The Lucky Country: Has it Run out of Luck?

by

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Australia: "one of the best managers of adversity the world has seen – and the worst manager of prosperity"
The Economist

Introduction

Australia is unique among advanced economies in having experienced almost a quarter century of uninterrupted economic growth.

This track-record is looked upon with envy in other parts of the world, but at home complacency endangers the capacity to extend this record, to sustain growth in employment and living standards, and to identify and pursue the next stage of Australia's economic development.

A key factor in Australia's success over the last 3 decades has been national policy discussions about how best to move forward. Yet, today, when huge structural shifts are underway globally that have profound long-term implications for individual economies and for the world at large, when Australia's productivity performance is poor, its fiscal position challenging, and living standard growth under threat, discussion of these developments is notably absent from national discourse.

Four forces are reshaping the global economy – technology, demography, sustainability issues and shifting economic weight. Each of these is recognised at some level domestically and internationally. What is rarely acknowledged, however, is that while each is impacting growth opportunities and pathways in different ways, their interaction is even more powerful.

These forces will shape the operating context for all economies over the first half of the 21st Century. Yet arguably, Australia, like other developed economies, is ill-prepared for the changes that are likely to occur.

The question facing nations is how to prepare for the long-term consequences for jobs, growth and living standards of these forces. Their consequences will neither be orderly nor easily managed without careful preparation. For Australia, it requires a mind-set that sees managing these challenges and grasping the accompanying opportunities as akin to the structural reform program pursued during the 1980s and 1990s to deal with the decline in Australia's relative economic performance. But unlike then, there is currently no community sense of a burning platform driving the nation to focus on what is required for future success.

Indeed, a common theme across Australia and other advanced economies is the lack of preparation to deal with the economic transformations that are unfolding. While this may be understandable in countries still focused on recovery from the Global Financial Crisis (GFC), Australia has no such justification.

In the mid-1980s, *The Economist* magazine described Australia as “one of the best managers of adversity the world has seen – and the worst manager of prosperity”. The latter part of the description accurately describes Australia’s experience over the last decade – what remains to be seen is whether the former still holds in a world of increasing complexity and interdependence.

This essay argues that Australia is not well positioned for either the opportunities or challenges ahead. It reflects on what has delivered past success and describes the challenges to future living standards and the equally big opportunities available for a country prepared to embrace change.

Change will require Australia’s political class to pick up the mantle of leadership and move away from the short-term opportunism that has characterized public policy debates for much of the last decade – repetition of slogans is not a substitute for policy action.

Concerns about leadership are not unique to Australia. Throughout much of the developed world there appears to have been a decline in the capability and willingness of the political class to lead – to lay out a vision for the future, to describe a pathway to achieve that future, and to take the hard policy decisions necessary to deliver.

Yet it is too easy to lament the lack of political leadership in isolation. Leaders never lead in a vacuum - the support of the broader community is critical if Australia is to embrace change. But community support will not be forthcoming without an honest dialogue of our strengths and weaknesses as a nation, and a careful prioritisation of national objectives.

In short, the key to the question:

The Lucky Country – has it run out of luck?

lies in our hands.

Australia’s Reform Era[1]

As is well known, “*The Lucky Country*” is the title of a book by the late Donald Horne, first published in 1964.

[1] This section draws on my presentation, *Reflections on Australia’s Era of Economic Reform*, delivered to the European Australia Business Council on 5 December 2014.

While the original intent of the term was ironic, over the years it has become a virtual synonym for Australia's prosperity, resource endowment and the geography that has isolated us from many of the problems experienced elsewhere in the world.

What Horne actually said is that:

"Australia is a lucky country run mainly by second rate people who share its luck. It lives on other people's ideas, and, although its ordinary people are adaptable, most of its leaders (in all fields) so lack curiosity about the events that surround them that they are often taken by surprise."

Horne also suggested that Australia "showed less enterprise than almost any other prosperous industrial society."

While these judgments referenced post-war Australia as it had evolved up until the 1960s, it was arguably true for another two decades, and perhaps never more so than in the late 1970s.

Elsewhere, I have described the late 1970s as a period of turmoil, where a sense of what Australia could have been, but was not, was influencing debates.

> "One side of politics was in denial about its failures in government while the other side promised much and delivered little in terms of righting the economic ship."[2]

By the early-mid 1980s, after a decade book-ended by two recessions and characterised by stubbornly high unemployment, stagnant growth, persistent inflation and declining relative living standards, Australians knew that they had to change. That recognition had been sharpened when then Singaporean Prime Minister Lee Kuan Yew said, in 1980, that Australians were on the way to being 'the poor white trash of Asia". If more urging was needed, it came with the warning from then Treasurer Paul Keating in 1986 that, without change, we would become "a third rate country…a banana republic".

And change we did.

Beginning in the early 1980s, Australia embarked on one of the most significant reform programs ever seen in an advanced economy.

We floated the currency, deregulated the financial system, and opened up product and labour markets by sweeping away ossifying rules and regulations designed to create a cosy life for business and unions at the expense of consumers. These changes to financial, labour and product markets increased the economy's ability to adjust to changes

[2] Presentation to QUT Business Leaders Forum, 14 July 2015. In that presentation I go on to note that "while we didn't know it then, this period was leading both major parties to a realization that we couldn't keep on as we were." This was manifest in the Liberal Party with the emergence of the ginger-group of Dries, and in the ALP with the National Committee of Inquiry and the thinking that eventually resulted in the negotiation of the Accord with the trade union movement.

in global economic circumstances and to deliver better products and services for consumers.

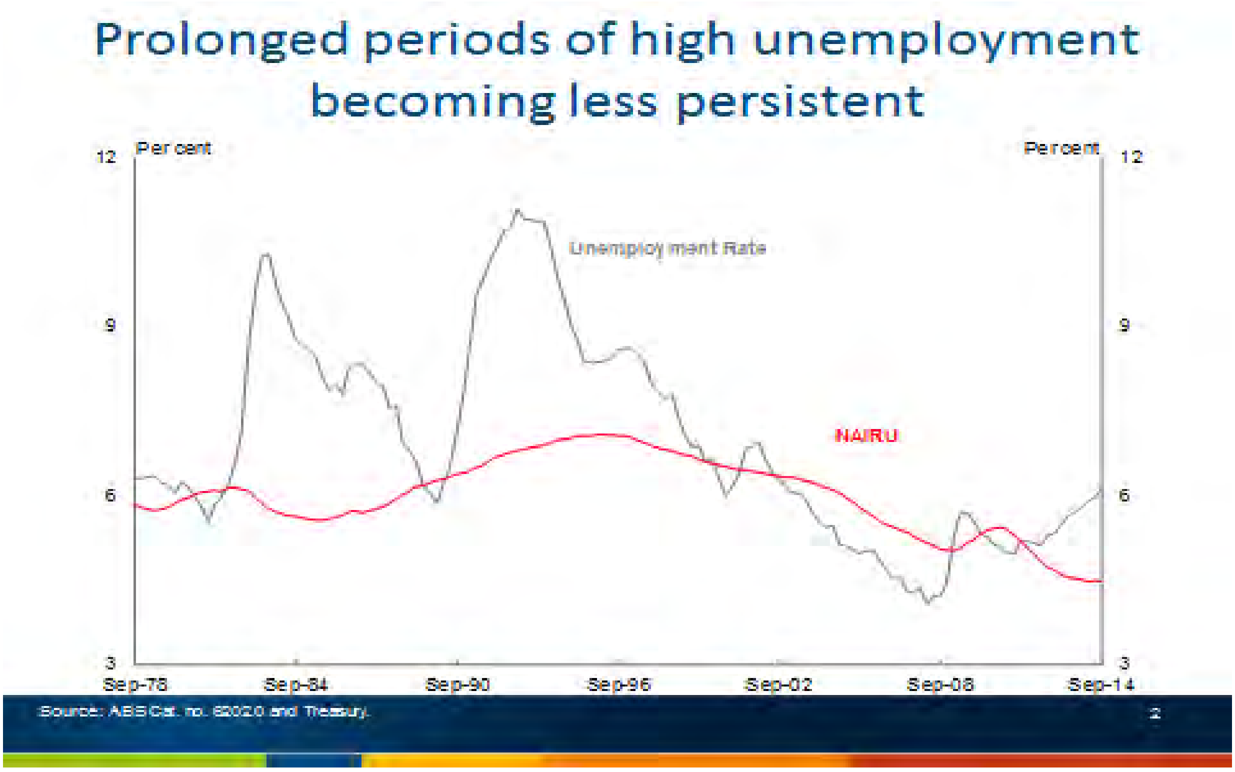
We also made major changes to macroeconomic policy. Our frameworks for monetary and fiscal policy were set out with a clear medium term focus, and in the process made more transparent and understandable.

