economic and political overview

2019

committee for economic development of australia

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About this publication
Economic and political overview 2019

ISSN: 0813-121X

DESIGN Robyn Zwar Design

PHOTOGRAPHY:

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About CEDA

CEDA – the Committee for Economic Development of Australia – is an independent, not-for-profit membership organisation. We identify policy issues that matter for Australia's future and pursue solutions that deliver better economic, social and environmental outcomes for Australia.

CEDA's cross-sector membership spans every state and territory and includes more than 780 of Australia's leading businesses, community organisations, government departments and academic institutions.

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The content in the *2019 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 report authors as well as business and political leaders.

committee for economic development of australia

Contents and contributors

Foreword

CEDA's 2019 *Economic and Political Overview* (EPO) looks back at the economic and political events that shaped 2018 as well as looking ahead to 2019. A new addition for 2019 is an overview of policy and how it relates to economic and political outcomes. Issues are explored through both a domestic and international lens.

The launch of the EPO has been the traditional start to CEDA's annual research and events program for more than three decades. Of all the EPOs CEDA has compiled, there's arguably never been an edition produced in an atmosphere of such high level global economic and political uncertainty.

As we went to press with this report, a new US Congress is in place with talk of possible impeachment for President Donald Trump while the record government shutdown continues. Having failed to secure passage of her preferred Brexit deal, and surviving both a move on her leadership and vote of no confidence in her government, UK Prime Minister Theresa May is putting together a Brexit 'Plan B'. Across Britain and Europe, ongoing protests against economic policies are causing considerable social unrest. And questions around the strength of the Chinese economy abound.

Against this backdrop of global turbulence, Australia rolls into a year of considerable domestic uncertainty. In 2018 we saw another change of Prime Minister with the ousting of Malcolm Turnbull, the National Energy Guarantee failed to get off the ground and the Government lost its slim majority in parliament. Independents have gained greater influence in policy-making as an increasingly disillusioned electorate turns away from major parties. Political journalist Karen Middleton notes in this report that the Government has a messaging challenge if it is to avoid defeat at the election, widely tipped to take place in May.

On the economic front, there are predictions of a slowing in the global economy with possible implications for Australia. In a report released in late January, the IMF revised down its global economic forecast for 2018–19, projecting global growth at 3.7 per cent, down by 0.2 per cent from its April 2018 forecast.

One of the reasons noted for the downward revision by the IMF is trade uncertainty brought about by potential trade conflict between China and the US, the ripples of which could flow to Australia.

Any slowing in the Chinese economy would likely impact on Australia's economic growth. Commonwealth Bank of Australia Chief Economist Michael Blythe notes in his economic overview that downside risks to the domestic economy in 2019 have risen and a degree of pessimism has emerged about the country's economic prospects for the year ahead.

To help CEDA members understand what all this uncertainty could mean, CEDA has been fortunate to receive contributions from economists, academics and journalists who have offered perspectives from Australia and abroad. They each bring considerable expertise in their field and years of experience analysing the issues at hand.

Our 2019 EPO contributors are:

- Michael Blythe, Chief Economist and Managing Director, Economics, Commonwealth Bank of Australia
- Karen Middleton, Chief Political Correspondent, *The Saturday Paper*
- Sara James, Emmy Award-winning journalist and author
- Dr Jenny Gordon, Chief Economist, Nous Group
- Dr Hubertus Bardt, Managing Director and Head of Research at the Institut der deutschen Wirtschaft Köln (German Economic Institute)
- Dr Joseph Minarik, Senior Vice President and Director of Research, US Committee for Economic Development
- Associate Professor Jane Golley, Acting Director, Australian Centre on China in the World, Australian National University

As usual, CEDA will conduct a series of events across Australia to further explore the issues raised in the EPO. I look forward to continuing these important conversations with CEDA members at our EPO events and throughout 2019.

Melinda Cilento
Chief Executive
CEDA

1 Economic overview

Michael Blythe

Michael Blythe is the Chief Economist and Managing Director of Economics at the Commonwealth Bank. His extensive experience as an economist reflects more than 30 years working in economic policy and financial-market-related areas. Michael's role encompasses monitoring, analysing and forecasting trends in the Australian economy and financial markets. In addition, he prepares a wide range of research material on matters of current interest. In his capacity as the CBA's Chief Economist, he is a regular conference presenter and media commentator on major economic developments and themes.

Australia in 2019: Risks and issues

- 2018 was supposed to be a year of transition to above-trend growth for the Australian economy.
- That outcome is still possible in 2019 but down-side risks have lifted.
- Uneven global growth, central bank actions, geo-politics, high household debt and falling house prices are the main risk sources.

Rearview

Views on Australian economic prospects waxed and waned during 2018. Growth concerns lifted in tandem with the rest of the world towards the end of the year. But 2018 delivered another decent set of outcomes for the Australian economy (Figure 1).

The economy looks to have grown by 2.75 to three per cent in 2018. That outcome is:

- not far from expectations at the start of the year
- at the top end of the 2.1–2.8 per cent outcomes over the previous five years
- a match to the consensus estimate of Australia's potential growth rate (of 2.75 per cent per annum).

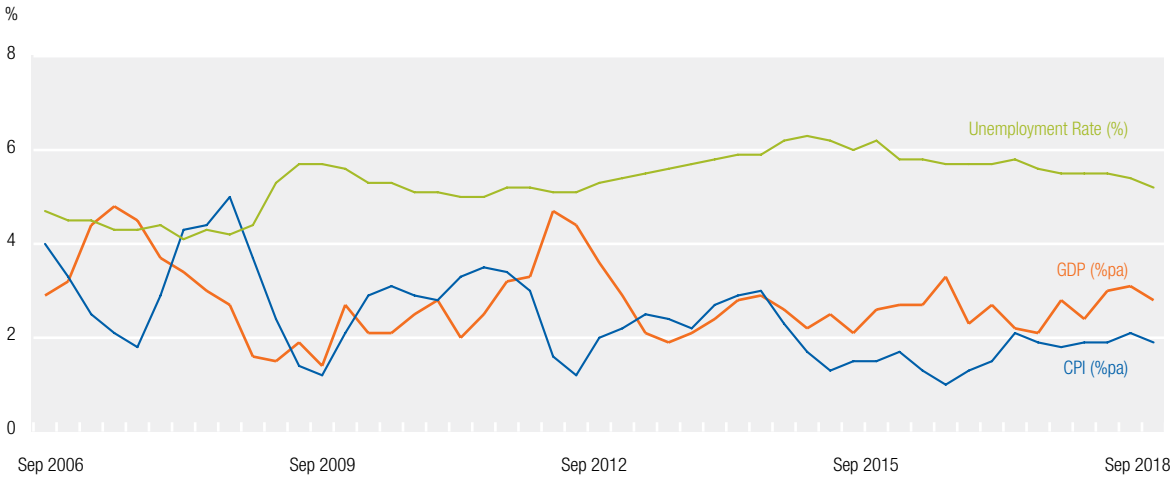
Growth was strong enough to drive a significant improvement in the labour market. The unemployment rate ended the year near the five per cent level typically equated with 'full employment'. There was a hint of a turn in the wages story, but inflation rates remained low.

Commodity prices defied the consensus again and the nominal economy (or incomes) benefited. But, as in 2017, the distribution of income growth remained skewed towards profits and taxes. Household incomes remain contained. (Figure 2)

The regulators declared victory in their attempts to remove some of the risks to financial stability. But the accompanying weaker credit growth and falling dwelling prices have emerged as significant risks for 2019.

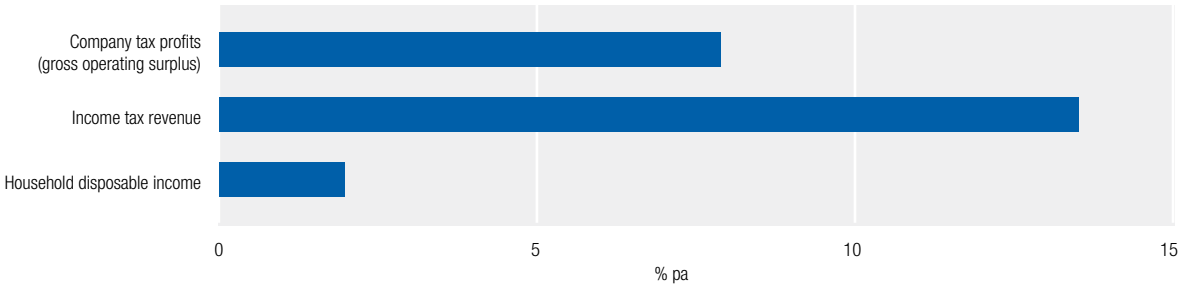
"The economy looks to have grown by 2.75 to three per cent in 2018."

