September 29, 2020

Revisiting Australia's economic model

Australia needs a new way of thinking about its growth model

This year Australia's economy entered a recession for the first time since the 1990s. While COVID-19 was the main trigger, there had already been a downtrend in growth over the past decade. An aging society, a shifting immigration landscape, China's slowdown and a structural fall in global demand for coal require Australia to rethink its growth model. Ultra-low interest rates will also pose a challenge to policy makers ahead.

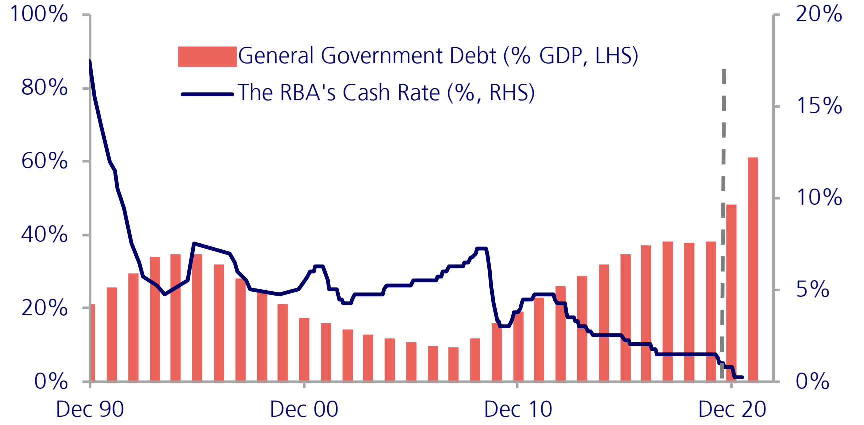
Source: iStock

Times are changing

Until last year, Australia had a record of a 29-year economic boom without a single recession. It escaped the Asian Financial Crisis in the late 1990s, the Dotcom Bubble in the early 2000s and the 2008-2009 Global Financial Crisis (GFC). Yet Australia's luck seems to have run out and the country is now experiencing its worst economic contraction since the 1930s due to the COVID-19 induced recession.

However, it is not the case that Australia's growth only decelerated once the pandemic hit. To the contrary, the slowdown had already begun to take place in the last decade. Several conditions that used to serve the country well have changed markedly, with many becoming less favourable in recent years. These include the changing dynamics of interest rates and public debt, an aging population, China's slowdown and a structural decline in global coal demand.

Ultra-low interest rates amid rising public debt



Source: Bloomberg, Bank of International Settlements (BIS)

Notably, some of these changes have been amplified by the COVID-19 crisis.

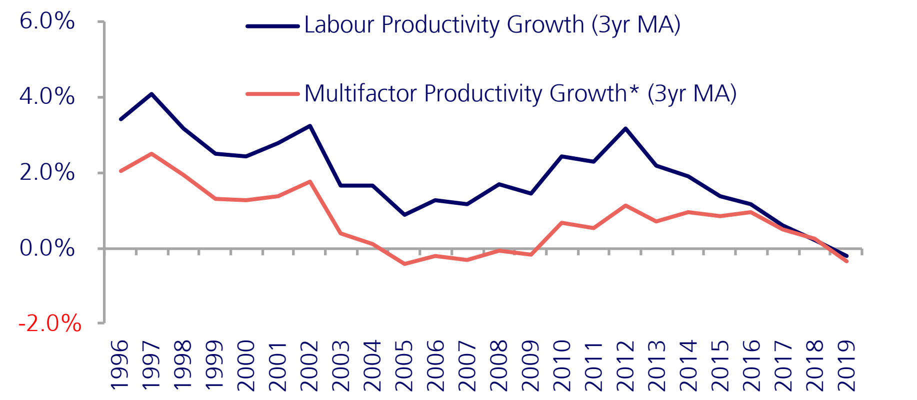
A shifting backdrop of interest rates and public debt

For decades, the Reserve Bank of Australia (RBA) has played an active role in managing the boom and bust of economic cycles. Accordingly, the central bank was able to lower policy interest rates effectively and hike rates when inflation exceeded its target. While policy coordination was well executed in times of economic contraction, fiscal measures used to play a supporting role. This partly explains Australia's low and relatively stable government debt, which has hovered below 40% of GDP since World War II (WWII).

