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Former Australian Prime Minister Julia Gillard commissioned a *White Paper on Australia in the Asian century*.¹ Its development involved hundreds of people drawn from government, business, universities and community groups, especially in Australia, but also in several other countries in the Asian region. Almost all of those involved in its development were of the view that fundamental policy and attitudinal changes were required if Australia was to make the most of the opportunities presented by the Asian century. Yet the White Paper has had no impact on policy; not even on the tenor of public policy debate in Australia. That's not because its insights are prosaic, or because Australian policy makers have had more pressing matters to attend to. The White Paper presented a fundamental challenge to the core narrative that had galvanised support for a couple of decades of economic reforms in Australia, commencing in the early 1980s. The challenge was intended to re-energise a reform effort that had run out of steam. But the White Paper has been ignored. In the meantime, the mainstream of Australia's policy discourse has become increasingly turbulent, its principal contributors fractious.

This paper provides an opportunity to re-state the core propositions of the *White Paper on Australia in the Asian Century*. The paper begins with a statement of the core economic policy narrative that motivated the reforms of the 1980s and 1990s; a narrative that I have labelled Australian mercantilism. It explains why the focus on something called 'international competitiveness', and especially its narrow interpretation in the form of the real exchange rate, was bound to generate a policy conundrum when, in the first decade of this century, Australia's terms of trade started to accelerate as a consequence of unprecedented rates of growth in China and a number of other countries in the region. If the term 'international competitiveness' is to prove useful in guiding the development of policies that secure Australia's place in the Asian century, then it will have to be framed not in simplistic unit labour cost terms – redolent of the concept of absolute advantage in international trade discarded by economists some two centuries ago² – but in terms of Australia's national endowments and capabilities – a framing compatible with neoclassical theories of comparative advantage. The paper emphasises that the set of relevant national endowments includes both the bequests of nature and the material and intangible legacy of earlier generations of Australians.

The challenges posed by the Asian century should energise a focus on the quality of Australia's national endowments, both natural and created. But Australia's success in the Asian century will rest on more than this, demanding the development of collaborative business relationships with Asian partners, a strong contribution to sustainable security in the region, and deep and enduring people-to-people links across a broad sweep of human activity: commercial, social, cultural and political.

¹ Australian Government (2012).

² For example, Ricardo (1817).

1 Economic policy in the late 20th century

Beginning in the early 1980s Australia embarked on a comprehensive reform program that liberalised market forces, enhanced economic efficiency and boosted productivity. The reform program had been motivated by discomfort with the economic and social consequences of a long-term trend decline in Australia's terms of trade.

Australia abandoned fixed exchange rates in December 1983, following the lead of many other countries that had grown tired of battling market speculators. But Australia retained a highly centralised model of wage determination featuring a strong element of wage indexation, according to which nominal wages would be adjusted to 'compensate' for increases in consumer prices. And product market competition was hampered by a lack of a coherent competition policy framework and high levels of border protection,³ permitting labour cost increases to be passed onto domestic consumers. If an economy with these features suffers a trend decline in its terms of trade it will experience a permanent spiral of currency depreciation, consumer price inflation, wage inflation and increasing unemployment. These dynamics are what characterises a group of economies labelled 'banana republics'. And that is how Australia's challenge was described by its Treasurer, Paul Keating, in 1986; that Australia was at risk of becoming a banana republic.

Treasurer Keating's challenge was to ensure that *nominal* currency depreciations became *real* depreciations. Because of the way in which this challenge was communicated at the time, and subsequently reinforced in a simplistic but powerful reform narrative, the real exchange rate has become the principal metric for assessing Australia's level of 'international competitiveness'.

1-1 International competitiveness

When I taught international trade theory in the early 1980s none of the textbooks or influential academic papers referred to 'international competitiveness'. Most likely, if the term had been used it would have been to describe some simple-minded notion of 'absolute advantage', displaced by the more insightful economic concepts of real opportunity cost and comparative advantage. Yet international competitiveness, and specifically the real exchange rate, continues to be at the centre of policy thinking about Australia's economic prosperity.

The real exchange rate is usually assessed by multiplying an index of domestic nominal unit labour costs by the trade weighted index of nominal exchange rates and comparing this product with an average of the nominal unit labour costs in our major trading partners. Nominal unit labour costs are obtained by dividing the average wage rate by average labour productivity.⁴ If we observe that the Australian product has increased at a faster rate than the index of unit labour

³ Illustrating the distracted nature of contemporary policy discourse in Australia, the term 'border protection' today refers to 'protection' from the incursions of small numbers of water born asylum seekers. I am using the term to refer to tariff and non-tariff (principally quota) barriers to the importation of goods and services.