FIGURE 1
Australia key indicators



Source: ABS

FIGURE 2
Income measures in 2018 (Annual percentage change)



Source: CBA/Department of Finance/ABS

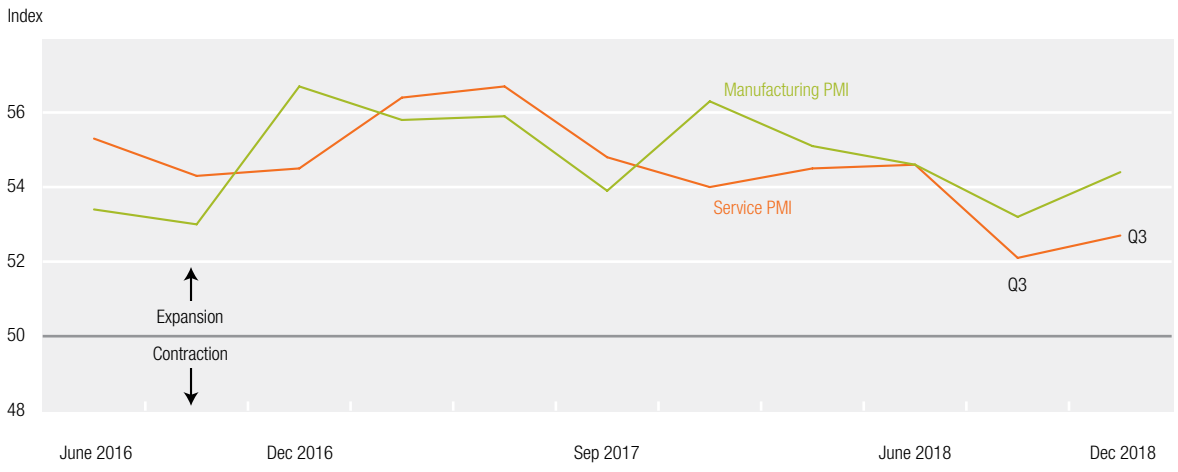
"A degree of pessimism has emerged about Australia's economic prospects. Global uncertainties and the gyrations on financial markets are to blame."

The starting point for 2019

A degree of pessimism has emerged about Australia's economic prospects. Global uncertainties and the gyrations on financial markets are to blame. And much of the domestic disquiet can be traced back to an overblown concern about the weak Q3 GDP numbers published in early December.

Some temporary factors weighed on Q3 GDP growth. The drag from these temporary factors should ease relatively quickly. And that is what leading indicators for Q4 are showing. CBA's Purchasing Manager Indexes (PMIs), covering manufacturing and services (or 70 per cent of GDP) picked up in Q4 after a period of weakness around mid-year (Figure 3).

FIGURE 3
CBA PMI surveys



Source: IHS Markit/CBA

Australia also looks well placed to ride out the global risks. Monetary conditions remain very accommodative and consistent with a respectable growth momentum:

- the RBA's cash rate is at a record low of 1.25 per cent and seems set to remain at that low for an extended period
- the AUD is at the low end of the range of the past decade.

Competitiveness and labour cost settings are also helpful:

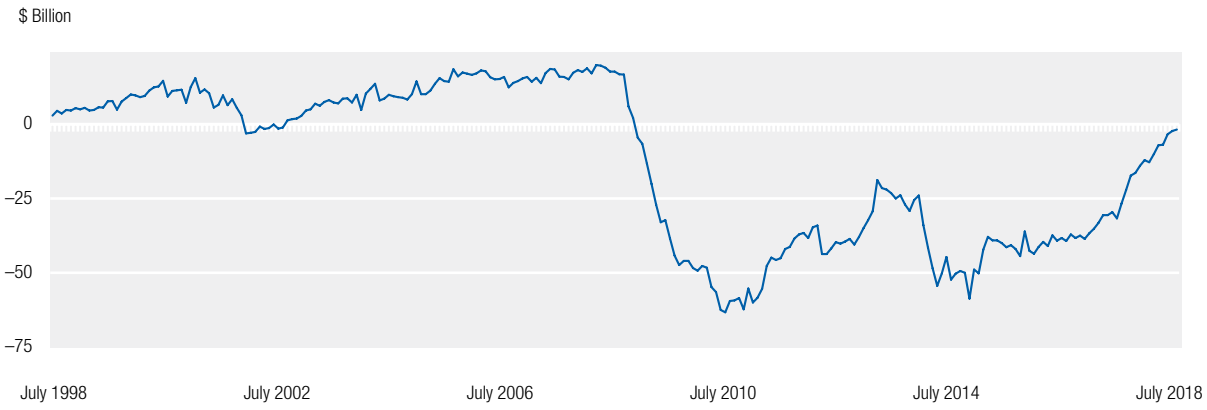
- the combination of flat unit labour costs and a weaker AUD has lowered the real Trade-weighted index (TWI), boosting export competitiveness
- a fall in real labour costs is helping support labour demand.

Australian policy-makers have the ability to deliver stimulus if required.

The cash rate is at record lows. But it could be cut further. RBA Deputy Governor Guy Debelle notes that "QE (quantitative easing) is a policy option in Australia, should it be required". The Commonwealth Budget deficit is shrinking at a rapid rate courtesy of the pick-up in income growth (Figure 4). This improvement in the budget bottom line allows scope for fiscal policy to move in an expansionary direction. Indeed, in an election year both of the major parties are already offering tax cuts.

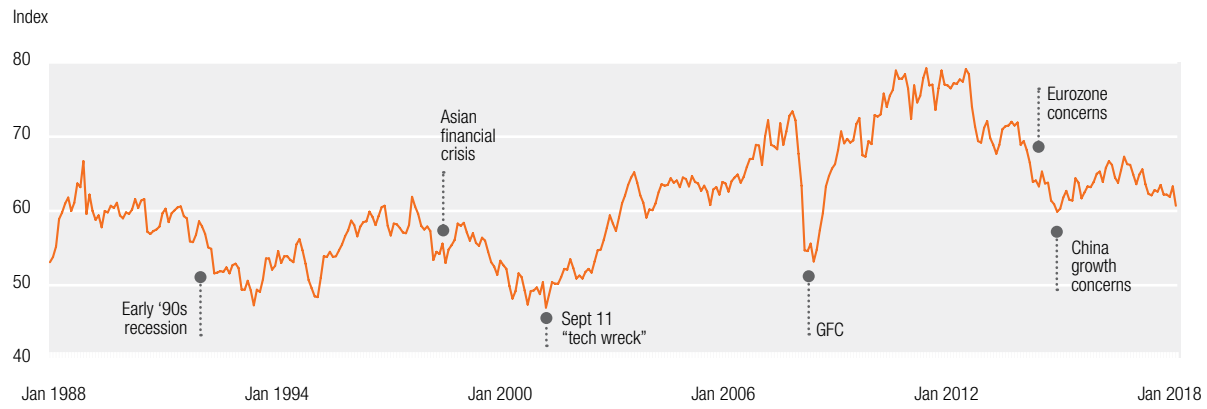
The floating AUD is very responsive to external economic shocks (Figure 5). The currency typically falls and falls sharply when those shocks hit the Australian economy. The ability of the AUD to move lower means it remains an effective buffer against those shocks.

FIGURE 4
Underlying budget balance (rolling annual total)



Source: Department of Finance

FIGURE 5
The AUD TWI



Source: Bloomberg

Commodity prices in a desynchronised world

Commodity prices are the main transmission channel from the rest of the world into the Australian economy. Prices defied expectations of a fall in 2018. The CBA Commodity Price Index (Figure 6) ended the year five per cent higher than at the start.

