# Comments by Alex Erskine, managing director of Erskinomics Consulting and ABE committee member, to open discussion of the paper on the economic outlook by Barry Hughes

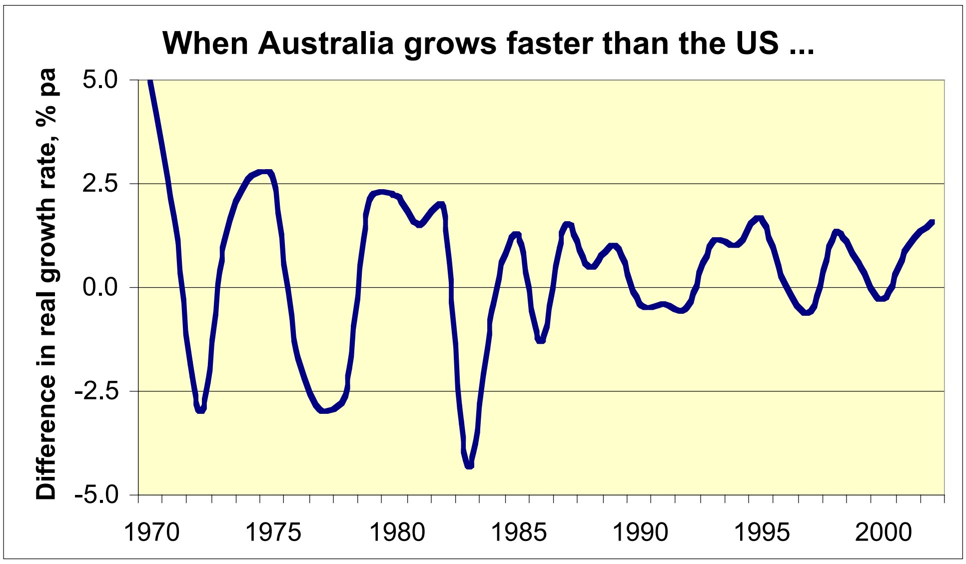
Barry has done us all a great service by reminding us very comprehensively that we are not dominated by the US economy. He rightly says that Europe and Japan matter as well, as does the rest of Asia. I am not all that reassured, however, because the "V"-shaped cycle that markets and policy makers have faith in leaves intact the key imbalances in the US economy which were to be corrected by a longer recession. This could be very drawn- out.

From my perspective on Asia, I must say that Japan has been an exquisite example of how not to tackle a financial crisis, because – 12 years on from bursting its bubble – it is still struggling to dimension the problems and has lost any leverage from the conventional policy levers. Increasingly it looks as though the line of least resistance is a depression within Japan.

Regrettably, 4_ years on from the Asian crisis, the previously-crisis-hit countries have also mostly done too little, too late to repair their corporate and financial sectors, and non-performing loans are beginning to increase again. The usually more successful NICs have been caught out, overexposed to the synchronized downturn in electronics and communication investment. While the latter cycle will no doubt be temporary, slow growth will compound the structural problems in the weaker countries. China, India and Vietnam are doing well, but elsewhere in Asia potential growth rates have probably halved.

Barry has served us still better by reminding us that it is up to Australians to play the hand that is dealt. Just because there is a world recession doesn't mean we have to succumb. We can act independently. So far, so good.

So let us look briefly at the use of independence and learn some lessons.

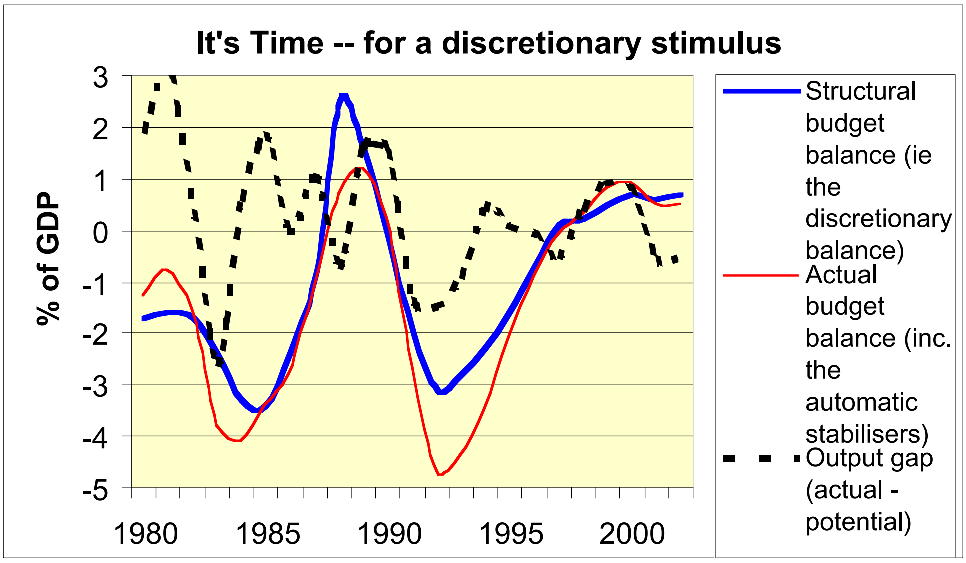



Source: Erskinomics and IMF WEO database, October 2001

Whenever we have tried to grow “too fast” relative to the US, we have paid for it with a year or more of massive underperformance. A 2% growth differential may be ok, but a 2.5% differential in the past has proved too much of a good thing.