However, these dynamics are shifting. The RBA's cash rate was already as low as 0.75% pre crisis. It only took a 50bps rate cut in March for the policy rate to hit a near zero interest rate of 0.25%. The RBA recently signaled another policy rate cut "without going into negative territory". Hence, we expect the cash rate will reach its effective lower bound of 0.1% in Q4. With that, a remarkable shift from monetary to fiscal measures as the key macro-policy will continue.

The size of Australia's COVID fiscal package is unprecedented. The total stimulus across federal and state governments is equivalent to

Productivity growth dips, dragged by low labour productivity



Source: Australian Bureau of Statistics *Multifactor productivity= output/combined inputs (labour, material, capital)

around 11% of GDP with 9.3% being direct measures such as cash handouts and job retention schemes. The JobKeeper program proved particularly effective in preventing the unemployment rate from skyrocketing, which would have crushed the country given that Australian households are highly indebted.

While this is encouraging, the government's bill is going to be large. According to the fiscal update by the government in July, it is estimated that the budget will shift from a surplus in 2019 to a deficit of around 4.3% of GDP this year and 9.7% next year. With Victoria's lockdown, the level of budget deficits will probably be higher given further stimulus needed to support Victoria. Accordingly, the IMF projected that Australia's public debt could rise as high as around 60% of GDP in the next couple of years.

A new era for macro policy

While Australia's public debt is increasing, it remains at a manageable level compared to other developed markets. However, Australia's sky-high household debt is a concern. Household debt to income in Australia is currently around 190%. Given the situation, interest rates need to stay low for longer to avoid financial distress among households. This is particularly critical on the back of current high unemployment and subdued wage growth.

Given a near zero cash rate, the RBA is short of an effective monetary tool to cope with further economic shocks, though Quantitative Easing (QE) and negative interest rates could be options. However, the potential side effects of these tools, such as QE inflating financial asset prices rather than stimulating real economic activity or negative rates depressing banking profits and encouraging cash holding among households, pose challenges that could prevent them from being as effective as conventional rate cuts. The RBA has shown little interest in negative interest rates while remains relatively conservative with regards to an expansion of QE beyond the current yield curve control.

> "Fiscal policy will have to play a more significant role in managing the economic cycle than it has in the past"
>
> Phillip Lowe, RBA Governor

That being said, Australia seems to be entering a new era of macroeconomic policy in which fiscal measures become central economic support. As a result, fiscal deficits will probably become more volatile throughout the different phases of business cycles than they were in the past. The shifting backdrop of macro policy with lower interest rates and high budget deficits may mark the beginning of weaker trend growth for Australia going forward, especially as a number of growth factors have become less favorable for Australia over the years.

An aging population and changing immigration landscapes

Like many other advanced economies, Australia's population is aging. Between 1970 and 2019, the median age of the population has risen from 27 to around 37. An aging population reduces direct labour input while increasing the number of people served by the social welfare system. Furthermore, a society which enters an aging phase tends to save rather than spend and invest, which are the two crucial pillars for growth.

Some adverse effects of the aging population have been absorbed by an open door immigration policy, picking up appreciably since 2005. According to the World Bank, Australia's population growth is around 1.5% per annum, compared to only 0.5% in the OECD in 2019. Accordingly, 60% of the increase is due to net immigration change with the majority being working-age immigrants. On the other hand, the natural increase has been flat since the 1980s.

While immigration is generally perceived as a positive and an important factor in Australia's prosperity, certain political pressure on curbing immigration growth has resurfaced in recent years. Last year, the government announced it would cut the immigration quota by 15% citing imbalances caused by immigration such as overloading infrastructures and less affordable housing in big cities. Despite that, there has not been a clear sign that reducing immigration will become a permanent policy stance.

