economic and political overview 2016

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About this publication
Economic and Political Overview 2016

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CEDA – the Committee for Economic Development of Australia – is a national, independent, member-based organisation providing thought leadership and policy perspectives on the economic and social issues affecting Australia.

We achieve this through a rigorous and evidence-based research agenda, and forums and events that deliver lively debate and critical perspectives.

CEDA's membership includes 700 of Australia's leading businesses and organisations, and leaders from a wide cross-section of industries and academia. It allows us to reach major decision makers across the private and public sectors.

CEDA is an independent not-for-profit organisation, founded in 1960 by leading Australian economist Sir Douglas Copland. Our funding comes from membership fees, events and sponsorship.

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Contents and contributors

The content in the *2016 Economic and Political Overview* was up-to-date at the time of printing. Due to the dynamic current economic and political environment, it may not address the most recent developments.

CEDA's Economic and Political Overview event series takes place around Australia to coincide with the publication's release, and provides the latest analysis from the report authors as well as business and political leaders.

foreword

This edition of CEDA's annual *Economic and Political Overview* again delivers a comprehensive analysis of Australia's political and economic developments, trends and projections in what is already shaping up to be an eventful year.

Commonwealth Bank of Australia's Chief Economist and Managing Director of Economics, Michael Blythe has expertly evaluated the economic indicators. Mr Blythe notes that last year Australia clocked up 24 years of unbroken economic growth, which he expects to continue in 2016 at 2.75 per cent. He also expects unemployment to steadily decline and wage growth to remain modest.

The chapter discusses the implications for Australia of China's slowdown as well as the United States' efforts to cautiously raise interest rates and drive a sustainable recovery. Mr Blythe reassures us that Australia does not risk recession in 2016 provided we offset falling commodity prices with measures that strengthen incomes.

Dr Peter van Onselen from the University of Western Australia, *The Australian* and Sky News, provides this year's insights into the Federal political scene. With an election looming, he predicts that the economy will be the primary campaign focus of all parties and candidates. Important issues of workplace relations and productivity are likely to be subsumed by widespread arguments about spending cuts and taxation reform, especially changes to the GST.

He predicts that the popular new Prime Minister will lead the Government to a second term – a significant victory for the Coalition considering that it was receiving historically low opinion polls only a year ago. Meanwhile the Opposition and minor parties will likely use the election to revisit their leadership and electoral prospects, respectively.

This year, in addition to the economic and political outlook, chapters also examine Australia's domestic and international competitiveness and policy priorities and reforms to boost productivity and stimulate investment.

Mondelēz International executives, Amanda Banfield and Leanne Cutts, present an optimistic view of 2016 and Australia's international competitiveness in general. They make an excellent case for accentuating the positive during this time of disruption and great change, reminding us that the unknown can represent huge opportunities.

Magellan Financial Group Head of Macro Research, Sam Churchill offers a comprehensive evaluation of current economic trends and their sectoral implications. He stresses the importance of productivity improvements and details the case for policy priorities including taxation system reform, a productivity agenda with a technology strategy at its heart, as well as infrastructure and education investment, and workforce participation measures.

Business Council of Australia Chief Economist, Lisa Gropp examines Australia's economic competitiveness. She also urges productivity improvements for driving growth, adding that capital deepening and innovation will contribute. But innovation can come with a sting in its tail as we've seen in recent years with the unprecedented pace of technological change disrupting business models, corporate structures and global supply chains and exposing more sectors to direct international competition.

I would like to thank the contributing authors for helping CEDA produce this important analysis and critical thinking on the year ahead.

To coincide with the release of this publication, CEDA will again be holding a series of EPO events across Australia during February and March to provide further business intelligence on the issues addressed in this publication. I look forward to seeing many CEDA members at these events.

Professor the Hon. Stephen Martin
Chief Executive, CEDA

economic OVERVIEW

Michael Blythe is the Chief Economist and Managing Director of Economics at the Commonwealth Bank of Australia (CBA). His role encompasses monitoring, analysing and forecasting trends in the Australian economy and financial markets.

Michael also prepares a wide range of research material on matters of current interest and is a regular conference presenter and media commentator on major economic developments and themes. He and his team have consistently ranked in the top three for macroeconomic analysis advice in various industry polls.

Michael spent 13 years in various roles with the Reserve Bank of Australia (RBA), including a stint at the International Monetary Fund in 1988. From 1991 to 1995, he was the RBA's Senior Economist, providing economic analysis and policy advice. He joined the Commonwealth Bank of Australia in late 1995.

Rear view

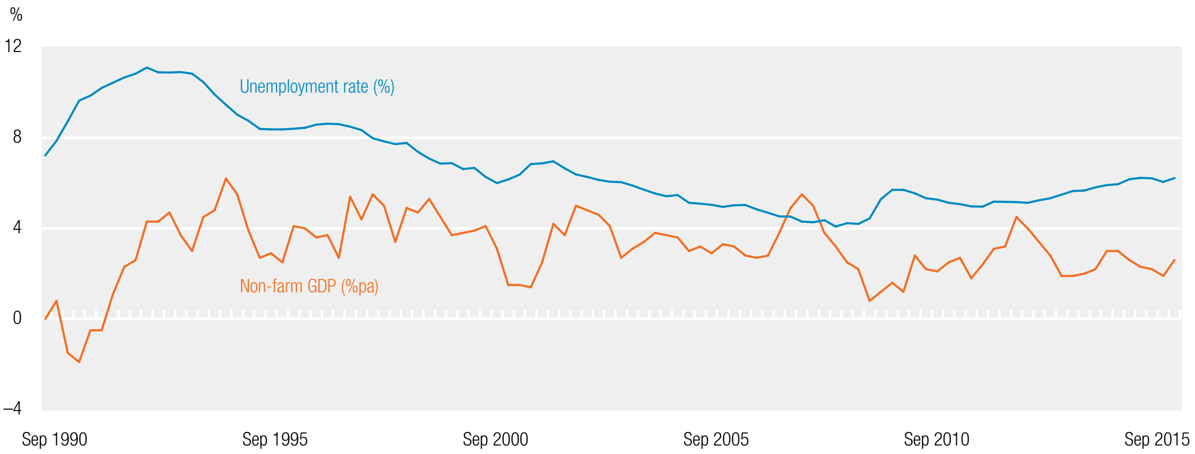
The pessimism about Australia's economic trajectory continued in 2015. As did the recession-risk talk that first surfaced in 2013.

But our economic resilience was once again on display. When the Australian Bureau of Statistics (ABS) finally rules a line under 2015, we should see an economy running at around 2.5 per cent per annum (pa) and an unemployment rate at year's end below six per cent. These are respectable outcomes for an economy facing an array of global and domestic headwinds. Australia clocked up 24 years of continuous economic growth in 2015. (See Figures 1 and 2)

Nevertheless, economic growth rates were lower than expected at the start of the year. And the *income* side of the growth equation was exceptionally weak, courtesy of falling commodity prices. The fallout was evident in a larger-than-planned budget deficit and a cash rate lower than signalled by the Reserve Bank of Australia (RBA) at the start of the year.

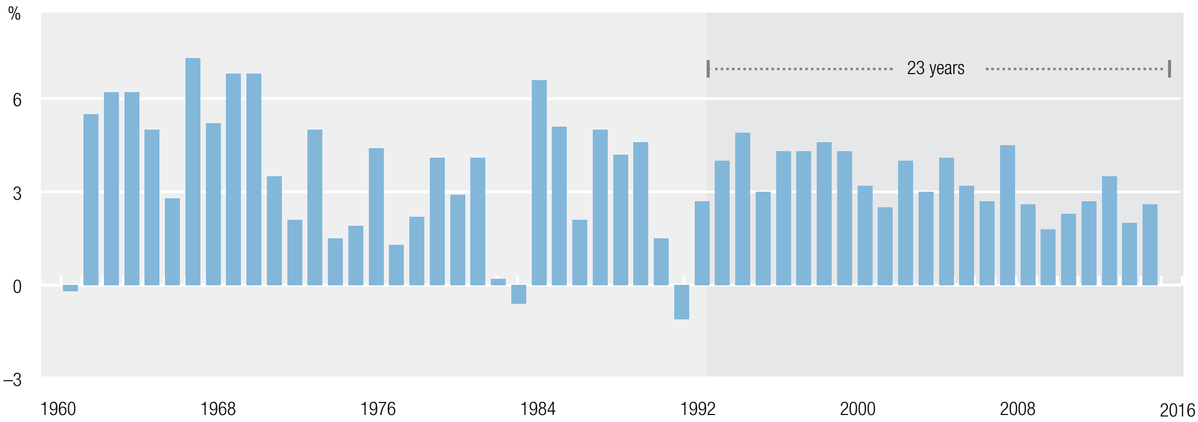
Many of the necessary policy adjustments to keep growth going were in place by year's end. The Australian dollar (AUD) ended 2015 at levels that are helping rather than hindering the economy. Policy interest rates were cut to a record low of two per cent. And the pace of fiscal consolidation was slowed.

Figure 1
Australia – key indicators



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Figure 2
Australia – economic growth



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

The baseline for 2016

We expect the economy to grow by 2.75 per cent in 2016. Such an outcome would be in line with our best guess on the new potential growth rate. As a result, we expect unemployment to grind lower during the year. Nevertheless, wage growth should remain modest and inflation outcomes restrained.

From a market perspective our calls have the RBA on hold, longer-term interest rates relatively stable and the AUD lower. (See Table 1)

Table 1
Australia: CBA key forecasts

	2014 (actual)	2015 (forecast)	2016 (forecast)
Real GDP (%ch)	2.6	2.3	2.8
Unemployment rate (%)	6.1	6.1	5.7
Underlying CPI (%ch)	2.5	2.3	2.3
Wage Price Index (%ch)	2.5	2.3	2.4
Current account deficit ($bn)	48	68	58

Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Risks: more global than domestic

The risks in the Australian economic outlook are many and varied. As usual, these risks are biased to the downside. Somewhat unusually, we can see more global threats than domestic issues in the mix.

The Fed – how far will they go?

The debate in 2015 was all about when, or if, the United States (US) Federal Reserve Bank (the Fed) would lift US interest rates. The debate in 2016 will be all about how far they will rise and how fast.

In December 2015, the Fed finally lifted the funds rate by 25 basis points (bpts) into a ¼-½ per cent range. Further rises are pencilled in for 2016. Policy makers stress that these rises will be careful and gradual. But there is no real agreement on what this approach means.

The typical US tightening cycle involves 300bpts of rate rises over 15 months. The Fed is currently signalling only 125bpts of rate rises over the next 15 months. And it takes more than three years to get to the terminal rate. This is a careful and cautious approach on any metric. Yet US financial markets believe this profile is too aggressive.

In the end, the US rates path will depend on progress towards the Fed's inflation and employment objectives. Unemployment is already at the Fed's full employment estimate. But inflation remains below the Fed's two per cent pa target. So inflation indicators are the ones to watch when assessing interest rate risks. (See Figure 3)

The Fed, the ECB and the BoJ

The Fed may be raising rates. But other central banks are still in easing mode. The European Central Bank (ECB) and the Bank of Japan (BoJ) are ramping up quantitative easing (QE) programs and buying more bonds. These two central banks will probably buy more than the likely new bond issuance in 2016.

The resultant downward pressure on bond yields in Japan and Europe is creating value for investors in US Government Bonds (US Treasuries). This shift will help limit the upside to US bond yields during the Fed rate rise cycle and limit the potential damage to US economic growth.

The Fed and the US dollar

The bigger US growth risk may come through exchange rates. The QE ramp up in Europe and Japan should weigh on the euro (EUR) and the Japanese yen (JPY) as interest differentials widen in favour of the US dollar (USD).

From an Australian perspective, the flip side of a stronger USD should be a weaker AUD. Lower commodity prices and China growth concerns are pushing in the same direction. (See Figure 4)

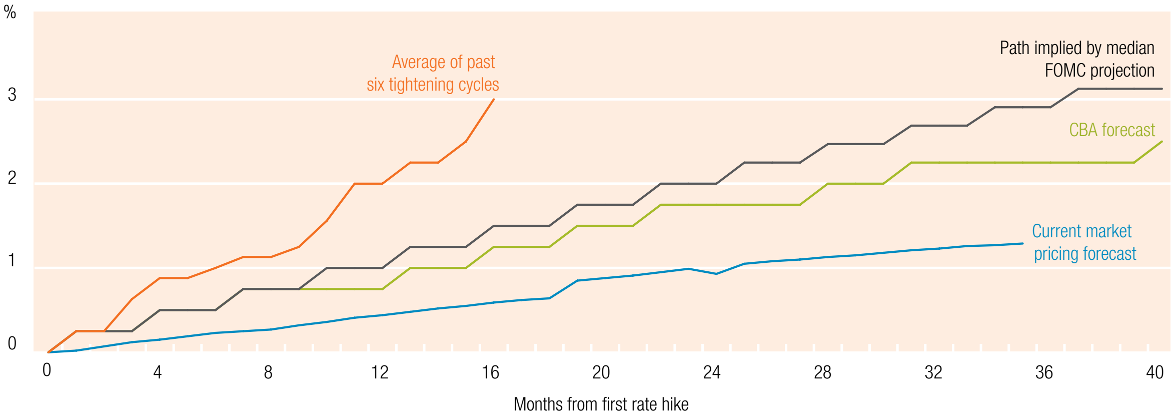
The Fed and emerging market economies

Emerging market economies are also at risk in a rising rates environment. But policy makers in those economies have taken the opportunity to strengthen their balance sheets in recent years. They are better placed to deal with Fed activity in 2016.

The sector most exposed is emerging market corporates. Many of these corporates took advantage of very low interest rates and ample liquidity to gear up. They are exposed to higher US interest rates, a stronger USD and weak economic growth. (See Figure 5)

Figure 3

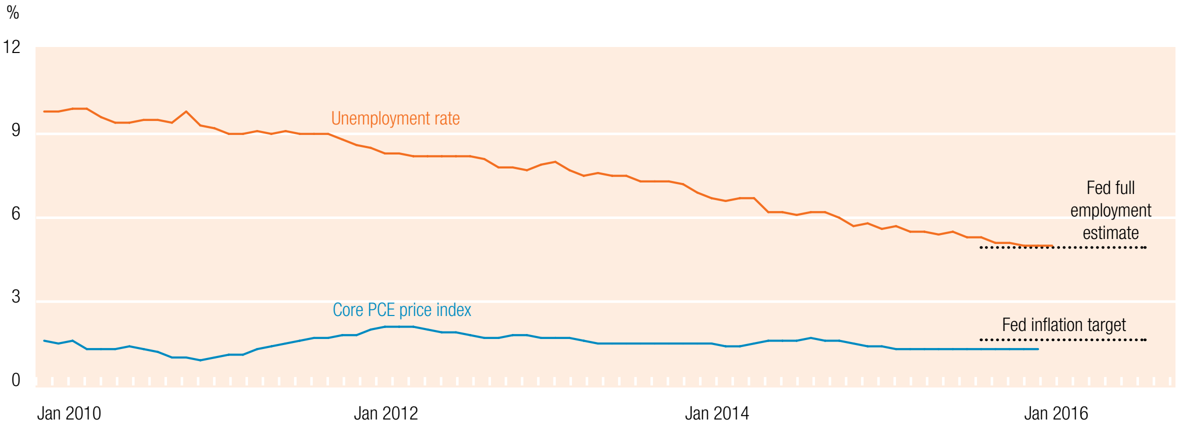
The Fed rate hike cycles (cumulative change in the Fed funds rate)



Sources: International Monetary Fund; US Federal Reserve; Commonwealth Bank of Australia

Figure 4

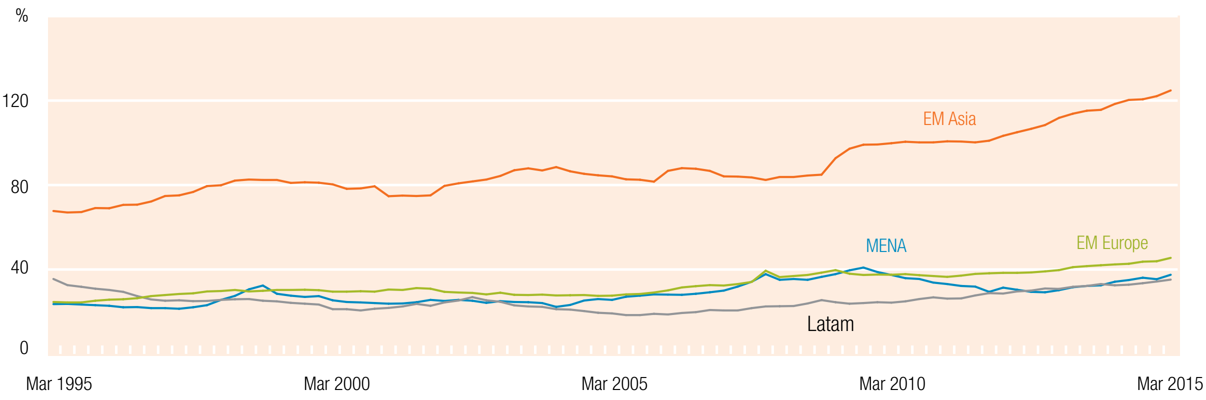
US policy indicators



Sources: US Federal Reserve; Commonwealth Bank of Australia

Figure 5

Emerging markets' (EM) corporate debt (non-financial, % of GDP)



Sources: International Monetary Fund; Bloomberg
Note: MENA – Middle East and North Africa; Latam – Latin America

> "The US, Europe and China are the main beneficiaries of low oil prices."

The Fed and low oil prices

A stronger USD is one factor contributing to the downward pressure on oil prices. Higher US interest rates are a factor exacerbating the risks from lower oil prices.

Oil prices are below fiscal break-evens for emerging economy oil producers. Fiscal pressures, lower currencies and higher interest rates in those countries can add to instability and shift global capital flows.

Nor are advanced economies immune. Earlier high prices encouraged the ramping up of debt-financed activity in unconventional energy sources such as shale oil. These corporates are now under pressure from low oil prices and higher interest rates.

What has been strangely absent from the debate about low oil prices is the potential boost to global growth. The US, Europe and China are the main beneficiaries of low oil prices.

The Fed and financial market extremes

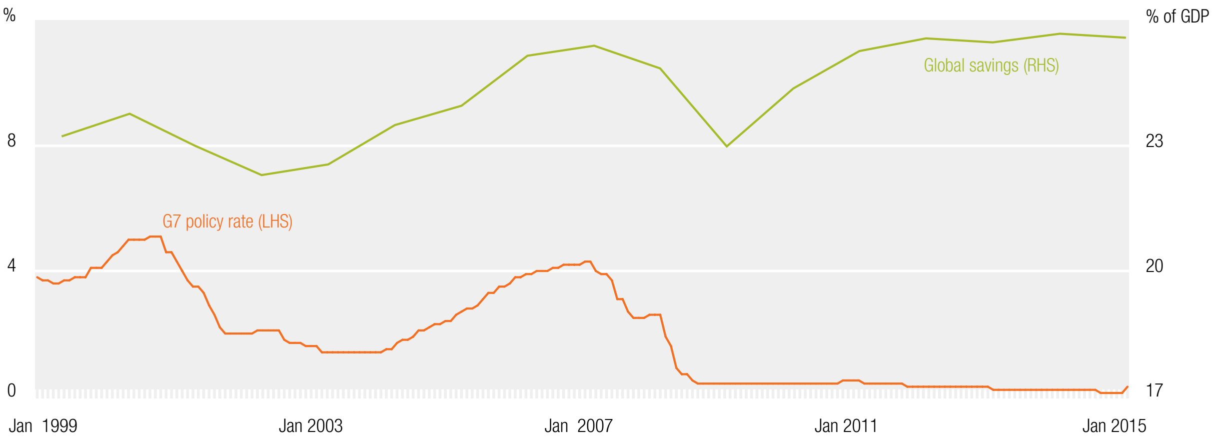
Global markets have experienced an extended period of low interest rates and high liquidity. Policy interest rates near zero and global savings running at 25 per cent of global GDP are extreme outcomes.

These settings have generated other extremes in some very high asset prices and some very low rates of return. (See Figure 6)

High asset prices can face a correction with the impact accentuated if the earlier rise in prices was fuelled by leverage. Low rates of return create problems for those managing long-term liabilities and retirees seeking income.

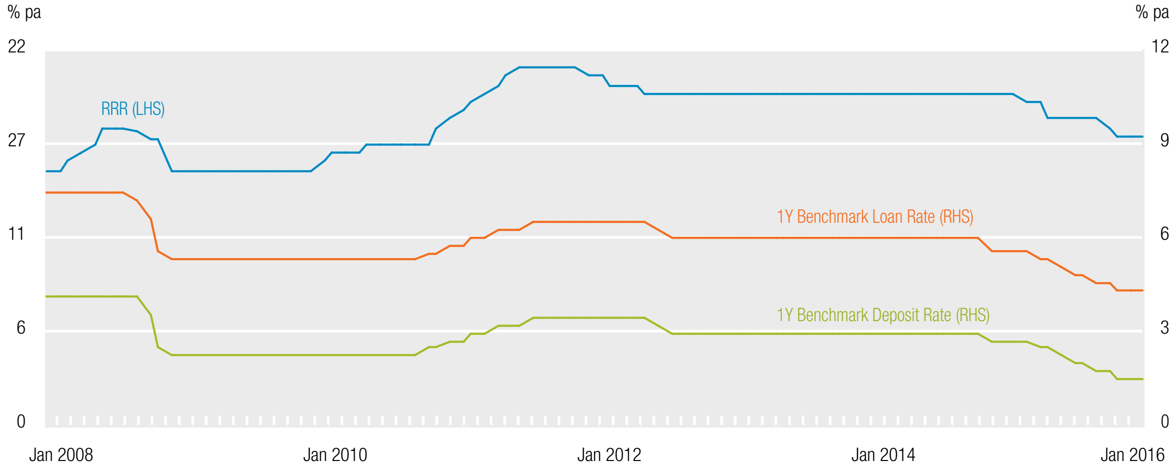
Market extremes have been in place for seven years. Many market participants would not have experienced a tightening cycle – the last time the Fed raised rates the iPhone did not exist.

Figure 6
Policy indicators



Sources: International Monetary Fund; Commonwealth Bank of Australia

Figure 7
Chinese monetary policy (percentage per annum)



Source: People's Bank of China

China: the structural and the cyclical

The global economy is increasingly dependent on China to drive economic growth. So the China slowdown is central to global risks in 2016.

The slowdown in Chinese growth reflects:

- A cyclical component driven by earlier policy measures, the global growth slowdown and delayed policy stimulus.
- A structural component resulting from overinvestment generating excess capacity, slower productivity growth and unfavourable demographics. (See Figure 7)

The *cyclical* story will turn as policy stimulus is applied. But the *structural* slowdown will continue.

There is a fair degree of scepticism about the ability of the Chinese economy to dig its way out of current problems.

Growth scepticism is understandable. The Chinese economy is almost certainly weaker than presented by the GDP Figures. Policy scepticism is also understandable. The experience with the 2009 stimulus package has left Chinese policy makers cautious. And the anti-corruption campaign appears to have added to that caution. The perceived mishandling of the stock market rout and depreciations of the Chinese renminbi (RMB) have dented the reputation of the all-powerful Chinese policy maker.

