

THE AUSTRALIAN ECONOMY IN A RAPIDLY CHANGING WORLD

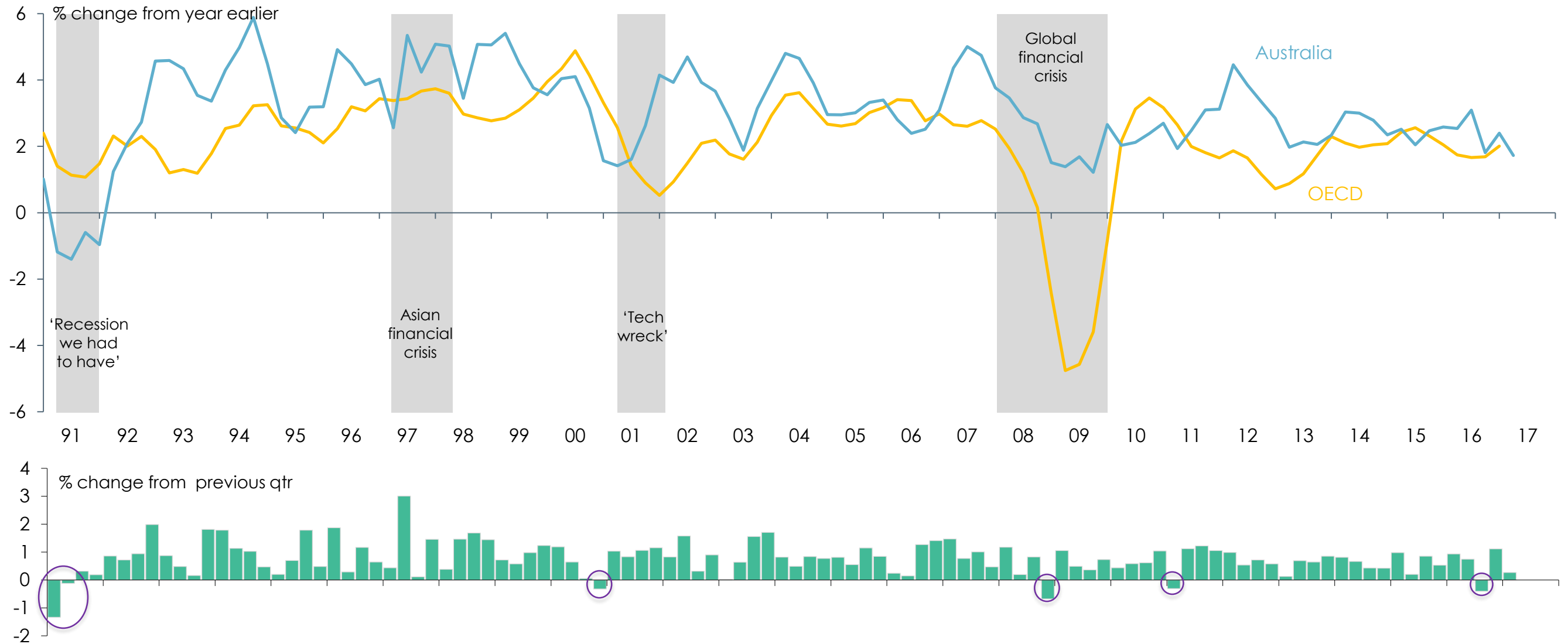
PRESENTATION TO A C3 PATHFINDERS BREAKFAST

THE WESTIN HOTEL, SYDNEY
28TH JULY 2017

**The Australian economy has done very well,
in most respects, over the past 25 years**

It's now been almost 26 years since Australia's last recession

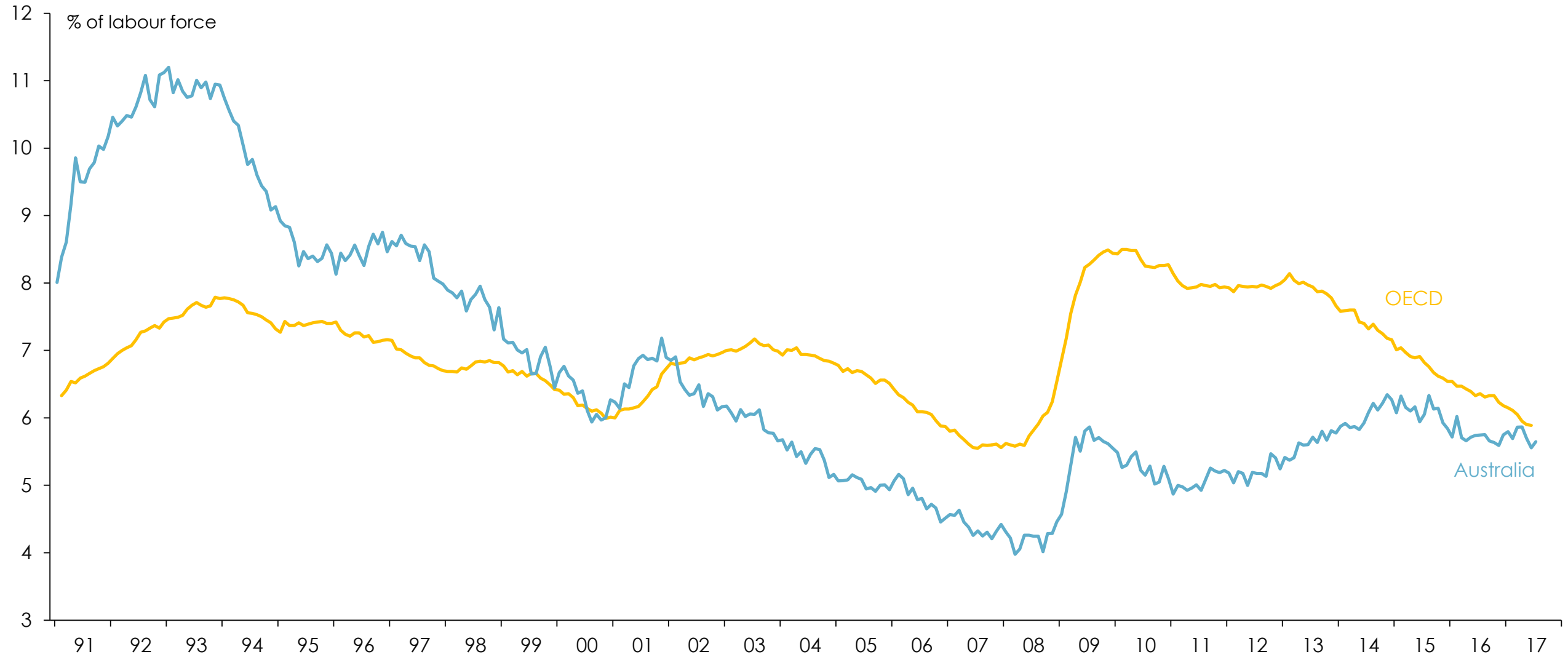
Australia and OECD countries – growth in real GDP



Note: 'OECD' refers to the Organization for Economic Co-operation and Development, a grouping of 34 (mostly) 'advanced' or 'industrialized' economies.
Sources: Australian Bureau of Statistics; OECD.Stat.

Australia's unemployment rate has been below the OECD average for the past sixteen years

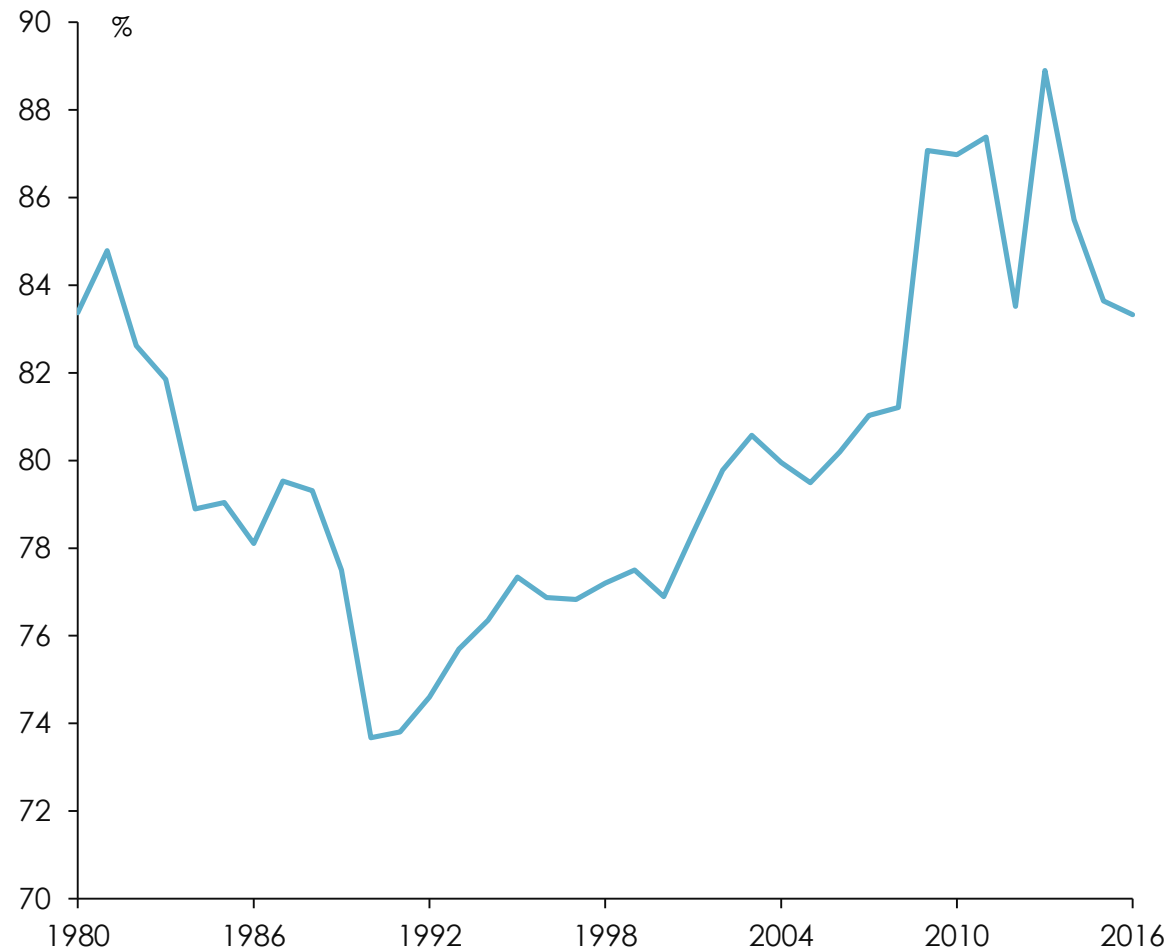
Australia and OECD countries – unemployment rate



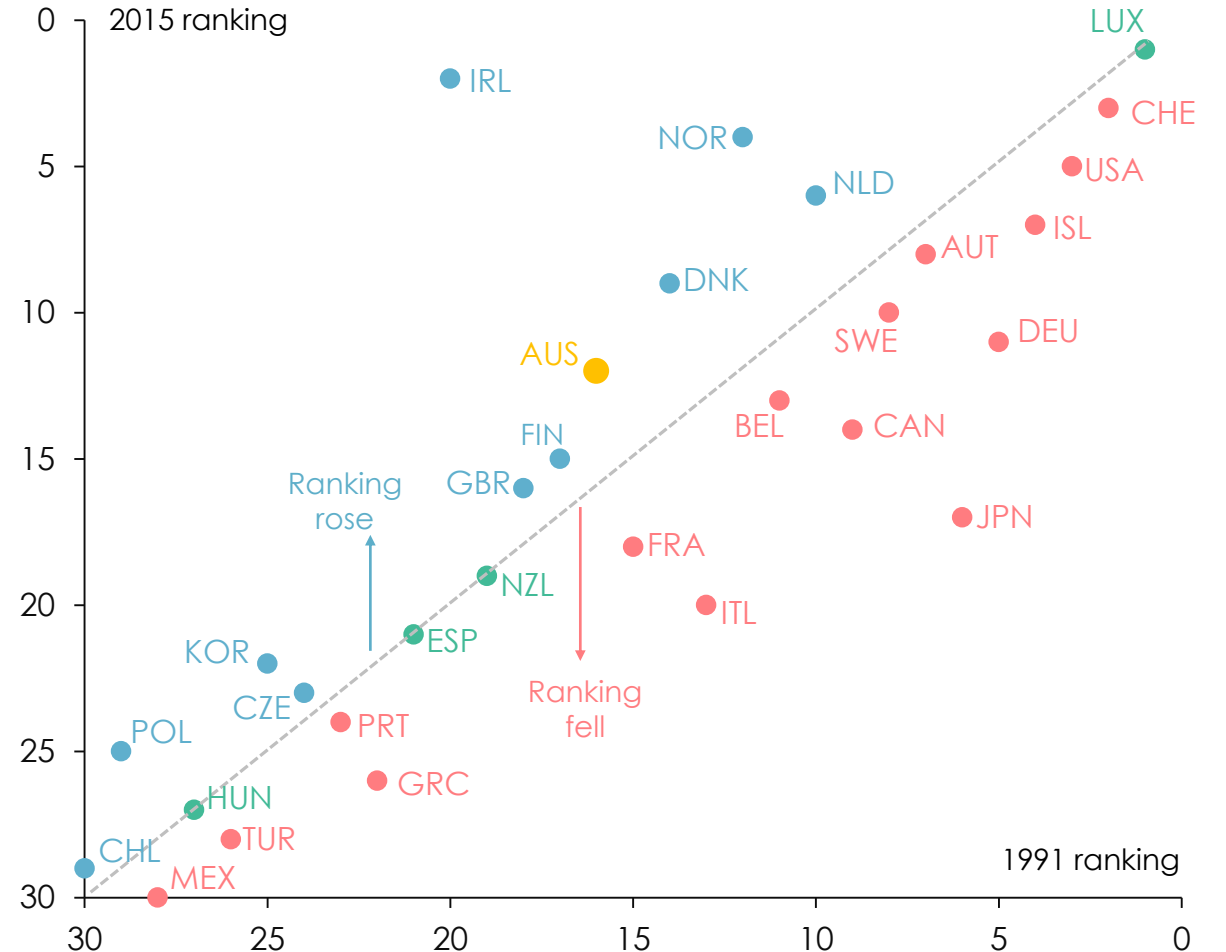
Note: 'OECD' refers to the Organization for Economic Co-operation and Development, a grouping of 34 (mostly) 'advanced' or 'industrialized' economies.
Sources: Australian Bureau of Statistics; OECD.Stat.

Australia's per capita income rose relative to that of the United States – and that of most other OECD countries over the past 25 years

Australian per capita GDP relative to the United States



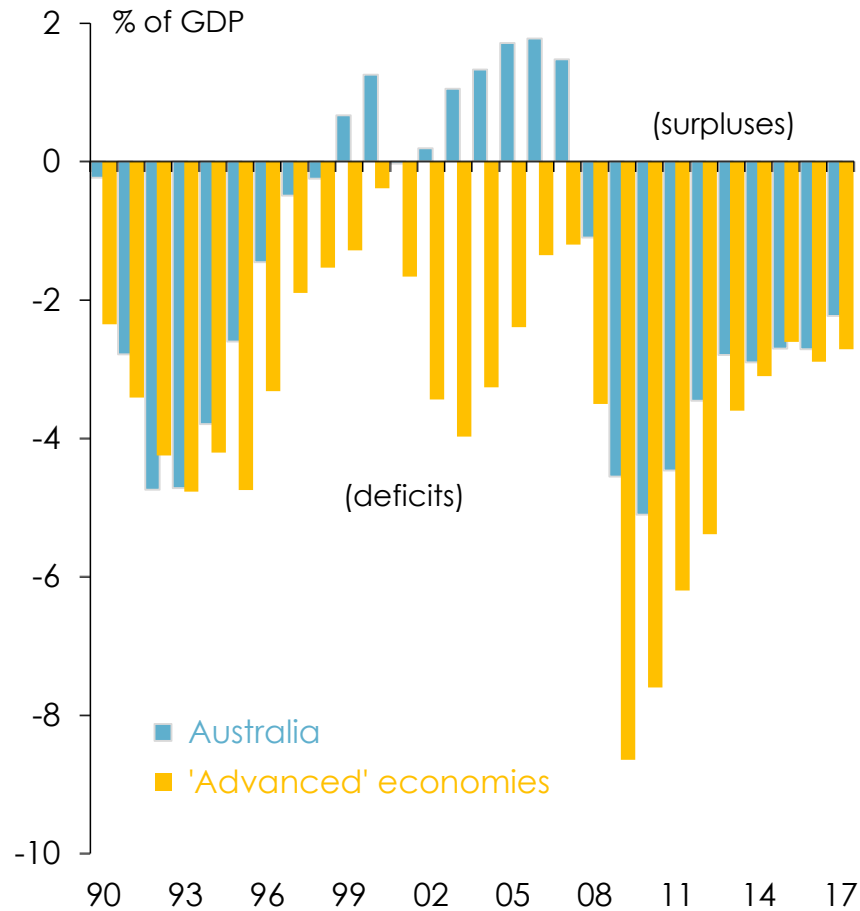
Country rankings in terms of per capita GDP, 1991 and 2015



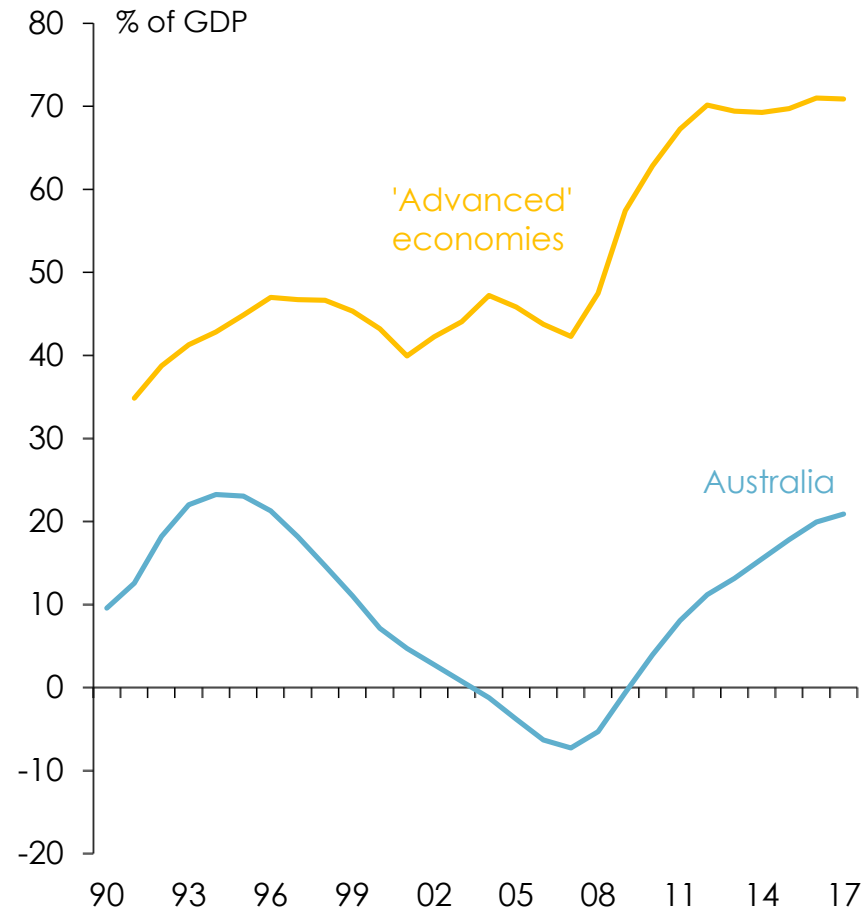
Note: Individual countries' per capita GDPs converted to US\$ at purchasing power parities. Country codes in right hand chart are ISO 3166-1 alpha-3 codes (see <https://unstats.un.org/unsd/tradekb/Knowledgebase/50347/Country-Code>). Source: OECD.Stat.

Australia's relatively good economic performance over the past 25 years reflects a combination of good 'macro' management ...