With COVID-19 arriving down under and causing a year-long border closure, net immigration has fallen to almost zero. Given the record number of people that are out of work following the lockdown, political pressure to reduce immigration further will probably increase in the foreseeable future. Whether this leads to a long-term shift in immigration policy in the years to come remains to be seen. However, the negative impact of current low immigration will be sizable as immigration is usually a source of demand creation, especially in the housing market.

The need to improve productivity

While population growth is vital for economic growth in Australia, on its own it might not be a sustainable source for the long haul, given a structural decline in fertility rates worldwide and an aging global population. It means Australia will not be able to count on immigrants as a source of population growth for much longer.

Besides labour, two other important factors for growth are capital input and productivity. Due to the COVID-19 induced recession, capex is likely to be lacklustre for an extended period. However, capex will eventually pick up in tandem with a recovery in activity.

A more concerning matter is the ongoing decline in productivity growth since 2010, with labour productivity growth having been the main drag. According to research by PwC, Australia's labour productivity level as of 2018 lags behind the US and most economies in Western Europe.

> "Productivity isn't everything, but in the long run, it is almost everything."
>
> Paul Krugman, Professor of Economics, Princeton University

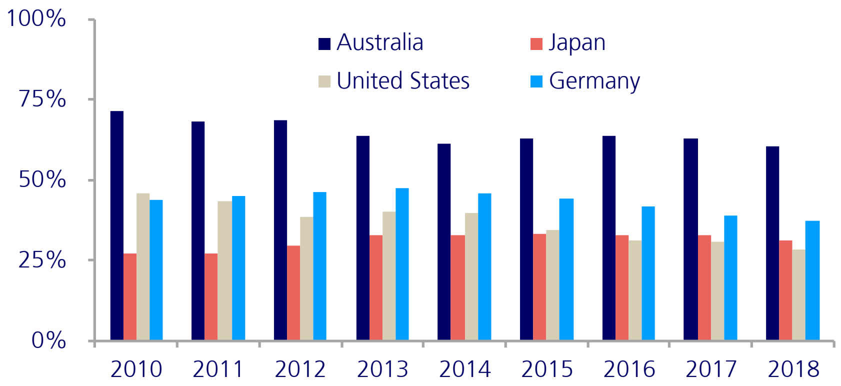
While Australia did not experience a recession for 29 years, GDP per capita growth dipped into negative territory several times over the last decade. That means aggregate GDP growth did not always translate into higher income and better living standards for households. Therefore, an improvement in productivity is needed for the country to move forward. Productivity can be boosted through policy reforms and embracing technology and automation.

Overall, the technology sector in Australia remains relatively small compared to other industries such as finance and mining. A cross-country comparison shows Australia's tech industry contribution to GDP lags that of China and other major developed markets including the US, Japan and Germany. Hence, this could be one area in which Australia can play catch-up.

Interestingly, COVID-19 lockdowns have boosted work-from-home and online shopping trends. These factors have helped to speed up the process of businesses deploying more technology in the workplace and physical shops moving online, which

Coal remains the main source for power generation in Australia

Share of Coal in Electricity Production (% of total)



Source: World Bank, International Energy Agency

potentially improves efficiency and productivity going forward.

Enhancing productivity requires a joint effort between the private and public sectors. Along with structural reforms to boost system efficiency, public investment in infrastructure and policy incentives for productivity enhancement are also needed. Overall, productivity growth will help to raise output and living standards through wage growth and make the country less vulnerable to the dynamics of population growth.

Spillover effects of China's slowdown

China's rapid industrialisation and urbanisation have created huge demand for steel and fuels over the past two decades. Australia, with outsized reserves of coal and iron ore, benefited substantially from this trend. Over time, China has become the largest client of Australia's mining sector, accounting for around 40% of the country's resource exports and 60% of Australia's iron ore exports according to the RBA. China is also a key buyer of Australia's dairy, alcohol and pharmaceutical products.

China's growing fortune also led to a boom in the number of Chinese tourists in Australia, accounting for about 25% of total visitor spending. A surge in the number of Chinese students has brought Australian universities billions of dollars in revenue every year, contributing to about 30% of education exports.