And we created an institutional framework, with the establishment of the Productivity Commission and independent regulators, that delivered tough independent policy advice and ensured the implementation of policy within clearly specified frameworks, free of political interference.

That reform program, which had bipartisan political support while Labor was in power, continued through the Hawke/Keating and Howard governments, arguably only faltering with the emergence of the resources boom in the early 2000s.

None of those reforms were easy, but the payoff was great - so great in fact that current generations would struggle to comprehend just how much Australia has changed, and how their income, wealth and opportunities outstrip anything of which their parent’s generation could have dreamed.

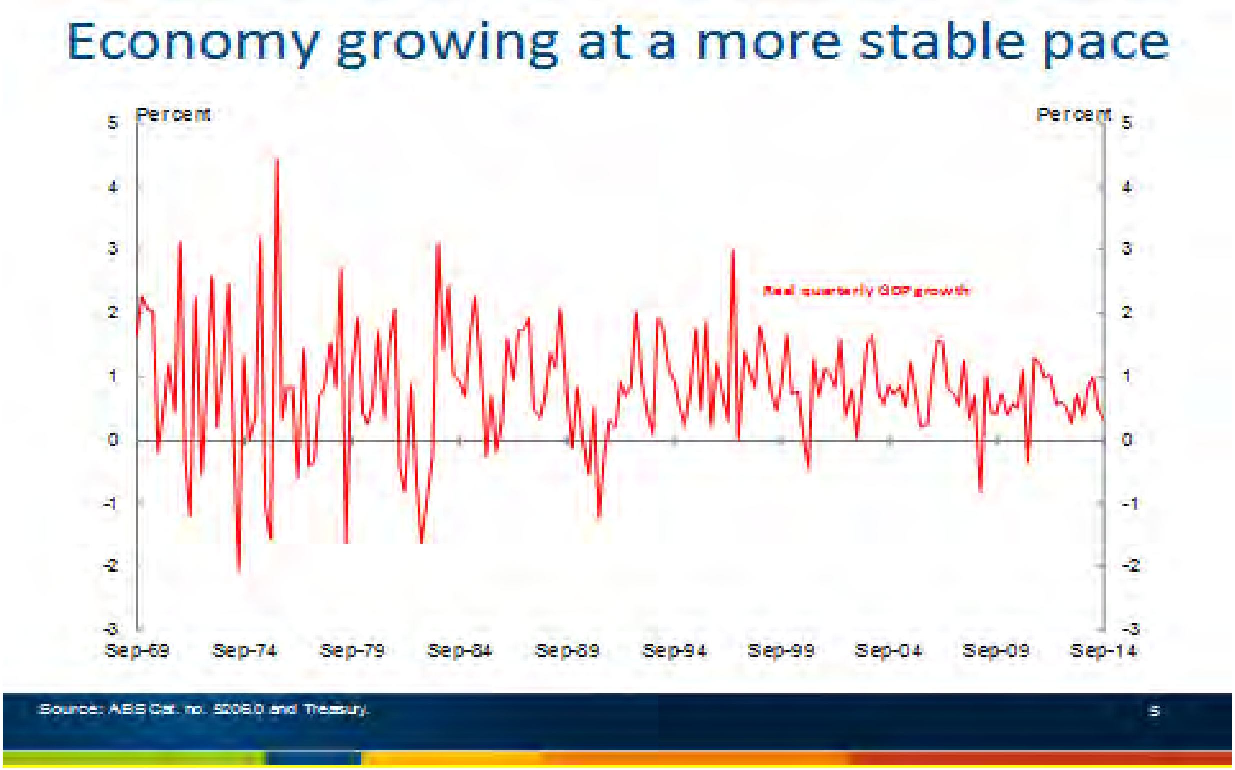
Chart 1



In the last three periods of economic slowdown – the tech wreck of 2000-01, the GFC, and the sluggish global growth and falling prices for Australian exports seen over the last few years, the unemployment rate has risen only by around 1 percentage point above the estimated "normal" rate of unemployment (NAIRU).[3]

In contrast, the 1970s, 80s and 90s recessions all saw the unemployment rate rise by 4-5 percentage points above the NAIRU.[4]

Chart 2



The counterpart to the change in our experience with unemployment can be seen in GDP growth, which has been far more stable, and with periods of economic slowdown that are shorter, and of smaller magnitude, than previously.

In short, that period of sustained reform set Australia up for two decades of uninterrupted economic growth, and for an economy that is far less volatile than anything that came before it. The consequences have been dramatic – average real incomes and wealth per capita are dramatically higher, and post-transfer payment inequality little changed[5], in part because we have avoided the social and economic cost associated with recessions.

But a quarter century of uninterrupted economic growth means that many of the leaders of our firms, unions, and even political organisations, have never experienced an economic downturn in the adult lives. Indeed, half of the population of working age population (15-64) had not even entered the workforce in 1990-91, the time of our last recession!

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[3] The "normal" rate of unemployment here refers to the NAIRU, or non-accelerating inflation rate of unemployment.

[4] Of course, as the Australian Treasury's Wellbeing Framework illustrates, policies that improve outcomes on some dimensions can come with costs in others. Arguably, the reform-induced improvement in macroeconomic performance was accompanied by some increase in risk and complexity for individual citizens as they had to, for example, manage their own retirement incomes and operate in newly deregulated product and labour markets.

[5] See Fletcher, M and B. Guttman (2013) *Income Inequality in Australia*, Treasury Economic Roundup 2.

The result is that complacency became endemic during the 2000s - the urgency of needing to compete to sustain growth in living standards ebbed away as we experienced the biggest, and longest, terms of trade boom in our history.

As a result of that complacency, Australia can no longer claim to be world-best in our policy design, and we are far from world best in our economic performance, notwithstanding that we avoided much of the impact of the GFC.

As journalist Paul Kelly[6] has noted, three unique factors gave rise to the post-1983 reform agenda:

- Widespread recognition that the status quo had failed, a sentiment driven by the deep recessions of the 1970s and early 1980s;
- A consensus in the political system in favour of new ideas such as the utility of markets and the need to deregulate, wind back protection, increase savings and impose more discipline on the public sector; and
- A political culture that was able to prioritise the public interest.

As Kelly argues, these three factors “gave governments an electoral incentive to look beyond narrow policies catering to their traditional voters and seek fresh supporters in the middle or from the opposing side of politics.”

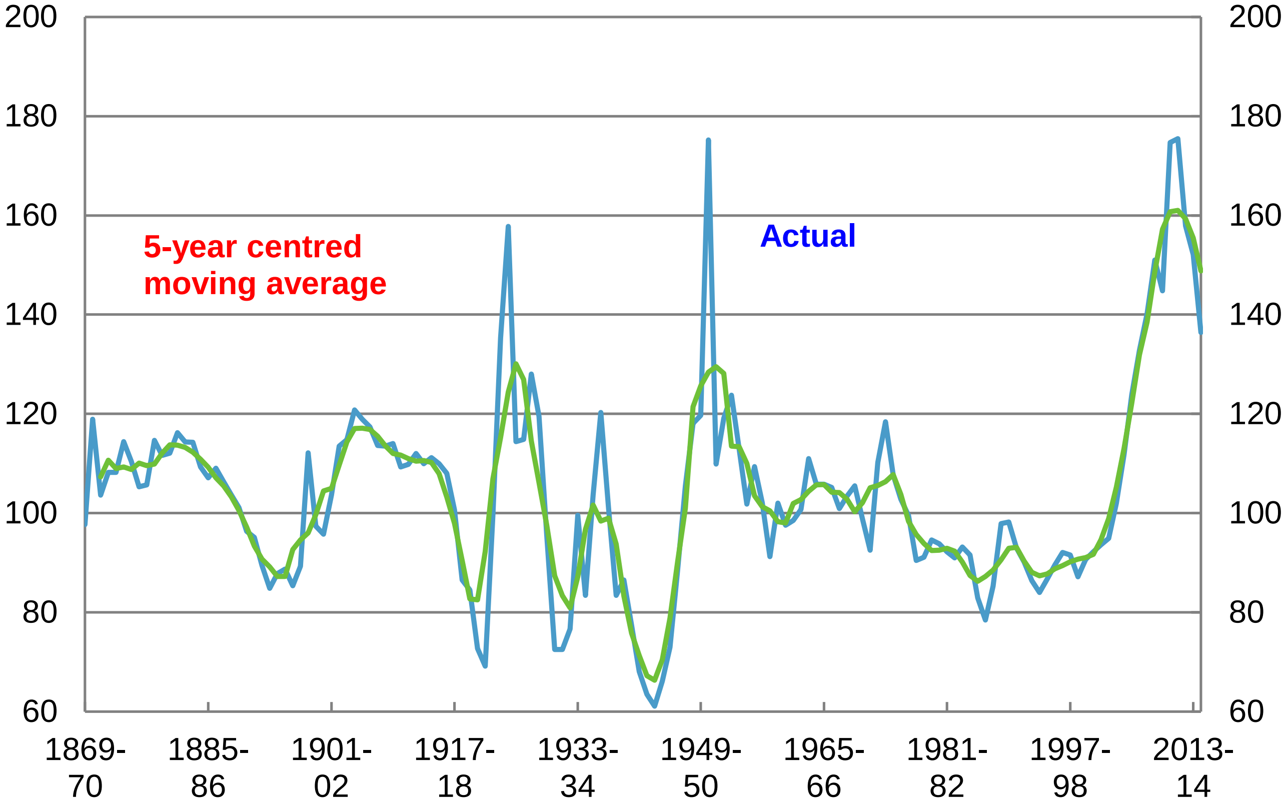
These factors have now disappeared.