⁴ Of course, it would make more sense to divide by the marginal product of labour.

costs in our major trading partners, then we say that Australia has experienced a 'real appreciation' and conversely for a 'real depreciation'.

The cumulative laws of multiplication and division permit other representations of real exchange rate dynamics. Thus, Australia will experience a real depreciation if, all else equal: Australian wage rates fall relative to foreign competitors; Australian labour productivity increases relative to foreign competitors; or Australia's nominal exchange rates fall.

With freely floating nominal exchange rates and flexible product and labour markets, a fall in the terms of trade due to softening export prices should lead to a fall in the real exchange rate. Currency markets are affected because exporters have less foreign currency to exchange for Australian dollars and because foreign investors view Australia as a less attractive capital destination. Both things mean a weaker demand for the Australian dollar. A nominal depreciation is required in order to balance demand and supply in currency markets. But the fall in the terms of trade constitutes a negative demand shock in product markets as well. With sufficiently flexible labour markets, that negative demand shock should flow through to lower nominal wages. Thus, nominal unit labour costs should fall. Of course, an autonomous improvement in labour productivity would have the same effect, also lowering nominal unit labour costs. The policy reform program thus focussed on wage restraint and microeconomic reforms designed to lift productivity.⁵

With the currency depreciating, average consumer prices will be increasing. Thus, both the fall in nominal wages and the currency depreciation act to reduce real wages. This states the core political challenge in the Australian reform program that was pursued in the 1980s. It is extremely unlikely that this challenge could have been met successfully in the absence of the unusual prices and incomes accord negotiated between the then Labor Government and the trade union movement.

1-2 Australian mercantilism

In the 1980s nominal unit labour costs sat at the core of a reform narrative that I have labelled Australian mercantilism. It goes like this: lowering unit labour costs through labour market deregulation and a set of productivity enhancing economic reforms enhances our international competitiveness. That boosts exports. Exports mean growth. Growth means jobs. And jobs are the source of higher living standards.

There was another, complementary, piece of this narrative: a tighter fiscal policy would improve the prospects of a real depreciation, further boosting exports, and export growth would cause the current account deficit to narrow, thereby dealing with the threat posed by Australia's relatively high level of international

⁵ Unit labour costs are a crude measure of the unit cost of production. More sophisticated concepts recognise other components of unit cost, including the true opportunity cost of additional capital that has to be utilised to expand production, the costs of various intermediate and other inputs, including transport costs, and, of course, various taxes embedded in production. All of these things, too, contribute to a country's level of international competitiveness as commonly understood.

indebtedness. Thus was born the sub-narrative of ‘debt and deficits’, part of the broader story of Australian mercantilism.

The narrative proved powerful in motivating action: to deregulate the labour market; to enhance product market competition; to implement a broad-ranging set of regulatory reforms to boost productivity; and to pursue aggressive fiscal consolidation.⁶ The set of reforms implemented in the 1980s and 1990s boosted Australia’s international competitiveness. Exports grew strongly. And while the Australian economy experienced a deep recession in the early 1990s, that turned out to be but a brief interruption to a very long period of strong economic growth and employment growth that has continued until very recently. Average living standards also grew strongly.

Securing higher average living standards in the face of declining terms of trade is an extraordinary achievement. And the reform narrative that I have labelled Australian mercantilism should take a lot of credit for that achievement.

But at the same time as that reform narrative was being developed, the world was changing for Australia. And it was changing in a way that would, ultimately, render the narrative misguided and dangerous.

2 *The shock of accelerating terms of trade*

In 1978 the Chinese government embarked on an ambitious growth program, based on economic liberalisation and internationalisation. Other countries in the region have also been pursuing ambitious growth strategies for some time now.

In just the past twenty years, China and India have almost trebled their share of the global economy, and increased their absolute economic size six times over. Indonesia’s economy has been growing at around five per cent a year for the past decade, and its economy is now larger than Australia’s in purchasing power parity terms.

More than forty per cent of global economic activity now occurs in Asia. The White Paper reported projections that, over the next decade, that will rise to almost one-half. One quarter of the globe’s economic activity will occur in China. Asia will have four of the top ten biggest economies in the World: China first, India third, Japan fourth and Indonesia tenth.

