Recession or rebound? That's the budget question

Budget 2015
With fiscal alarm bells ringing, the government has to deliver structural reforms to build confidence.

Stephen Anthony

We stare down the barrel of a recession in 2016. On budget night the Abbott government must instil confidence by holding the course on fiscal policy towards a credible and sustainably structural budget path over the medium term and demonstrating its preparedness to do the hard yards on microeconomic reform.

The Australian economy is feeling the chill of post-global financial crisis fallout of risk aversion, liquidity constraints and secular stagnation that have choked productive investment in plant and physical infrastructure in major economies. This is heightened now by a China slowdown with renewed concern over bad debt levels there.

Major economies have resorted to using quantitative easing or financial asset purchases to paper over their own domestic structural imbalances. No doubt, delaying adjustment will come with a huge price tag for the global economy. In the end, if countries want sustainable growth this is determined by their rate of productivity increase stemming from the combination of technology and industrial organisation over time. Macro policy should just be about little more than smoothing the business cycle. The lesson for Australia based on the overseas experience is that we need to place more emphasis on structural policy.

Domestically, the headwinds from slower global growth are exacerbating the income compression (via profits and wages) experienced by Australian businesses and households from the declining resource commodity prices and unwinding of the mining investment boom. No wonder federal and many state budgets are floundering. Certainly, a circuit breaker is needed in the face of global and local headwinds.

But unfortunately, our macro policy response has not borne fruit so far.

Monetary policy (275 basis points of official interest rate cuts so far) is working through conventional credit channels and carrying the adjustment burden. But it is also spurring the housing investment casino in established residential property in Sydney. This frenzy is assisted by the offshore capital flows fed by

The last budget floundered: the new one can do better. PHOTO: ANDREW MEARES

unconventional monetary policies offshore that are feeding local asset valuations even where prospects for future earnings look less rosy. Associated capital flows have neutralised the exchange rate channel of domestic rate cuts, forestalling the further 10 to 20 per cent real depreciation justified by falling commodity prices. This may even prevent the Australian economy maintaining respectable growth over the next eighteen months to two years.

Supply-side policy, or the lack of any concerted microeconomic reform pipeline in Australia since the 1990s, has ensured that the burden of all structural adjustment must be achieved via the now less effective nominal exchange rate channel, or regrettably borne via wage restraint, which will be acute for those with less bargaining power. This is the price of our major political parties not taking a micro reform for the entire 2000s.

Fiscal policy has floundered with the failure of the federal structural budget repair job in the 2014-15 budget. Clearly, the growth in public spending is unsustainable. Most of that growth is occurring in health, social assistance to the aged and families

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with children. A fix can be found here that spreads the burden of adjustment as thinly as possible to those who can most afford it by tightening eligibility criteria for certain spending programs, but political courage and a strong and consistent narrative is required. Perhaps paring back the concessional treatment of superannuation contributions and/or discount on capital gains would help broker a compromise.

Certainly, the fiscal alarm bells are ringing now. Macroeconomics is forecasting a budget deficit of just under $50 billion in 2015-16 plus deficits of closer to $40 billion over most of the outlook, and this is without a domestic recession as the central scenario. The nation will face the equivalent of fiscal quicksand if real growth slips into negative territory in conjunction with declining terms of trade.

In the end, business needs to be convinced there is some reason to invest. But animal spirits in the form of optimism over prospects for incomes growth over the near term can be fanned by decisive political leadership: agreeing to key measures likely to raise prospects of productivity growth; addressing liquidity in financial markets; dealing with the sustainability of fiscal policies; addressing the adequacy of public infrastructure investment, and instilling policies which reward innovation and entrepreneurship.

On budget night, Treasurer Joe Hockey can offer a balanced and fair set of medium-term structural reforms which deal directly with the cost drivers in health and limit eligibility to aged and family assistance to the most needy over time.

Mr Hockey can also assist business and households to get access to credit on more favourable terms via the Murray financial system review reforms.

Mr Hockey can support other worthy microeconomic reforms such as the Harper competition policy findings by expanding the role of the Productivity Commission to report league tables of the top 10 welfare-enhancing microeconomic reform policies, infrastructure projects, regulatory reductions, and other fiscal and social policy changes.

Finally, any reform program could include 10 or so major infrastructure projects (one or two for each state and territory). It would be prudent to have these on the drawing board with approvals ready to go as soon as possible. If it does proves necessary to fire the fiscal cannon, the use of high-quality public infrastructure projects and base-broadening taxation policy reform measures (which restore the balance between earning, spending and investment) would be the best bet to grow jobs with no regrets.

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Neither Cameron nor Miliband is fit to run Britain's economy

British election
Labour did not cause the UK's economic problems, and despite the rebound, more Tory austerity cannot fix them.

Martin Wolf

Labour overspending did not cause Britain's economic woes and Tory austerity is not the cure for them, despite a shallow recovery.