Nevertheless, a sizeable shift in policy stance occurred in 2015 – with more to come. The annual *Central Economic Work Conference* in December concluded that "the proactive fiscal policy needs to be more forceful and the prudent monetary policy needs to be more flexible". So we expect further interest rate cuts and fiscal stimulus in 2016. RMB moves may be adding to market volatility but any weakening of the Chinese currency does represent an easing of monetary conditions. There could be more action on this front in 2016.

"The Chinese economy is almost certainly weaker than presented by the GDP figures."

"China's role as a global growth driver is migrating over to global financial markets as well."

Some emerging global themes

There are some new risks to keep in mind. The shape of these risks became clearer in 2015 and could be more prominent in 2016. (See Table 2)

Table 2
CBA global growth forecasts

	2014 %ch	2015 %ch	2016 %ch
World	3.0	2.8	3.1
United States	2.4	2.6	2.6
Japan	–0.1	0.7	0.9
Eurozone	0.9	1.4	1.4
United Kingdom	2.6	2.5	2.4
Canada	2.5	1.0	2.0
China	7.3	7.0	6.5
India	7.4	7.3	7.5

Sources: International Monetary Fund; Commonwealth Bank of Australia

1. A new Chinese investor?

China runs a current account surplus. That surplus needs to be recycled into global financial markets.

Until now, that recycling was the job of the Chinese central bank via its foreign exchange (FX) reserves. Like all central banks, the preference was to place those reserves in safe assets like US Treasuries.

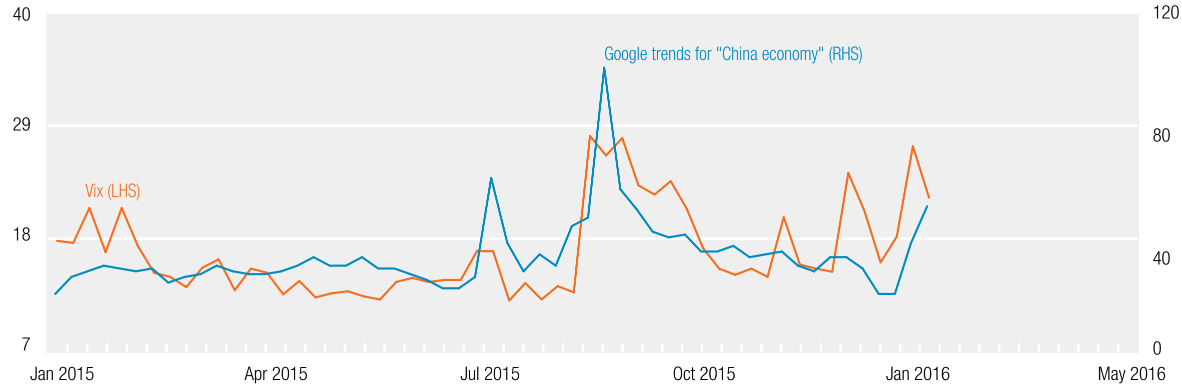
But more of Chinese trade is settled in RMB. The RMB will now take its place in the International Monetary Fund's (IMF's) special drawing rights (SDR). Capital account liberalisation is inching along. The task of recycling the surplus will migrate to Chinese private investors. These investors will prefer a wider range of geographies and assets than just US Treasuries.

2. China: driving market volatility as well as growth?

China's role as a global growth driver is migrating over to global financial markets as well. The fallout from the Chinese share market rout and RMB moves during the second half of 2015 and early 2016 are recent examples. We should now watch Chinese financial markets very closely when assessing global financial market risks. (See Figure 8)

Figure 8

China worries and volatility

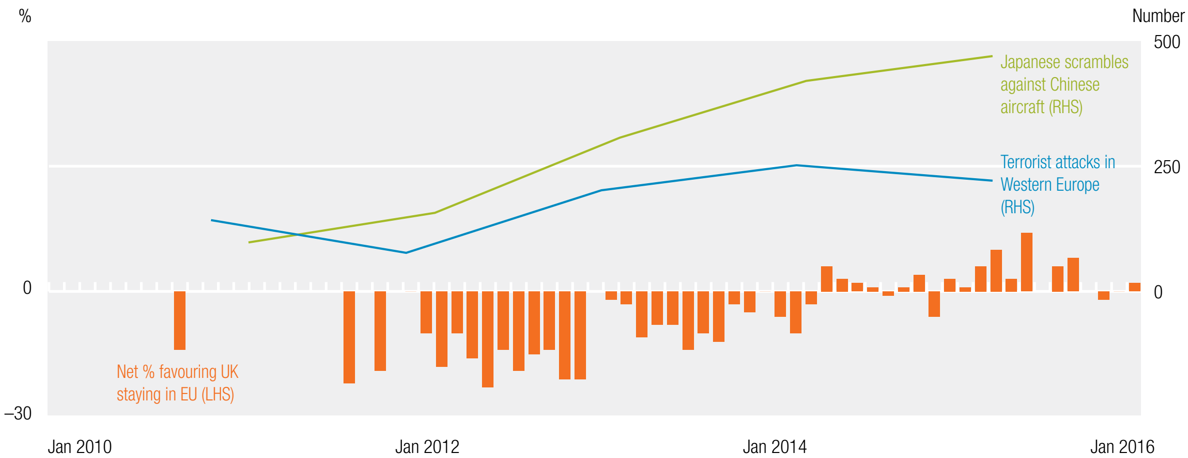


Sources: Institute of International Finance; Google Trends

Note: Vix – CBOE Volatility Index

Figure 9

Geopolitical indicators



Sources: YouGov; Global Terrorism Database; Defence of Japan 2015

3. The completion of globalisation?

Economists have long promoted the benefits of global trade in driving economic growth. But world trade peaked as a share of gross domestic product (GDP) in 2008 and growth has been lacklustre since then.

Part of the slowdown reflects the completion of global value chains. These chains were particularly helpful in driving growth in emerging economies. But countries that relied on this participation as a growth strategy are now exposed.

Economies have become increasingly dependent on domestic markets. And the risk is that policy focuses on protecting that source of growth. The desire for lower exchange rates is one reflection of the domestic focus. As is the gradual creep up in the use of restrictive trade measures.

Trade, currencies and protectionism are potential flashpoints.

4. Geopolitics

From a geopolitical perspective, tensions continue in East Asia as Chinese policy makers become more assertive and the debacle in the Middle East rolls on. But it is not just the emerging world that is a source of tension. (See Figure 9)

The possibility of a Greek exit from the Eurozone was a frequent source of market concern in 2015. And a referendum on the UK's exit from the European Union (Brexit anyone?) will be debated in 2016. It is, of course, also a US presidential election year.

Australia: unfinished business

Australia faces the same global risks. But there are also some domestic challenges. These challenges reflect the income drag from falling commodity prices and the growth drag from falling mining capex.

This mix of challenges and risks saw Australian economists debate the risk of recession in 2015. The same growth concerns meant that financial markets spent most of 2015 debating how far the RBA would cut interest rates.

Is a recession likely?

Nobody is forecasting recession in 2016. A range of factors are at work that will limit recession risks. And some of the arguments for recession look weak on closer examination.

Policy settings are already very accommodative. The AUD may have taken longer to adjust than expected. But monetary conditions overall are very stimulatory and consistent with a sizeable lift in economic growth momentum.

Considerable policy firepower remains. Interest rates can be cut further. The budget is in deficit but debt is low and fiscal policy can be ramped up if needed.

But there are risks that should not be ignored. The *real* economy is a fair way from recession, but a variety of *income* measures show a much weaker picture. Incomes in 2015 grew at the slowest pace since the early 1960s.

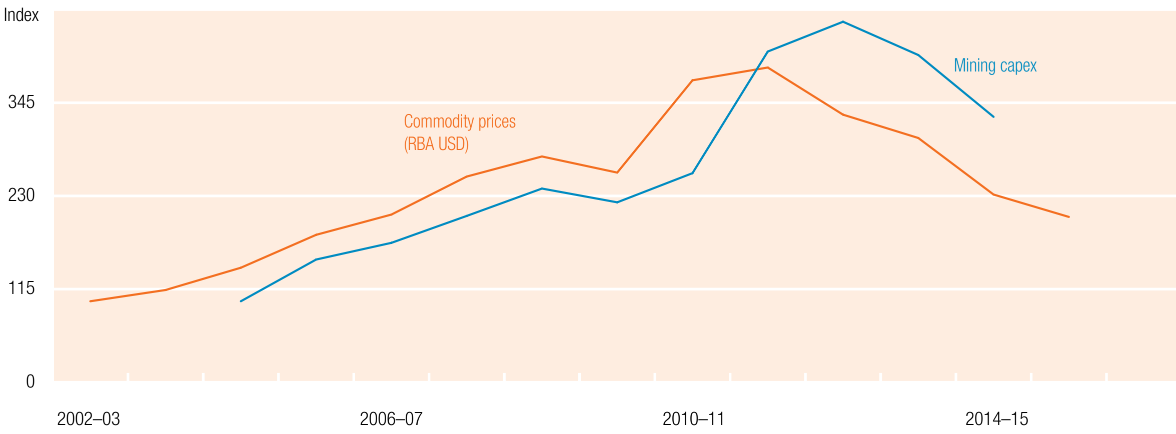
The income threat

Income weakness is the one real source of recession risk:

- Income weakness brings a focus on cost containment. Households defer spending and focus on balance sheet repair. Businesses defer capital spending and labour hiring. And governments facing growing budget deficits want to tighten the fiscal screws.
- Income weakness encourages the pursuit of yield and capital gain. Asset price inflation creates "bubble" risks. The composition of balance sheets becomes riskier. And exposure to economic shocks or policy changes increases.

"Nobody is forecasting recession in 2016. A range of factors are at work that will limit recession risks."

Figure 10
Australia – the end of the booms



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Falling commodity prices weigh on incomes – essentially we get fewer dollars (income) for every tonne of iron ore (production). So the direction of commodity prices in 2016 is a key to how income risks play out.

Our views on Chinese economic prospects suggest demand weakness will no longer exert significant downward pressure on commodity prices. But nor will demand be providing much in the way of upside incentive.

The *supply* side will remain the more important driver. The global mining construction boom pushed up supply of many commodities – with more to come. Australia is a significant contributor to the lift in supply, especially for the bulk commodities, and is now starting to add to the supply of energy as well. Over the next few years Australia will become the largest producer of liquefied natural gas (LNG). At that point it will be Australia's second largest export.

Our commodity price forecasts reflect the idea that global demand and supply trends should lessen the downward pressure on commodity prices. At best, this means that the drag on Australian incomes should lessen during 2016.

Income opportunities

There are other income opportunities that should help in 2016.

A central theme in our forecasts for a number of years now has been the idea that a rising Asian middle-income population is offering new opportunities for the Australian non-resources economy.

The historical experience is that middle income consumers want: larger and better quality housing; more and better quality food; more consumer durables; more education services; and more holidays.

The opportunities are there for those who want to take them. Education and tourism, for example, already rank in Australia's top five exports.

Asian demographics also involve an ageing population. Again, experience tells us that older consumers have certain needs – notably health and financial services. Australia's experience in these areas means we are, again, well placed to take advantage.

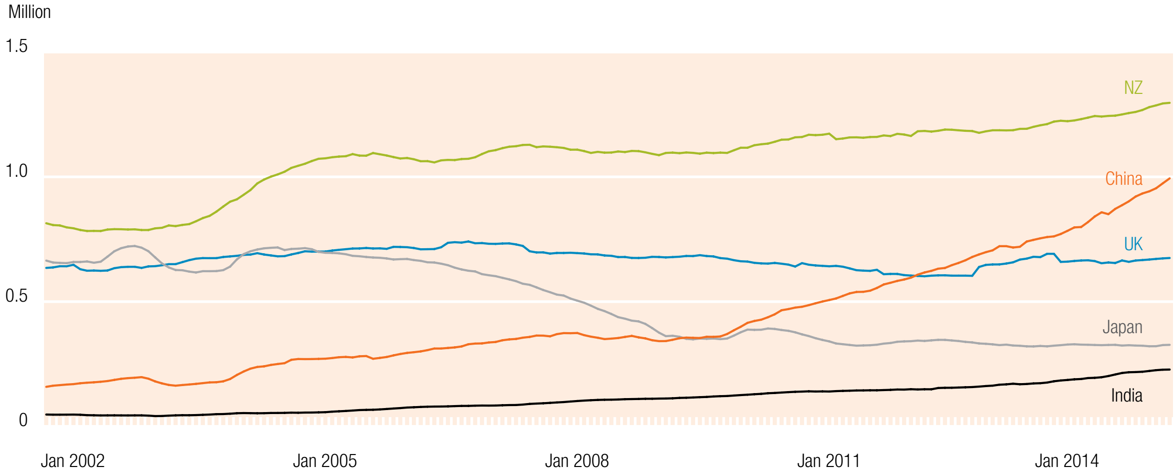
Energy consumption also increases as incomes rise. So, Asian income growth should help drive demand for Australian LNG over time.

The mining capex cliff

The biggest mining construction boom in 150 years peaked in 2012 and has been in decline ever since. On our figuring we are already about 70 per cent of the way down the cliff. And nearly 60 per cent of the expected job losses are in place. (See Figure 10)

We have never been concerned about the GDP growth implications of falling mining capex. The expansion in the mining capital stock is driving a boom in resource exports. And there is plenty more to come. Rising LNG, iron ore and coal exports will contribute up to one per cent pa to Australian GDP growth over the next few years.

Figure 11
Short-term overseas arrivals



Source: Australian Bureau of Statistics

We have successfully "exported" other parts of the problem as well, for example:

- This construction boom was dominated by LNG. About half of LNG capex went on imports. So half the pain is being exported to those countries that provide us with the capital goods.
- On the jobs front, we are exporting part of the problem as those specialised workers on 457 visas move on to the next big project and New Zealanders return home.
- Fly-in fly-out workers are losing their jobs in remote areas like the Pilbara. But they are becoming unemployed in Sydney and Melbourne where they live. We are exporting job losses from regional to urban areas. And that is where the new job creation is occurring. (See Figure 11)

Transition issues

The capex cliff is being resolved by a combination of rising exports and lower imports. But negotiating the jobs cliff requires other sectors to pick up and generate new jobs. (See Figure 12)

The plan was to stimulate other forms of construction – residential, non-mining and government infrastructure. The plan has worked in aggregate, but the transition has been uneven.

A residential construction boom is underway. Building houses is an effective generator of jobs and activity, but other parts of the transition have failed to fire. Businesses have been reluctant to invest. Governments have cut capex. The 30 per cent *decline* in government capex since the mining capex peak is particularly disappointing.

The ongoing success of the jobs transition will depend on how much can still be squeezed out of the residential construction boom, and whether business and government regain their appetites to invest. (See Figure 13)

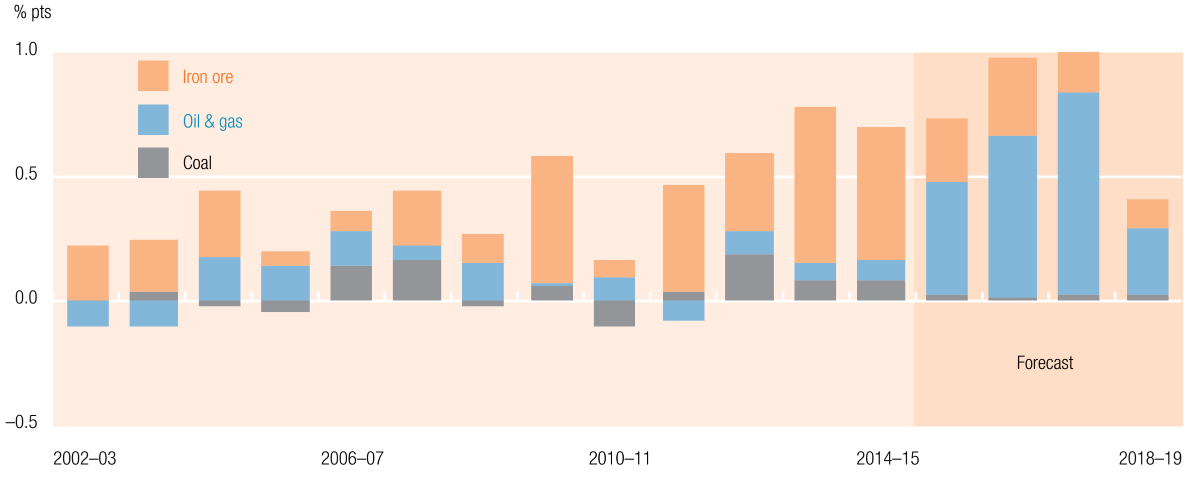
1. Is the residential construction boom over?

Leading indicators of residential construction, such as building approvals, are running at record highs. But some of the drivers that contributed to those highs are receding. Population growth, for example, has slowed.

An extended top in new construction seems likely in 2016. Any significant pull back is unlikely before 2017. The demographics will, however, mean significant variations between the states. Population growth in the mining states is slowing quickly and will weigh on construction trends.

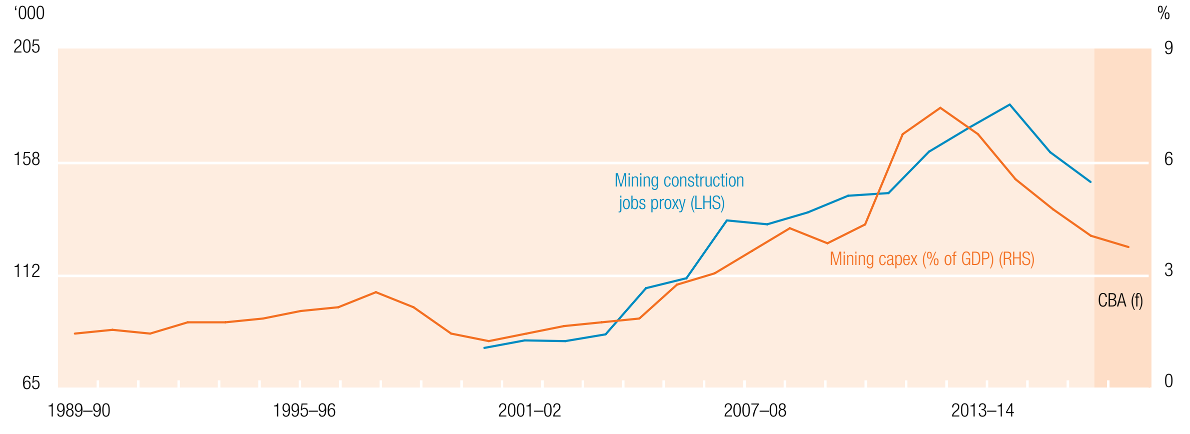
There is scope for renovations activity to prolong the building boom. Renovations of existing dwellings normally accounts for 40 per cent of residential construction. But the renovations share is currently unusually low. Spending on renovations normally lifts as house prices rise. And activity normally lifts when moving costs outpace building costs (as they are at the moment). (See Figure 14)

Figure 12
Bulk commodities, contribution to GDP growth



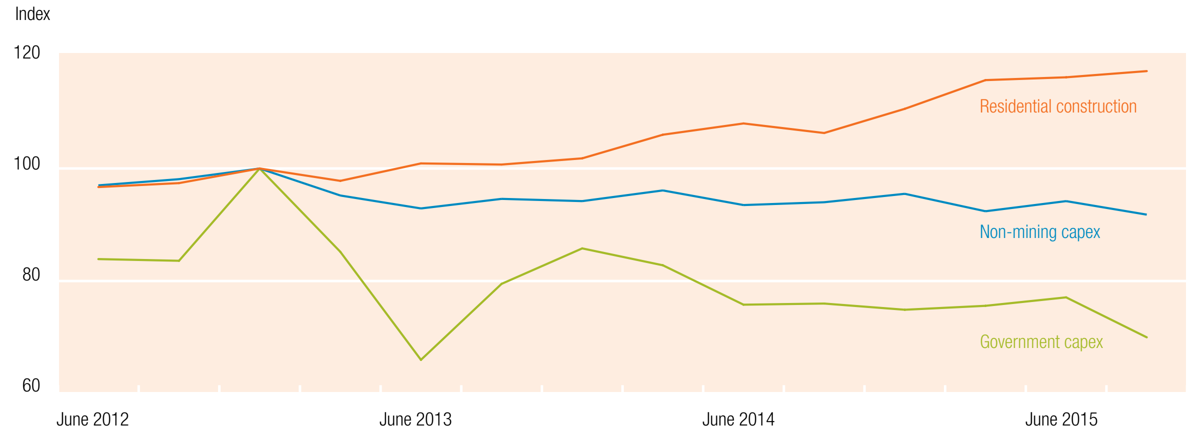
Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Figure 13
Mining capex and jobs



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Figure 14
Transition drivers



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

2. Will non-mining capex lift?

Interest rates are low and credit is readily available. But businesses can cite a shopping list of reasons behind the reluctance to invest. These include: a lack of demand, excess capacity, political concerns, a high AUD, lack of confidence and less appetite for risk. But, item-by-item, this shopping list is being ticked off. The pick-up in business credit outstanding towards the end of 2015 is an encouraging sign.

Unfortunately, there are some more intractable parts of the capex equation that limit the upside. Businesses, for example, maintain high hurdle rates of return (typically 10–16 per cent) for evaluating projects. Such rates look unrealistically high in a low inflation, low yield, low return environment. They need to come down.

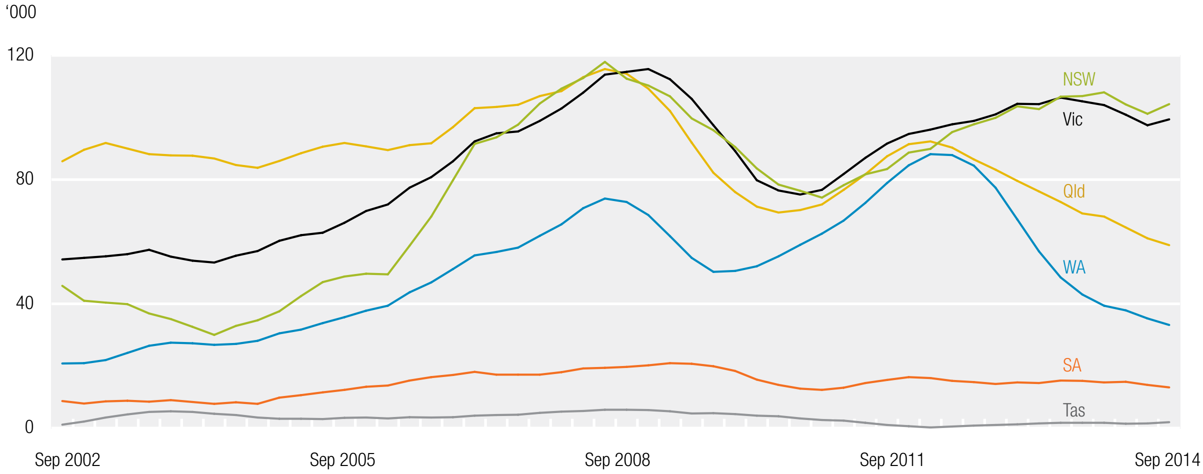
3. Will infrastructure spending turn?

The states account for most public infrastructure spending. This spending diverges widely across the country. New South Wales (NSW) and the territories provide a noticeably stronger picture than the other states. (See Figure 15, Figure 16)

There are long lags in getting big infrastructure projects moving. But the lesson from NSW is that spending can be ramped up. And the voters like it. We expect public infrastructure spending to slowly move in a more supportive direction.