What makes this time different?

Most factors would suggest that we can be more independent than usual. We have unrivalled policy flexibility, because inflation is under control and our habitual bête-noire, the current account deficit, is in better shape than usual. But in addition, the fiscal situation is very sound and this gives additional scope for action. Indeed, I argue that fiscal policy is too tight at present – for instance, see the fiscal policy situation observed by the IMF in preparing its World Economic Outlook in October 2001. Again, we need to grow at the right pace, not too fast or too slow compared to potential. Earlier we heard some sound argument on whether potential is now faster than the 3_% pa that the authorities and the IMF assume.



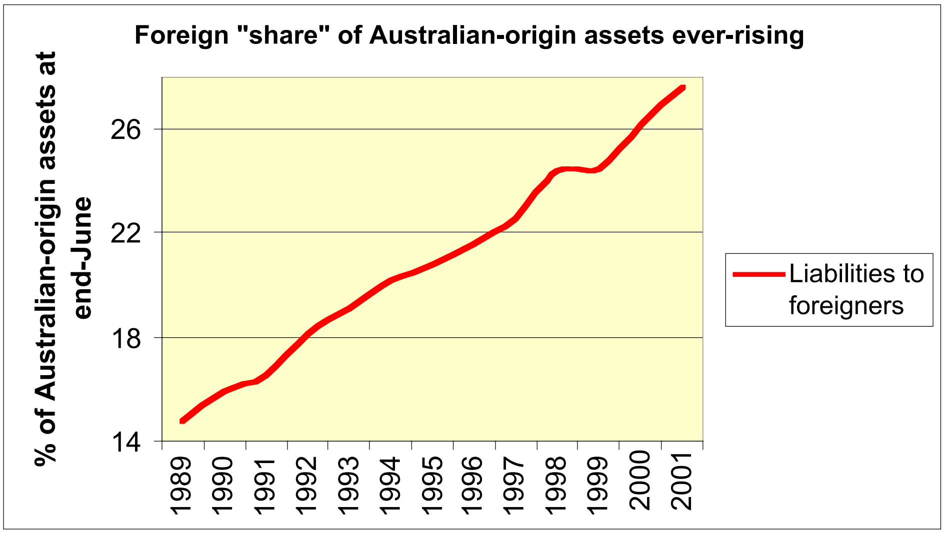

Source: Erskinomics and IMF WEO database, October 2001

Elsewhere I have put the case that when (I do not believe that it is “if”) the global downturn hits we should reduce the GST on a strictly temporary basis, to inject an incentive to spend and to relieve the burden on households. This would be a discretionary stimulus to go on top of the so-called automatic stabilizers, which by definition will be not doing a sufficient job.

But can we get away with such independence?

Obviously not if Australian business economists maintain their false god of a budget surplus for all seasons. We need to hear sensible discussion about the active use of fiscal policy, especially if the monetary policy transmission channel becomes ineffective – for instance because business confidence is too badly depressed by global events.

Another – more serious – limit on our scope to act independently resides abroad. We are more globalised than before, despite Barry's trade perspective that we are a not-very-open small economy. This is not the late-1980s, when foreigners had financial claims of under 15% of the total of Australian produced and non-produced assets. Years of current account deficits and a sensible outflow of accumulating domestic savings have seen the ratio rise to 27%, and at some stage – no one knows when – we will have to dance more strictly to the piper's tune.




Source: Erskinomics and ABS Cat No 5204.0 11/01

What reel is the piper playing?

My suspicion is that we need especially to avoid disappointing our foreign creditors. In other words, we need to astutely use our independence to grow faster than the US and elsewhere during the global downturn AND (this is the really hard bit) to ensure that our growth does not disappoint in the global recovery period. We must avoid the policy blunders that led to drastic underperformance in 1972, 1976 – 1978 and 1983, and minimize the "loss" of potential growth and jobs. Not easy – the high-jump bar has been raised – but not impossible.

But the foreign claims are a concern. Many economic accidents are caused by the trouble that investors suddenly face in other – quite different – markets. This is where the non-resolution of US imbalances matters. The US current account deficit and offsetting capital inflows are so large that it seems inconceivable that catastrophic accidents are not a certainty. 2002 and the next decade will therefore remain a highly uncertain period for the world economy and for the Australian economy.

4 December 2001