While the passage of time from the crises of the 1970s and early 1980s was always going to erode the commitment to reform, that erosion has been hastened by the record terms of trade experienced over the last decade.

Australia has always experienced fluctuations in its terms of trade – the ratio of export prices to import prices – but the sheer magnitude, and duration, of the recent period has been unprecedented.

[6] *Triumph and Demise*, Melbourne University Press, 2014, p70.

Chart 3 - Terms of Trade (Index: 1900-1901 to 1999-2000 =100)



Source: Australian Treasury calculations

It was as if the world woke up one day and decided to shower us with money without us, as a nation, having become any more productive.

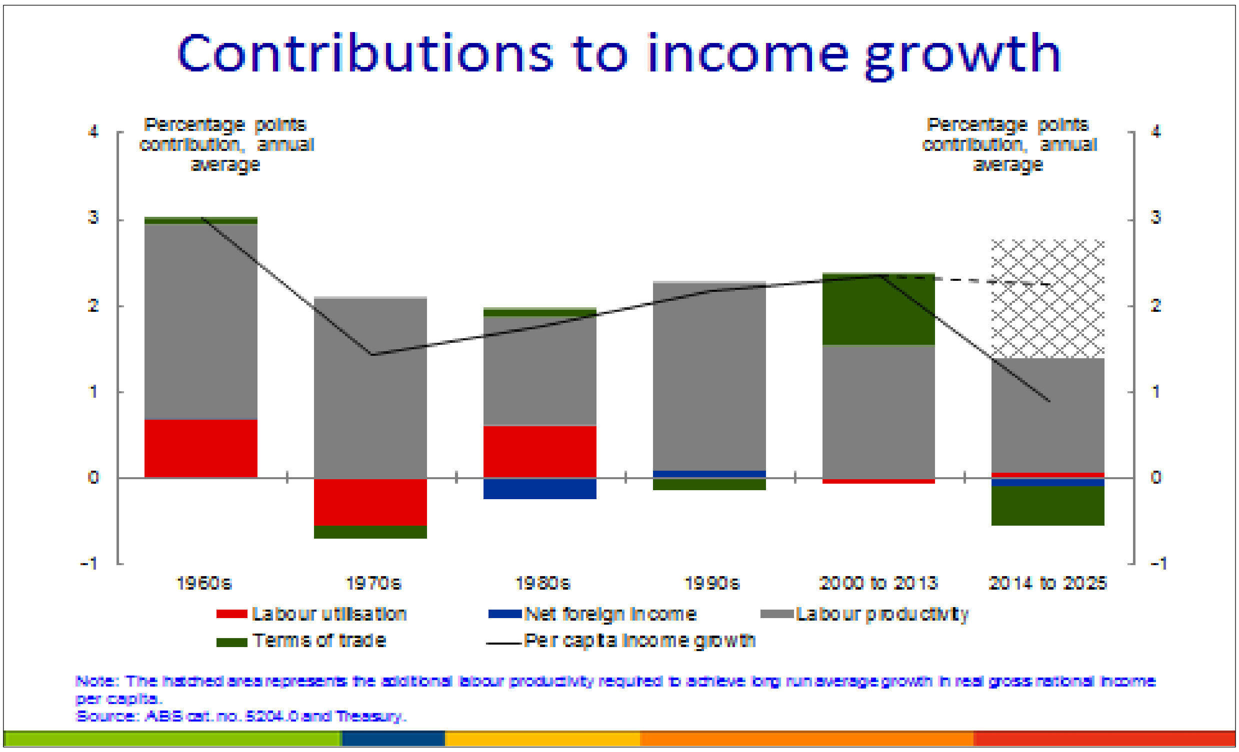
As Reserve Bank Governor Glenn Stevens famously pointed out in 2010:

> "five years ago, a ship load of iron ore was worth about the same as about 2,200 flat screen television sets. Today it is worth about 22,000 flat-screen TV sets – partly due to TV prices falling but more due to the price of iron ore rising by a factor of six…the general point is that high terms of trade, all other things equal, will raise living standards, while low terms of trade will reduce them." [7]

The impact of the terms of trade can be clearly seen from a decomposition of the sources of growth in Australia's living standards.

[7] *The Challenge of Prosperity*, address to CEDA, 29 November 2010.

Chart 4



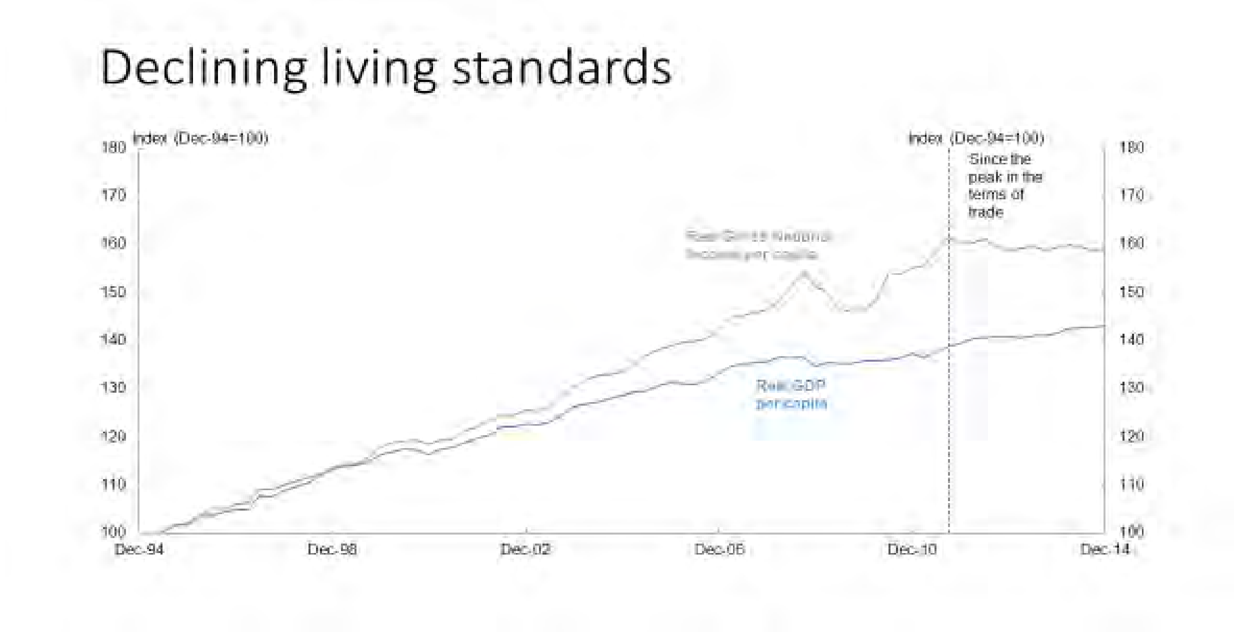
Unlike the 1990s, when the entire increase in living standards was driven by strong productivity growth resulting from the reform programs, over the period to 2013 the terms of trade contributed around one-third of the broadly similar growth in living standards.

The chart also illustrates that without the resources boom driven terms of trade boost, the last decade would have seen a dramatic slowing of living standard growth.

More importantly, it shows that without sustained and dramatic improvement in our productivity performance, the decade ahead is likely to see sharply slower growth in living standards than Australian's have become used to – with productivity needing to grow at almost double its long run rate on a permanent basis to sustain living standard growth around the rate of the last two decades.

Indeed, without a significant increase in productivity, living standard growth will not only fall sharply but in some years living standards are likely to fall – a phenomenon witnessed over the last few years.

Chart 5



Harking back to The Economist’s depiction of Australia, in large part the opportunity offered by the terms of trade shock and resulting revenue boom was frittered away.

Rarely do developed economies experience such dramatic terms of trade booms. And while Australia is not unique in frittering away the benefits, this is something more typically associated with developing economies than developed.