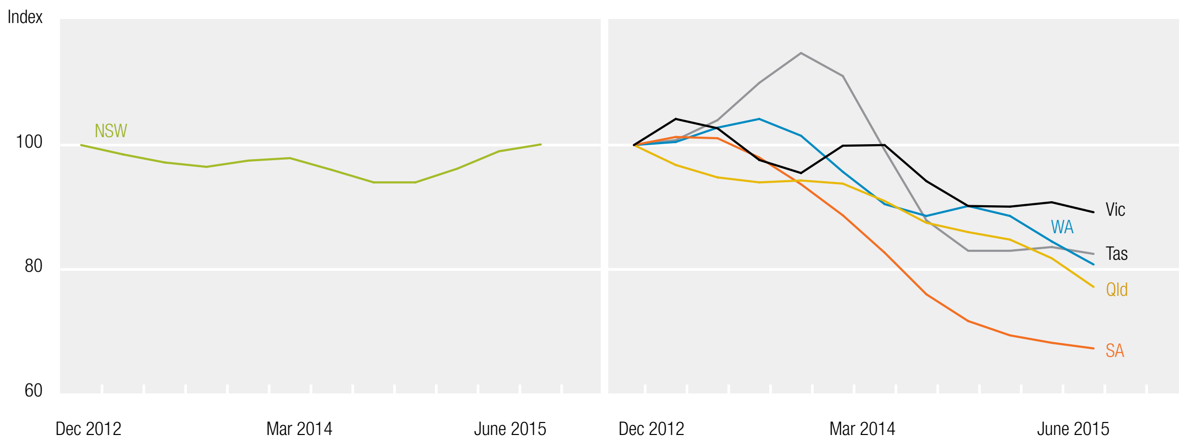
There is also some potential *upside* growth surprises from areas outside the narrow transition focus. These surprises partly reflect developments that at face value look like negatives.

Figure 15
State population growth



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Figure 16
State Government fixed capital expenditure (Index Dec 2012 = 100)



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

The benefits in adversity

The flip side of weak incomes is restrained labour costs. This restraint is providing some support to labour demand. And it is turning the large nominal depreciation in the AUD into a real depreciation as well. Australia's competitiveness is lifting as a result.

At the corporate level, weak profits encouraged a focus on cost control. This cost focus could impact in a negative way on capex and labour hiring plans. But one positive outcome was a lift in productivity that allowed corporates to adjust to the extended period of a strong AUD.

Some surprises

The number of exporters doesn't normally vary much from year to year. But there was a significant spike up in the number of companies exporting in 2013–14. The spike is all the more interesting because it occurred at a time when the AUD was still relatively high (averaging USD 0.92). The larger part of the currency drop has happened since then. (See Figure 17)

Non-resource exports may continue to surprise on the upside in 2016.

Another surprise of 2015 was the consumer. Consumer spending rose by about 2.6 per cent in 2015, in line with the post-global financial crisis (GFC) average.

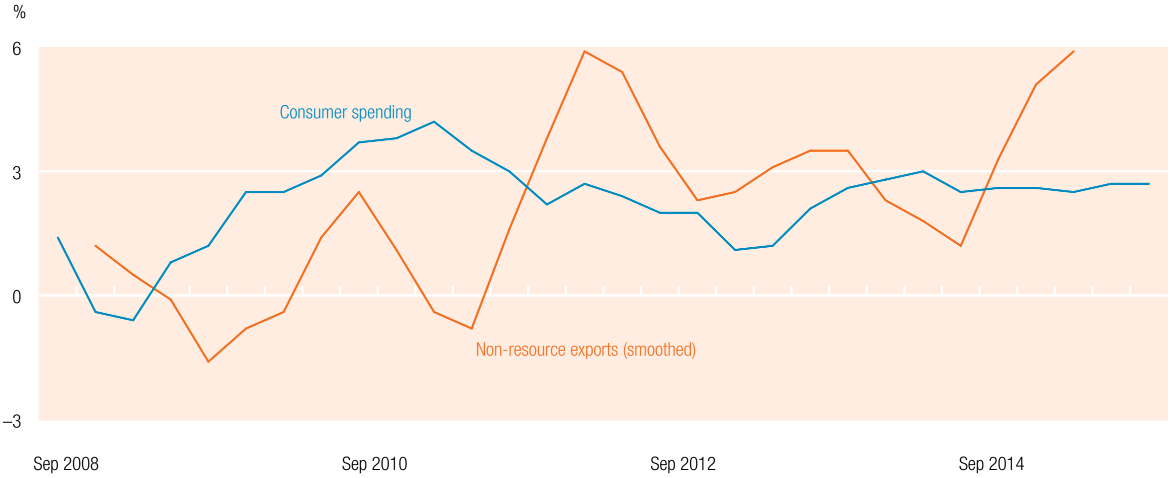
This average outcome is impressive given that weak income growth and changed household attitudes to spending/saving/borrowing were expected to weigh on consumer activity.

An array of forces is improving the consumer backdrop:

- There is a flow on from other parts of the economy – new housing construction is boosting housing-related spending;
- There is a diversion of spending from offshore back onshore – courtesy of the lower AUD;
- There is an inflow of spending from the tourism boom – especially from China given that Chinese tourists spend more than any other at the retail level;
- There is a wealth effect from higher house prices – studies show that each dollar change in housing wealth moves consumer spending by about three cents;
- There is a disposable income boost from lower petrol prices – everyone benefits unlike rate cuts that help only mortgagees;
- There is a fiscal boost – some May 2015 budget measures add to household spending power.

The direction of the labour market will ultimately determine consumer trends. The high levels of job security concerns in recent years have weighed on wages growth and consumer spending appetite. Improved labour market outcomes in the second half of 2015 mean job security fears have receded a little. But further progress is required.

Figure 17
Some surprises



Sources: Australian Bureau of Statistics; Commonwealth Bank of Australia

Inflation: up or down?

Inflation trends in 2015 reflected three forces:

- A *volatile* component driven by the big fall in petrol prices;
- A *cyclical* component that ran below the RBA's two-to-three per cent target range;
- A *structural* (sticky) component that remained above target but nevertheless slowed during 2015.

All three components exerted a significant degree of inflation restraint in 2015. But a repeat of the same benefits is unlikely in 2016.

We expect inflation rates to move higher during 2016. But only a modest pick-up is likely. Our forecasts have inflation rates in the middle of the RBA's two-to-three per cent target band by year's end.

Some new challenges

Some risks, such as a housing bubble look less threatening. But new risks are always emerging.

"Fewer people reduces the demand for housing, consumer spending and the need to lift the capital stock."

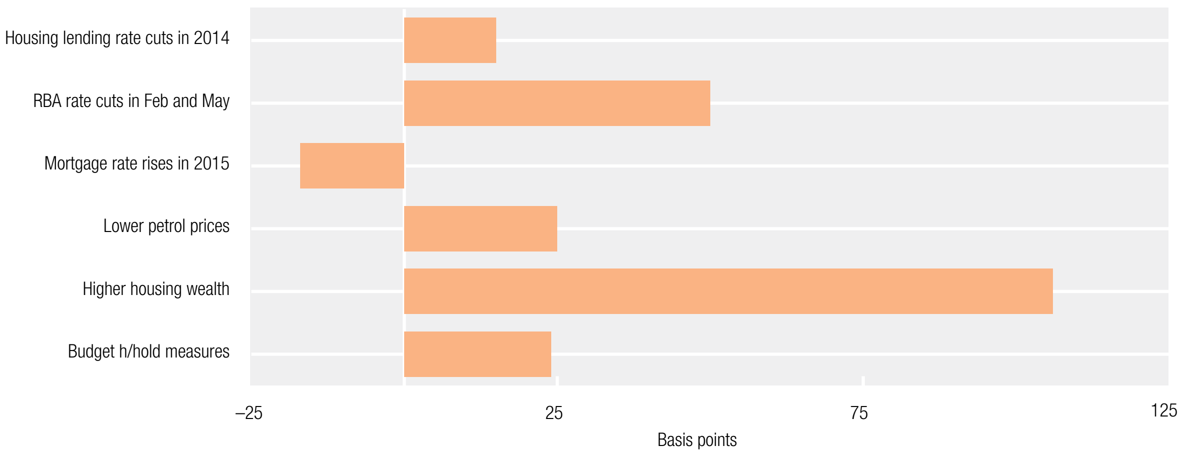
1. A slower potential growth rate?

A standard assumption for many years was that Australia's potential growth rate was 3.25 per cent pa. The reality is that the economy has not grown near that pace in a sustained fashion since 2006–07. This extended shortfall is convincing evidence that potential growth is now lower.

We now put potential growth at around 2.75 per cent pa. A lower trend growth rate means slower growth in incomes and the tax base. And it also means that there is less spare capacity in the economy than previously assumed. The need for the RBA to provide additional stimulus is reduced. (See Figure 18)

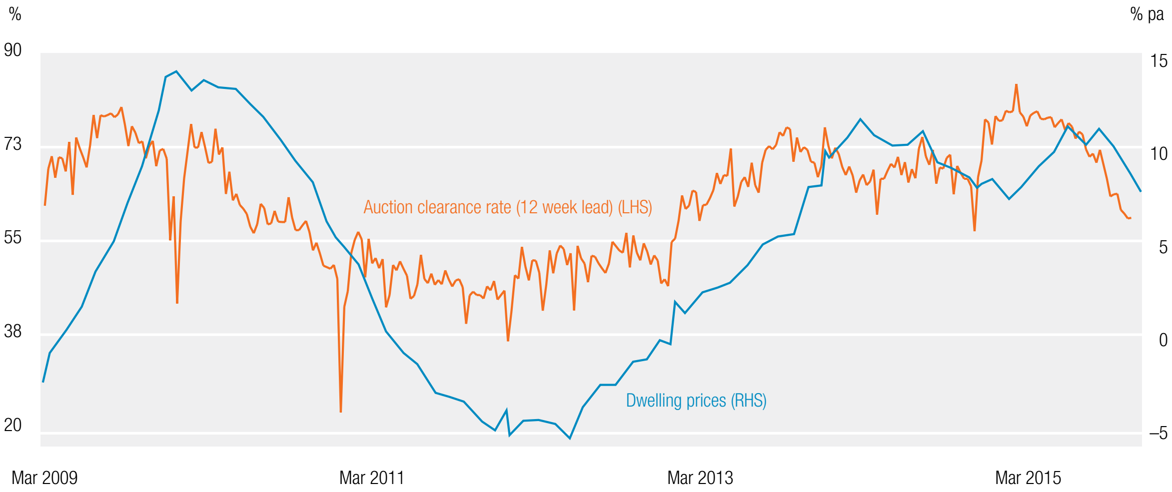
The step down in potential growth reflects weak productivity growth, the ageing of the population, reduced labour force participation and slower population growth. Fewer people reduces the demand for housing, consumer spending and the need to lift the capital stock.

Figure 18
Household stimulus



Sources: Reserve Bank of Australia; Australian Bureau of Statistics; Commonwealth Bank of Australia

Figure 19
Auction clearances and prices



Source: CoreLogic RP Data

2. House price boom to bust?

Rapid growth in house prices for much of 2015 raised fears that a bubble was forming. By year's end credit growth was slowing, lending standards were tighter, mortgage rates were higher and rapid price growth expectations were gone. House prices have fallen in some capital cities.

The debate may now switch to the potential fallout from lower prices. However, as with the earlier "bubble" arguments, more than just falling dwelling prices is needed to signal a significant economic threat. The risks from falling prices would increase if accompanied by rising unemployment and higher interest rates.

We expect unemployment to slowly grind lower. And mortgage rates should remain low. (See Figure 19 and Table 3)

3. Rising financial risk?

Australian households are caught up in the global pursuit of yield and asset price inflation. So the composition of household financial assets has shifted in a slightly riskier direction. And leverage ratios are rising again.

But some unexpected outcomes have strengthened household balance sheets. Lower mortgage rates have accelerated the repayment of principal. As yields on financial assets such as term deposits have fallen, the attractiveness of devices such as mortgage offset accounts has increased. These accounts stand at around 16 per cent of outstanding loan balances (or more than two years of scheduled repayments).

The other asset price in the RBA's sights is commercial property. The search for yield drove significant demand for commercial property, especially from foreign investors. This demand boosted prices despite weak leasing conditions and subdued tenant demand. So the risk of prices adjusting lower has increased. A reversal of foreign investor demand would accentuate the risks.

Table 3
CBA interest rate forecasts

	Mar 2016	Jun 2016	Sep 2016	Dec 2016
Cash rate	2	2	2	2
90-day bills	2.2	2.2	2.2	2.2
3-yr bonds	1.9	1.7	1.7	1.7
10-yr bonds	2.7	2.6	2.6	2.7
Au 3–10 curve	80	90	90	95
Au-US 10-yr spend	40	20	15	15
Au 2-yr swap	2.1	2.2	2.2	2.2
Au 10-yr swap	3.3	3.3	3.4	3.4
Fed funds	¾	1	1	1¼
US 10-yr bonds	2.3	2.4	2.5	2.5

Source: Commonwealth Bank of Australia

"The year ended with RBA Governor Glenn Stevens advising everyone to "chill out". More formally, we see the RBA starting 2016 with a conditional easing bias."

The RBA and financial markets in 2016

The year ended with RBA Governor, Glenn Stevens advising everyone to "chill out". More formally, we see the RBA starting 2016 with a *conditional* easing bias. Low inflation rates do leave scope to cut rates but the flow of economic data needs to make the case.

Other inputs into the policy equation include:

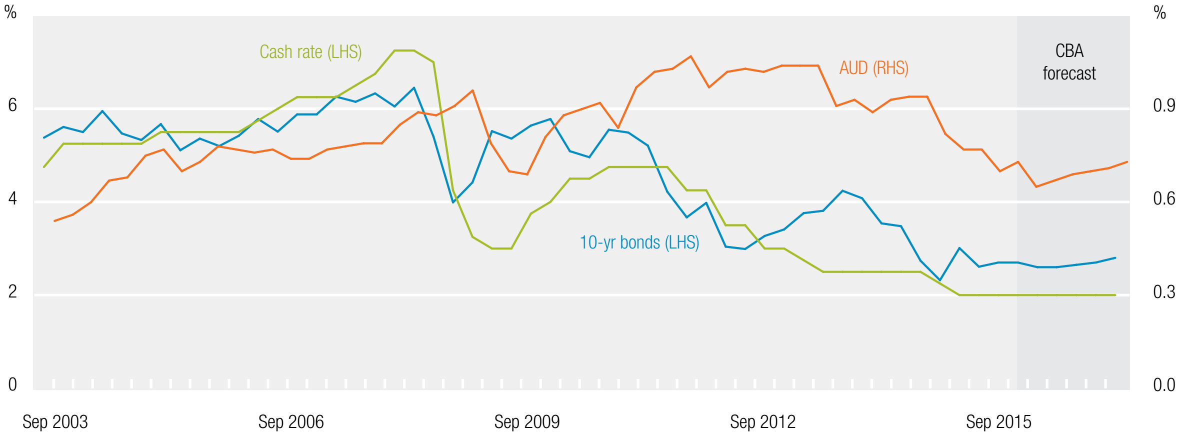
- A clear RBA preference for additional stimulus to come via the AUD and infrastructure spending. The currency is delivering. And the prospects for more infrastructure spending have improved.
- A belief that the RBA would not want to jeopardise the recent loss of momentum in house prices by cutting rates.
- A step down in potential growth rates. The output gap is smaller than thought. And there is also less need to stimulate the economy to close the gap.
- A growing concern about the imbalances from the period of extreme policy settings.
- A question of whether rate cuts work from low levels. Households now worry that rate cuts are an indicator of worsening economic prospects. And there is a risk that shareholders respond to rate cuts by demanding higher dividends that companies pay for by cutting capex. (See Figure 20 and Table 4)

Our view is that the cash rate will remain at two per cent throughout 2016.

Further out along the interest rate curve, the risks lie with higher yields, although we suspect any increase will be modest. Inflation and inflation

Figure 20

Interest rates and the Australian dollar



Sources: Reserve Bank of Australia; Commonwealth Bank of Australia

Table 4

CBA currency forecasts

	Mar 2016	Jun 2016	Sep 2016	Dec 2016
vs USD				
AUD	0.65	0.67	0.69	0.70
EUR	1.05	1.08	1.10	1.12
JPY	115	117	118	119
CNY	6.55	6.50	6.40	6.30
vs AUD				
JPY	75	78	81	83
EUR	1.62	1.61	1.59	1.60
GBP	0.43	0.44	0.44	0.44

Sources: Reserve Bank of Australia; Commonwealth Bank of Australia

expectations are low. Diverging monetary policies are creating value in US Treasuries and Australian government bonds.

The USD should move higher early in 2016 as the Fed lifts rates, the US economy outperforms and China fears persist. Other currencies should weaken as a result. We put the low for the AUD at USD 0.65, but the USD often peaks six to 12 months after the first Fed rate rise. We should be prepared for some strengthening in the AUD towards the end of 2016.

The views in this article are those of the author and should not be attributed otherwise.

political OVERVIEW

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Introduction

This year will see a federal election at the centre of political action. While Prime Minister Malcolm Turnbull may choose to go to an early election, last year ended with the new Prime Minister intent on serving a full term and using 2016 to build a policy agenda for the next election. We will find out soon enough if the temptation to take advantage of Labor's poor polling, and especially poor polling for the Opposition Leader Bill Shorten, is too much for Turnbull to resist. He has certainly been encouraged by colleagues to call an early election.

The year in politics will take one of two shapes:

1. If an early election eventuates, the political contest AFTER polling day will dominate proceedings. The contest in the Senate, the jockeying for position within the new Government, recriminations within the Opposition, and, of course, the debate over the extent to which the Government has a mandate based on what policies were taken to the election. The earlier polling day, the thinner the political mandate for the party forming government, and the more complicated it will become to deal with the Senate.
2. If the Turnbull Government goes full term and a late-year election eventuates, this year will be a more traditional election year. The budget will need to be crafted with a poll in mind. The trickling out of policies on both sides of the major party divide will dominate the agenda. The media will come to view such policy debates through the prism of popularity and saleability, which will itself have a profound impact on key debates concerning tax and federation reform.

There is a wide range of issues in the 2016 political equation, not least of which includes the internal stresses within the Liberal and Labor parties. Last year's change of prime minister has heightened tensions within the Government. The Coalition agreement is more precarious than it had been previously. Conservatives within the Liberal Party are feeling unloved, and the policy framework the Government seeks to adopt will need to walk a philosophical line between the party's strands.

On Labor's side of the Parliament, the tensions between left and right factions have resurfaced as the left looks towards the post-election period with eyes on the party leadership. Anthony Albanese remains the man most likely to bind the left around an alternative leadership option should Shorten lose the election. If the polls are to be believed, a potential change of leadership on the Labor side of the major party divide is a significant consideration in 2016, either before a late-term election or after a defeat.

The year in politics in 2016 will be defined by the economic agenda each party takes to the election, and how successful they are at selling their ideas – to voters and to the Senate crossbenchers. While national security will loom large, alongside the internal party machinations already mentioned, it's the economy, stupid, that will be the primary focus in this election year.

A quick look back at 2015

Last year was another year in politics which saw a prime minister removed from office by his colleagues before returning to face the voters. Former prime minister Tony Abbott's downfall was all his own doing, but it was still a surprise to many that the Liberal Party emulated Labor's treatment of prime ministers. Abbott had been warned in February 2015 when he faced a spill motion that saw nearly 40 per cent of his colleagues vote for an empty chair. There was no challenger at the time. By the time of the Canning by-election in September, mismanagement and poor polling saw enough Liberal MPs and Senators support a change to Turnbull.

The change of prime ministers had an immediate impact on the polls as well as on the Government's confidence. Turnbull and his new Treasurer, Scott Morrison, geared up for possible tax reform, and worked with Minister for Industry, Innovation and Science, Christopher Pyne to hand down an innovation statement designed to prepare the Australian economy for the post-mining boom era.

But 2015 ended controversially for the Government. Mal Brough's role in the Ashby saga dominated the final fortnight of Parliament for the year and, in the quiet period following Christmas, he stepped aside pending the outcome of an Australian Federal Police investigation. Minister for Cities, Jamie Briggs was also forced to stand aside from his junior ministry for poor behaviour while representing the Commonwealth in Hong Kong. It was a messy end to a difficult year for the Coalition, even if Abbott's removal gave the Government confidence that it would be re-elected in 2016.

The politics of 2016: an election year

The trouble with predictions is that the art of politics is highly unpredictable. However, this political analysis for 2016 must address the chances of an early election. At the time of writing the odds of an early election appeared to be growing. In response to the final report of the Royal Commission into Trade Union Governance and Corruption, the Government announced that it would reintroduce legislation to bring back the Australian Building and Construction Commission (ABCC). Announcing the plans, the Prime Minister gave the Parliament until the end of March to pass the required legislation. Soon thereafter, this could mean either a double dissolution or a half-Senate election, using the ABCC and union reform as a central issue for the campaign. There is even a chance that an election will have been called before the return of Parliament. A number of senior ministers believe an early election is the best strategic course of action to capitalise on the polling advantage for the Government. Another good reason for the Government to go to the polls early would be to avoid delivering a budget in May, which would be difficult to craft as an election budget under the fiscal circumstances.

"Having missed the opportunity to take a comprehensive tax package to the last election from opposition, the Abbott Government baulked at major reforms early in its term."

If Turnbull avoids the temptation of an early election, a full-year election campaign will make tax and federation reform difficult to compartmentalise from the campaign politicking. Equally, the national security debate could morph into a partisan contest over which side of politics is best at handling the challenges of terrorism, although at the end of 2015 the differences on how to handle radical Islam were internalised within the Liberal Party. Having missed the opportunity to take a comprehensive tax package to the last election from opposition, the Abbott Government baulked at major reforms early in its term. It wasn't able to legislate the relatively mild reforms it put up in its first budget because voters resented broken promises from the campaign. Turnbull will want to spell out legislative reform ideas ahead of the election to avoid the hole Abbott dug for himself on this score, but the constraints of electioneering will likely tone down what is proposed.

Will we see a GST debate?

The signs from 2015 are that the Turnbull Government intends to run a Goods and Services Tax (GST) reform debate this year, and it appears likely to take some form of a package to the next election. The polls and the political challenges of the year will partially dictate what that reform package looks like, and how far Turnbull and his Treasurer are prepared to go.

Morrison has refused to rule out major tax reform, including a recalibrating of the system around higher consumption taxes, with income tax cuts and compensation for lower income earners to follow. Turnbull has followed this line also, but with slightly less force.

Tensions between a treasurer and prime minister when it comes to tax reform are nothing new. John Howard wanted to tone down reforms to manage the politics when Peter Costello wanted to stay pure. As shadow treasurer ahead of the 1993 election, Peter Reith wasn't impressed by some of the compromises John Hewson instituted when the polls tightened. How Morrison balances the political mortality of the Government with the urgent need for improvements to the tax system will be the most important policy debate of 2016, whether the campaign is early or late.

There is a series of options as to how the Government might prosecute a GST campaign. The option of a large scale reform process would see the rate increased to 15 per cent, the tax broadened to virtually all goods and services (it currently applies to roughly 50 per cent), and equalisation

> "The signs from 2015 are that the Turnbull Government intends to run a Goods and Services Tax (GST) reform debate this year."

measures between the states would also need to be addressed. Hand-in-glove with such a radical change would be handouts as compensation for lower income earners, income tax cuts to address bracket creep, and a re-allocation of social services funding between the Commonwealth and the states. But Treasury modelling reveals that even large-scale GST changes will struggle to meet all of these spending needs, which is a problem given that one of the arguments for adjusting the GST is to simplify the system and help pay down debt.