The forecast 'error' in 2018 was on the supply side of the equation. Growth in demand did slow as the global economy moved to a more desynchronised growth pattern. But the failure of supply to respond to a lift in margins helped limit the price impact of the slowdown in demand.

The risk for 2019 is that the capex lift needed to boost supply remains elusive. Miners prefer to focus on cutting debt, boosting dividends and reducing costs.

With a relatively benign supply backdrop, the direction of commodity prices in 2019 will be set by demand. China is the key to that demand.

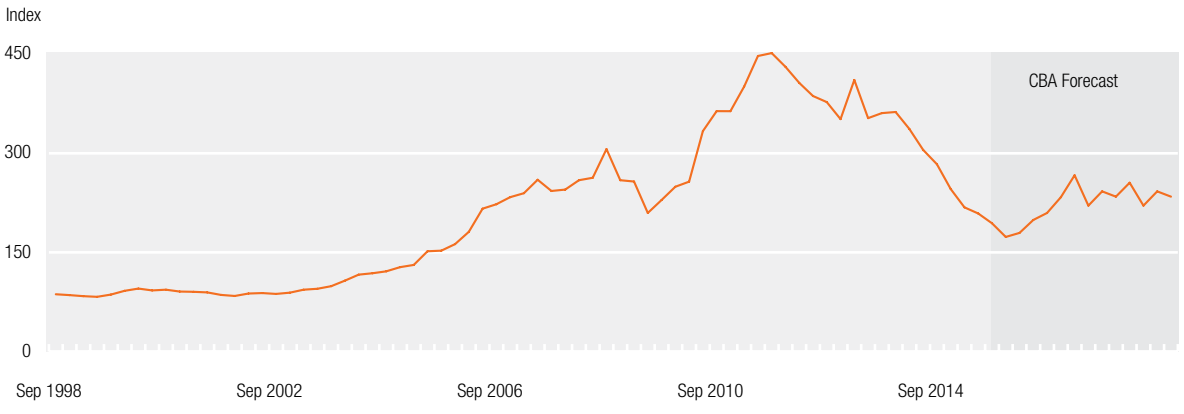
The Chinese economy slowed during 2018. Somewhat paradoxically, that weak momentum gives a degree of confidence about growth prospects in 2019. It makes a more aggressive policy response more likely. Chinese policy makers have a demonstrated ability to change direction if the economy appears to be slowing too quickly. And they have already started. Fiscal policy will become "more forceful and more effective". The People's Bank of China (PBoC) has shifted its policy stance from 'prudent and neutral' to 'prudent'.

Policy stimulus typically involves lifting commodity-intensive infrastructure and other construction spending.

"Commodity prices are the main transmission channel from the rest of the world into the Australian economy."

The bottom line supply-demand mix for 2019 is one that should limit the downside to commodity prices.

FIGURE 6
CBA Commodity Price Index



Source: CBA

The economy in 2019

CBA forecasts have the Australian economy growing by around three per cent in calendar 2019 (Table 1). Growth at this pace would be a good outcome.

The main growth drivers should be an average type outcome for consumer spending (2.5 per cent per annum) boosted by business capex, public infrastructure spending and higher exports. Small growth drags are likely from the peaking in residential construction and the drought.

Favourable labour market trends should continue against this backdrop. The rate of improvement is likely to be slower than in 2018. But the unemployment rate at year end should be around 4.75 per cent, or below our full-employment estimate of five per cent.

A tightening labour market gives some confidence that the modest lift in wages growth in 2018 will continue in 2019. The pace of improvement will remain slow, however. And underlying inflation is only likely to make it back into the bottom end of the RBA's two to three per cent target band in H2 (fiscal year second half) 2019.

Nominal GDP growth should remain around the five per cent per annum mark. This sort of growth will help drive favourable budget revenue outcomes.

The combination of rising export volumes and a flat price picture means trade surpluses should remain large. The slow reduction in the current account deficit should continue.

As always, the risks and issues facing Australia remain many and varied. Some of those risks have receded, some have intensified, and some new risks have emerged.

The risks that have receded relate to a sharp downturn in residential construction activity and the business reluctance to lift capex. An elongated top now looks likely for residential construction. And business capex is finally lifting. To this list we can add the tentative signs of an improvement in wages growth.

The risks that have intensified relate to the global backdrop and the high-household-debt/weak income-growth nexus in Australia.

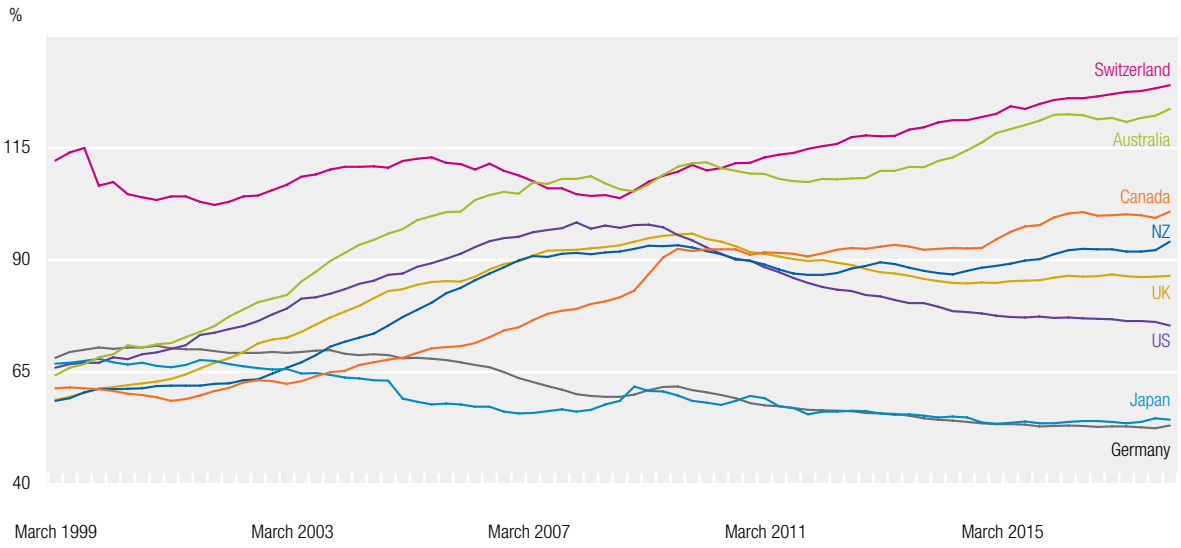
TABLE 1
Australia: CBA key forecasts

	2017 (actual)	2018 (forecast)	2019 (forecast)
Real GDP (percentage change)	2.4	2.9	3.1
Real GDI (percentage change)	4.8	3.1	2.9
Employment (percentage change)	2.3	2.7	2.0
Unemployment rate (percentage)	5.6	5.3	4.9
Headline CPI (percentage change)	1.9	1.9	2.0
Underlying CPI (percentage change)	1.9	1.8	2.0
Wage Price Index (percentage change)	2.0	2.2	2.6
Terms of trade (percentage change)	11.5	0.8	–0.7
Nominal GDP (percentage change)	6.1	4.9	4.9
Current account deficit ($ billion)	46.5	44.8	40.2

Source: CBA data

"The combination of rising export volumes and a flat price picture means trade surpluses should remain large. The slow reduction in the current account deficit should continue."

FIGURE 7
Household debt (percentage of GDP)



Source: IIF

Household debt: turning the dial up to 11

A constant source of worry in any analysis of Australian domestic risks is household debt and the housing market that lies behind it.

Concerns about high/rising household debt date back to late last century. Concerns about an overvalued housing market arose early this century. Over that period any number of "stress tests" have been applied to Australian households and the housing market, including the Global Financial Crisis.

Households have emerged battered but still standing from those tests. That outcome is a testament to the underlying resilience of the Australian economy, some good policy choices and some luck.

House prices have fallen on occasion in response to these shocks. And prices are falling again at the start of 2019. But the oft forecast collapse has not eventuated (so far).

Nevertheless, debt and price concerns will carry over into 2019, with fears intensified by growth uncertainty, weak income growth, volatile financial markets, falling dwelling prices, political dynamics and debate about a credit crunch.