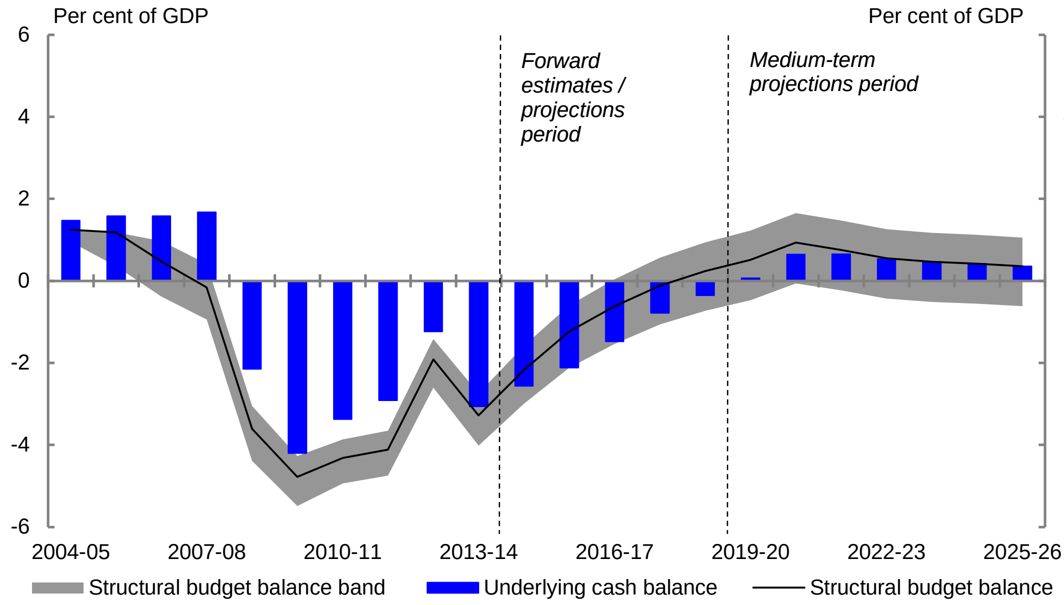
A sharp contrast can be seen across the Tasman – while the magnitude and duration of New Zealand’s terms of trade increase have been less than that for Australia, it has arguably been managed better by the Key Government than by successive Australian governments due to New Zealand’s sustained commitment to delivering real economic reform.

In Australia, commencing in 2003, the flood of revenue was too tempting not to spend - the result was that growth in outlays started to run ahead of growth in GDP, and tax cuts became an almost mandatory part of the annual Budget.

The problem was that while the outlays increases and tax cuts were permanent, the revenue to pay for them was not.

As a result, Australia’s structural budget position begun moving toward deficit from the early-mid 2000s, even though in headline terms (the Underlying Cash Balance) it remained comfortably in surplus until the GFC - while there was more revenue than outlays, the revenue increases were to a large extent temporary and the outlays permanent. And not only were those permanent, or structural, increases in outlays, the tax cuts resulted in a permanently lower revenue collections once the temporary effects of the terms of trade boom ended.

Chart 6 – Structural Budget Position



Source: Australian Government, Budget 2015-16.

While all this may seem a bit dry, it goes to a key point related to Australia's future prospects.

Specifically, our success in the longer-term is in our hands.

All societies have choices and the choices made, in large part, determine our future.

As former Treasury Secretary, Ted Evans, noted in the early 1990s, countries ***choose*** their own rate of unemployment.

While true, it was hardly a popular comment at a time of double-digit unemployment!

The choices we make also, in general, determine our potential GDP growth rate – how much we can produce as a nation – even though global shocks and weather events will influence how much we actually produce.

Those choices also heavily influence growth in our living standards – although, again, the recent terms of trade boom highlights that the price we receive for our exports, and pay for our imports, will be affected by global forces, and changing tastes and technology.

Unfortunately, Australia seems to be in a period of denial about these truisms. Nothing highlights this more than the inability of the public debate to acknowledge and, importantly, act on the points made earlier:

- that living standard growth will slow dramatically, and in some years living standards will actually fall, without sustained efforts to improve productivity; and
- that measured, steady Budget repair is necessary to reduce external vulnerability and provide the flexibility to deal with future shocks.

These issues are inextricably linked.

First, both issues share common antecedents – the complacency engendered by economic success compounded by the terms of trade boom.

Second, when voters experience slowing growth in living standards they are likely to look to government to cushion this, yet government at all levels lack the fiscal room to ease the impact on the community.

Thirdly, how we respond to these interlinked challenges will determine our medium- and longer-term prospects – in short, how well-equipped we are to grasp the opportunities opening up for Australia.

While it is true that economic growth in many advanced economies has disappointed in recent years, for Australia this is not about growth in any one year.

Rather, almost a quarter century of superior economic performance is being replaced by moderate growth at best, and perhaps by a period of sustained mediocre performance.

If this turns out to be the case, the social consequences will, as always, be concentrated, with marked impacts on the poor, low- to middle-income earners, and the young. Indeed, as I have stated elsewhere, Australia is at risk that our young adults will find themselves in a unique position – the first generation in modern history with living standards below those of their parents.[8]

So, has the "Lucky Country" ran out of luck?

In short, if "out of luck" means we have to rely on our own hard work to sustain and grow living standards, invest for the future and ensure fiscal sustainability, the answer is yes!

While the situation is not a simple re-run of the late 1970s/early 1980s, Australia is at a cross-roads as a nation – the decisions taken today will determine the opportunities for our people over the decade ahead. The question, though, is whether Australia is capable as a nation of maturely exploring options and pursuing policies that will allow it to meet the challenges and grasp the opportunities thrown-up by an ever-changing world.

Future challenges and opportunities

[8] University of Adelaide Graduation Address, 6 May 2015.

So, what does the future look like?

Unfortunately, none of us know.

What we can see, though, are a series of medium and longer-term issues that will help shape that future.

Chart 7

Broad Longer-term Trends

1. Sustainability concerns – climate change, water and energy security, urbanisation and their implications
2. Demographic change – aging populations
3. Technological revolution – implications for productivity, growth, inequality, and social cohesion
4. Global reweighting – shift toward emerging economies, especially those in Asia.

The global economy is being reshaped by four fundamental forces – the shift in economic weight toward Asia; technology; demography; and the challenges posed by sustainability, in particular climate change but also food and water security and the challenges of urbanization.

Sustainability

The combination of climate change, the growth in the world's population and its increasing urbanisation, and the likely growth in average living standards, will place serious pressure on a wide range of global resources, including food, water and energy. While it is not clear that climate change *per se* will be the unifying theme for a policy response, the issue will keep coming back in the context of resource management and environmental contamination.

As McKinsey has noted, almost 60 per cent of the world's GDP emerges from 600 cities, with half of global GDP sourced from 380 cities in the developed world. By 2025 one-third of the current 380 developed world cities cities will disappear from the ranking, having been overtaken by cities from the developing world. [9]

The rapid growth in mid-size cities, combined with the emergence of mega-urban environments, will bring new challenges for the supply of safe, high quality food and water, and for the reliable supply of energy.

The result will be a renewed focus on energy, resource and environmental efficiency – and these may emerge as key drivers of productivity. If so, countries and firms at the forefront of these areas could gain considerable comparative advantage. This capacity for

[9] *Urban World: Mapping the Economic Power of Cities*, McKinsey Global Institute, March 2011.

technological leap-frogging, combined with the need to address global and geographically-specific environmental problems (i.e. climate change and air and water pollution), lies behind China's massive investments in low-emissions technologies. The US is also investing massively in these technologies. Australia is not.

Climate change is a real threat to Australia. Not just via its direct effects – that is, on rainfall patterns and agricultural production, or on the magnitude and frequency of severe weather events – but also because the way other countries respond could have serious implications for our competitiveness and our capacity to sustain traditional export sources.

One key area of risk surrounds the outlook for thermal coal.

In many emerging countries there remain ongoing concerns about inadequate access to energy. Some see this as promising a bright future for coal – after all, the technology to generate electricity from coal is relatively simple and commercially viable coal deposits are widely distributed globally.

However, over the next decade or so, the desire of some to revoke the social licence to produce and use thermal coal will likely become more influential – in part because the cost of alternative energy sources, and especially distributed-generation technologies (in contrast to centralized power plants), and advances in storage technology, will become increasingly competitive.

Ironically, the pressure to revoke or curtail the social licence is likely to be strongest in advanced economies like Australia. However, in a scenario where the world had adopted a global carbon price, Australian coal exports would likely displace higher emissions intensive coal from other countries during the transition to sustainable low-emissions technologies. The absence of a global carbon price, combined with pressure in advanced economies to revoke coal's social licence, is likely to result in a classic case of leakage of coal production to higher emitting sources offshore, with negative global consequences.

And this could occur at the time the sector is suffering from two other forms of disruption – the massive increase in global supply that has outstripped growth in demand, meaning a structural or long-term decline in price; and the competitive threat to coal from gas and from unconventional energy sources in the United States.