A further problem with such goals for increasing the GST is Morrison's pledge not to increase the overall tax burden on voters. This is an odd commitment to make – especially because if a simpler tax system helps "grow the pie", to paraphrase Paul Keating, by definition the tax take will increase. But politics is about perceptions. The salesmanship of a GST change will be important in an election year as it will determine whether the Government is to be trusted. The polls will play a role in this process. In 1998 Howard wasn't polling well when he introduced the GST debate, but he had a lifetime's commitment on tax reform to fall back on, so voters believed Howard when he pursued the changes. The Coalition still only won the 1998 election with 48.9 per cent of the two-party vote. Turnbull's popularity won't last if he pursues major GST reform, but it will help him gain the benefit of the doubt as he sells changes, after which advocacy skills will become all important. If there is one consistency in modern politics it is that both major parties struggle with their advocacy skills in the wake of the skills of the Hawke, Keating and Howard governments.

The more likely option for changes to the GST is a toned down version, incorporating either:

1. A smaller increase in the rate, perhaps to 12 per cent;
2. No increase in the rate but a broadening of the GST's application; or
3. A very mild reform, for example by applying the GST to financial services and other sectors but not to fresh foods, which would be more contentious.

This final option is more likely if an early election is called, because the Government won't have had the time to sell major reform. It is also unlikely to adequately address the deficiencies in the tax system highlighted by the experts, thereby kicking the reform can down the road. I fear this path of least resistance is the one the Government may go for in order to safely secure its re-election.

"Underlining this election year is a weak economy, rising unemployment, growing debt and higher-than-anticipated deficits."

It's the economy, stupid

Underlining this election year is a weak economy, rising unemployment, growing debt and higher-than-anticipated deficits. The economic conditions have dampened economic growth, and forced the Government to write down revenue expectations in the Mid-Year Economic and Fiscal Outlook, released late last year. The innovation statement was designed to assist with the transition of the economy away from mining dependency, but the dividends of any refocus will take years to filter through the economy.

The Government will want to use 2016 to start a serious debate about government spending, and whether the welfare state we have grown used to is sustainable in the context of an ageing population. But it is another matter as to whether the Government will be prepared to have this debate in an election year. What it wants and what politics will allow are two different matters. The Abbott Government previously tried to start this debate but, armed with poor advocacy skills, had little success. Interestingly, with the exception of changes to the pension, the social services reforms Abbott and Joe Hockey sought to introduce were not ruled out ahead of the 2013 election. But their poor salesmanship prevented changes being enacted.

In the context of a difficult economic environment, 2016 is unlikely to be any different to other years in modern politics, which have seen voters unwilling to tolerate tough decisions that curtail spending. During the mining boom years the electorate grew used to surplus spending and the political culture hasn't allowed the political class to rein this in while still maintaining voter satisfaction. We will find out if Turnbull can be a change agent in 2016 or gets politically burnt while trying, or whether he simply avoids making tough decisions in this space.

One policy area where the Coalition is certain to avoid tough decisions is in the industrial relations space. Despite Kevin Rudd's government winding IR reforms back much further than the overreach of Work Choices, even removing some of the reforms Keating introduced in 1991–92, timidity in this space has prevented the Coalition from re-engaging in serious IR reform. The attempt to reintroduce the ABCC is more an exercise in union bashing than IR reform. It will have some impact, but it is compartmentalised to the construction sector. Conditions and contracts more generally need a new wave of IR reform but neither major party is prepared to go there, and the political culture remains weak when it comes to this important fillip for promoting productivity and helping "grow the pie".

"Labor and the Greens are likely to remain obstructionist, although even the Greens have shown signs of compromise since the change of prime minister."

The Senate

The role of the Senate in the Australian political system has long been debated, and since Keating's "unrepresentative swill" comments, the mandate debate has become more pronounced. Senate obstruction was an issue for the Abbott Government over the previous two years, and it is likely to remain an issue in 2016. There are three areas of interest when assessing the Senate in 2016: the pre-election impact the chamber will have on policy debates; the post-election ramifications of the result; and the way Senate parties are likely to fare at the election. This final area of interest includes a party like Nick Xenophon's contesting lower house seats, which will have an impact in South Australia.

1. The Senate in the lead-up to polling day

The Government is hopeful that the change of prime minister will improve relations between the Senate crossbenchers and the ministry. It was no secret that the Prime Minister's office didn't have a particularly cordial relationship with crossbenchers during Abbott's prime ministership, or that Eric Abetz, the Government's Leader in the Senate at the time, wasn't regarded as a strong negotiator. Under Turnbull's prime ministership, George Brandis is the new Leader of the Government in the Senate, and the early signs are that the Government is taking a more nuanced approach to its dealings with the crossbenchers. Labor and the Greens are likely to remain obstructionist, although even the Greens have shown signs of compromise since the change of prime minister. The remaining crossbenchers have already spoken publicly about the improved dialogue they are having with ministers, but the real test will come when unpopular legislation aimed at reining in the budget is put before overtly populist senators.

2. What will a post-election Senate look and act like?

The post-election composition of the Senate will depend on whether the election is early or late, whether it is a double dissolution or a half-Senate election, and whether or not the Government seeks to institute Senate electoral reforms recommended by the Joint Standing Committee on Electoral Matters, which would stymie the electoral prospects of minor players. If a double dissolution is called, for example over the ABCC legislation as previously noted, even with Senate reform, minor parties will be in the running for picking up seats, given the halved quota of 7.69 per cent rather than 14.29 per cent. But it would be a very new-look Senate after polling day because the swathe of new parties elected in 2013 would have all faced the people once again.

However, if the election is only a half-Senate election, reforms will all but wipe out the electoral prospects of minor parties beyond the Greens and Xenophon's new party, which would make for an interesting outcome. But it must be noted that the class of 2013 would remain, so the balance of power in all likelihood would continue to be shared by a cross section of small players.

3. How will minor parties and independents in the Senate fare at the election?

It is hard to see the Palmer United Party winning Senate positions, and its leader in the lower house, Clive Palmer, will lose his seat if he even bothers to contest it. The Greens are defending six Senate seats at a half-Senate election, 10 at a double dissolution. Under either scenario they would be expected to lose seats. The Government should retain its share of seats in the Senate, and Labor might benefit from the demise of minor players. But the threat to either major party in the Senate comes from the Xenophon party, which will certainly win a seat in South Australia and perhaps in other states too, depending on preference distributions and what happens with Senate reform. While Senate parties chiefly aim to win seats in the upper house, their preferences are important in lower house contests. The Xenophon party is a genuine chance to win seats in South Australia, and the Greens should hold Melbourne and perhaps threaten in the newly-distributed inner-city seats in Sydney. By way of preferences, Xenophon is likely to use an open ticket, turning his party into a useful portent for dealignment and protest vote tendencies.

The Greens preferences always favour Labor ahead of the Coalition, but a Turnbull prime ministership may see more leakage on this score than is usually the case, certainly compared to the last two elections under Abbott's leadership of the Liberal Party.

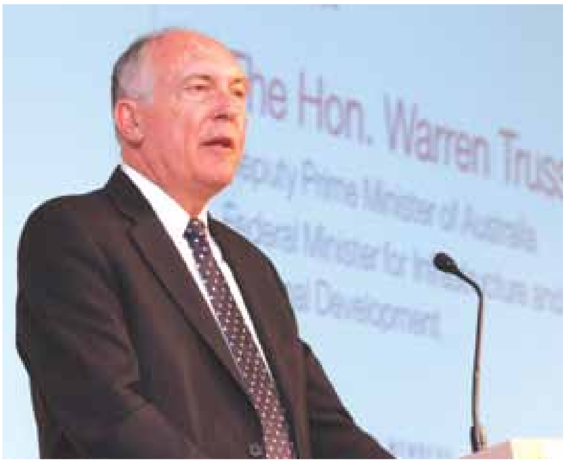
Terrorism and Islam

Towards the end of 2015, growing tensions within the Coalition over how to manage the threat of radical Islam became a dominant theme. A series of conservative Liberal MPs followed Tony Abbott's lead and began arguing that Islam required a "reformation", and that Islamic leaders needed to do more to condemn terrorism in the name of their religion. This has set up a fascinating situation for 2016, given that it is an election year.

The security experts say that the political class's public admonishing of the Islamic leadership makes it harder for them to do their jobs – engage with the Islamic community and gather information to thwart terror acts. The decision by some politicians to defy such requests and speak out may well be a simple case of doing their duty as elected representatives and exercising their free speech. But those who are doing so are the same MPs who used the shield of security experts' advice in 2014 and 2015 to justify harsher legislation for surveillance and data collection. It is a selective approach, which only serves to highlight that the criticism might be sections of the Government spoiling for a fight, either with the Islamic community or the new Prime Minister. Perhaps both.

"Towards the end of 2015, growing tensions within the Coalition over how to manage the threat of radical Islam became a dominant theme."

On the Opposition side of the Parliament, the response has been to side with the Prime Minister, offer moderate rhetoric and accuse the Government of risking national security by making the job of the security agencies more difficult. Shorten will be mindful to remain in lockstep with the incumbent leadership of the Government on national security matters, rather than chase the former leadership group down the rabbit hole of turning the threat of terrorism into a wider problem with Islam. If there is a domestic terrorist incident in 2016, this debate could heat up. Traditionally such a tragedy would politically assist the incumbents, but this year it could flare up into significant divisions within the Government, thereby having the opposite impact. And that's before even assessing how divisive such a debate would be in the wider community.



"Conservatives within the Liberal Party are struggling to overcome the new paradigm which sees a relatively moderate prime minister leading the party."

Party internals: moderates and conservatives

Courtesy of last year's change of prime minister in September, there are some residual internal tensions within the Government. The Nationals are more conservative than their senior Coalition partner, hence a number of National Party MPs and senators were unimpressed by Tony Abbott's removal. We saw this play out last year in the willingness of Warren Truss and Barnaby Joyce to encourage Ian Macfarlane to defect to The Nationals. That move was thwarted by the Queensland LNP, but the sentiment speaks to tensions in the Coalition that will likely continue this year. There is an expectation that Truss will announce his retirement early in the new year, which will likely see Joyce elevated to the Deputy Prime Ministership. It will be interesting to watch how his working relationship with Turnbull develops during 2016.

Aside from tensions between the Coalition parties, there are internal factional tensions within the Liberal Party. As already examined, some of these tensions relate to how to handle the threat of Islamic terrorism, but this policy disagreement is a proxy for deeper philosophical tensions between Liberal conservatives and moderates. To some extent, the tensions will be papered over because 2016 is an election year. But if the messy ending to 2015 is any indication, there will be breakouts of ill-discipline this year despite the election.

Conservatives within the Liberal Party are struggling to overcome the new paradigm which sees a relatively moderate prime minister leading the party. They are seeking to clarify their internal authority and power, while making sure the Government under its new leadership holds ground on the agreed policy script. It is early days, which means that this "feeling out process" will continue in 2016. It is worth noting that tensions extend to differing attitudes between sections of the party on the balance between maintaining experience in the ministry and seeking renewal. Turnbull is spruiking for renewal. However, the likes of Abetz, Kevin Andrews and Abbott are showing few signs of supporting such a push. It is important, however, to note that next generation conservatives are focused on the issues they want to push, rather than some sort of spruiking for an Abbott comeback, even to the frontbench.

In 2016, the importance of the internal tensions within the Government relates to both electioneering and policy development. In the context of a campaigning year, Coalition strategists won't want the distraction of internal tensions to erode voter support, nor give the appearance of a dysfunctional government. Labor will certainly seek to paint any such tensions that way, as Abbott did during the Rudd and Gillard years. Internal tensions will also impact on Turnbull's policy agenda. Conservatives are comfortable with a robust economic reform agenda, but will resist adjustments to the Government's climate change policies, or any perceived weaknesses on national security matters. They are also keen to tie more conservative social programs to policies Christian Porter will pursue as the new Minister for Social Services.

While there is currently no sign that 2016 will see a break out in factional fighting within the Liberal Party, nor between the Coalition partners, this could change quickly. Especially in the aftermath of a disappointing election result.

Labor's expected approach to 2016

The Labor Party goes into this election year in a difficult position. A victim of his own success, Shorten contributed to Abbott's downfall in that he neatly exposed the weaknesses of the former prime minister. However, Abbott's presence helped cover up the weaknesses in Shorten's own position. Now that Abbott is gone, Shorten's unpopularity stands in sharp contrast to Turnbull's standing. While the contest will inevitably tighten throughout the year, if the election isn't called early, few within Labor's ranks believe Shorten can win the next election.

No first-term opposition has won an election at the federal level since 1931, yet many have come close. Abbott in 2010, and Kim Beazley in 1998 are the two most recent examples. Shorten should be able to win seats off the Government, but in a contest of 90 seats for the Coalition verses just 55 for Labor going into the next election, Shorten needs to do more than just win back a handful of seats to retain his leadership in the aftermath.

Shorten's desperation for a strong showing risks stifling Labor's willingness to pitch major reforms to the voters. While it is true that there are a number of significant policy proposals already on the agenda

"Conservatives are comfortable with a robust economic reform agenda, but will resist adjustments to the Government's climate change policies, or any perceived weaknesses on national security matters."

from 2015 – superannuation and multinational tax reforms, changes to union governance, along with higher education adjustments – none of these are on a grand scale. And they really don't address the fiscal challenges economists are telling us about. The biggest challenge for Labor is modernising the party and the way it philosophically approaches economic issues, just as Hawke and Keating did in the 1980s. This area of reform has been sadly lacking within the Labor Party of recent years, and it is unlikely to improve in 2016.

2016 will see the Labor Party adopt a traditional opposition scare campaign about the Government's policies, meaning that if the election centres on a GST debate, Labor will have significant areas to mine voter concerns. If Turnbull goes to the polls early, this will nullify such attacks from Labor, forcing it to fall back on labelling the Government dysfunctional over the change of prime minister and the ministerial scandals which ended 2015. The real story within the Labor Party is more likely to unfold AFTER the election.

Election aftermath: a prediction and what might follow

I predict that, notwithstanding the internal divisions within the Coalition and the factional ranks of the Liberal Party, the Government will be re-elected. But it will be returned to power with a reduced majority. At issue is the size of the majority even if it is reduced. Abbott won a landslide result in 2013, so Coalition strategists know that losing seats in some states is inevitable. It will be interesting to see if the Coalition can mitigate some of the losses, for example by picking up seats in states like Victoria where the party's vote has long been depressed. One of Howard's electoral strengths was winning seats off the opposition even when his government was losing parts of its majority elsewhere.

If Turnbull can win the election with upwards of 85 seats in the 150-seat House of Representatives, he will have a sizeable mandate in his own right. It should quash internal divisions, especially if he secures such a victory with a robust agenda laid out ahead of polling day. An election fought arguing for major tax reform would mean any result retaining upward of 80 seats would similarly give the new prime minister a strong mandate. However if Turnbull takes a weak agenda to the election, yet loses more than half a dozen seats in the process, he will come out the other side of polling day with only limited authority, and the leadership failures of recent years risk continuing.

As far as Labor is concerned, it is very hard to see how Shorten can retain his leadership in the aftermath of a defeat, especially if he can't build Labor's share of the lower house to 65 seats or more. Anthony Albanese is the most likely alternative to Shorten, and the new voting system which empowers the members would favour Albanese. But, for him to be successful, the parliamentary right would need to fracture and the organisational left would need to unite. All eyes will be on Tanya Plibersek in this respect.

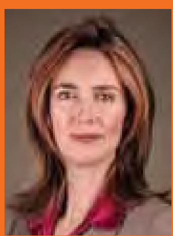
Where I think the internal politicking within Labor will be most interesting to watch is in how they respond to the Government's fiscal agenda after its re-election (assuming my initial prediction comes true). There will be competing tensions within the labour movement – the parliamentary forces seeking to emulate Hawke and Keating; the old guard seeking to protect the legacies of the most recent Labor government; and the unions and a party membership further to the left than mainstream voters. While we tend to focus on the crossbenchers when assessing the capacity of the Government to implement its agenda, the role of the Opposition in the upper house is also important to watch.

Finally, a short note on Tony Abbott. 2015 ended with low-level speculation about an Abbott comeback. This strikes me as beyond ridiculous. While few would have predicted either Kevin Rudd or Malcolm Turnbull returning to lead their parties shortly after they were deposed, Abbott's example is very different. His unpopularity was virtually unprecedented, and to the extent that Turnbull was unpopular when he was deposed in 2009, it took him six years in the wilderness to mount a comeback. Abbott doesn't have that much time, and the ambitions and the talents of the next generation of Liberal leaders inside the Parliament will have taken over by then. My strongest prediction of 2016 is that talk of an Abbott comeback will remain just that, talk.

The views in this article are those of the author and should not be attributed otherwise.

Positives aplenty:

Australian business competing overseas



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Originally from the UK, Amanda Banfield is leading Mondelēz International's local operation as its Managing Director of Australia and New Zealand markets. Amanda oversees a significant operation across her geographies including four manufacturing sites and around 3000 employees.

Mondelēz International is the world's largest snacking company with 2014 pro forma revenues of $30 billion (USD) and products in approximately 165 countries. Headquartered in Melbourne, Mondelēz International Australia owns local and international favourites including Vegemite, Cadbury, Oreo and Philadelphia.

Overcoming the negativity bias

What stuck in our minds last year, from managing the local business, overseeing trade and factory visits, and trips home from Japan, is how unreasonably negative Australia's world view became.

A quick look at the most quoted macroeconomic headlines show we face some challenges: 6.2 per cent unemployment[1], 33.88 government debt-to-GDP ratio[2] and inflation at 1.5 per cent[3] , which will require long term solutions. But, compared to other developed economies, our picture is not as dire as some might suggest.

And yet, in the business pages the 'if it bleeds, it leads' maxim was in full effect. Too often, Australia's situation is compared with the extreme conditions in Greece (177.10 debt-to-GDP[4]) when a more salient comparison might be with conditions in Canada, France, Germany or Norway. The focus on fluctuating commodity prices, China's softening growth, and US interest rates further perpetuates the negative outlook.

The headlines, together with the relentless focus on crisis reporting, may be giving us a misleading picture of important long term development trends across the world. Statistician Hans Rosling, perhaps best known for his engaging TED Talks, recently provided a terse reality check with examples of a world heading in the right direction, including Nigeria and Indonesia's democratic elections and India being declared free of maternal and neonatal tetanus. Then he commented on the way these stories seem to be underreported in the news.

> "No, no, no that is completely wrong. You're wrong... News outlets only care about a small part, but you call it the world. The big difference is that the girls do attend schools, the children are vaccinated, and most of the world population has electricity. Those are the things that are important to report on, but it happens so slowly that it doesn't make the news."[5]

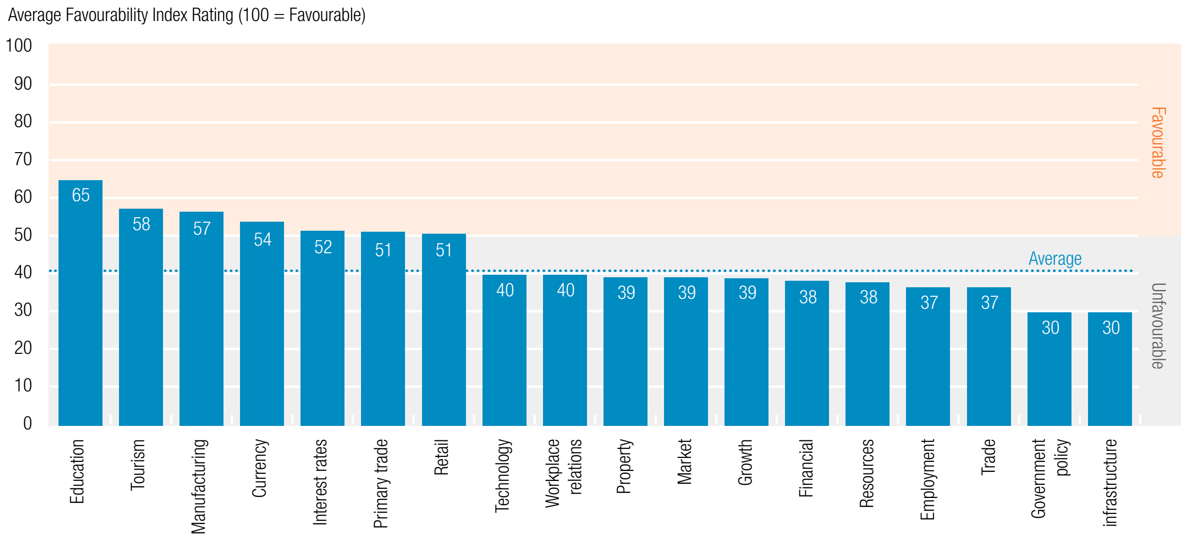
Rosling's critique resonated with us. The picture we see when looking at our markets in Australia, or the role of that operation in our regional business, doesn't always match up with the reporting on business or economic issues.

An Isentia analysis of the front pages of business sections and business-oriented newspapers confirmed our intuition (see Figure 1 below).

They examined 148 business news headlines and lead paragraphs that related to economic conditions across five major newspapers (*The Australian Financial Review*, *The Australian*, *The Age* and *The Sydney Morning Herald*, and *The West Australian*) during mid-March, early June and early August. Overall, the coverage of current economic conditions and prospects was predominantly unfavourable, with an average favourability of 41.6 on their scale of 0 to 100 (100 being positive). Of the articles, 105 were unfavourable, 32 were favourable and 11 were neutral or balanced.

Figure 1

Australia newspaper[1] business section sentiment by topic (2015)[2]



Notes: 1. Articles sourced from *The Age, West Australian, Australian Financial Review, The Australian, Sydney Morning Herald*
2. Samples from three time periods in 2015: 9–13 March, 1–5 June, 3–7 August
Source: Isentia

During this period, Isentia analyst Patrick Baume noted the business media seemed almost obsessed with the threat of a housing bubble and the continuing weak outlook for the mining sector. By way of contrast, Mr Baume said:

> "Positive indicators such as retail sales, and export growth across agriculture, education and tourism were given far less prominence, with strong criticism of government economic policy or proposals also gaining coverage. The share market was underperforming during much of the period analysed, but of course that may have partly been owing to extensive unfavourable media coverage concerning the broader economy. Given Australia was virtually the only major developed economy to avoid recession during the GFC, it seems that in the financial media in the middle of 2015 there was an accumulation of pessimism that the chickens must at some point come home to roost."

In recent years Reserve Bank of Australia (RBA) Governor Glenn Stevens has also repeatedly commented on the culture of negativity, which feels out of step with reality.[6] He suggested the same culture was holding back the "animal spirits"[7] required to unlock growth in non-mining sectors.

With a shroud of negativity obscuring many positives during 2015, what are we to make of the prospects for Australia's international competitiveness in 2016; where are the bright spots?

"…the business media seemed almost obsessed with the threat of a housing bubble and the continuing weak outlook for the mining sector. "

Overhauling our focus and boosting confidence

Manufacturing in Australia faces some big challenges. Reports indicate that Australia has the highest manufacturing costs of the world's 25 leading manufacturing exporting economies.[8]

Operating in a high cost environment is not ideal. Steps can and should be taken to make Australia a more attractive place for foreign investors and home grown companies to make Australia a profitable base – any unnecessary cost is a deterrent.

However a decades-long focus on driving down those costs doesn't seem to have changed much (using the manufacturing decline as a yardstick) and our economic narrative has in some senses hit a wall.