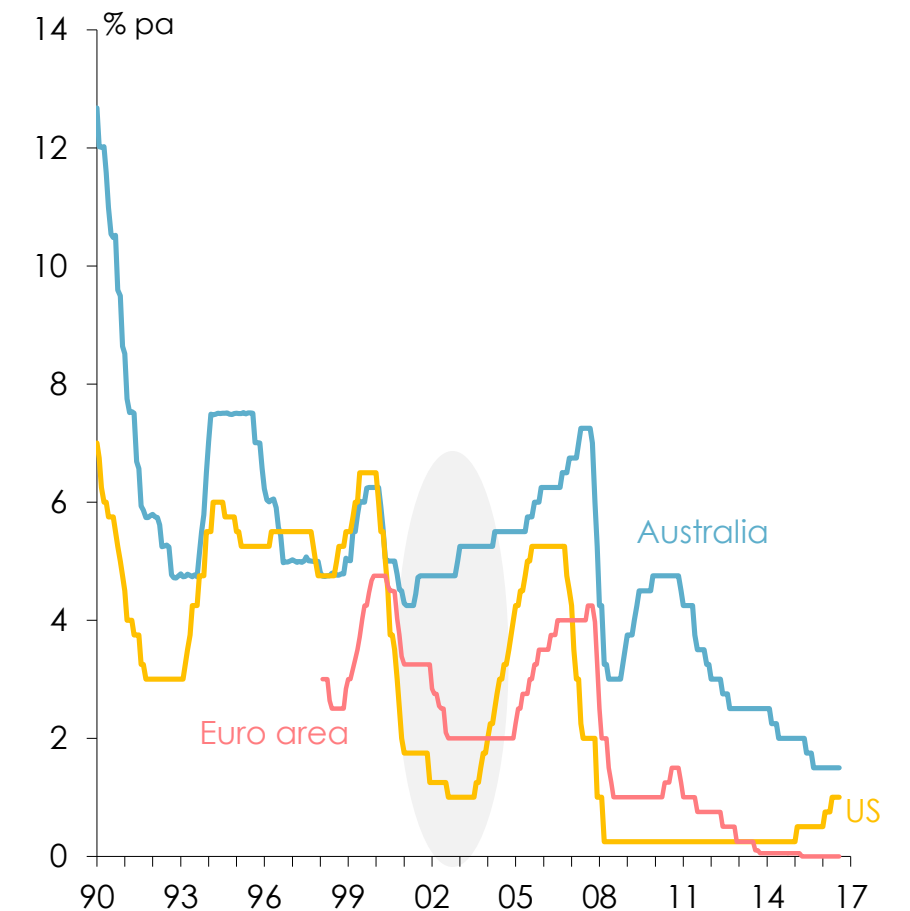
'General government' net lending



'General government' net debt



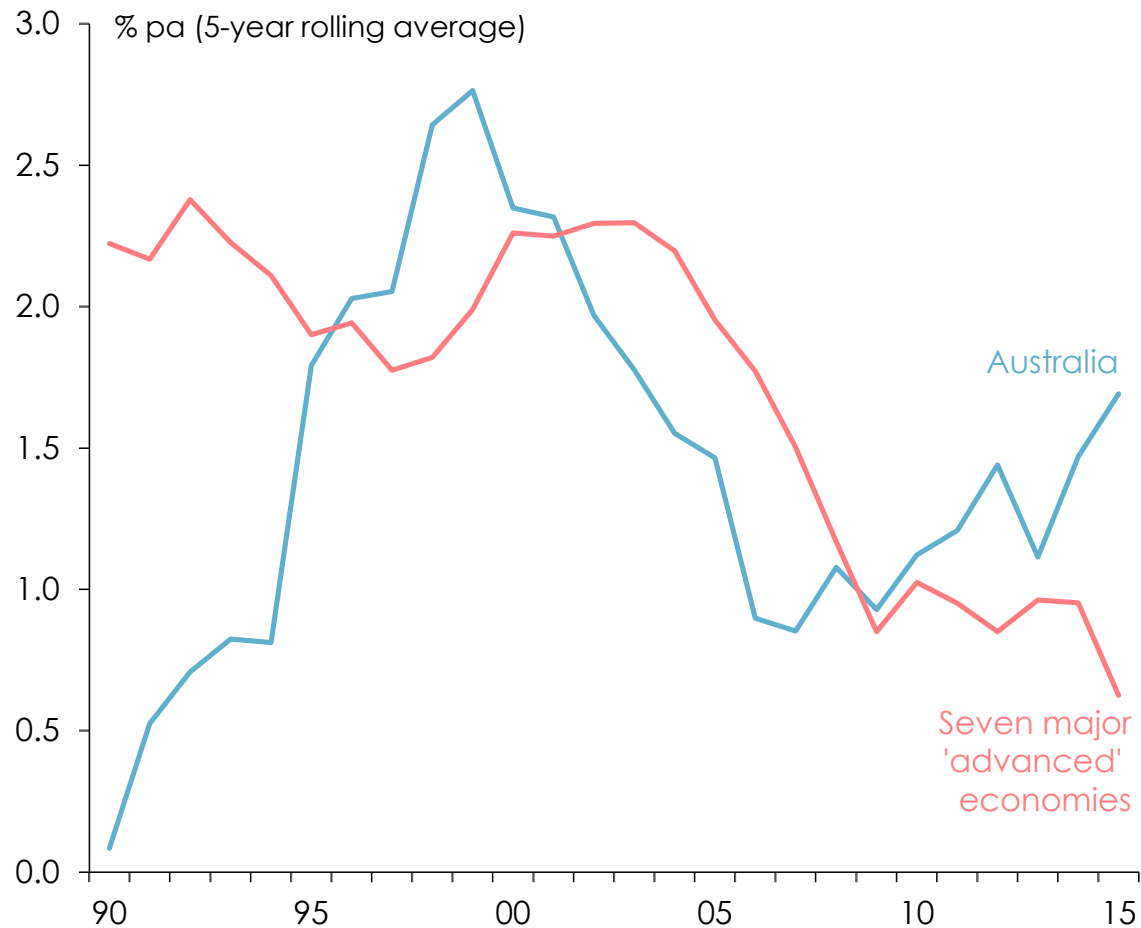
Monetary policy interest rates



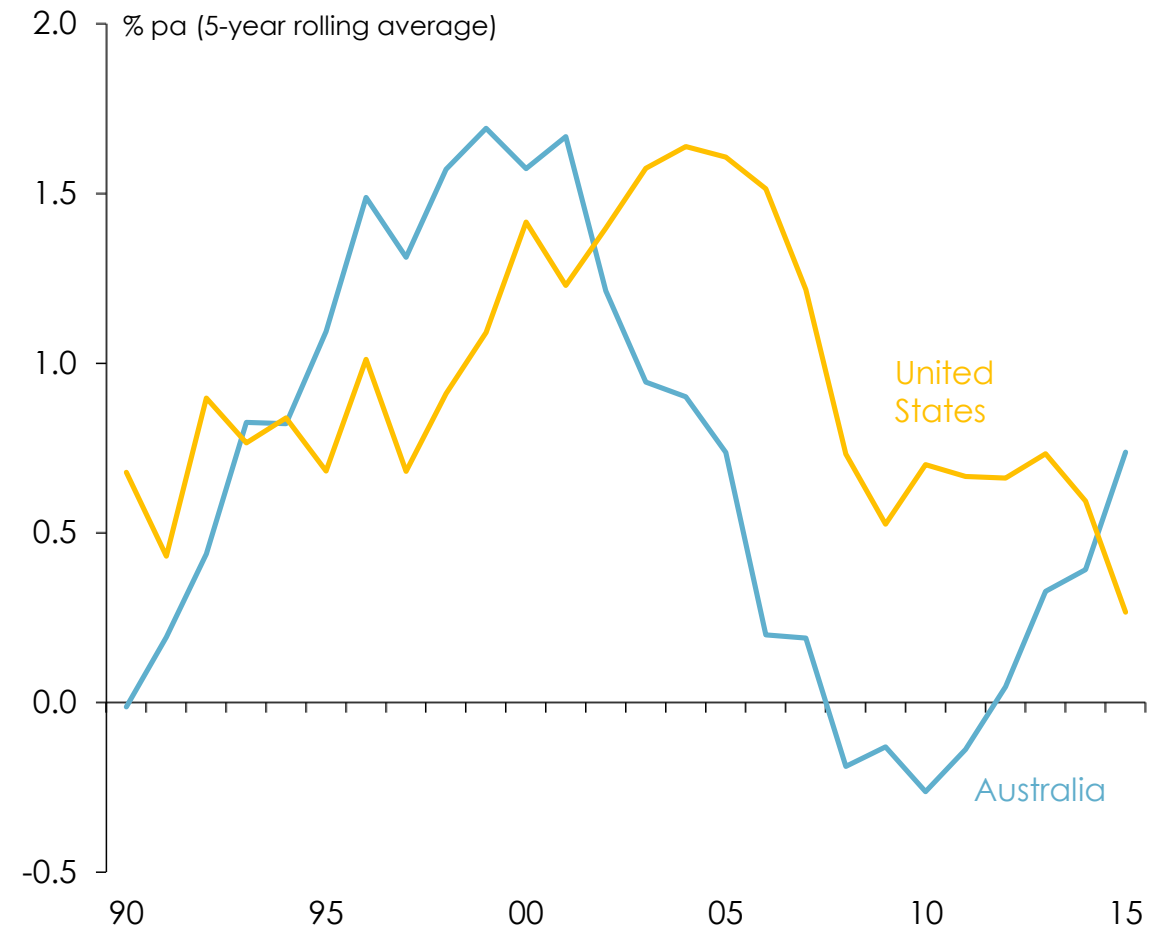
Sources: IMF, [World Economic Outlook database](#), April 2017; Reserve Bank of Australia, US Federal Reserve & European Central Bank.

... good 'micro-economic' policy, at least during the 1980s and 1990s ...

Labour productivity, Australia vs seven largest 'advanced' economies



'Multi-factor' productivity, Australia vs US



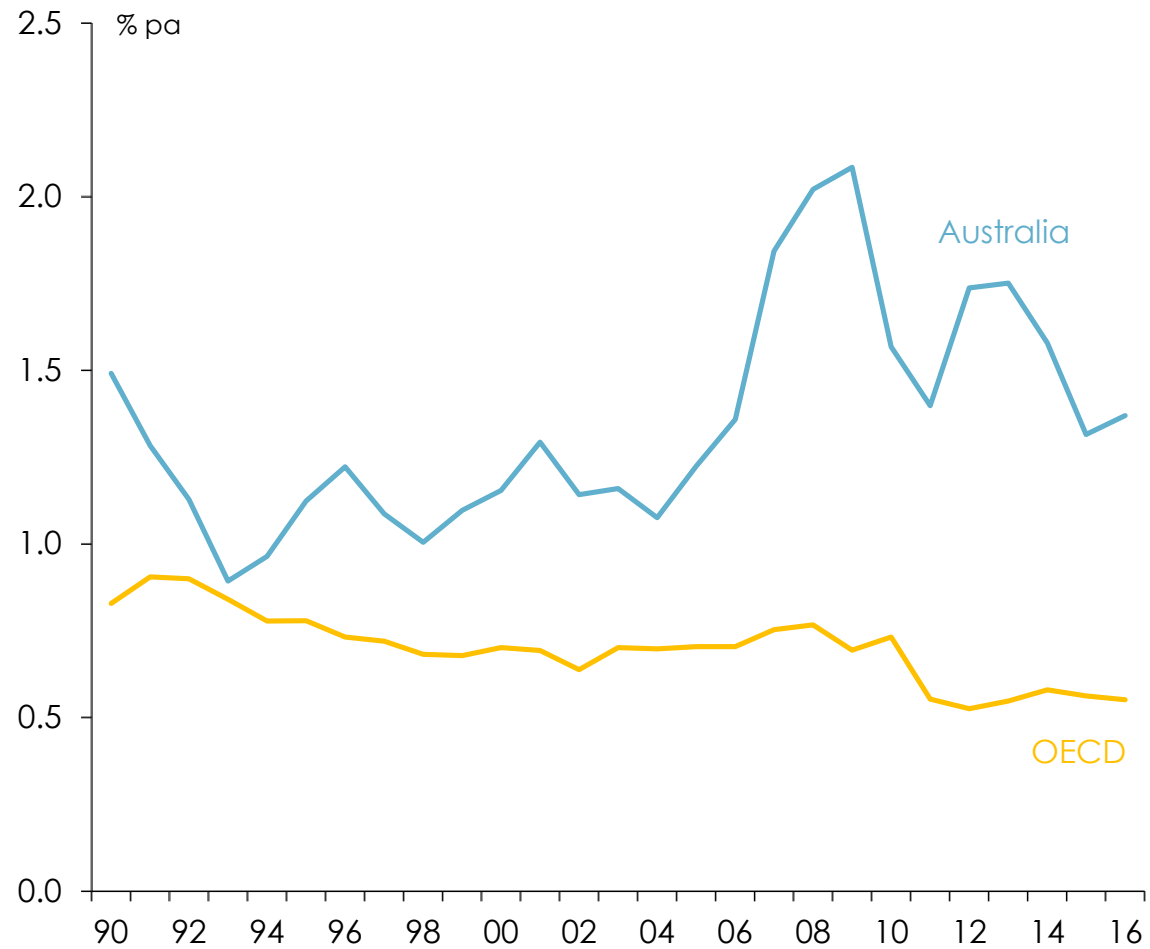
Note: Labour productivity is real GDP per hour worked. The seven major 'advanced' economies are the US, Japan, Germany, the UK, France, Italy and Canada.

'Multi-factor' productivity is output per unit of combined capital and labour inputs. Not available on an aggregate basis (eg G7 or OECD total).

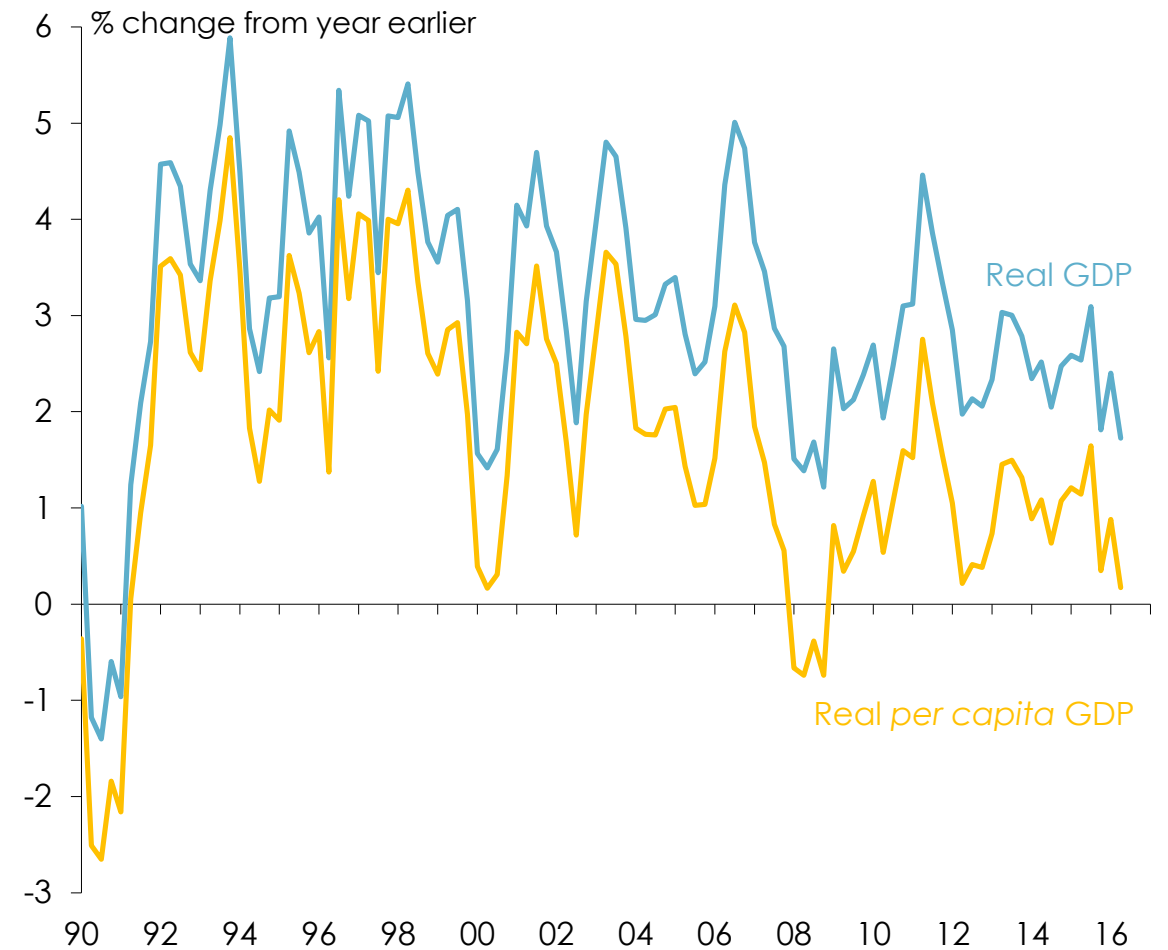
Source: OECD, *Compendium of Productivity Statistics* 2017.

... relatively rapid population growth ...

Population growth, Australia vs OECD



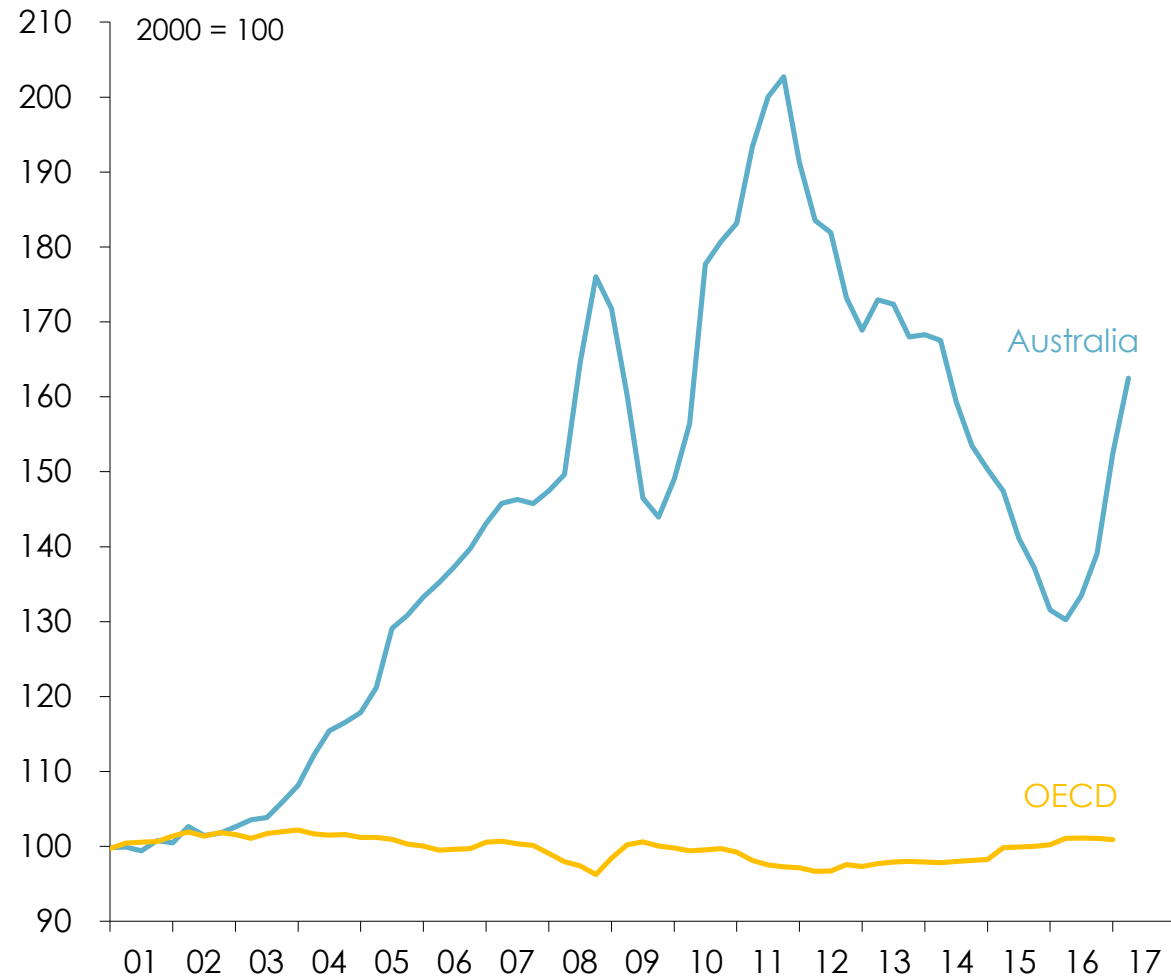
Australian GDP vs per capita GDP growth



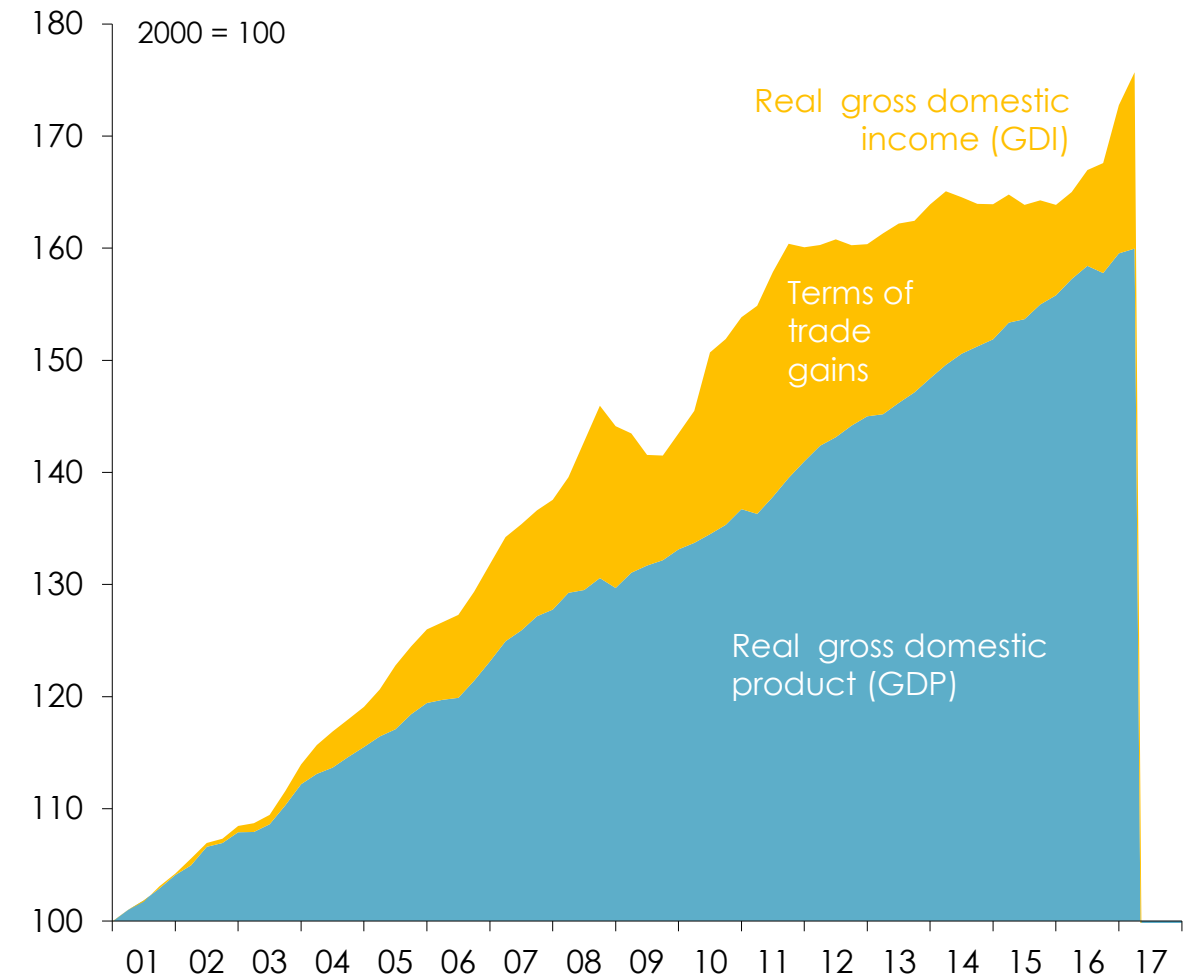
Sources: OECD.Stat; United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2017 Revision*; ABS.

