Journal & Proceedings of the Royal Society of New South Wales, vol. 152, part 1, 2019, pp. 115–120. ISSN 0035-9173/19/010115-06

Australia, the safe

James Morley

School of Economics, University of Sydney

Email: james.morley@sydney.edu.au

Abstract

In these turbulent times, Australia stands out as a safe option for foreign investors and migrants. The resulting capital and labour inflows are likely to be a boon for the economy. But they come with risks of fickle financial markets and political backlash over high levels of migration, no matter how skilled the migrants. I discuss the economic basis, consequences, and risks involved in being a safe harbour for the world.

Introduction[1]

Australia has experienced more than 27 years without a recession, the longest-ever period of uninterrupted economic expansion amongst advanced economies. But will the luck of the "Lucky Country" soon run out?

Predicting recessions is more difficult than often believed. Yes, if one *always* predicts the end (of expansion) is nigh, the doomsayer will eventually be right. But they would be wrong far more often than not. The trick is to do better than an "unconditional" forecast that effectively tosses a coin and chooses to predict a recession in any future quarter based only on their general historical frequency.

To do better than an unconditional forecast, one must try to take an objective stock of current economic conditions and consider how these might change in the near future. Despite some ominous storm clouds on the horizon, I argue that the prognosis for Australia in the near term is not so dire as it might at first appear. In particular, if we think of Australia's economic fortunes as at least partly reflecting global capital and labour flows, the news is actually pretty good.

Storm clouds on the horizon

Before explaining my optimistic prognosis for the Australian economy over the next few years, it is worth reviewing the major risks we currently face.

First, Australia, like many countries, has been suffering from relatively low productivity growth over the past decade or so, a particularly worrisome aspect of a phenomenon often referred to as "secular stagnation." This is clearly a risk to the continuation of the current expansion given that most theories of economic growth see productivity growth as *the* main driver of why economies prosper.

Second, house prices are declining in Sydney and Melbourne and the scale of the decline looks to be larger than it was in previous episodes. Given that housing represents a major source of wealth for Australian households, a dramatic fall in house prices could spill over into lower aggregate consumption and trigger a severe downturn in the economy, similar to what occurred in

[1] This article is based on a talk given at The Royal Society of New South Wales Forum on "Towards a prosperous yet sustainable Australia — What now for the Lucky Country?" on 29 November 2018. I thank participants at the forum for helpful questions and a stimulating discussion.

the United States with the Great Recession in the late 2000s.

Third, Australia has a very large current account deficit and has been continuously running one for decades.[2] If the capital inflows that sustain this deficit were to suddenly stop, there would be a serious economic crisis, as has happened in many other countries with similarly large current account deficits.

Fourth, inflation has remained stubbornly below the Reserve Bank of Australia's 2–3 per cent target for a number of years in a row. It has not been very far below, but it has notably failed to return to the target range despite fairly loose monetary policy over the same timeframe. Low inflation is, of course, not a major problem in and of itself. But it is a symptom of low wage growth, amongst other things. It is natural to expect that such low wage growth will spill over into weak aggregate consumption.

Fifth, there has been some political chatter in recent months about reducing immigration rates. Whether such policies will come into effect is unclear, regardless of the outcome of the next federal election. But if they do, it would directly reduce economic growth, although it would be unlikely to trigger a recession in and of itself.

[2] The current account measures the net flows of payments related to current income across countries. A current account deficit means that more such payments are going out of a country than coming in, such as would occur if there are more imports than exports, all else equal. Given a floating exchange rate, the direct counterpart of a current account deficit is a capital account surplus of the exact same amount, where the capital account measures net flows of payments for assets, broadly defined (i.e., claims on future income). Thus, it is natural to think of a current account deficit as reflecting net capital inflows.

Safe harbour

So, given these ominous storm clouds on the horizon, why do I argue that the near-term prognosis for the Australian economy is actually pretty good? My simple thesis is that the capital and labour flows that help prop up growth are based on *relative* risks and returns. On this basis, Australia stands out as a safe harbour in a world covered by tumultuous seas.

Where else should capital flow? Europe? The US? China? Japan? All of the large economies of the world face huge economic challenges. The rest of Asia? Latin America? Africa? Emerging economies always have risk.

In the following discussion, I take an investment-portfolio perspective to capital-flow determination.

Starting with Europe, most of its countries have demographic time bombs in the form of rapidly aging populations. As a consequence, Europe will soon have even lower economic growth, not just because of low productivity growth, but simply because working-age populations will start declining. At the same time, Europe is going through a period in which populist, nativist governments are elected and pursue policies that could be economically counterproductive (e.g., the anti-immigrant policies in Austria and Italy). Furthermore, while the sovereign-debt crisis that engulfed Greece and other countries in the early 2010s appears to be over for now, it could certainly flare up again at any moment. Meanwhile, if we choose to think of the UK as fundamentally separate from Europe, as many of its citizens did in voting for Brexit, the massive economic uncertainty that results from the Brexit vote doesn't exactly make it a safe choice by comparison. Whatever form it might take, Brexit

will almost certainly harm the UK more than Europe.