While managing costs and productivity remain crucial, we need to shift our focus to a new economic narrative as Secretary to the Treasury, Dr Ken Henry AC, pointed out, to focus on and develop other strengths.[9]

In doing so, we also need to overcome the negativity that has held us back and give ourselves a confidence boost. Australia's ability to adapt and thrive depends on it.

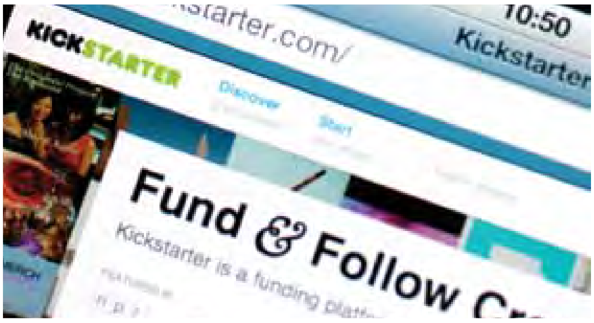
More than any other sector, manufacturing should feel the impetus to refocus and change. The Organisation for Economic Development and Cooperation (OECD) neatly summarised potential areas of competitive advantage saying, "the long-term productivity and competitiveness of Australian manufacturing will be increasingly based on innovation, targeted at new products/processes/services for (new) niche markets, and based on factors beyond cost efficiency". They added that investment in human capital (skills development) and collaboration with external partners (research organisations, universities, suppliers, customers, etc.) are crucial.[10]

Given recent car manufacturer exits and predicted continuing global economic headwinds[11], 2016 must be the year that policy makers and business leaders alike are able to refocus, identify and act upon their strengths so that Australia continues to prosper and maintain its quality of life.

For this to happen, the best intentions need to be informed by practical examples, especially where innovation is concerned.

What has set us apart in a competitive global company, involved thinking broadly about the Australian advantage in the context of our global business, and placing this at the heart of our local business strategy.

> "2016 must be the year that policy makers and business leaders alike are able to refocus, identify and act upon their strengths so that Australia continues to prosper and maintain its quality of life."



In 2016, our Australian advantage will increasingly involve three things:

- Operationalising innovation
- Talent incubation and export
- Successfully appealing to a diverse pool of global talent.

Operationalising innovation

It's easy to get excited about the concept of innovation but much harder to develop a practice that delivers real and measurable results.

Innovation isn't just a concern in Australia. The current US presidential race is seeing innovation emerge as a central theme. Marco Rubio's 2015 book *American Dreams* features the terms 'innovation', 'innovate' and 'innovator' 33 times. Hillary Clinton is telling audiences her goal for the State Department (in her role as Secretary of State) had been to make it a 'hub of innovation', having hired an Innovation Adviser, created an Innovation Award, and unveiled an Innovation Agenda.[12]

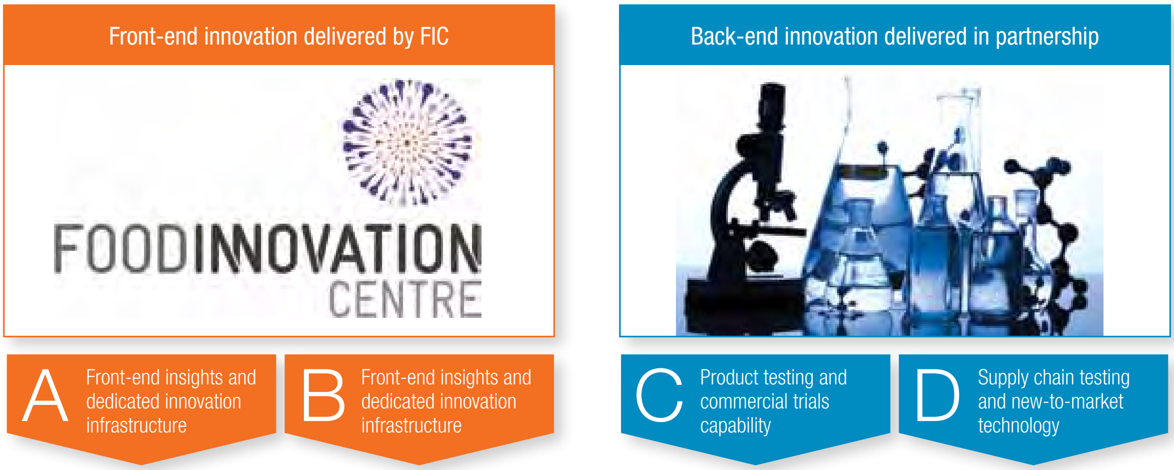
We operate a relatively mature market for chocolate in Australia, and innovation has been critical to growing sales and becoming more efficient. For us, innovation spans the product and packaging research and development (R&D) process and stretches into our factories in the form of new technologies and ways of working. Externally, it reaches out to the broader food manufacturing industry via our Food Innovation Centre.

Policy and industry conversations about innovation often focus on commercialising innovation. However, we talk about operationalising innovation. This reminds us that the benefits of innovation accrue at more than just the point at which there's a commercial return. Innovation for us involves culture, education, marketing, sales, and technology, to name a few.

Commercially, around nine to 12 per cent of our revenue comes directly from new product development, with 'innovation' more broadly accounting for even more (taking into account savings from new technologies, reduction in time spent on R&D processes and the like).

Innovation also features heavily in our global strategy of jump-starting growth. That's why in 2012 we seized the opportunity to create an open innovation facility with the Victorian Government. Evidence that collaboration and co-creation through more open and diversified networks produces better market performance[13] underpinned the creation of the Food Innovation Centre at our Ringwood manufacturing site in Victoria.

Figure 2
Food Innovation Centre process



In partnership with the Victorian Government, the Food Innovation Centre brought together technologies (including a 'virtual store' for testing concepts, 3D retail environments, 3D printers, and tools for rapid packaging prototyping), experts across design and innovation, and most importantly a process (see Figure 2) to service both our own business and small and medium-sized enterprises (SMEs) from across Victoria.

To date, the Food Innovation Centre has provided specialist innovation training to more than 180 Victorian SMEs and 30 SA-based SMEs, as well as facilitating collaboration workshops for more than 400 SMEs.

In focusing on the 'front end' (Fig. 2) of the innovation process and partnering with others who could provide 'back end' services, we have been able to zero in on the practical aspects of de-risking new product development and also foster collaboration in the food sector. This sounds lovely, but the key question is what did we achieve?

While it is still early days, a few highlights have included:

- Facilitating a joint venture between two competitor co-packers.
- Introducing a muesli manufacturer to co-packers and enabling them to develop a new packaging line.
- Supporting two local SME manufacturers sell their products into Vanguards Supermarkets in China with $5m projected initial sales.
- Connecting a number of Asian buyers with SMEs.
- Cutting three months development time off our own average new product development for the highly complex Cadbury Dairy Milk Marvellous Creations Easter Egg, using the rapid prototyping facilities attached to the Food Innovation Centre.

The last example saved us tens of thousands of dollars and around a third of the typical time required to develop a new product. This brought home for us what a well-developed innovation process and new technologies could do for our bottom line and for consumers.

There is a role for governments to play if innovation is to become the common factor that reshapes industries and propels us forward. That role is primarily in helping foster collaboration within and across sectors, where it may not make sense for a private company to handle others' intellectual property, or where town planning and place/destination marketing are required to set up innovation precincts. Having the right education policies, tax incentives and trade policies will also be important.

Ultimately, the challenges we face are a test of our will. As Glenn Stevens[14] and others have suggested, will – together with knowhow where innovation is concerned – is a principal factor in creating or holding back growth.

A willingness to try new things, attempting to shape the future of existing markets, and creating new markets are the fundamental prerequisites for innovation and growth.

Incubating talent for the world

Last year the Australian Trade Commission published a compelling benchmark report, *Why Australia?*[15] aimed at encouraging overseas investment. The report was a rousing, positive exposition of Australia's competitive advantages, and a brilliant example of the rational side of the marketing communication required to lure investment to Australia.

The report's summary of the relative strength of our local talent was especially well aligned with our experience:

> "The Australian labour force is one of the most educated, multicultural and multilingual in the world.
>
> Australia offers a workforce that is equally at home in both Western and Asian cultures. Almost 30 per cent of Australia's workers were born overseas. Around 2.1 million Australians speak an Asian language and 1.3 million speak a European language in addition to English.
>
> Australia's higher education enrolment rate ranks in the world's top 10. The nation's high-quality education system also makes it the fourth most popular destination for international students. Almost 75 per cent of these students are enrolled in business and technology-related courses."[16]

To colour that summary with our personal experience:

- Twenty-six per cent of our regional leadership team, which operates out of Singapore and covers the Asia Pacific including giant growth markets China and India, have either spent time working in or were exported from Australia. Australian talent is therefore overrepresented relative to country revenue and population.
- Beyond the leadership teams, there are many examples of locally developed talent who have moved into senior regional roles.
- The existence of high quality education provides benefits in itself but greater benefits can be achieved through closer collaboration with the sector. Last year, in partnership with the University of Melbourne we developed and launched the Master of Food and Packaging Innovation in order to secure a pipeline of job-ready graduates who could think and apply their skills in immediately useful ways.

With the number one global secondary education enrolment rate and almost 40 per cent of workers on average holding a tertiary qualification or advanced diploma[17], Australia can lay claim to being an excellent source of educated talent.

But we cannot afford to lose our competitive advantage in this area. We need the public conversation about the quality of our education system and educational outcomes to be focussed on the tangible advantages of having an educated workforce, without being waylaid by the funding debate as it was in 2015.

> "The report was a rousing, positive exposition of Australia's competitive advantages, and a brilliant example of the rational side of the marketing communication required to lure investment to Australia."

"With Melbourne, Sydney, Adelaide and Perth all frequently making the most liveable cities lists, Australia's simplest pull factor is that our major cities are great places to live…"

Appealing to diverse global talent

Measuring the impact of diversity (shorthand for a mix of individuals from different races, ethnicities, genders, sexual orientations, ages, etc) is difficult for an individual company, but on a collective basis research has indicated that:

- Companies in the top quartile for gender diversity are 15 per cent more likely to outperform those in the bottom quartile on financial performance.[18]
- Companies in the top quartile for ethnic diversity are 35 per cent more likely to outperform those in the bottom quartile on financial performance.[19]

As well as being a fundamentally decent and ethical approach, diversity is good for business. It also has the practical benefit of letting us draw from a larger pool of potential employees and leaders.

Helpfully, Australia has a proud tradition of multiculturalism. Occasional examples of fringe groups arguing against multiculturalism do not reflect the majority attitude with 85 per cent of Australians agreeing that it has been good for the country.[20] As well as coalescing with our own corporate values, to labour the point, diversity is good for business.

That's part of the reason we have a Diversity and Inclusion Council within the Asia Pacific region. Our senior management comprises 59 per cent men and 41 per cent women. Our manufacturing operation is similar, with 62 per cent men and 38 per cent women, and ultimately we're working towards gender equality throughout the organisation.

In a global organisation where innovation is key, the ability to work within a framework of diversity and difference and being ready to work with different cultures and ideas, is essential.

Although government can set a positive example of diversity (with both the Turnbull Government and the Labor Opposition making commendable progress in 2015), achieving diversity in the workplace has to be a partnership between business and the education sector. In order to institutionalise diversity, we need a diverse pipeline of potential candidates.

That partnership needs to break established cultural norms and patterns that have resisted gender and ethnic diversification. Within engineering for example, at last count only 16 per cent of graduates were women.[21] To change this, we need intervention at the earliest possible point, reaching into our kindergartens and primary schools.

Diversity lets us appeal to a larger global talent pool, but there's a more basic appeal that has also helped us to draw the best and brightest to Australia.

With Melbourne, Sydney, Adelaide and Perth all frequently making most liveable cities lists, Australia's simplest pull factor is that our major cities are great places to live.[22] Education, healthcare, safety, public transport and education, pedestrian amenities, a clean environment and a broad range of cultural activities all form part of the complex mix of qualities that make our cities liveable. This also creates a delicate mix to be maintained by town planners and policy makers into the future.

We are increasingly competing within a globalised economy. Our ability to cast a wide net and successfully appeal to top talent, offering them much more than just a well-paying job or access to universities, will continue to be hugely important.

Putting it into action

We are seeing the early stages of a blueprint for the future starting to form in the national psyche.

Prime Minister Malcolm Turnbull has said: "The Australia of the future has to be a nation that is agile, that is innovative, that is creative".[23] The key and ultimate challenge is in the delivery. It is now that Australia needs to be agile, innovative and creative – not in some distant future. Businesses can develop and thrive thanks to their Australian advantages including innovation, talent incubation and diversity.

With strong conditions for doing business in Australia, 2016 needs to be a year in which we cast off the negativity, take some calculated risks, and make our own luck.

The views in this article are those of the authors and should not be attributed otherwise.

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Challenging times for Australia

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Introduction

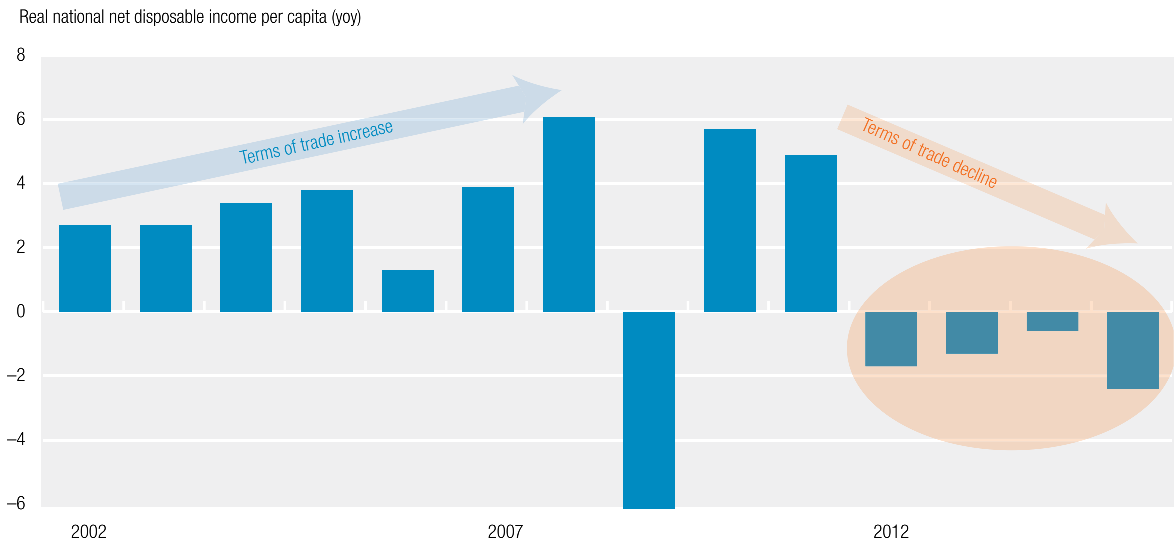
The Australian economy is facing a challenging period ahead. Australia is coming out of its biggest mining boom since the 1850s, China's economy is slowing, and the United States (US) Federal Reserve is entering an interest rate hiking cycle at a potentially problematic time. Major commodity economies such as Canada, Brazil and Russia have already entered recession.

Unlike previous mining boom and bust cycles, Australia's economy is better positioned to meet today's challenges with a floating exchange rate and more flexible labour markets. However, there is an above-average risk of a recession and a house-price correction in the next few years, and global events could well exacerbate domestic economic challenges.

The mining boom provided a huge stimulus to national income, via higher prices for our mining exports, royalties, and a surge in investment. It also led to significant appreciation of the Australian dollar, which helped raise living standards. Households took on substantial amounts of debt and bid up property prices. Non-tradeable service businesses and the construction sector benefited from the boom and the rising national income. Meanwhile, non-mining trade-exposed sectors such as manufacturing and agriculture, struggled due to significant currency appreciation. This process is currently reversing, causing domestic incomes to fall (see Figure 1) and the Australian dollar to move closer to long-run normal levels.

Despite significant challenges facing the economy, Australia has a number of excellent opportunities for growth over the long term. These come from the recent depreciation of the Australian dollar, population growth, productivity growth and economic growth in the rest of the world, particularly in Asia. Policymakers have a critical role to play in driving the reforms necessary to increase Australia's productivity growth rate in the years ahead.

Figure 1
Australian incomes have declined with commodity prices



Source: Australian Bureau of Statistics; Magellan
Note: Real national net disposable income is a modified real GDP measure that accounts for terms-of-trade effects and international ownership.

Risks to the Australian economy

Australia's economy faces a number of risks from both global and domestic sources. If multiple risks were to manifest at the same time, this could cause a further slowdown in economic growth or a recession over the next few years.

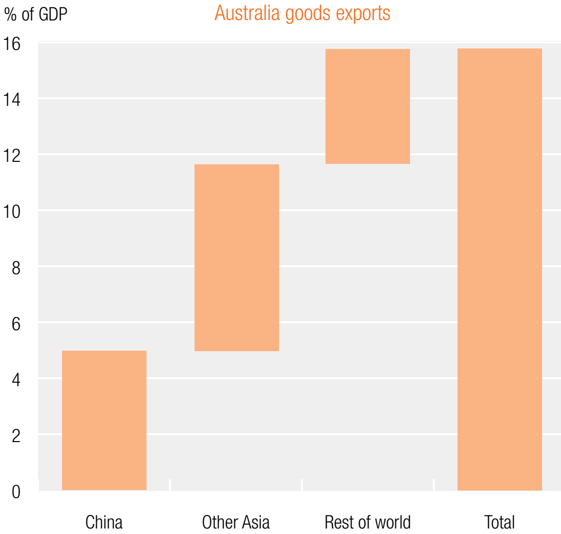
Global risks

China's credit and property bubble

China's rapid economic growth may be taking a significant turn. As Australia's largest trading partner (see Figure 2) and a key driver of growth in other Asian economies, China's slowdown presents a major risk to the Australian economy.

Figure 2

China is Australia's biggest customer



Source: Australian Bureau of Statistics; International Monetary Fund; Magellan

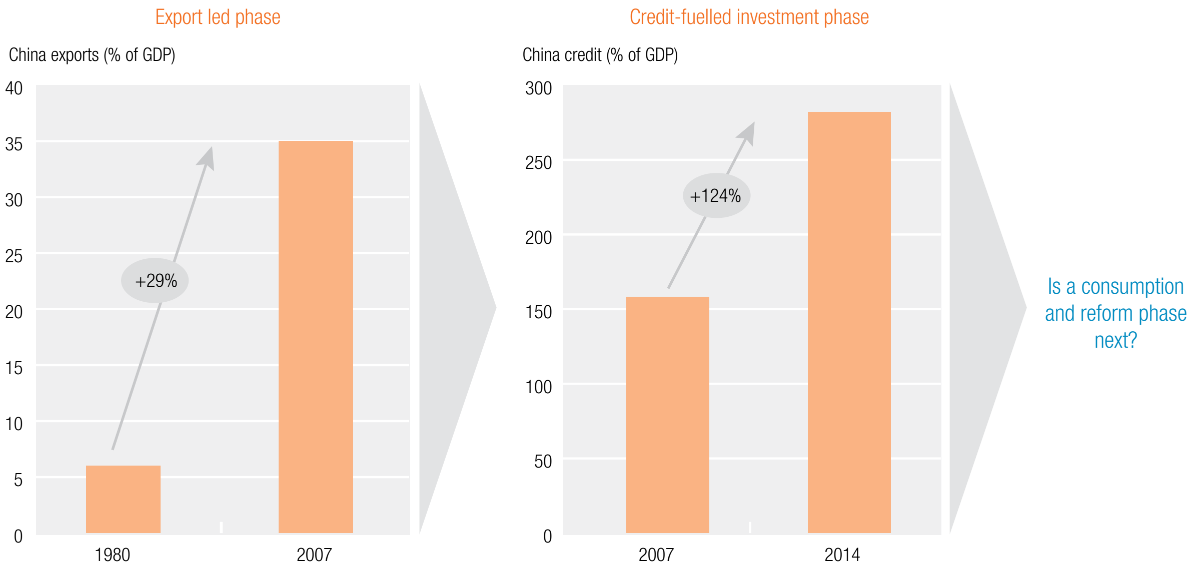
Australia's exports are dominated by hard commodities, the prices of which are heavily influenced by Chinese demand. China is by far the world's largest consumer of commodities and accounts for around half the world's consumption of iron ore, aluminium, cement, coal and steel. Australia has played an important role in supplying the raw materials for China's building boom and industrialisation, particularly iron ore and coal.

However, China's rapid economic growth has become unsustainable. When demand for Chinese manufacturing exports deteriorated during the global financial crisis (GFC), a credit-fuelled domestic investment boom took over (see Figure 3). Under strong influence from the Communist Party, China's state-owned banks lent the equivalent of the entire US banking system to state-owned enterprises, local governments, private businesses and households to keep the economy moving.[1] A large slice of this lending ended up in the Chinese property market.[2]

Rapid credit growth in China has created several years' worth of excess housing supply, comparable to recent property booms in the US, Spain and Ireland, all of which ended in deep recessions and financial crises. Although China's urbanisation and population growth rates have hardly changed in the past 15 years (urbanisation has actually slowed in recent years), property completions are up by one third from pre-GFC levels (see Figure 4). Overbuilding has sent vacancy rates in China's urban housing market as high as 22 per cent.[3] Meanwhile, vacant floor space on developers' books has increased by more than 500 per cent since 2007.[4]

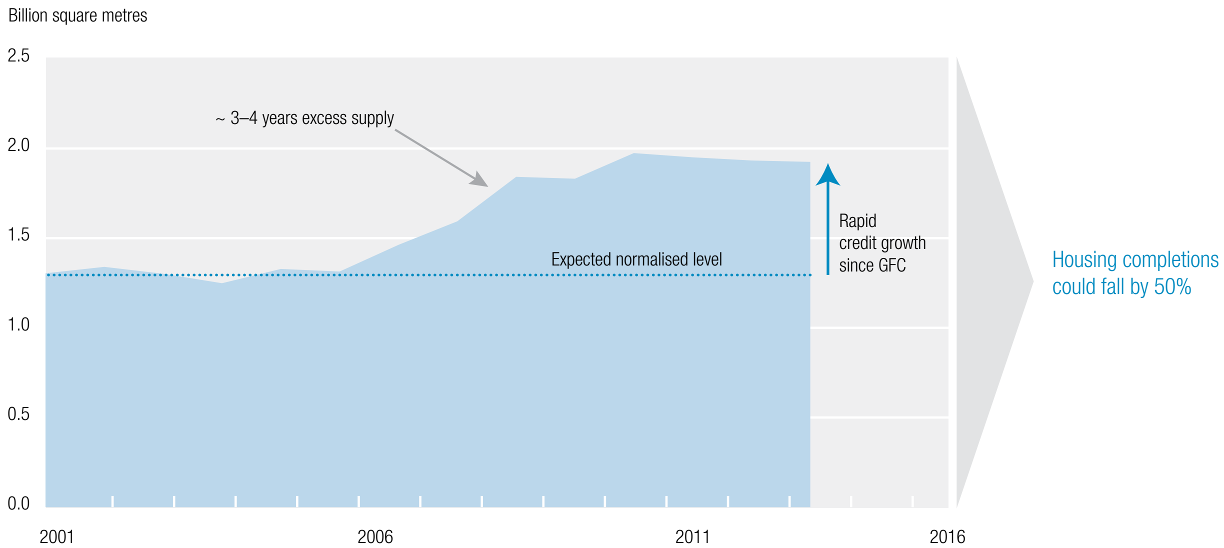
> "China's rapid economic growth may be taking a significant turn."