... and good luck, principally as a result of our unusual (for an 'advanced' economy) economic relationship with China

'Terms of trade' – Australia vs other 'advanced' economies



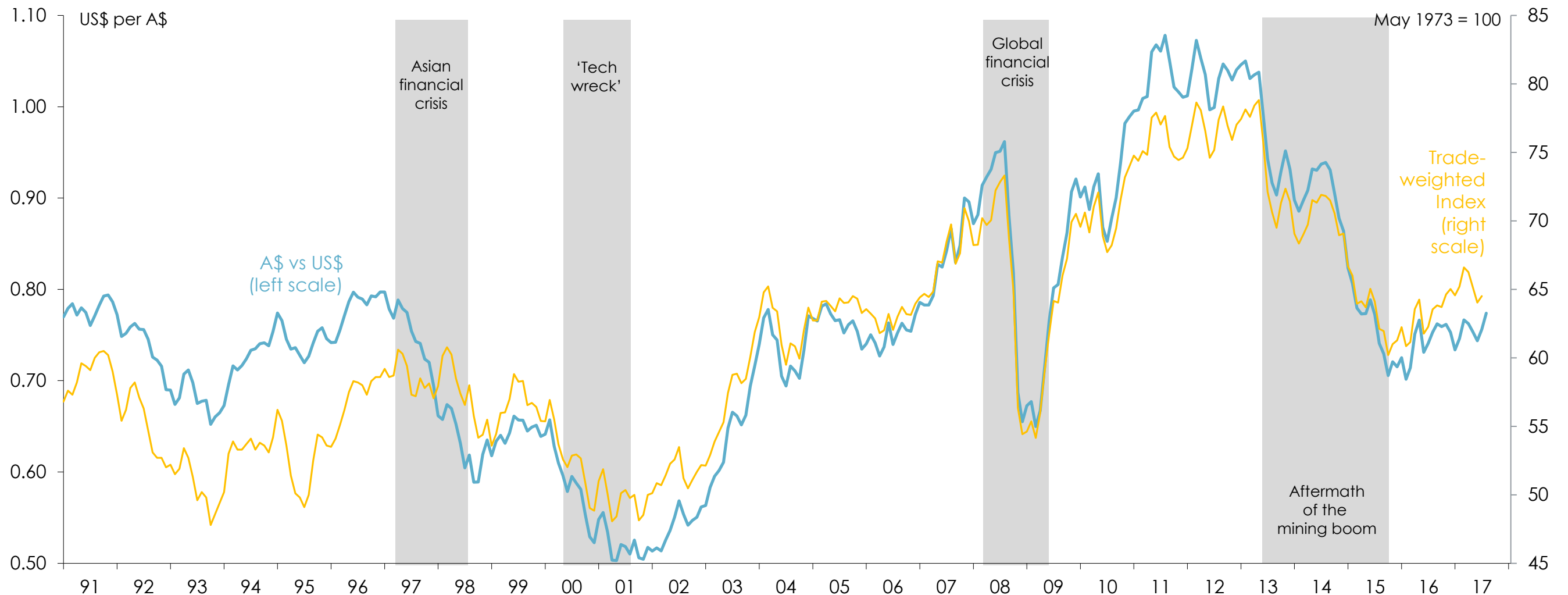
Income gains from changes in the terms of trade not captured by real GDP



Note: 'The 'terms of trade' is the ratio of the implicit price deflator of exports of goods and services to the implicit price deflator of imports of goods and services. Real gross domestic income is real GDP plus net income gains arising from changes in the terms of trade. Source: ABS.

The freely floating A\$ has played an important role as a 'shock absorber'

Australian dollar vs US dollar and trade-weighted index

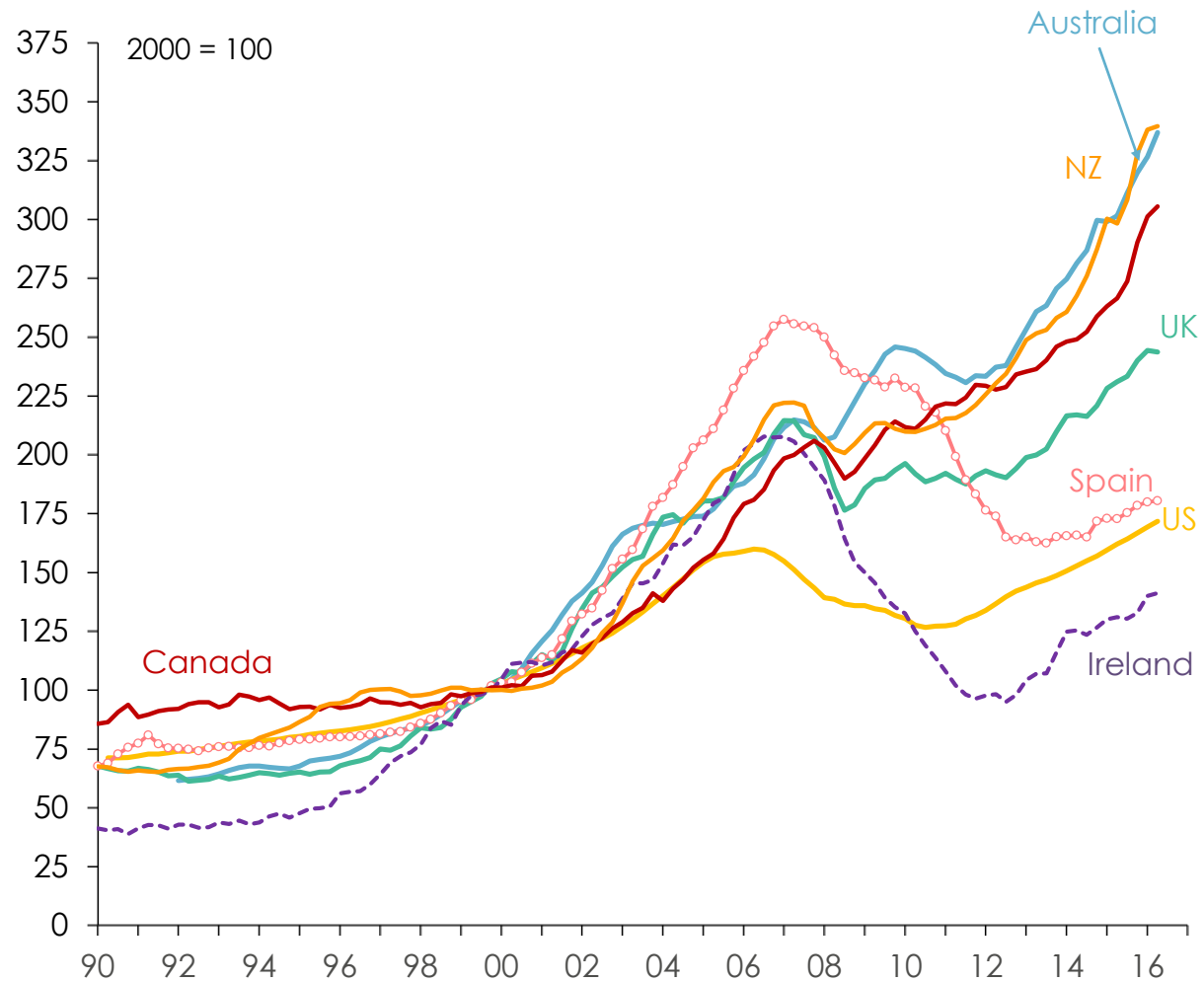


Source: Reserve Bank of Australia

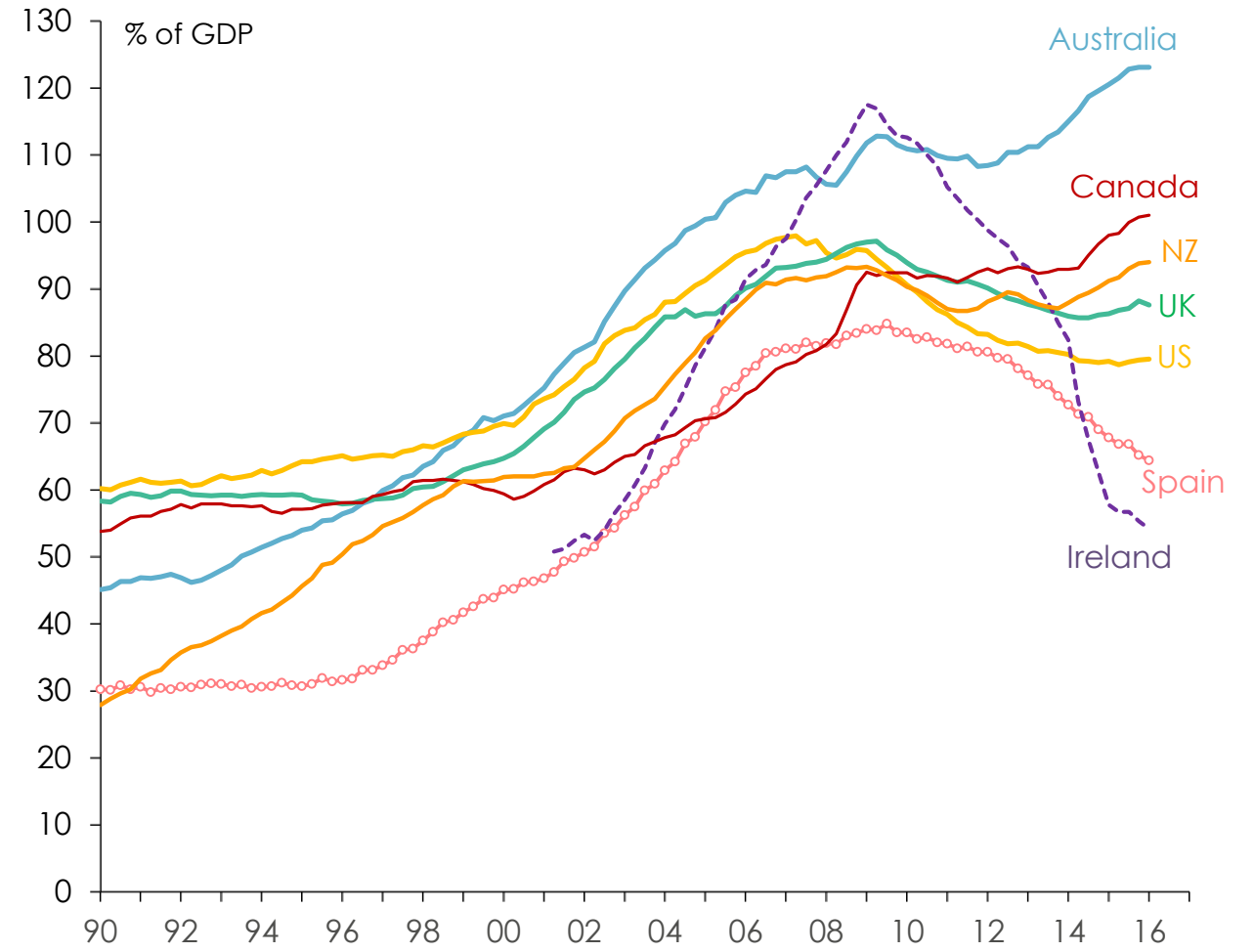
**But some problems and risks have been
building up**

Australia now has relatively high residential property prices (by international standards) and very high levels of household debt

House prices – Australia vs other 'advanced' economies



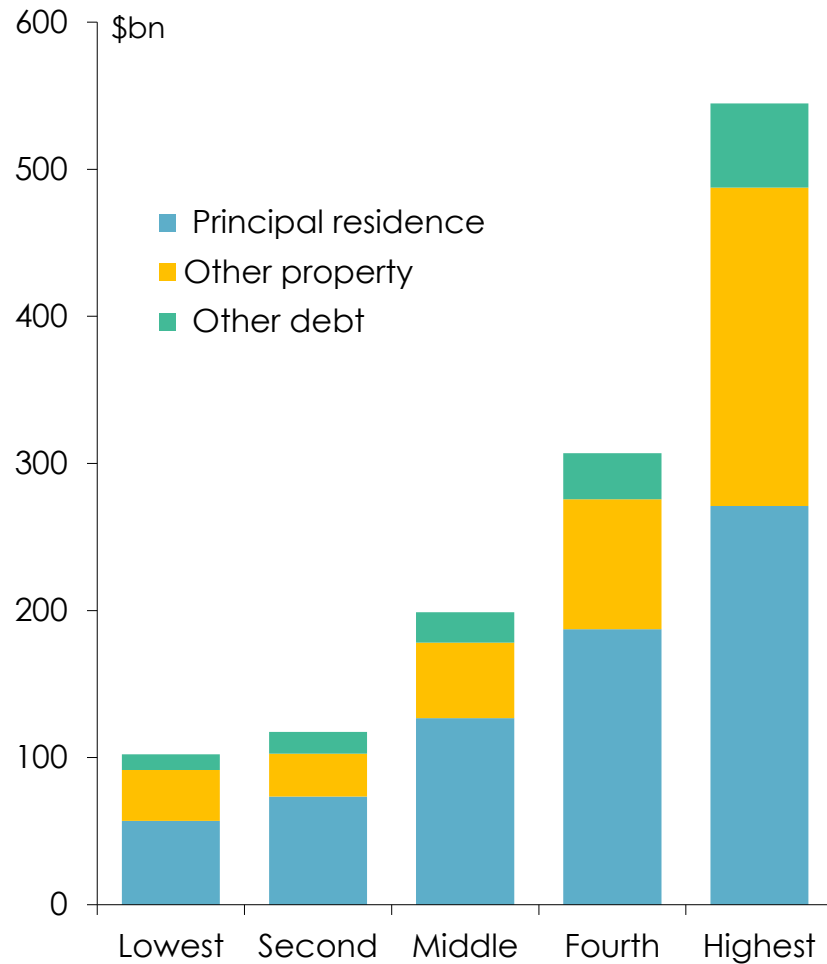
Household debt – Australia vs other 'advanced' economies



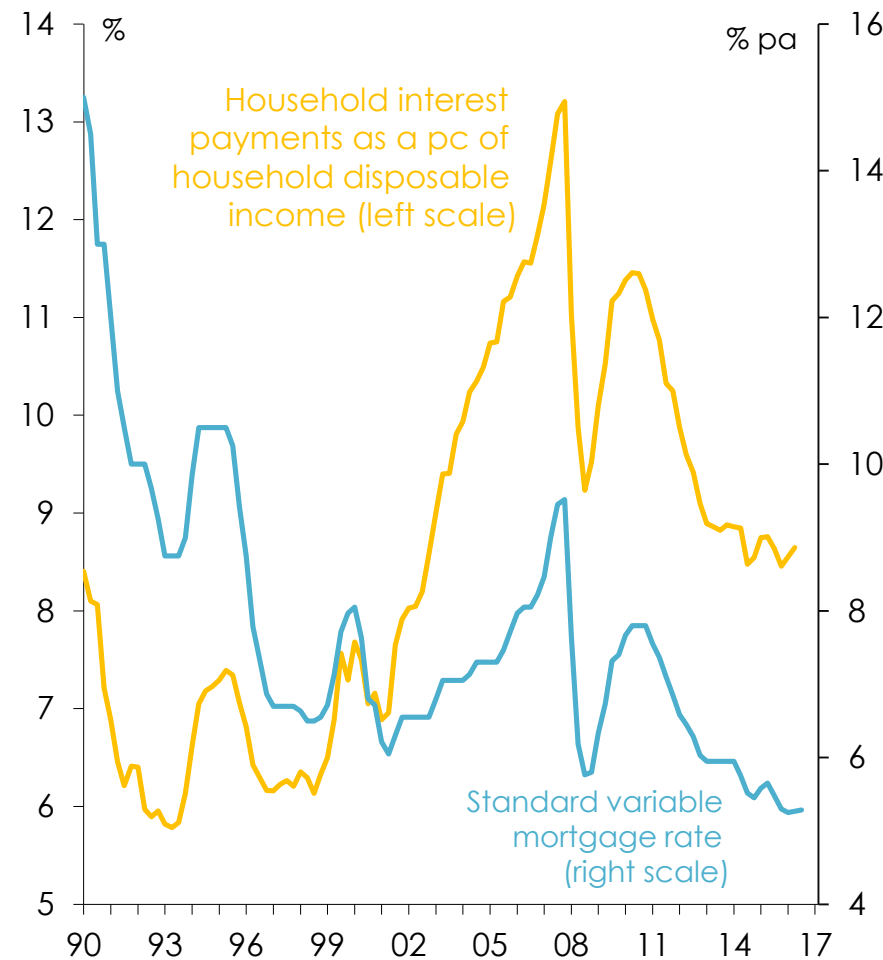
Sources: [RP Data - Core Logic](#); [S&P, CoreLogic Case-Shiller Home Price Indices](#); Bank for International Settlements (BIS), [residential property price series](#) and [credit to the non-financial sector](#) database.

Over two-thirds of Australian household debt is owed by the top 40% of households – and at current interest rates debt-service burdens are low

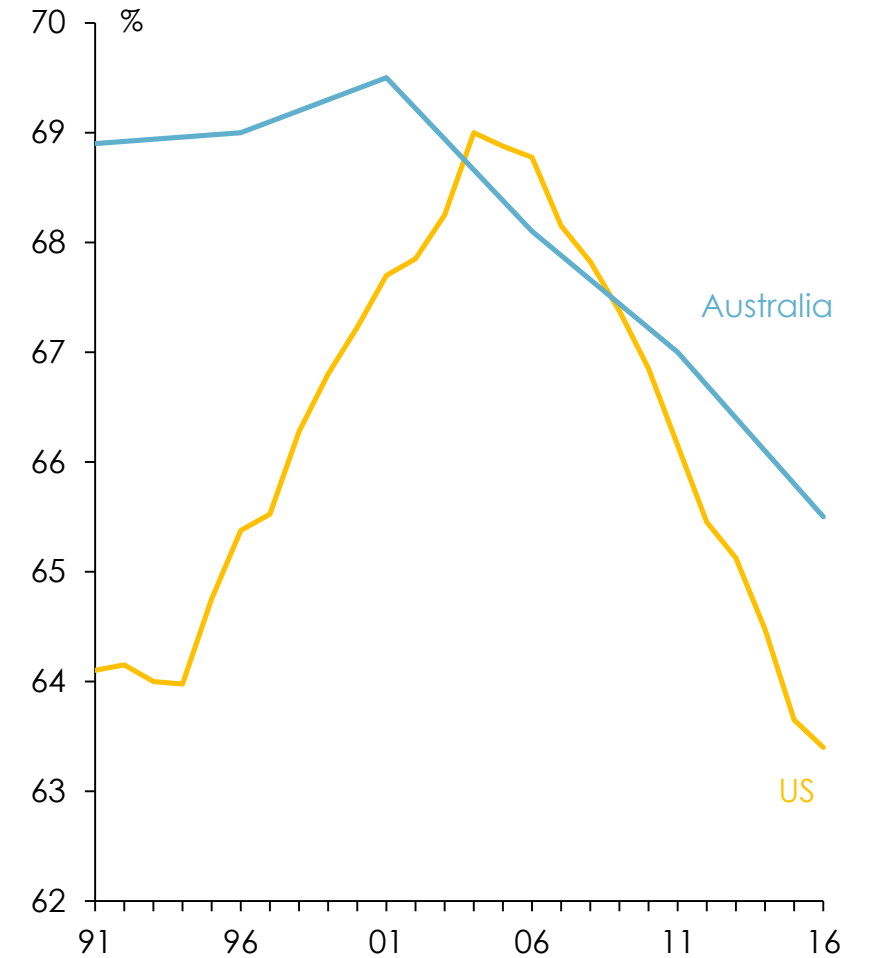
Household debt, by income quintile, 2013-14



Household debt service ratio and interest rates



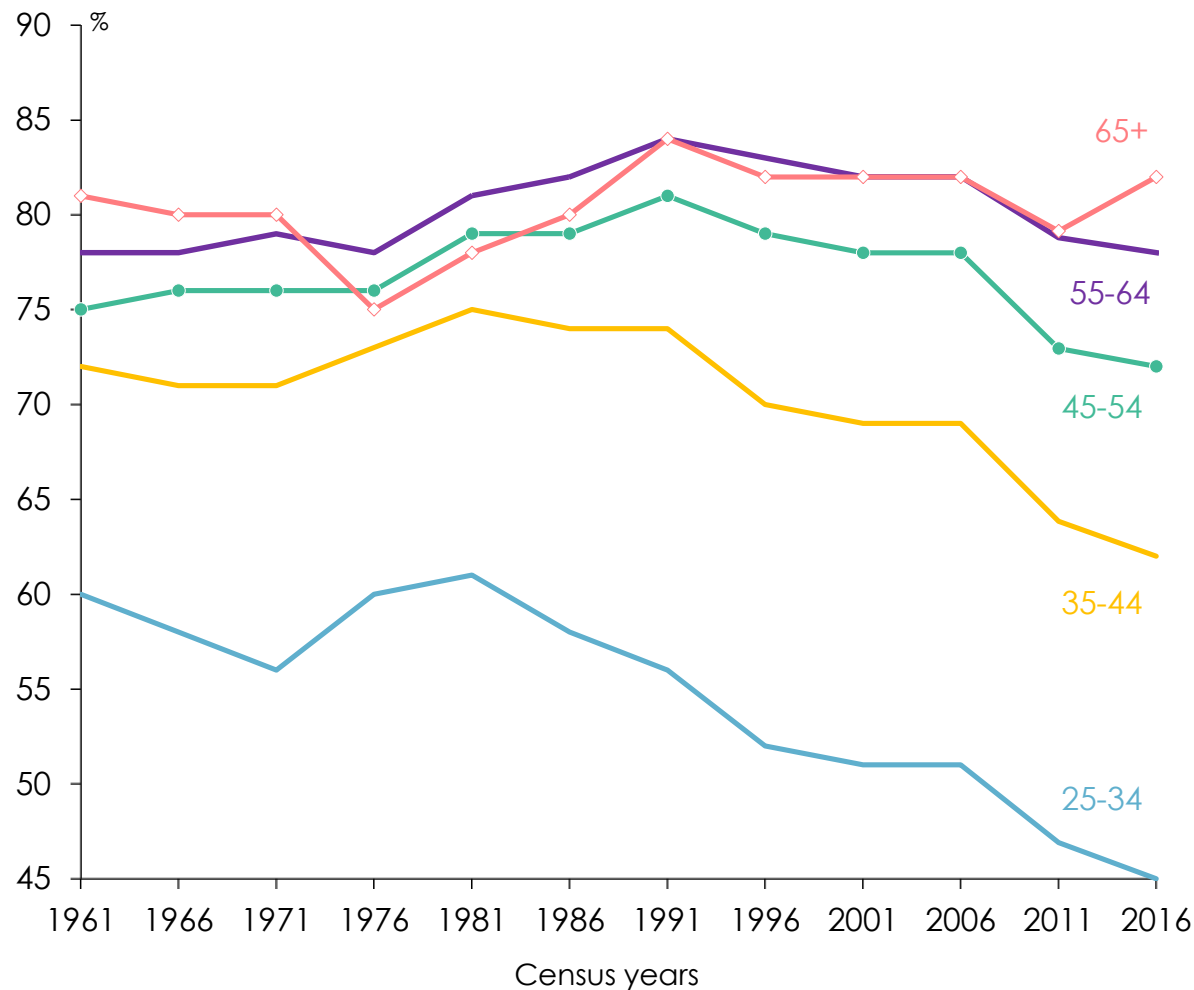
Australia vs US home ownership rates



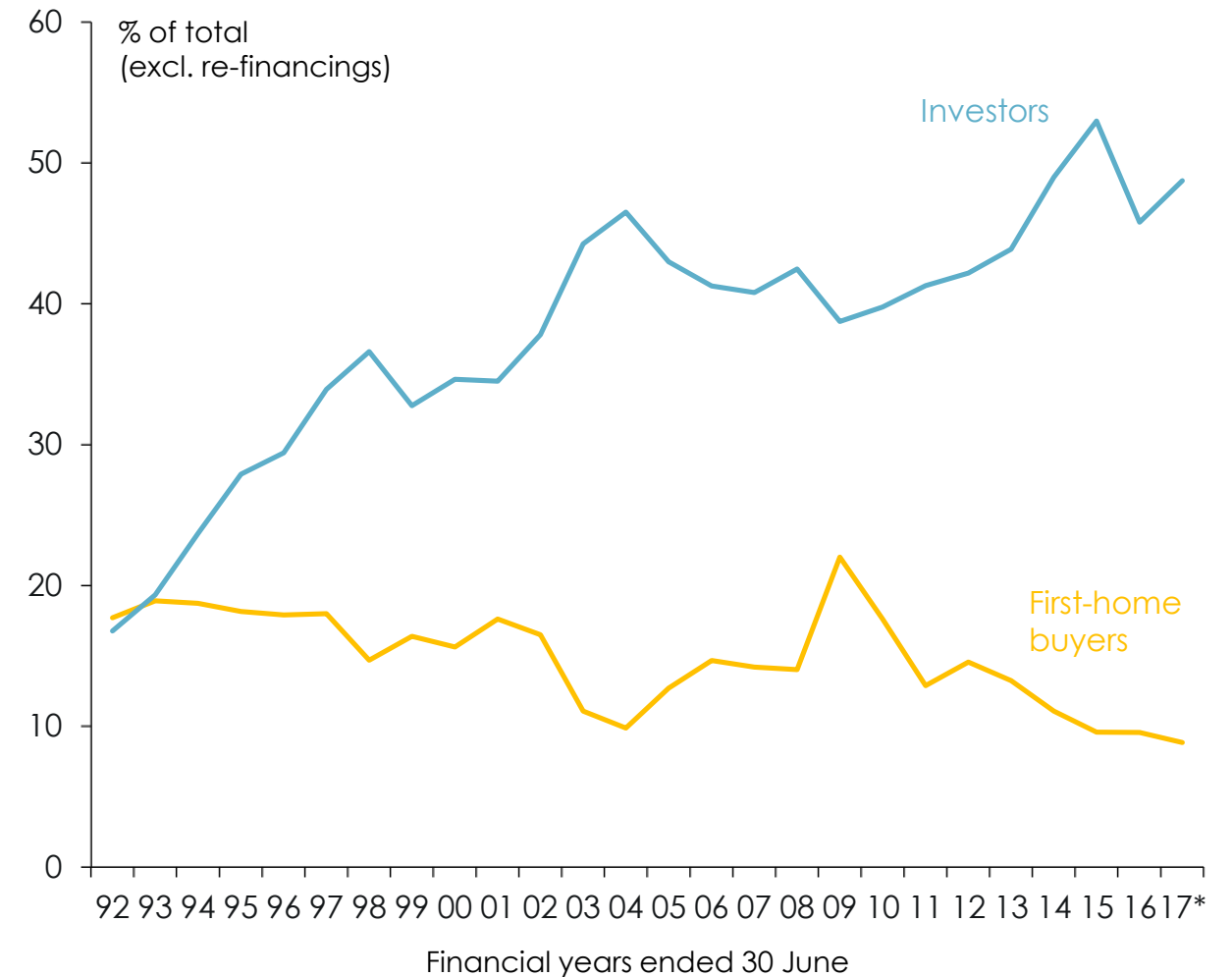
Sources: ABS; RBA; US Commerce Department.