Informed Chinese commentators have also indicated they believe China's thermal coal demand is at or close to its peak (demand actually fell in 2014) and that steel demand will peak in this decade.[10]
The issue of the social licence and resource efficiency is also playing out in other countries – in Canada, Ontario is joining the California-based Western Climate Initiative emissions trading scheme, which already includes Quebec. Alberta, the home of the oil sands, has

[10] Zhong Xiang Zhang, *Making China – the Transition to a Low Carbon Economy: Key Challenges and Responses*, Presentation to Promoting Future Economic Prosperity in the Asian Region, EABER/ANU Conference, 16-17 April 2015, Canberra.

committed to doubling its carbon tax to $C30 by 2017, and may rescind proposals for two major oil pipelines, while British Columbia is in the midst of debate over the export of LNG.

Both Canada and Australia, like many other countries, are likely to end up with a sub-optimal patch-work quilt of initiatives whereas a coherent, national, response could deliver more effective emissions reductions at lower cost.

Responding to climate change – through both mitigation and adaptation – requires countries to prepare for long-term transitions that will impact disproportionately on some industries and regions. As such, a key focus should be on finding ways to maximise the positive opportunities for employment and growth from the enforced transition. Thought about this way, a successful policy regime to respond to climate change has similarities to Australia's approach to structural reforms that Australia pursued during the 1980s and 1990s.[11]

More generally, climate change poses risks to which financial market regulators and company boards have, to date, given little attention. In particular, they have been slow to acknowledge the risks to the financial sector – banking, insurance, superannuation, capital markets and infrastructure – of the direct financial exposure to carbon-intensive assets that may be priced, regulated or stranded by technology or which may incur increased legal risk through their operation.[12] Similarly, little attention has been paid to the knock-on effects to macro-economic stability of falling demand for carbon-intensive exports – a particular issue for Australia and other fossil-fuel dependent economies.

However this situation is changing, with the G20 recently asking the Financial Stability Board to "review how the financial sector can take account of climate related risks."[13] The Bank of England has also begun considering the ramifications of climate change in its regular deliberations on risks to financial stability and is assessing climate risk for the insurance sector.[14]

Technology

Turning to technology, the impacts of the digital revolution and the explosion in opportunities for new avenues of competition are clear for all to see, whether for consumer- or business-facing firms, for sectors like the media, or for institutions like government.
These changes are remaking traditional market boundaries and eroding the long-held distinction between the traded and non-traded sectors of the economy.

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[11] For a more detailed discussion of the similarities and key differences, see Martin Parkinson, *Climate Change and the Australian Reform Agenda*, Sir Leslie Melville Lecture, ANU, 28 June 2010.
[12] *Australia's Financial System and Climate Risk*, Climate Institute, July 2015.
[13] Communique of G20 Finance Ministers and Central Bank Governors after their meeting of 16-17 April 2015, p5, April 2015.
[14] Bank of England Prudential Regulatory Authority, 'Supervisory Activities – Climate Change Adaptation Reporting', accessed July 2015. http://www.bankofengland.co.uk/pra/Pages/supervision/activities/climatechange.aspx

Two key issues emerge from a consideration of current rates and types of technological change.

First, is the rate of global technological innovation slowing or accelerating? The answer to this has implications for productivity growth, the labour share of income, and inequality within and between countries.

If it is accepted that much of future technological change likely to impact today's industries will be labour displacing, this raises the question of how countries should prepare to manage that transition. Since it is difficult to be categoric about which types of labour could be displaced, and when, this suggests a priority should be placed on measures that boost technology-related skills and encourage agility among firms and workers.

Second, it has become common to discuss the role of technology as a market-disrupter. However, technological change has always been a disrupter. As such, it is important to be clear about why the current wave of change is different to what has gone before – is it simply a matter of scale, or is it inherently different – and ask again how best should workers, firms and governments prepare for this.

The pace of change

Advocates of the view that the pace of technological change is slowing point to slower global productivity growth in recent decades, while those arguing for acceleration point to breakthroughs in fields as diverse as IT, bio-tech and materials technology.

It is clear that national statistical agencies are lagging in their ability to measure the productivity and economic gains from the emergence of new products and processes enabled by the digital revolution.[15] That said, it is hard to believe that mis-measurement alone explains the magnitude of the dramatic slowing in multi-factor productivity growth over the last decade. This has led some to argue that innovation overall is slowing, notwithstanding rapid progress in some high-profile areas. And even some areas where innovation has been rapid may not be seeing a commensurate increase in productivity.[16]

Whether this fall in productivity growth reflects the widespread slowing in investment which commenced before the Global Financial Crisis – new capital equipment typically embodies new technology, so a slowing in the rate of investment could result in slower productivity growth – or a slowing in innovation more broadly, is likely to remain unclear for some time to come.

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[15] See, for example, Brynjolfsson, Erik, and Joo Hee Oh, *The Attention Economy: Measuring the Value of Free Digital Services on the Internet*, January 2012. Available at http://aisel.aisnet.org/cgi/viewcontent.cgi?article=1045&context=icis2012.

[16] For one perspective suggesting innovation has slowed, see the video of Peter Theil, founder of Paypal, speaking on "What Happened to Innovation" at The Nantucket Project, 2012. Available at https://www.nantucketproject.com/peter-thiel. For another analysis reaching the same conclusion, see Edmund S. Phelps, *What is Wrong with the West's Economies*, New York Review of Books, 13 August 2015.

If the former, a question to be asked is whether this is a consequence of short-termism on behalf of investors - a relentless focus on short-term yield resulting in long-term damage to economic growth prospects, or as Andrew Haldane, Chief Economist of the Bank of England, described it, firms are "almost eating themselves" in the pursuit of short-term shareholder returns.[17]

This issue of the pace of technological change has profound implications for many countries – for their future living standards, for fiscal performance in both the short and long-run, and for inequality within, and between, countries.

The impacts will be determined by numerous factors, the interrelationship amongst which will be complex.

Consider, for example, the following - to what extent will the aging of the population combined with the rise of labour-displacing technology in manufacturing and in some parts of the services sector lead to a shift in employment toward low productivity level, and low productivity growth, sectors? If employment growth becomes concentrated in such sectors, what does this imply for the profit and wage shares, and for perceptions of inequality within countries?[18] And if we are to maximize high productivity, high wage employment opportunities, where do we need to invest?

Even if innovation has slowed, it is possible that global growth could remain relatively healthy if developing economies moved closer to the global productivity frontier.

That is, since technological innovation expands the world's capacity to create goods and services, if innovation slows it will immediately constrain growth in productivity, and hence in living standards, and this is likely to be most marked in countries closest to the productivity frontier i.e. those most dependent on new innovation to deliver improved living standards.

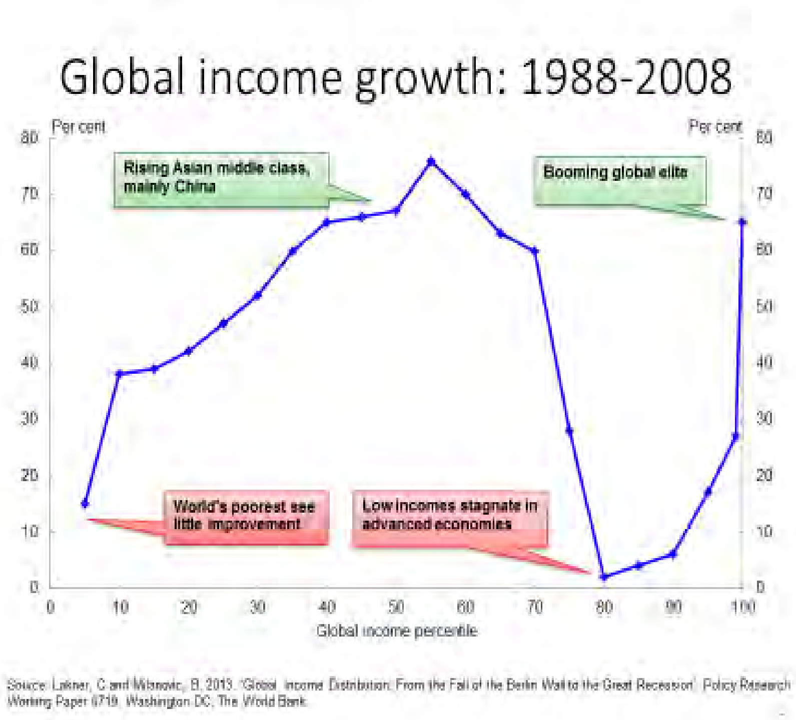
However, there remains considerable scope for emerging and developing economies – by definition, those well within the productivity frontier – to increase productivity and living standards by adopting technologies and processes used by advanced economies.

While this would have knock-on benefits to the advanced economies, it would also result in a decrease in inequality **between** countries.

[17] Interview on BBC Newsnight, July 24, 2015. Available at https://www.youtube.com/watch?v=ZmUlTuyRPd8.

