Hoping Trump doesn't deliver

In an AFR summer series, investment experts give us their thoughts on the year ahead – and how they unwind. **Saul Eslake**, a former chief economist who now runs Corinna Economic Advisory, says there are huge downsides for Australia if Donald Trump does follow through on his election promises.

On balance

Debra Cleveland

What will the world be like if Donald Trump is able to do everything he flagged in his election campaign?

Two of the biggest uncertainties surrounding the global economic outlook for 2017 are: how much of what Donald Trump said he would do during the election campaign will he actually seek to do once he takes office; and how much of what he seeks to do will he be able to do (notwithstanding that his Republican Party holds majorities in both houses of Congress)?

Since the result of the election became clear, financial markets have operated on the assumptions that Trump will seek, and be able, to implement all the "good" things he promised during his campaign – that is, cut taxes for corporates and wealthy households, and increase spending on defence and infrastructure – and that he won't seek to do any of the "bad" things that he also promised – such as start a trade war with China. If he does everything he flagged during the election campaign, the implications for the world economy (and for Australia) are highly likely to be negative. There are two reasons for that.

First, the "bad" things (such as imposing 45 per cent tariffs on things the US imports from China, and 35 per cent tariffs on things the US imports from Mexico, or "stacking" the Federal Reserve with his cronies) will almost certainly have bad consequences. These include higher inflation, weaker economic growth if not outright recession, higher unemployment and probably heightened geo-political tensions as well (since history shows that trade wars often lead to real wars).

Second, the things which financial markets have assumed will be "good" – tax cuts and infrastructure spending – probably won't be as "good" (for economic growth) as markets assume. The US economy of 2017 is very different from the US economy of 1983-87 which markets are taking as a template for how Trump's fiscal strategy will work. Interest rates are likely to rise (not fall by more than 10 percentage points, as they did under Reagan); the unemployment rate is already down below 5 per cent (compared with over 10 per cent when Reagan's fiscal policies began to take effect); and the US working age (15-64) population is now growing at barely more than 0.2 per cent a year, compared with almost 1 per cent a year between 1983 and 1987.

So one has to hope Republicans in Congress will curb some of the new president's inclinations, if he indeed does seek to "deliver" on all of them.

Will the Chinese be able to keep their economy on an even keel and what are the implications for Australia?

The "Chinese authorities", under successive leaders, have shown a remarkable ability to keep their economy steady in the face of external and internal shocks. Some of that, of course, reflects their unparalleled (compared with other countries) ability and willingness to "massage" economic statistics so that they convey the message the authorities want. Even allowing for that, China's capacity to deliver more or less continuous economic growth, keep unemployment down and maintain household living standards on a generally upward trajectory over long periods of time does invite admiration.

But stimulus has introduced new risks beyond simply having a very high level of debt, relative to the size of the economy. In particular, the latest round of monetary stimulus appears to have taken the form of having the major banks borrow in the wholesale money markets to lend either to local governments (by buying their securities) or to non-bank financial intermediaries who then on-lend to local governments and others. The ratio of deposits to loans for the Chinese banking system as a whole has dropped below 100 per cent for the first time – signifying that the Chinese banking system has started to become more dependent on wholesale funding, in much the same way (although not yet to the same extent) as other banking systems that have subsequently experienced liquidity crises.

Liquidity crises are much harder to deal with than banking crises brought on by a sharp increase in bad debts (although the two are often related). If something were to happen that precipitated a liquidity crisis among China's banks – although what that "something" might be is hard to predict – the "Chinese authorities" might find it harder to deal with. And of course anything that pushed the Chinese economy onto a significantly lower growth trajectory – even temporarily – would have material consequences for Australia's economy. In particular, the "reprieve" we've been granted over the last 12 months from falling commodity prices would be withdrawn – resulting in additional headwinds for the federal budget, and renewed downward pressure on Australian incomes.

Will the Reserve Bank of Australia raise interest rates in 2017?

It's possible, although if it does, it is unlikely to be before the closing months of the year. I don't think the RBA wants to cut rates any further – although it has the capacity if Australia experiences another deflationary shock, contrary to the RBA's latest set of forecasts.