Home ownership rates have declined – particularly among 25-44 year olds – partly because they’ve been ‘squeezed out’ by investors

Home ownership rates, by age group



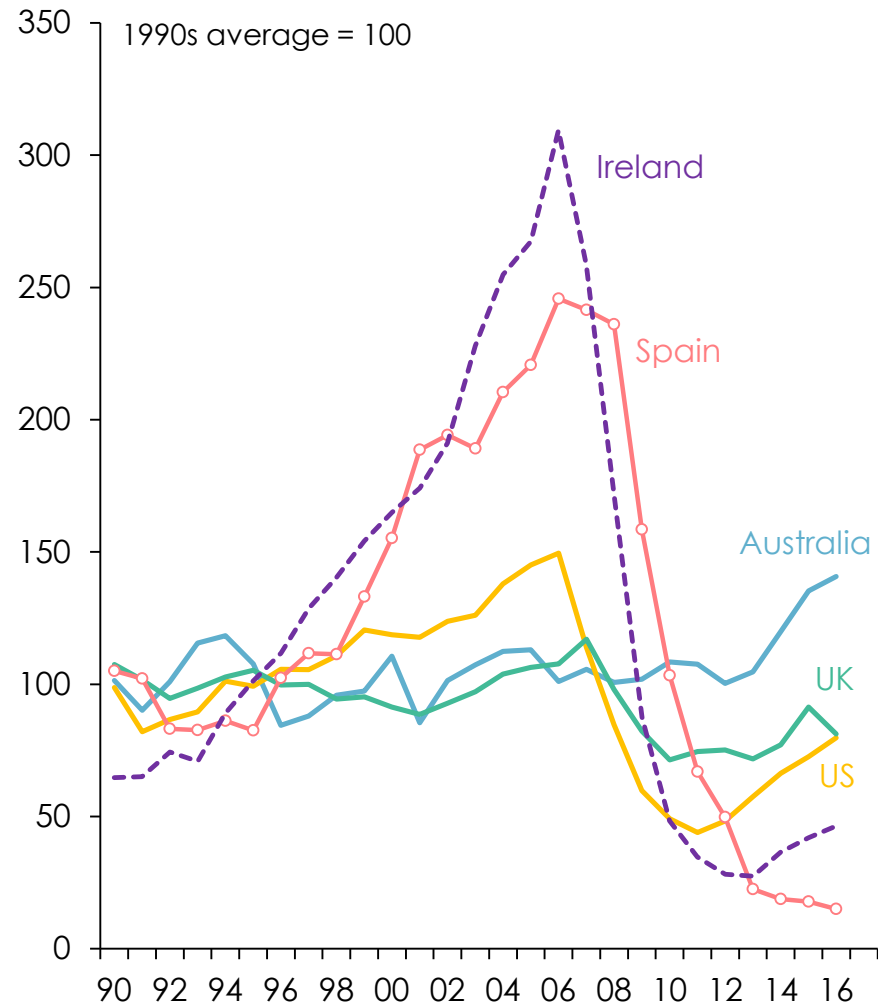
Shares of housing finance – investors and first home buyers



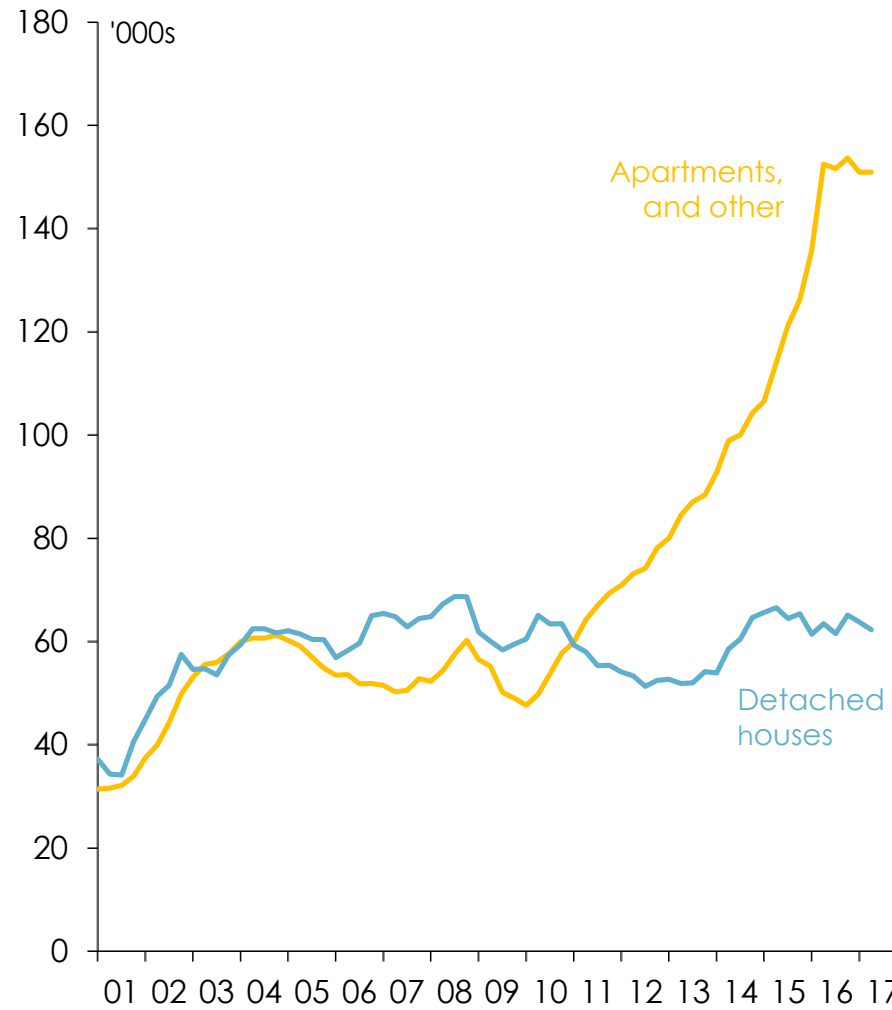
Note: Housing finance commitments data for 2016-17 is for the period July 2016 through May 2017.
Source: Australian Bureau of Statistics.

'Excess supply' has been a factor in many overseas housing 'busts' – so rising supply of apartments could become a risk in Australia

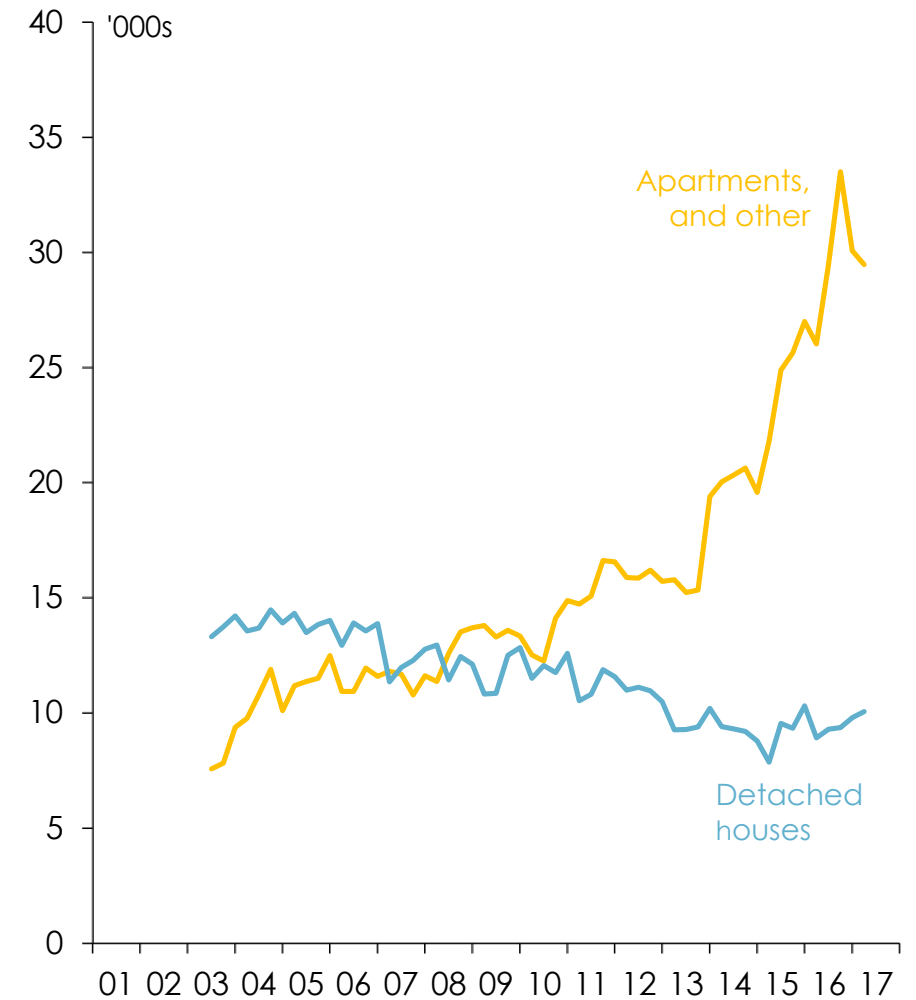
Housing completions - Australia and other selected countries



Residential building under construction



Residential building approved but not yet commenced



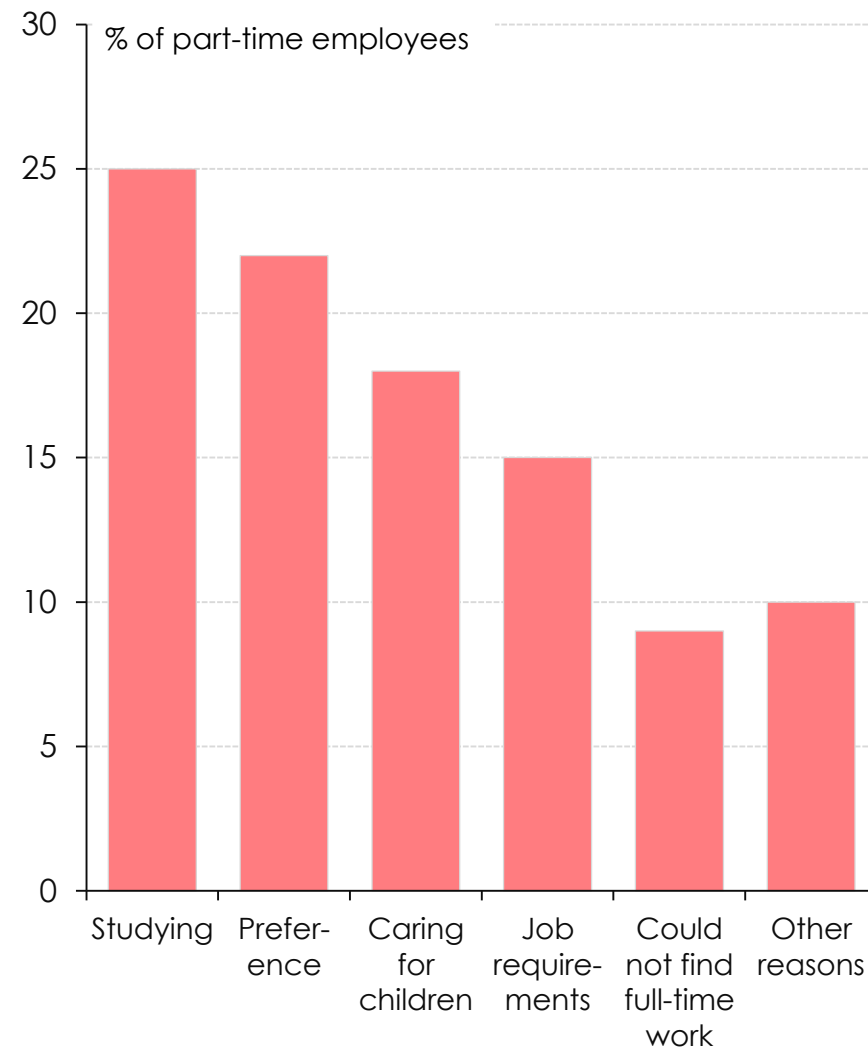
Sources: ABS; US Commerce Department; UK Office of National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office.

A growing proportion of the labour force is working part-time – and not always by choice

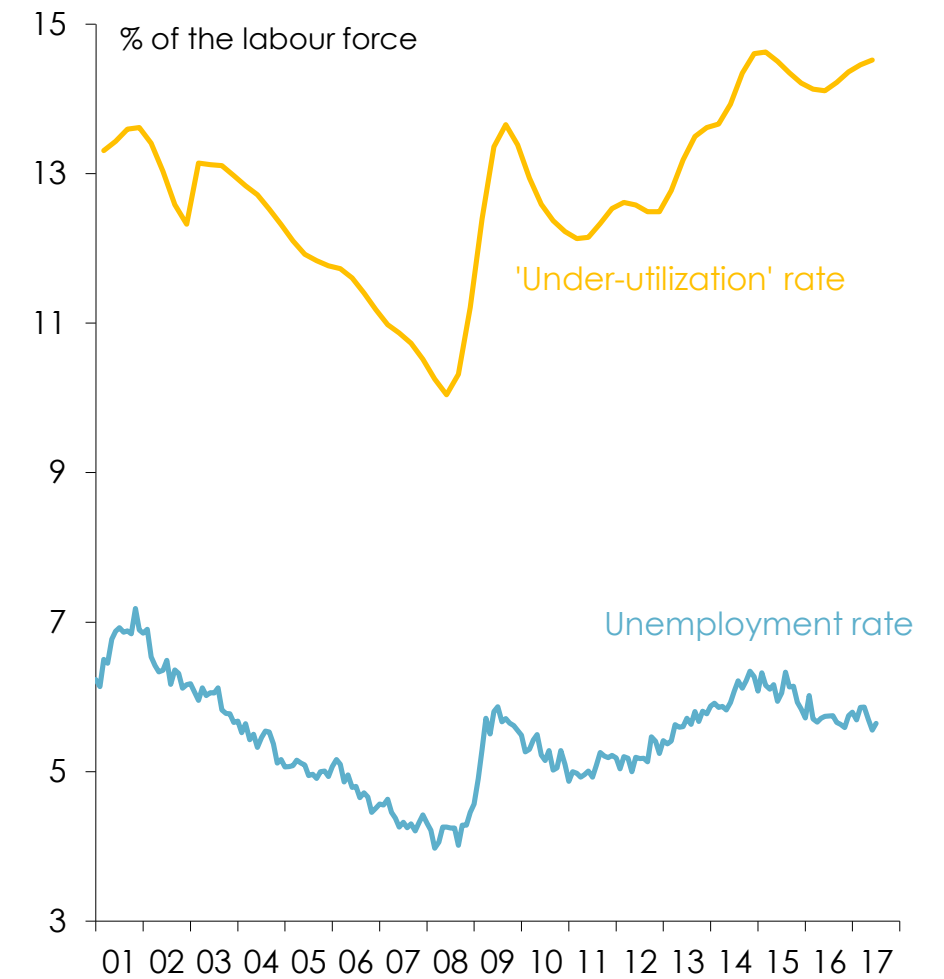
Part-time employment as a pc of total



Reasons for working part-time, 2015



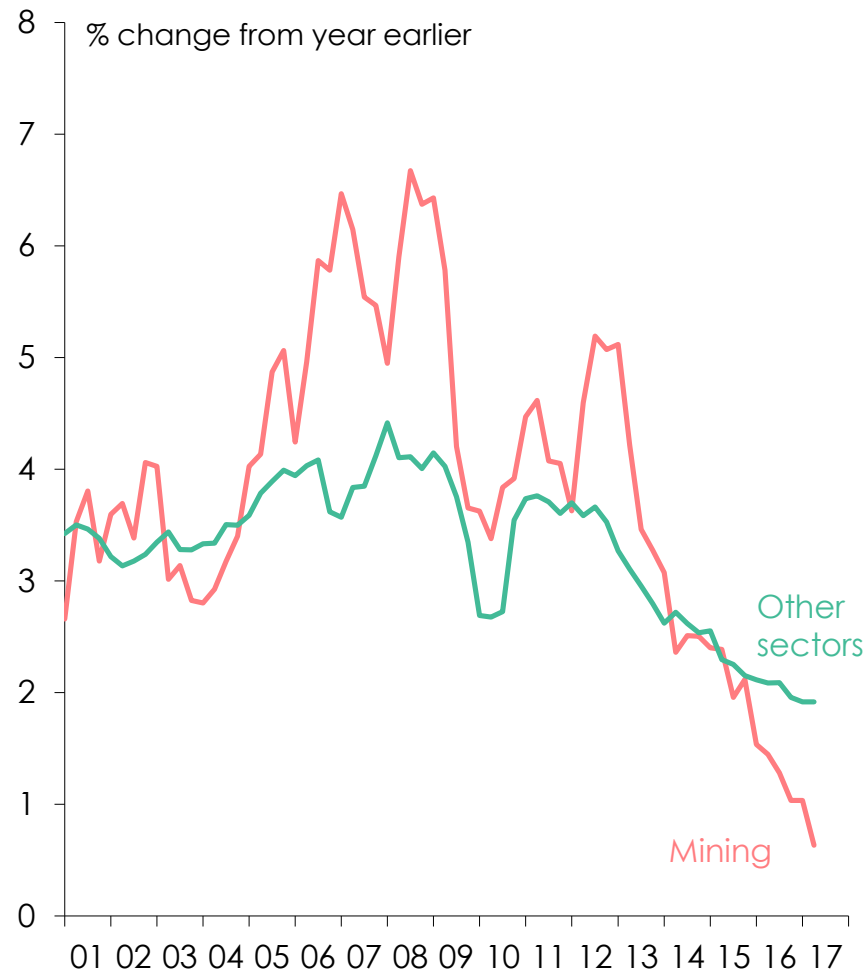
Unemployment and 'under-employment'



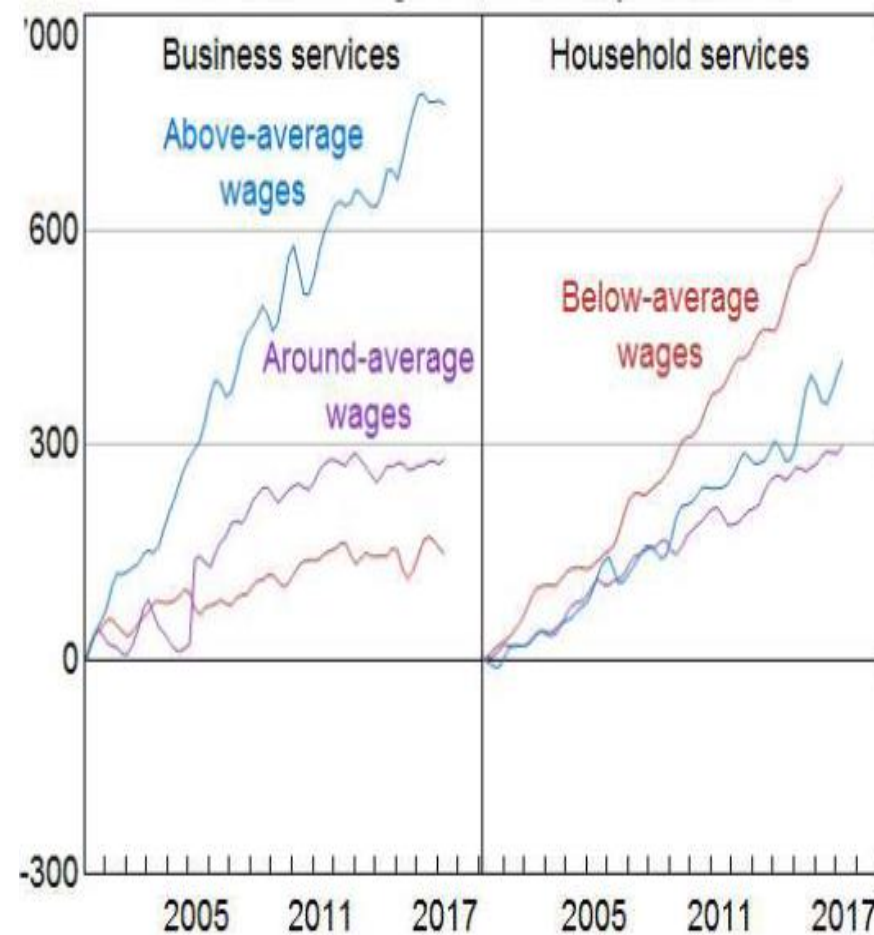
Source: ABS; Philip Lowe, *The Labour Market and Monetary Policy*, Address to the Anika Foundation, 26th July 2017.

