

POLITICS AND POLICY – THE OUTLOOK IN AUSTRALIA

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I've been working up to it for some years in these talks, but today I think I'm finally in a position to pronounce the Death of Economics. Last week's decision to postpone indefinitely the privatisation of Telstra has removed the fig leaf covering the Howard Government's loss of commitment to further micro-economic reform. It's equally true that the satisfactory state of the economy has allowed concerns about macro-economics to recede. The economy is now on automatic pilot and it won't return to top priority until the next recession – which I'm not expecting any time soon. The most significant development for politics and policy this year – and thus the most significant influence over the outlook for politics and policy in the coming year – is the way the events of October 12 have moved concerns about defence and domestic security to the forefront of the public's mind and to the top of the Howard Government's agenda. The public was greatly disturbed by the Bali bombings and is very worried about the possibility of a terrorist attack on our shores. You and I may not be terribly conscious of this growing crisis atmosphere, but the politicians are in no doubt about it.

The chief political consequence of the terrorist threat has been to complete John Howard's personal dominance of the political scene. All incumbent governments around the world have benefited from the post-September 11 climate of uncertainty, but John Winston Howard has shown himself particularly well suited to the role of 'wartime leader'. He won many plaudits for the way he comforted the Bali bereaved; in general, he's said all the right things and rarely said the wrong thing.

The chief policy consequence of the terrorist threat has been to shift defence and domestic security to the top of the Government's preoccupations and thereby complete the eclipse of micro-economic reform. Howard made that crystal clear in his recent CEDA speech: 'Mounting a strong, focused and resolute defence of Australia and our national interests is the most critical continuing challenge that we face. Not since the early 1960s have we faced a more complex and uncertain region. Some trends, particularly the emergence of terrorism, clearly run deeply counter to our interests. And Australia's national security will therefore require the highest priority and continuous review by the Government.' So the dominance of economics in the political debate has passed and, for the first time in about 30 years, defence and foreign affairs are the main game.

Now, before we move on, I want to be clear that to freely acknowledge John Howard's political success is not to approve of the way he has come by it. To say that he's the most successful politician of his generation is also to say he's the most cynical politician of his generation. Howard is a walking political calculator. He couldn't kiss his granny without the political implications of the act flashing across his mind as he did so. And it's a long time since we've had a prime minister more uninhibited by ethical concerns in his efforts to garner the xenophobic vote. We were reminded of that when, in response to Fred Nile's bigoted and idiotic suggestion about preventing women from wearing the chador, he failed to immediately dissociate himself, but slipped into his old Pauline Hanson soft-shoe shuffle, observing that Nile 'speaks for the views of a lot of people'. That was a dog-whistle to people who hate the 'towel-heads'.

The Liberal leadership

John Howard now has almost total, personal dominance of the federal political scene. He has the electorate eating out of his hand and is reigning, like a head of state, above the political fray. He has completely wrong-footed, overawed and demoralised the Labor Opposition. And he has total dominance over his own party. You'd never imagine this was the same man who, not so long ago, so many punters were contemptuously referring to as Little Johnny. I should add that he's also enjoying a media that's unquestioning and complacent, where it isn't belligerently defensive of his every move. So after he reaches his 64th birthday in July, it would be the perfect time for him to retire.

I'm not really joking. All former prime ministers are obsessed by just one thing: how they'll be remembered by history. And Howard knows that all political leaders are remembered by the manner of their going. History is littered with prime ministers who clung on past their time, had to be pushed out and so diminished their reputations. But quit while you're riding high and your good reputation is assured. This is why I believe Howard fully intended to retire next year, just as soon as he'd pipped Malcolm Fraser's seven year term as PM.

There's just one thing wrong with this analysis, however: if you're riding high, why on earth would you quit? The kind of person who has what it takes to climb the greasy pole as far as prime minister, and cling tenaciously to the job despite all the blows, is simply not the kind of person who knows when to call it quits. That's why so few PMs have left at a time of their own choosing. So, though they say Howard is tired more than he looks, I won't be surprised if he decides to stay on after all. The temptation to stay on and enjoy the adulation would be huge. Howard will have many self-serving people around him urging him to stay on – he even has callers on talkback radio urging him to stay. And he has the perfect excuse: I promised the people I'd see them through the crisis and I just couldn't desert my post at my country's hour of need (cue the violins).

But note this: should Howard decide to stay, it means he has to stay for another three years ie until he's 67. Why? Because he couldn't get through another election campaign without making another commitment to stay for the best part of two years into the new term before handing over to his successor. And what would Peter Costello do about all

this? Nothing. He'd be deeply unhappy, of course, but he'd be a long way from having the numbers in the party room and he lacks the courage to make an issue of it.

