Australia's 'nirvana' economy

Peter Jonson

Surely it doesn't get any better than this? Inflation at 2.5 per cent in the June quarter was firmly in the middle of the Reserve Bank's target range, rocketing export prices are making Australia wealthier, equity markets are booming, housing markets are still rising fast in the resource States and may be recovering elsewhere, bond yields have remained low, the currency hasn't collapsed and a new era of economic reform has arrived with the Coalition majority in the Senate. The Reserve Bank Governor has spoken of Australia as experiencing an economic 'nirvana'.

The debate on economic reform is running hot and strong. The government is focusing on selling the rest of Telstra and reforming industrial relations. Its coalition partner, the Nationals, seem set on getting the best outcome for the bush rather than supporting the entirely sensible view that running a telco is not a task for government. IR reform is being opposed more vigorously by the unions—those great Australian conservatives—than by the Australian Labor Party.

The Business Council has its own well-articulated reform agenda, and recently the Victorian Government issued a paper focusing on health and education reform as well as competition policy. I venture judgement that if all the reform packages were laid out systematically, there would be a 70 per cent overlap. Is there no way to get on with the 70 per cent while debating the rest?

The global economy has performed much better than expected. A systematic reason for this is the continuing reaction to the flood of liquidity that enormous US budget deficits and super-low US interest rates unleashed from 2002. The size of the liquidity flood explains stronger-than-expected global growth, high, strongly rising, commodity prices and generalized asset inflation in many places. But, as my colleague Henry Thornton pointed out recently in *The Australian*, this flood has peaked—the pace of increase in global holdings of international reserves has been declining for a year now. We are almost certainly past the time of maximum global growth.

The long-awaited Chinese revaluation began with only minor impact on financial markets, with an initial 2 per cent appreciation against the $US. China will eventually be better able to manage its economy with a more flexible currency regime, which, over time, will further restrain the growth in global liquidity.

The US is showing firm growth with low inflation. China is still booming. India is following closely. Japan's long delayed recovery is sputtering into life again. Russia, Brazil, even Argentina are growing strongly. To be sure, Europe is growing only slowly and spasmodically, but we are used to that.

What could go wrong? One cannot rule out a major terror attack, environmental catastrophe or global pandemic, in which case many bets would be off. The large US 'twin deficits' and associated external deficits provide a source of serious international tension, and if the US became protectionist, global growth would be hit. Global interest rates almost certainly have to rise substantially from current levels and this might well produce hard landings in many asset markets. The price of oil keeps setting new records in nominal terms and may soon reach levels in 'real' (inflation-adjusted) terms that limit prospects for growth. So far, at least, financial markets seem to have decided that the high price of oil is mainly a response to strong global growth.

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Domestically, productivity growth has slowed, and on some measures is negative. Australia's current account deficit remains far too large and this will worry international investors if there are other signs of weakness or serious political discord. Wages are beginning to stir, with the unions beginning to pick off their political brethren at the State levels. The shake-up to the industrial relations landscape is likely to have a surprising outcome as employers scramble to retain skilled workers. I disagree with the Reserve Bank's recently stated view that the next move in interest rates is as equally likely to be down as up.

Whether or not Australia can remain in a situation of 'nirvana' as inflation builds and with a monster current account deficit is the big question—only time will tell. Resource booms like the one we are now enjoying almost always end in tears.

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