

# Australian Business Economists



## Economic Outlook > 2005/2006 > Australia and the United States of America

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**Dr Ken Henry**

Secretary to the Treasury

An ABE breakfast briefing

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at: Four Seasons Hotel, 199 George Street, Sydney

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**Transcript of questions and answers  
following Dr Henry's presentation**

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**Dr Ken Henry, Secretary to the Treasury**  
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The recording at the beginning of this question is unclear...

Q ...how much your new forecasting methods added to your tax revenue forecasts and secondly, how much your different assumptions about terms of trade may have detracted from tax revenue forecasts?

A Well, I don't want to go into it in too much detail. Sorry, I don't want to be too specific about the numbers because that will focus people on the things that are of secondary importance rather than those of primary importance, but both of those adjustments are significant. Let me say both of them are worth several billion dollars per year.

Q **Rory Robertson, Macquarie Bank.** It is said you should never ask the question unless you know the answer, but I don't know the answer to this, Dr Henry, for the past several decades the biggest problem in Australia, in the Australia economy obviously has been unemployment has been too high and there's been a need to get it lower. Now we're down around 5% which is better than most people hoped, so what now is the biggest problem in the Australian economy, if any?

A Well, when you started the question I thought, cripes if Rory doesn't know the answer to it, I'm not going to know the answer to it either, but you've disappointed me, I think I do know the answer to this one. Yes, if it's not unemployment what is it? Well, with respect to Labor, it's participation and the need to get a larger proportion of the population of working age into jobs, particularly older workers, particularly those who are on income support payments. And I could say, although this is controversial, particularly females, because it is the case that among OECD countries, Australia's rates of female workforce participation are not particularly high. So in those three areas I would say there is a strong case for focus. And the focus, as I said, should be on finding ways of improving labour market participation. Beyond labour market participation the other focus obviously, it should be obvious, is on productivity. Australia's productivity performance has been very strong over the 1990s, particularly over the second half of the 1990s, strong relative to our history and strong relative to other countries. Stronger even, as I've said on a number of occasions, including for this audience, stronger even than the 'new economy' United States.

In more recent times, the last few years, US productivity growth has been stronger than Australia's productivity growth, but United States' multifactor productivity growth has not been stronger than Australia's multifactor productivity growth over that period, that is from 2000 to 2004. Rather it seems that the reason for United States' productivity growth outstripping Australia's productivity growth over that period has to do with the peculiar way in which the United States came out of its recession in 2001 with, as you would all know, very, very slow employment growth and so the United States performance in that period, the first few years of...sorry, from 2000 to 2004 has more to do it seems to me with cyclical than structural phenomena. But the focus should be on productivity and you know the standard decomposition of productivity growth into capital deepening and multifactor productivity and you know that microeconomic reform is what makes the strong contribution to multifactor productivity growth and you know that it's investment that explains capital deepening.

Q Dr Henry, with regard to your forecasts, I was curious that Treasury is only forecasting a 2% downturn in housing this year. We did have a 3% downturn last year, but typically the cycle will go two or three years and typically housing will turn down 10 to 15%. I know that all of us have been wrong in being too pessimistic about housing in the past, do you think you might be making the mistake about being too optimistic now that we're actually starting to see the downturn.

A Well, as you've noted Bill, the thing is this housing cycle clearly is not typical. What you say about typical housing cycles I'd agree with, but this one, and the evidence is very much to this effect, this one is not a typical housing cycle. We made the best judgment that we can. In the budget we list a number of risks to the forecast and certainly that's one of them, that the housing cycle could come off more sharply than what underlies the budget forecast and we note that were it to do so then it could have implications for the strength of household consumption activity. In particular, it would also have implications for investment activity. But it's our...that is our best judgment at this time, recognising the risks.

Q **Dr Henry, Steven Long from the ABC.** Could you explain how your analysis on capacity constraints relates to the different inflation forecast from the Treasury and the Reserve Bank?

A No. Not just because I don't want to, I'm sorry, I couldn't. But look seriously, there is very, very little difference between the Reserve Bank's forecast for inflation and the Treasury's inflation forecasts. Very little difference indeed and I would say, and if this is what your question is really about, not enough to raise the interest of anybody engaged in policy.

Q And your suggestions about macro economists misreading capacity restraints, would it be unreasonable for people like me to think that we could say the same thing about the Reserve Bank officials?

A Very unreasonable.

Q We're unusually short of questions today, so I'll ask another one. The bond market people were pretty pleased to see that we have finally seen recognition of the future fund and the fact that bond supply will survive now and the recognition by the Government of how important it is to have a liquid bond market. I thought the details about the future fund were a bit sketchy however, a couple of questions. Investment guidelines for the future fund, would you expect that there'd be less of an emphasis on equities than a normal fund because of the market to market issues with regard to the future fund, or you would expect that the future fund would have typical investment guidelines like a normal balanced fund?