Household debt: just the facts

Household debt towards the end of 2018 was equivalent to 127 per cent of GDP or 189 per cent of disposable income. Both of these ratios are near record highs and very high on any global comparison (Figure 7).

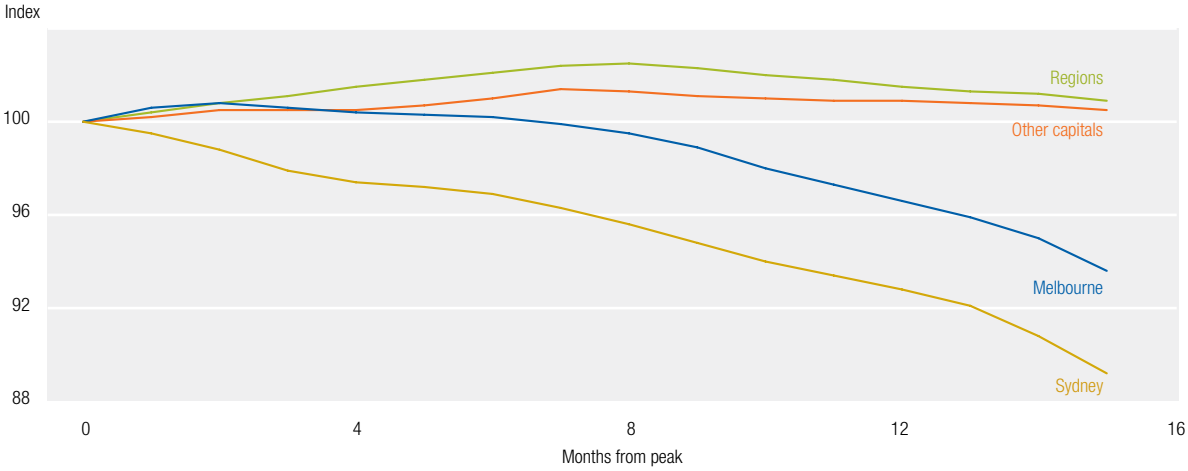
The standard housing valuation metric, the price:income ratio, was a bit under five. That ratio is again close to a record high by Australian standards. But it sits in the middle of the pack on any global comparison. It seems odd, then, that the Australian housing market is routinely seen as the most overvalued on a global comparison.

The impression is that Australian households have been buffeted around by forces beyond their control. The reality is that households responded to the incentives on offer. Record low interest rates, ample liquidity and attractive tax benefits produced a debt-driven housing boom.

The reality also is that households have been building up some protection against adverse shocks:

- The asset side of household balance sheets has also expanded. Until recently housing assets were growing at a faster pace than housing debt. The debt:assets ratio is well below 2009 peaks.
- While most debt is at floating rate, most borrowers have kept their repayments constant in dollar terms. As mortgage rates have trended down from earlier peaks, borrowers have automatically accelerated the rate they are repaying their loans.
- Many borrowers have discovered mortgage offset accounts. Every dollar in such accounts earns the mortgage rate after tax on a cash investment. Nothing else comes close. Home loans with offset facilities now account for 46 per cent of housing credit outstanding.

FIGURE 8
Dwelling prices: The cycle (peak =100 at September 2017)



Sources: CoreLogic/CBA

House prices are falling (Figure 8). Australian dwelling prices are now 6.7 per cent below the 2017 peak. But the declines are concentrated in Sydney and Melbourne. Falls are skewed towards the higher end of the price range. And prices have risen further in other state capitals and regions. We are not seeing the universal price falls associated with a slump.

Some perspective is required as well. The 6.7 per cent fall in Australia-wide dwelling prices to end 2018 follows a 47.9 per cent rise over the previous five and a half years.

Household debt: looking for a trigger

A trigger is needed to turn household debt into a serious problem for the economy and financial system.

Rising unemployment and/or rising interest rates are the traditional triggers. But both seem unlikely at present.

Most household debt is housing related. So, the housing market itself is a potential trigger.

1. From financial stability risk to consumer risk

Unusually high shares of housing lending going to investors and unusually high levels of interest-only (I-O) lending raised fears about financial stability. The regulators responded by:

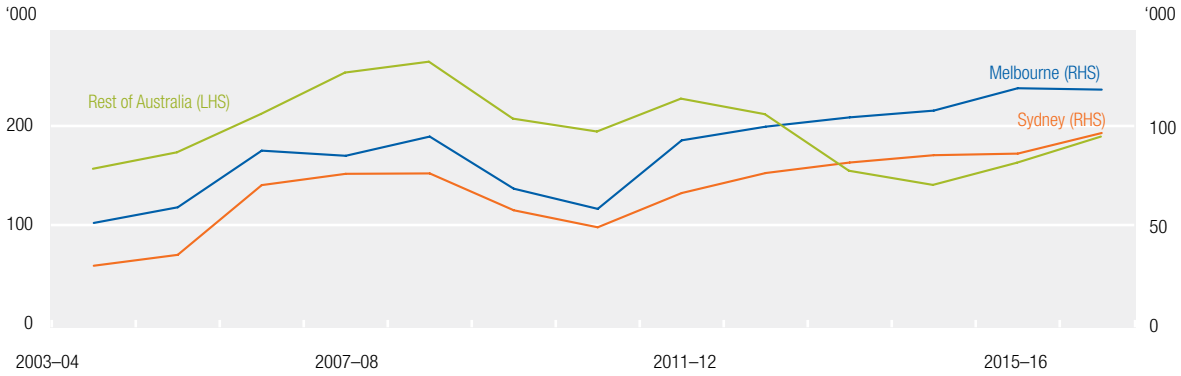
- putting a 10 per cent per annum speed limit on investor credit growth at the end of 2014
- allowing spreads between rates on investor loans and I-O loans versus other mortgages to widen in 2015
- limiting the share of new I-O loans to 30 per cent of the total in March 2017.

These measures were very successful. Growth in lending to investors ground to a halt. The share of I-O loans in housing credit has plunged – with more to come as remaining I-O loans roll off over the next few years. The degree of success is such that the regulators have removed some of the restrictions.

The financial stability risk from excessive I-O lending is receding. But a new risk is emerging. By definition, payments on principal and interest (P&I) loans are higher. The RBA has estimated, for example, that repayments on an interest-only loan increase by 30–40 per cent after the switch to P&I (even after allowing for the lower interest rates on P&I loans). Subdued income growth means any increase in mortgage payments reduces household spending power.

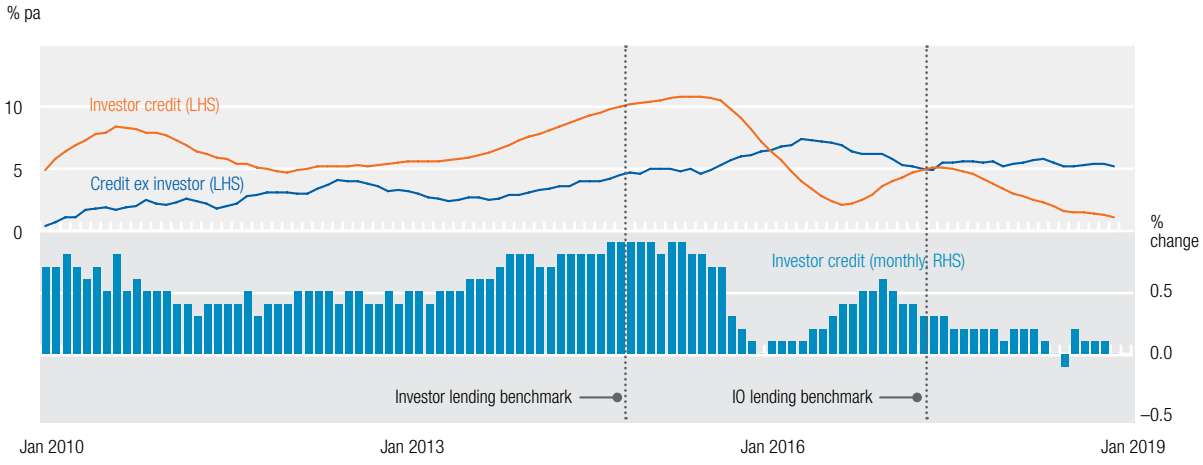
"Australian dwelling prices are now 6.7 per cent below the 2017 peak. But the declines are concentrated in Sydney and Melbourne."