Wages growth is at a record low – partly because of where the jobs growth has been – but also because real wages haven't kept up with productivity

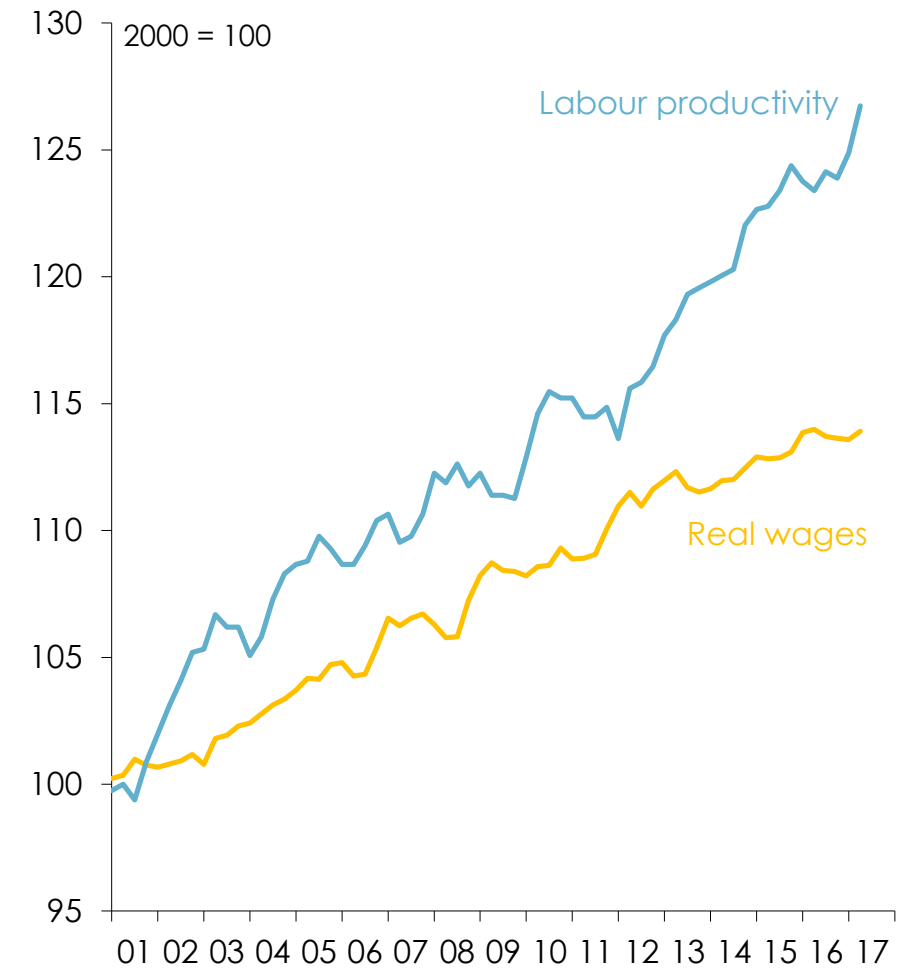
Wages growth



Employment growth in services sectors since 2000



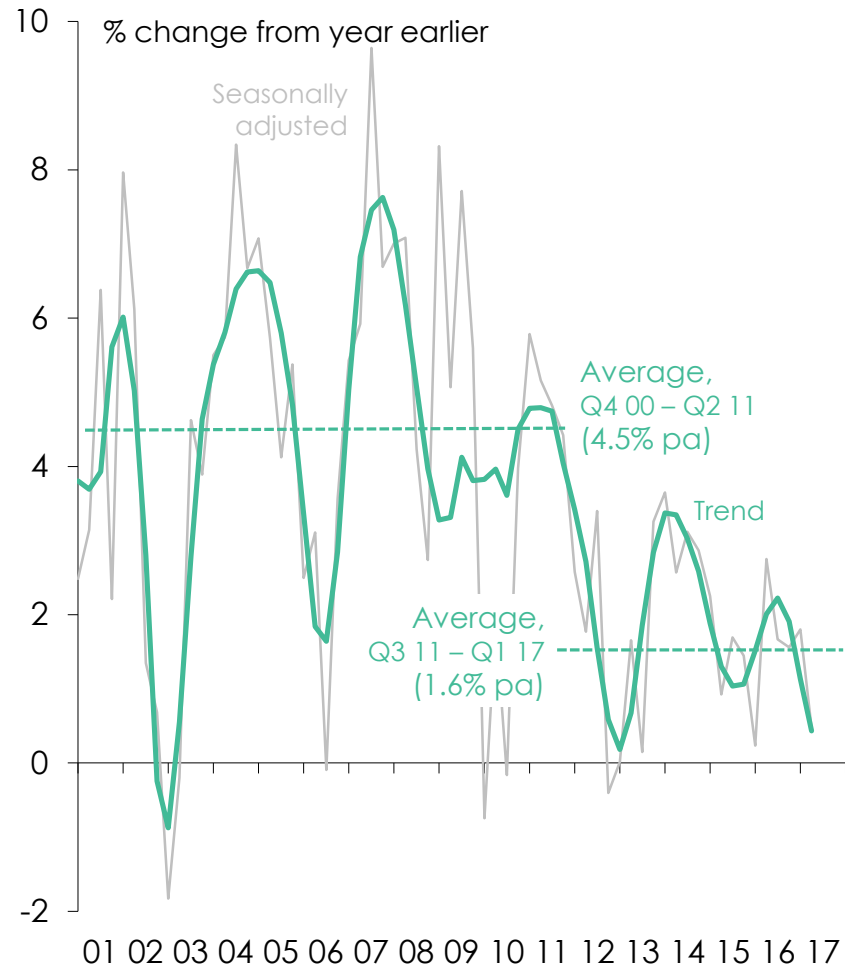
Real wages vs labour productivity



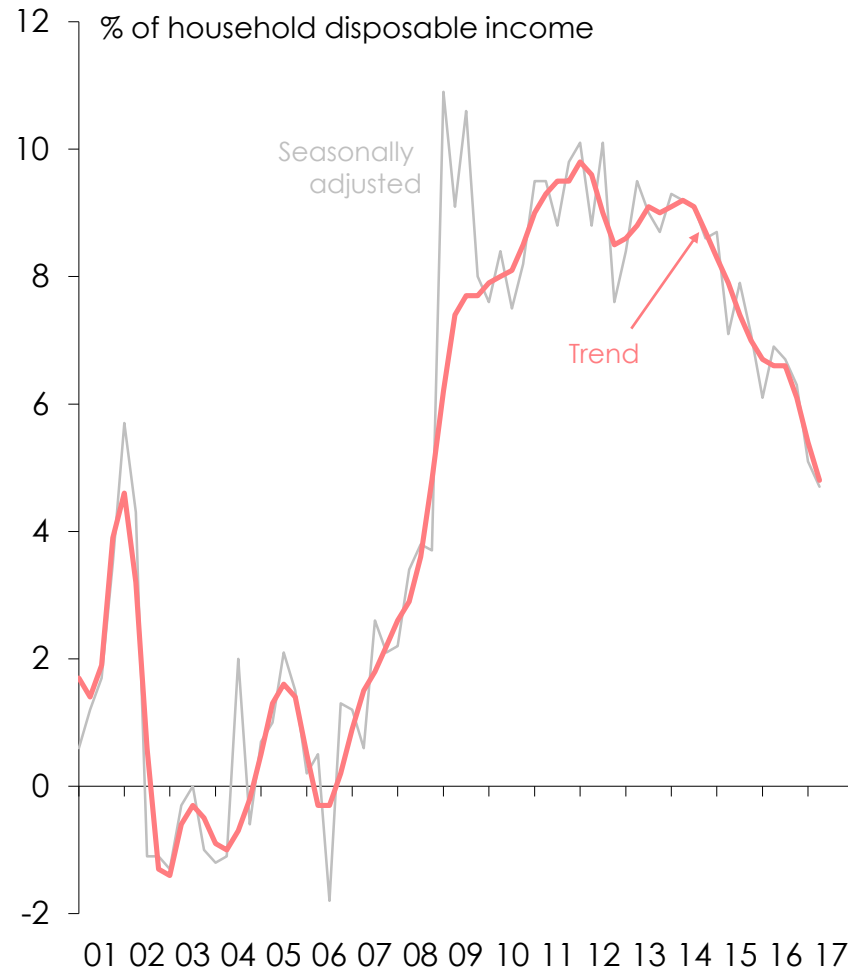
Source: ABS ; Philip Lowe, *The Labour Market and Monetary Policy*, Address to the Anika Foundation, 26th July 2017.

Weak income growth and debt repayment continue to detract from growth in consumer spending

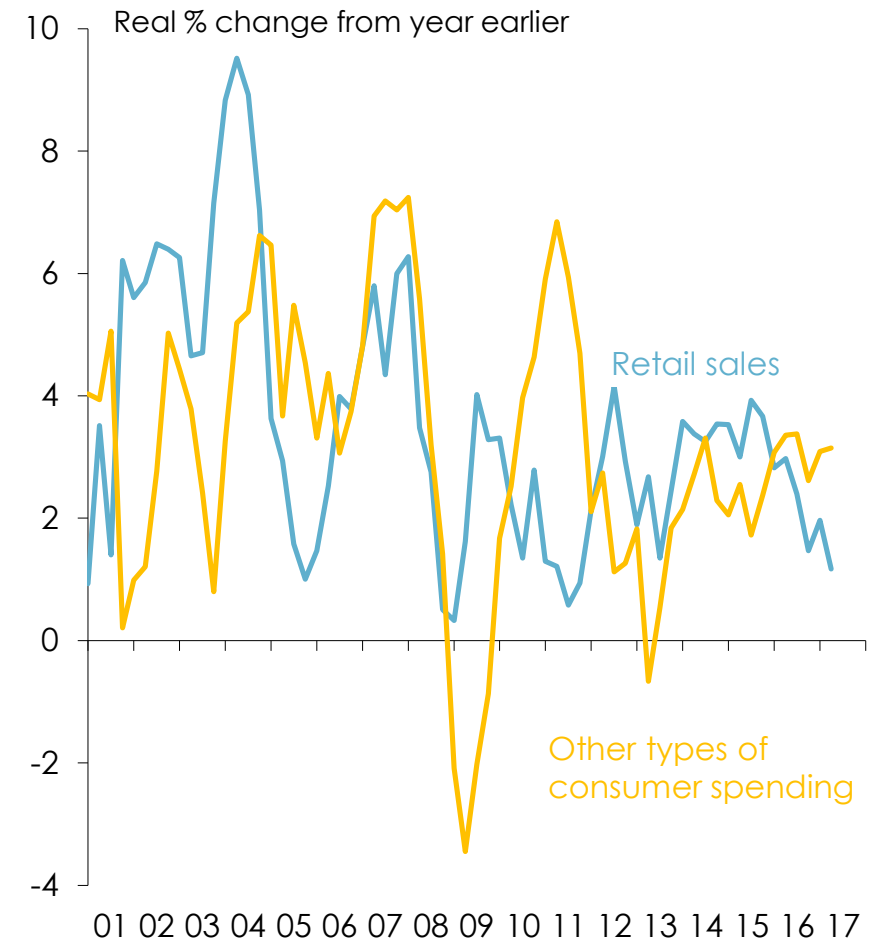
Real household disposable income



Household saving rate



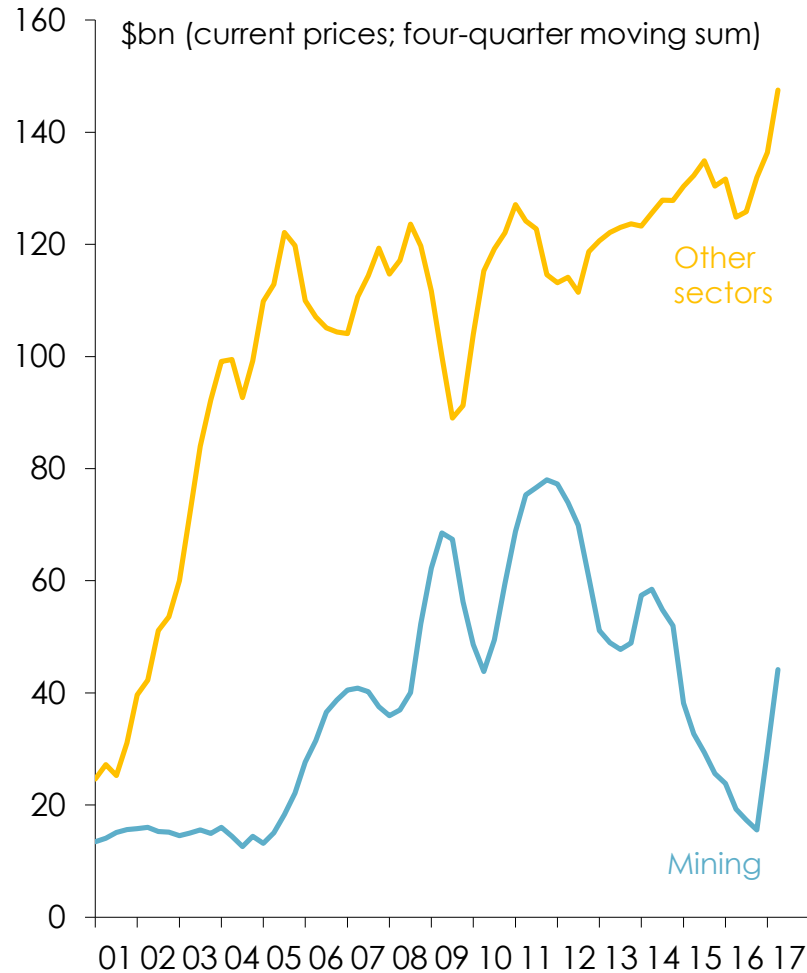
Consumer spending



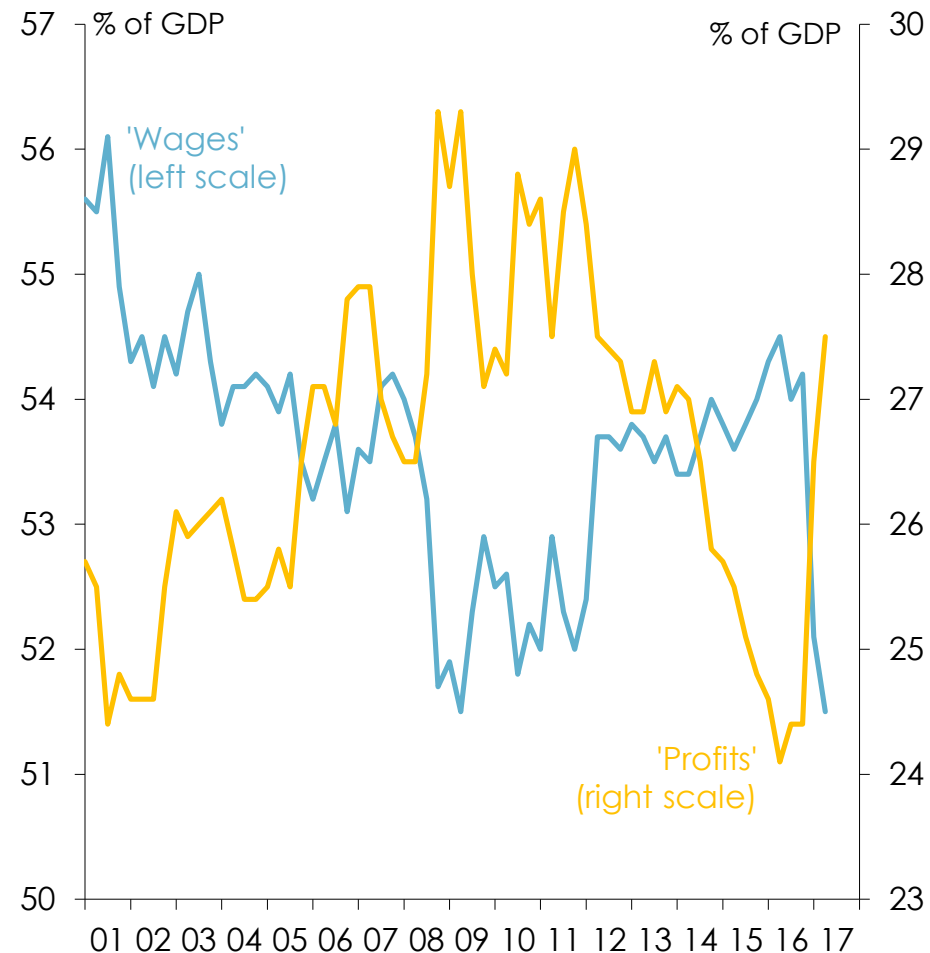
Source: ABS.

Meanwhile profits have risen strongly, while the wages share of national income has fallen – yet business investment remains soft

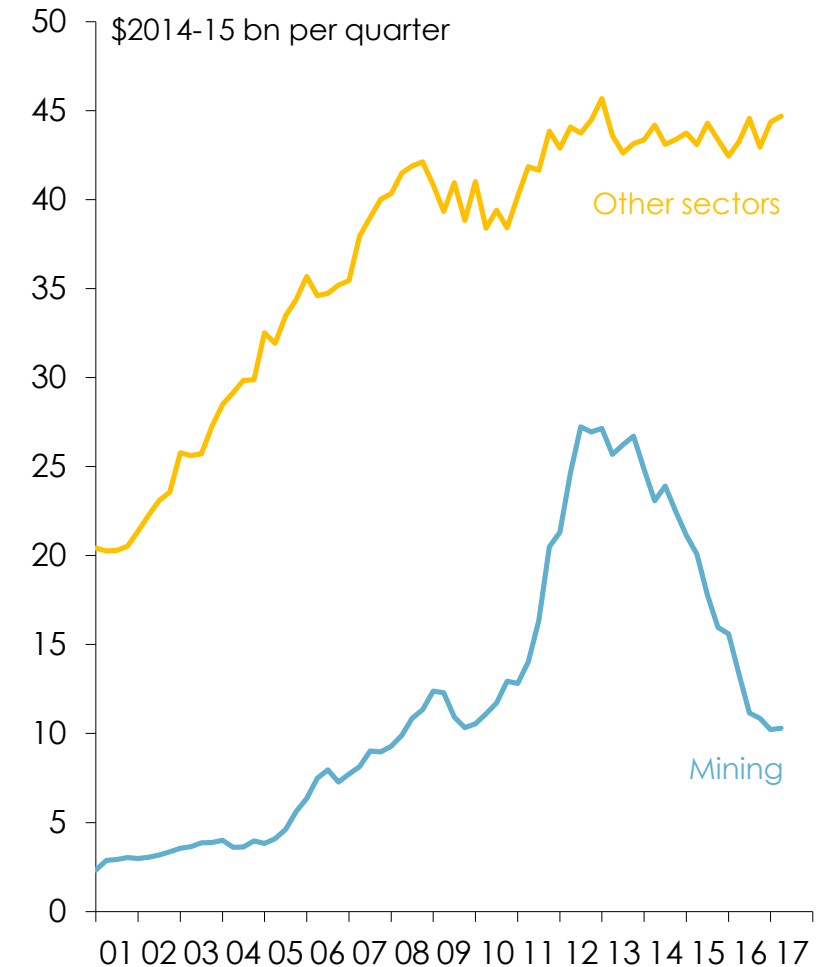
Pre-tax company profits



Shares of national income



Business investment

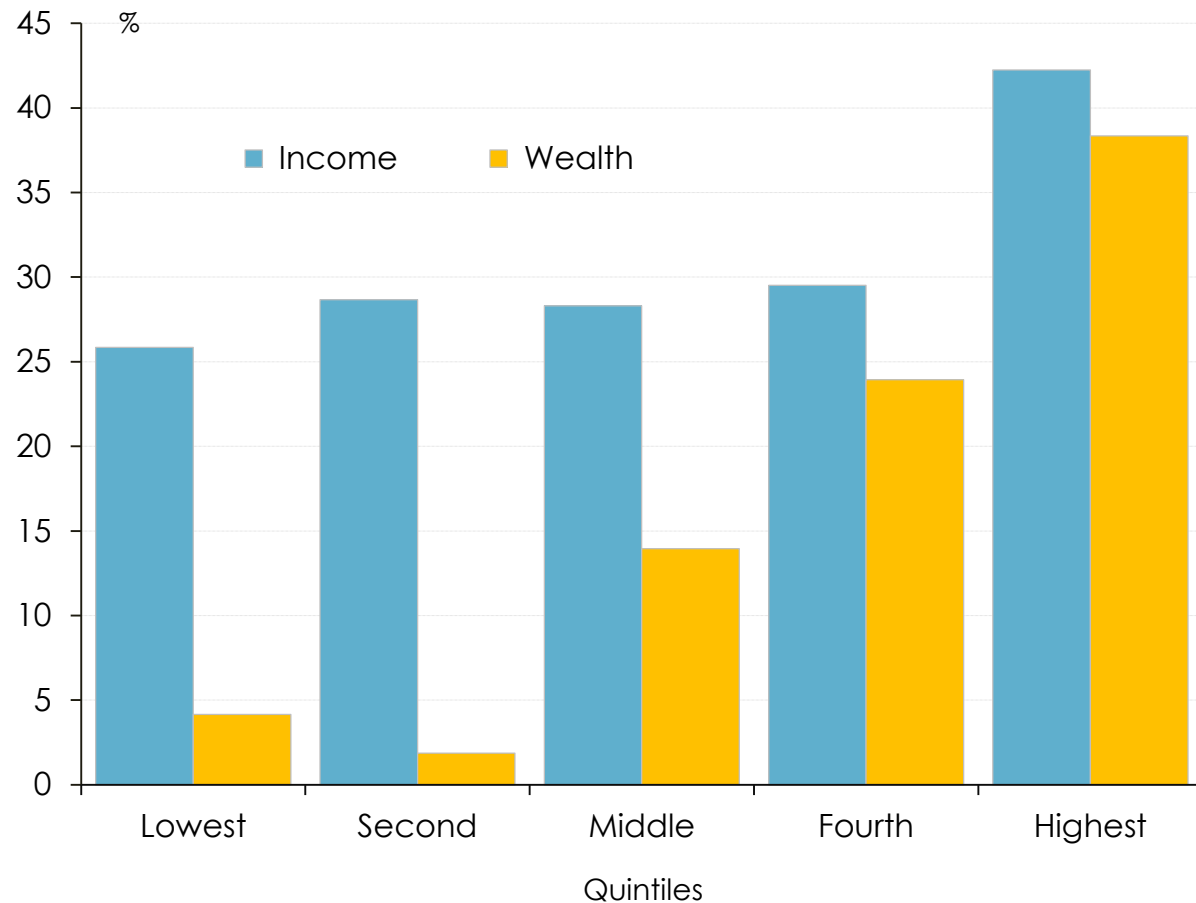


Note: 'Other sectors' in the company profits survey exclude banks and other deposit-taking intermediaries, insurance and super funds, education & training, and health care & social assistance. Mining investment includes buildings & structures and plant, equipment & machinery from the capex survey plus exploration expenditure; investment by 'other sectors' is the national accounts measure of total new business investment minus this estimate of mining investment.

