

THE NEW WORLD OF ECONOMIC DISRUPTORS – FROM BREXIT TO TRUMP

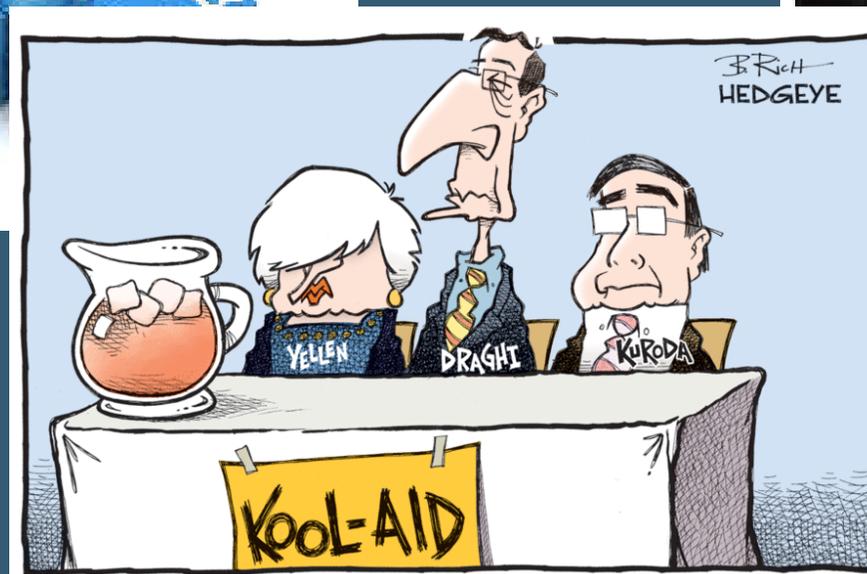
PRESENTATION TO FIRST SAMUEL'S INVESTMENT FORUM

LEONDA BY THE YARRA, HAWTHORN, MELBOURNE - 16TH AUGUST 2016

bettercallsaul.com.au

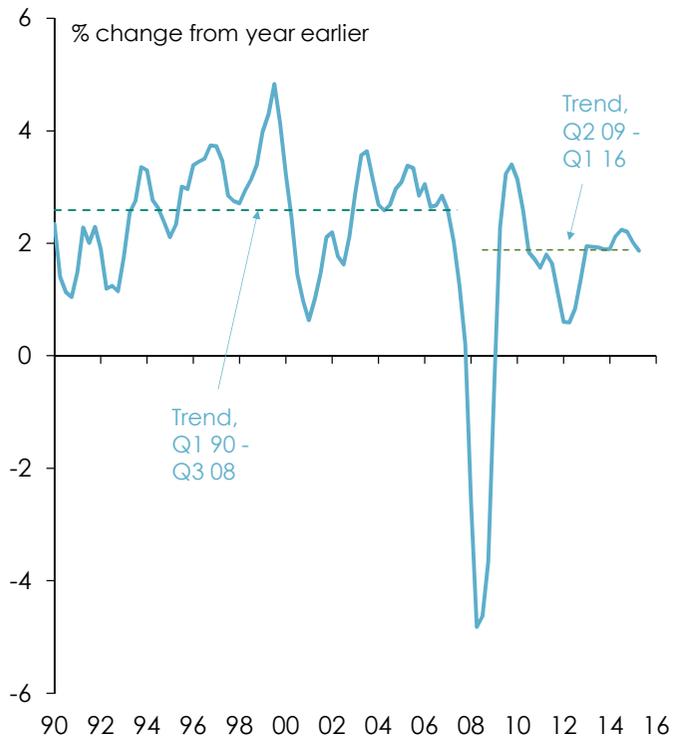
SAUL ESLAKE

What's happening to the world economy?

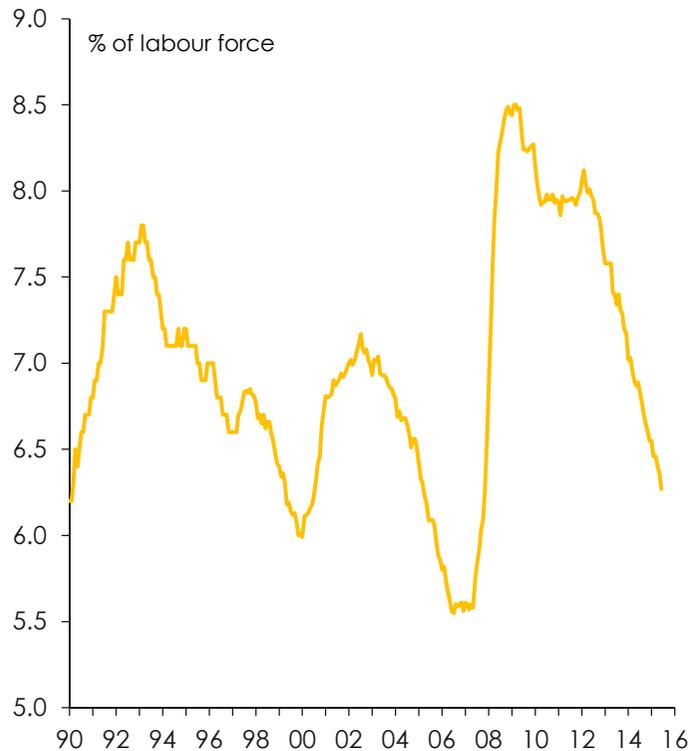


Economic growth across 'advanced' economies has been consistently weaker than expected - yet unemployment has fallen sharply

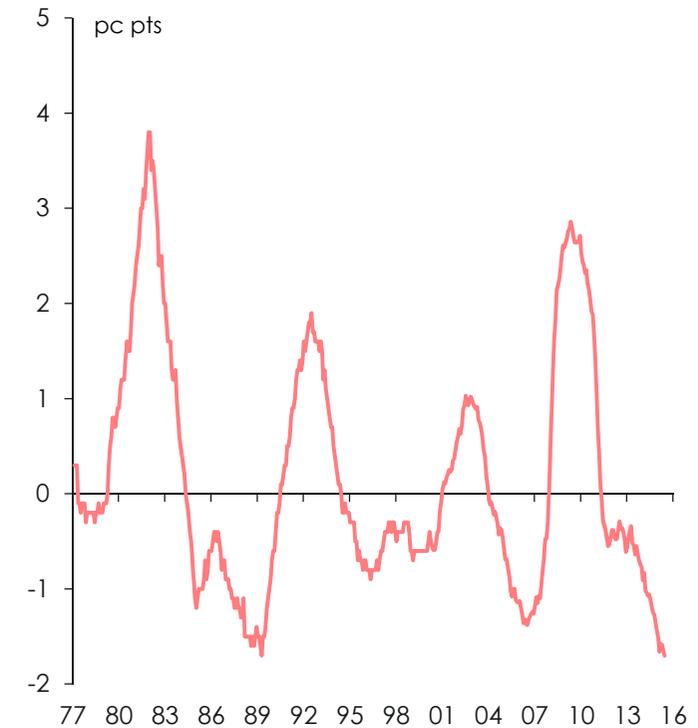
OECD area real GDP growth



OECD area unemployment rate



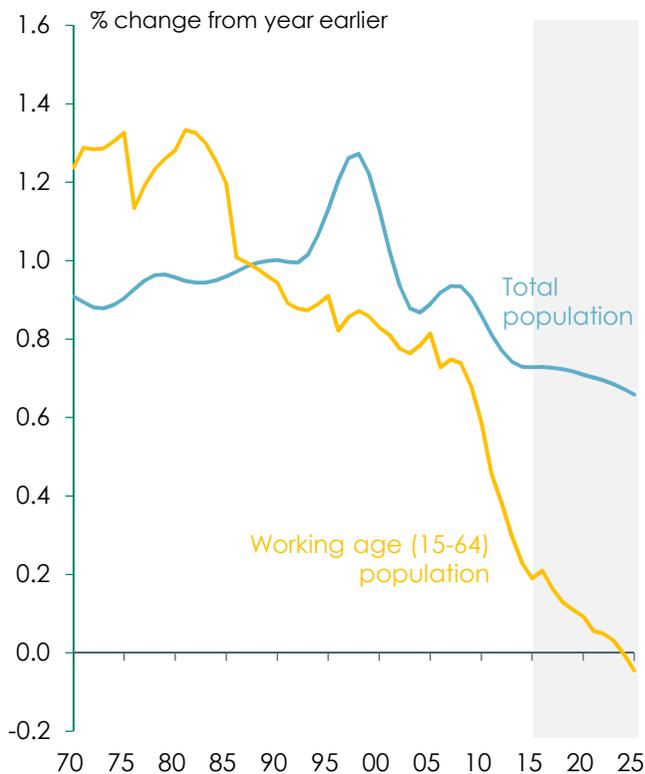
3-year change in OECD unemployment rate



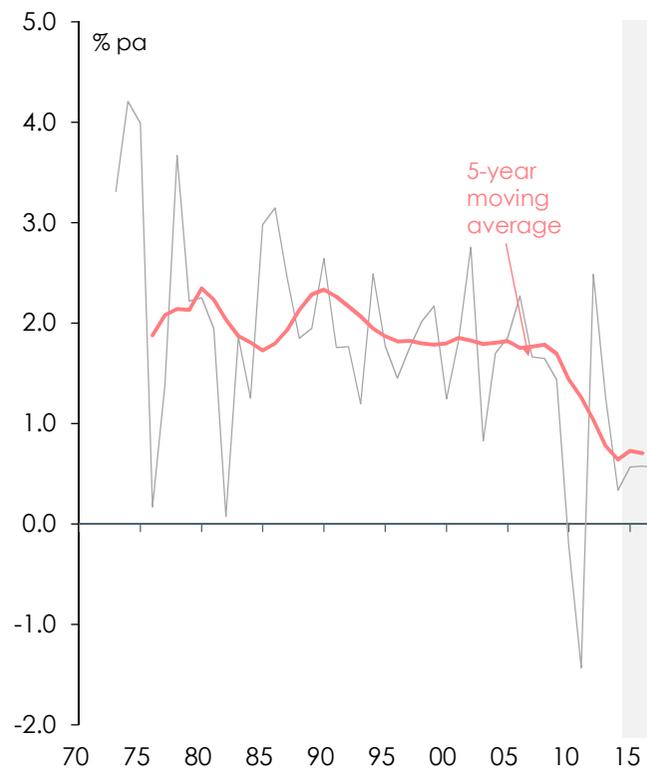
Source: Organization for Economic Co-operation & Development (OECD). The OECD comprises 34 (mostly) 'advanced' economies in North America and Europe, plus Japan, Korea, Australia, New Zealand, Mexico, Chile, Turkey & Israel.

It could be that GDP growth is being understated - or it could be that 'potential growth' has slowed

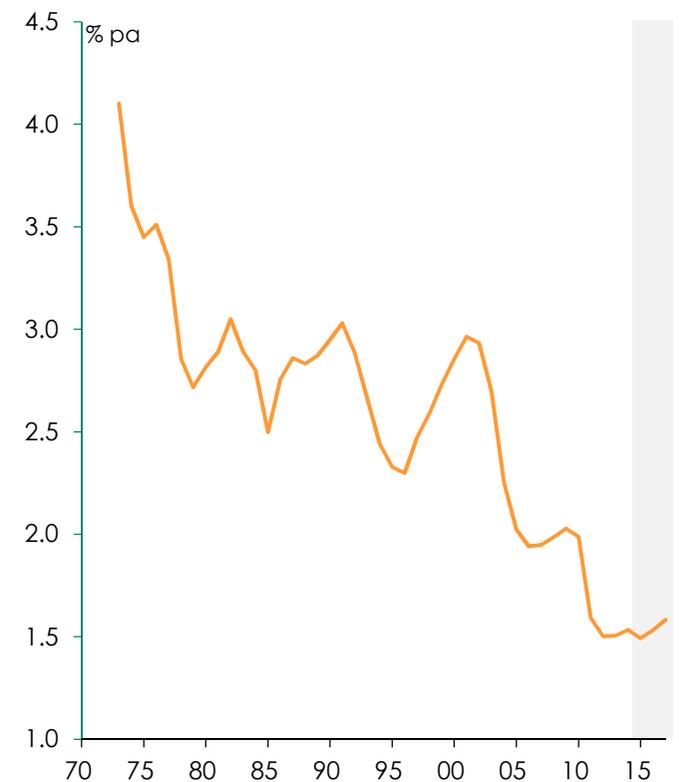
OECD area population growth



OECD area labour productivity growth



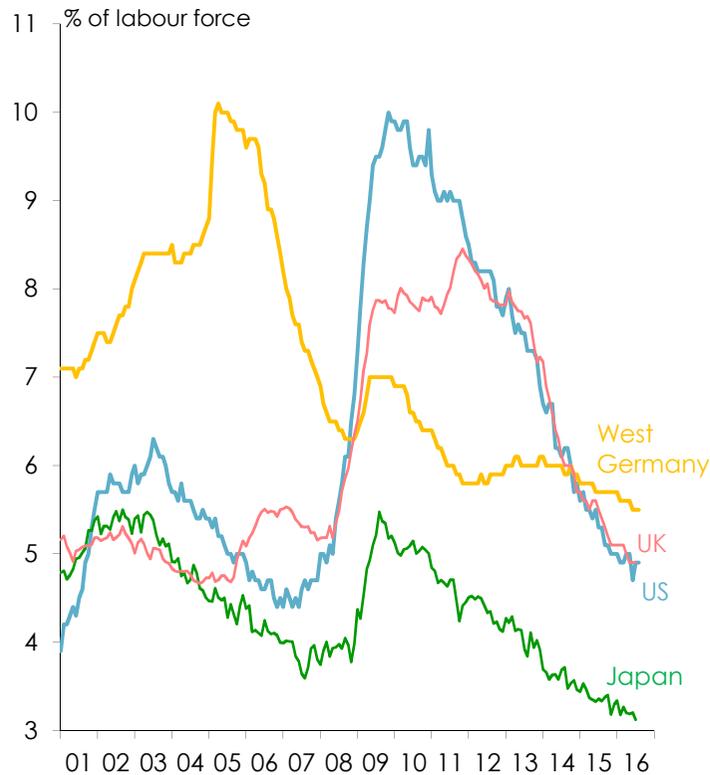
OECD area potential GDP growth



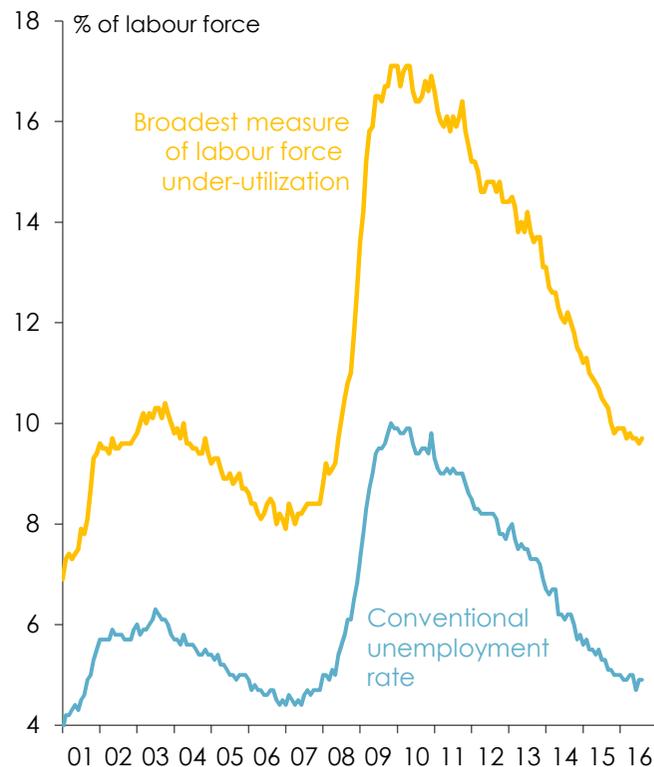
Sources: United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2015 Revision*; Organization for Economic Co-operation & Development (OECD), *Economic Outlook* database. 'Potential growth' means growth in the level of real GDP assuming full employment of the available labour force.

The four largest 'advanced' economies are now more or less at 'full employment' ...

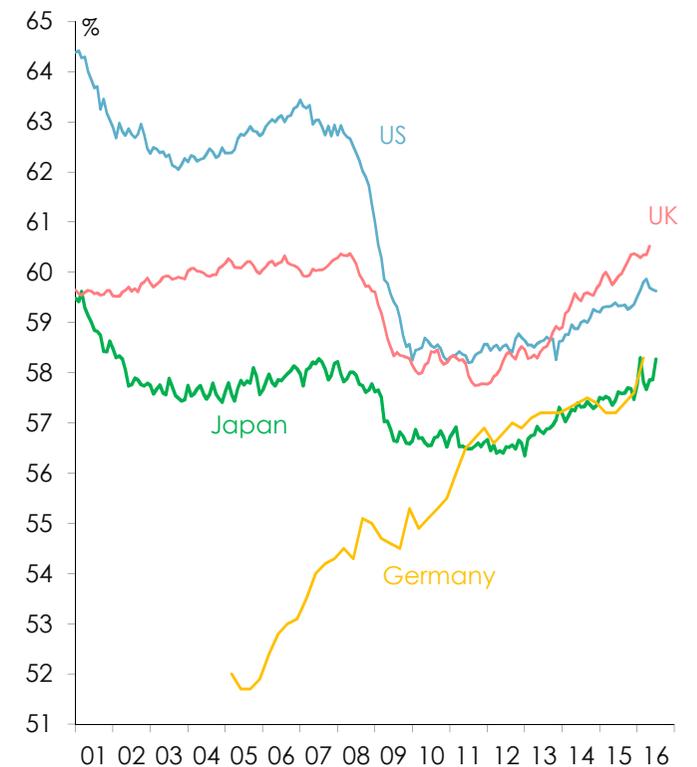
Four largest 'advanced' economies - unemployment



Broader measures of US 'under-employment'



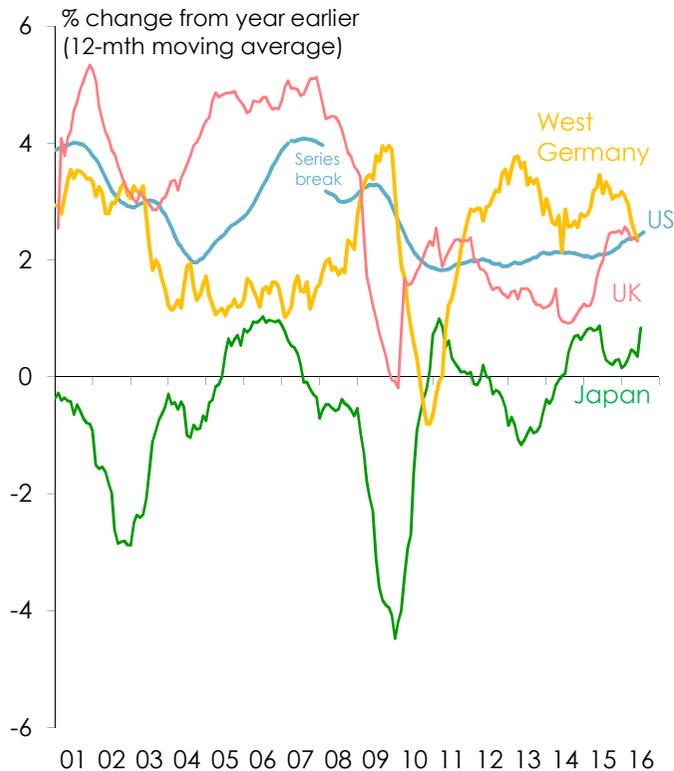
Employment-population ratios



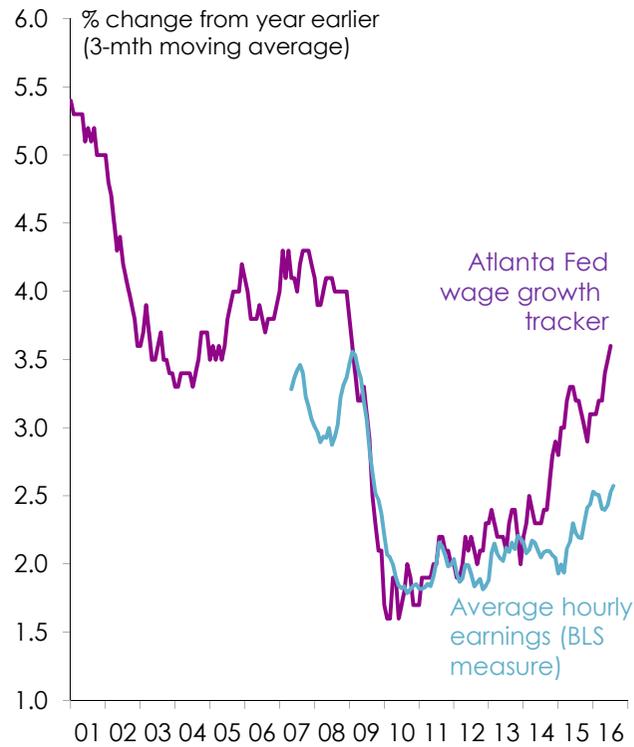
Sources: US Bureau of Labor Statistics; Japan Labour Ministry; Statistisches Bundesamt; UK Office of National Statistics; Thomson Reuters Datastream.