FIGURE 9
Population growth (annual change)



Source: CEIC

FIGURE 10
Credit and regulation (percentage change)



Source: RBA

2. From financial stability risk to house price risk

The regulatory measures reduced financial stability risks. But the targeting of investors produced a dwelling price response that brings a new set of risks to the outlook for 2019.

Some analysis by the RBA highlights the importance of regulation in driving the current dwelling price trajectory. They examined price trends in markets dominated by investor activity and markets dominated by owner-occupiers. The analysis shows the bulk of price falls since the 2017 peak are concentrated in those investor-dominated segments.

It seems that most of the price action in the down phase is a regulatory driven outcome. And not an indication of any fundamental imbalance in the housing market that could produce a more catastrophic outcome.

Countervailing forces are coming in to play. Lower prices mean first home buyers have returned. Population growth in the weaker housing markets of Sydney and Melbourne remains robust (Figure 9). Competition for 'high quality' borrowers means the mortgage rate for new loans has fallen.

3. From financial stability risk to credit crunch

Concerns about tighter lending standards and a credit crunch have lifted. And certainly any restriction in the supply of credit would be a negative for the housing market and the economy.

Once again, the investor-focused thrust of regulation appears to explain much of the "crunch". The various regulatory steps were followed by a significant step down in investor credit growth. The key point, however, is that growth in credit-excluding-investors has not slowed (Figure 10).

4. From financial stability risk to wealth shock

Housing is also the main component of household wealth.

Housing wealth grew by nine per cent per annum from 2013–17. Growth stalled in 2018 as dwelling prices fell. Nevertheless, the value of the housing stock at the end of 2018 was $2.2 trillion higher than at the end of 2012.

The historical evidence is that households like to spend four cents of each additional one dollar of wealth. Based on those metrics, Australian consumers should be transitioning from a boom to a bust as a negative wealth effect takes hold.

But this risk is not as great as the headline figures would suggest. The states with the strongest consumer spending growth over the past year, for example, were NSW and Victoria – the two states where house prices are falling (Figure 11).

Some risks receding

A number of risks that were quite threatening at the start of 2018 look less so at the start of 2019.

Wages growth turning?

One factor intensifying the risks emanating from high household debt was weak income growth. Real household disposable income grew by only 1.6 per cent per annum over the past five years, less than half the rate of the previous five years (Figure 12).

Subdued wages growth was the main contributor to weak incomes. So, the (modest) turn up in wages growth over the past few quarters is encouraging.

The tighter labour market that pushed unemployment to the full employment rate of five per cent is finally producing some wage impact. But it is too early to sign off on an ongoing wages recovery just yet.

FIGURE 11
Consumer spending and house prices (annual percentage change)

Source: ABS/CoreLogic

FIGURE 12
Wages and underemployment

Source: ABS

The fundamental restraint on wages growth is that labour market slack is larger than the headline unemployment rate suggests:

- There is a significant proportion of part-time workers who want to work longer hours. The underemployment rate stands at 8.5 per cent.
- And a solid labour market has pushed up the participation rate as discouraged workers returned to the labour force.

A significant and sustained lift in wages growth is unlikely until there is a significant and sustained fall in underemployment.

These observations underline the critical importance of getting the economic and policy backdrop right. The correct environment will see jobs growth continue, labour market slack diminish and wages respond. The question is whether more could or should be done given the downside risks to the consumer story.

These risks underlie commentary from RBA Governor Philip Lowe who has warned on several occasions of the risks from weak wages growth. Recently, he has cited weak wages growth as a threat to social cohesion.

These risks are why the personal income tax cuts in the May 2018 Budget should be welcomed. Disposable income is what drives consumer spending in the end.

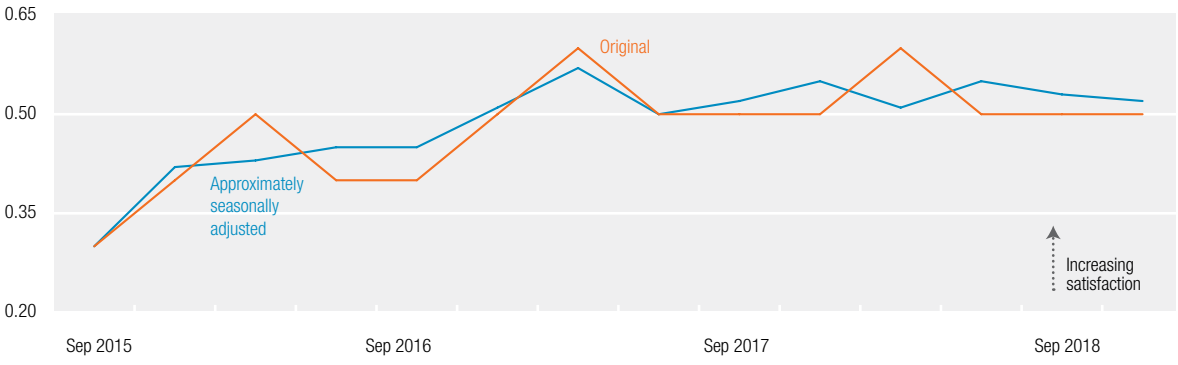
The Government's fiscal position is clearly much better than expected at Budget time. There is scope to top up the personal income tax cuts. Or to bring forward the tax cuts. The decision in October 2018 to bring forward tax cuts for small to medium enterprises (SME's) is a potential precedent.

Of course, household activity depends on more than just the base financial indicators. OECD surveys show that income, wealth, jobs and housing do matter. But items like health, work:life balance and education are important in determining the quality of life.

"The correct environment will see jobs growth continue, labour market slack diminish and wages respond."

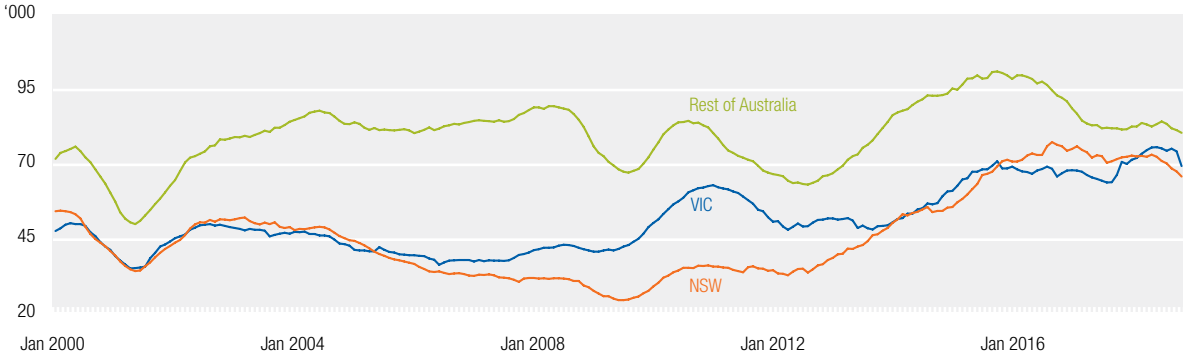
The very granular data on households from CBA's business allows us to quantify these items and estimate satisfaction. CBA's Household Satisfaction Index (HSI) slowly improved up to early 2017 and has tracked sideways since (Figure 13). Readings a little above 0.5 suggest Australian households tend to be of the glass half full variety when assessing their level of satisfaction. Areas with low satisfaction scores include civic engagement, environment and education. So, policies targeting improvements in those areas would help.

FIGURE 13
CBA household satisfaction indicator (0= completely dissatisfied, 1= completely satisfied)



Source:CBA

FIGURE 14
Dwelling approvals (rolling annual total)



Sources: ABS

Residential construction subsiding?

Dwelling starts have run at record highs above 220,000 per annum for the past five years. Every boom brings fears of an ensuing bust. And the consensus forecast since 2014 has been for a sharp retracement. The start of 2019 is no different. Falling house prices have only freshened up fears of falling construction.

But strong population growth is a powerful offset. We need to keep building at historically high rates to keep up with the demographics.

"We need to keep building at historically high rates to keep up with the demographics."