Today there are about 500 million people in Asia who would be regarded as being ‘middle class’. By 2020 that’s expected to rise to 1.7 billion people, and by 2030 to more than 3 billion, with Asia then accounting for about 60 per cent of global middle class consumption.⁷

In the last couple of decades of the 20th century, China’s internationalisation rarely rated a mention in Australian policy circles. There were some notable

⁶ The last of these was seen as a respectable means of achieving a nominal currency depreciation, in contrast to competitive devaluations of managed exchange rates in the pre-float era. And that remains true today, even as attention focuses once more on the question of whether and to what extent monetary authorities might be engaging in ‘currency wars’.

⁷ Kharas and Gertz (2010).

exceptions,⁸ but these had little impact on the core Australian reform narrative; indeed, they made no attempt to do so. In the early years of this century, the Australian government's senior international relations advisers identified the key strategic challenge to be making the most of a century or more of American hegemony. But even those who considered that far greater attention should be paid to the implications of a rising China failed to anticipate the acceleration in Australia's terms of trade that got underway late in 2003, driven by rapid increases in the world prices of Australia's minerals and energy exports. By September of 2008, just as Lehmann's was collapsing in what we have chosen to label the global financial crisis, Australia's terms of trade stood more than 80 per cent above their average level of the last decade of the 20th century. And while the terms of trade fell with the onset of the crisis, they rebounded quickly. By mid 2011 they were more than double their 1990s average.

The lift in the terms of trade caused a significant real appreciation; in the order of 50 per cent. This real appreciation can be decomposed roughly 80:20 into nominal exchange rate appreciation and nominal unit labour cost increase. The real appreciation played an important role in macroeconomic stabilisation and provided the principal endogenous mechanism for redistributing to Australian households the benefits of higher world commodity prices.⁹ But it also damaged our international competitiveness. That shouldn't have been an issue for the minerals and energy producers who were benefiting from higher export prices, but Australian manufacturers, tourism operators and exporters of education services suffered. Their businesses contracted. They had to, of course. The boost to Australia's terms of trade hit an economy that was more or less fully employed. Expanding resources extraction activity, and especially the construction boom that accompanied it, necessarily implied contraction in other sectors. But the narrative of Australian mercantilism couldn't explain what was going on. Instead, it insisted that the loss of international competitiveness, captured in the real appreciation, had to be a problem.

According to Australian mercantilism, if international competitiveness falls then governments should do something about it. Thus, successive Australian governments have had to respond to various proposals designed to reverse the real currency appreciation caused by international commodity price inflation: cut business costs, especially wages and taxes; boost productivity; and cut government spending.

Some of what has been called for makes a good deal of economic sense. It is the sort of policy that should be pursued regardless of what is happening to the terms of trade. But it really is quite astonishing that the extraordinary growth in the terms of trade has had almost no impact on the dominant economic reform narrative of Australia. How could it be that a reform narrative constructed to deal with a trend decline in the terms of trade could be equally relevant to the policy requirements of an unprecedented terms of trade boom; a boom that might last for at least a decade?

⁸ Especially Garnaut (1989).

⁹ Tax cuts and increases in family payments provided complementary exogenous magnitudes of redistribution.

And there is a more fundamental question to be answered. Could Australian mercantilism, with its focus on unit labour cost competitiveness, provide sufficient guidance for the development of the set of policies and institutions that would enable Australia to make the most of the opportunities of the Asian century? Or was a different narrative required?

3 *The White Paper vision*

Supported by the three ‘external’ members of the Advisory Panel established to guide the development of the White Paper, a small group of officials developed a vision of a future Australia in the Asian century. It is a vision of a prosperous and secure nation, with sustainably rising living standards and quality of life, that is integrated into this diverse region and open to the world; a nation whose people understand and, together with partners in the region, have the capabilities to deal confidently with the challenges of the Asian Century and to make the most of its extraordinary opportunities.

In this vision Australian businesses are deeply integrated into the economies of Asia, through trade and investment linkages and in partnership with regional businesses, employing people in Australia and from across the region, supplying global markets.

It sees a highly skilled and educated, dynamic and optimistic Australian community that understands the region’s diversity and builds enduring relationships with its people through tourism, education, science and research collaboration and cultural exchange.

And it sees Australian governments, at all levels and in all parts of the country, strengthening productive relationships in the region, based on consultation, collaboration and mutual respect.

