Some serious concerns I have for the Australian economy.

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Introduction

I am concerned that Australia might have many tough years ahead. As always, in the face of such challenges, we are far better to work to optimise our outcomes, rather than to bury our head in the sand.

Of course, these challenges also pose risks and challenges for Australian investors. My objective has been to find investments that seem likely to deliver good returns, despite the risks posed by the issues identified here. The issues raised, clearly create the potential for a fairly large fall in the Australian $, and also major challenges to the domestically-focused part of the Australian economy.

Executive Summary:

Concern 1. 40-year problem. The impact of 3billion people emerging into the global workforce.

- The **historically largest emergence event** seems likely to cause falling standards of living for Australians on average over the next 4 decades – and could cause major structural problems to Australia's federal deficit through that period.
- We are living through the largest emergence event in history – with 3 billion people emerging from comparative poverty into middle class living in China, India, and the developing world more broadly.
- A study (by Russell Napier) of the 2 previously largest emergence events, (USA in the 1800s and Japan 1950-1971), point to a key feature of emergence events – price convergence. That is, that price in the emerging world and the developed world converge. A key price that seems likely to converge is wage prices – and this seems likely to cause falling standards of living in much of the developed world including Australia. (These effects are being felt now – and will simply become greater over time.) Lower wages & salaries seem likely to put massive downward pressure on the Federal Government tax take – a very large structural problem for the federal government deficit.

Concern 2. 15-year problem. Australian debt bubble. Australian house price bubble.

- For this summary, let me simply assert that Australia is currently experiencing the historically largest personal debt problem and also the historically largest residential property bubble. As these bubbles deflate, as they must, this will create a very severe drag on the Australian economy at best – and could cause a very serious economic recession, somewhat analogous to what the 2008 Global Financial Crisis did to USA and much of Europe. The factors that have caused serious recessions in 2008 in USA & much of Europe are major risks to the Australian economy, because we have the same preconditions for such a crisis.

Concern 3. 5-year problem. Australian wages & salaries are not competitive.

For example, our wages are about twice USA, making it difficult to compete with developed countries, let alone developing countries. This seems to condemn the Australian non-resource economy to difficult times until these issues are resolved.

In summary: Over the short, medium and long-term, the Australian economy faces very serious challenges. Strategies need to be developed to optimise the outcome of Australians through these very difficult challenges – and this is likely to include having to make some tough decisions.

So what actions could the government take to help tackle these problems?

- **Very long-term (40-year but starting now). Managing emergence event impacts.**
  - Australia needs 40-year strategy needs manage the likely-negative economic impact of wage-price convergence with the emerging world. These effects already seem to be impacting Australia – but the effects are likely to become more extreme over time.
  - So far, this issue does not seem to be understood, or any strategy developed.
  - My current best guess as to the elements of an optimisation strategy are as follows:
    - That unless we want very high unemployment for a long-time, we must have a much more flexible industrial relations system, including the public service – and this needs to include flexibility for employers to reduce staff levels without major termination costs to the employers. Some may not like this path – but the alternative is worse – high unemployment.
    - I think this historic emergence event, will cause Australia to continue to experience Dutch disease (http://en.wikipedia.org/wiki/Dutch_disease) for the next 3 or 4 decades, unless we take measures to specifically counter that. The best-counter measures that I have seen are by Norway. (http://elsa.berkeley.edu/users/webfac/cbrown/e251_f03/larsen.pdf and as this paper says as a result of their strategy *"arguably, Norway is now the richest country in the world." P2*) We must learn from Norway's experience and follow their example, if we are to thrive as a country over the next 3-4 decades – and this seems to be a truly fundamental strategy we MUST pursue, for the long-term good of Australia, because the likely consequences of not doing so are dire.
    - Given that price-convergence (discussed below) with the developing world over the next 4 decades, might cause falling standards of living and falling real wages in Australia (and hence potentially, falling government revenues), it is crucial that the Australian government moves quickly into surplus … and moves quickly to pay down its debt – and that the Australian government maintains strong fiscal discipline.
    - Finally, given the likely effects of price convergence, this places even greater urgency to develop a long-term financial plan for Australia, that effectively manages the structural budgetary problems of an aging population.
- **Medium-term. (15 years) managing impacts of personal debt & property price bubble.**
  - The solutions to the very long-term problem are also very pertinent to the medium-term problem, but I would also add, that the following measures should be implemented urgently:
    - That Australia follow New Zealand and Canada in implemented measures to impose limits on Loan-to-Valuation ratios for residential properties so as to ensure that the current house price bubble gets no more extreme and the resultant crash less damaging.
    - Australia needs to impose on the big 4 banks, a fee for the implicit guarantee that comes from being "too-big-to-fail".
    - Plans also need to be developed/prepared for the eventuality of a US-style Global Financial Crisis event, where many banks were at risk of failure. We have to ensure that, rather than the tax-payer picking up the tab, as happened in USA and Europe during the GFC, bank shareholders and creditors (eg investors in bank hybrid securities) need to take all the pain (to the extent possible), before there is any impact on depositors or the taxpayer. The Bank of International Settlements (BIS) now supports this approach – and I think the IMF does also from memory, but the BIS is the important one. The Financial Stability Board is also thinking along similar lines as can be seen by this article. http://www.afr.com/p/business/sunday/push_ins_force_too_big_to_fail_bank_qSf8sGKzJaYuahgIwOCLIM