As in some of Europe, the US is also going through period in which populist, nativist policies are being implemented. Just how serious the long-run consequences of the protectionist trade policies will be is still unknown. Maybe it won't be so bad. After all, the renegotiation of NAFTA appears to have largely been a rebranding process rather than anything more fundamental in nature. But the trade war with China appears real and its consequences potentially far reaching. Basic economics tells us that those consequences are likely to be negative for all parties involved. Trade is not a zero-sum game. Furthermore, a high US dollar means that the US trade deficit is unlikely to actually improve despite the protectionist policies, while it mostly places a lot of downside risks on future growth and returns on US assets.

China has been the major engine of global economic growth for the past few decades. But a trade war with the US would introduces serious risks to the Chinese economy. Similarly, it would be prudent to think there are some risks for foreign investors in terms of the Chinese political and financial systems. For a risk-averse investor, it is better to look elsewhere first.

What about Japan? It is a large economy that, from some appearances, seems to be finally climbing out of three decades of relative stagnation. But the demographic time bomb that is ticking for Europe has already gone off in Japan, with more than a quarter of the population already over the age of 65 years. Thus, Japan is unlikely to be much of a powerhouse of growth, even if it crawls out of stagnation. Perhaps related, Japanese assets generate low returns and even very long-term government bonds are paying less than 1% interest rates. For an investor chasing yield, it is necessary to go elsewhere.

Turning to emerging economies in the rest of Asia, Latin America, and Africa, things actually look good in the sense that old political risks seem somewhat diminished (but not gone, as recent elections in Brazil and Venezuela have proven) and there has been some convergence in standards of living, as long predicted by neoclassical growth models. However, even if the expected returns are high, there is always more risk in emerging markets. The main point is that it would be prudent to diversify some of that risk by including major investments in safer countries such as Australia in any portfolio that also includes emerging markets.

"Countries like Australia" brings us to Canada, which would seem to be our main competitor as a potential "safe harbour." But it faces the same storm clouds and is certainly subject to huge risks if the US turns its protectionist focus north again.

Perhaps what is notable about this discussion is that there isn't anything particularly new about many aspects of it, although the rise of populist, nativist policies appears to be gaining momentum in the last few years. Many of the same forces have been contributing to net capital inflows into Australia for decades, with these inflows simply being the accounting counterpart to the persistent current account deficits mentioned above.

So is there a risk that the tap will be turned off and Australia forced to run current account surpluses? One big difference for Australia compared to many other countries that suffered "sudden stop" crises after years of current account deficits, such as many Asian economies in the 1990s or Argentina at many times, including recently, is that foreign-held liabilities are largely denomi-

nated in domestic currency.[3] Thus, we can still repay the debt even if the Australian dollar depreciates. And the dollar has actually depreciated in recent years, following the end of the mining boom. This has had the predictable effect of improving the trade balance. Indeed, Australia is currently running a trade surplus, even if payments on foreign-held debt mean that it still has an overall current account deficit. Were capital flows to suddenly stop, the Australian dollar would likely fall further and we would likely be able to pay back past debts by exporting more goods and services. Of course, the ability to pay back in this way helps prevent a crisis in the first place. That is, there is no reason to expect that capital flows will stop in anticipation of a failure to pay back foreign-held debts, the dynamic that can explain past crises in Asia and Argentina.

In terms of labour flows, the story is even simpler to tell. Australia is an unusually appealing destination for young, skilled migrants. Beyond the direct benefits to economic growth from skilled migration in terms of adding to the productive stock of labour, there is an indirect demographic benefit. In particular, Australia has a relatively low dependency ratio. It has more people of working age to support those of retirement age, in the range of more than 4 persons, compared to close to 3 for most of Europe or close to 2 for Japan. For Australia, a low dependency ratio is a clear consequence of sustained high levels of immigration, with one of the highest ratios of overseas-born citizens in the world keeping the population relatively young. This is not to say Australia is devoid of demographic challenges. It is just that they are less serious or pressing than for many other countries.

Silver linings

There are some silver linings that mitigate the risks associated with the storm clouds discussed above.

First, despite low productivity growth, it is notable how stable — at around 3% per annum — real GDP growth has been for Australia over the past few decades. As an accounting matter, this stability must reflect relatively strong growth of the labour force in order to offset the weaker productivity growth, so it doesn't translate into as strong an increase in income per capita. However, there is at least one economic setting where real GDP growth matters more than productivity growth. This is in terms the ability of a country to sustain or pay off its debts. Australia actually has a relatively low ratio of public debt to GDP, partly due to less runup of debt than in other countries with the global financial crisis, but also due to relatively strong GDP growth over the same period. Given that the ability to raise tax revenues goes up with GDP, this growth makes the level of public debt quite sustainable. Similarly, the ability to pay back foreign debt has been made more manageable due to strong GDP growth.