A Well, it's too early for me to be talking publicly about these issues in any detail and that is just to say that we're still looking at the design of the investment mandate for this particular fund. I'll say that clearly there is a desire that this fund achieve a rate of return that is better than what we would get from leaving realised surpluses on deposit in our account with the bank, but at the same time the fund will have, for very obvious reasons, a rather prudent investment mandate and this is not really answering your question, it's just a way of endorsing what is implied in your question I think, that there is balance to be struck between those two objectives.

Q **Stephen Halmarick from City Group.** Bill pinched my question from the future fund, so I'll ask you another question. You mentioned that you expect commodity prices to climb over coming years because of a supply side shift. I'm just wondering on the other side, on the demand side, what's your expectation for strong demand for our commodities, particularly from places like China?

A Well, the circumstances that give rise to the strong demand for commodities relate principally, in fact overwhelmingly, to the strength of the Chinese economy of course and one should be, one should be very optimistic about the Chinese economy. That's not to say that Chinese economy growth trajectory could not be disrupted. Indeed, it could. The strength of the Chinese economy depends, among other things, upon the continued strength of the United States economy, particularly so given that Europe was promising

some years ago a return to strong growth but is once again disappointing and also because Japan continues to disappoint and for those reasons there is a strong dependence of China on the United States. There's no reason why policy makers should take decisions in either of those economies that pose a risk to the continuation of strong demand conditions for Australia's bulk commodities. There's no reason why they would do so. That isn't to say they couldn't do so. So there is a risk, there is a risk there. I don't see that risk materialising any time soon and that's why our forecasts have in them continued strong growth in China. That I think will underpin the demand side of the market, the world market for bulk commodities for quite some time, for a very considerable period of time, and it's going to be on the supply side that we're going to see much of the cyclical action.

**Q Rob Henderson from National Australia Bank.** Dr Henry, one of the things that the budget has been criticised for quite roundly is the size of the tax cuts for high and upper income earners and also the dropping of the surcharge on superannuation, and I guess there's a bit of a smell about that commentary that this has been done for political reasons. My question is, to what extent does the Treasury believe that there will be changes in activity as a result of these changes and were there any efficiency arguments put forward to support those tax cuts.

**A** Well, you know, if you wanted to...if your motivation was politics I doubt you would have structured the tax cuts in this way. I doubt that that would have been seen as being a strong argument for abolishing the superannuation surcharge. You understand, I think everybody in this room understands the political economy of tax cuts in Australia, and it is, just in case you don't understand, that you always give the biggest tax cuts to the people who don't pay tax. That's the political economy of it. The reason for these, there are different reasons. As far as the superannuation surcharge is concerned, superannuation surcharge, as the Government has been saying in recent days, was introduced at a time when the Government saw the need to reign in the budget and having reigned in the budget the Government now sees an opportunity to get rid of the surcharge. Are there sensible reasons for getting rid of the surcharge? Yes, indeed there are. There are as far as complexity is concerned and there are as far as superannuation savings are concerned. So for those two reasons getting rid of the surcharge I think most people would regard as sound policy, even if they might be concerned about the distributional implications of removing the superannuation surcharge. And of course governments are there to balance those various things off in respect almost of every decision they take, to balance equity issues off against efficiency issues; to balance, although this doesn't occur often enough for my liking I'd have to say, but to balance off concerns about complexity against equity considerations, because much of the complexity in our tax and regulatory systems is motivated by equity concerns.

As far as the income tax cuts themselves are concerned, I think the Government's objectives in this area are very clear and people have known them, for some time. The Government has had a very consistent approach over recent years, over many years indeed, to the way that it has sought to restructure the personal income tax system. Since tax reform, since 2000, the Government has continually delivered a tax rate scale that ensures that at least 80% of individual tax payers will have a top marginal rate of no higher than 30%. That's something that obviously the Government feels is important. The Government also over that time period has had an objective of trying to get Australia's top threshold closer to something that might be regarded as an international norm. Those are the Government's objectives and that's what motivates those tax cuts. The Government's concern.... in doing that it's principal focus is on efficiency issues. It's concern is with the extent to which high marginal tax rates might distort behaviour, including decisions about where people decide to work and obviously about how many hours they decide to work.

**Q Matt Wade from the Sydney Morning Herald.** Dr Henry, you've spoken today about the boost in the terms of trade and it's impact on the economy, I wonder if you could

comment on how you think that might be distributed in the Australian community and does that raise any equity issues?