Inflation is still very low in the largest 'advanced' economies – but deflation risks are diminishing

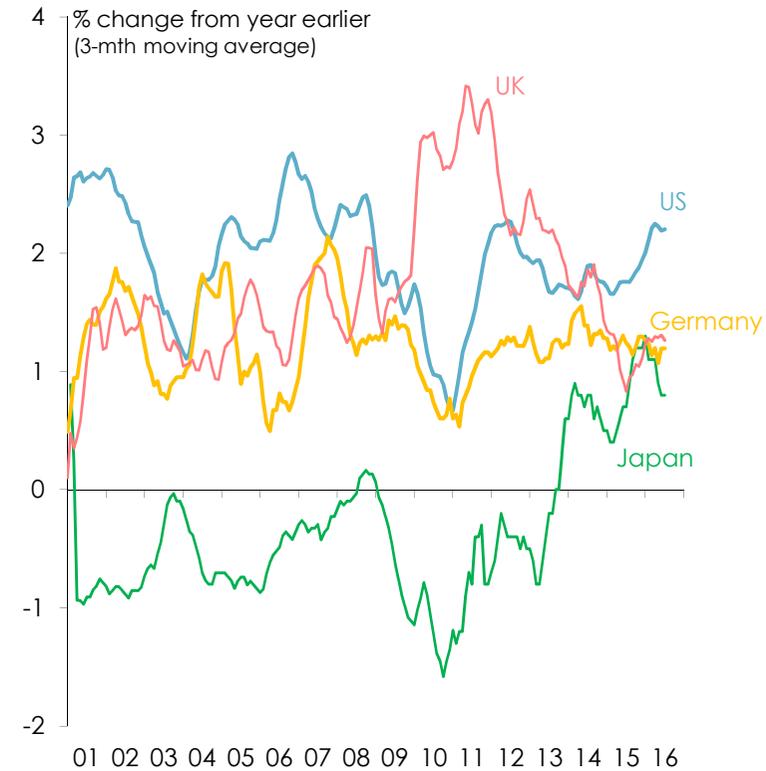
Wage inflation – four largest 'advanced' economies



US wage inflation – alternative measures



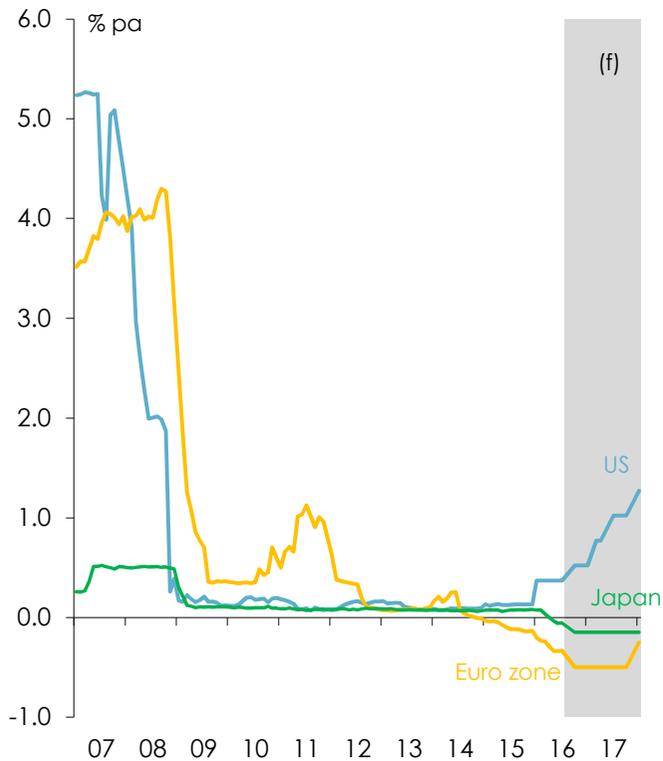
'Core' CPI inflation – four largest 'advanced' economies



Note: The Atlanta Fed wage growth tracker measures the increase in the hourly earnings of identified individuals over 12-month intervals. It excludes those with annual earnings exceeding US\$150K, and hourly earnings less than US\$2.13. 'Core' inflation figures for Japan exclude effects of GST increase in April 2014.
Sources: US Bureau of Labor Statistics; Federal Reserve Bank of Atlanta; Japan Labour Ministry; Statistics Japan and Bank of Japan; Statistisches Bundesamt; UK Office of National Statistics; Thomson Reuters Datastream.

Interest rates need to go up in the US – and negative rates in Europe and Japan haven't turned out to be such a good idea

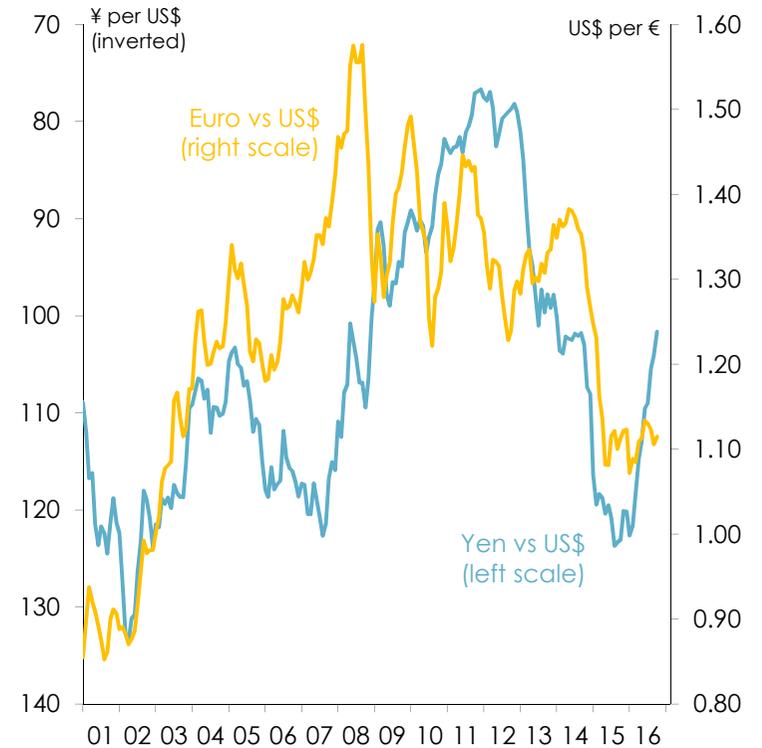
US, Euro area & Japan policy interest rates



Bank share prices



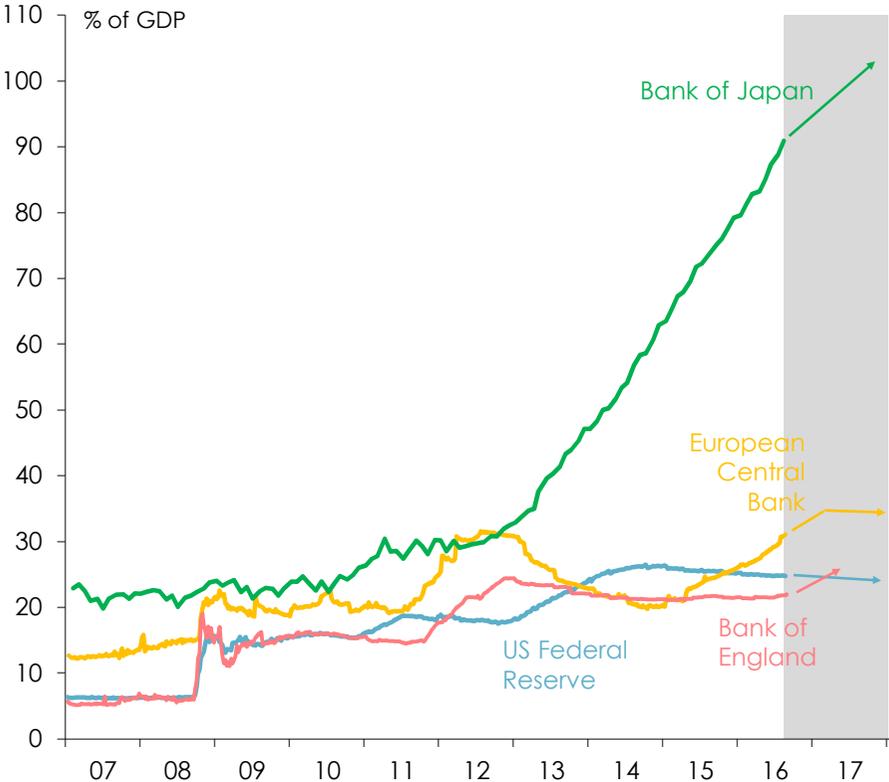
Euro and Japanese yen vs US dollar



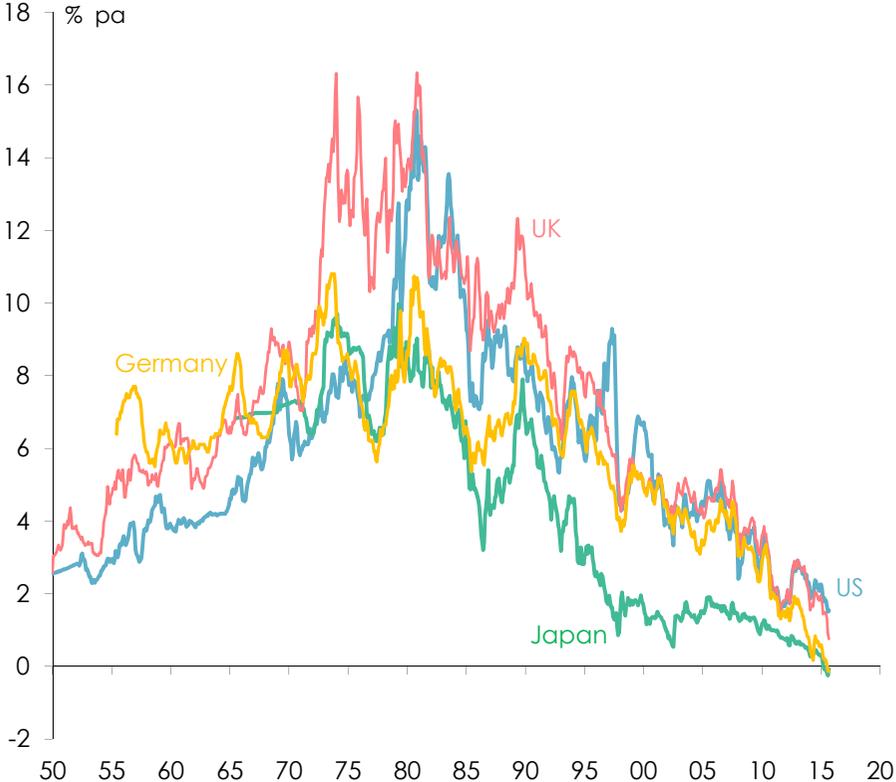
Sources: US Federal Reserve; European Central Bank; Bank of Japan; Thomson Reuters Datastream.

Central bank 'quantitative easing' has been a major factor driving long-term interest rates to record lows (as well as boosting share markets)

Central bank balance sheets



10-year government bond yields

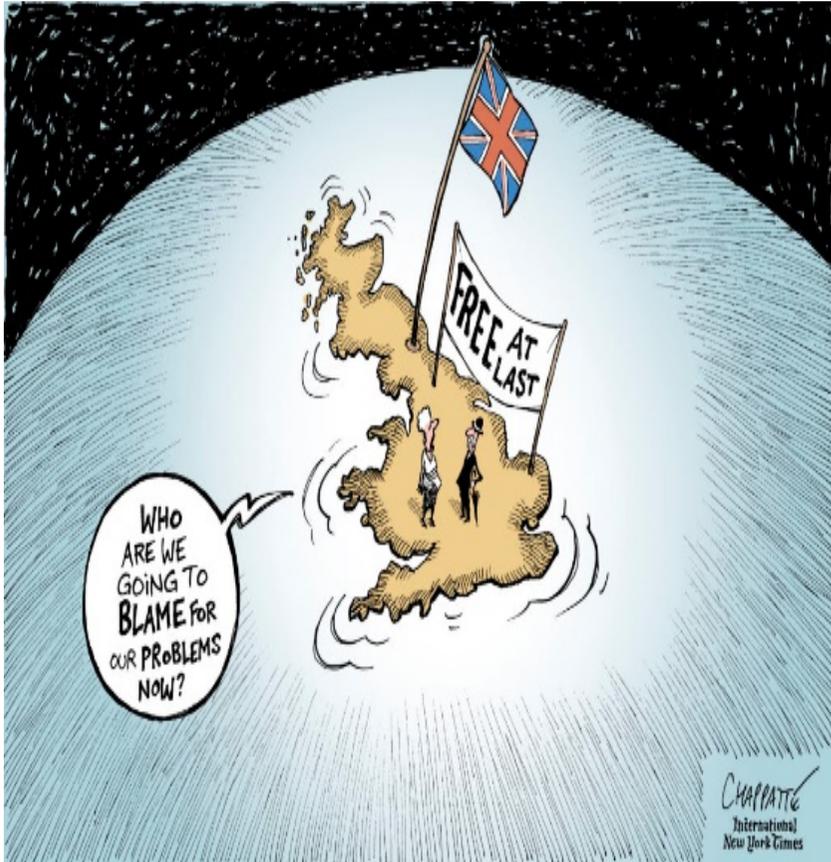


Sources: US Federal Reserve; European Central Bank; Bank of Japan; Bank of England; Thomson Reuters Datastream.

Brexit



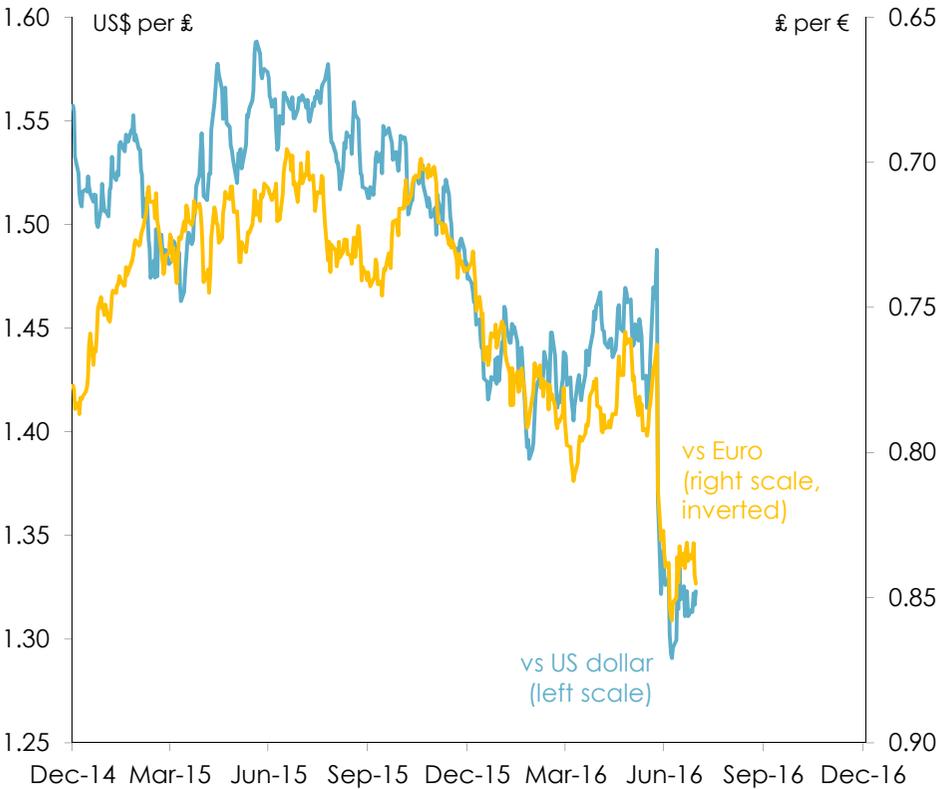
Understanding Britain's vote to leave the EU



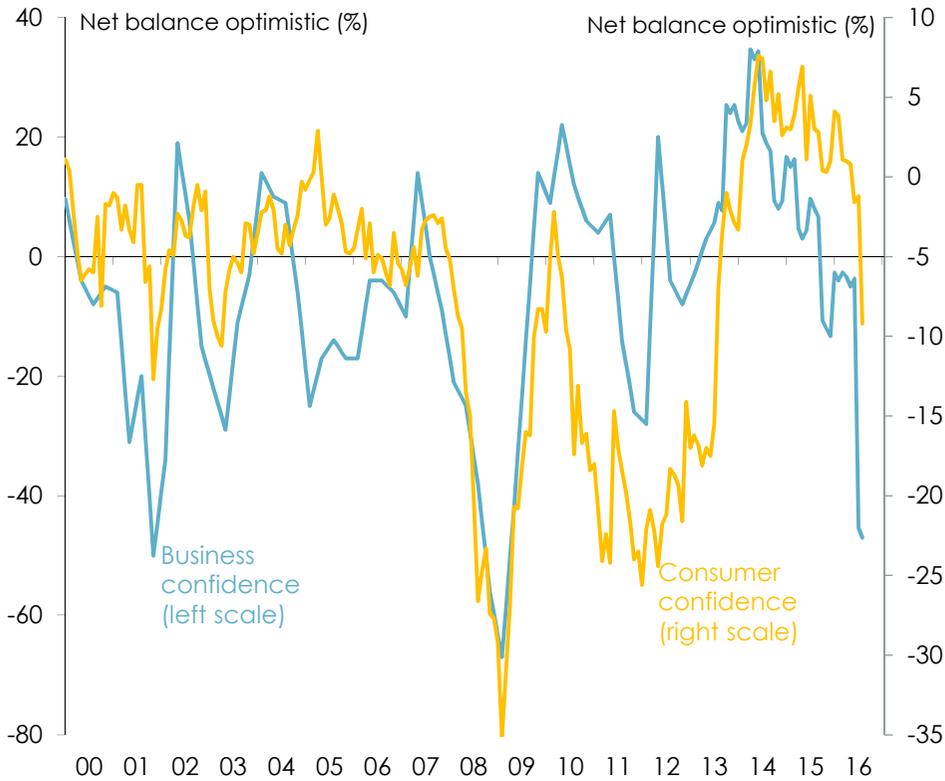
- ❑ The 'Brexit' vote was a victory of
 - the old over the young
 - the angry over the ambivalent
 - the fearful over the hopeful
 - the insular over the cosmopolitan .. and
 - people living in small towns and rural areas over people living in big cities
- ❑ It was to some extent a triumph of
 - those who see themselves as 'victims' of globalization, of rapid technological and social change, and of changes in the ethnic or racial composition of society ...
 - over those whom the same people see as the 'perpetrators' of those changes (the 'elites' and 'experts')
- ❑ And it was a vote for greater control by national governments over the movement of goods, services, capital and (especially) people across national borders
 - and against individuals' ability freely to choose where they live, and from where they buy goods and services