Figure 3
China needs a new growth model



Source: World Bank; McKinsey; Magellan

Figure 4
Housing completions exploded following the GFC



Source: National Bureau of Statistics (China); Magellan

To work off the excess supply, housing construction in China could fall by as much as 50 per cent. This is a significant risk for Australia, which has supplied a large portion of China's building boom and is shipping ever-increasing volumes of commodities abroad. Residential construction represents 10 per cent of gross domestic product (GDP), around 50 per cent more than the US pre-GFC.[5] When linked industries such as cement and steel are included, real estate accounts for approximately 20–25 per cent of GDP in China. A large contraction in China's property sector would cause a major slowdown in the Australian economy and perhaps even a recession.

A range of indicators suggest that China's economy is slowing somewhat more quickly than

> "However, with China and its Asian trading partners facing a significant slowdown, the coming US rate hike cycle could prove painful for Australia."

official figures imply. Weakness is most apparent in the industrial space (see Figure 5), which accounts for around 43 per cent of China's economy, a large portion of which is linked to property. Import data also suggests that domestic demand in China is weaker than GDP statistics imply.

It remains to be seen whether China's economy can shift to consumption-oriented growth while the industrial sector is weak without major policy reforms.

China's demographics also present a challenge for growth as the working-age population peaks and begins to decline over the next few years. Since 2010, China has directly contributed around a quarter of total global economic growth. Should China's economy slow faster than expected, or enter recession, the potential repercussions for Australia and the world are significant.

Figure 5
China's economy is slowing more than GDP data suggests

	2000–2008	2009–2013	Latest
Real GDP	9%	9%	7%
Bank credit	14%	19%	15%
Steel production	15%	11%	0%
Electricity production	11%	12%	4%
Cement production	11%	11%	–6%
Urban housing completions	9%	10%	–6%

Source: National Bureau of Statistics (China); Bloomberg
Note: Data as at 14 January 2016

While there are a number of reasons to be optimistic about China's long-term economic future, the short-to-medium-term challenges are considerable. Australia could suffer a large, negative, net exports shock as China's property construction contracts and the economy shifts away from investment and heavy industry. Given the strong trade linkages between China and neighbouring East Asian economies, any slowdown in China will likely spill over to Australia's other key export partners in the region.

US interest rate normalisation

The ongoing recovery of the US economy poses both opportunities and risks for Australia.

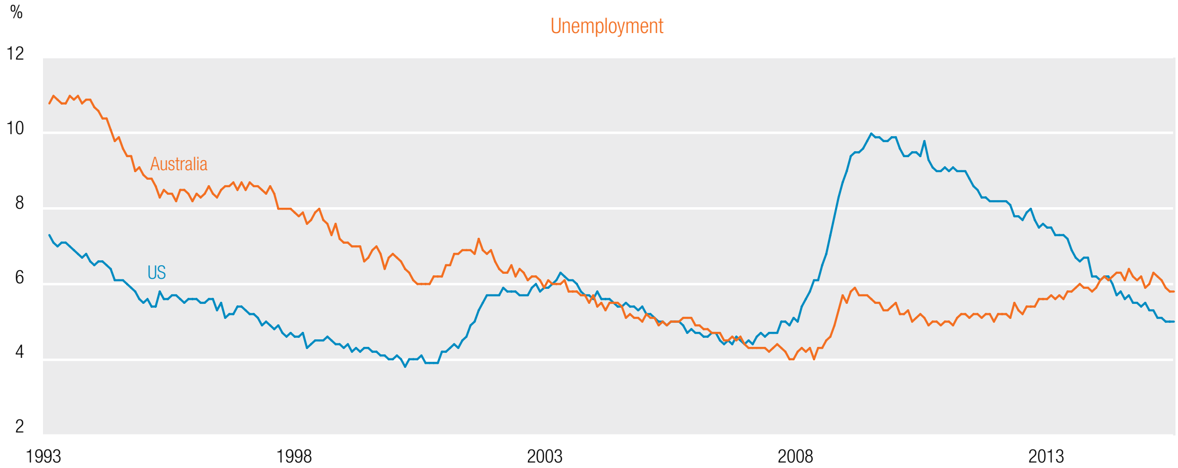
As the world's largest economy (one quarter of global GDP), growth in the US will provide an important economic stimulus to many of Australia's trading partners.

However, with the US labour market recovering strongly (see Figure 6), the Federal Reserve is entering an interest rate hiking cycle that will put pressure on economies with asynchronous economic cycles and large debt burdens, such as Australia and some of its key trading partners. In the past, Australia's economic and interest rate cycles have been well aligned with the US. However, with China and its Asian trading partners facing a significant slowdown, the coming US rate hike cycle could prove painful for Australia.

During the GFC, major developed world central banks cut interest rates to near zero and embarked on quantitative easing programs. This initiated a global search for yield among investors and made credit easier to access for borrowers, boosting asset prices around the world including in Australia.

Figure 6

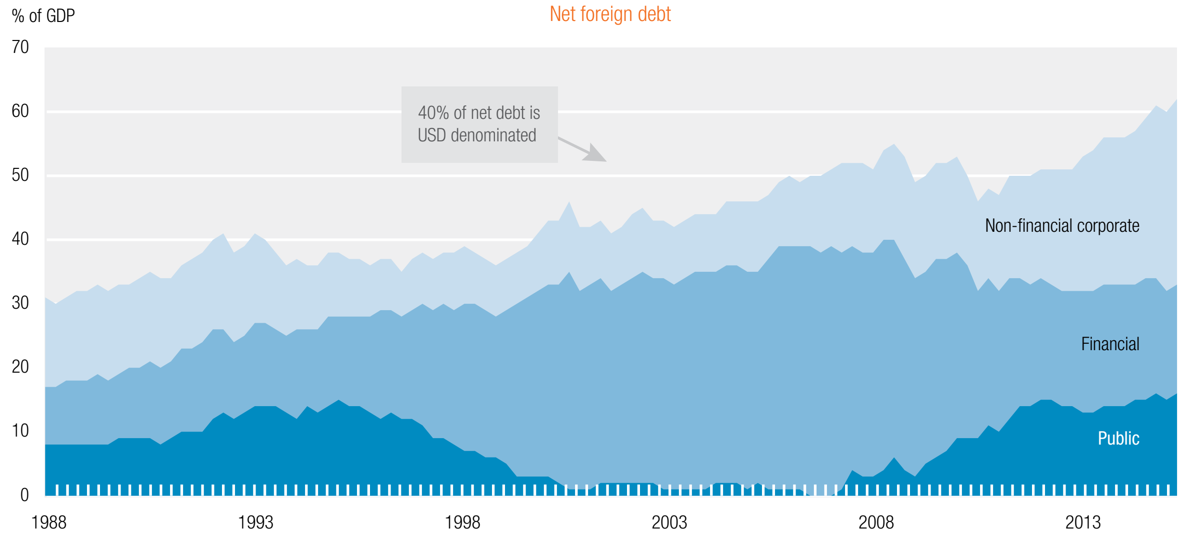
Australia and the US are on asynchronous paths



Source: Australian Bureau of Statistics; Bureau of Labor Statistics (US Department of Labor); Thomson Reuters

Figure 7

Australia's foreign debt has grown substantially



Source: Australian Bureau of Statistics; Magellan

The Australian economy has benefited from ultra-low global interest rates, via lower borrowing costs for households, banks, businesses and government, which enabled large debt burdens to be sustained. A number of Australia's major trading partners including China, Japan, South Korea, Thailand and Malaysia have also benefited from significant credit growth since 2007.[6]

> "Long-term borrowing rates for most sovereigns and creditworthy private borrowers remain remarkably low. Overall, global financial conditions remain very accommodative."
> *Glenn Stevens, Governor, Reserve Bank of Australia, 6 October 2015*

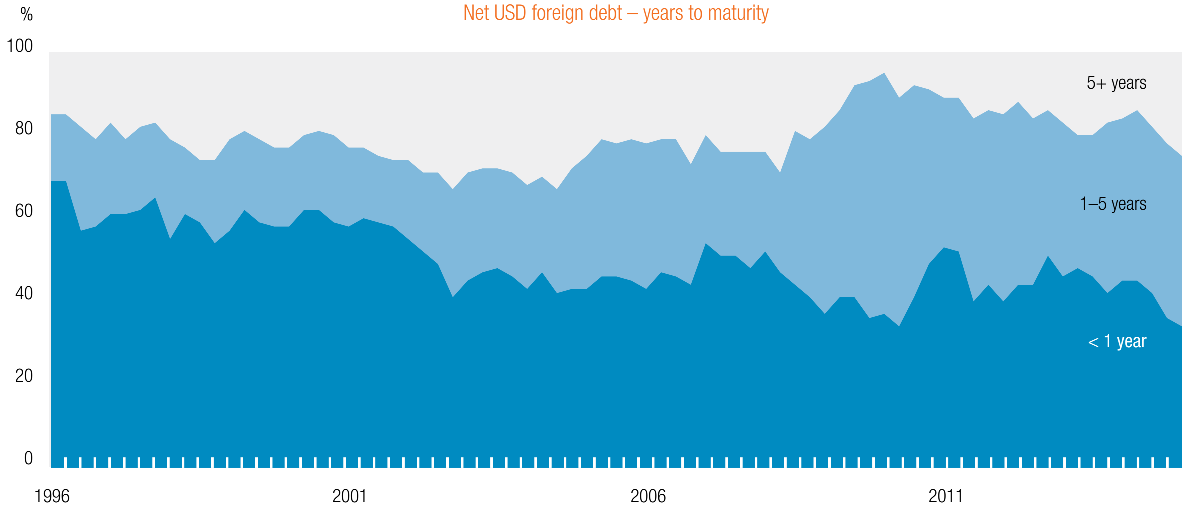
Aided by low interest rates, Australia's net foreign debt has continued to increase in recent years (see Figure 7). Much of the recent borrowing has been by non-financial corporates, making this sector more sensitive to changes in global interest rates. In contrast, Australia's banks appear to have learnt their lesson in the GFC and have substantially reduced their net foreign debt exposure; although banks' exposure to wholesale funding markets remains significant at more than 30 per cent of total funding sources.[7]

Corporates that have borrowed in foreign currency may have boosted their profit margins by taking advantage of lower interest rates abroad. There are two issues with this practice. First, as the Australian dollar depreciates, any unhedged liabilities risk growing materially or becoming unsustainable. Second, rising US interest rates will lead to an increasing cost of debt as borrowings mature and are refinanced. Three-quarters of Australia's net foreign USD debt rolls over in the next five years (see Figure 8).

In December 2015, the US Federal Reserve raised interest rates for the first time in almost a decade, but the real issue for countries like Australia with large foreign debts is how much they are raised. Currently, the Federal Open Markets Committee (FOMC) that sets US interest rates is projecting substantially higher rates than financial markets over the next few years (see Figure 9).

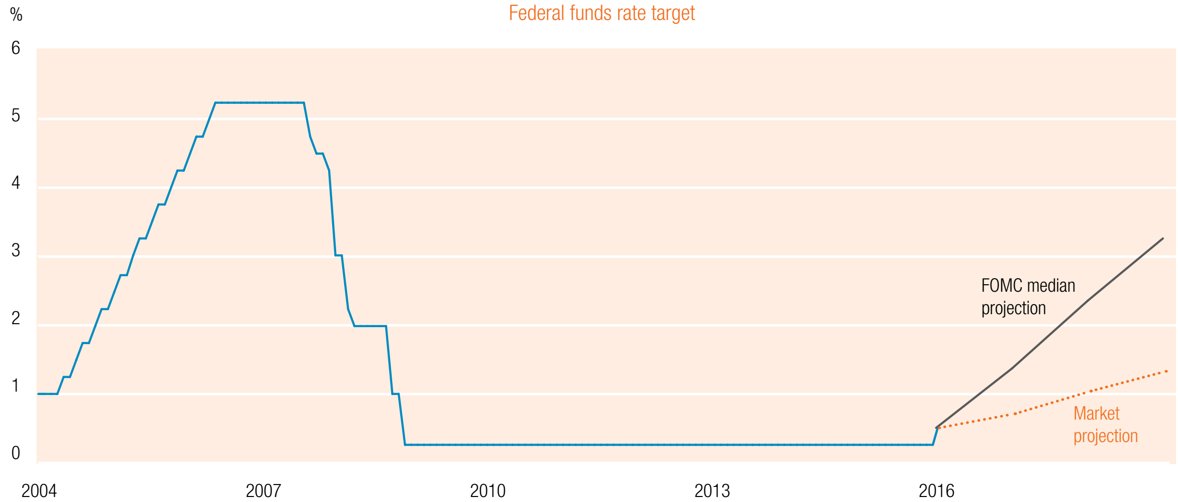
> "At present, the equilibrium real federal funds rate… appears to be well below the longer-run normal levels assessed by the FOMC."
> *Janet Yellen, Chair US Federal Reserve, 27 March 2015*

Figure 8
More than 75 per cent of Australia's USD debt rolls over in the next five years



Source: Australian Bureau of Statistics; Magellan

Figure 9
The cost of USD debt is set to rise



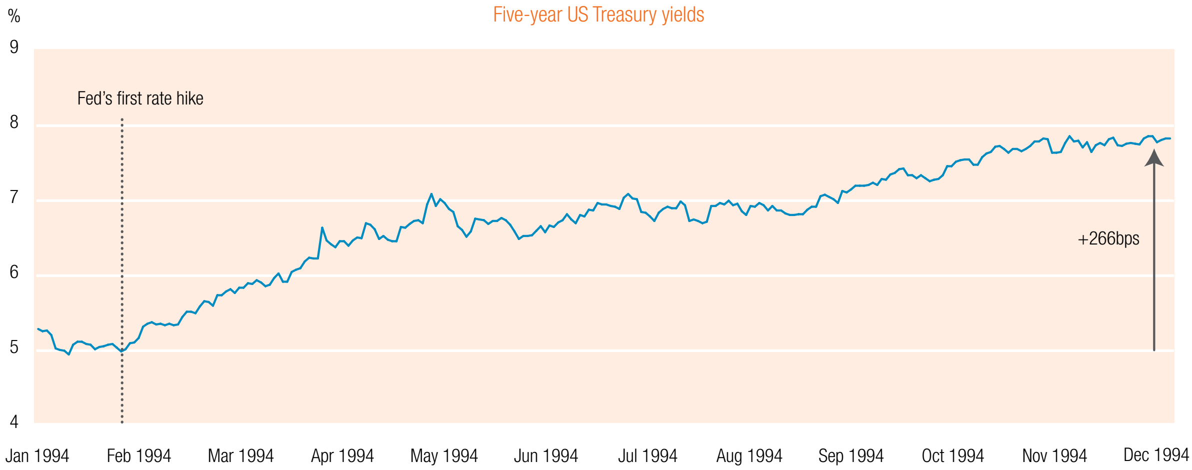
Source: Thomson Reuters; Federal Reserve; Bloomberg
Note: data as at 14 January 2016

Nobody knows how financial markets will react as the US Federal Reserve normalises monetary policy. However, it is worth remembering that in 1994 rates increased further and faster than markets were expecting. In 1994, five-year US Treasury bonds increased by more than 260 basis points (see Figure 10). This led to a tightening of global financial conditions and losses in credit and equity markets, including Australian 10-year government bonds which lost more than 20 per cent of their value (see Figure 11).

Faced with rising global interest rates and a slowing domestic economy, the Reserve Bank of Australia (RBA) may be forced into further easing of domestic monetary policy. Indeed, with the cash rate already at a historic low of two per cent, there may be limited scope for the RBA to offset further weakness in the domestic economy and/or tighter global financial conditions. Like other advanced economy central banks before it, it is not unthinkable that Australia could find its monetary policy options constrained by the zero lower bound. The big four banks

Figure 10

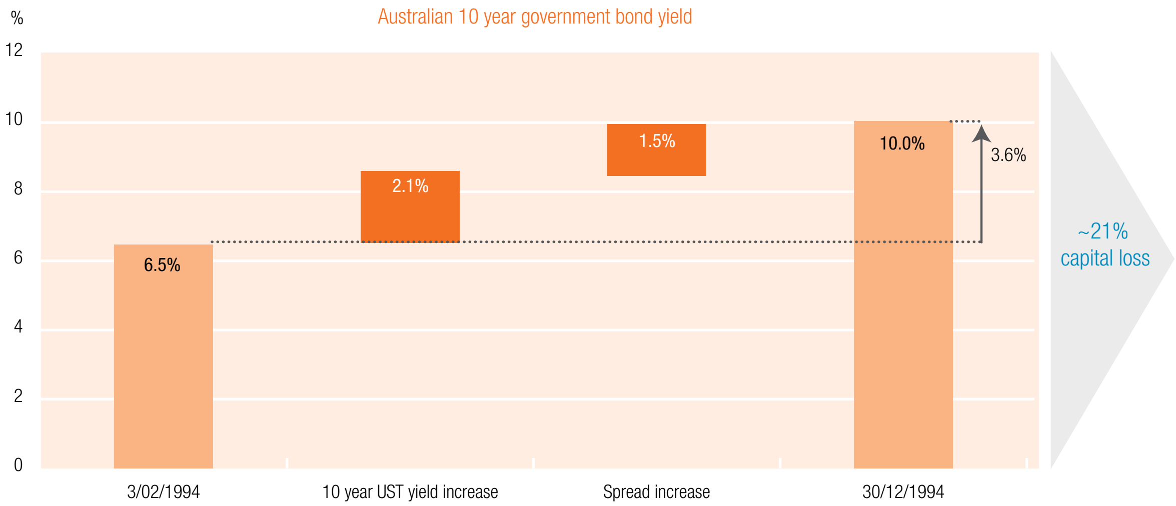
In 1994, five-year US Treasury bond yields increased by over 260 basis points



Source: Thomson Reuters

Figure 11

Australian government bond yields followed suit



Source: Bloomberg; Magellan

in Australia have recently raised interest rates on mortgage and investment loans to protect their profit margins. This may be a sign that financial conditions are beginning to tighten in a pro-cyclical way, running against the RBA's recent interest rate cuts.

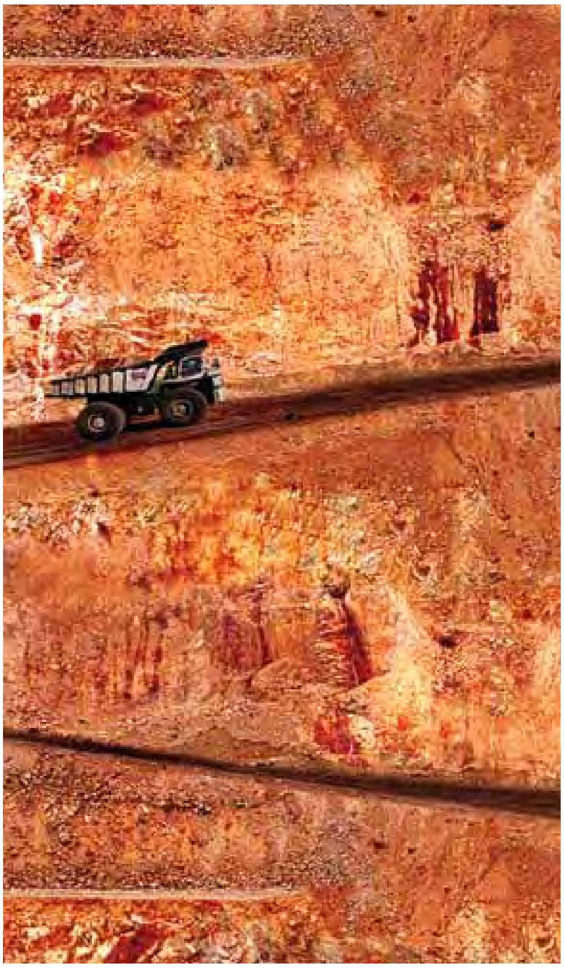
A normalisation in global interest rates, risk premiums and borrowing conditions poses a risk to Australia at a time when the economy is managing a reduction in domestic income from the falling terms of trade. The credit cycle may also be turning among Australia's major trading partners as China's economy slows. As foreign debts mature, Borrowers may face higher interest rates, which could prove problematic for countries like Australia with large foreign debts.

> "Key areas of vulnerability include high household debt, property market excesses, mining investment and the labour market."

Domestic vulnerabilities

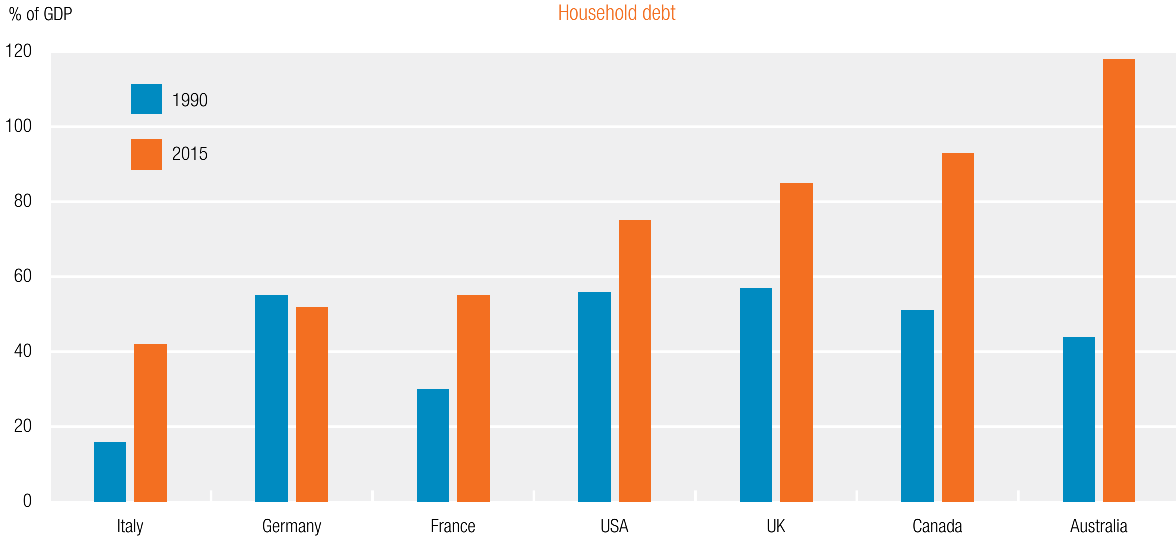
There are a number of imbalances in Australia's economy that make it vulnerable to adverse economic shocks. Key areas of vulnerability include high household debt, property market excesses, mining investment and the labour market.