A Well, look, it has a lot to do with the extent to which the dollar appreciates, because of our anticipation of those terms of trade increases. If the dollar didn't appreciate at all, since what's driving the increase in terms of trade is higher export prices, then the beneficiaries of those higher export prices would be those people who have an interest, whether as an employee or as a shareholder, in mining companies. Those would be the principal beneficiaries. That would be...that's a first round effect. There would be subsequent spillover or second round effects throughout the economy as some of those people spent their higher income in the Australian economy and that would have distributional consequences, rather complex distributional consequences. If the exchange rate appreciates then that's the principal mechanism through which an increase in the exchange rate redistributes income. Now, of course, since the question relates to distributional implications of course not everybody is delighted to see a higher exchange rate. There are some exporters for example, particularly those who export services, but also those who export manufactures, who presumably don't think this is a terribly good thing that the exchange rate has appreciated as commodity prices have moved to record highs, and that's understandable. So that's another distributional implication of the effect of an increase in the terms of trade. But that's another way of saying that as far as macro implications are concerned that a real appreciation has a contractionary effect on the economy.

Q **Andrew Robertson from the ABC.** I just wanted to ask you another question on capacity constraints. A few months ago the Reserve Bank Governor sparked a national debate on our infrastructure or the lack of it, when he talked about the damage being done by capacity constraints. You seem to have played down that issue today and I'm just wondering why there is such a difference between the importance you give to that issue and the importance the Reserve Bank Governor gives to that issue?

A I don't want my comments to be interpreted as suggesting that infrastructure is not an important issue. Clearly it is and that's why I...well, perhaps I should have been clearer, but in talking about what's going to contribute to Australia's productivity growth in the future, I distinguished between the multifactor productivity growth that is really a result of a more efficient economy and productivity growth that is due to capital deepening. Infrastructure has a role to play in both of those of course: in facilitating a more efficient allocation of productive resources within the economy, but also, and more directly, in enhanced capital deepening. It seems to me, indeed, I fail to see how it could not seem I guess to anybody thinking about the balance between the short and the long term here, that infrastructure issues are to do with the medium to longer term performance of the economy. I mean, obviously enough, if your view is that the economy is running up against brick wall capacity constraints you'd hardly be suggesting that we should have a spending boom on infrastructure, at least if your concern was about the short term inflationary implications of those capacity constraints. That would be a rather perverse policy prescription. Instead, those who call for more investment on infrastructure have a long term perspective in mind. Their perspective is to shift out the economy's productive capacity in the medium to longer term. Now, as far as that goes do I think there's a case for more spending on infrastructure? Well, I'd be surprised if there was not a case for more spending on infrastructure. That isn't to say though who should be doing the spending.

And the second thing I'd say is, if as a country, irrespective of who is going to do the spending, if as a country we are going to spend more on infrastructure, please let us make sure that this time around we've got the right regulatory regimes and the right relative prices so that the infrastructure goes in the places that are going to generate an economic rate of return.

- Q Steven Koukoulas TD Securities.** I noticed in the budget that the Government has allocated some more money to the Bureau of Statistics for a whole range of things, which is good news, but I also note that they didn't allocate any money to the publication of a monthly inflation number, is this because the Melbourne Institute is doing such a great job of producing monthly inflation? Secondly, how important is that monthly inflation to the RBA Board when it comes to their interest rate deliberations each month?
- A** As far as the second part of the question is concerned. The Governor speaks for the Board publicly, I don't speak for the Board publicly, so I'm afraid you'd have to ask him that question. As far as why the Government hasn't funded an ABS monthly CPI series, well, it's a long time since I've seen that issue emerge within Government, but you know, that price series are incredibly volatile, it's not so long ago that we moved away from looking at the monthly average weekly earnings figures because of the volatility in those figures, both price and quantity series surveys of the ABS and others are subject to extraordinary volatility, and policy makers, and I'm speaking generally now rather than on behalf of the Reserve Bank Board, policy makers are interested in underlying trends rather than in month to month volatility.
- Q** I'd like to thank you all for some great questions and particularly thank Dr Henry for once again giving us a profound insight into the way we should be thinking about some of these issues at the moment, particularly the risks to inflation. We've become used to Treasury, to Dr Henry's presentations giving us these insights and once again we haven't been disappointed. For those of you that were wondering about the trivia question, about who did come second in that pole, the answer is Martin Felstein, so give yourself a tick if you got that one right.

Just if I could now say we will be crossing live at 9 o'clock and Dr Henry will be introducing Dr Kohn and once again.....

END OF TRANSCRIPT