The Brexit vote is likely to have an immediate negative effect on the British economy – and adverse long-term effects as well

Pound sterling vs other currencies



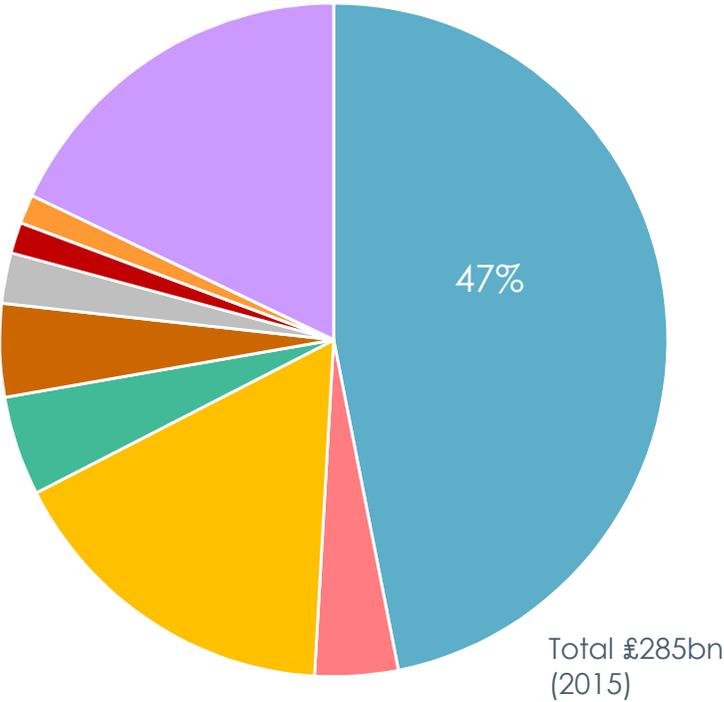
UK business and consumer confidence



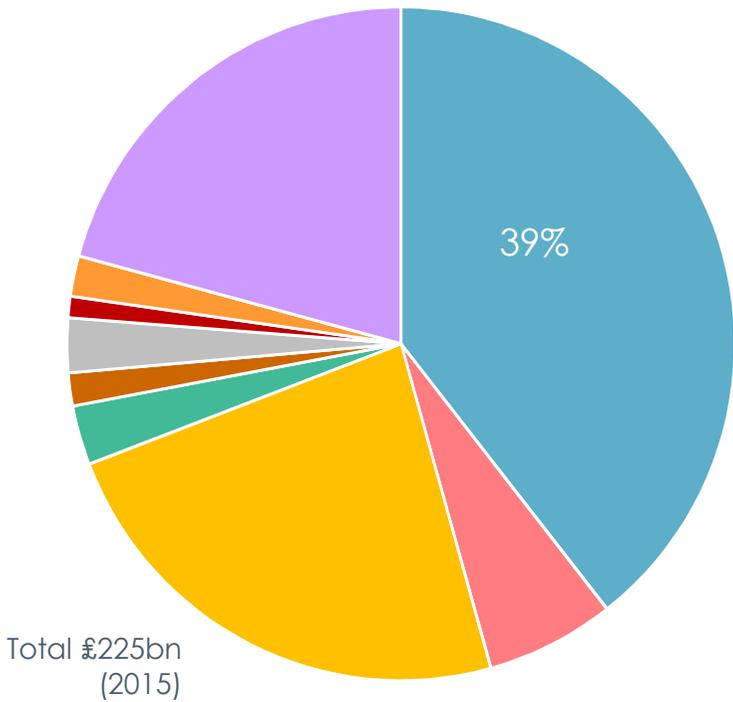
Sources: Thomson Reuters Datastream; UK Confederation of British Industry (CBI); European Commission.

44% of Britain's exports go to the EU – and it's hard to imagine Britain retaining access to that market on the same terms it has now

UK exports of goods



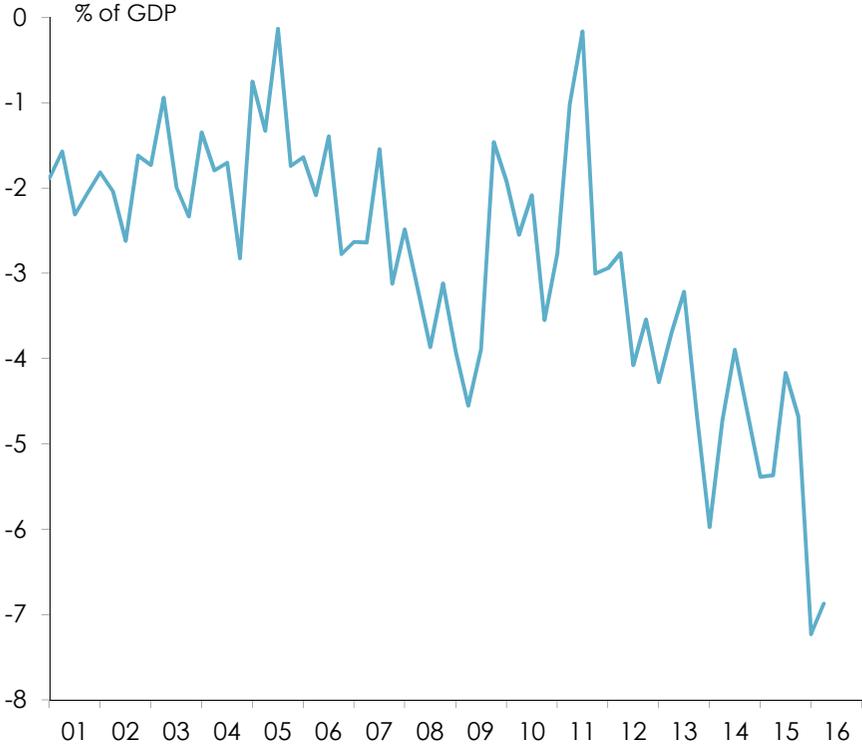
UK exports of services



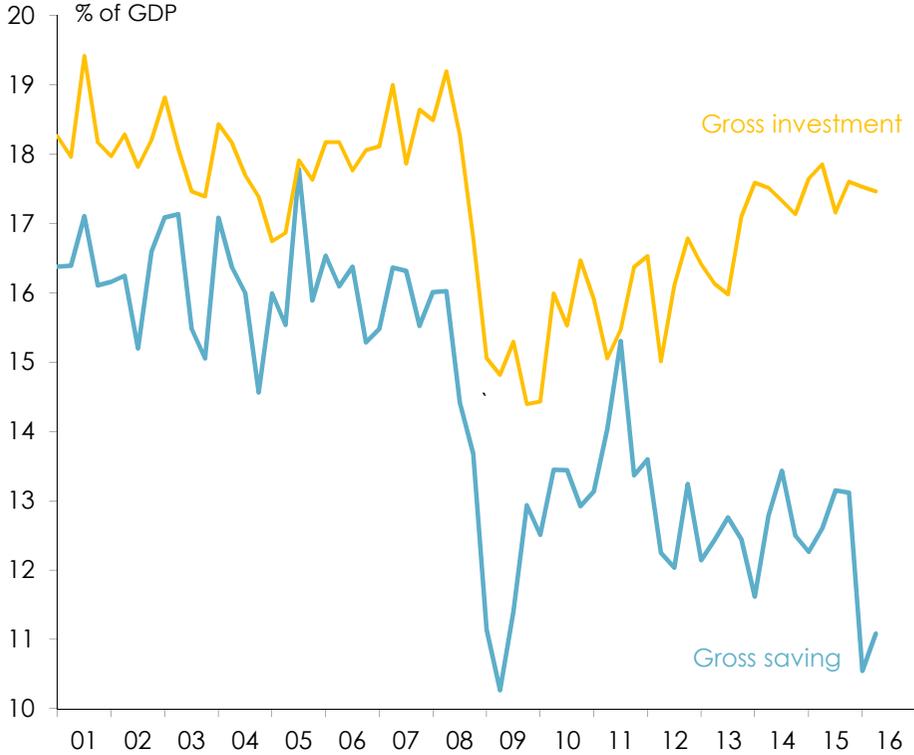
Source: UK Office for National Statistics, *The Pink Book*.

If the UK can't attract the foreign investment required to finance its large current account deficit, saving must rise and/or investment must fall

UK current account balance



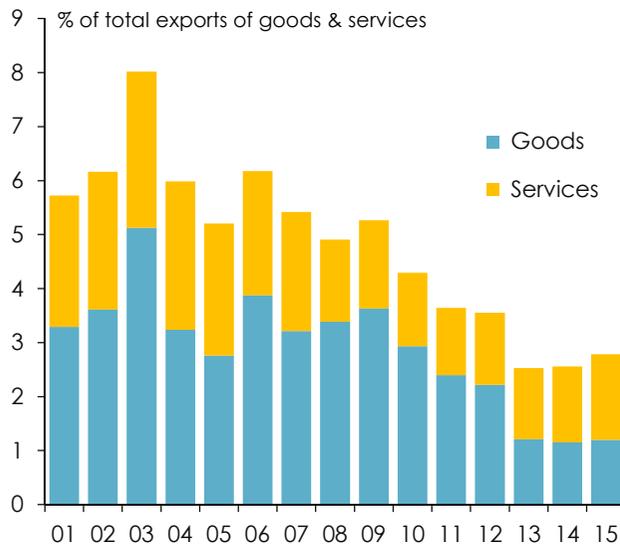
UK gross saving and investment



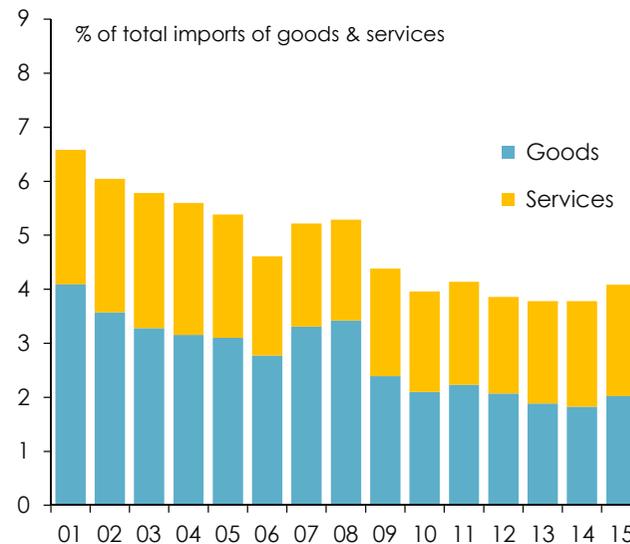
Source: UK Office for National Statistics.

The UK is no longer an important trading partner for Australia – but it is the second-most important source of and destination for investment

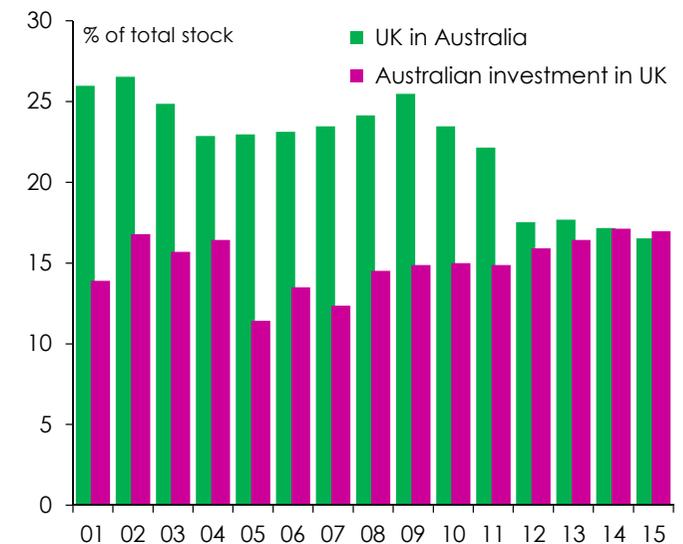
Australian exports to the UK



Australian imports from the UK



Australia-UK cross-border investment



- ❑ Post-Brexit Britain will be keen to show it can ‘do’ trade deals – perhaps Australia could regain the access its agricultural producers had to the UK market before 1973
- ❑ And perhaps having the Queen’s name in our passports and the British flag in the corner of ours might once again count for something at Heathrow

Sources: Department of Foreign Affairs & Trade; ABS.

Will America switch
from 'Yes we can'...

... to 'I alone can' ?

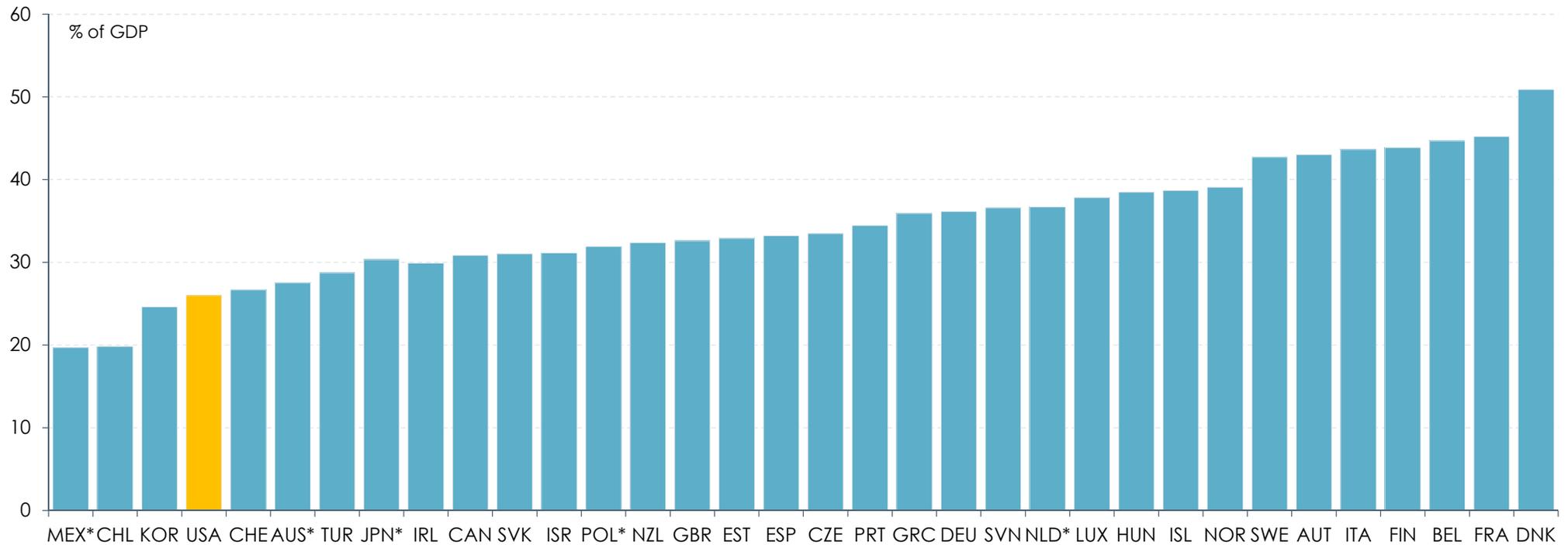


What to expect from a Trump Administration – in Donald Trump’s own words

- ❑ “Nobody knows the system better than me, which is why I alone can fix it”
- ❑ “We must immediately suspend immigration from any nation that has been compromised by terrorism until such time as proven vetting mechanisms have been put in place”
- ❑ “We are going to build a great border wall to stop illegal immigration, to stop the gangs and the violence, and to stop the drugs from pouring into our communities”
- ❑ “I have made billions of dollars in business making deals – now I’m going to make our country rich again. I am going to turn our bad trade agreements into great ones ... I will make individual deals with individual countries ... We are going to enforce all trade violations, including through the use of taxes and tariffs, against any country that cheats ... Our horrible trade agreements with China and many others, will be totally renegotiated. That includes renegotiating NAFTA to get a much better deal for America – and we’ll walk away if we don’t get the deal that we want”
- ❑ “America is one of the highest-taxed nations in the world ... I have proposed the largest tax reduction of any candidate who has declared for the presidential race this year ... Middle-income Americans will experience profound relief, and taxes will be simplified for everyone”

Actually, the US is not 'one of the highest-taxed nations in the world'

Taxation as a pc of GDP – OECD member countries, 2014



“I will present the facts plainly and honestly ... We will honour the American people with the truth, and nothing else”

— Donald Trump, acceptance speech, Republican National Convention, Cleveland Ohio, 21st July 2016

Note: * Data is for 2013. Source: OECD, <https://data.oecd.org/tax/tax-revenue.htm>

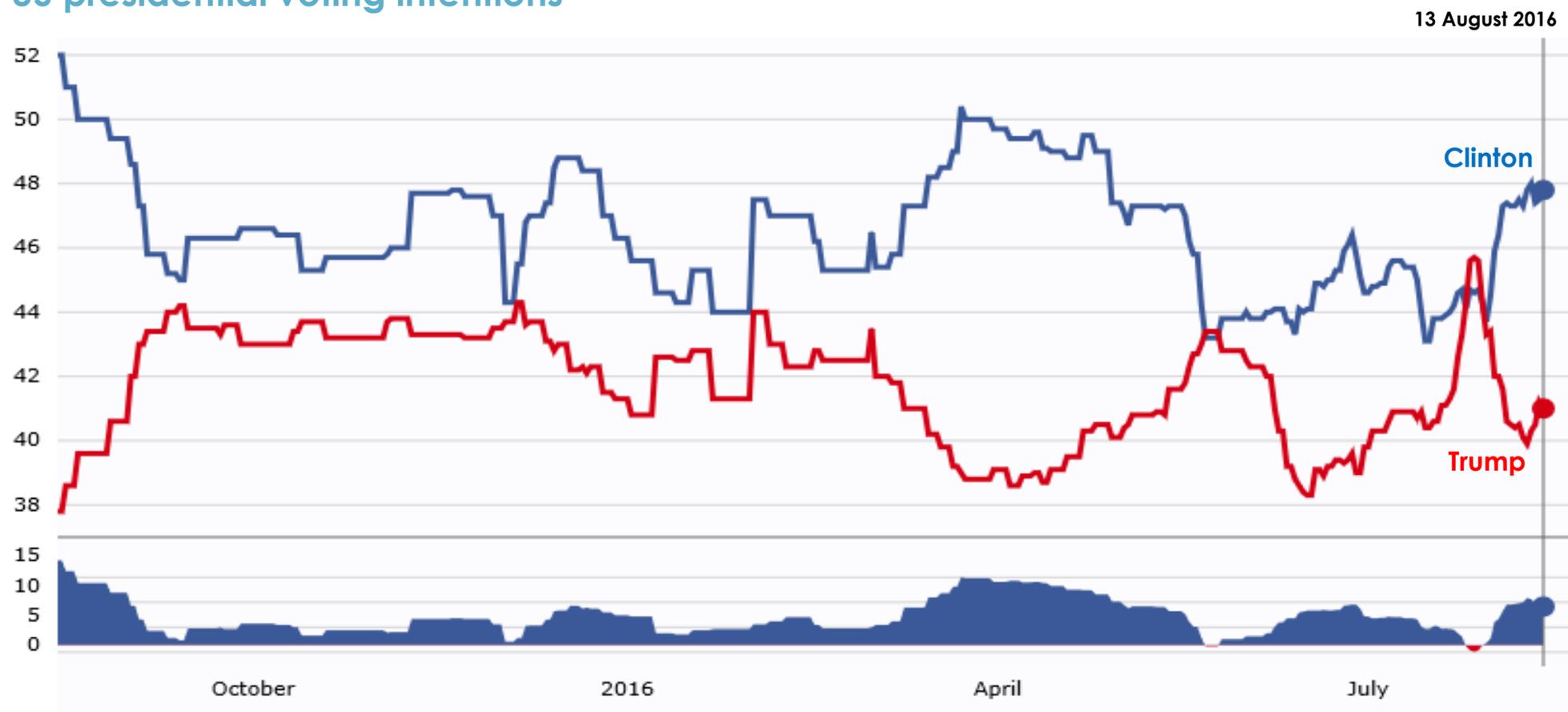
SAUL ESLAKE

What to expect from a Trump Administration – in Donald Trump’s own words

- ❑ “Nobody knows the system better than me, which is why I alone can fix it”
- ❑ “We must immediately suspend immigration from any nation that has been compromised by terrorism until such time as proven vetting mechanisms have been put in place”
- ❑ “We are going to build a great border wall to stop illegal immigration, to stop the gangs and the violence, and to stop the drugs from pouring into our communities”
- ❑ “I have made billions of dollars in business making deals – now I’m going to make our country rich again. I am going to turn our bad trade agreements into great ones ... I will make individual deals with individual countries ... We are going to enforce all trade violations, including through the use of taxes and tariffs, against any country that cheats ... Our horrible trade agreements with China and many others, will be totally renegotiated. That includes renegotiating NAFTA to get a much better deal for America – and we’ll walk away if we don’t get the deal that we want”
- ❑ “America is one of the highest-taxed nations in the world ... I have proposed the largest tax reduction of any candidate who has declared for the presidential race this year ... Middle-income Americans will experience profound relief, and taxes will be simplified for everyone”
- ❑ “When I am President ... with these new economic policies, trillions of dollars will start flowing into our country ... We will build the roads, highways, bridges, tunnels, airports, and the railways of tomorrow. This, in turn, will create millions more jobs”

Opinion polls currently give Hillary Clinton a clear lead over Donald Trump – as they did ‘Remain’ over ‘Leave’ in the UK referendum

US presidential voting intentions



Source: RealClearPolitics.