Australian household finances are stretched with debt levels among the highest in the developed world (see Figure 12). Most of this debt is tied to the property market and was accumulated with the assistance of mining boom conditions that temporarily boosted household income growth. Over the past three years, the ratio of household debt to disposable income has continued to increase, from 170 per cent to 185 per cent. If Australia experiences a sharp increase in unemployment as it did in the early 1990s, if there is a general tightening of financial conditions, or if demand-supply dynamics in the housing market shift unfavourably, this could lead to defaults and forced sales, with significant consequences for the property market and financial system. Australian house prices are among the highest in the world relative to incomes.[8]



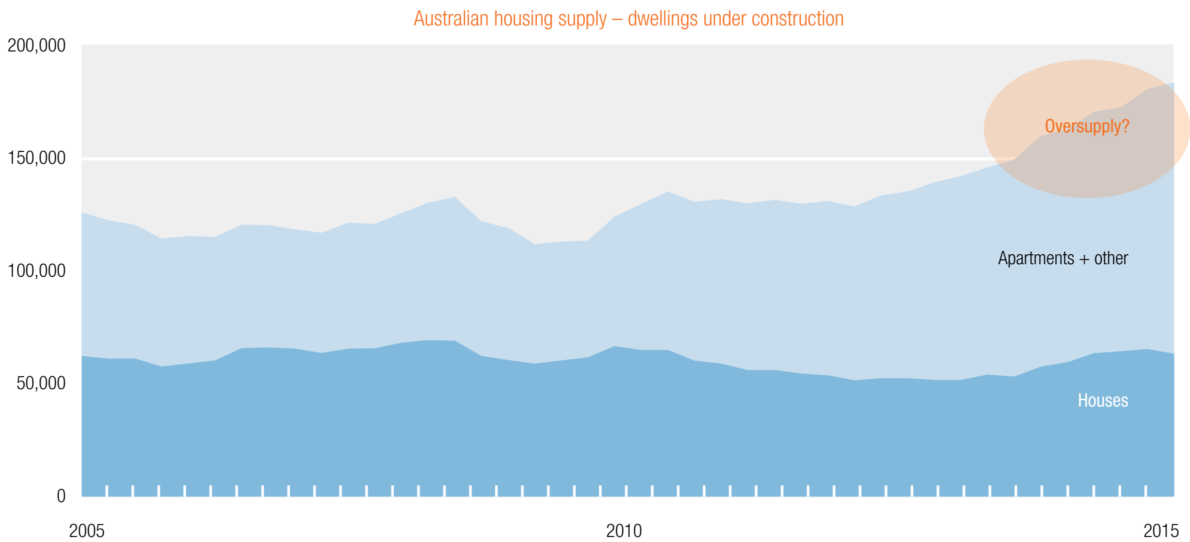
High household debt levels and property market exposures are complicated by unsustainable housing construction activity. While Australia's population growth rate has slowed in recent years to 1.4 per cent per annum, the number of homes under construction, particularly apartments, has increased significantly (see Figure 13). This activity has been largely financed by bank lending to Australian and foreign property investors (particularly Chinese).[9] A change in lending conditions, or a reversal in foreign demand potentially caused by a slowing Chinese economy, could exacerbate the excess supply problem and lead to significant falls in Australian apartment prices. The knock-on effects to the financial system and the broader economy of such an event could be substantial.

Figure 12
Australian households are among the world's most indebted



Source: Bank for International Settlements; IMF; Thomson Reuters; Magellan

Figure 13
Australia is building too many apartments



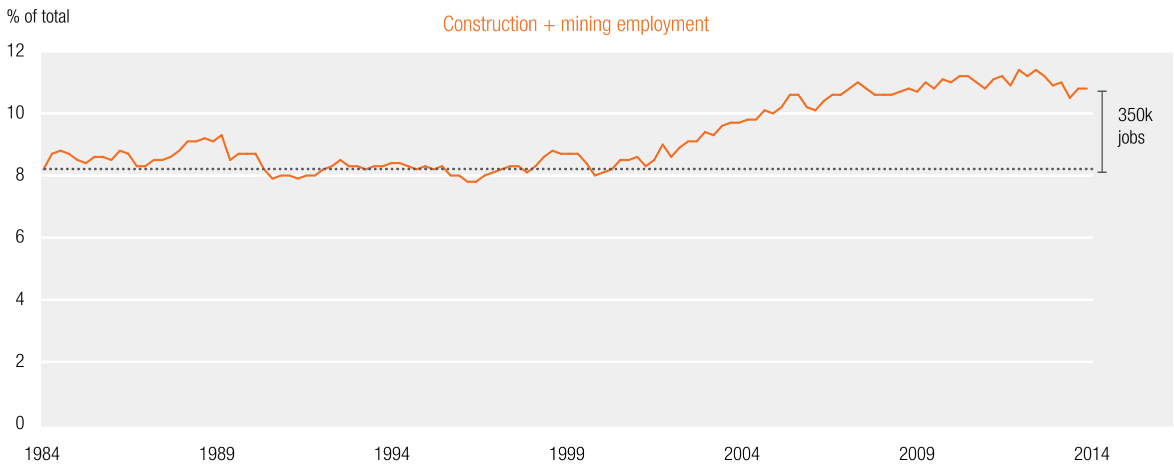
Source: Australian Bureau of Statistics

Since 2000, construction and mining increased as a share of total Australian employment (see Figure 14). A normalisation of economic conditions and a fall in employment in these industries could trigger broader job losses and even credit events among highly-geared households and businesses.

During the mining boom, capital expenditure rose significantly from an average of seven per cent of GDP from 2000–05 to 11 per cent of GDP in 2012, driven by mining investment (see Figure 15). With the terms-of-trade boom unwinding, capital expenditure has begun to decline sharply and likely has some way further to fall from its current level of around nine per cent of GDP. How quickly this will happen is unknown. A rapid fall in capital expenditure (capex) could trigger a recession, particularly if investment overshoots on the downside and if there are significant multipliers and linkages to other sectors.

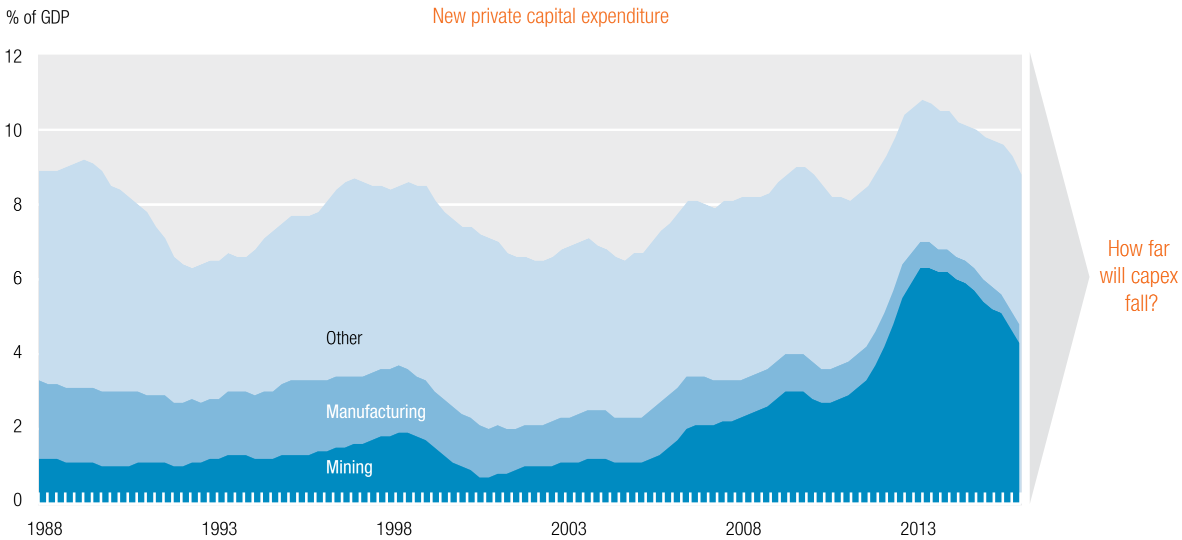
Following one of the largest terms-of-trade booms in Australia's history, it is little wonder that a number of imbalances have developed in the Australian economy. These could prove difficult to manage and, combined with global macro risks, make Australia vulnerable to a recession and house price correction in the next few years.

Figure 14
350,000 mining and construction boom jobs could be at risk



Source: Australian Bureau of Statistics; Magellan

Figure 15
Capex cycle unwind only just beginning



Source: Australian Bureau of Statistics; Thomson Reuters; Magellan

Opportunities for Australian businesses

Depreciation of the Australian dollar

The recent depreciation of the Australian dollar has significantly improved the competitive positions of a broad array of trade-exposed businesses. Sectors such as manufacturing, agriculture, tourism and tertiary education will benefit the most from this depreciation over the next few years.

Australia's real effective exchange rate (REER) and the terms of trade remain above pre-boom levels (see Figure 16). Due to the strong wage growth that occurred during the commodities boom and its impact on international competitiveness, it is possible that the Australian dollar still has further to fall or may overshoot on the downside. Commodity prices may also have further to fall given the supply-demand dynamics unfolding in these markets. Additional depreciation would provide further impetus for growth in trade-exposed sectors of the Australian economy.

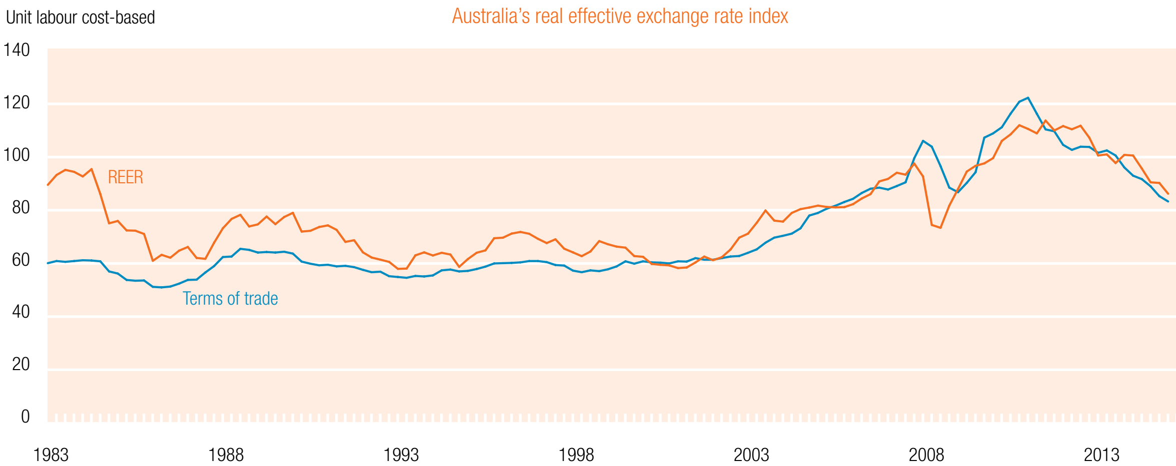
> "While population growth will not generate higher per capita incomes, it will help stimulate the economy and create opportunities for Australian businesses to grow …"

Population growth

Australia's population growth rate of 1.4 per cent per annum currently exceeds that of all other major advanced economies. While population growth will not generate higher per capita incomes, it will help stimulate the economy and create opportunities for Australian businesses to grow, all else being equal. Australia's working age population (15–64 year olds) is projected to grow by around 1.3 per cent per annum over the next 10 years.[10]

The benefits of population growth are mitigated to some extent by the impact of population ageing. The working age population peaked at 67.5 per cent of the population in 2009 and has since declined by around one per cent due to the faster growth of the 65+ age group.

Figure 16
Downside risk remains for the Australian dollar



Source: Australian Bureau of Statistics; Organisation for Economic Cooperation and Development; and Thomson Reuters

Over the past 10 years, net overseas migration has driven around 60 per cent of Australia's population growth.[11] However, there is a risk of a slowdown in migration over the next few years as the commodities boom fades, labour market conditions adjust, and other economies such as the US continue to strengthen relative to Australia. Indeed this process appears to have already commenced.

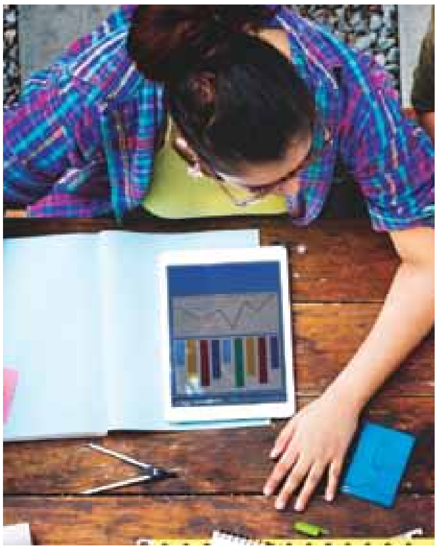
Over the longer term, Australia's high standard of living and relatively open immigration policies are likely to generate continued strong population growth, providing support for growth of the Australian economy and businesses.

Productivity growth

Productivity growth is a key long-term driver of real GDP. Although measured productivity growth has been relatively weak in recent years, global technological progress has continued. Australian businesses will have the opportunity to modernise and harness this innovation in the years ahead. New jobs will be created in as-yet unknown industries, as creative destruction takes its course and the economy evolves.

In the short term, productivity statistics can be adversely impacted by changes in aggregate demand which can provide a misleading picture of an economy's underlying capacity to innovate. Australia's measured productivity growth may continue to decline as the commodities boom unwinds and domestic incomes fall. However, a reallocation of resources to other more productive activities and the adoption of new technologies will lead to more goods and services being produced from existing inputs, in the long term. Productivity growth also relies on sufficient investment being made by business in new technologies, and physical and human capital, which will be influenced by current economic conditions.

Policymakers have a critical role to play in generating productivity growth, by undertaking appropriate reforms to attract more world-leading technology to Australia's shores, and creating the conditions for workers and businesses to flourish.



"Productivity growth also relies on sufficient investment being made by business in new technologies, and physical and human capital…"

Growth in Asia

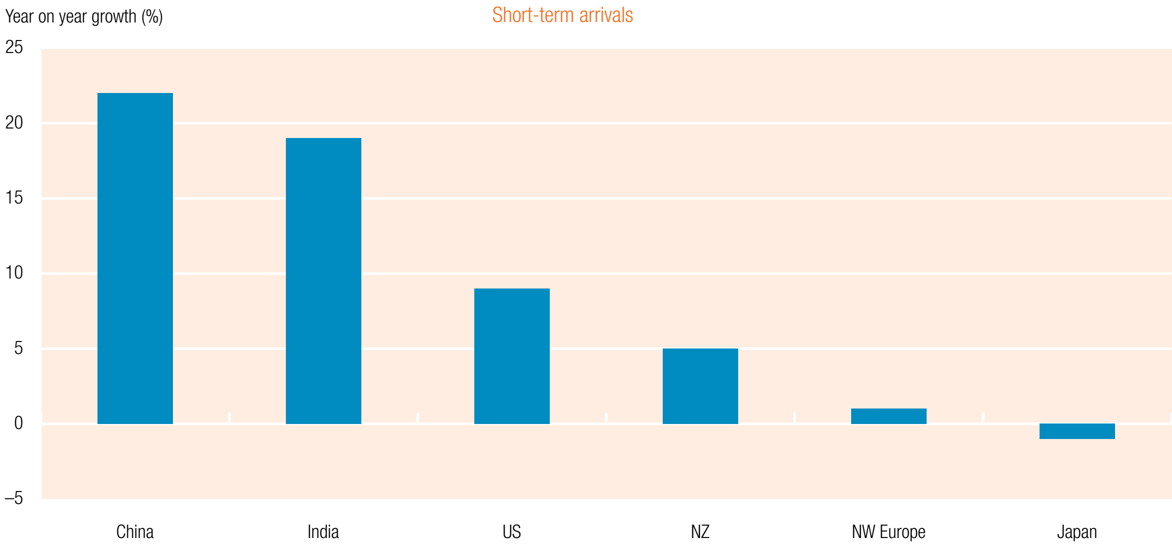
Asia accounts for around three-quarters of Australian goods exports, with the balance coming mostly from advanced economies such as the US, Europe and New Zealand. Despite the challenges presented by slowing growth in China, rising debt levels and the normalisation of US interest rates, the Asian region is likely to offer significant growth opportunities for Australian businesses over the long term.

In the next 10 years the world's population is projected to grow by 11 per cent (800 million people), and half of this growth is expected to come from Asia.[12] With the Asian region already comprising the majority of Australia's exports, Australian businesses are well positioned to benefit from this growth. Once the negative impact of commodity price normalisation fades, exports will likely resume growing as a share of Australia's economy.

Furthermore, as Asian economies develop and reform, per capita incomes will also grow. Some may continue to catch up with advanced economy income levels. As this occurs, the needs of Australia's customers in Asia will change. There will be increased demand for high quality food produced by Australia's farmers; more opportunities in tourism and financial services; and increased demand for health products and services, education and other products. For example, in recent years China and India have been sources of rapid growth in tourism (see Figure 17). Indeed there will be a broad array of new opportunities across a diverse range of businesses with an increasing focus on services.

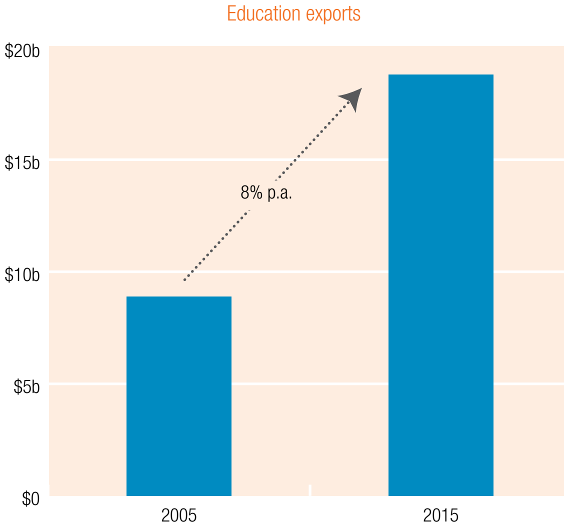
> "Asia accounts for around three-quarters of Australian goods exports, with the balance coming mostly from advanced economies…"

Figure 17
Short-term arrivals from China and India are growing very strongly



Source: Australian Bureau of Statistics; Magellan
Note: Data based on year to September 2015.

Figure 18
Education exports have grown in importance



Source: Australian Bureau of Statistics; Magellan

Education exports have grown strongly over the past decade (see Figure 18) and have become Australia's third largest export after iron ore and coal. Asian countries account for nearly 80 per cent of Australia's education exports.[13] Australia has the advantage of being a multicultural nation and is located closer to Asia than most of its Western competitors. In the years ahead, these advantages will benefit the education sector and other outward-oriented Australian businesses.

Policy

With challenging times ahead, additional policy stimulus may be needed to generate stable growth as the Australian economy adjusts to the end of the mining boom. However, with the government sector already in deficit (two per cent of GDP), and the RBA cash rate having been cut substantially from over seven per cent in 2008 to two per cent, there may be limited options to stimulate the economy with traditional tools. This increases the urgency of a comprehensive reform agenda to boost productivity, stimulate investment and create new opportunities for Australian businesses.

Priority areas for reform include:

- Tax system reform to stimulate business investment, reduce unproductive investment (e.g. housing), encourage saving, and enable a more efficient allocation of resources.
- Infrastructure investment to improve the productivity of Australian workers, businesses and households.
- Education investment to increase the productivity of the future Australian workforce and boost the world ranking of Australian universities to attract more high paying foreign students.
- A technology strategy should be at the heart of Australia's productivity agenda. Small open economies, such as Ireland and Singapore, have significantly raised their incomes and living standards by developing and attracting high-tech businesses.
- Workforce participation measures to encourage experienced workers to stay in the workforce longer and to attract more women into the workforce.

Conclusion

The end of the mining boom poses a major challenge for the Australian economy. Household incomes and living standards have fallen with the terms of trade. Global risks such as a slowing China and the normalisation of US interest rates are complicating the post-boom adjustment process and could lead to slower growth or a recession for Australia. A number of domestic imbalances, specifically high household debt, property market excesses, elevated construction and mining employment, and the unwind of the mining investment boom, make the Australian economy vulnerable to adverse shocks in the short to medium term. Over the longer term, Australia has a number of areas of opportunity that could drive sustained economic growth long after the mining boom fades. Intelligent policy decisions, if made, could make a significant difference to Australia's prospects in the years ahead.

The views in this article are those of the author and should not be attributed otherwise.

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Endnotes

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4 NBS
5 IMF
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9 Business Spectator
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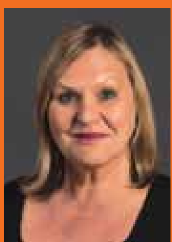
11 ABS
12 UN
13 ABS

Achieving stronger growth



Lisa Gropp joined the Business Council of Australia (BCA) as Chief Economist in January 2014. She came to the BCA from the Productivity Commission, where she most recently served as First Assistant Commissioner and Principal Adviser, Research. Lisa joined the Productivity Commission in 1998, taking a lead role in a number of Productivity Commission inquiries, including into carbon policy emissions in key economies, executive remuneration in Australia, road and rail freight infrastructure pricing and impacts of medical technology.

Prior to joining the Productivity Commission, Lisa was a Research Fellow at Monash University as well as holding ministerial advisory positions. She studied economics at both Melbourne and Monash Universities.

Introduction

Economic growth is the bedrock of Australian living standards and civil society

Economic growth is a means to an end. It is the bedrock of the high living standards Australians enjoy and delivers the capacity to support people in the community who are disadvantaged. In short, growth is the prerequisite for a well-functioning, creative and compassionate civil society.

Australia has seen almost 25 years of uninterrupted output growth which has increased living standards across the community. Relative to other industrialised countries, Australia continues to perform well but we cannot be complacent about the future. Economic fortunes can turn remarkably quickly.

The Australian economy is facing extraordinary challenges … and opportunities

All economies face continual challenges and Australia is no different.

The Australian economy is adjusting to the largest fall in the terms of trade in 50 years and the end of the mining investment boom. With the terms of trade reverting to pre-boom levels, real income per head has fallen since 2013. During the year to June 2015, real gross domestic product (GDP) growth weakened to two per cent, well below its long-term average of 3.5 per cent. While a lower exchange rate will facilitate the transition, depreciation will need to flow through as real reductions in costs – a real depreciation – to lift competitiveness and growth.

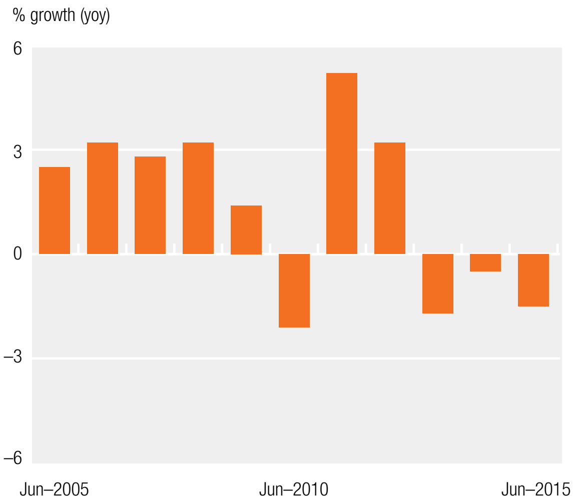
Like many industrialised countries, our population is ageing. One-in-five Australians will be 65 years or older by 2055, compared with one-in-seven today. An ageing population will drive increased government spending in health, aged care and age pensions while reducing labour force participation and thus the capacity to pay for that higher spending.

Without action to slow spending growth, ageing is projected to generate increasing structural deficits over coming decades. Moreover, our current starting point is a structural deficit of around three per cent of GDP, and ageing is not the only source of spending pressures. The 2015 Intergenerational Report projects real spending growth of 3.1 per cent annually over the coming decades while GDP is projected to grow at about 2.8 per cent, well below the long–term trend. Both the Treasury and the Reserve Bank of Australia (RBA) have signalled that we are facing the prospect of a step decline in trend growth.