The Labor leadership

Turning to the Opposition, it's been completely outmanoeuvred by Howard and lives in fear of him. He can make his criticisms of it stick with the electorate, but it can't make its criticisms of him stick. Part of its problem is that the media have no enthusiasm for holding the government to account. Howard has stolen much of Labor's foreigner-fearing blue-collar base. It's efforts to retain that base by saying 'me too' to his populist policies on asylum seekers don't have much effect – except to alienate Labor's educated, middle-class, socially progressive base – which is switching its first-preferences to the Greens to register its disapproval of Labor's pandering to redneck intolerance.

Labor is convinced it could do a lot better with Costello as PM so, should Howard decide to stay on, it will be a further blow to Simon Crean – assuming he survives long enough to be hit. Crean's case is terminal. The recent outbreak of muttering and manoeuvring against him is no media beat-up – it never is. In such cases the gallery is always reacting to what it's being told off-the-record by plotters and disaffected backbenchers. In this case, the rumblings were prompted by the Newspoll finding that, even among Labor voters, only 26 per cent preferred Crean as leader, while 44 per cent still hankered after a proven loser like Kim Beazley. But here's the point: it's hard to think of a previous occasion when a leader has suffered such public destabilisation and yet survived. No, Crean will be out of the job before next year is over – probably long before it's over.

He'll be succeeded by Wayne Swan – who'll be no better. Mark Latham has little support within the caucus and is considered unstable. Which is a pity because (apart from the Left's Lindsay Tanner – who doesn't have the numbers) Latham is one of the few contenders who has what I consider to be the bedrock qualification for high office: he wants the job because he has policies he deeply believes in and wants to implement because he's convinced they'd make the world a better place. All the rest of them are men who want the job because they want the job, and don't have a deeply held belief to bless themselves with. That's Crean's problem and it's also Swan's problem.

The remarkable federal/state dichotomy

It's important not to overlook the present remarkable federal/state dichotomy. At the federal level, the Libs are all-conquering and Labor is in utter, hopeless disarray. At the state level, however, Labor holds all eight state and territory governments and most of the Liberal oppositions are in terrible shape. Amazing. You can imagine how much the federal Libs would like to break that drought, and how anxious Labor is to hold the state line. And with the Libs so hopelessly routed in Victoria, the focus now turns to the NSW election in late March. Here the Carr Government will be trying to jump the hurdle Jeff Kennett couldn't make: to win a third term - with its various weaknesses and failures well known to the electorate and an accumulation of niggles on 101 issues. I'm told Labor is quite worried about the possibility of losing, while the Libs are hopeful of progress with

such a young, intelligent and attractive candidate as John Brogden. And here's the point: federally, neither side will be rocking the boat before the NSW election. So, Crean is safe from challenge until after the NSW election. And that election was one of the factors in the Howard Government suddenly going cold on the sale of Telstra – Brogden and his National Party mates don't need any further problems with country seats, thank you.

Howard's policy agenda

That's enough about politics; let's move on to policy matters and let's look at the items the Howard Government has on its agenda. The big point of Howard's recent CEDA speech was to demonstrate how busy he is on the policy front by laying out the cabinet's recently determined list of 'longer-term strategic objectives'. There were no fewer than nine of them. Let's go through them quickly and see what they add up to. Howard stressed that, apart from the first, they were in no particular order – 'they all have a special importance of their own' ie no particular importance.

First is, as you'd expect, 'the twin dangers of rising international terrorism and the proliferation of weapons of mass destruction' and these are 'clearly . . . more fundamental than any of the others'.

Second is 'balancing work and family life'. It's clear Howard has a quite narrow conception of this issue: he thinks it's all about mothers having 'choice' over whether or not to stay at home full-time with their young children. He seems to be working on a rejig of the Government's many and various family payments. This could be announced in association with the next election – which is probably the only context in which the Government would be likely to pick up the moderately expensive proposal for taxpayer-funded paid maternity leave.

Third is 'demography' and the ageing of the population. On this Mr Howard will continue preaching about the need for people to avoid early retirement – he may get around to taking measures to affect the incentives and disincentives. There's little sign of any policies aimed at raising fertility.

The **fourth** 'strategic objective' is 'science and innovation'. All very worthy – doesn't seem to amount to much.

Fifth is education. Here Brendan Nelson is working on further reforms to university funding, and has won the vice-chancellors' agreement to a scheme which will allow them to take in more full-fee paying students and also charge fees in excess of HECS if they think the market will bear it. Problem eased with little or no extra cost to the budget.

Sixth is 'sustainable environment'. This means pressing on with water reform, with the Commonwealth's incentive payments to the states under national competition policy being diverted to this purpose. Also under this heading is Mr Howard's remarkable policy of insisting that our greenhouse gas emissions target under Kyoto will be met easily and at no cost to the economy, while also insisting that actually to sign the Kyoto agreement would do our economy incalculable economic damage.