SAUL ESLAKE

What might a Trump presidency mean for Australia?

❑ A shock to global financial markets – and to Australia's

- financial markets are assuming that Hillary Clinton will win – just as they assumed that Britain would vote to stay in the EU
- a different outcome could likewise produce sharp movements on financial markets (after all, there's more at stake)

❑ An abrupt decline in business confidence – in the US and elsewhere

- notwithstanding US business' traditional alignment with the Republican Party, most American business leaders don't want a Trump Presidency – any more than they would have wanted Bernie Sanders in the White House

❑ Possibly, a large fall in the US dollar

- foreigners have over US\$30 trillion (170% of US annual GDP) invested in the US
- if foreign investors seek to reduce their exposures to the US, the US\$ could fall significantly
- in such circumstances, the A\$ (along with other freely-floating currencies) could rise sharply against the US\$
- which, as the RBA has said after each recent Board meeting, would 'complicate' the adjustments currently under way in the Australian economy

❑ A 'trade war' with China – and possibly Japan

- a Trump Administration would declare China (and potentially Japan) a 'currency manipulator' – opening the way for the imposition of tariffs of up to 45% on imports from China (and possibly Japan)
- such measures would be intended to cause a sharp drop in Chinese (and Japanese) exports to the US – which would in turn likely result in those economies weakening – with adverse consequences for Australia's exports to them
- it's hard to believe that China and Japan wouldn't retaliate in some (equally damaging way)

❑ 'Trade wars' can lead to real wars

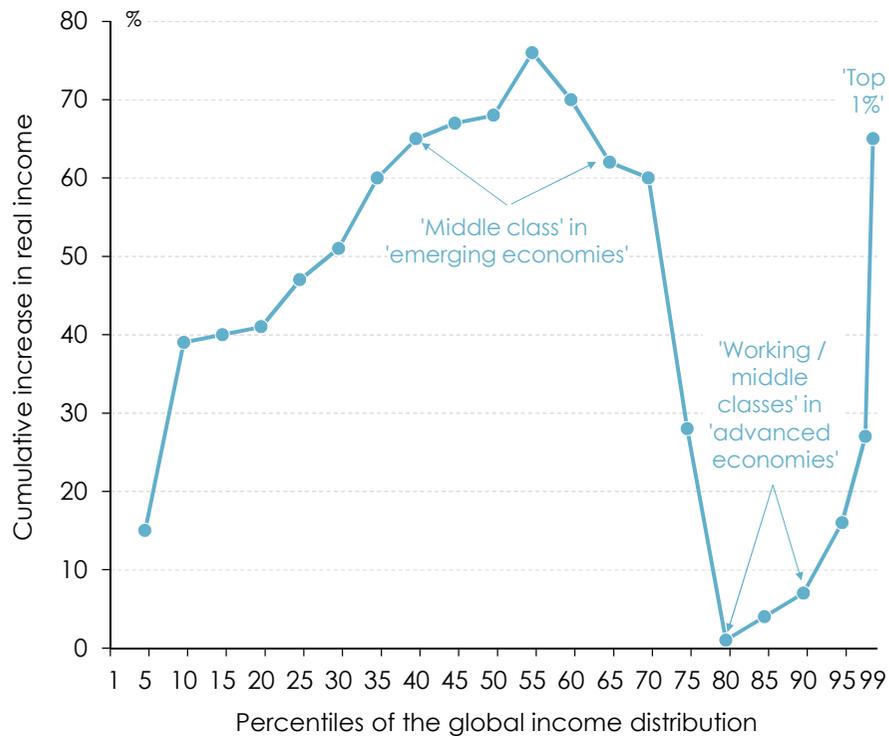
- Australia would be a big loser from any armed conflict between its biggest trading partner and its most important ally

These political trends aren't unique to the US and UK

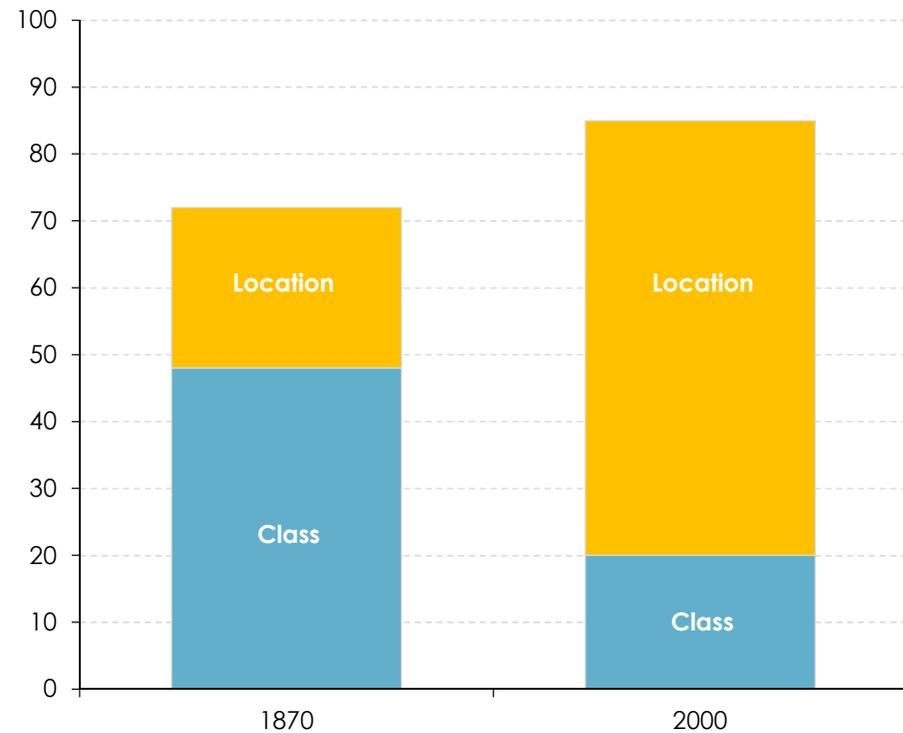


Two charts that help explain 'Brexit', Trump & Sanders, Le Pen and other troubling political trends across the 'developed' world

Growth in real income by percentiles of the global income distribution, 1988-2008



Level and composition of global inequality, 1870 and 2000

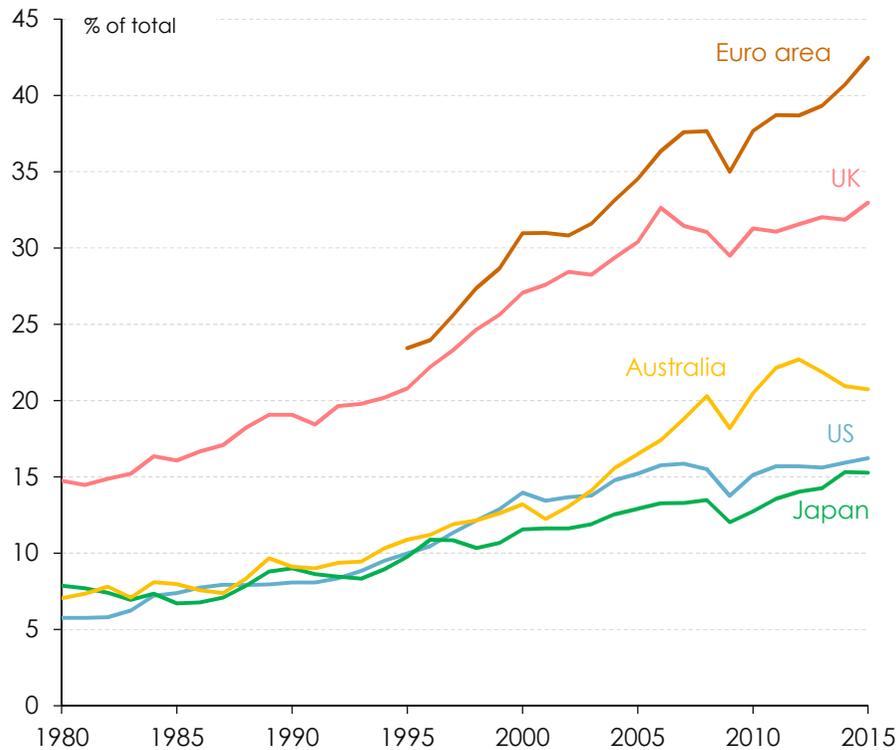


Note: Real income measured in 2005 US dollars (converted at purchasing power parities). Inequality measured by a Theil Index.

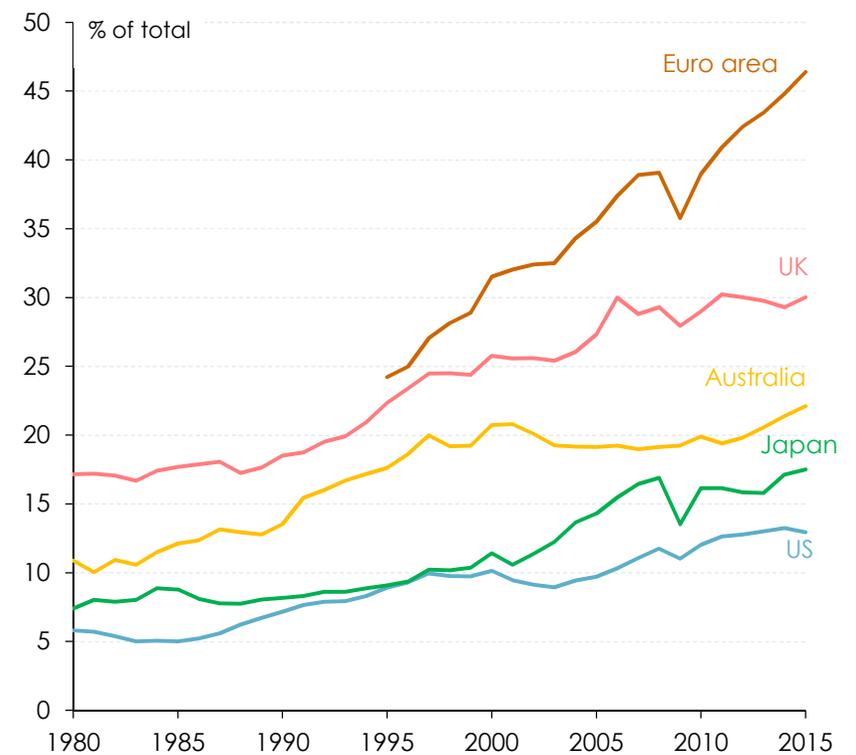
Sources: Christoph Lakner and Branko Milanović, *Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession*, World Bank Economic Review August 2015; Branko Milanović, *Global Income Inequality by the Numbers: in History and Now - An Overview*, World Bank Policy Research Working Paper No 6259, November 2012.

Imports have risen strongly as a share of US GDP – but so have exports; and both have risen by less than in other ‘advanced’ economies

Imports as a share of GDP



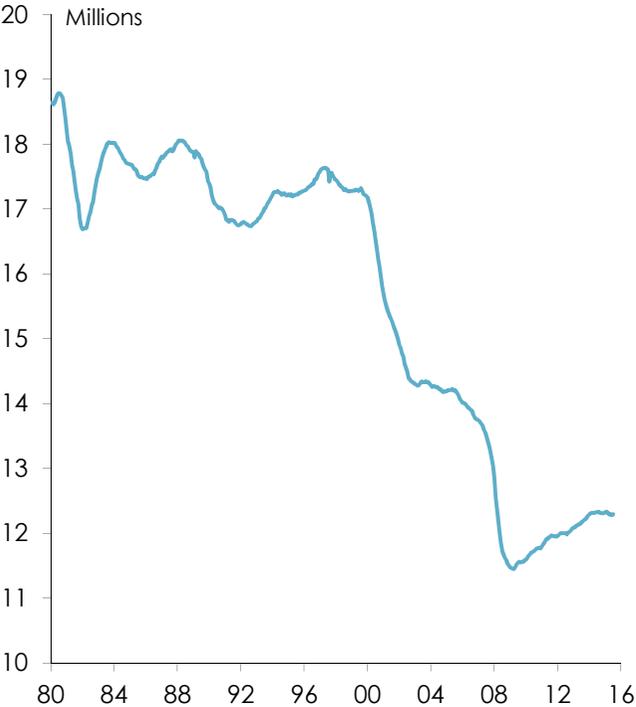
Exports as a share of GDP



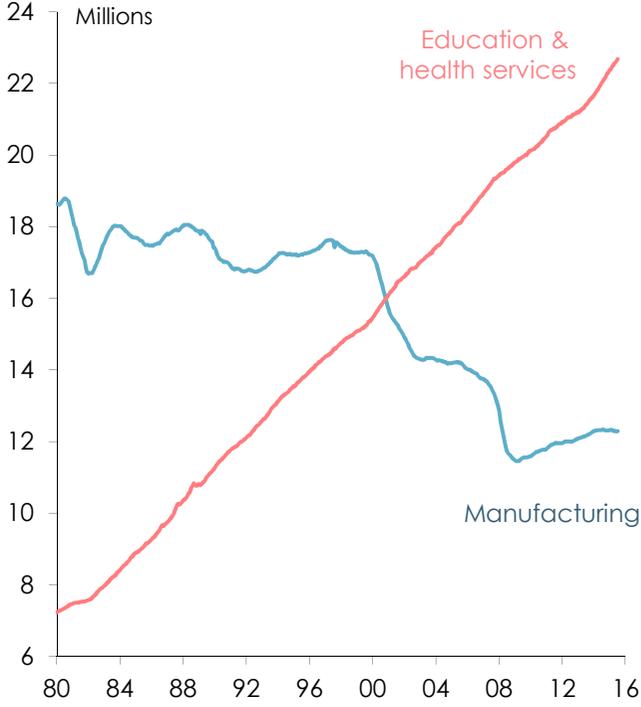
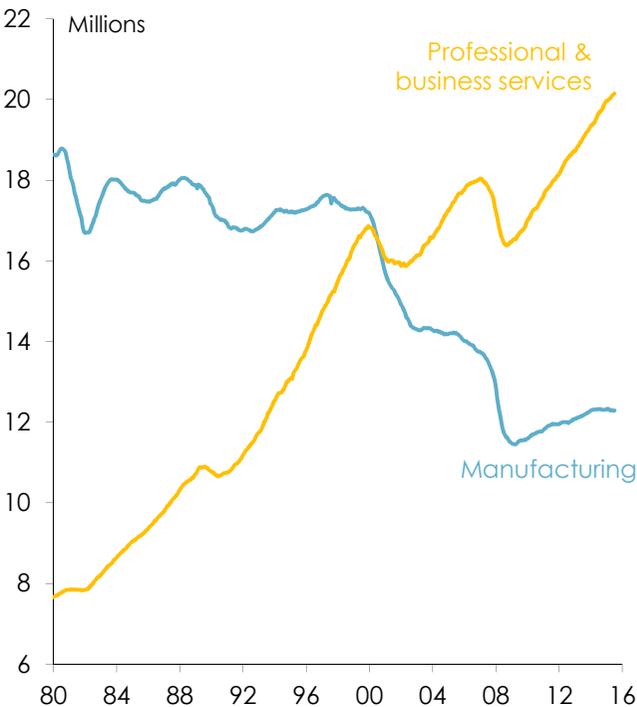
Sources: US Bureau of Economic Analysis; Japan Cabinet Office; Eurostat; UK Office for National Statistics; ABS.