If the Conservatives win enough seats in the general election to retain power, it will be their reputation for economic competence and Labour's for the opposite that does it. Are these reputations deserved? Not as much as conventional wisdom has it, would be my answer.

The story we have been repeatedly told has three elements: Labour profligacy was responsible for the chaos the coalition inherited; the austerity of the past five years has produced a remarkable recovery; and continuing on the same path is the way to return the economy to health.

Simon Wren-Lewis, who teaches macroeconomics at Oxford University, labels the elements of this story myths. So what is true and what is less so?

In its latest World Economic Outlook, the International Monetary Fund states the UK's cyclically adjusted fiscal balance was minus 6.8 per cent of gross domestic product in 2008 and minus 9.9 per cent in 2009. But in October 2008, it had thought the same deficit would be 2.9 per cent of GDP in 2008 and 2.8 per cent in 2009. The IMF has changed its view of the past. But nobody had that wisdom before the crisis.

What role, then, did fiscal mistakes play? The Office for Budget Responsibility concludes: "It is hard to argue that the tax and spending policies implemented in the early and mid-2000s were in themselves an important cause of the crisis and recession. But there were undoubtedly weaknesses in fiscal management during that period."

The view that the UK's crisis was essentially due to Labour profligacy is false.

Thus, government spending did indeed grow too fast before the crisis. But the ratio of spending to GDP had been very low in 1999-2000. A period of faster growth in spending than GDP was justified. Again, the cyclically adjusted deficit should have been perhaps two percentage points of GDP smaller than it was. Yet, if it had been, and if the ratio of net public debt to GDP had also been 10 per cent lower in 2008 than it was, the fiscal deficit and net public debt would still have soared. Since the government never found any difficulty in selling debt at very low interest rates, the difference in the debt service burden would have been negligible. And the pre-crisis ratio of debt to GDP was very low by historical standards.

So the view that the UK's crisis was essentially due to Labour profligacy is false. This mistaken belief allows people to ignore the weaknesses of the private economy, which was more fragile than thought in those pre-crisis years.

Turn now to whether the recovery has vindicated the coalition's austerity. One response is that the coalition ended up delivering not its own plans but those of Labour's March 2010 budget, as is shown in a New Policy Institute paper. Yet Labour might not have delivered what it promised, particularly under Gordon Brown, prime minister from 2007-10. Maybe it took George Osborne, Conservative chancellor of the exchequer, to deliver what Labour promised.

Another response is that fiscal tightening did indeed slow the recovery significantly. This is consistent with the OBR's analysis. When interest rates have reached a floor, fiscal tightening is bound to weaken demand and output, argues Professor Wren-Lewis. Even if aggressive monetary policy offsets fiscal tightening, it may impose its own costs via unsustainable asset prices or excessive credit expansion.

Yet the more fundamental point is that this has been a disturbingly weak and unbalanced recovery, not a strong, healthy one. True, it has brought forth a welcome improvement in employment, but only because of a collapse in productivity growth.

Notes the NPI, the growth in self-employment has soared from just under 40,000 a year between 1987 and 2007 to almost 140,000 a year since 2009. Before 2007, self-employment accounted for 16 per cent of jobs growth; now it is 45 per cent. One must ask what sort of jobs these are. Low-paid self-employed jobs may be better than nothing but they are hardly a triumph.

What, then, of the next parliamentary term? There is a real difference between Conservatives and Labour on fiscal policy, though both promise tightening and not even Labour is prepared to argue for significant tax increases. This means fiscal adjustments will continue to be on the side of spending. The difference is that the Tories seek an overall fiscal surplus and Labour a surplus on the current budget. The former also means lowering spending to ratios to GDP barely glimpsed in half a century. Such a low level is unlikely to be achieved or, if achieved, sustained.

In brief, my assessment of the records of both Labour and Tory-led governments is that neither party is competent. Neither showed healthy scepticism about financial services. Neither tackled the growing crisis in the supply of housing and consequent overdependence of the financial sector on lending secured against it. Under both parties, the economy has been too dependent for demand on household borrowing and spending. Not least, UK prosperity lags: in GDP per head (at purchasing power parity), the UK is behind not only the US, Germany and France, but also Singapore, the Netherlands, Sweden, Denmark and Finland. If productivity growth fails to recover, this relative position must grow worse.

The time has surely come to shift the focus from the obsession with fiscal deficits and debt. These were neither the cause of the crisis nor the solution. Whatever one thinks of the fiscal policies of the coalition, a weak, unbalanced recovery from a huge recession is not a vindication. The UK faces big economic challenges, and equally huge questions about its place in the world and in Europe, as well as its own constitutional future. Neither main party offers convincing responses to these challenges. Have no illusion: real competence is not on offer, either in economics or, in truth, much else.

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