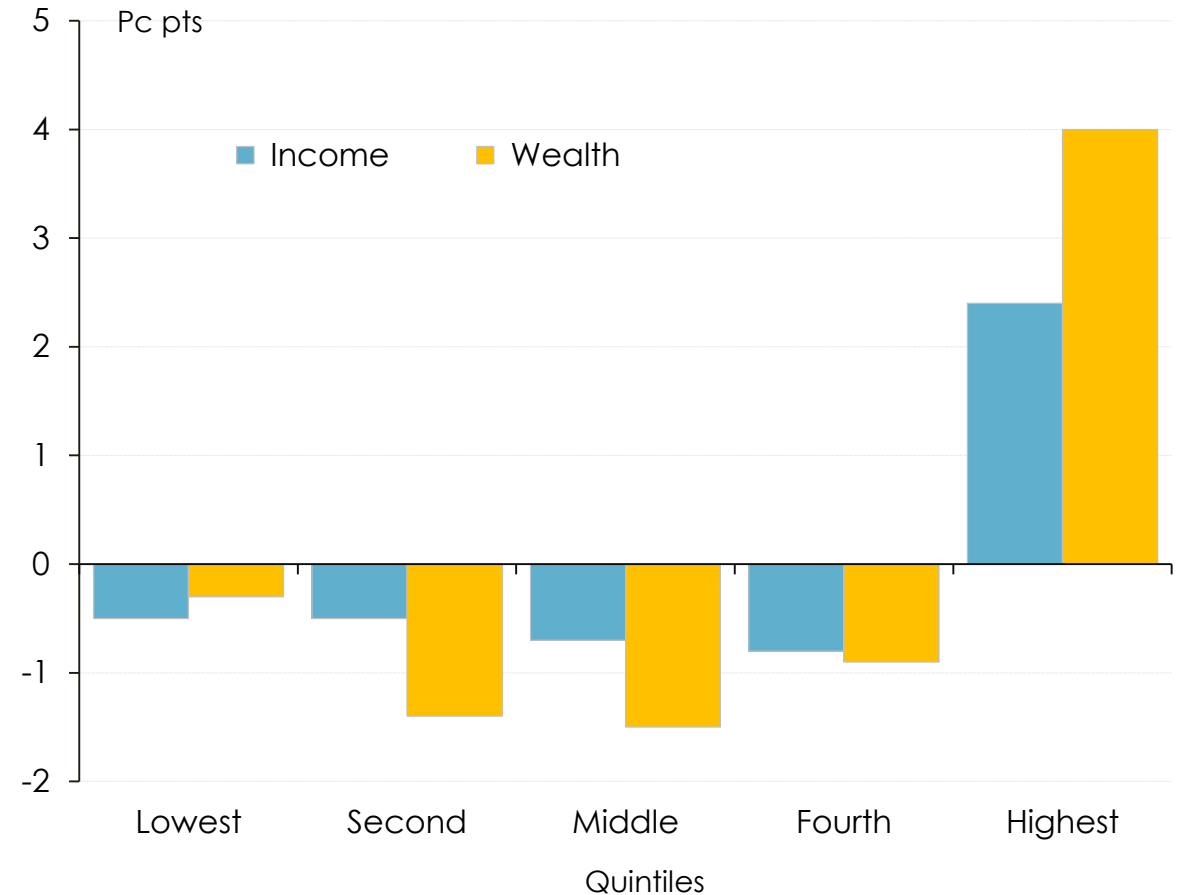
Sources: ABS

Income and (especially) wealth have become less equally distributed over the past decade – although not as much as in many other countries

Change in level of household disposable income and wealth, 2003-04 to 2013-14



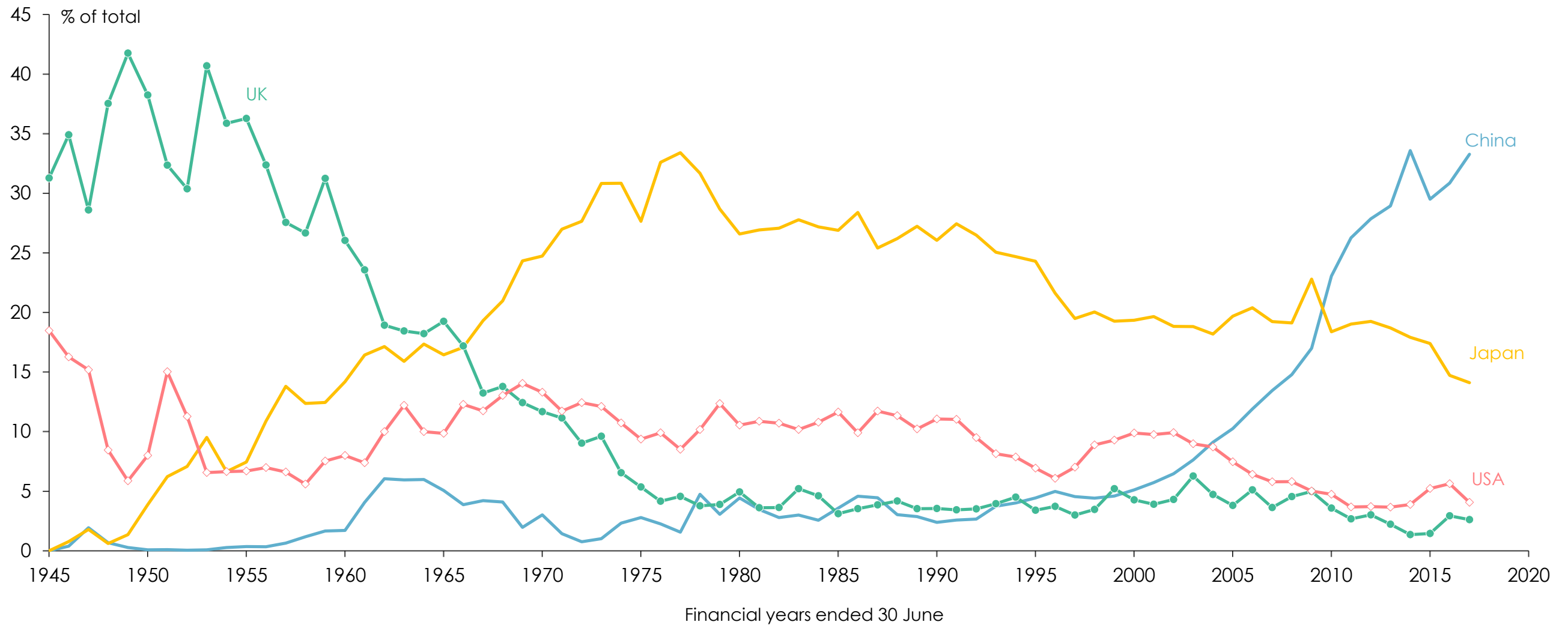
Change in shares of household disposable income and wealth, 2003-04 to 2013-14



Note: 'Quintiles' are 20% shares of Australian households ranked in ascending order of disposable income – and 'equivalized' for differences in the average number of people per household. Incomes and wealth are in 2013-14 dollars. Source: Australian Bureau of Statistics, *Household Income and Wealth 2013-14* (catalogue no. 6523.0).

Australia's export income is now more dependent on a single market (China) than at any time since the 1950s

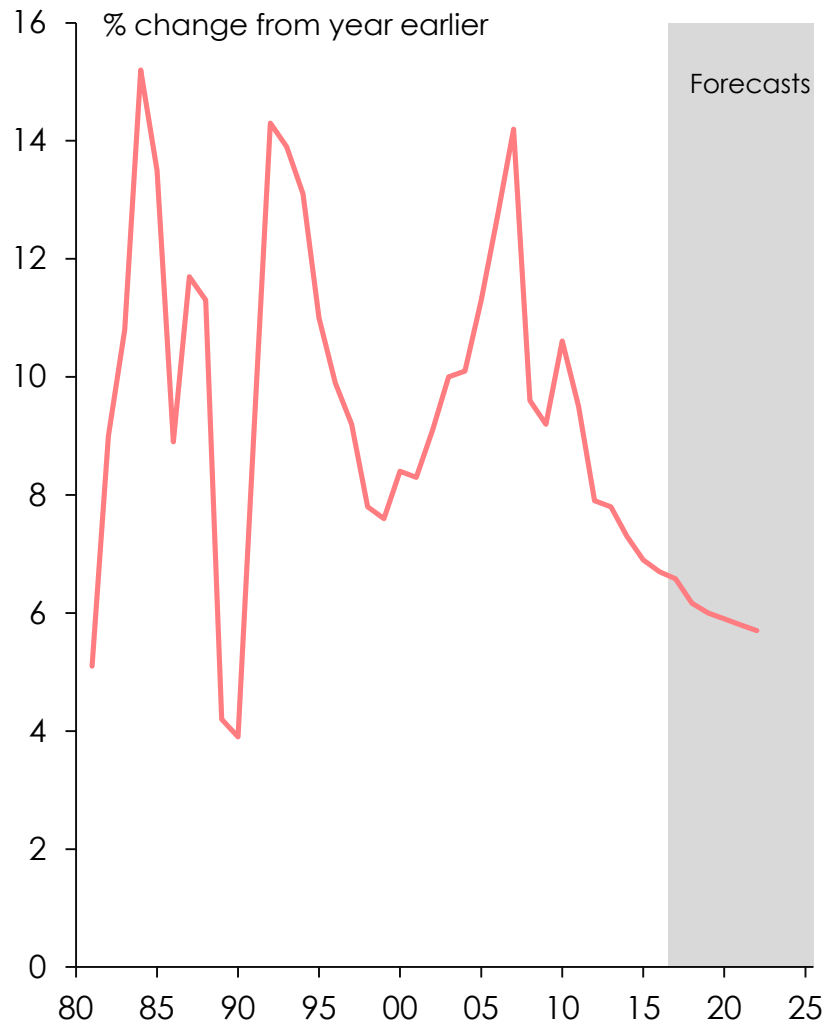
Australia's major merchandise exports markets, 1945-2017



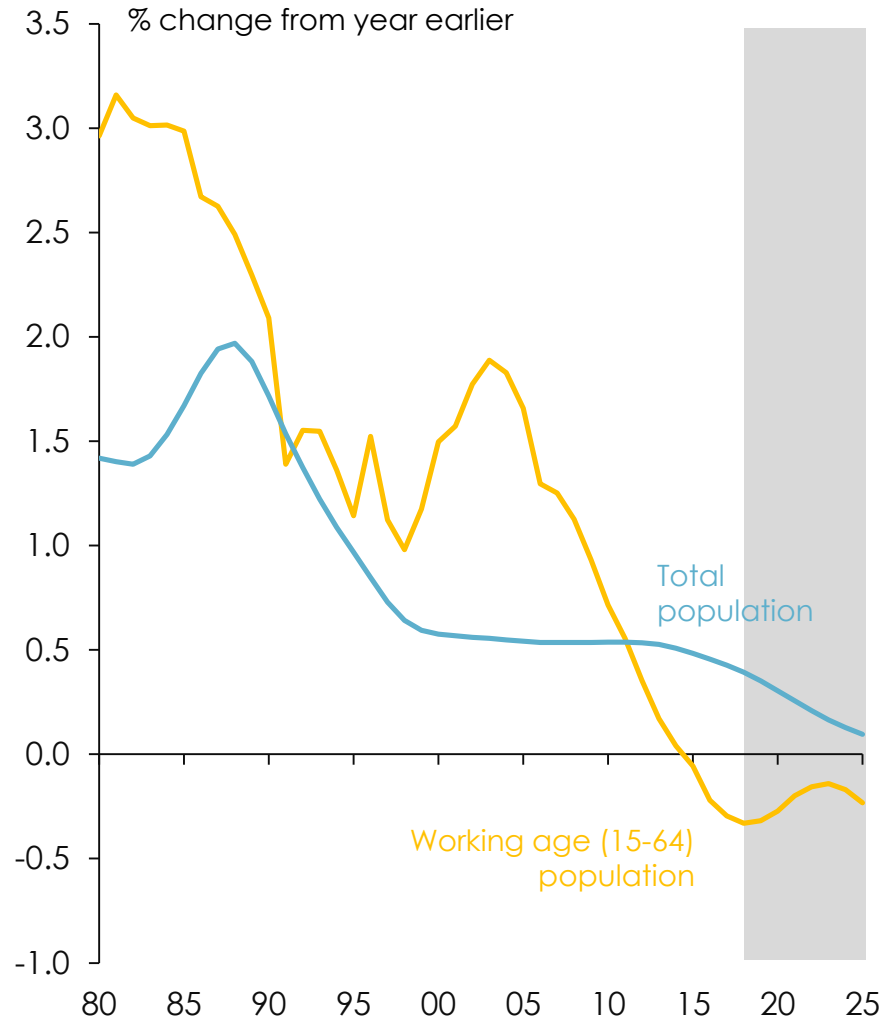
Sources: Department of Foreign Affairs and Trade, *Trade and Investment Statistics*; ABS.

Australia is thus exposed to any abrupt slowing in Chinese economic growth – for example as a result of problems in China’s financial system

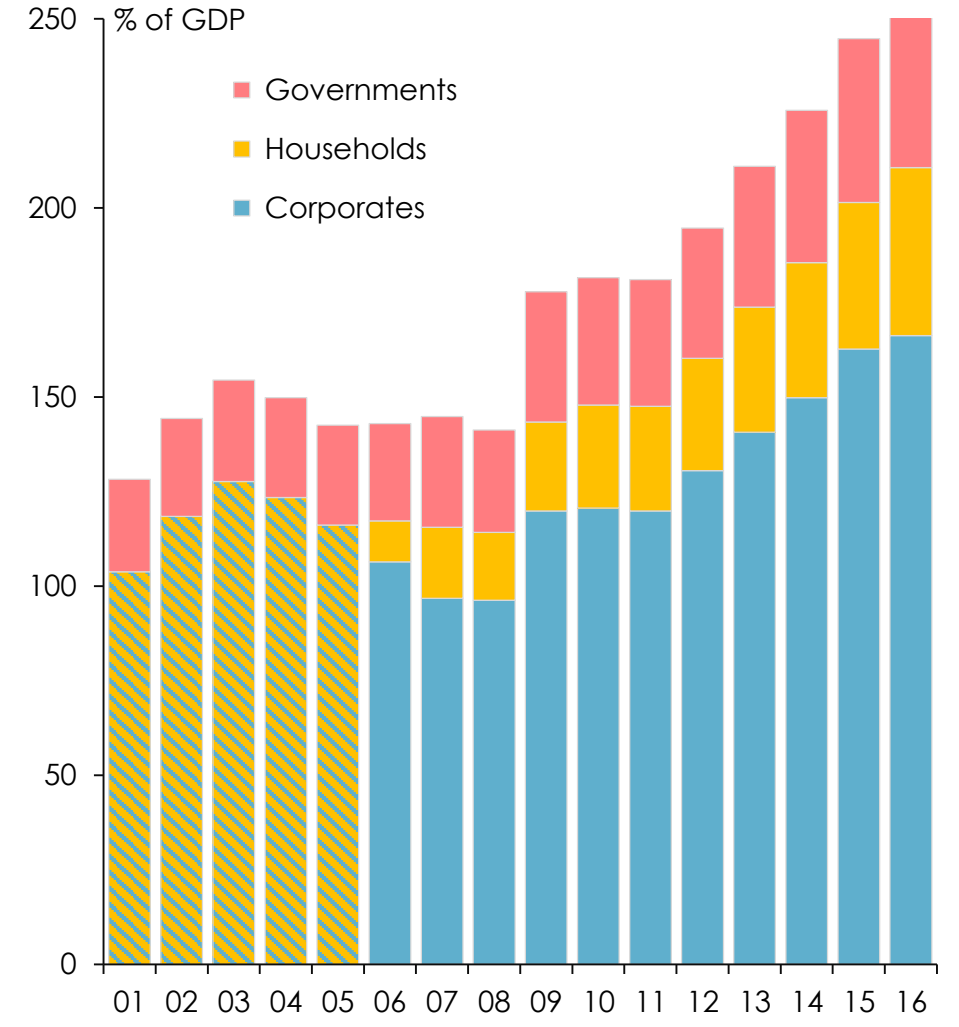
China real GDP growth



Chinese population



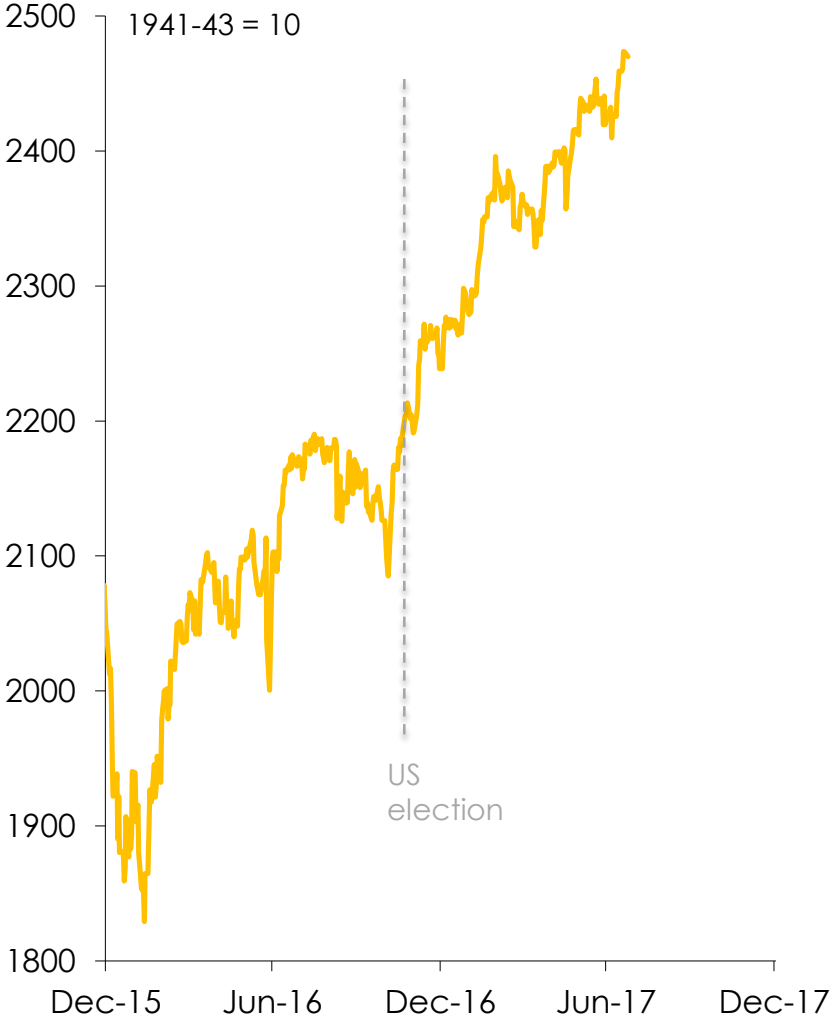
Chinese debt



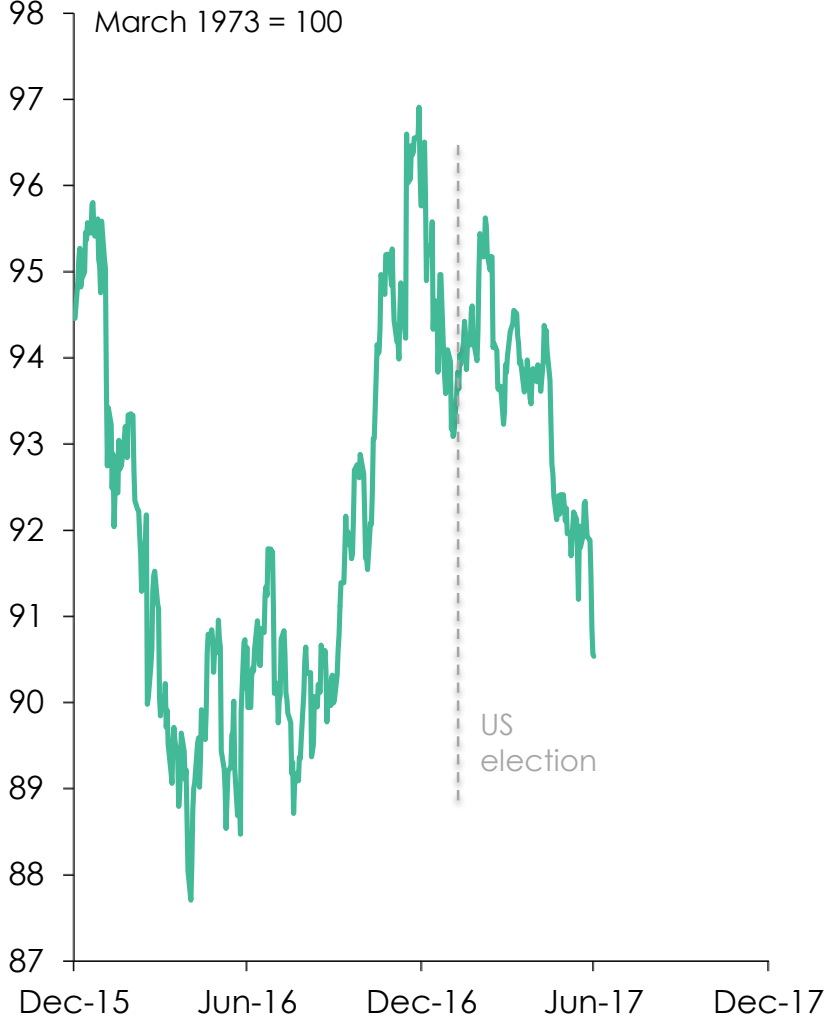
Sources: China National Bureau of Statistics; IMF; UN Economic & Social Affairs Division, Population Branch; Bank for International Settlements

The share market still loves The Donald – but other financial markets are now much less convinced