Employment in US manufacturing fell precipitously between 1997 and 2009 - although a greater number of jobs were created in other sectors

Employment in US manufacturing



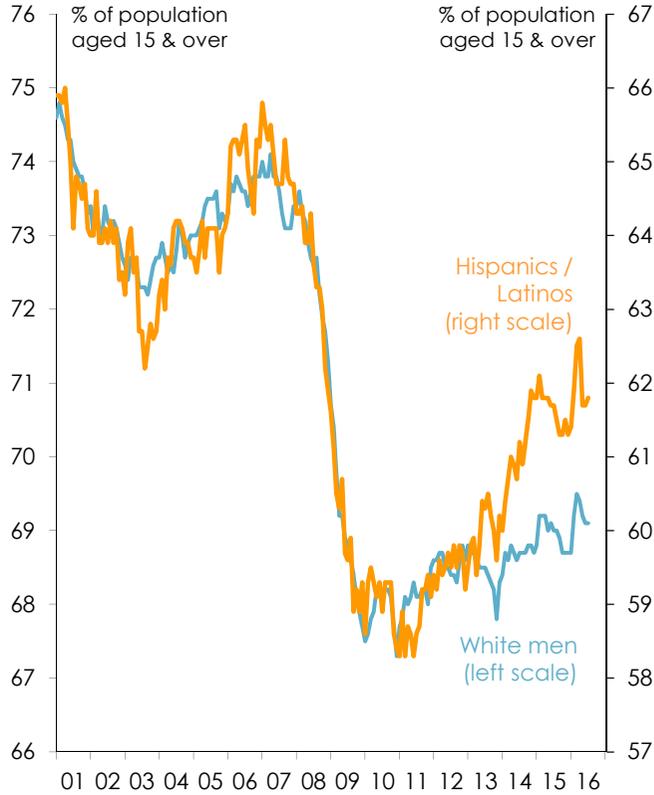
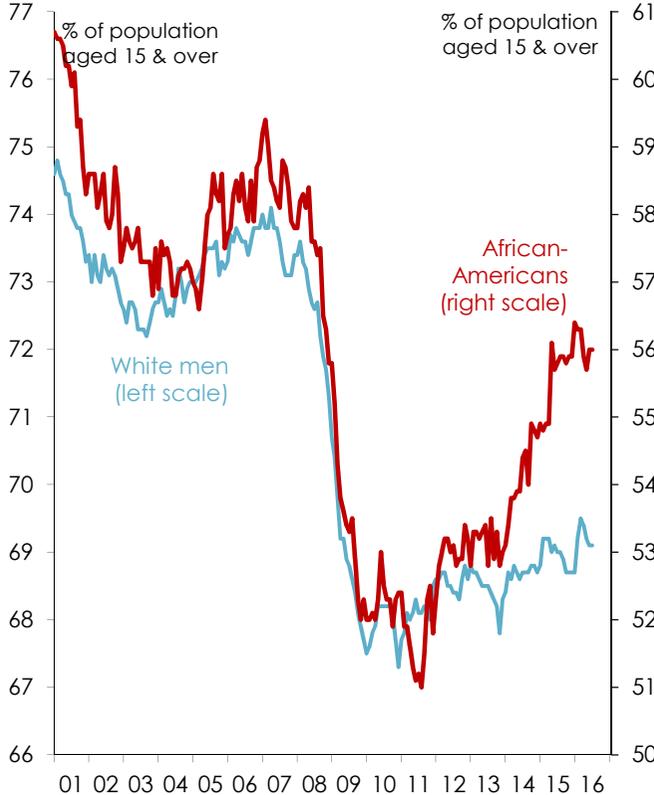
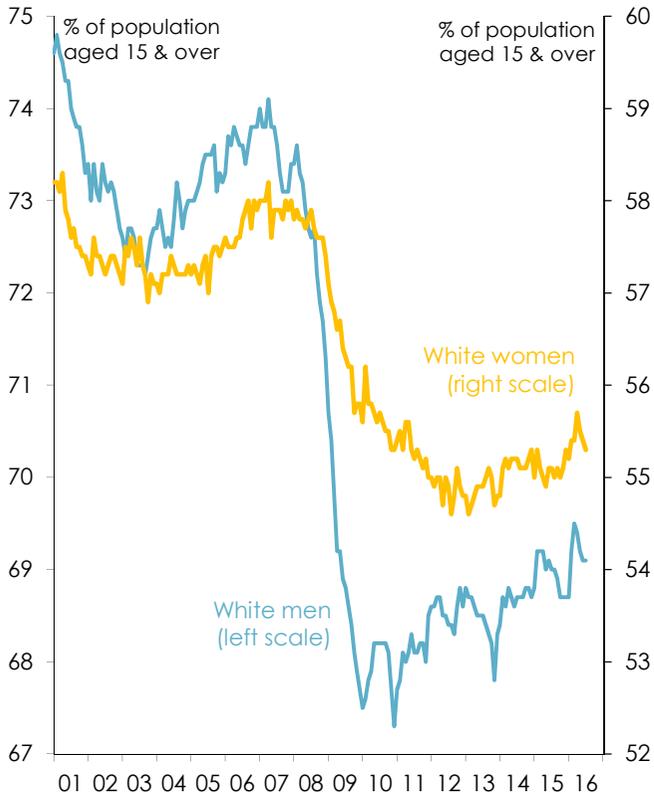
Employment in US manufacturing compared with selected services sectors



Source: US Bureau of Labor Statistics.

Changes in the US labour market have been tougher on white men than on other demographic groups

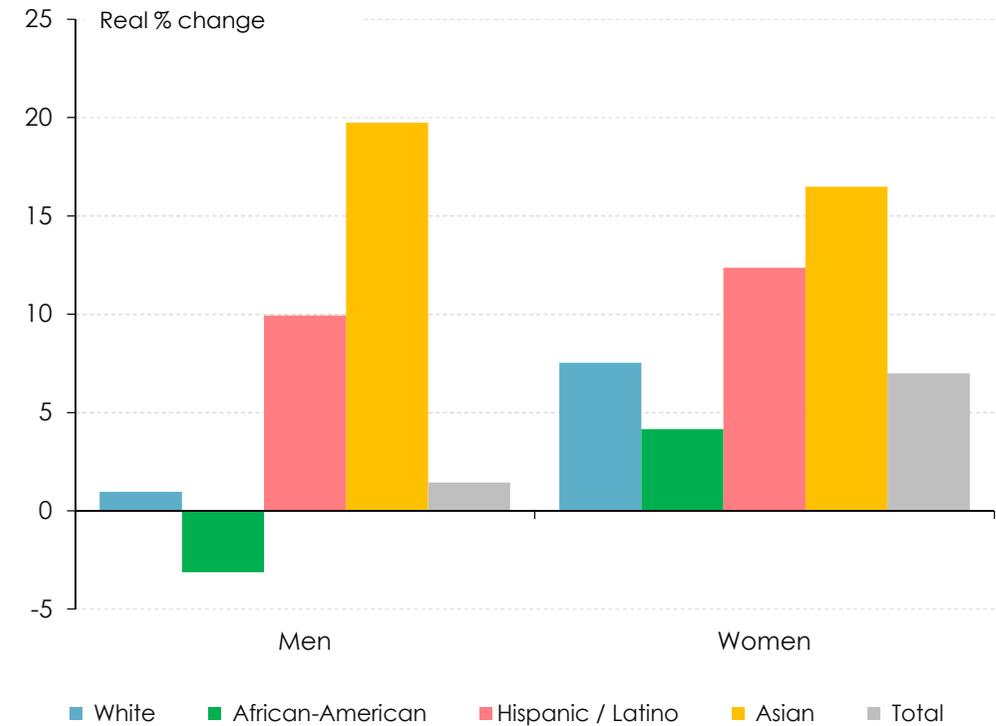
Employment as a pc of the working-age population – white men vs other demographic groups



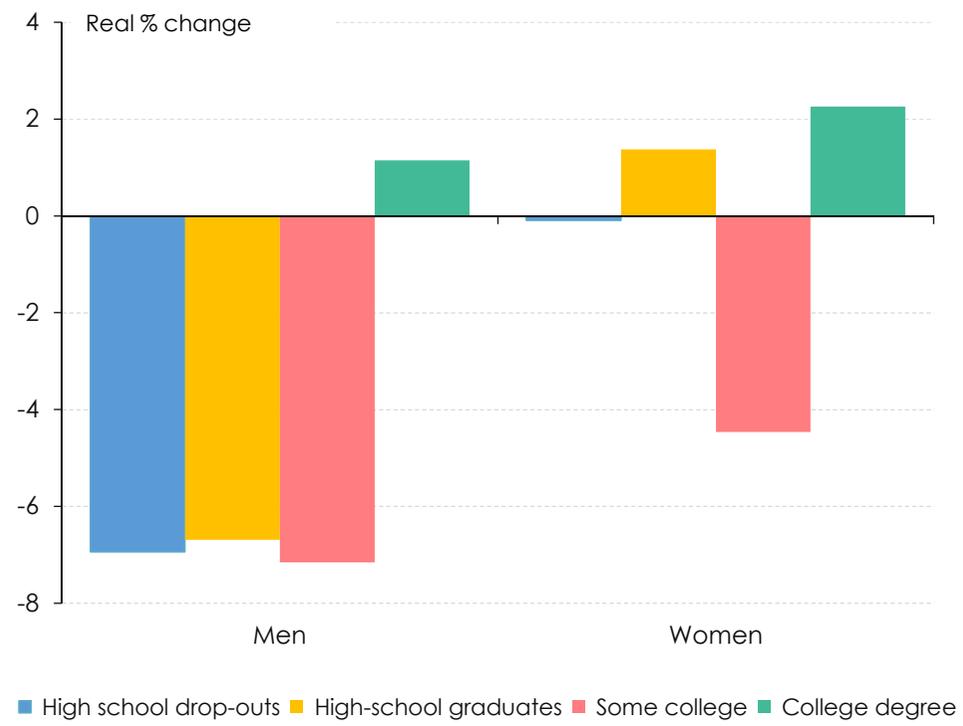
Source: US Bureau of Labor Statistics.

Men – and especially older, poorly-educated men – have experienced significant declines in their real earnings over the last 15 years

Change in median real earnings, 2000-2015, by demographic group (16 and over)



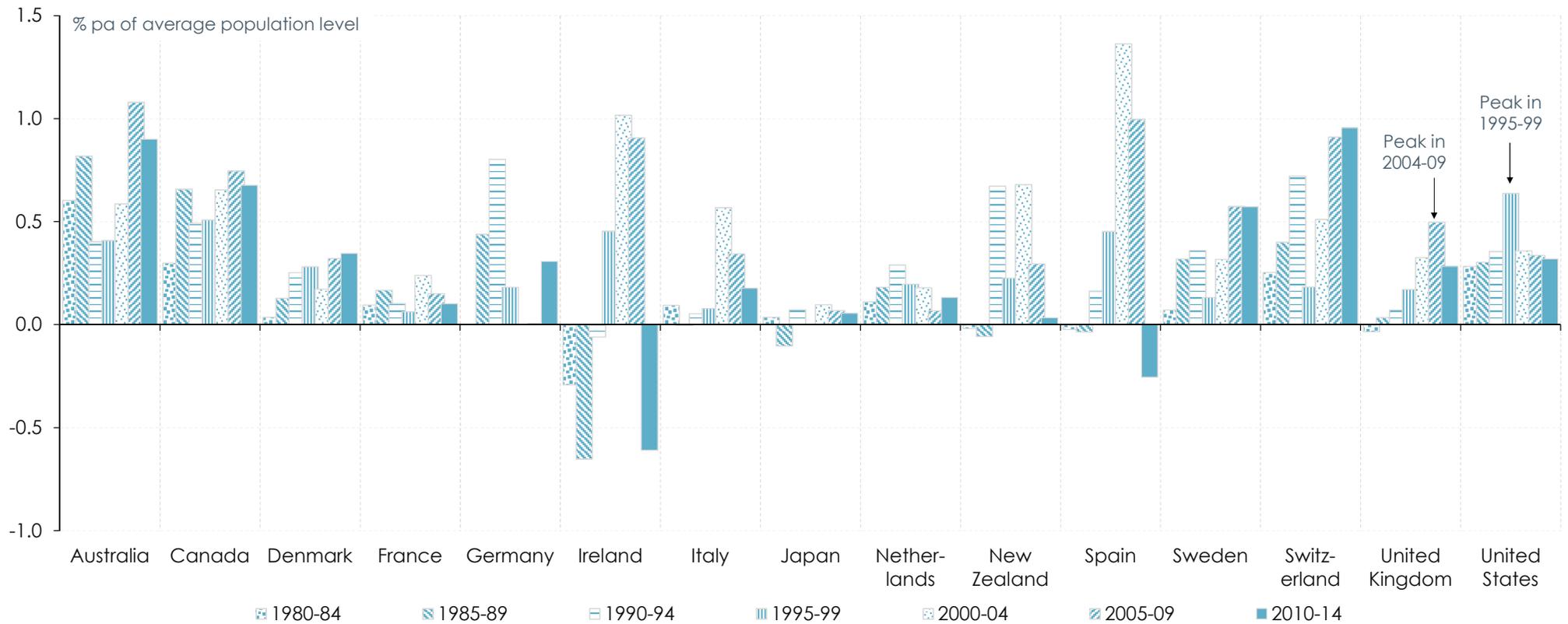
Change in median real earnings, 2000-2015, by educational attainment (25 and over)



Source: US Bureau of Labor Statistics.

Many (though not all) countries have experienced higher rates of immigration since the late 1980s

Net immigration as a pc of total population, selected 'advanced' economies, 1980-2014



Sources: World Bank, *World Development Indicators*; United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2015 Revision*.

Australia hasn't been immune from these political trends – although so far the lunatics *haven't* taken over the asylum

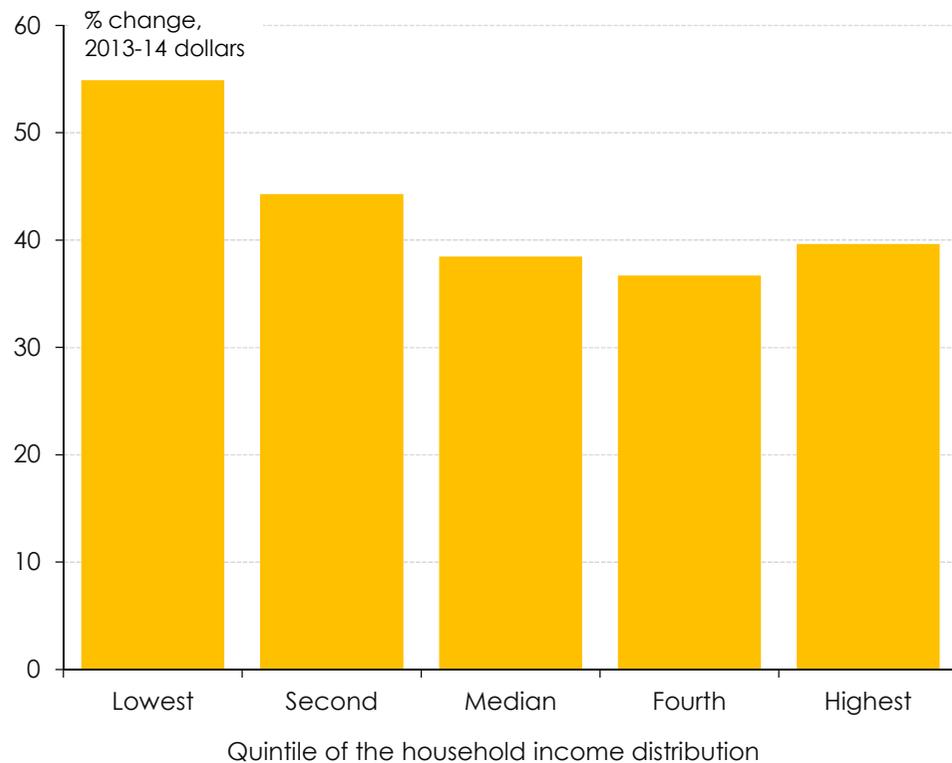


.... even if some of them have come pretty close

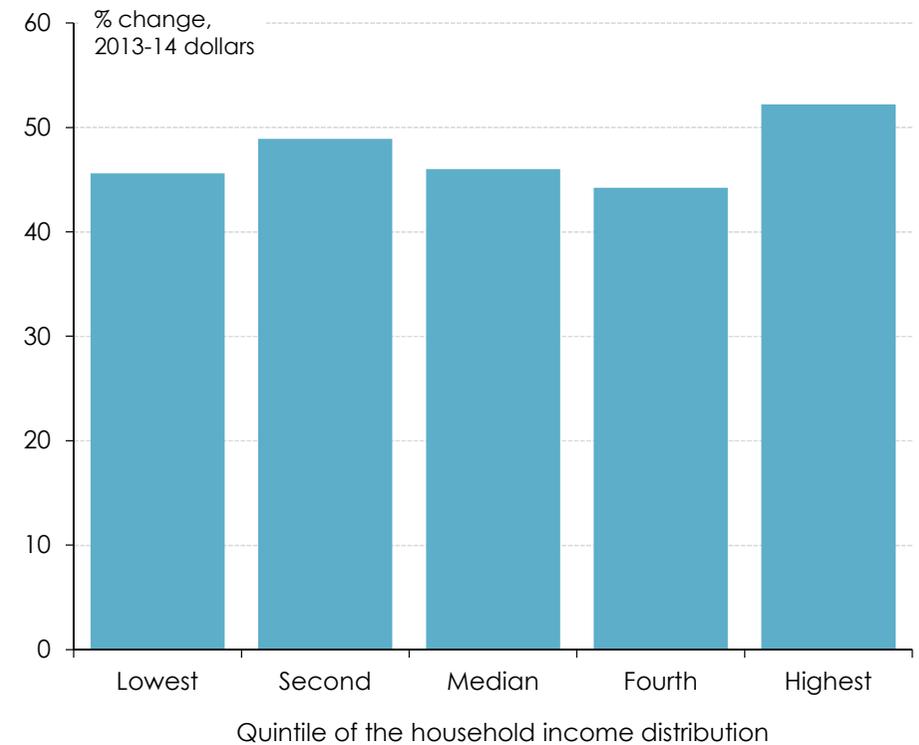


Australian household incomes have risen by much more than in the US, and have been much less unequally distributed than in the US

Real change in Australian gross household income, by quintile, 1999-2000 to 2013-14



Real change in Australian household disposable income, 1999-2000 to 2013-14

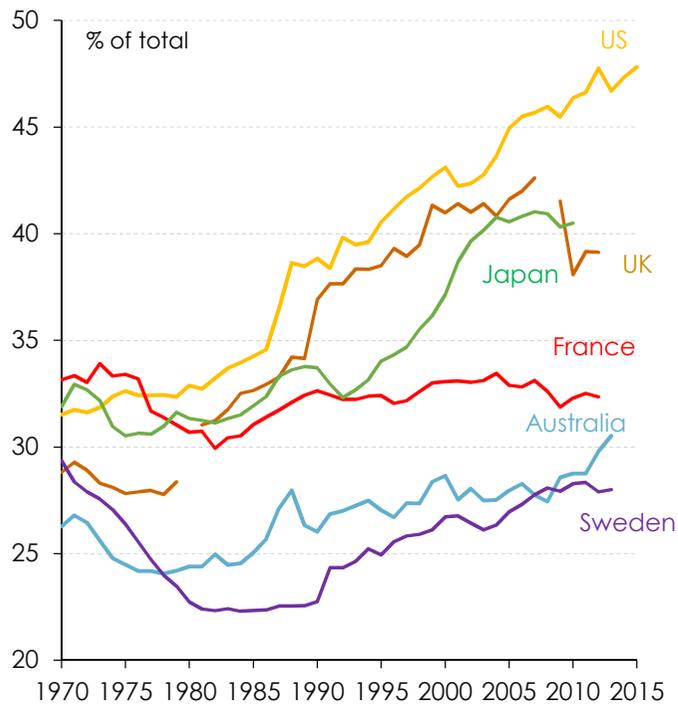


Note: 'Quintiles' are one-fifths (20% shares) of households ranked by pre-tax income and adjusted ('equivalized') for household size.
Source: ABS, *Household Income and Wealth, Australia 2013-14* (catalogue no. 6523,0, September 2015).