In its judgment, there remains a considerable amount of "spare capacity" in the labour market, and it does not expect the "underlying" inflation rate to return to the 2-3 per cent target band until 2018. So there would need to be some significant "upside" surprise to growth and (especially) inflation for it to perceive a need to raise interest rates before, say, October this year, at the earliest. In particular, I don't think it would raise rates simply to dampen property price inflation if for some reason that continued to run along at a much higher-than-expected rate during 2017.

What's the outlook for house prices in Australia?

It's unwise to talk about the Australian housing market as a single, homogeneous entity. There is a considerable divergence between supply and demand conditions across Australia, and among Australia's major cities. In Perth and Darwin, in the aftermath of the mining investment boom and with population growth slowing sharply, property prices have begun to decline and will likely fall further this year. By contrast, population growth in Victoria is accelerating (reaching a seven-year high in mid-2016) so even though there is a lot of new supply coming on-stream in Melbourne, prices could still keep rising during 2017, albeit at more moderate rates. There might conceivably be more risk in Sydney – where new housing supply is picking up more rapidly than in Melbourne while population growth has begun to slow – although at least partly offsetting those risks is that the new supply is less geographically concentrated in Sydney than it is in Melbourne (or Brisbane).

In the absence of any obvious "trigger" for prices to start falling, I'm more inclined to think that, like Melbourne, Sydney will see further property price increases in 2017, but at a more sedate pace than in 2015 or 2016. I should add, I don't think this is a good thing – I don't believe that Australia's long-term economic and social interest is well-served by ever-rising property prices, or by an entrenched belief that property prices only ever go one way. I don't think it's a good thing that lending to property investors has started to rise again, after slowing during 2015-16 in response to the tightening in lending standards dictated by APRA. And I continue to advocate for changes to Australia's taxation system which would lessen the incentives it provides for geared speculative investment in residential property.

What's been your best personal investment?

The best personal investment [my wife] Linda and I have made was almost certainly the house we bought in Melbourne in late 1995, which we sold in 2014 for more than four times what we originally paid for it (or about three-and-a-half times what we paid for it and spent on renovations about half-way through that period). That in turn made possible what we now have here in Tasmania. A close second would be handing over the management of our equities portfolio and self-managed superannuation fund to Melbourne-based boutique fund manager First Samuel.

What's been your worst personal investment?

I made a lot of very bad investment decisions, mostly in shares, from the late 1980s through the late 1990s, largely because I wasn't sufficiently interested and couldn't find the time to do the "homework" I needed to do to be successful at making personal investment decisions. That was one reason why I turned it all over to First Samuel. And having done so, I would now really struggle to recall what some of those "really bad" investment decisions from more than 20 years ago actually were.

Saul Eslake is the former chief economist (Australia and New Zealand) at Bank of America Merrill Lynch, ANZ and other financial institutions.

Time out

We moved to Tasmania from Melbourne at the end of 2014. I'd grown up here, going to school and uni in Tasmania. I've always thought of Tasmania as home. Things are close here and you're not constantly battling for a parking space. Most Tasmanians feel more able to have a say in what's going on around them. When you get into the bush or go to the beach, there is much more at your disposal. We're on the eastern outskirts of Hobart, 20 minutes from town and five minutes from the beach and we're on 14 acres (so there is a fair bit of gardening). My hobbies are fairly sedentary. I read a lot – some work but mostly I read for pleasure. We have two dogs so go on long walks. I'm chair of Ten Days on the Island, an arts festival that runs in March every two years. My wife Linda Arenella is a New Yorker. We met in a bar in Washington DC in May 1988. I'd been out for dinner with John Fraser – currently Treasury secretary but then Minister (Economic) at the Australian Embassy in Washington. Linda was with a bunch of mates and I started speaking to her. Our kids Caroline, 15, and Jonathan, 9, are adopted from China. I was adopted myself.

Saul Eslake with his dogs, Beatrice and Barnaby, at Seven Mile Beach near his home in Hobart, Tasmania. PHOTO: PETER MATHEW