Second, even though house prices are falling a lot in Sydney and Melbourne, they are more stable in the other capital cities. This suggests a return to earth of high prices in particular markets, rather than a collapse due to oversupply or ill-advised loans, as arguably was the case in the US with the Great Recession. Furthermore, Australian banks, due in part to a lack of competition, are much better capitalized and able to cope with a significant fall in house prices than was the

[3] See, for example, the discussion in a recent speech by Christopher Kent, Assistant Governor (Financial Markets) of the RBA at https://www.rba.gov.au/speeches/2018/sp-ag-2018-12-10.html

case for the financial system in the US. If the migrant flows discussed above continue, the basics of supply and demand will mean house price growth should return to positive territory once a correction has occurred in markets with particularly high price-to-rent and price-to-income ratios.

Third, despite the ongoing current account deficits, Australia's net foreign holdings (net foreign-held debt plus net foreign-held equity) have stabilized over the past couple of years, albeit at a high level that is not far shy of 100% of GDP. This stabilization in the face of ongoing current account deficits reflects a better performance of Australian-owned assets abroad than foreign-owned assets in Australia. Combined with (and reflecting) the fact that most foreign holdings of Australian liabilities are denominated in Australian dollars, this stabilization suggests that no current account crisis is imminent.

Fourth, low inflation and wage growth reflect a number of one-off factors that suggest inflation and wage growth can be expected to pick up at least slightly in coming years. Inflation is low, but stable at close to the 2–3% target range for the RBA. This stability may have made inflation targeting a "victim of its own success", with market-based measures of inflation expectations (e.g., break-even 10-year inflation rate) at the low end of the RBA's target range. The manifestation of these low expectations is self-fulfillingly low levels of price growth for domestically produced goods and services for which producers have some ability to set prices. For example, price growth in the education sector showed a marked drop a couple of years ago that seems to have led to a similar drop in wage growth in the sector. What is notable is how price and wage growth in the education sector are more in line with overall inflation expectations, instead of running above in a way that would help offset lower price growth of import goods and services. It is this sense in which I suggest inflation targeting could be a victim of its own success.

At the same time, even with inflation expectations bringing down price and wage growth for some domestically produced goods and services on a one-off basis, there are countervailing forces that should lead to inflation returning back to the RBA's target range and higher wage growth in coming years. For example, despite the arrival of Amazon.com being widely touted as a reason for inflation to fall further, import price growth is currently higher than it has been for a more than a decade, in part due to the fall in the Australian dollar. Also, the unemployment rate is falling. The "Phillips curve" that links low unemployment to higher wage growth and inflation may go missing every so often. But, historically, it does eventually show up. And the recent increases in the participation rate are a reason why wage growth has not gone up as much in response to a low unemployment rate as would be historically expected given that new participants would be expected to earn lower wages than more established workers. However, there are limits to how much participation rates are likely to rise and when they stop doing so, the unemployment rate can be expected to fall faster and wages to start rising faster.

Furthermore, there is an important, but often overlooked silver lining to the slow wage growth in Australia. It has meant that, after a long period in the 1990s and 2000s of unit labour costs (i.e., how costly one unit of output is to produce in terms of hiring labour) growing at a much faster

rate than the G7 industrialized economies — which made Australian labour expensive and uncompetitive — these costs have been growing at a slower rate since 2012. This sustained lower growth of unit labour costs means that Australian labour is now finally becoming competitive again on the global scene, making Australia a more desirable place to invest. Any resulting growth from foreign investment in Australia should be expected to improve incomes over time.

Fifth, in terms of the political risks to migration flows, the silver lining is that there are frequent elections in Australia and it would be unusual to see a successful political movement that seeks to strongly restrict migration when the unemployment rate is low and the economy is growing at a reasonable rate. In particular, the rise of nativist policies in the US and Europe in recent years came out of economic crises from which Australia was relatively less affected.

Conclusion

It is, of course, always dangerous to make sanguine predictions. My prognosis for Australia would certainly look foolish if the Australian economy is in recession by the time someone reads this, as inevitably someday it will be.

But it would also be foolish to focus exclusively on downside risks and always predict the end is nigh. There are a number of reasons to expect economic growth to continue for the Australian economy for the next few years. One major reason is that the capital and labour flows that have helped sustain growth over the past few decades should continue in the absence of a major change in policy. In particular, the external forces that drive these flows are likely to continue. Australia is a relatively safe bet for both capital and labour when looking at the global landscape. Only a major change in domestic policies could disrupt these flows.

Furthermore, although there are various storm clouds on the economic horizon, there are silver linings to most of these that suggest economic growth should continue. Australia has a good public-debt situation, providing fiscal capacity to address future global economic shocks. It has low unemployment despite rising labour-force participation. Finally, after many years of increases in unit labour costs at a faster rate than most other industrialized economies, recent slow wage growth means that Australian labour is finally becoming relatively more competitive. Along with a low Australian dollar, this all suggests that capital inflows could actually increase and the resulting investment will produce somewhat faster, not slower growth over the next few years.