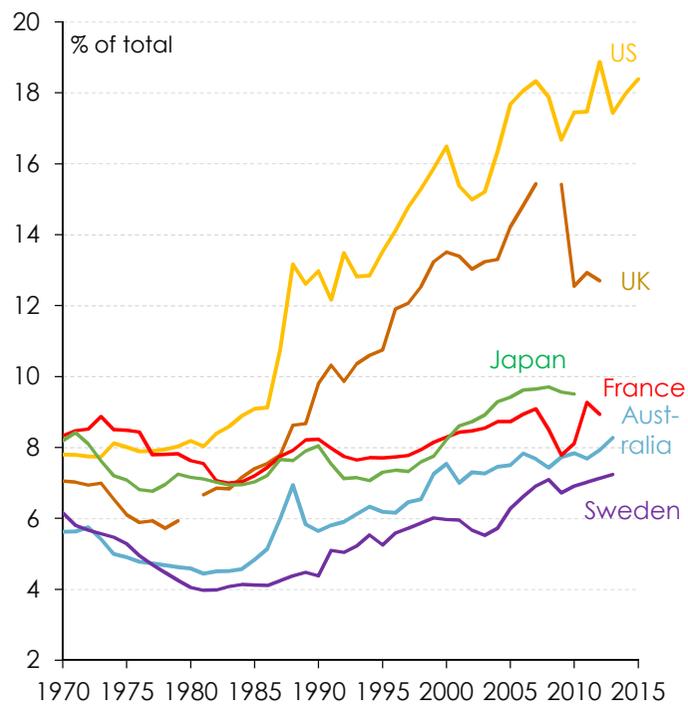
Australia is actually at the Swedish end of the spectrum of trends in pre-tax income distribution

Upper income groups' share of total pre-tax income in selected 'advanced' economies

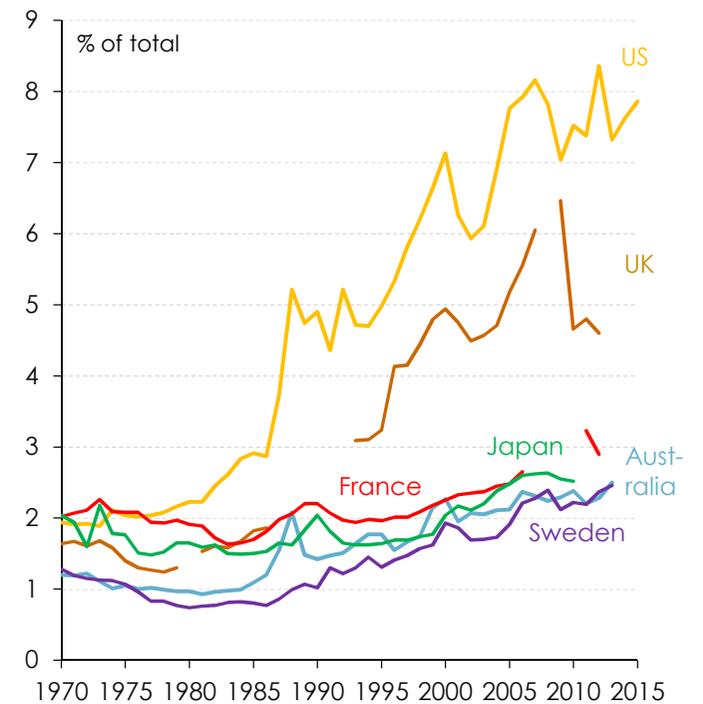
Top 10%



Top 1%



Top 0.1%

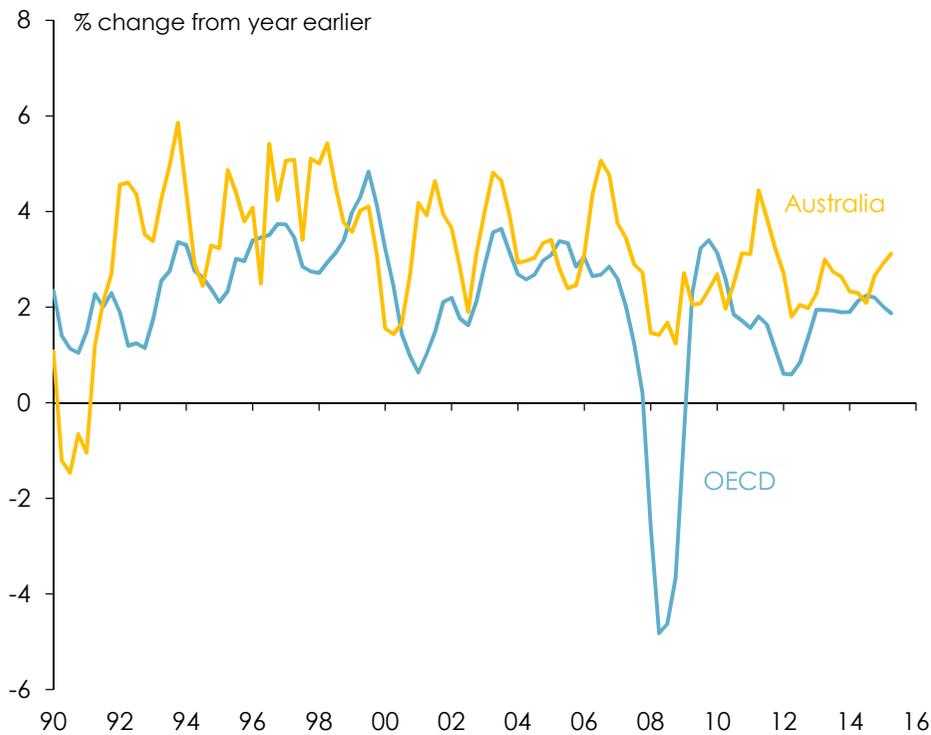


Note: Shares are of pre-tax taxable income as reported to and published by national tax collection agencies.

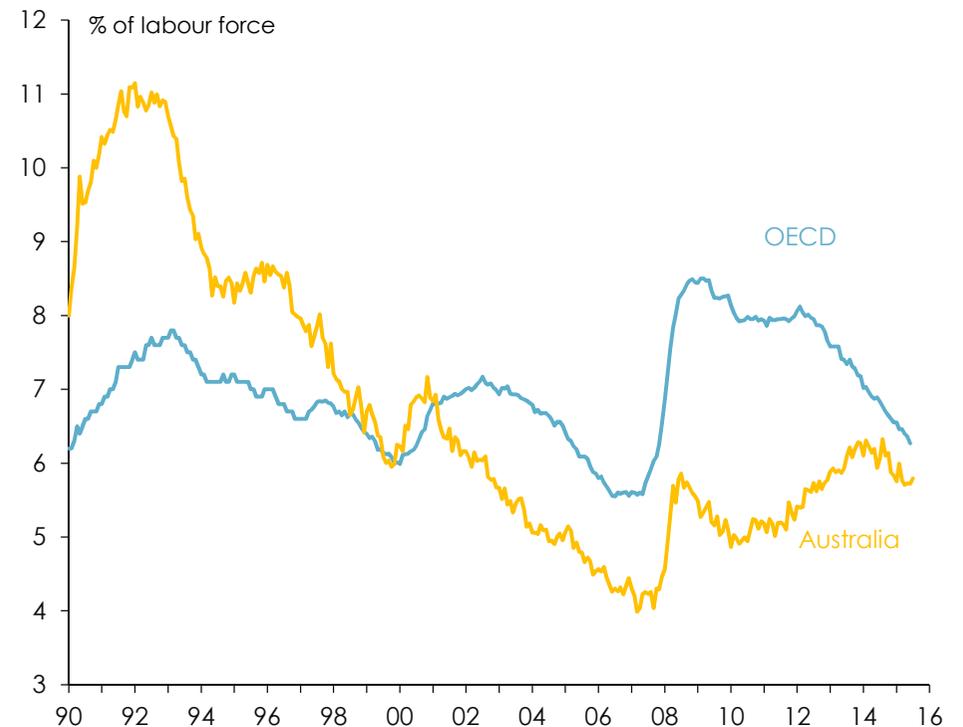
Sources: Facundo Alvaredo, Tony Atkinson, Thomas Piketty, Emmanuel Saez and Gabriel Zucman, *The World Wealth and Income Database* (<http://www.wid.world/>)

Not having had a recession since the early 1990s has been a major factor in the stronger income growth enjoyed by Australian households

Real GDP growth – Australia vs OECD countries



Unemployment rate – Australia vs OECD countries



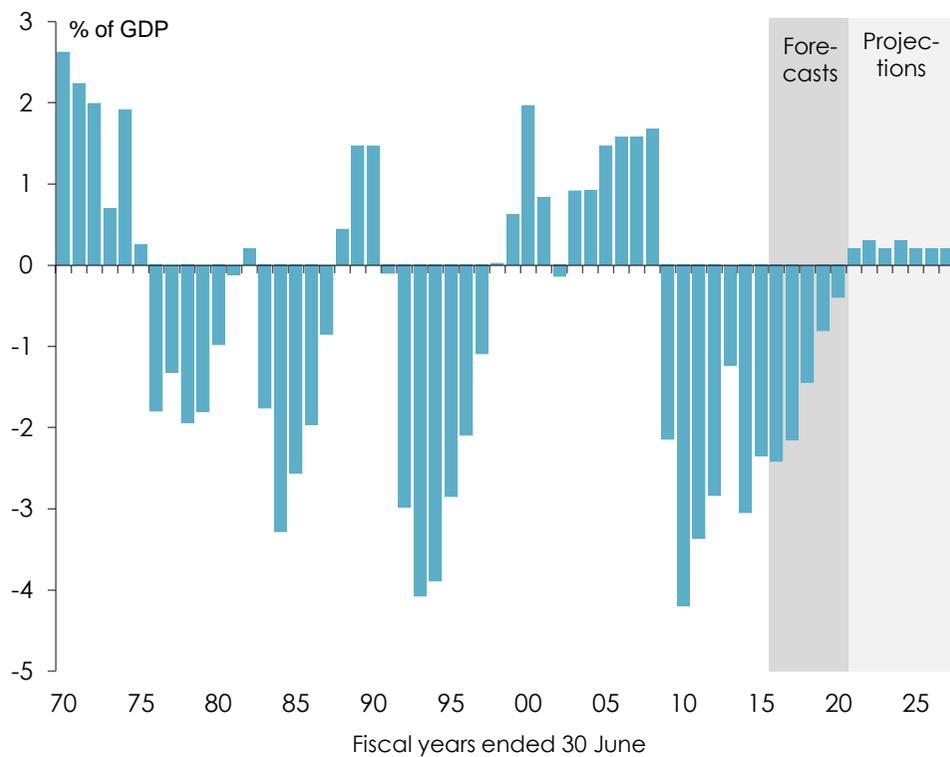
Note: The Organization for Economic Co-operation and Development (OECD) comprises 34 (mostly) 'advanced' or 'industrialized' economies in Europe and North America, plus Japan, Korea, Israel, Turkey, Chile, Australia and New Zealand.
Source: OECD; ABS.

Fixing the budget

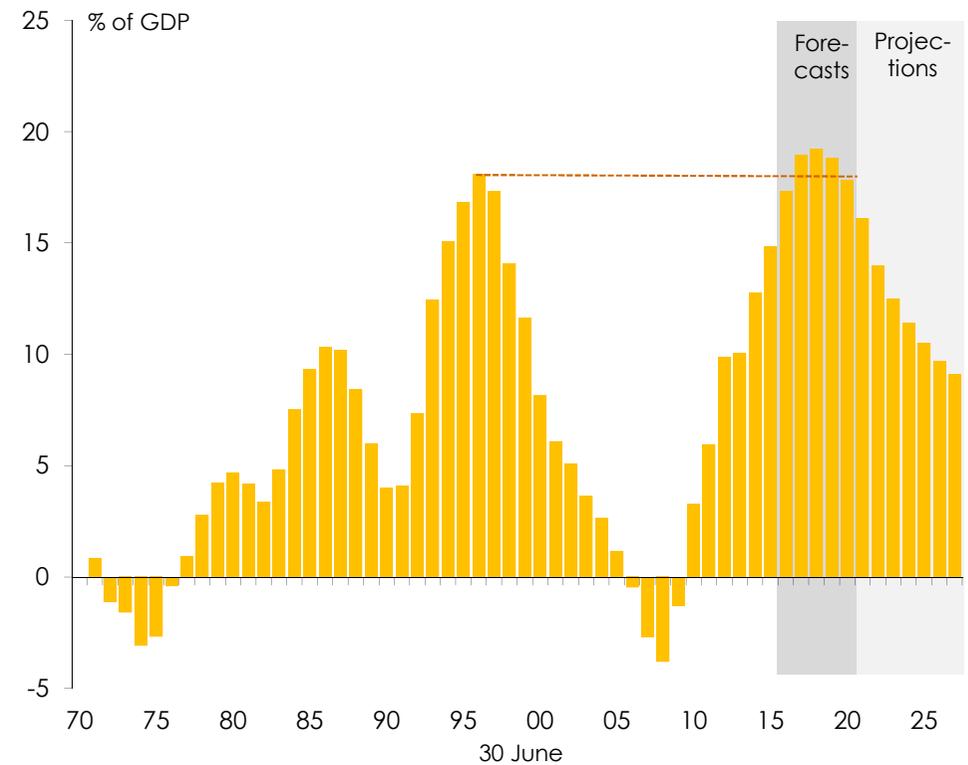


Australia's longest-ever run of budget deficits isn't over yet

Australian Government 'underlying' budget balance



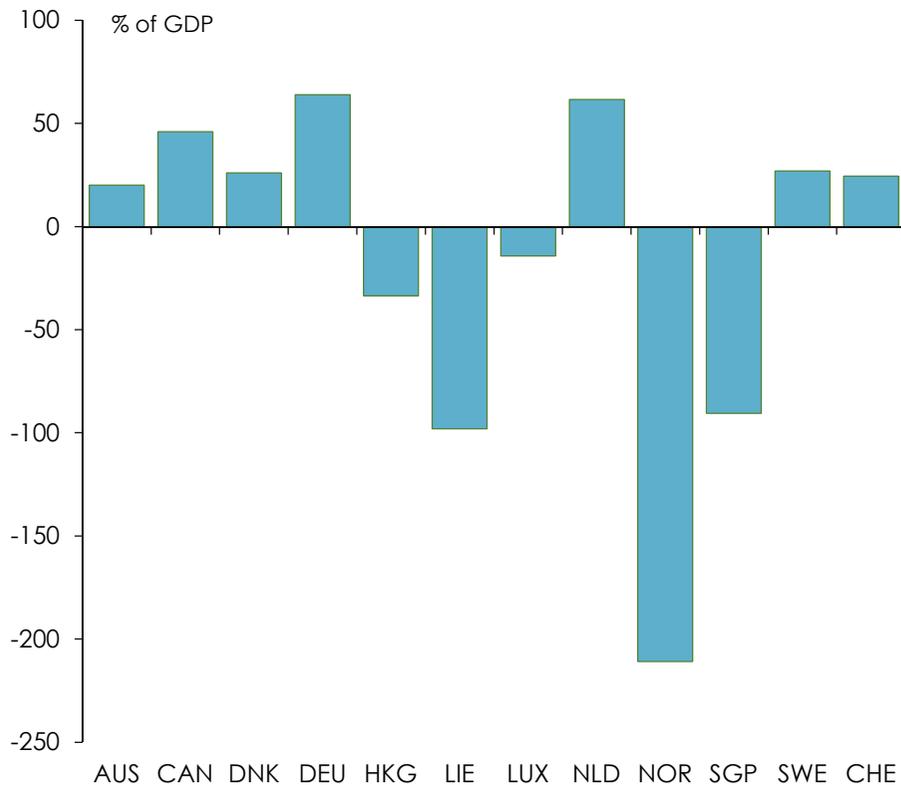
Australian Government net debt



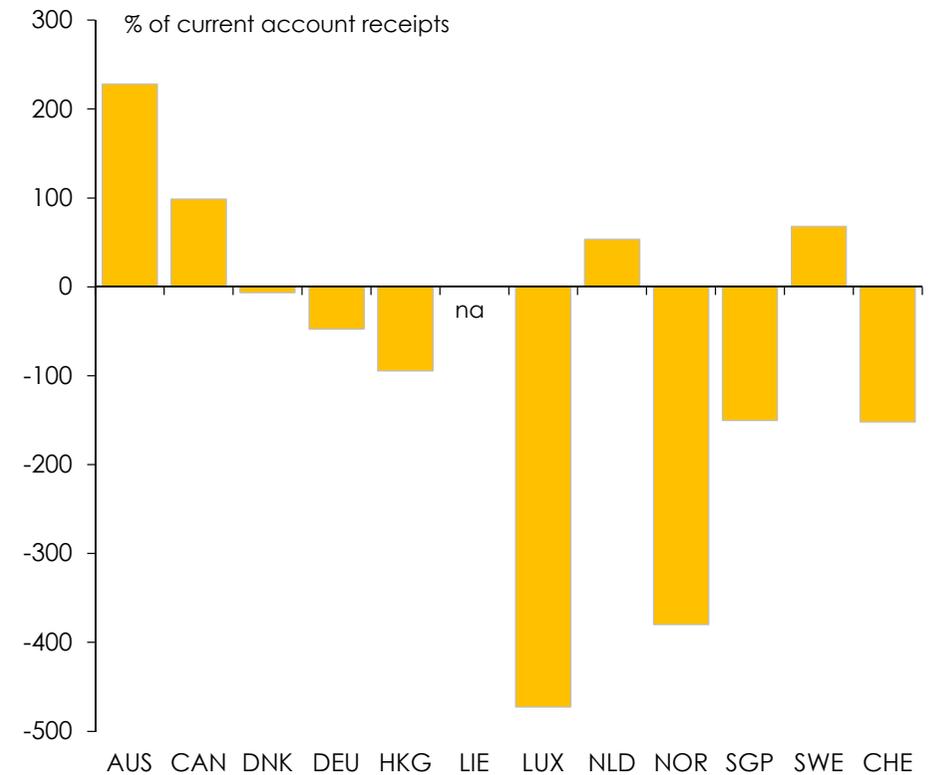
Source: Australian Government, 2016-17 Budget Paper No. 1.

Australia's public sector debt is still quite low - but Australia has a lot of foreign debt by comparison with other AAA-rated countries

'General government' net debt – AAA-rated countries, 2016



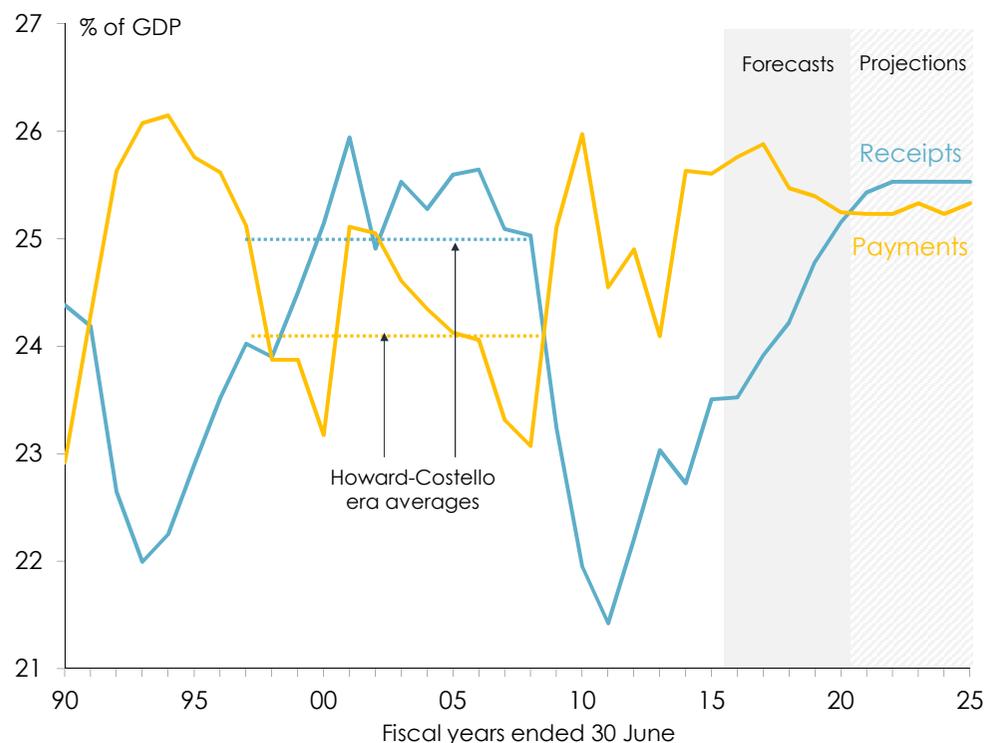
Net foreign debt – AAA-rated countries, 2016



Note: DEU = Germany; LIE = Liechtenstein; LUX = Luxembourg; NLD = Netherlands; CHE = Switzerland.
Source: Standard and Poor's.

Australia has a revenue problem, as well as a spending problem – and the Government doesn't have much of a mandate to fix either of them

Federal government spending and revenue as pc of GDP



Source: Australian Government, 2016-17 Budget Paper No 1, *Budget Strategy and Outlook*.

- ❑ Government spending in 2016-17 is forecast to be almost 1 pc pt of GDP above the average for the Howard-Costello years, while revenues will be more than 1 pc pt of GDP below the Howard-Costello average
- ❑ More than three-quarters of the projected improvement in the budget bottom line between 2016-17 and 2020-21 comes from increased revenues – and that in turn depends on optimistic assumptions about growth, and ‘bracket creep’
- ❑ The Government didn't seek – and hasn't received – a mandate for significant spending cuts or revenue reforms, apart from the company tax cuts which it will have difficulty getting passed by the Senate
- ❑ The National Party now has a more powerful position within the Coalition, the Coalition has a weaker position in the House of Representatives, and protectionists & populists have a more powerful position in the Senate – none of which augurs well for good economic policy

Questions?