[18] Note that this is a very different phenomenon from that raised by Thomas Picketty in his book *Capital in the 21st Century*, which focuses on the dominance created by inherited wealth within societies.

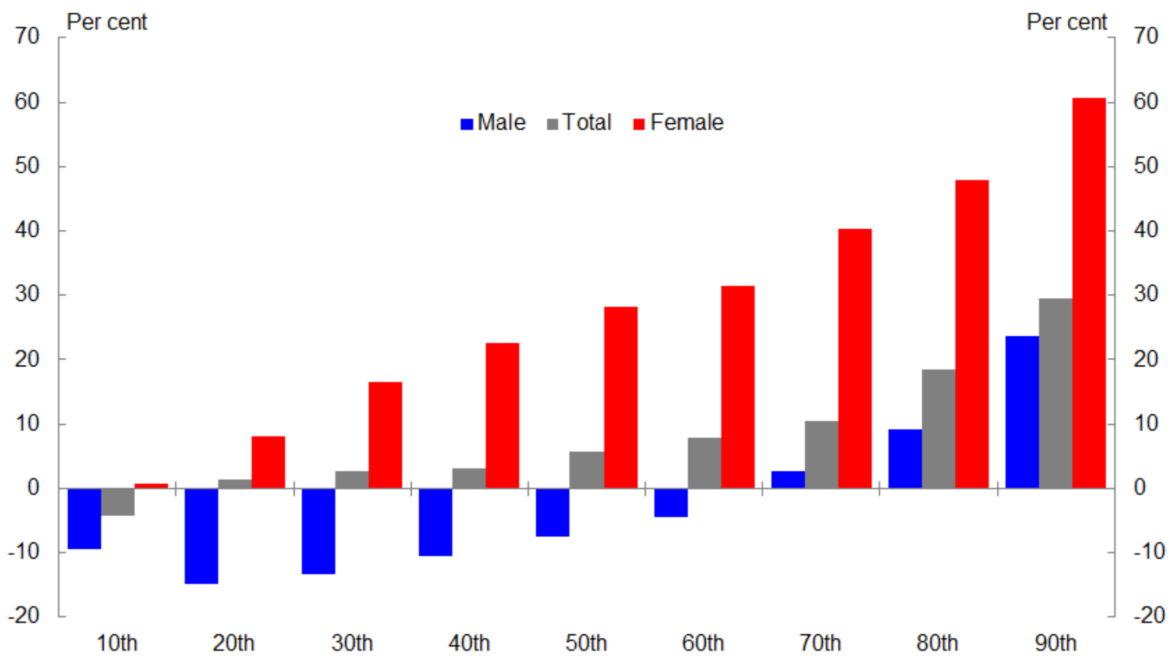
Chart 8



To illustrate this effect, consider the distribution of the dramatic improvements in income in the two decades prior to the Global Financial Crisis. The distribution of that income was heavily concentrated among the world's wealthiest citizens and the Asian middle classes. As is now well known, low incomes stagnated in advanced economies as a group, especially in the United States.

Chart 9

US Hourly Real Wage Growth by Decile, 1979-2011[19]



Source: The State of Working America, Economic Policy Institute, 12th Edition.

[19] To the extent that benefit payments have increased as a share of total income the estimates contained in this chart would change although the general picture of worsening inequality is likely to be little affected.

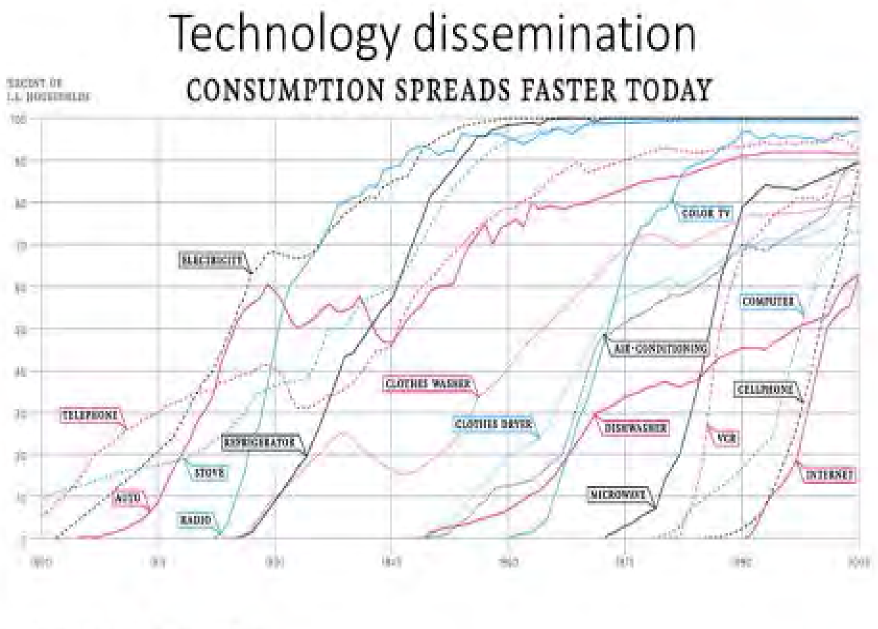
Technology as a market disrupter

As noted, technological innovation has often acted as a disrupter of the status quo – think the Luddites, the replacement of steam power by electricity or the automobile displacing horses as the primary means of transport.

This prompts the question – is disruptive innovation more prevalent today or is the term now simply being applied to ordinary improvement in products and processes – what has sometimes been called “sustaining innovation”?[20]

It is clear that the speed of the dissemination of new products and processes has accelerated in recent decades, but this is, of itself, not proof that there is a greater prevalence of disruption.

Chart 10



Source: Nicholas Felton, New York Times

Yet many existing industries clearly face technology-driven disruption. As is known from the celebrated case of Eastman Kodak, failure to anticipate and/or respond to such shocks can lead to the overthrow of the existing order and even to the virtual disappearance of former industry and technology leaders. And Kodak is far from alone.

[20] For an interesting discussion of criteria by which to judge whether innovation is truly disruptive, see “*Tesla’s Not As Disruptive As You Might Think*”, Harvard Business Review, May 2015, pp22-23.

As Charles Darwin said:

Chart 11

"It is not the strongest of the species that survives,
nor the most intelligent.
It is the one most adaptable to change."

While Australia has been a relatively poor product innovator, anecdotal evidence suggests a better record as a process innovator. Importantly, at least in the case of sustaining innovations, it is not necessarily where the product or process is invented – rather, much of the benefits appear to accrue to early adopters, and on this metric Australia has a stronger track-record.

The focal point for true disruption will be the firm and its response to emergent technologies and business models – success seems likely to be determined by the willingness and capacity of firms and workers to take risk and innovate. As such, business, not government, will be the determinant of Australia's future economic success.

The ability to cause, and to respond to, disruption will be influenced by the human capital Australia is able to deploy into this new environment. This suggests a renewed focus on the teaching of STEM should be a policy priority.[21] However, this seems likely to be a necessary but not sufficient condition for success if, as argued by Phelps, "young people are not taught to see the economy as a place where participants may imagine new things, where entrepreneurs may want to build them and investors may venture to back some of them."[22] As such, a key focus of government policy should be on how best to create an innovative, entrepreneurial business culture. It also means considering ways in which to foster the willingness and capacity of firms and government to utilize the massive, and growing, holdings of data now available.[23]

By its nature, true disruption is hard to forecast. If it is not possible to predict what disruption will impact on a market or firm, or when, what form of business model is most likely to handle these shocks the best? Drawing on the work of American scholar, statistician and former hedge fund manager, Nassim Nicholas Taleb[24], it seems plausible that entities which are inherently centrally organised – with rigid structures and modes of operation, and limited openness to new ideas – are less likely to be able to adapt quickly – as such, centralisation magnifies the impact of deviations from the norm.

If true, this likely applies as much to governments as it does to firms, and may explain the apparent limited capacity of governments to respond substantively to the forces reshaping the world economy and individual societies.

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[21] This has been a continuing theme of thought leaders such as Catherine Livingston, President of the BCA, former Chief Scientist, Professor Ian Chubb, and Nobel Prize winner, Professor Brian Schmidt.

[22] Ibid.

[23] IBM has suggested that 90 per cent of all of the world's data holdings have been created in the last few years, and by 2020 annual data production may be 44 times what it was in 2009. See the *Big Data at the Speed of Business* webpage, www.ibmbigdatahub.com.

[24] Nassim Nicholas Taleb and Gregory F. Treverton,"*The Calm Before The Storm*", Foreign Affairs, January/February 2015.

A key message from these developments is that governments everywhere need to devote time and resources to tackling these issues, domestically and multilaterally.

Demography

Demographic change is not a uniquely Australian challenge - the UN has pointed out that, in less than a decade, globally the over-65s will outnumber the under-5s for the first time ever. While individual country experience will differ, it is fair to say that on average this will reduce workforce participation rates, and therefore lower potential growth in GDP and living standards. In Australia's case, it is also likely to result in higher demand for government services.