3-1 *Core propositions*

The White Paper vision emerged from a set of core propositions that provide the architecture for Australia’s future in the Asian century. First, the rise of Asia is reshaping the world, and this reshaping has some way to run. Second, these regional developments are occurring against the backdrop of truly profound global challenges. Third, Australia is well placed, and is adapting to the rise of Asia, though the gap between its potential and present reality is expanding rapidly. Fourth, regional economies are moving up the value chain, and this has implications for Australia. And fifth, Australia’s future is in its hands.

While the conduct of policy making in Australia in recent years falls well short of the quality of policy making in the 1980s and 1990s, Australia remains in relatively good shape. Unlike most of the rest of the developed world, government balance sheets are strong. The financial system is sound.

Australia’s economic policy frameworks and governance institutions, developed over several decades, insulated the Australian economy from the external shocks associated with the Asian financial crisis of the late 1990s; the ‘tech wreck’,

global stock market correction and widespread developed-world recession a few years later; and the recent global financial crisis. These frameworks and institutions represent 'created endowments' – a legacy from an earlier generation of Australians.

Australia's natural endowments have a strong measure of complementarity with the world's fastest growing economies. Australia has a large endowment of environmental assets, though it needs to do a better job of protecting them. It has abundant mineral and energy reserves, though they will not last forever. It has the capacity to produce greater volumes of high protein foods, though it needs to find more sustainable farming practices. And in this Asian Century, Australia has locational advantage.

Australia's human capital endowments are also significant. It has a highly skilled, diverse and creative population that has deepening connections with the region and demonstrated capability in innovation, design and complex problem solving.

People-to-people ties with the region are growing deeper. The face of Australia is changing at a faster rate than in any other developed country (with the possible exception of New Zealand) as migrants, students and visitors from Asia bring new perspectives, energy and skills. One in ten Australians was born in Asia. Today, China and India are the principal source countries of Australian immigration. Increasingly, Australians also live, study and work in the region, strengthening the exchange of ideas and cultures.

3-2 Australia's future is in its hands

But it would be a mistake to think that Australia has done all it needs to do in order to guard against the risks, and make the most of the opportunities, associated with the Asian century.

Indeed, the challenge for government, business and the community is immense. It is no exaggeration to say that a new mindset is required. Success in this century means a willingness to adapt continually. Several factors provide necessary foundations, including: free trade in goods and services, capital mobility, the globalisation of ideas, and people movements. But much more is required.

The White Paper concluded that Australia needs to act in five key dimensions.

First, Australia's prosperity will come from building on its strengths, reinforcing the domestic foundations of society and a productive, open, flexible and resilient economy. This is not about pursuing various means of securing a real depreciation. Rather, the agenda involves investing across the five pillars of productivity — skills and education, innovation, infrastructure, tax reform and regulatory reform.

Second, Australia must do even more to build the capabilities that will help it succeed. This means an investment in its people through education and skills to

ensure that all Australians can participate in, and contribute to, the Asian century.

Third, Australia's commercial engagement in the region will be most successful if highly innovative, competitive Australian firms and institutions develop collaborative relationships with others in the region. Australian firms need new business models and new mindsets to operate and connect with Asian markets. Australian governments need to be involved in initiatives that make the region more open and integrated, encouraging trade, investment and partnerships.¹⁰

Fourth, Australia's future is irrevocably tied to the ongoing prosperity and sustainable security of the region. Australia has much to offer through cooperation with other nations to support sustainable security. Australian governments have a role to play in contributing to trust and cooperation, bilaterally and through existing regional mechanisms. And Australian governments should continue to support a greater role for Asian countries in a rules-based regional and global order.

Fifth, Australia needs to strengthen its already deep and broad relationships across the region at every level. These links are social and cultural as much as they are political and economic, developing out of shared experience in commerce, institutions, travel, arts, sport, education, and the exchange of ideas and knowledge. Australia's engagement to date might best be described as episodic, constructed around significant events, with insubstantial, fragile linkages between these events. Australia's governments, businesses, unions, community groups and educational and cultural institutions need to adopt a more strategic approach to bilateral relationships.

3-3 A need for new mindsets

The White Paper argued that Australia's traditional approach to openness is not sufficiently ambitious.

Australia has to pursue regional harmonisation (or mutual recognition) across a broad sweep of areas: educational qualifications, occupational skills recognition, financial regulation, corporate governance and so on.

And Australian businesses need products and knowhow that are valued in the region. That means understanding where they can add value through innovation and the development of long-term relationships.

