is now more closely aligned with that of the developing world than with that of the United States and other advanced economies, there are also downside risks for our economy associated with the possibility of a sharp downturn in the US.

These developments add an additional significant complication to the task of containing and reversing rising domestic inflationary pressures. And although the Reserve Bank has so far handled the effects of these developments on the Australian financial system quite adroitly, avoiding the dogmatic responses initially adopted by some other central banks, they do nonetheless increase the risk that monetary policy could be tightened 'too far', so that the challenge then facing the Government could become one of containing and reversing a sharper downturn in domestic demand than the one which the Reserve Bank is now saying, in effect, that we 'have to have'.

All the more reason, I would say, for the Government to avoid adding to inflationary pressures in the near term through fiscal policy measures, and to conserve its fiscal firepower for a time when it might actually be genuinely required.

There are also of course longer-term economic challenges facing the Government which cannot be ignored despite the importance of those more immediately at hand.

I wouldn't cavil at the suggestion that climate change represents Australia's greatest medium- and long-term economic, as well as environmental, challenge. I accept the scientific consensus regarding the likely course and consequences of global warming. Like many other economists, I have some reservations about some of the calculations in the Stern Report, but those reservations don't lead me to doubt the importance of taking actions to reduce the carbon-intensity of economic activity. I accept that doing so may entail greater change for Australia than for many other advanced economies given the relatively high carbon intensity of our existing economic structure. And along with four other economists working in the financial markets, last year I publicly supported policy interventions directed towards that aim, such as a carbon emissions trading regime incorporating a numerical target for overall emission reductions.

Although it may come as a surprise to some, I would also nominate rising inequality as a longer-term challenge which the new Labor Government would do well to address. My reading of the available evidence suggests that the distribution of income, after taking account of the impact of Australia's tax and social security systems, has not altered significantly over the past decade, except perhaps at the very top end; but that there has been a significant increase in inequality in the distribution of wealth, and that over time this will, if unaddressed, accentuate the existing inequalities in the distribution of economic opportunities in the broadest sense.

I'm sure that most people here this evening would find that prospect disturbing, at the least – as indeed do I. I also worry about that prospect for another reason, namely, that it would ultimately undermine support for (or, perhaps more accurately, acceptance of) the market-based economy which, more than any other system known to humanity, facilitates the creation of wealth and economic opportunity but does a poor job of distributing it in a way that doesn't offend most people's notions of social justice. Striving for that balance is, perhaps, another great long-term challenge for a modern Labor Government.