Seventh is 'energy' where Mr Howard is developing 'a strategic plan for Australia's long-term energy policy'. Wow.

Eighth is ‘rural and regional policy’ where the Government has ‘important and enduring priorities’ including a national response to the drought. Obviously, no post-Hanson government could have a list of priorities that didn’t include the magic word RARA. **Ninth** is ‘transport policy’ – which also doesn’t seem to amount to much.

Looking at this agenda you’d have to say it’s not wildly impressive. This is not a government with a host of major reforms it’s bursting to get on with. This list is not one of ‘longer-term strategic objectives’ as Mr Howard so grandly puts it, it’s just an ordinary old to-do list that any government could rustle up at any time. It’s not about Reform with a capital R so much as running repairs and the oiling of squeaky wheels. It’s the agenda of a government that knows it’s expected to look busy. You’ll note that, though many items on the list are matters a reformist government would want to do big things about, few are the sort of matters you’d think of as ‘micro-economic reform’. There’s little that involves reducing government intervention or increasing competition. Indeed, it’s clear the National Competition Council is being wound up and Graeme Samuel moved on to the ACCC. The era of micro reform has finished.

You’ll notice that one glaring omission from the nine-point agenda is health. Clearly, there’s no sign of any grand plan for the reform of health-care funding. But the present funding arrangements aren’t working well and Mr Howard won’t be able to avoid more patch-ups. He’ll have to do something next year to try to turn around the decline in bulk billing – which I’m sure is annoying GPs and patients in equal measure – particularly in RARALand. Less acute but more chronic is the problem the recent IMF staff report drew attention to: the moral hazard arising from the elimination of out-of-pocket payments for many people with private health insurance. There’s simply too much scope for over-servicing by specialists – in an area that’s even more heavily subsidised by the taxpayer than it was.

Telstra and the bond market

You wouldn’t forgive me if I failed to say something about Telstra and the end of the bond market. A lot of business economists have been reluctant to be seen coming out in support of the retention of government intervention that contributes to their own livelihoods. But I think I’ve found the right form of words to overcome the problem: we could certainly live without a bond market if there was a good reason to, but there isn’t. So what’s to be gained by killing it off? Nothing. Australia doesn’t have, and never has had, a problem with an excessive public debt to GDP ratio. Last week I heard the Chancellor of the Exchequer boasting that Britain had one of the lowest public debt ratios in the world: 31 per cent. With our federal ratio already a mere 5 per cent, there is simply no economic reason to want to get it to zero. It’s obvious that Peter Costello’s ambitions are purely political: he wants to be able to boast that he’s paid off ‘every last cent’ of ‘Labor’s debt’. He dreams of being able to use this as the ultimate proof of the Libs’ impeccable economic management and a reminder of Labor’s appalling mismanagement. The more spotty his record becomes on the maintenance of budget surpluses, the more he emphasises debt reduction. It’s become clear, however, that the goal of literally paying off ‘every last cent’ is unattainable. Telstra isn’t worth that much and the foreseeable

underlying cash surpluses won't be big enough. With the indefinite deferral of the Government's plans to sell the rest of Telstra, the threat of the bond market being wiped out has passed, but a subtler threat remains: that further smaller-scale debt redemptions will fatally wound the bond market (in terms of critical mass) without actually killing it off. Were this to happen it would be a great pity because it would mean that, for no good reason, we'd incurred many of the losses canvassed in the debate. Presumably, the market would become moribund. To me, the strongest argument in favour of preserving an active market is that, sooner or later, the budget will return to deficit and the government will need to issue bonds to cover it. It would be galling to find we had to run to the expense of reviving a bond market we'd allowed to expire purely through lack of foresight. Costello's blinkers may prevent him from seeing this – just as the Bush Administration and its Republican supporters' lust for income-tax cuts blinded them to the obvious implausibility of those happy projections showing the US budget remaining in surplus for as far as the eye could see – but it should be clear enough to the rest of us. I wouldn't be surprised to see the federal budget return to modest deficit within the next year or two. The notion that we've entered an era of permanent surplus is the product of ignorance or hubris.

Let me just say something about the deferral of the Telstra sale. One point to note is that, though the notional sale has been pushed back to the 2004-05 financial year, the next election is due in November/December 2004 and it's hard to see the Government wanting to stir up controversy about Telstra's ownership before the election. So we're talking about the actual sale of the first tranche some time in late 2005 at the earliest. Even by then I wouldn't be confident Telstra's share price would be much higher than it is today. It certainly could take many years to get back to anything like \$7.40 – you only get one dot.com bubble in your life. I believe Howard, Costello and the Government generally have had a lot of ego riding on completing the privatisation of Telstra. So I'm not convinced they've indefinitely deferred the sale primarily because they believe the company is worth infinitely more than its present share price. No, I think they've decided that proceeding with the sale is all too hard politically – getting it past the Nats, getting the numbers in the Senate, wearing the flack in rural electorates. And, because they see privatising Telstra as a major micro reform – up there with the GST – I see their decision to put Telstra on the backburner as strong confirmation of their loss of interest in micro reform. John Howard has simply moved on.