For more details...

bettercallsaul.com.au

SAUL ESLAKE

Supplementary material

For more details...

bettercallsaul.com.au

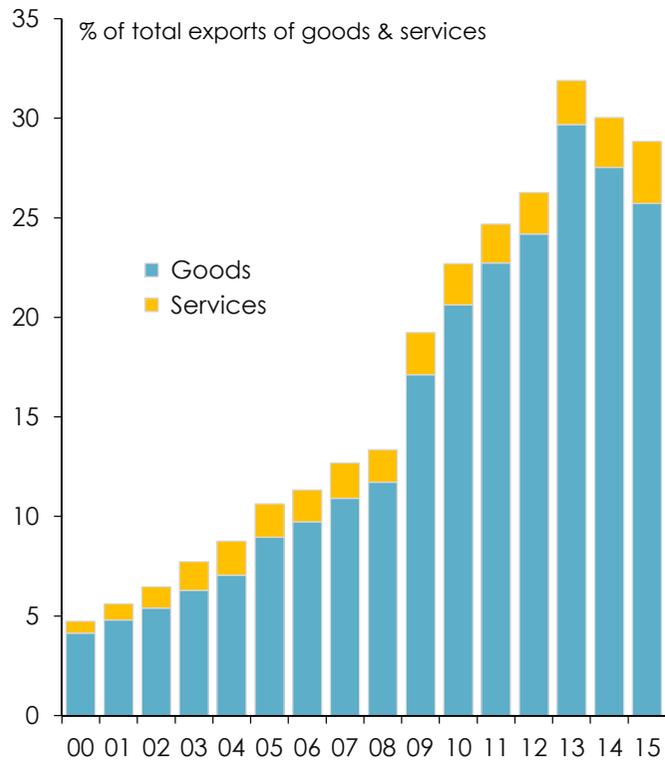
SAUL ESLAKE



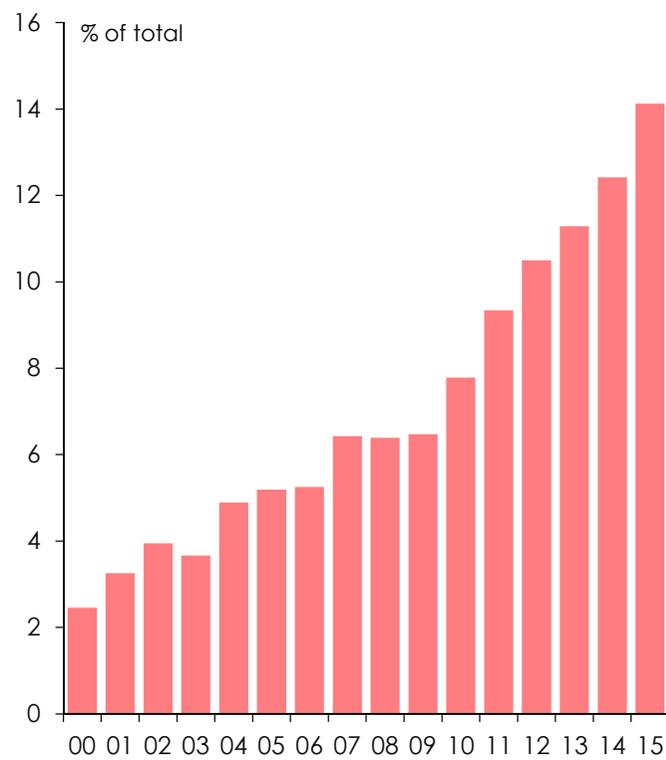
China matters to Australia

China is increasingly important to Australia – as an export market, and as both a source of and destination for investment

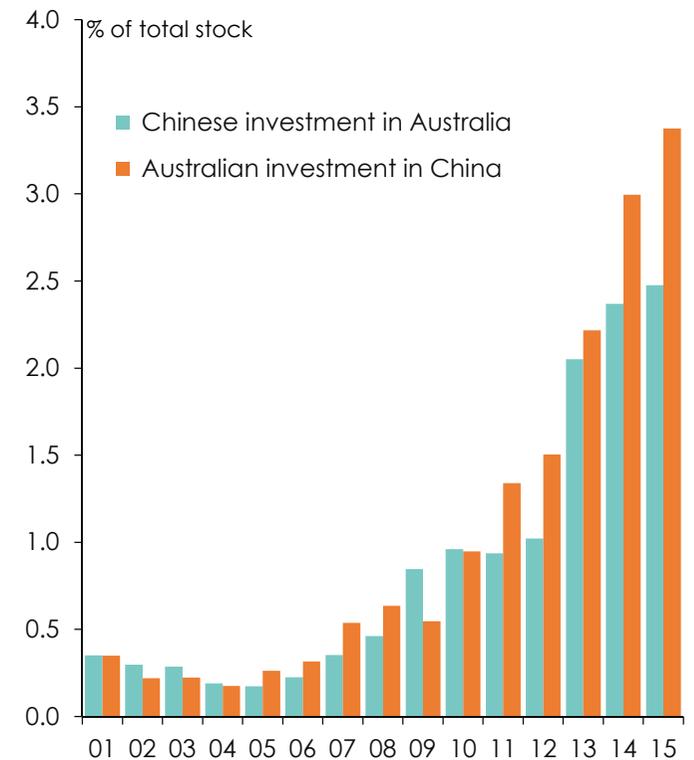
Australian exports to China



Chinese visitors to Australia



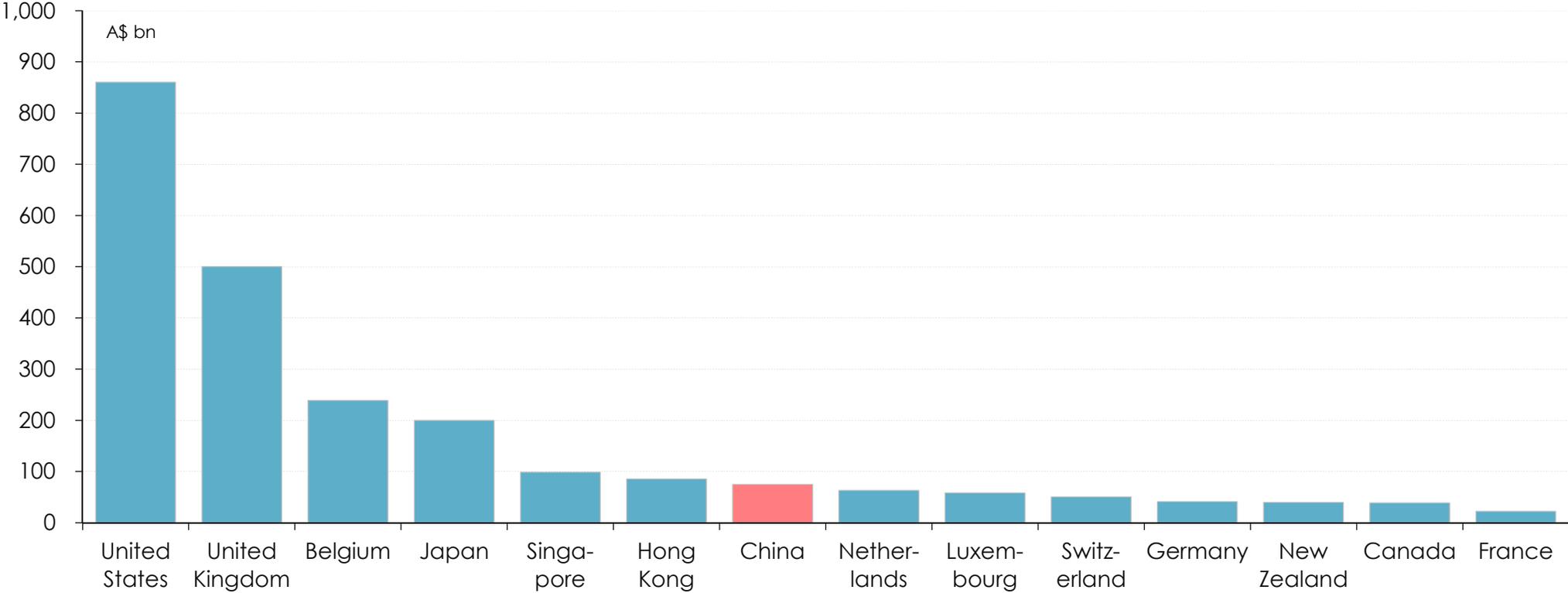
Australia-China cross-border investment



Sources: Department of Foreign Affairs & Trade; ABS.

Although China still only accounts for 2.5% of total foreign investment in Australia

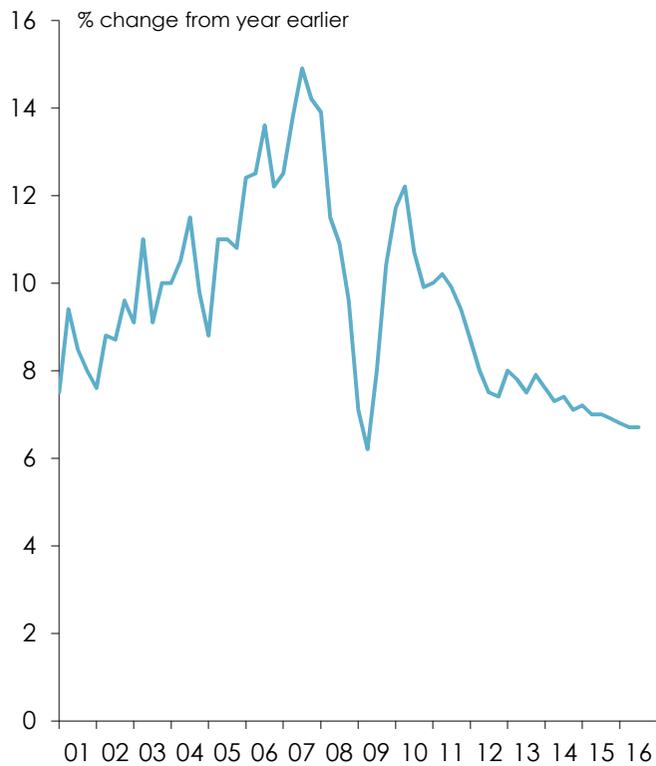
Stock of foreign investment in Australia, by country of origin, December 2015



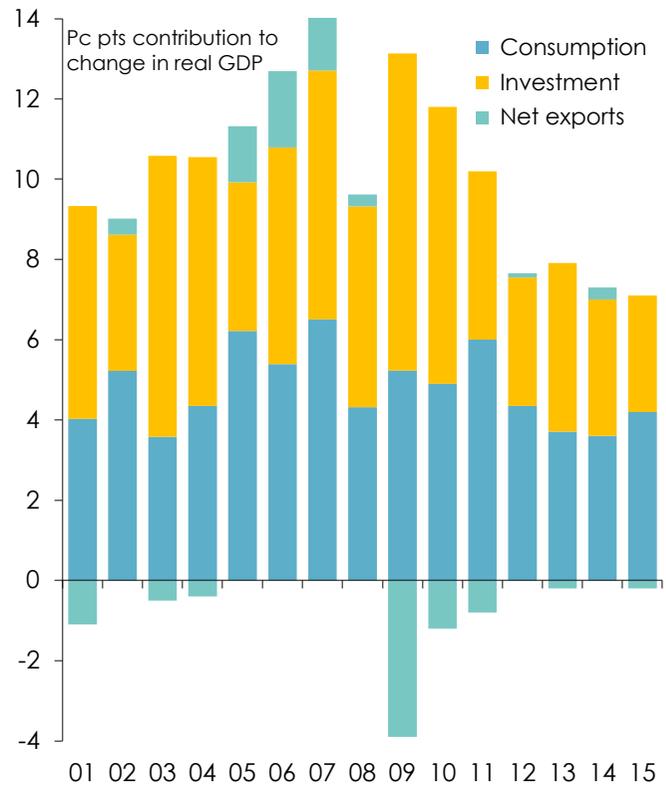
Source: ABS.

China's sustainable economic growth rate is slowing – and the 'mix' of Chinese growth is changing

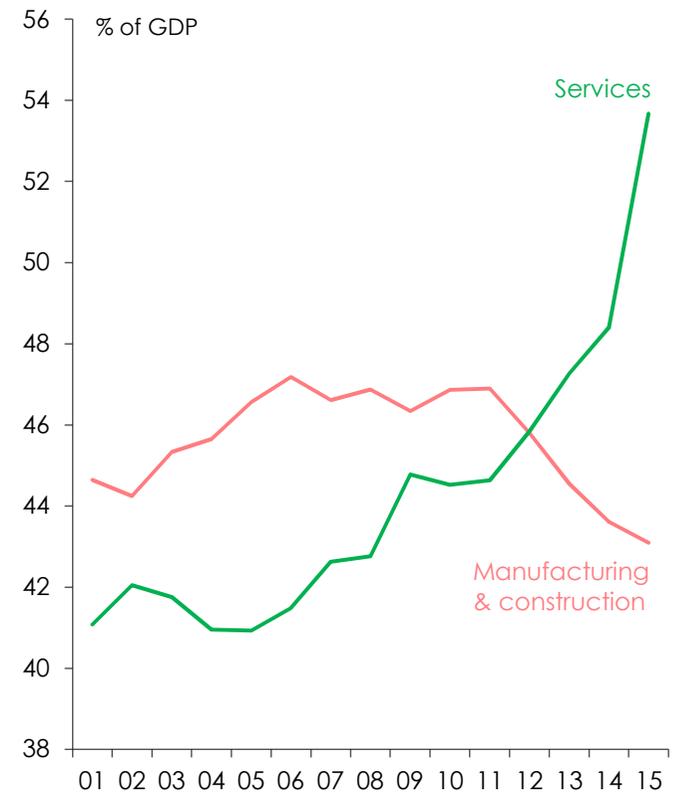
China real GDP



Contributions to annual growth in GDP



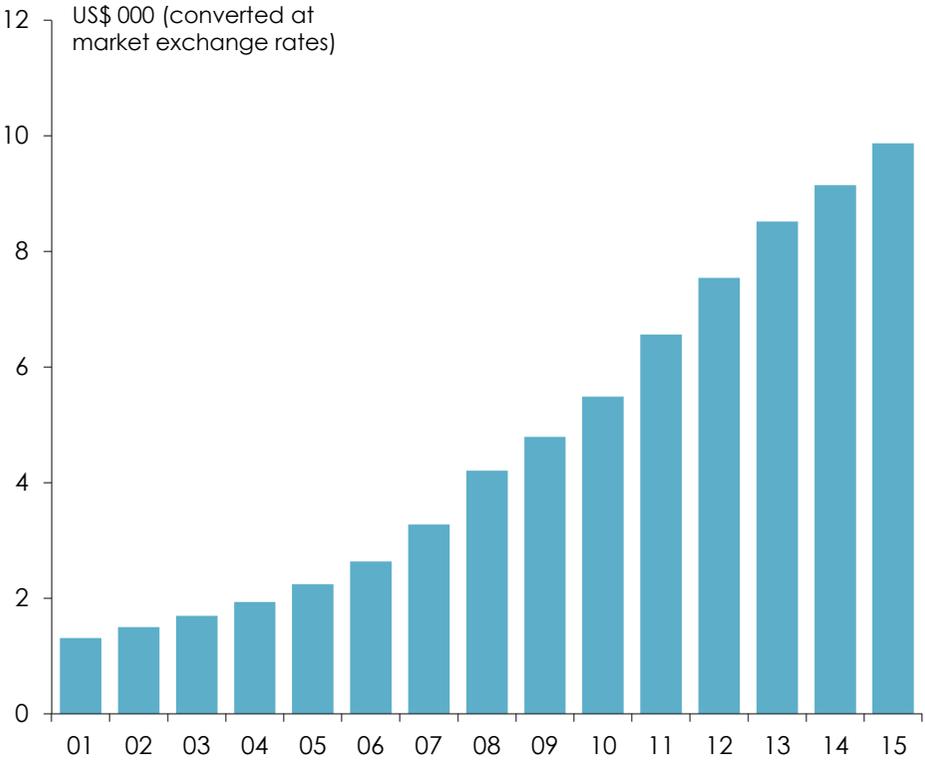
Major sector shares of GDP



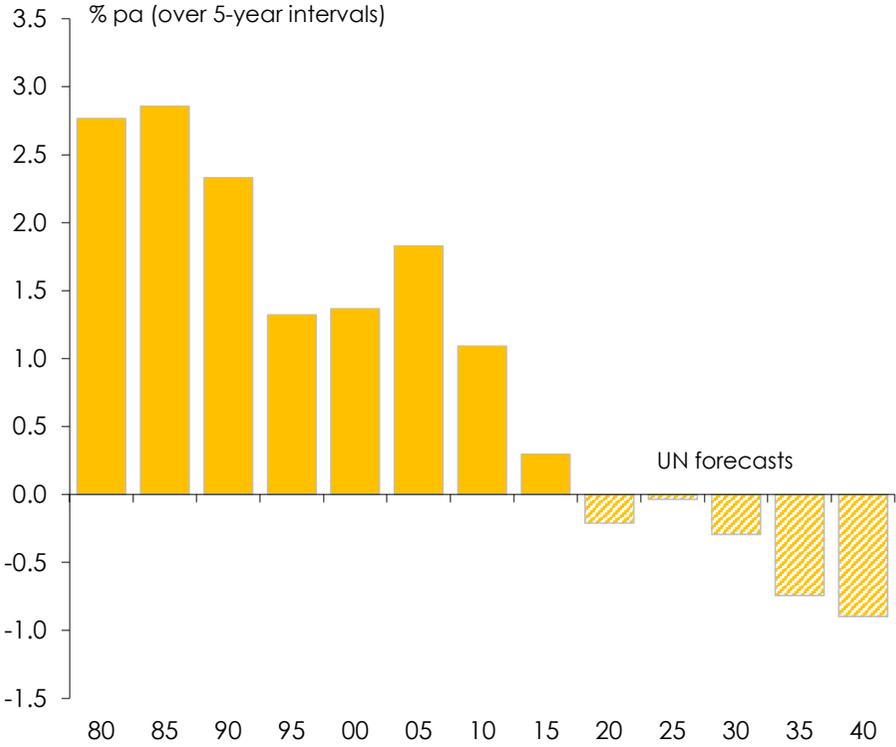
Source: China National Bureau of Statistics (NBS).

Chinese workers aren't so cheap any more: and there will be fewer of them from now on

Average wages of Chinese urban workers



Growth rate of China's working-age population



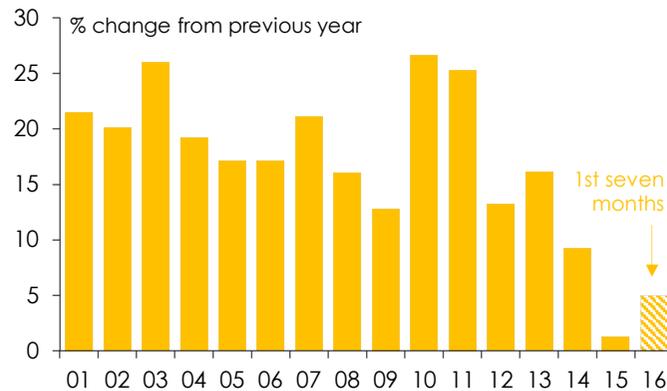
Sources: China National Bureau of Statistics; United Nations Economic & Social Affairs Division, *Population Prospects*.