Some leading indicators like building approvals and construction finance have pulled back. But the trend is not uniform. Activity remains robust in NSW and Victoria where population growth is strong. The adjustment is in the rest of Australia. Construction in those areas is already back to more normal levels, limiting the need for a more savage pull back (Figure 14).

The end of the mining capex drag…

Mining capex peaked at an extraordinary 9.3 per cent of GDP in 2012. Falling capex has been a drag on spending and jobs since then. But we are near the bottom of the cliff. The last of the massive LNG plants that drove the boom-bust cycle is nearly complete. Mining capex is levelling out at around 2.5 per cent of GDP.

The bottom of the capex cycle means that it will be actually a little easier for the Australian economy to grow in 2019.

…and a sustainable turn up in non-mining capex?

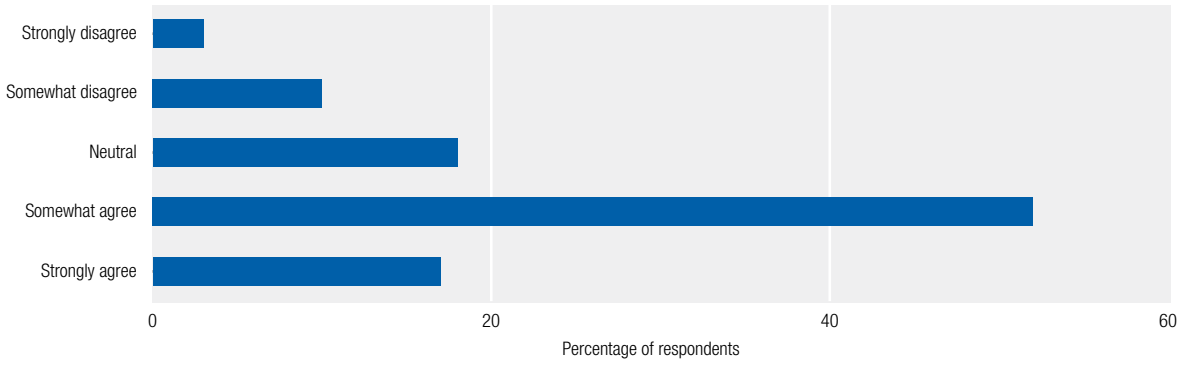
The long-awaited lift in non-mining capex has finally arrived. Business investment grew at a respectable pace during 2018. And surveys indicate that businesses were revising up their capex plans at the end of the year. Business credit growth finally started to accelerate.

The turn in capex indicators reflects a delayed response to a positive set of fundamental drivers. The capital stock has aged, capacity utilisation is above average and business balance sheets are in good shape.

Positive industry dynamics are also helping. The NDIS roll out, for example, requires a significant lift in

"Environmental objectives mean more renewable energy investment. The booms in tourism and education come with a significant capex task."

FIGURE 15
Is there a risk averse culture on Australian boards?



Source: AICD

health sector capex. Environmental objectives mean more renewable energy investment. The booms in tourism and education come with a significant capex task. The infrastructure boom requires private sector participants to tool up.

There are still some reasons for caution, however. The recent AICD Director Sentiment Index reported that 69 per cent of company directors believe there is a risk averse decision-making culture on Australian boards (Figure 15). Directors attribute this culture to an excessive focus on compliance over performance and shareholder pressure for short-term returns.

Directors are also inclined to put some of the blame on government. More than half indicate that the federal government's performance is having a negative impact on business decision-making. They highlight the need for policy action in energy, taxation, infrastructure and climate change.

The growth 'guarantee' continues to deliver

One of our consistent economic themes over the past few years is the idea that a significant part of the Australian growth story is 'guaranteed' by the nature of the underlying drivers.

The resource export pay-off

The mining construction boom more than tripled the size of the mining capital stock. The pay-off comes from the rise in resource production and export, especially LNG. The guarantee comes from the fact that most of the LNG has been sold. The gas has to be produced and delivered.

The infrastructure boom pay-off

The infrastructure construction boom became a significant growth driver in 2016 (Figure 16). The pay-off comes from the necessary refurbishment and expansion of the infrastructure stock, especially transport. The guarantee comes from the fact that the focus is on multi-year projects that have started. These projects will go through to completion.

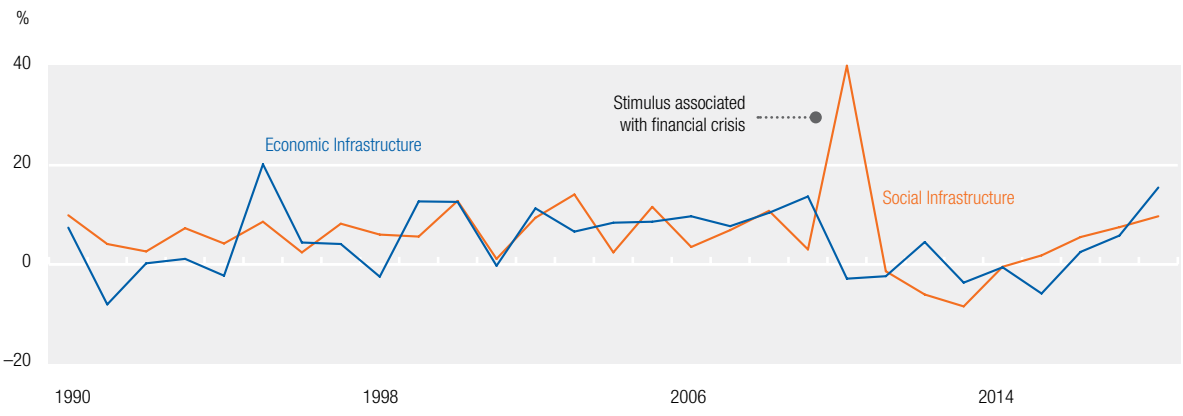
The process could run for quite some time. Work prepared for the G20 puts the shortfall of actual infrastructure spending relative to what is required at 10 per cent of GDP by 2040. To close that gap would require additional infrastructure spending of 0.35 per cent of GDP each year.

Australia's improving fiscal position opens up scope for some additional spending. The G20 analysis suggests that the best outcomes are achieved via deficit financing or PPPs (rather than tax increases).

"Infrastructure supports economic activity in the short term. But it also boosts productivity and income over the longer haul."

Infrastructure supports economic activity in the short term. But it also boosts productivity and income over the longer haul. The boost to GDP according to analysis for the G20 puts the benefit at 0.4-0.7 per cent of GDP. Other estimates are higher.

FIGURE 16
Infrastructure spending (annual percentage change)



Source: ABS/CBA

"Like the earlier Asian-driven commodity boom, the Asian income boom offers plenty of opportunities for Australia. But we need to pursue these opportunities to extract the maximum benefits."

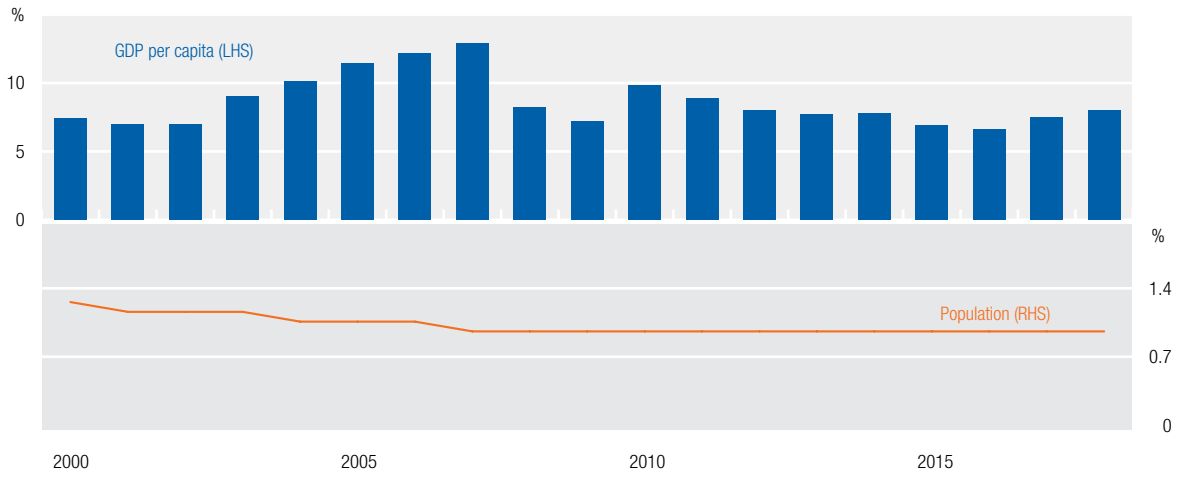
The Asian income expansion

The incomes of Asia's 3.5 billion people are now above the global average in per capita terms (Figure 17). The pay-off comes through many channels but particularly from the booms in tourism and education. The guarantee comes from the fact that rising Asia income is a demographic/momentum structural shift that has further to run.