Monetary policy

I should now turn to fiscal policy, but I know you're not interested in it, so let's go straight to monetary policy. I want to start the way Ian Macfarlane starts his parliamentary testimony: by reviewing the forecasts he made last time. This time last year I observed that the Fed might have more easing to come and, if it did, the Reserve would ease a little more, too. This was much more pessimistic than the markets' thinking at the time, so I predicted that 'most of you guys will spend most of next year anticipating a rise in rates that never eventuates'. Now, as most of you would remember, once it became clear that the Reserve intended to begin tightening in May, I wrote a Monday column in which I ate humble pie and admitted I'd got that forecast wrong. At this late stage,

however, I'd like to regurgitate some of that pie and say that, by the end of the year, I'm not as wrong as I thought I was in May. I was out on the Reserve, but only to the tune of 50 basis points. And I was right in thinking the Fed was more likely to cut than to tighten, even if the easing came at the opposite end of the year to what I thought. So, in a different way to what I was expecting, I think I was reasonably right in predicting that most of you would spend most of this year expecting rate rises that didn't happen. Certainly, it took people like John Edwards (to whom I'd apologised in May) a long time after June to realise there were no more tightenings to come. In fact, the Reserve lost its appetite for tightenings as soon as it realised there was a growing chance the Fed would resume easing.

What does this post mortem prove? Nothing – other than that I can wriggle on the hook as well as the best of them. But I do think that, looking back over the year, the Reserve has been consistently more worried about the state of the US and world economies than most business economists have. And that's true even though there was that period in April-May-June when the Reserve said it was pleasantly surprised by the stronger state of the world economy. It soon changed its mind back again – sooner than a lot of you guys. Over the past two years – going back to Greenspan's first, surprise easing on January 3 last year – the US financial markets have been consistently over-optimistic, and that's rubbed off on our markets and our economists. It's true that the net fall in share prices and bond yields over that period reveals the US markets to be a lot less optimistic today than they were at the start. But, as the Reserve argued in the November SOMP, it seems pretty clear that the US markets remain more optimistic than they should be – ie that Wall Street may have further to fall. The one bloke who merits an honourable exception to all this is, of course, Rory the Wonderboy. I rehash all this to make my first substantive point: I believe we're likely to see the same phenomenon in the coming year: markets and economists in the US and here being consistently more optimistic about the outlook for the US and world economies than both the Fed and the Reserve. Every time you're tempted by the thought that the US is looking up, remember two things. First, Europe is in worse state than the Yanks. It has a debilitating structural problem: the euro and its policy regime is seriously flawed and is slowly squeezing the life out of the German economy. Second, if, as seems possible, the Japanese are finally stirring themselves to tackle their structural (banking) problems, that will make their economy weaker before it makes it stronger. I repeat: the most likely second-guessers' error I foresee in the coming year is to be more optimistic about the strength of the world economy than the policy makers.

The other useful lesson I think we can draw from this year's experience is that, these days, central banks in general and ours in particular change the direction of policy a lot sooner and more often than they used to. Consider the record: we had our Reserve tightening four or five times through 2000, then, last year, after a pause of just six months, easing six times between February and December. It then paused just five months before starting to tighten again, telegraphing its intention to raise rates by 125 to 175 basis points - but, in the event, halting after just 50. It's now done nothing for six months. It may be that this yoyo-like behaviour is a product of times in which currents and crosscurrents are especially hard to read, but I suspect it has a fair bit to do with the

present extremely pre-emptive approach to the conduct of policy. The pre-emptive approach makes central banks more dependent on forecasts and, as we all know, our forecasts frequently prove astray.

Which brings me to my call. Starting with the Fed, I think it could end up doing more. Certainly – and as I said last year – it will regard the whole of the remaining 125 basis points as available to be used if necessary. With some small possibility of deflation, I don't expect it to be erring on the side of overconfidence. Turning to the Reserve, I don't believe that, at this stage, it has any clear expectation of what it will do with rates over the coming year – except that it expects to be doing nothing for quite a few months yet. If rates are shifted some time next year, it could be in either direction: up if it's clear the US and world economies are recovering satisfactorily and it's clear the domestic economy still has a lot of steam left in it; but down if the outlook for the world economy has deteriorated further and the domestic economy is losing momentum. Of course, should the world economy get weaker while we stayed strong, I'd expect the Reserve to continue sitting on its hands. If this call doesn't strike you as particularly courageous I'm sorry, but it's about as definite as I think it's sensible to be.