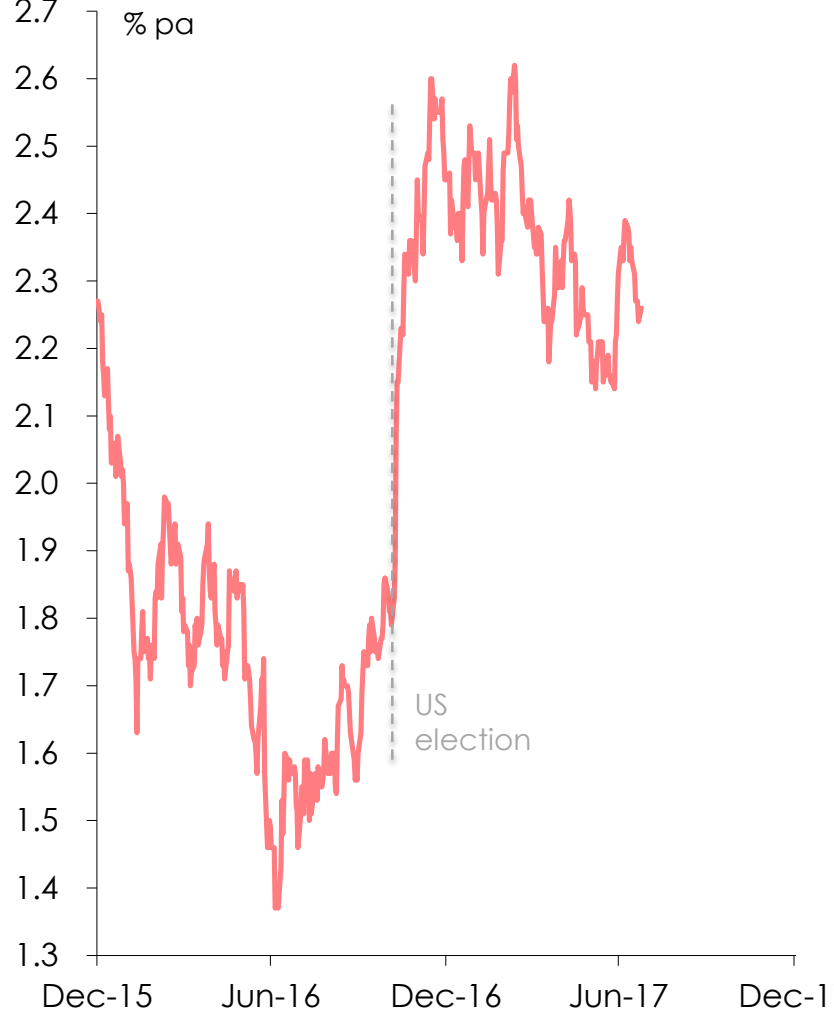
S&P 500



US 10-year bond yield



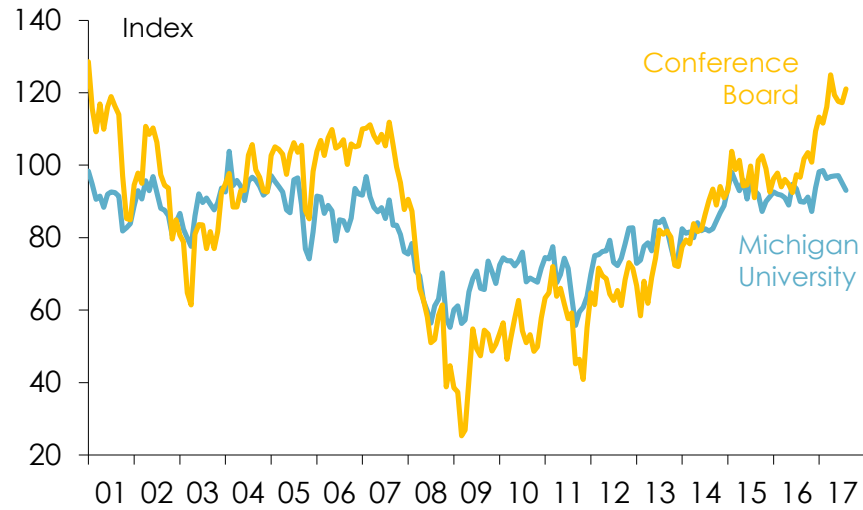
US dollar



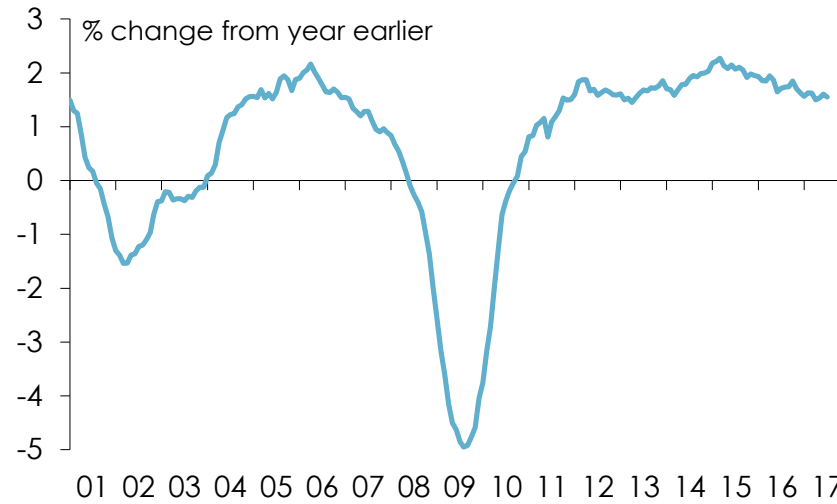
Source: Thomson Reuters Datastream.

US consumer and business confidence appear to have peaked; the economy hasn't picked up; and US interest rates may go back 'on hold'

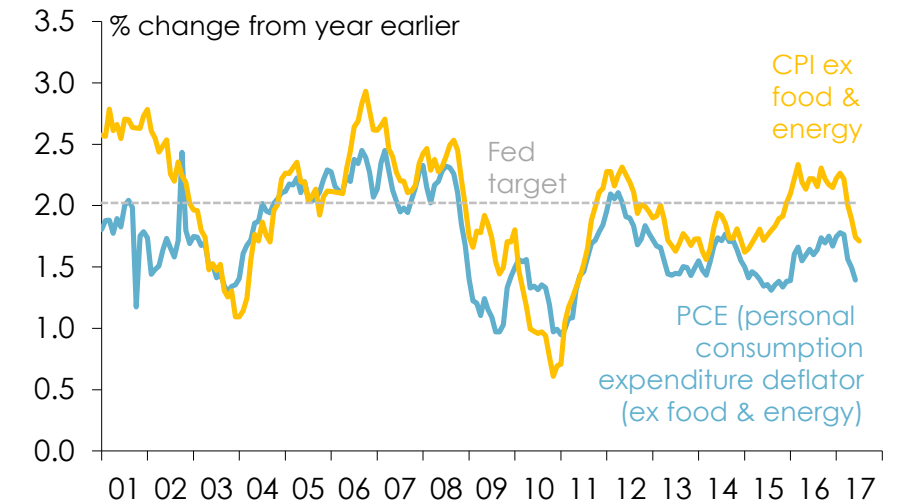
Consumer confidence



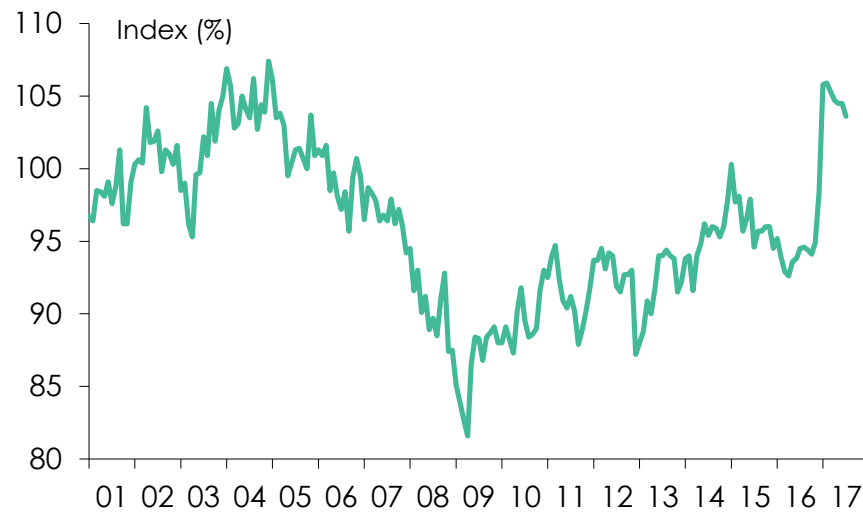
Employment



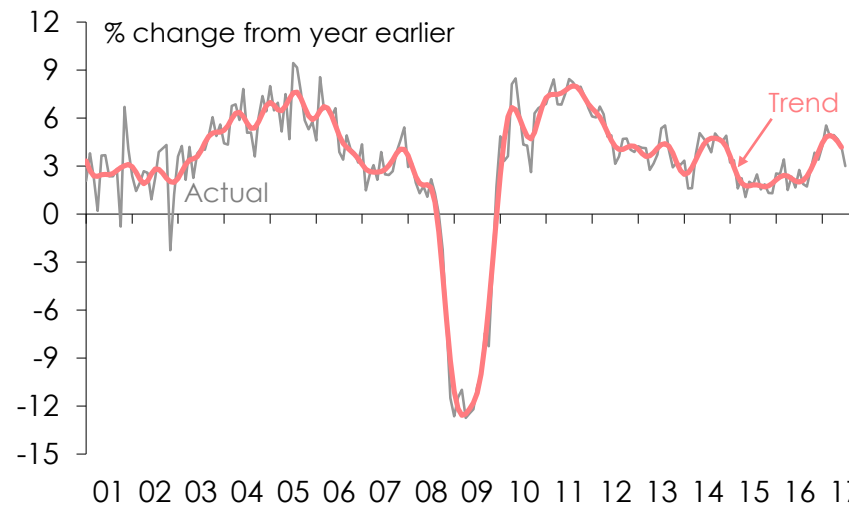
'Core' inflation



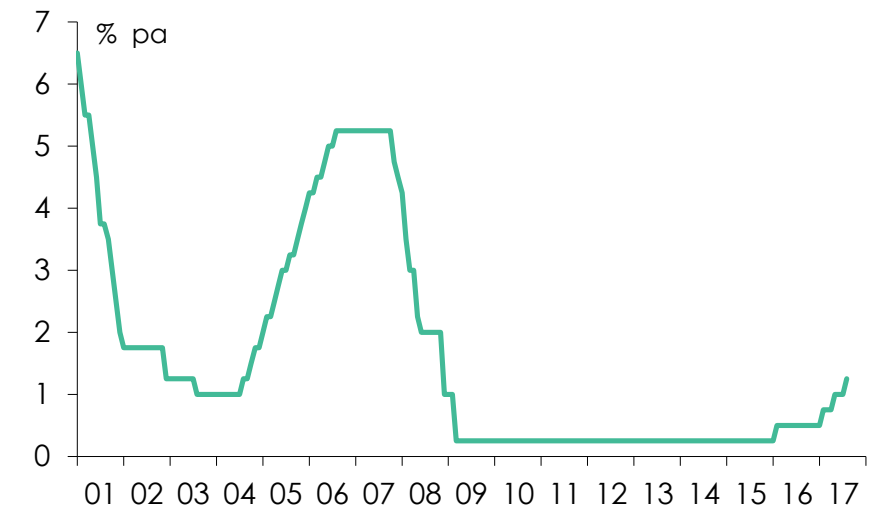
Small business optimism



Retail sales



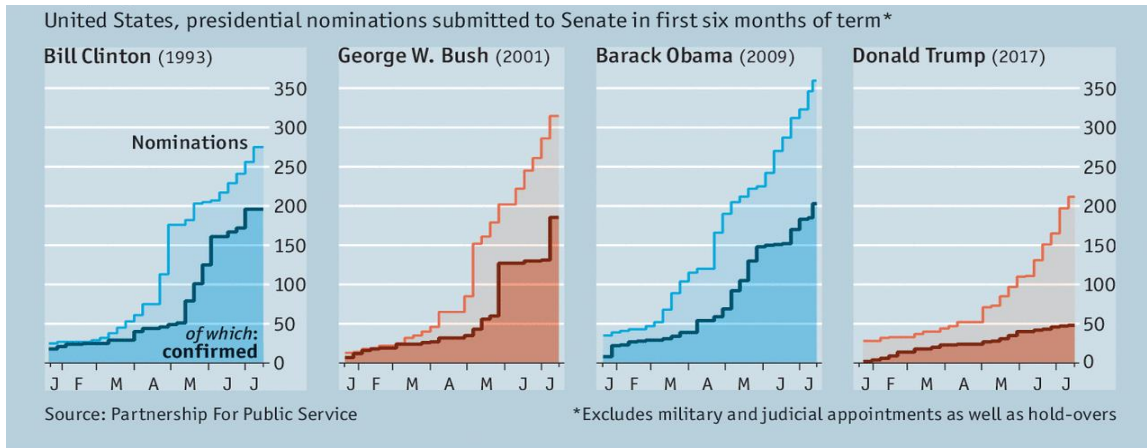
Fed funds (cash) rate



Sources: The Conference Board; University of Michigan Survey Research Center; National Federation of Small Businesses; US Bureau of Labor Statistics; US Commerce Department; US Bureau of Economic Analysis; US Federal Reserve.

But it's also the Trump Administration's sheer incompetence that is weighing on market sentiment

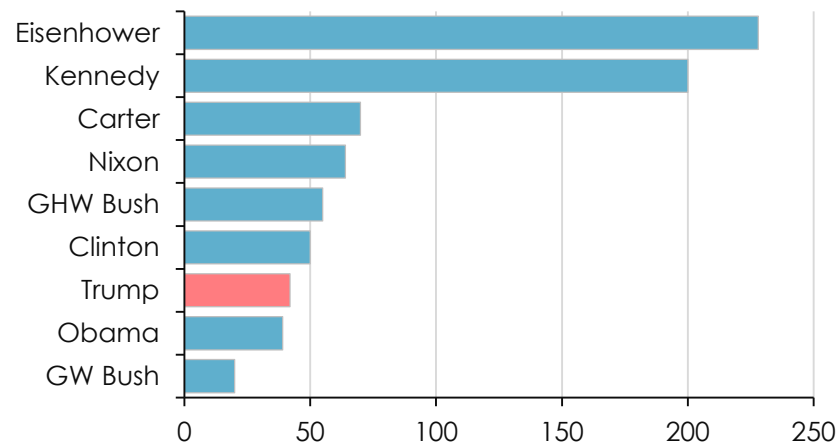
Lack of preparation



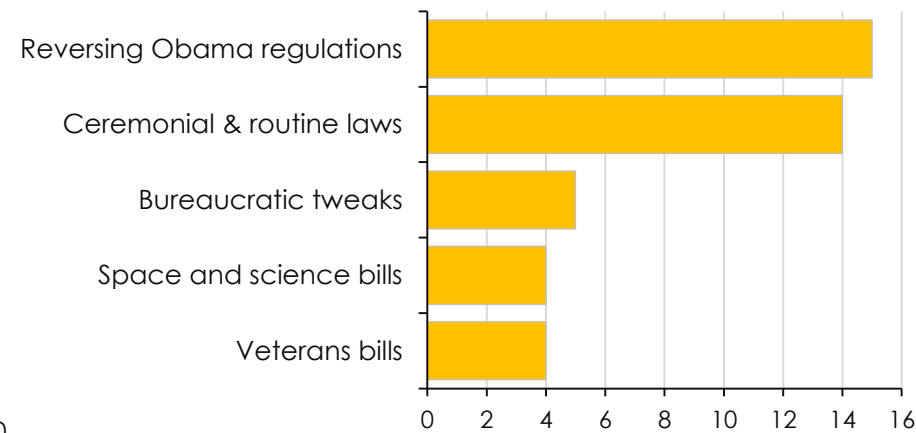
Economist.com

Lack of legislative achievements

Number of bills signed in first six months



Content of bills signed by Trump



Mixed record on promises

- A few major campaign promises implemented
 - Conservative justice appointed to Supreme Court
 - Withdrawal from TPP and Paris climate accords
 - Increased military spending
- Zero progress in other areas
 - Health care
 - Tax cuts
 - Infrastructure spending
 - Wall on Mexican border

Lack of detail

2017 Tax Reform for Economic Growth and American Jobs

The Biggest Individual And Business Tax Cut In American History

Goals For Tax Reform

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families—especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

Individual Reform

- Tax relief for American families, especially middle-income families:
 - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
 - Doubling the standard deduction
 - Providing tax relief for families with child and dependent care expenses
- Simplification:
 - Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers
 - Protect the home ownership and charitable gift tax deductions
 - Repeal the Alternative Minimum Tax
 - Repeal the death tax
- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

Business Reform

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

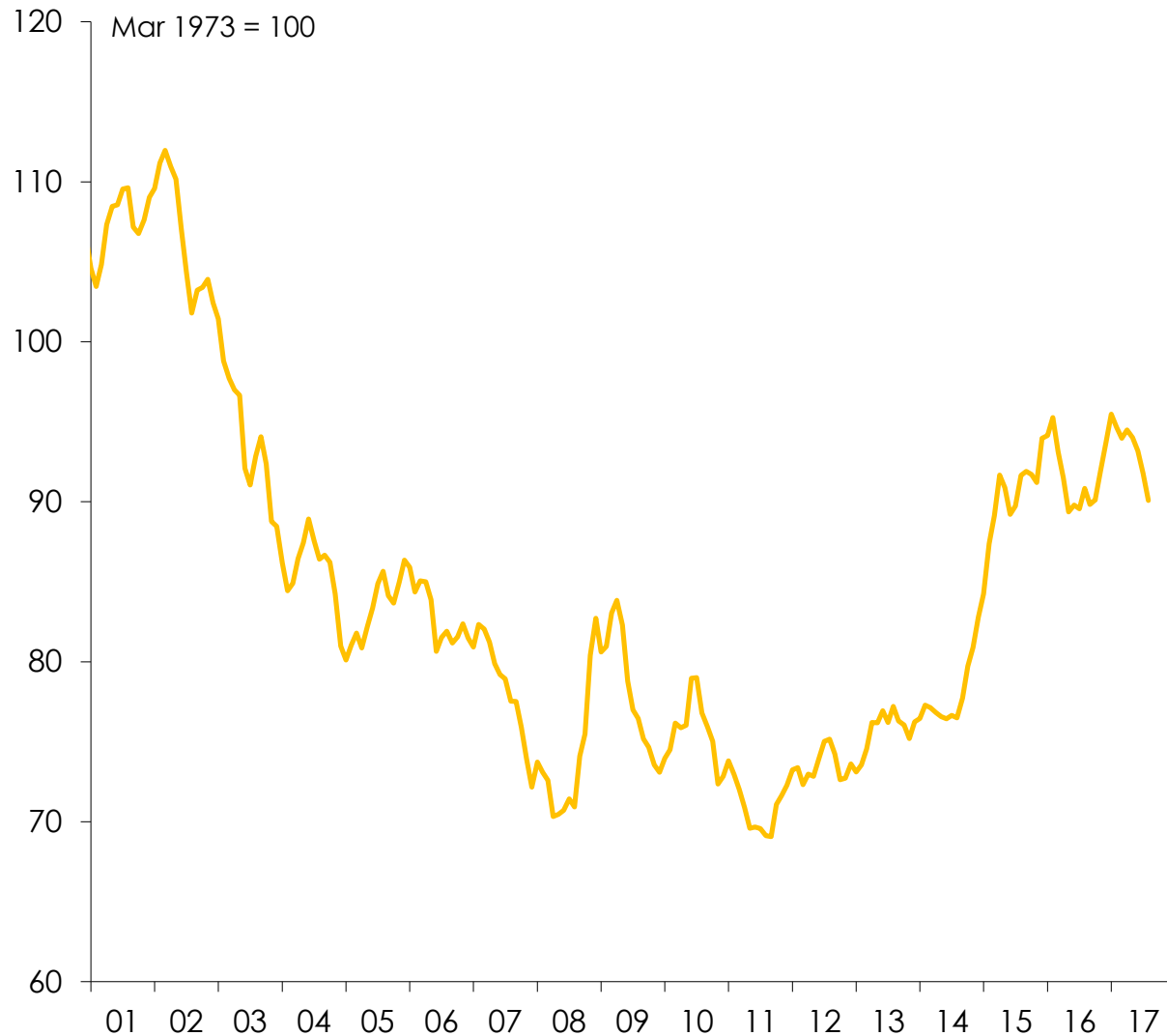
Process

- Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive—and can pass both chambers.

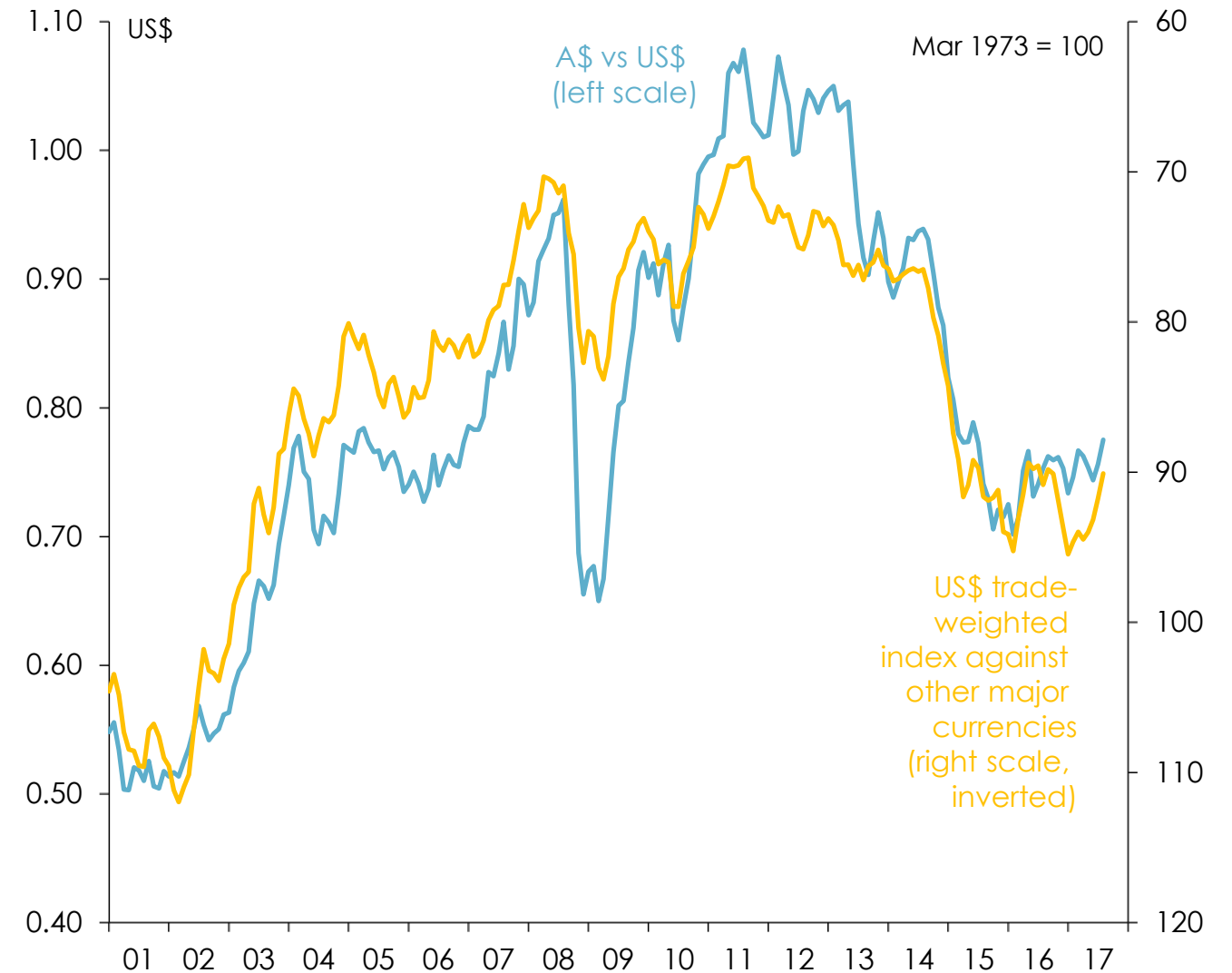
Sources: The Economist; New York Times; Politifact; CNN.