Like the earlier Asian-driven commodity boom, the Asian income boom offers plenty of opportunities for Australia. But we need to pursue these opportunities to extract the maximum benefits. The spending impact is available for all countries, not just those with a commodity base.

Emerging and Developing Asia is in the middle-income club. Middle-income earners want more goods (food, housing, consumer durables). And they also want more services (education, holidays, financial and health services).

FIGURE 17
Emerging and developing Asia (annual percentage change)



Sources: IMF

"Elections always bring concerns about the impact on the economy. The economic impact of an election campaign proper seems small."

The political dynamic

Elections always bring concerns about the impact on the economy. The economic impact of an election campaign proper seems small. The underlying business cycle trends typically dominate. Nor are there any particular indications of an impact on sentiment or financial markets (Figure 18).

Opinion polls suggest a change of government is possible. Despite this possibility, measures of policy uncertainty remain well contained. In the end, whomever wins, the mainly positive economic fundamentals will still be in place. And many of the key policy metrics will remain. An independent central bank, for example, will set monetary policy.

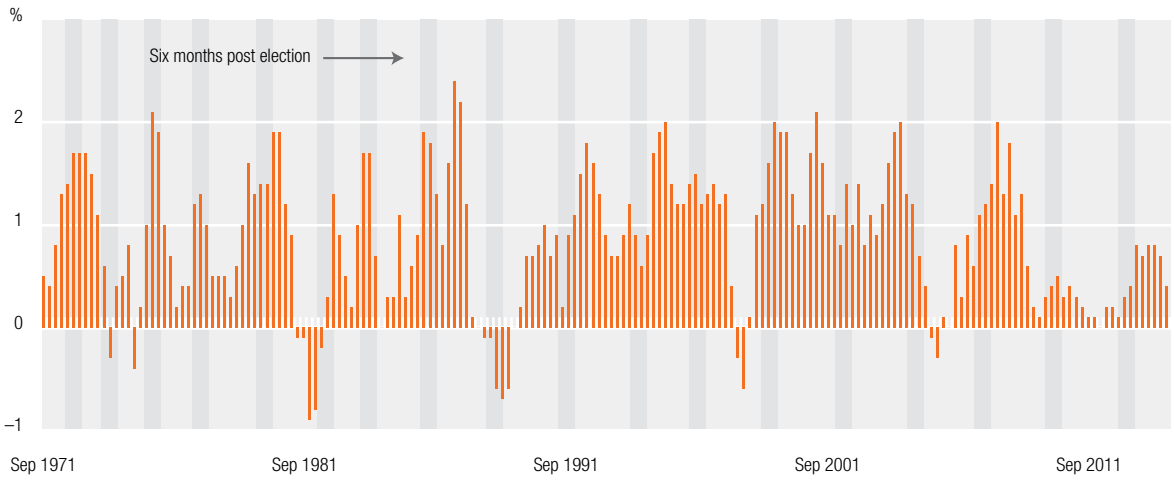
Is the growth-wages-inflation nexus broken?

The unemployment rate edged down to the full employment level of five per cent during 2018. Wages growth showed some early signs of turning up. But inflation remained dead in the water. As at Q3 2018, the inflation rate had been below the RBA's target for 14 of the past 16 quarters.

At face value the traditional linkages between the economy, labour market and inflation no longer seem to be working.

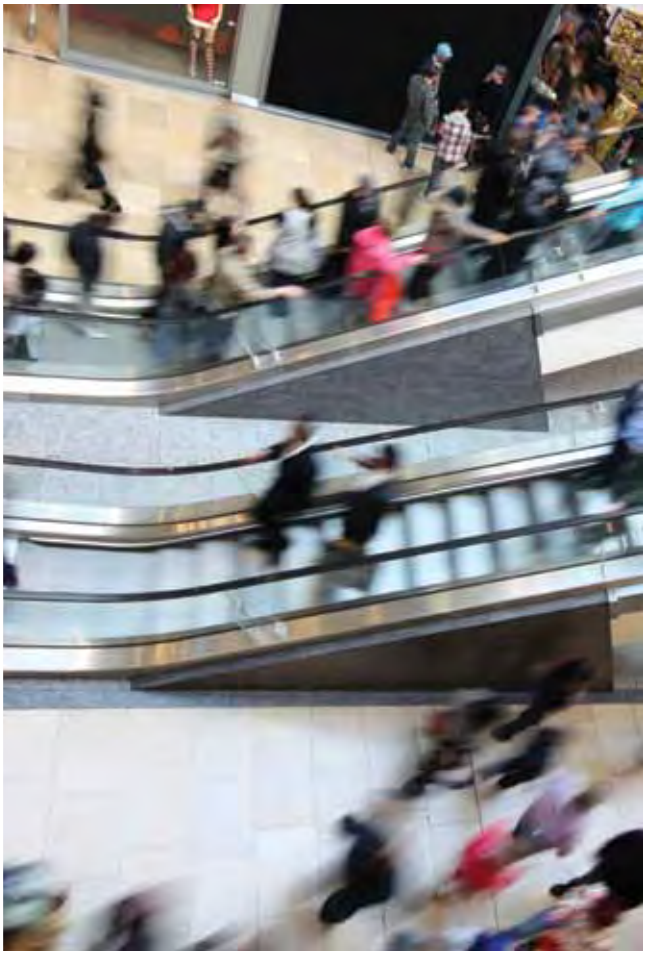
But other indicators show some tentative signs of normality. The subset of the CPI that should be responsive to changing economic conditions

FIGURE 18
Private spending (smoothed percentage change)



Sources: ABS/CBA

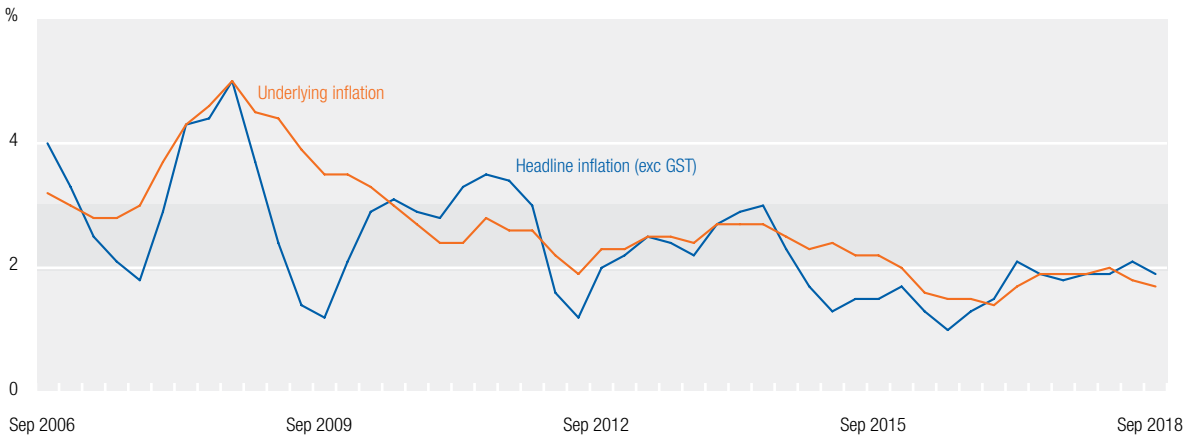
"...So, background economic conditions are moving in a way that favours a turn in the inflation cycle."



trended up during 2018, consistent with movements in measures of economic slack such as underemployment. So, background economic conditions are moving in a way that favours a turn in the inflation cycle (Figure 19).