Chinese authorities have launched another round of monetary stimulus, which seems to be have had some effect in the first half of this year

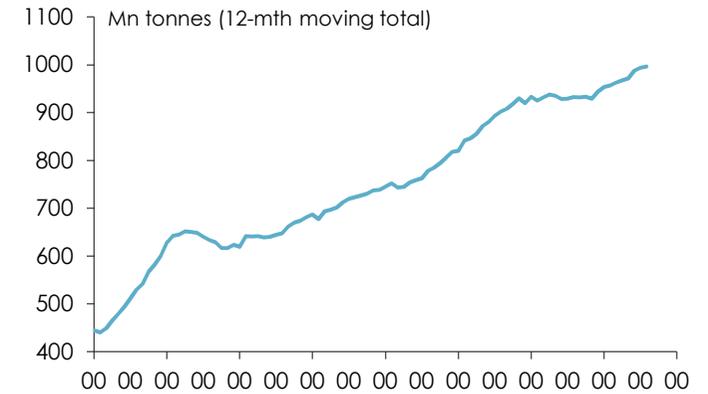
Credit growth - total



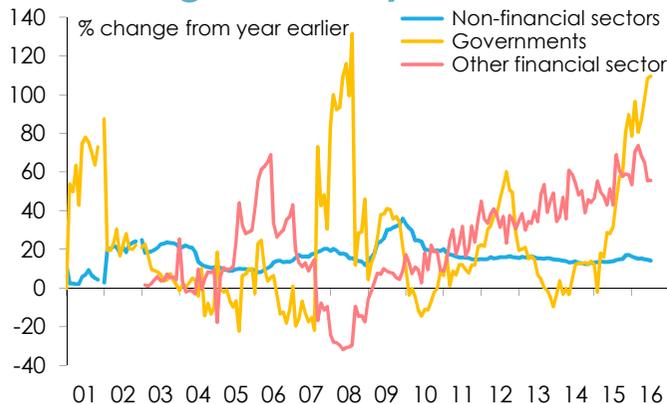
Floor space under construction



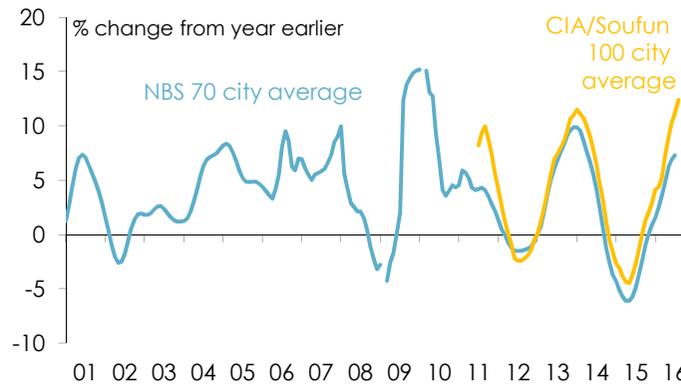
Iron ore imports



Credit growth - by sector



Urban property prices



Steel and iron ore prices

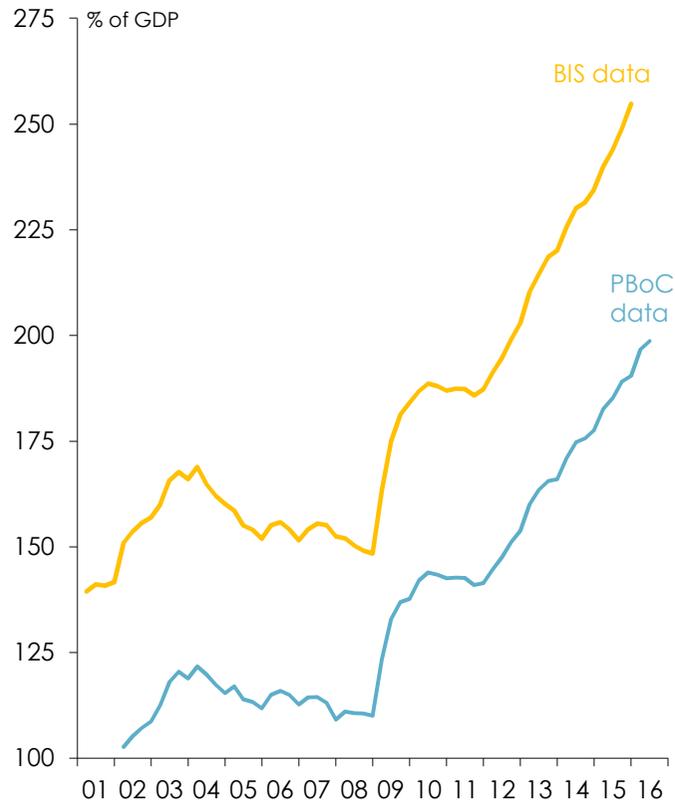


Sources: People's Bank of China; China National Bureau of Statistics; China Index Academy (CIA) & Soufun; Caixin & Markit Economics; MySteel; Thomson Reuters Datastream.

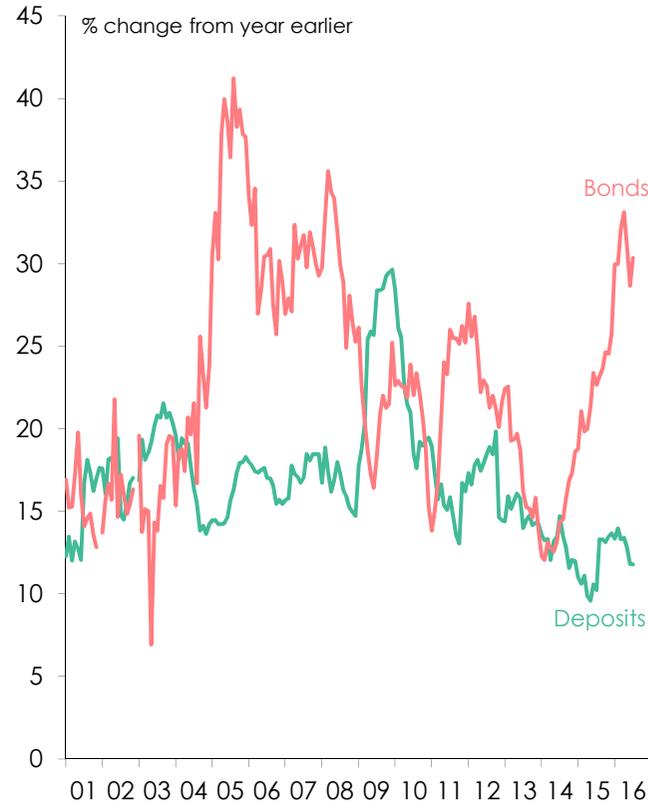
SAUL ESLAKE

But these measures are increasing the risks inside the Chinese financial system

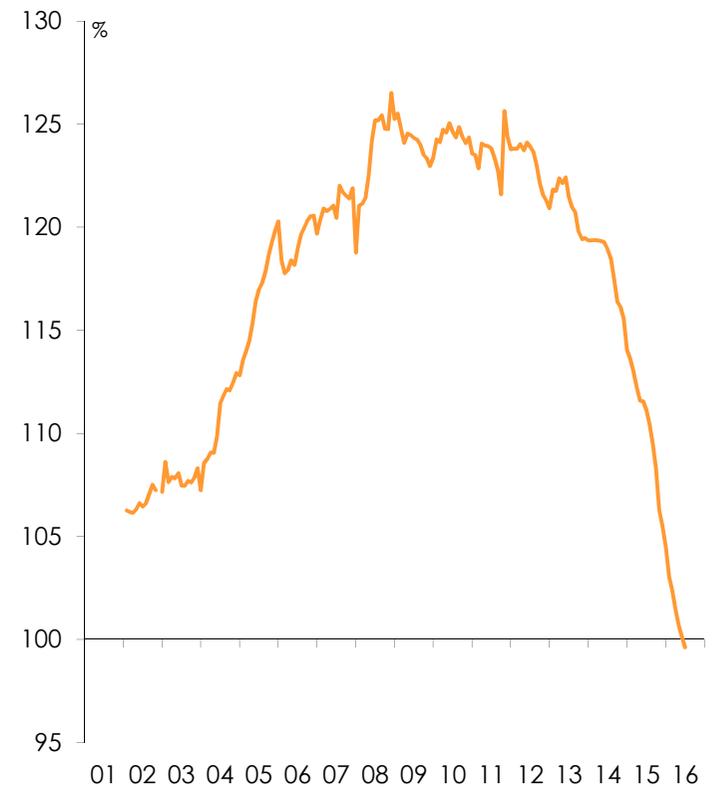
China debt outstanding as a proportion of GDP



China bank funding



China banks deposit-to-loan ratio

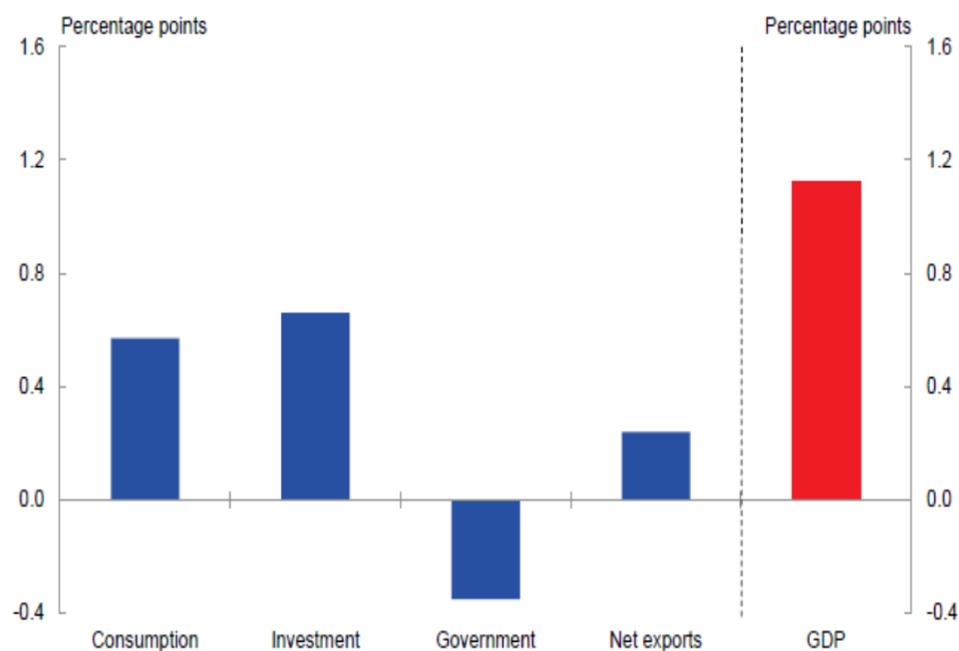


Sources: People's Bank of China (PBoC); Bank for International Settlements (BIS).

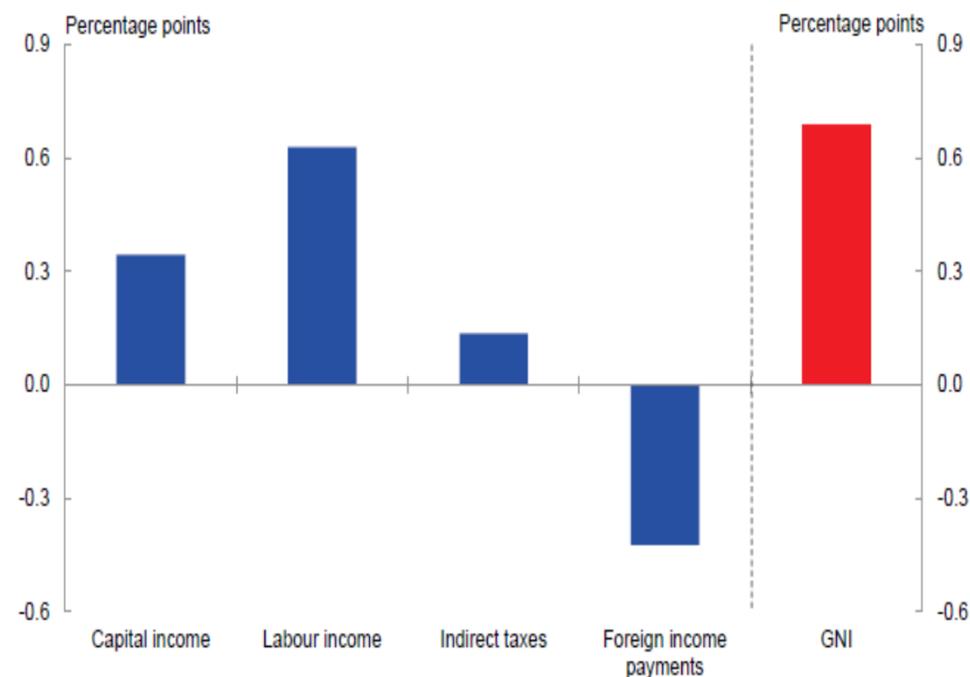
Treasury modelling suggests that a 5 pc pt cut in the company tax rate would lift the *level* of real GDP by 1% in the long run

Long-run impact of a 5 pc pt cut (from 30% to 25%) in the company tax rate financed by lower government spending

On real gross domestic product (GDP)



On real gross national income (GNI)

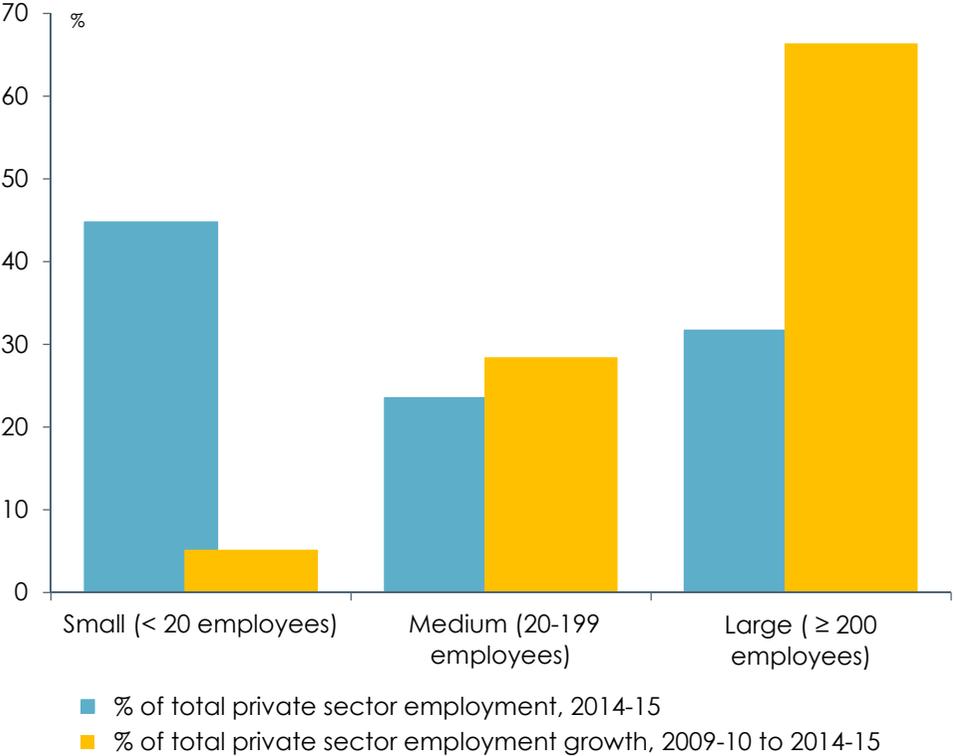


Note: 'Long run' in these charts means between 10 and 20 years. Impact is on the *level* of real GDP or GNI, not on the *rate of growth*. Real GNI is real GDP minus net payments of primary income (eg, interest on foreign borrowings and dividends or profit payments to foreign equity investors) to foreign residents.

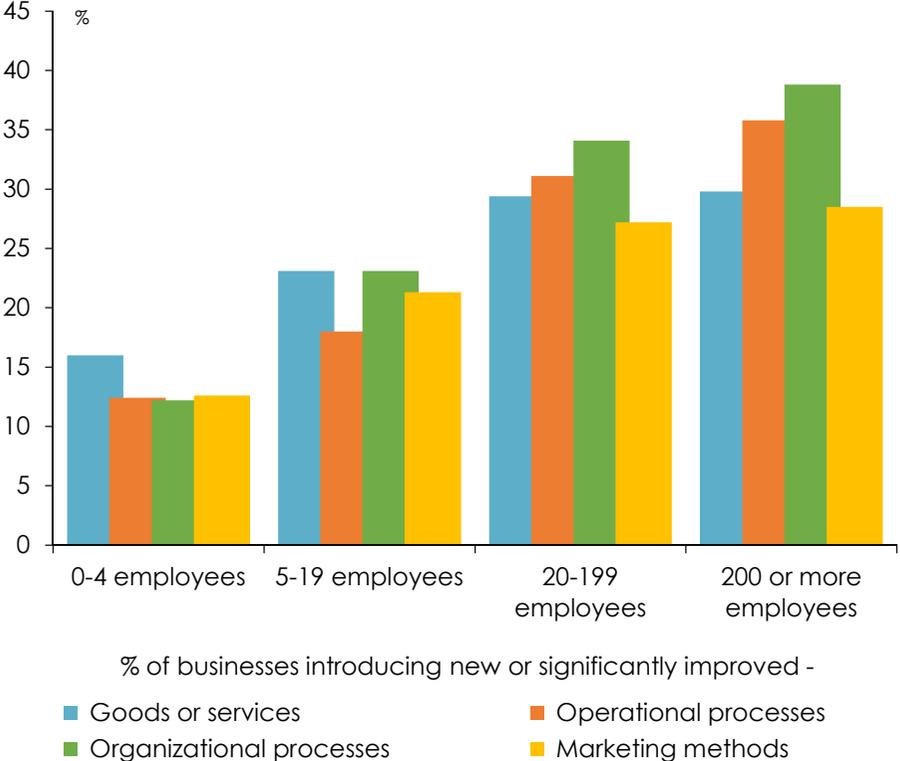
Source: Michael Kouparitsas, Dinar Prihardini and Alexander Beames, *Analysis of the Long Run Effects of a Company Tax Cut*, Treasury Working Paper 2016-02, May 2016.

There's absolutely no evidence to suggest that preferencing small business will provide a greater boost to jobs growth or innovation

Employment and employment growth by business size



Business innovation, by business size



Sources: ABS, Australian Industry (catalogue no. 8155.0), 2014-15; Summary of IT Use and Innovation in Australian Businesses (catalogue no. 8166.0), 2014-15.

This document has been prepared by Saul Eslake on behalf of Corinna Economic Advisory Pty Ltd, ABN 165 668 058 69, whose registered office is located at Level 11, 114 William Street, Melbourne, Victoria 3000 Australia.

This document has been prepared for the use of the party or parties named on the first page hereof, and is not to be further circulated or distributed without permission.

This document does not purport to constitute investment advice. It should not be used or interpreted as an invitation or offer to engage in any kind of financial or other transaction, nor relied upon in order to undertake, or in the course of undertaking, any such transaction.

The information herein has been obtained from, and any opinions herein are based upon, sources believed reliable. The views expressed in this document accurately reflect the author's personal views, including those about any and all financial instruments referred to herein. Neither Saul Eslake nor Corinna Economic Advisory Pty Ltd however makes any representation as to its accuracy or completeness and the information should not be relied upon as such. All opinions and estimates herein reflect the author's judgement on the date of this document and are subject to change without notice. The author and Corinna Economic Advisory Pty Ltd expressly disclaim any responsibility, and shall not be liable, for any loss, damage, claim, liability, proceedings, cost or expense ("Liability") arising directly or indirectly (and whether in tort (including negligence), contract, equity or otherwise) out of or in connection with the contents of and/or any omissions from this communication except where a Liability is made non-excludable by legislation.

Any opinions expressed herein should not be attributed to any other organization with which Saul Eslake is affiliated.

bettercallsaul.com.au

SAUL ESLAKE