What happens to the US\$ will probably determine the direction for the A\$ – if the US\$ keeps falling, then the RBA has a big problem

US\$ vs other currencies



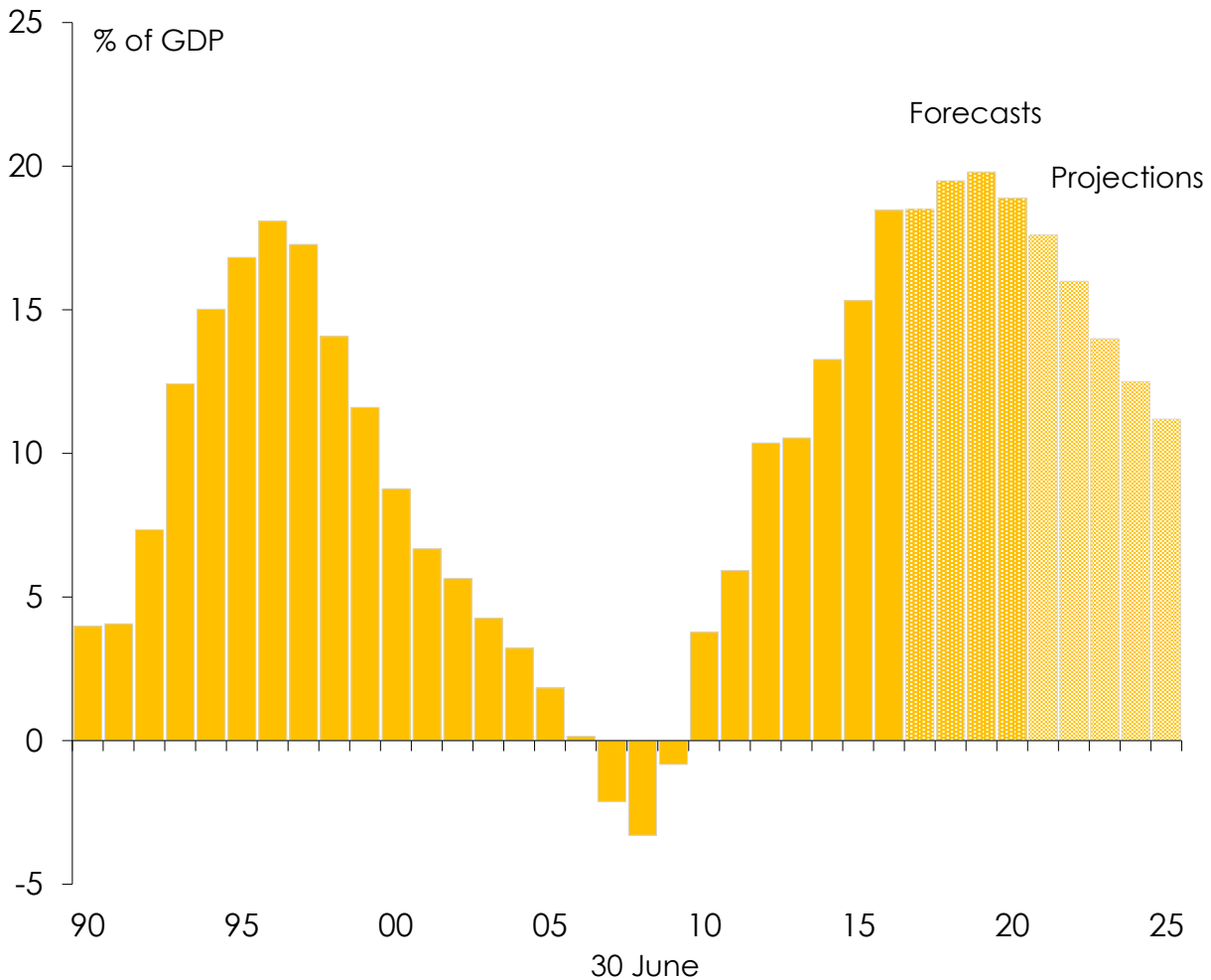
A\$-US\$ and US\$ vs other currencies



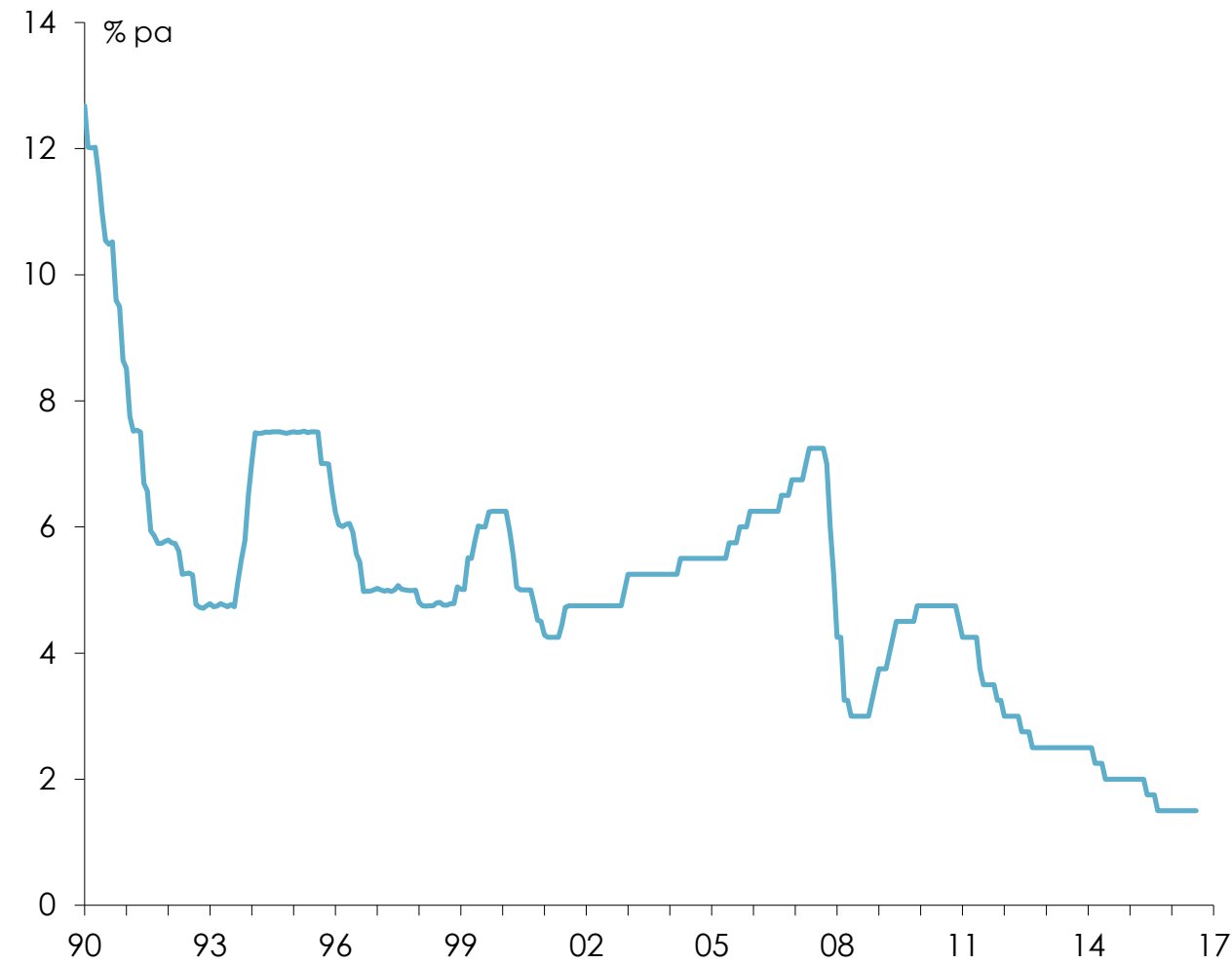
Sources: Thomson Reuters; US Federal Reserve ; Reserve Bank of Australia.

Other than allowing the currency to fall, Australia no longer has many policy options for responding to any new economic shocks

Australian Government net debt



RBA cash rate



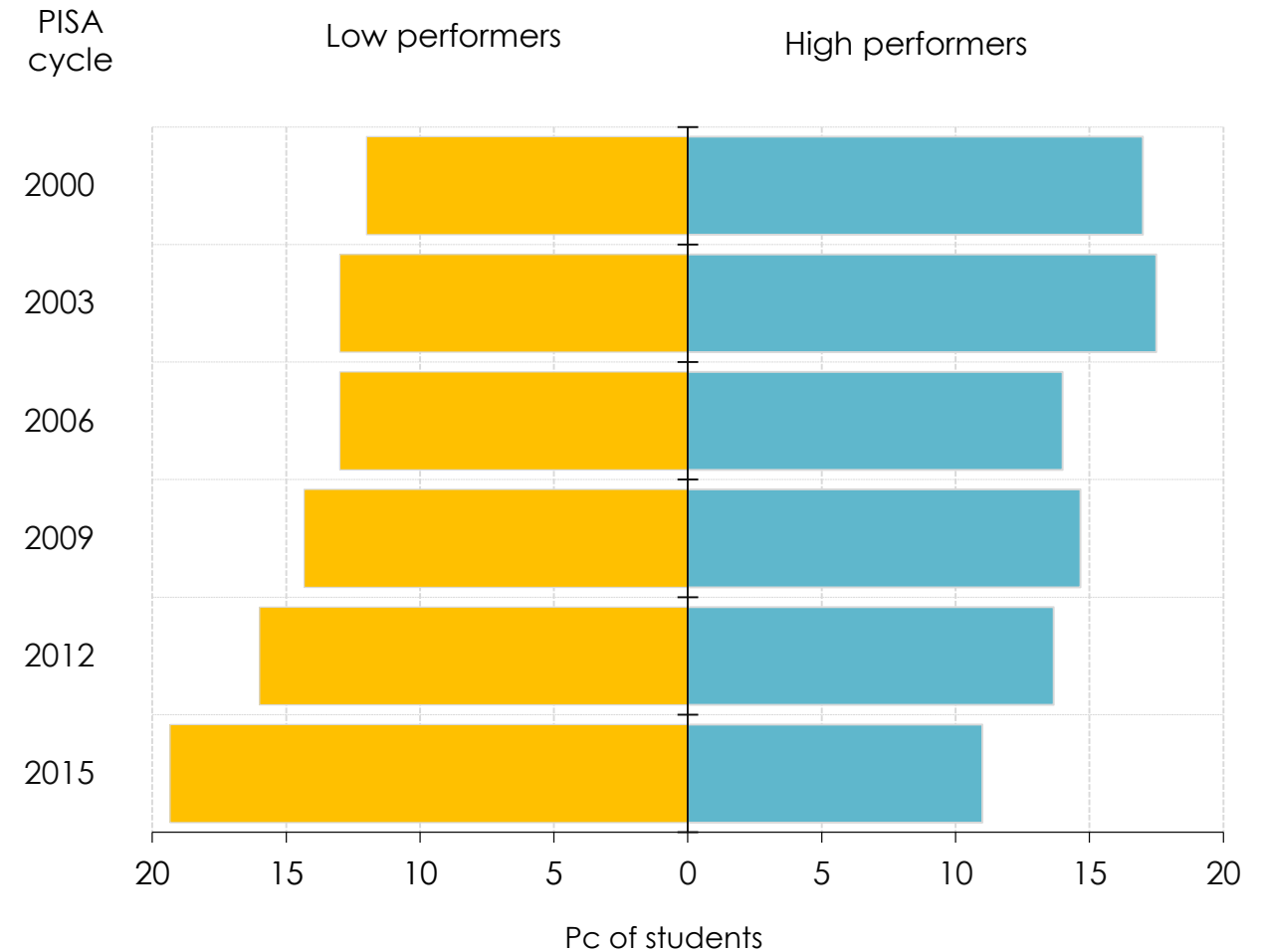
Sources: Australian Government, 2017-18 Budget Paper No. 1 ; Reserve Bank of Australia.

The quality of Australian school education seems to be deteriorating, both in absolute terms and relative to other countries

Australia's average PISA scores compared with OECD average



High and low performers in Australia

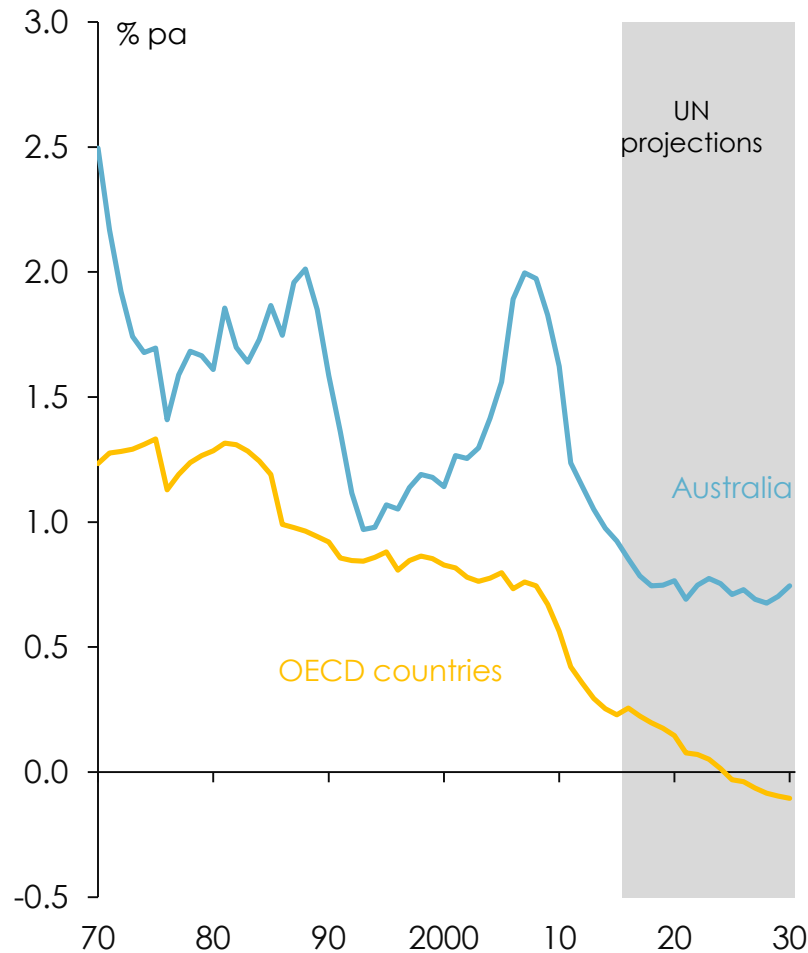


Note: Scores are averaged across reading (2000 onwards), mathematical literacy (2003 onwards) and scientific literacy (2006 onwards).

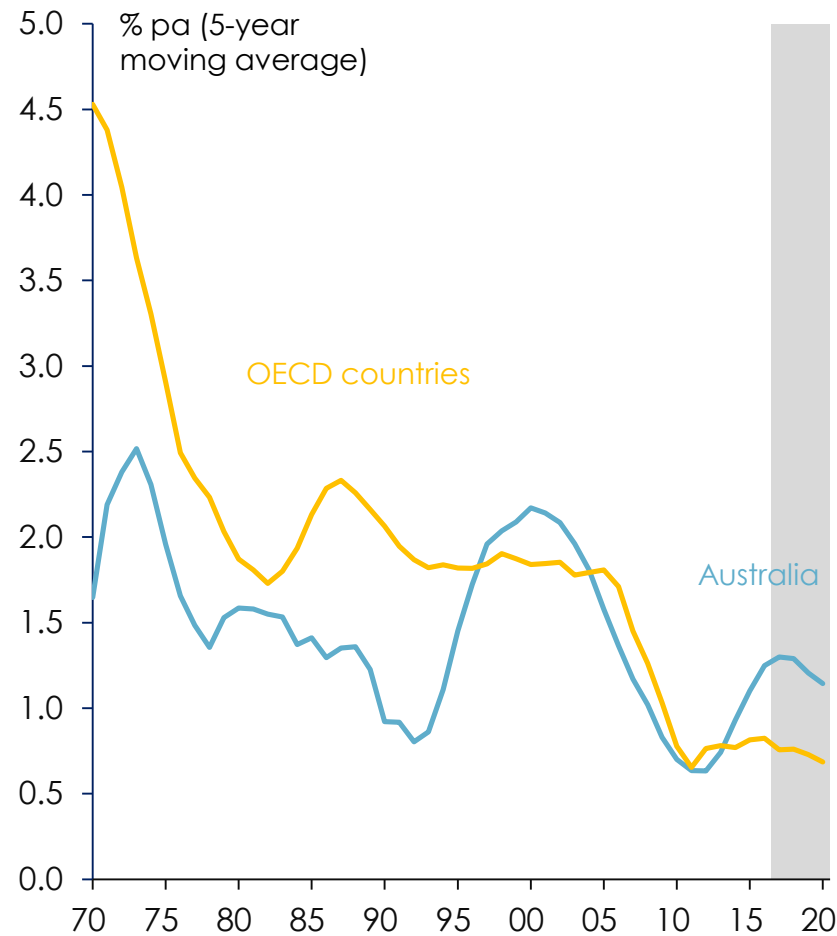
Source: Sue Thomson, Lisa De Bortoli and Catherine Underwood, [PISA 2015: A first look at Australian student's \[sic\] performance](#), Australian Council for Educational Research, December 2016.

Demographic change is starting to constrain Australian economic growth – though not nearly as much as in other countries

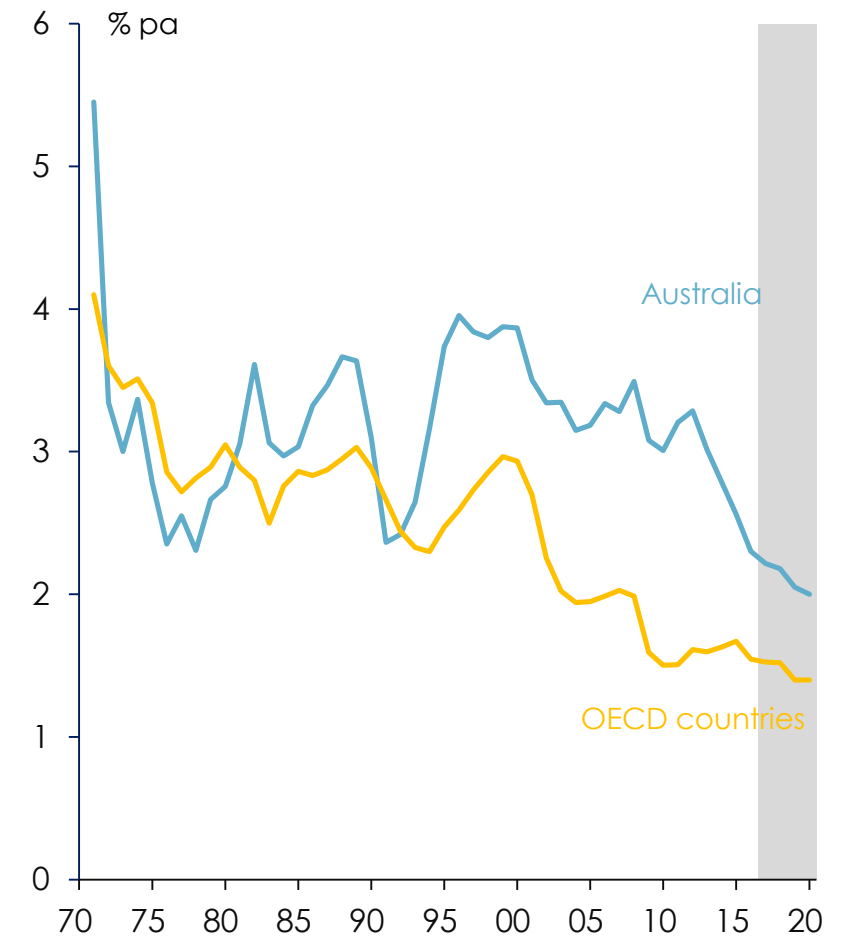
Working age (15-65) population growth



Labour productivity growth



Potential GDP growth



Sources: United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2017 Revision*; Organization for Economic Co-operation & Development (OECD), *Economic Outlook* database. 'Potential growth' means growth in the level of real GDP assuming full employment of the available labour force.

**So what is the outlook for the
Australian economy?**

The Australian economic outlook in a nutshell

- ❑ **In the absence of any major adverse shocks, the Australian economy is likely to continue ‘puttering along’, with only modest growth (by the standards of the past 25 years)**
 - exports and public infrastructure investment would be the main drivers of economic growth
 - household income and spending growth would remain sluggish
 - a clear risk that public frustration with ‘more of the same’ leads to pressure for more ‘populist’ economic policy settings (as in the US, UK etc)
 - and to counter that, more attention needs to be given to distributional (equity) questions
- ❑ **In those circumstances, Australian interest rates will probably start rising gradually from around the middle of next year, but nonetheless remain very low by historical standards**
 - a serious complication would be if the Australian dollar continued rising
- ❑ **However it would be foolish to assume that there won’t be any major adverse shocks ...**
 - the probability of a housing market ‘correction’ (or worse) is rising
 - so is the risk of a ‘hard landing’ in China (eventually)
 - and who knows how the ‘Trump experiment’ is likely to end?
- ❑ **... and Australia is less well-placed to withstand a major shock than we were a decade ago**
 - we would need to hope that the A\$ fell a lot, in the event of a shock
 - and we would probably need to give up our AAA-rating in order to pursue renewed fiscal stimulus
- ❑ **If we want sustainably faster economic growth, we need to find ways of boosting productivity**
 - and that probably requires greater investment in human capital, technology and infrastructure