The 21st century business model is likely to be very different from the successful business models of the last quarter of the 20th century. The best recipe for long-term success comes from making the most of complementary interests and working collaboratively with partners in Asia, not just competing against them. In some cases, Australian businesses will be able to access large Asian markets through export, including as part of regional supply chains. In other cases, the business opportunities will be secured through the establishment of enterprises,

¹⁰ Which is why Australia's participation in the Asian Infrastructure Investment Bank is not optional.

including business partnerships, in Asian countries. Australian businesses will need the capabilities to do both.

'Collaboration', 'cooperation', 'partnership', 'matching capabilities' and 'engagement' are part of the language of this century, just as 'international competitiveness' was the language of the last quarter of the last century. The central point here is not iconoclastic. Rather, it is one that has been understood by economists for at least two centuries: the gains from trade arise not from mimicry, but from harmonious points of difference that define complementarity. In this Asian century, Australia's harmonious points of difference include: exceptional standards of corporate governance and workplace safety; an insistence on quality, including with respect to food standards and animal welfare; and an intolerance of corruption.

For Australian businesses and individuals that develop the capability to engage in this way, there is a vast landscape of new opportunity, especially in supplying goods and services to an increasingly prosperous Asia, and in ventures to help address the challenges confronting several large regional neighbours in respect of water security, energy security, food security, green growth, urban design, health care and aged care.

But only a small proportion of Australia's population has these capabilities at the present time. What is needed is Australians with the knowledge and skills to develop strong relationships in the region. To build partnerships Australians need the capacities to understand and operate in cultures, languages and mindsets other than their own. Within Australia there is a need to put in place the advisory, decision-making and representational structures required to make informed decisions in an increasingly complex environment.

Australia's major bilateral relationships need to be transformed into comprehensive partnerships involving government, business, community organisations and citizens generally. Common experience through commerce, institutions, travel, arts, culture and sport, as well as education, ideas and knowledge exchange should increase.

4 *Concluding remarks: The nature and nurture of international competitiveness*

At its core, the White Paper draws attention to the need to focus on the capabilities of Australians to engage effectively in the Asian century. The focus on capabilities informs a more sophisticated understanding of international competitiveness and a more relevant economic reform narrative.¹¹ The narrative should comprehend the role played by national endowments in driving national performance; that is, it should be capable of explaining how the economic, social and environmental outcomes of a nation, and the distribution of those outcomes among its people, rest upon its particular set of endowments.

¹¹ A similar criticism of the incumbent narrative, and call for a different approach to policy development in the Asian century, is presented in Livingstone (2015).

Some of a nation's endowments are a consequence of nature. Others have been developed by earlier generations of humans. In the former category are a set of natural assets, including: geographic location; demography; energy, minerals and soil deposits; and native flora, fauna and ecosystems. While these endowments are the product of nature, they are not static. The human population of Australia is growing rapidly, and it is ageing. Mineral, energy and soil resources are being depleted. Native flora, fauna and ecosystems are being degraded, in many cases irreparably. In the category of endowments created by humanity are to be found the products of foundational investments in such things as: a richness of indigenous cultures; modern multiculturalism; investments in the visual and performing arts; transparent and incorruptible legal and regulatory structures; high quality education and health facilities; national investments in research and innovation; policy frameworks that promote economic security; and working conditions that support human dignity.¹² The seriousness of the deficiencies in the Australian mercantilist narrative is underscored by observing that every element of this set of created endowments would have been argued, at some time or another, to be inimical to Australia's international competitiveness.

The need to ensure that Australians are endowed with the capabilities that will be relevant to success in this Asian century calls for a renewed focus on these, and other, national endowments. The *White Paper on Australia in the Asian Century* identified a need for new foundational investments, including public investments: in Australian schools, universities and vocational training centres; in developing Asia-capable workplaces and institutions; in developing a much deeper understanding of the history, cultures, languages, geography and governance of our regional neighbours; in devoting more effort to what has become known as 'track 2 diplomacy'; in building strong people-to-people relationships based on trust and mutual respect; and in encouraging adaptability. International competitiveness in the Asian century will be enhanced by paying attention to all of these endowments, and leveraging them into commercial partnerships, not by pursuing a race to the bottom on wages, taxes, social foundations, environmental standards or animal welfare.

¹² National endowments and individual capabilities are not the sole determinants of economic, social and environmental outcomes, of course. External drivers and shapers also impact national outcomes. Notable among current shapers of Australian outcomes are: the information and communications revolution; global climate change; and the industrialisation and urbanisation of China. And outcomes are impacted, too, by all of the current policy settings of government, only some of which would properly be characterised as foundational investments.

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