        - Further, if one of the big 4 banks is on the verge of failure, even after exhausting all shareholder-funds and all funds of bank hybrid securities, then the Federal government must be prepared to nationalise the bank (rather than simply recapitalising the bank at the expense of the tax-payer) and to strip the bank back to the simple functions of a commercial bank – deposit taking, lending and the payments system.
- **Short-term. (5 year) Managing problem of uncompetitive wages & industries.**
    - A tough budget in May 2014.
        - A tough budget, cutting spending and/or raising taxes can drive A$ down, making Australian companies more competitive, boosting Australia's GDP in real terms. See further discussion of this below.
        - Well-targeted spending cuts and tax increases, do not necessarily create a negative Keynesian stimulus to the Australian economy – as explained recently by economist Andie Xie. See further discussion of this below.
        - Spending needs to be cut in the short-term and structurally.
        - I suspect tax increases are also necessary, but if this can be achieved while boosting the GDP and increasing jobs (as I argue is possible), this does not necessarily need to electorally negative by next election.
        - Need a serious plan to get back to surplus very quickly (next year or two). Currently, our current trajectory apparently does not get us back to surplus until 2023 (according to David Hale). That is not good enough in light of the risks Australia faces.
    - A more flexible industrial relations system as identified as part of the long-term solution components above + productivity drive.
    - Brief discussion of the budget & related issues:-
        - In the short-term, Joe Hockey's plan for a tough budget is the right one in my view. I know that some worry, that from Keynesian economic perspective, a tough Federal budget may drive the Australian economy into recession – and this would be traditional Keynesian thinking, but this thinking fails to acknowledge that in this increasingly globalised world, Australia does not live in a closed economy (a closed economy is an assumption behind Keynesian economics). A tough budget may actually be very good for Australian GDP growth if the budget cuts are well-crafted. My line of thinking goes like this:
            - Globalisation is changing how economics works, and we need to adapt economic policy strategy accordingly. Consider Keynesian economics. Traditional Keynesian theory suggests that Australian federal deficits should stimulate Australian economic growth. However, here is two reasons why cutting the federal deficit can help boost Australian economic growth:
                - First, the Australian dollar should fall (and this could provide the biggest possible boost to the Australian economy.). If the Australian government runs a lower deficit, the Australian government borrows less from overseas investors (who largely fund the economic Federal deficit). The less Australia borrows from overseas investors each year, the lower the demand for the A$, as less A$ needs to be bought in the process of foreign investors buying Australian government bonds. Less demand for the A$, means (all things being equal) a lower A$, and this helps boost the Australian economy as Australian companies become comparatively more competitive.
                - Second, if well-designed, there may be no negative Keynesian stimulus effect. As economist Andy Xie points out (http://www.marketwatch.com/story/breaking-out-is-hard-to-do-2014-01-

22), in this globalised world, an economic stimulus in one country may stimulate another country's economy, rather than the economy of the originating country. For example, the extra spending that takes the Australian budget into deficit, may well be stimulating the economies of our trading partners, rather than our own, as the deficit money may be spent on the goods and services from our trading partners rather than on domestic goods and services. Since Australia is such an open economy, Australia is particularly susceptible to this effect. Therefore, cutting the deficit will not necessarily have any negative effect on Australia's GDP – particularly if the cuts are well-targeted.

- Finally, if we want some evidence that a more-austere budget can lead to good economic outcome, we simply need to look at the UK which now seems to have one of the stronger economies in Europe, even though critics warned that the austere budgetary policy would damage UK growth prospects.