Like the rest of the world we are also facing great challenges, uncertainties and opportunities from rapid technological advances. Technology has long driven structural change but today's pace of change is arguably unprecedented. Digitisation is disrupting business models and corporate structures and fragmenting global supply chains. Large parts of the services sector, up until now categorised as non-tradeable, are being exposed to direct international

Figure 1

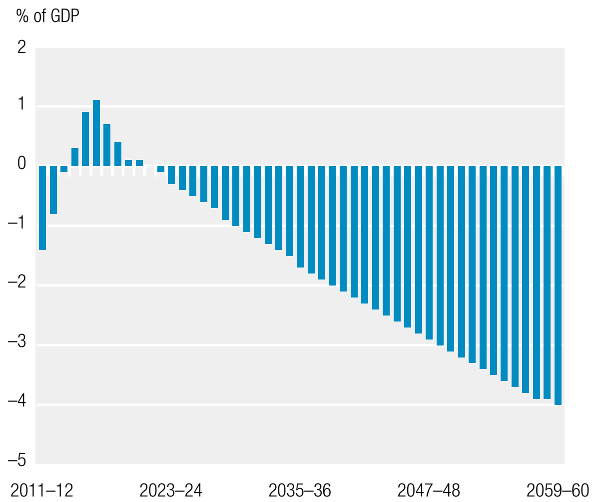
Real income per head is falling



Source: Australian Demographic Statistics (cat. no. 3101.0) and ABS projections

Figure 2

The Commonwealth fiscal gap is projected to widen



Source: Productivity Commission http://www.pc.gov.au/research/completed/ageing-australia#data competition. These forces are fundamentally changing how and where we produce, sell, work and consume, and challenging our regulatory and taxation structures as well as how well we measure our economic performance.

There are, and will be, numerous other challenges from shifting global economic forces, including in our largest export market, China. While higher domestic consumption in China will open up new opportunities for Australian exporters, they will face intense competition from other global suppliers.

In short, the only certainty is that change is inevitable. What is critical is the way we respond – whether we embrace and adapt to change, or misdirect our energies vainly trying to fend it off. The only durable strategy is to build a strong and resilient economy, an economy that is agile, flexible and innovative enough to adapt to economic shocks, positive or negative.

Australia's future economic growth will go hand in hand with productivity growth

Aside from serendipitous increases in the terms of trade, real per capita incomes can only be increased by producing more valued output per person. Essentially this requires using and allocating our scarce 'endowments' more effectively – that is, our natural resources such as our minerals and land, our human capital (our people) and our physical or built capital. Growth comes from increasing and improving our human and physical capital and innovating to produce existing goods and services more efficiently or to develop new ones (improving multi-factor productivity). More often than not, investing and innovating are complementary and drive a virtuous circle.

Multi-factor productivity is about doing things better

MFP captures the extent to which we are doing things better (the efficiency of production). It is measured as residual output growth after controlling for changes in all factor inputs. In this sense it is output growth that cannot be 'explained'.

MFP growth can be the outcome of many things, including spillover benefits from technological advances and inventions, the application of science and knowledge, learning by doing, operational efficiencies, and greater specialisation.

"… labour productivity will need to become an even greater driver of income growth, as the positive influence of the terms of trade on our incomes is reversed."

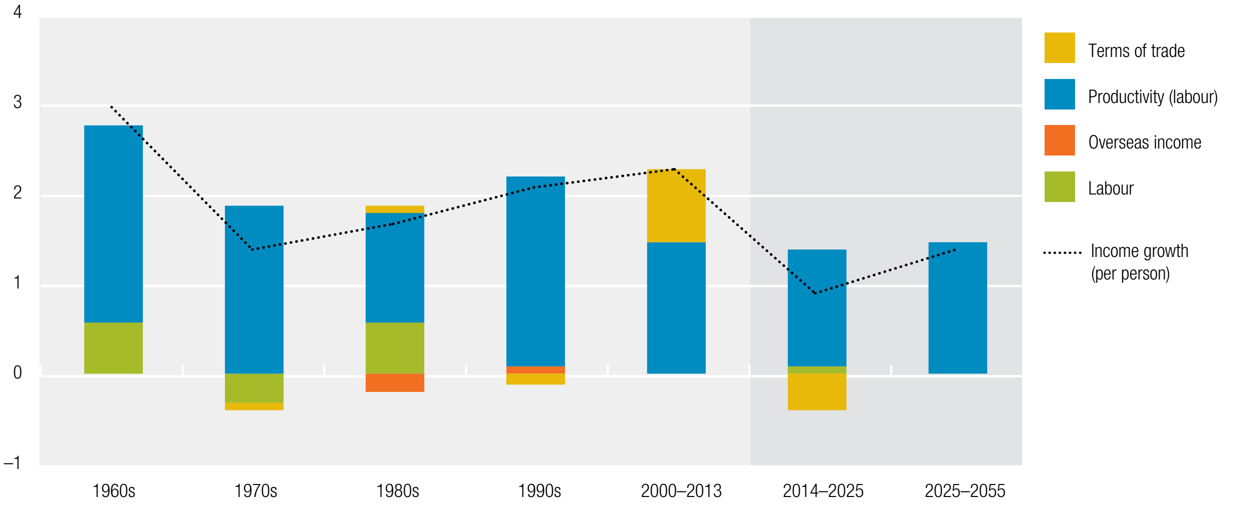
Capital deepening and innovation will be major drivers of future growth

Labour productivity has been far and away the single most important driver of Australia's economic growth, accounting for more than 80 per cent of the improvement in measured living standards over the last 40 years. Going forward labour productivity will need to become an even greater driver of income growth, as the positive influence of the terms of trade on our incomes is reversed.

Labour productivity growth comes from the combination of capital deepening (investment) and multi-factor productivity growth (MFP). But as noted earlier, business investment has been depressed and the short-term outlook remains weak.

Figure 3

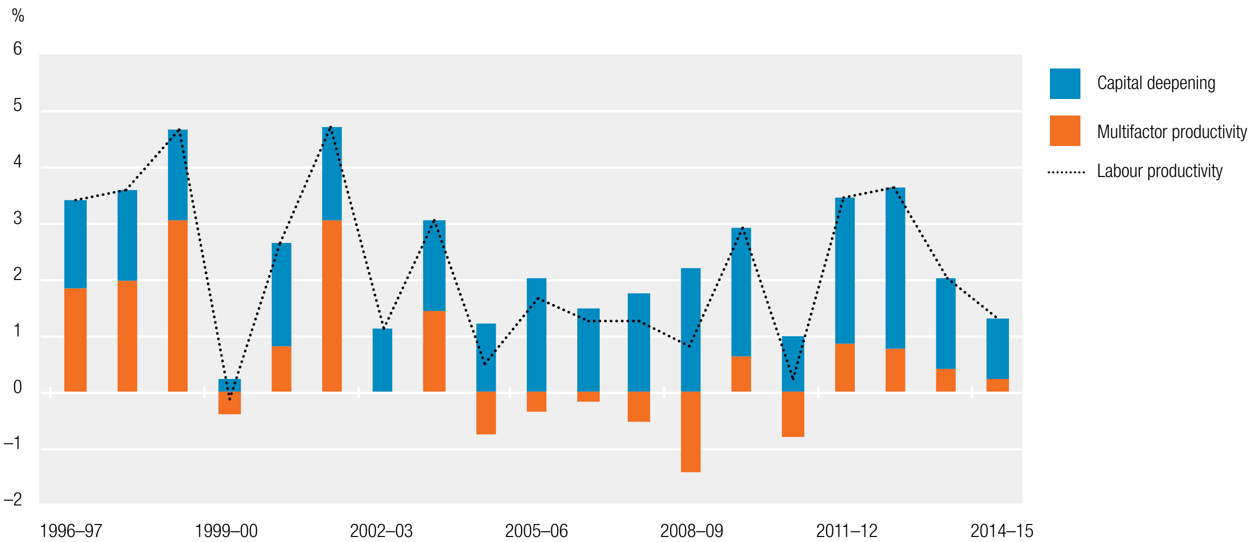
Labour productivity is the main driver of income growth



Source: Australian Tax Office http://bettertax.gov.au/publications/discussion-paper/chart-data/chpt1/

Figure 4

MFP growth has slowed



Source: ABS 5260.0.55.002 Estimates of Multifactor Productivity, Australia; ABS 5204.0 Australian System of National Accounts

Multi-factor productivity growth (for the market sector) has improved in recent years following many years of measured decline during the mining boom (in part reflecting unusually large investments in that sector which skewed estimates). However, it still remains flat. Labour productivity growth, the main determinant of real income growth per capita in the long run, has performed better than MFP because of investment, but has been volatile.

Increased labour inputs, including from increased labour force participation, also contribute to per capita income growth, although historically their contribution has been less than that of productivity and there are natural limits to who can work and for how long. With an ageing population, the policy challenge will be to slow the inevitable decline in aggregate workforce participation by removing barriers to people entering and remaining in employment.

Policy priorities for growth

There is no single policy lever to increase productivity and growth. Productivity ultimately depends on how efficiently individual enterprises produce goods and services that consumers in Australia and abroad want to buy. This in turn depends on how innovative these enterprises are, and how much and where they invest. The cold reality is that productivity improvement requires ongoing and unrelenting effort.

Productivity growth is inextricably linked to the search for profits and associated investment and production decisions by enterprises and individuals. People in enterprises must make decisions every day including about what and how much to produce, how many people to employ, what technology to use and whether or not to invest in the context of incentives provided by markets, taxes, regulations and institutions.

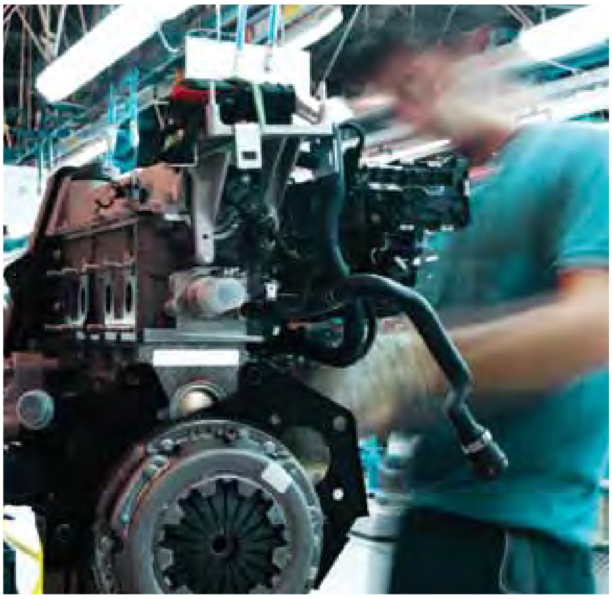
While people in enterprises ultimately drive productivity, governments play a pivotal role in either helping (or hindering) it.

Getting the incentive framework right

One of the most important roles of government is setting the right incentive framework. The 'rules of the game' must create (and not blunt or destroy) the right incentives and price signals for individuals and firms to make privately and socially efficient production, consumption and investment decisions. Put bluntly, this means that rewards should come from socially productive endeavour rather than rent seeking or political favour. Robust and transparent political, legal and economic institutions are thus vital prerequisites for a strong, agile and resilient economy that serves the interests of the wider community.

Competitive dynamics are crucial for growth. Open, competitive markets combined with profit-seeking form a potent mix that drives innovation and entrepreneurship, firm entry and exit. Competition also ensures that productivity gains are shared amongst consumers, workers and producers as real income gains. Competition and market prices that reflect private and social costs also ensure that productivity gains translate into improvements in community wellbeing.

Market incentives are heavily influenced by laws, regulations, taxes and subsidies. Such interventions are clearly necessary to achieve a range of social goals including through influencing behaviour, by redistributing income and by funding public goods. However, it is essential that they are designed to deliver maximum community benefits without unnecessarily discouraging productive, growth-enhancing activity or constraining healthy competition.



"People in enterprises must make decisions every day including about what and how much to produce, how many people to employ, what technology to use…"

Enabling enterprises to be productive

Enterprises must also have the flexibility to adapt in the face of opportunities and challenges. All regulation needs to strike the right balance between providing legitimate safeguards and enabling enterprises to be agile, efficient, innovative and willing to take risks. Ill-conceived regulations and taxes can impose large costs by obstructing efficient production choices and adjustment. Regulations can impede competitive pressure and the ability of enterprises to respond to it.

To take advantage of new opportunities and implement innovative technology or systems, employees and employers also need to have the capabilities to make changes. Well-designed policies to correct private underinvestment in R&D, education and skills and public infrastructure and planning can enable productivity gains and drive growth.

Governments as service providers

Governments directly influence productivity and growth as providers of social services and public goods. To achieve more productive government services, governments need to rigorously and routinely examine their spending priorities and program design. Fiscal discipline should be about getting the best value from our scarce resources. It is critical that the value of government spending to the community exceeds the value of its best alternative use – its opportunity cost – whether that is in the private or government sectors. Otherwise we are simply wasting precious resources and unnecessarily constraining growth and living standards.

"Governments directly influence productivity and growth as providers of social services and public goods."

Key components of an incentive framework for growth

A competitive tax system to encourage investment and entrepreneurship

Tax reform must be about driving greater economic efficiency and growth. If it doesn't deliver productivity and growth (or indeed risks reducing it) it is not worth doing. Real tax reform must first and foremost be economic reform.

A more efficient tax system should also provide a more sustainable revenue base. But tax reform must not be about increasing revenue of itself. Increasing revenue to fund growing expenditure without looking to improve the efficiency of spending would impose an additional burden on the economy for uncertain benefits at best and, at worst, underwrite wasteful spending.

Taxes impose costs on the economy because they change behaviour. Australia's tax system is inefficient because it relies too heavily on taxes that discourage highly valuable activities and thus effectively waste scarce community resources:

- High marginal personal income tax rates discourage some people from working or from working additional hours and from investing in skills improvement. High effective marginal tax rates discourage people receiving transfer payments from taking up employment opportunities.
- Australia's 30 per cent company tax rate is out of step with many other countries (Asian economies in particular, where the average is 22 per cent.) This makes investing in Australia relatively unattractive at the margin. And the margin arguably is becoming increasingly competitive as the costs of exchange are lowered by new technologies.
- High taxes on transactions such as property sales and insurance discourage valuable activity and impede labour and business mobility.

Rebalancing that tax system towards broad-based taxes with lower rates would relieve the burden on investing, risk-taking, entrepreneurship and working. Primarily this requires reducing our reliance on relatively high-cost personal and company income taxation to greater use of less distorting taxes such as the GST.

The Business Council believes that cutting the company tax rate to 25 per cent at a minimum will be essential for making Australia a more attractive destination for investors. More investment will generate a higher capital stock, higher labour productivity and higher real incomes. Capital investment also leads to higher technological innovation and MFP. Treasury estimates indicate that reducing the company tax rate to 25 per cent would reduce its excess burden by around 20 cents per dollar collected.

At the same time, strenghtening the transparency of integrity measures would give the community confidence that everyone is meeting their obligations.

Future orientated workplace relations

The nature of enterprises and jobs is changing. Traditional firm structures are under challenge with digital technologies enabling more dispersed, atomistic, competitive provision and ad hoc, fluid alliances.

Australia needs a workplace relations system that facilitates these changes rather than stymying them.

The Productivity Commission draft report into the workplace relations framework is a significant piece of work, and the draft recommendations and focus on establishing a safety net should not be recontested. However, the final report needs a much more extensive reform agenda, with an emphasis on repairing modern awards and agreement making.

Awards need to be streamlined to the core purpose of establishing a floor of wages and conditions, and the number of awards needs to be reduced.

Agreement making needs to establish collaborative rather than combative relationships. We need a clear set of rules that specifies what can be included in agreements, and workers and enterprises should be able to choose to negotiate an individual agreement.

The ultimate test for reform in this area is whether the proposals will create a workplace relations system that drives collaboration, innovation, and ultimately, productivity – the key to job creation and wage growth.

More efficient and effective regulation

The cumulative burden of regulation on business is very large. It directly adds to production costs but arguably of even greater concern, deters innovation and entrepreneurship.

The Business Council strongly supports measures to improve the efficiency and effectiveness of regulation. Although the government's deregulation program has started to make significant progress in reducing the red tape imposed on business, it has focused on reducing administrative burdens. The benefits of deregulation in the future will need to be generated from the implementation of more challenging and substantive reforms, including:

- Working with the states and territories, for example, on better planning approval processes and more consistent retail trading hours or occupational licensing.
- Removing costly regulations that have not been properly scrutinised including, for example, Australian Industry Participation Plans under the *Australian Jobs Act 2013*.

"The ultimate test for refom in this area is whether the proposals will create a workplace relations system that drives collaboration, innovation, and ultimately, productivity..."

"Due to disruptive technological, global and other forces, competition is increasingly dynamic, and can come from emerging start-ups, international rivals entering the domestic market or businesses established in one sector moving horizontally into another."

An open, competitive economy

Competition is absolutely essential for productivity growth and maintaining Australia's high standard of living. Effective competition generates benefits for consumers, businesses and the economy through lower prices, greater choice, increased innovation and improved productivity.

Due to disruptive technological, global and other forces, competition is increasingly dynamic, and can come from emerging start-ups, international rivals entering the domestic market or businesses established in one sector moving horizontally into another.

Priorities for facilitating competition should be:

- Agreement by all levels of government to progress competition policy reform across jurisdictions. The Government's acceptance of the majority of the recommendations set out in the 2015 Competition Policy Review provides an extensive reform agenda that will be transformational in delivering benefits to consumers, businesses and the economy.
- Enabling international competition, including through bilateral and multilateral trade negotiations. Reduced tariff barriers increase domestic competition, while providing greater market access for internationally competitive Australian firms.
- Foreign investment policies that signal Australia's openness to productive direct investment. Recent reductions in the screening thresholds for agribusinesses and agricultural land, risk reducing investment in sectors that need foreign capital, knowhow and global supply chain linkages to reach their full potential.
- Maintaining a stable competition law framework that provides clarity and certainty when vigorously competing, while addressing anti-competitive behaviour. The 2015 Competition Policy Review, chaired by Professor Ian Harper, recommended changes to Section 46 of the *Competition and Consumer Act 2010* governing the 'misuse of market power', which would hinder rather than support this objective. The proposed changes are too broad and risk capturing pro-competitive conduct and chilling business innovation and investment, ultimately harming economic growth and consumer welfare.
- Ensuring regulation or other government interventions do not impede competition, especially where technology or other developments may have made legacy regulation obsolete or no longer fit-for-purpose. Continuation of the deregulation agenda will assist with this.
- Introducing more competition and contestability in the provision of government services – including healthcare – to improve consumer outcomes and delivery efficiencies.

"A number of preconditions will enhance the productivity and liveability of cities, including good transport design, efficient and competitive planning systems…"

Capabilities to build a productive society

A skilled workforce for a dynamic economy

A well-functioning Vocational Education and Training (VET) sector is fundamental to delivering a skilled and adaptable workforce. Australia's education and skills systems need to enable people to realise their full potential and be able to adapt to and keep pace with changes in the economy. But the VET system as it currently stands is not up to the task.

The Business Council believes Australia needs to develop a tertiary education system that meets the needs of the 21st century. Such a system would:

- Deliver high-quality skills development to people across all stages of their lives.
- Give people an entitlement to a level of government support, be it in VET or higher education, and ensure that both sectors are equal.
- Ask people to make a personal contribution to their education that can be deferred through an income contingent loan.
- Give students the choice about what they study and where.
- Ensure strong enforcement of quality standards to deliver high-quality education by both public and private providers.

Efficient infrastructure

Infrastructure can provide an important platform for supporting economic growth. But, as for any investment, productivity improvements will flow only if the benefits of the services provided outweigh the costs. Sound processes for public infrastructure decision-making are critical. Infrastructure Australia should bring forward the publication of the new infrastructure priority project list in its forthcoming 15-year plan. Planning approvals processes should be reformed to adopt the 'one agency, one assessment, one approval' model to encourage more private sector investment and reduce costs.

Efficient infrastructure provision and use should be promoted through better infrastructure regulation. Cost-reflective pricing models should be implemented to provide incentives for the efficient use and allocation of road and water infrastructure. Regulatory barriers that prevent, limit or make difficult the efficient use of infrastructure should be removed, simplified or avoided (such as the proposal for a curfew for the Western Sydney airport).

Infrastructure procurement models should promote efficient allocation of capital. Infrastructure procurement should be well-informed, through a clear needs assessment and the mandatory use of independent cost-benefit analyses. Alternative approaches that efficiently augment the capacity of existing infrastructure, including through the application of technology, should be applied where possible.

Governments should adopt asset governance models that encourage the efficient management of capital. Where possible, governments should seek to move towards corporatisation and then privatisation of infrastructure as a means to increase the efficient operation of the asset. Regulatory structures can help ensure that service standards and other community expectations are met.

Cities that enable collaboration, creativity and innovation

Well-functioning cities are key drivers of prosperity. A number of preconditions will enhance the productivity and liveability of cities, including good transport design, efficient and competitive planning systems, the extent to which cities encourage innovation, sufficient and affordable housing and high-quality environments, communities and amenity.

Collaboration on cities management will be required between government portfolios, across different levels of government and with the private sector and the community.

As a first step, the Commonwealth government should:

- Establish early its vision for Australia's cities and the parameters for the Commonwealth's policy role in relation to state and territory governments and local councils.
- Prioritise the Commonwealth's role around the funding of infrastructure in cities that enhances productivity and workforce participation.
- Focus on working with the states and territories on better strategic planning, a reinvigorated approach to design and liveability and getting institutional settings right.
- Work with states and territories to improve the efficiency and competitiveness of planning systems (as recommended by the Competition Policy Review and the Productivity Commission), and move all jurisdictions towards a best practice model.

A more productive and innovative government sector

Improving program delivery and effectiveness will lift public sector productivity and have a dividend of slowing the growth trajectory of major spending areas to strengthen the budget. Spending redesign can also be achieved in a way that is consistent with improving outcomes for consumers.

Without action, anticipated increases in program outlays beyond the forward estimates could see the Federal deficit entrenched at three per cent of GDP (around $50 billion in today's terms). An ongoing deficit of three per cent of GDP would mean (in today's terms) around $50 billion additional debt each year and increasing interest payments to service it.

This would not only jeopardise Australia's AAA credit rating with consequences for investment and productivity across the economy, but higher debt interest payments will constrain our capacity to provide services, potentially triggering blunt and inequitable rationing of services and cuts in base entitlements.

In its 2015–16 Budget submission, the Business Council called on the government to commit to a 10-year progressive, transparent review and restructure of major expenditure programs to ensure that programs have sound objectives, are effective and are delivered as efficiently as possible. The overarching objective should be that programs deliver maximum community benefits and value for money. The focus must be on consumers and outcomes, supported by greater transparency and information and a culture of evaluation to identify what works.

There is substantial scope for efficiencies in service delivery through the use of technology and better targeted, evidence-based spending. Market-based approaches including private sector delivery and competition have the potential to promote innovation, improve quality and reduce costs. A transparent **evaluation culture** is critical – knowing what works and why is essential in designing successful policies, and for accountability.

Lining up all the ducks

This priority list is large but not exhaustive. An added degree of difficulty in many areas, not explicitly discussed, is that of roles and responsibilities, and alignment of incentives across the Federation.

The list nonetheless highlights the scope for growth-enhancing reforms that would be fiscally neutral or even positive in the short term. Over the medium to longer term, higher growth would deliver a revenue dividend that could fund lower taxes, additional spending or government saving.

Implementing reforms as a package will be critical as the pay-off from the whole will exceed the sum of the individual parts because of the synergies and interconnections between them.

The views in this article are those of the author and should not be attributed otherwise.

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MAI Capital

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Metro Trains Melbourne

Mitchell Institute

Monash University

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