The fact that China is slowing down affects Australia in two ways: it lowers demand growth for Australia's commodities, goods and services, and it lowers commodity prices as China reduces its commodity import growth over time. Note that China currently accounts for more than half of global commodity demand.

In the short run, the spillover effects are not so visible, masked by a short-term economic rebound in China post COVID-19, along with multi-year high iron ore prices. Yet this short-term development will not stop the structural slowdown from taking place in the long term.

Recent trade spats between Australia and China have added some headwinds to Australia's trade. This year, China announced it would impose anti-dumping tariffs on barley and halt beef imports from Australia. China's authorities have also cautioned Chinese students to reconsider studying in Australia. These actions followed Australia joining the US in calling for an investigation into the origin of COVID-19 and China's early handling of the outbreak.

Undoubtedly, the economic link to China has helped Australia escape several economic downturns in the past. Yet the flipside is an economic dependence on China's demand. Given its growing share in the global economy, China will continue to be a strategic trading partner for Australia. However, there is also clearly the need for diversification to ensure Australia's economy will be able to derive its income from various trading partners.

A structural decline of coal production

Globally, coal is used for two main purposes: electricity generation (accounting for around two-thirds of total coal consumption) and industrial production, particularly steel manufacturing. Accordingly, China and India are the top two importers of coal given their rapid growth over the past decades as well as their outsized populations. On the supply side, Indonesia and Australia are the two largest coal exporters. Given that coal shipments accounts for around 25% of Australia's total resource exports, the global outlook for coal has crucial implications for Australia's economy.

The response to the COVID-19 outbreak has led to a sharp drop in global usage of electricity and industrial production, creating a strong headwind for coal demand in 2020. The International Energy Agency (IEA) estimated that global coal demand fell by around 8% YoY in Q1 2020, the largest drop since WWII. In contrast, the use of renewable energy did not fall amid social restrictions. Instead, it grew by about 1.5% YoY in Q1 2020.

Apparently, the decline in coal consumption is not only due to idiosyncratic factors brought about by COVID-19, but also a long-term shift in the global energy landscape. Two key driving forces are behind the structural slowdown in coal consumption: economic slowdowns in China and India, the two main consumers of coal, as well as a global transition to renewable energy.

These trends will negatively impact Australia's mining exports and investment. In fact, a future full transition away from coal for power generation is unescapable, given the low efficiency of the coal mining business, the adverse environmental effects of coal as the worst CO2 emitter, and the increasing affordability of renewable energy.

On a global scale, Australia still lags behind most advanced economies with regard to a transition away from coal. More than 60% of Australia's electricity is still generated by coal while this figure is only 30% or less in Europe, the United States and Japan.

While investment in renewables rose sharply between 2016-2017, research by the RBA noted that it was gradually reduced after 2017. With Sun Cable, the latest 22-billion-dollar venture announced last year, aiming to build a large-scale solar farm in Australia to export electricity to Singapore, we hope more attention will be drawn to the renewable energy sector in the years to come.

Admittedly, ongoing policy incentivisation and support continue to be crucial to boost investment in clean energy in Australia. This will not only help broaden energy sources for the country and reduce its reliance on coal, but also enhance its global role in tackling climate change, given that the country itself has been heavily affected by droughts and catastrophic bushfires over the past few years.

Conclusion

The changing dynamics of macro policy, an aging population, the structural decline of China's growth, and a long-run downtrend in global coal consumption all pose challenges for Australia to maintain the same growth level as before.

However, being out of the comfort zone could create a powerful boost for necessary reforms and innovations. In Australia, we see the need to reconsider the growth model in order to maintain solid economic performance and improve living standards in the years to come.

Lifting productivity growth and seeking new sources of growth to avoid an overdependence on only a few sources of income, including a dominant trading partner and a heavily weighted single industry should be considered. Renewable energy could be a promising area for public and private investment, given that Australia lags behind other developed markets in this area. This will become increasingly relevant for Australia given the inevitable fall in global coal consumption on a long-term basis.

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