One of the consequences of population aging is that the ratio of workers to older people falls over time, in some countries quite markedly. Australia's latest Intergenerational Report (IGR)[25] indicates that the number of Australian workers for every person over 65 has fallen from 7.3 in the 1970s to 4.5 now, and is heading toward 2.7 by 2055.

Reflecting this, by 2055 Australia is likely to have around 40,000 people over 100 years of age, and 2 million over 85, out of a population of almost 40 million.

While much of the discussion of an aging of the population has been seen through the prism of the impact on the economy, in particular in terms of the slowing of growth in GDP per capita and demands on health and aged care expenditure, it should be celebrated as it means that people are living longer. Indeed, Australian life expectancy is rising sharply – taking account of expected improvements in mortality, ***life expectancy at birth*** is today already 93.6 and 91.5 years for women and men, and is expected to reach 96.6 and 95.1 years by 2055.

Australia is not alone in facing an aging population – indeed, relative to most other advanced countries we are in a good position. Japan for example is aging so markedly that the working age population has been declining since the 1990s and, at 80 million, is now the lowest in 32 years. Moreover, the total population is expected to decline from around 128 million last decade to around 95 million by 2050 – a decline of around 25 per cent. Similarly, as far back as the early 2000s, economists have been asking whether China would get old before it got rich – the answer of course being that it has done both.

More generally, latest UN projections[26] suggest Africa will be the most rapidly growing region, adding 1.3 billion people to its population between 2015 and 2050, while Asia will add around 0.9 billion. India is likely to be the world's most populous country by 2022. In both cases, this opens the prospect of a demographic-driven growth dividend, but such

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25 The Australian Inter-Generational Report attempts to project forward over the next 40 years the impact on the Budget and economic growth of demographic change and of key trends in government expenditure.

26 *World Population Prospects: 2015 Revision, Key Findings and Advance Tables*, United Nations Department of Economic and Social Affairs, Population Division, ESA/P/WP.241, 29 July 2015.

outcomes are not pre-ordained – they require good policies to provide any chance of reaping the potential offered by stronger growth in working age populations.

Notwithstanding continuing population growth, the world population will continue to age. In 2015, 12 per cent of the global population is aged over 60 – by 2050 this is likely to rise to over 25 per cent in every major region bar Africa. In countries with aging populations, overall participation rates in employment will likely fall, and fall sharply, even though the actual rate of participation of older people may well be rising.

Immigration cannot be presumed to automatically reverse this phenomenon since immigrants age, even if they are younger on average than existing citizens when they arrive. But maintaining a sensible migration program, focused on people with real skills, will help slow the impact.

Ageing of the population will make it even harder to deliver the sorts of growth in living standards that Australians have become used to without dramatic improvements in productivity, as shown by chart 4 above.

Yet the aging of the population means that the age of the median voter is also rising, which may make it increasingly harder to achieve reform.

Shifting economic weight[27]

The fourth factor currently playing out is the dramatic shift in the centre of global growth, from the Atlantic to Asia.

Chart 12

[27] Arguably, there are two power shifts currently underway. The first is the transition of power among nations states, from West to East. The second is the diffusion of power away from governments toward non-state actors, domestically and internationally. For the purposes of this discussion, we are focused on the first although the second is also likely to pose significant policy challenges across economic, strategic and other dimensions over coming decades.

Emerging markets and developing economies have grown to make up slightly more than 50 percent of global GDP (on a PPP basis) and, on reasonable assumptions, are expected to increase their share to more than 60 percent of world GDP within the next ten years, with much of that growth potential centred in the Asian region.

This is not to suggest that the growth paths of EMEs will be smooth - far from it.

Indeed, the recent experience of China illustrates the challenges faced when attempting to manage a transformation toward greater reliance on market based instruments – speculative bubbles, excessive risk-taking by firms and households exacerbated by poor or non-existent risk assessment by financial institutions, and knee-jerk policy reactions to the dislocations that arise during the adjustment process.

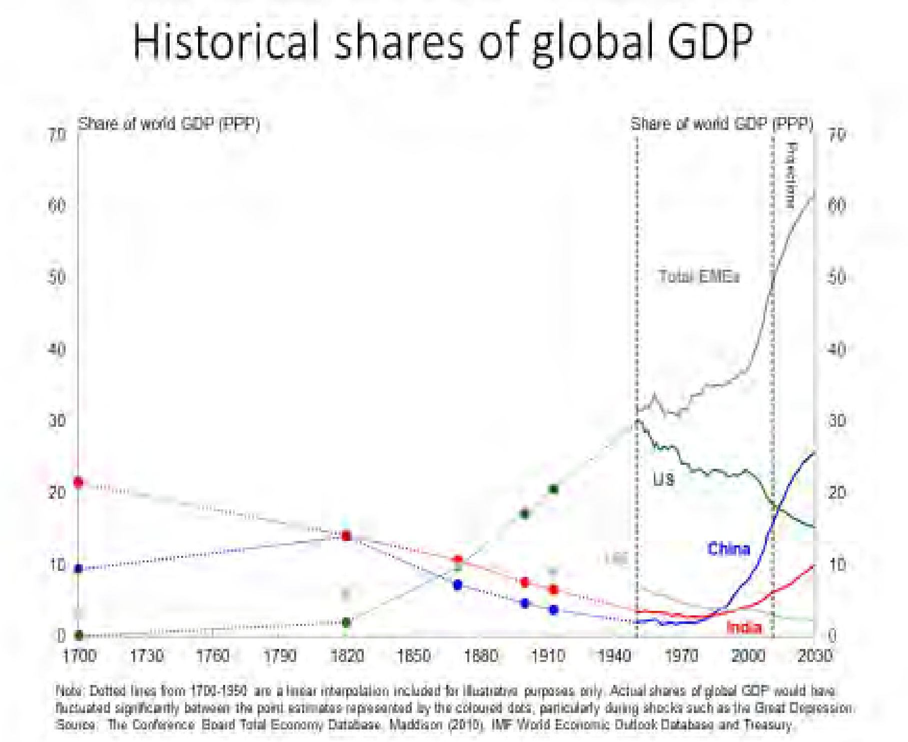
Put another way, EMEs by their nature are at heightened risk of policy missteps, meaning their trade and investment partners have a heightened need for good policy of their own to help deal with any flow-on effects – the more so the deeper the economic relationship. As such, Australia's deep engagement with China ***should*** be increasing the incentive for policy reform in Australia.

The challenge is not, however, the short-run fluctuations in EME growth.

Rather, it is that on current indications, and notwithstanding bouts of instability, EMEs are heading to be an increasingly important part of the world economy. This increase in weight needs to be recognised in the governance structures of the global institutions and in the attitude of existing powers to new institutions proposed by EMEs.

National policy-makers also need to consider how the increasing centrality of EMEs will impact on the stability of global growth. In particular, there has been a worryingly long lag in recognition by many countries of the capacity of developments in EMEs, especially China, to impact global and individual country growth paths. Few, if any, countries have prepared for potential shocks emanating from these sources. For example, China's likely capital account liberalisation over coming years could result in a significant capital outflow as its citizens engage in portfolio diversification, resulting in upward pressure on exchange rates in recipient countries.

Chart 13



By 2050, four of the 5 largest economies in the world will be in Asia – China, India, Japan, and Indonesia. The fifth is, of course, the United States.

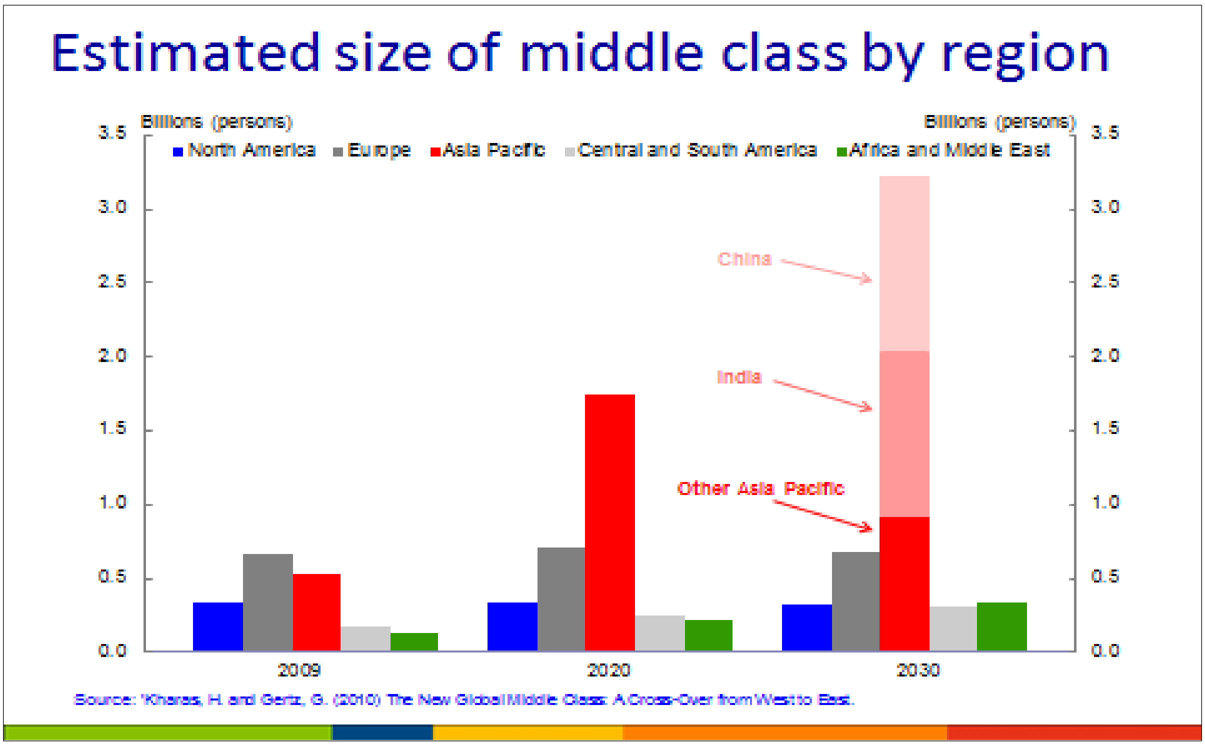
Australia has already benefited from this shift in economic weight, as evidenced by demand for mineral commodities over the last decade.

But the growth in mining exports is only one manifestation of the change underway globally – and it is far from the most important factor influencing Australia's longer-term opportunities.

The emerging middle class in China, India, Indonesia and other populous countries, will likely provide the next source of global growth in consumption. In this decade – and for the first time in 300 years – the number of Asian middle-class consumers is likely to equal the number in Europe and North America.

This middle class – which is expected to grow from around 500 million people in 2009 to around 3.2 billion by 2030 – is likely to increase its demand for a wide range of goods and services. It is true that the middle class is an income band, and that many of these people will be in the lower half of that band – but the purchasing power will be there and, importantly, it is not just a China story.

Chart 14



Some Australian industries – including education, tourism and agriculture – are already benefiting from this demand.[28]

But unlike in resources and commodities, Australia has no inherent comparative advantage in the services sector writ large. As I have noted on other occasions, Beijing is closer to Berlin than Brisbane – the idea that the opportunities in the services and advanced manufacturing sectors will fall into Australia's lap doesn't stand up to scrutiny.

If Australia is to grasp these opportunities, it will need to work for them, and work hard. There are no grounds for complacency.

Developing a politically bipartisan approach to engaging with the region will be critical. An approach that focuses clearly on what Australia, and Australian firms, need to do to take advantage of the opportunities arising from what is likely to be the economic transformation story of this century. Such an outcome requires a political maturity that carries these policies across changes of government.

While the response to the Australia in the Asian Century White Paper process was longer on rhetoric than action, the fact the ideas have been expunged from conversation in Canberra is a lost opportunity.

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[28] Education exports to Asia, particularly to China, India and ASEAN, have increased threefold since the beginning of this century. China has become our largest source of overseas students and our second-largest source of tourists. And rising incomes in Asia is likely to continue driving demand for Australia's agricultural commodities.

Australia also needs to acknowledge that it is not as Asia-savvy, and that its Asian networks are not as deep, as it thinks and as much of the rest of the world assumes.

Just as flexibility and diverse approaches will be critical to dealing with technological disruption, diversity, broadly defined, will be a key enabler in managing the implications of Asia's rising economic and strategic weight.

Yet deep understanding of the region within the Australian Government resides in a relatively small group of people. In the case of business, and accepting that ethnicity doesn't equal expertise, the absence of Asian faces and names around Board tables and senior executive teams is striking – though, admittedly, the same could be said about the lack of female faces!

This is not just of commercial importance. The transformation of economic weight is also shifting the focus onto the Indo-Pacific – spanning the arc from the Persian Gulf through Asia to the west coast of North America – as the theatre of strategic competition.

For Australians reaching adulthood in the last decade, this economic and strategic transformation is likely to provide the backdrop against which they operate over their entire working lives. Australia's capacity to grasp the opportunities and navigate the economic and strategic challenges will be determined by the ability of Australians to truly understand the countries of the region, and particularly those of Asia – on this score, much remains to be done.

Potential Growth

A common thread among these four factors is that they all have big implications for global and national growth potential. Individual countries will be differentially impacted by these changes, but each is vulnerable in some way to how one or more of these forces play out.

The right sorts of policies would minimise the negative effects of climate change and population ageing, while grasping the opportunities offered by rapid technological change and shifting economic weight. In Australia's case, we are vulnerable to negative developments from all four, and have been slow to pursue the countervailing opportunities.

This is despite mounting evidence[29] suggesting that potential growth has already slowed in recent years, although the reasons for this remain unclear.

If Australia's potential growth has slowed from the commonly accepted estimate of 3 percent per annum to, say, something closer to 2 ½ per cent per annum, this means that

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[29] See, for example: *Concluding Statement* of the IMF's 2015 Article IV Mission to Australia, June 24 2015; the remarks by Martin Parkinson to the Crawford Leadership Forum, reported in the Australian Financial Review on June 29 2015; Glenn Stevens, *Issues in Monetary Policy*, Presentation to the Anika Foundation, 22 July 2015; and Janine Dixon, *Living Standards have Peaked this Decade*, presentation to the Melbourne Economic Forum, June 2015.

the economy will be around 5 per cent smaller than otherwise over the course of a decade – somewhat akin to the loss of GDP from a recession.

Slower potential growth also means that assumptions about the magnitude of the existing output gap – the cumulative gap between what the economy is capable of producing and what it is actually producing – are called into question.

Since the closing of the output gap underpins the Australian Government's assumptions of a return to Budget surplus, a smaller output gap means that the ability to deliver the proposed fiscal consolidation is also at risk, while suggesting that the structural budget deficit is even larger than currently estimated.

More importantly, if the capacity of the economy is unable to sustain growth much faster than 2 1/2 percent, in the absence of serious structural reform, it implies that "normal' rates of unemployment have risen beyond the widespread assumption that the NAIRU is around 5 per cent.

If slower potential growth is a result of weaker innovation and productivity, it will also be reflected in slower growth in living standards, which is already expected to be less than half of that experienced over the last two decades. In contrast, if the slowing in potential growth solely reflects slower growth in population, the outlook for living standards would be little affected.

Conclusion

As has been increasingly apparent, the 20th Century world is being recast. The combination of aging populations and sustainability challenges, the emergence of new technologies, and the shift in economic weight toward Asia and away from the advanced economies of the trans-Atlantic, is leading to pressure on global institutions and modes of governance. It is recasting areas of strategic interest, and competition, bringing forward both national and global policy challenges for countries to navigate while opening up massive opportunities for those with the foresight to position their nations to take advantage of this era.

A forward-looking, confident, flexible and innovative Australia has much to gain from these developments, notwithstanding the challenges.

But we are far from being able to grasp the opportunities or navigate the challenges.

The complacency engendered by past economic performance – itself a function of hard work and reform of the 1980s and 1990s, assisted by serendipity in the form of demand for Australia's resources over the past decade – has seen the emergence of an insularity in Australia.

Indeed, New Zealand Prime Minister John Key has been reported[30] as describing Australia as suffering from a lack of confidence, a recession "temperament".

Australia is not unique in its current bout of self-absorption. Many countries more deeply affected by the GFC are also suffering from a loss of confidence and questioning their future prospects.

But if Australia, a country long-admired for its forward-looking national policy debates and willingness to embrace change, favours the status quo over reform, and acts as if the reshaping of the world will leave it untouched, it will be continuing the complacency of the last decade and be unprepared for what awaits.

Our political discourse is failing to provide the public with an explanation of global or national economic developments, or a roadmap for the future.

This vacuum of leadership, and the tendency to talk rather than act, is facilitating the emergence of a wide array of voices on policy directions. But rather than being a healthy sign of a national discourse, the diffusion and fragmentation of debate is allowing groups to conflate their own personal interests with the national interest. True leadership from the political class is required to move the debate to the workable centre from where reform in Australia has always been driven.

Australia's current bout of complacency will be broken and reform will restart – the choice confronting Australians is whether they willing embrace change or have it forced upon them.

[30] *Australia needs to get over its recession 'temperament' says NZ prime minister John Key*, Australian Financial Review, July 30, 2015. Available at http://www.afr.com/news/economy/australia-needs-to-get-over-its-recession-temperament-says-nz-prime-minister-john-key-20150730-ginqka.