CBA inflation forecasts have the inflation cycle turning modestly higher in 2019. The pickup is modest, and we do not expect to get back into the target range (bottom end) in a sustained fashion until the second half of the year.

FIGURE 19
Consumer prices (annual percentage change)



Source: ABS

"From the vantage point at 2018 year end, 2019 looks like another year of masterly inactivity from the monetary authorities."

The RBA in 2019

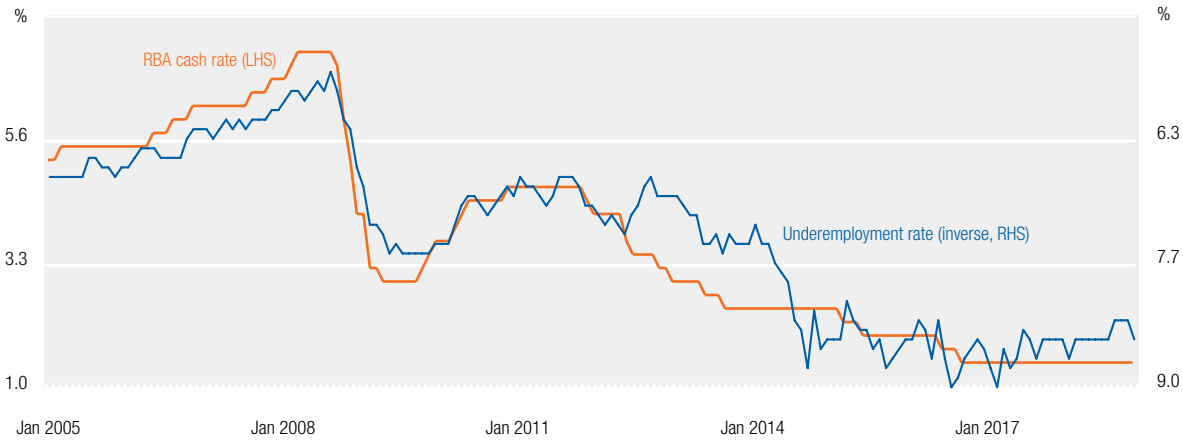
2018 ended for the RBA much as it began:

- the cash rate remains at a record low of 1.5 per cent (Figure 20)
- the RBA's generally positive view on the economic outlook remains
- the policy metric that 'the next move in the cash rate was more likely to be an increase than a decrease, but that there was no strong case for a near-term adjustment in monetary policy' persists.

From the vantage point at 2018 year end, 2019 looks like another year of masterly inactivity from the monetary authorities. Nevertheless, the trajectories we expect for activity and inflation means the pressure to start 'normalising' Australian interest rate settings should lift. Underemployment remains the key to policy settings.

The CBA house view has a rate rise pencilled in for November 2019. High levels of household debt mean the tightening cycle will be cautious, drawn out and peaking below the RBA's neutral estimate of 3.5 per cent. We put the peak at 2.5 per cent. We don't expect to get there until mid-2021.

FIGURE 20
Cash rate and underemployment



Sources: IIF/ABS

"The turn in the USD means that most currencies will strengthen against the US unit. We put the AUD at USD 0.75 at the end of 2019."

Financial markets in 2019

The financial market waters were muddied at the end of 2018 by rising fears about the economic outlook and an associated lift in volatility. Our financial market forecasts are shown in Table 2.

Cutting through the murk, the set of forces that pushed the USD higher in 2018 should slow in H1 2019. And then reverse in H2 2019.

The turn in the USD means that most currencies will strengthen against the US unit. We put the AUD at USD 0.75 at the end of 2019.

Expected economic outcomes and policy developments favour a higher yield curve. But the lift is limited by growth concerns, low inflation outcomes and the end of the Fed's tightening cycle. Indeed, US bond yields could be falling by year end as markets move to price some chance of a reversal in Fed policy settings.

TABLE 2
CBA financial market forecasts

	March 2019	June 2019	September 2019	December 2019
Cash rate	1.5	1.5	1.5	1.75
Three-year bonds	2.15	2.20	2.25	2.4
10-year bonds	2.70	2.70	2.80	2.85
Fed funds	2.75	3.00	3.00	3.00
US 10-year bonds	3.30	3.20	3.05	3.00
vs USD:				
AUD	0.73	0.74	0.74	0.75
EUR	1.14	1.18	1.20	1.22
JPY	112	111	110	110
CNY	7.00	7.10	7.20	7.30

Source: CBA data

2 Domestic political overview

Karen Middleton

Karen Middleton is Chief Political Correspondent at *The Saturday Paper*. Karen is a Canberra-based journalist and author with 30 years' experience covering national and international affairs both in print and broadcasting. She is former president of the federal parliamentary Press Gallery and a Churchill fellow. Karen worked in newspapers before spending a decade as SBS TV's chief political correspondent.

Returning to print in her current role, she also continues broadcast work and is a regular panelist on ABC TV's *Insiders* and *The Drum* and a political commentator on the Ten Network's *The Project*. Karen is a correspondent for Radio New Zealand's *Nine-to-Noon* program, British radio Monocle 24 and Turkey's international English-language TV news network TRT World.

Introduction

Twelve months ago, as the political year kicked into gear, a senior government adviser dropped by my Press Gallery office for a chat.

Things were looking good, he said – certainly better than they had the year before – and the Coalition was facing 2018 with confidence. The same cannot be said, a year on.

Starting the year on the wrong foot

New year 2019 has begun with hundreds of thousands of fish dying in the irrigation-heavy Murray-Darling river system because there is not enough water left to keep it habitable and with the Prime Minister blaming his department for photo-shopping a Morrison family portrait to replace his regular sneakers with a gleaming white pair – on two left feet. Together, these events seem to illustrate the state of things for the Coalition, heading into a crucial election year. This was not how it was a year ago.

Things looked good at the start of 2018

As 2018 began, the section-44 constitutional tentacles that had entwined three Nationals and two Liberals and flung them from the Parliament, along with two Greens and three independents, had begun grasping at Labor members as well, challenging their claim that superior candidate vetting processes guaranteed no dual citizens among them.

In the new year, government strategists were confident that finally the pressure would be on the Opposition.

The Coalition had triumphed in the two Lower House by-elections that the dual citizenship debacle had delivered in 2017, with Liberal John Alexander returned in John Howard's old Sydney seat of Bennelong and Deputy Prime Minister Barnaby Joyce victorious in New England, declaring alongside Prime Minister Malcolm Turnbull on the night he won: "We're getting the band back together."

An equally jubilant Turnbull had told Joyce, in front of the cameras:

"The thing is, if I'm going alright and you're going alright, we're going alright – that's the key. The *country's* going alright."

And as Parliament resumed in the first week of February 2018, it looked like things *were* going alright. The government adviser, who is sometimes given to pessimism, was actually upbeat. As our chat wound up, I agreed with his observation that the Coalition's year was starting well but also offered a slightly impertinent one of my own – that nobody doubted their capacity to stuff it up. He recognised it for the jibe it was and we both laughed.

The following morning, the *Daily Telegraph* broke the news of Barnaby Joyce's extra-marital affair with his former media adviser Vikki Campion, along with a photograph of her that confirmed he was about to become a father for the fifth time, a status undeclared to his constituents before seeking their re-endorsement just two months earlier. Another 24 hours on and I was apologising to the adviser for being a jinx. He just rolled his eyes and shook his head at the disaster of it all.

Within weeks, Turnbull had announced a formal ban on ministers having sex with their staff – something overseas media organisations took great delight in having journalists here try to explain – Joyce had been forced to quit as Nationals leader and Deputy Prime Minister and the relationship between the two had turned to poison.

Then, instead of the section-44 by-elections damaging Labor and its leader Bill Shorten, they had precisely the reverse effect. Former Australian Council of Trade Unions president turned candidate Ged Kearney retained the Victorian seat of Batman for Labor after the embattled incumbent and suspected dual citizen David Feeney quit.

"Within weeks .... Joyce had been forced to quit as Nationals leader and Deputy Prime Minister".

The Labor Party went on to be returned in three more seats – marginals Braddon in Tasmania and Longman in Queensland and the safer Fremantle in Western Australia – while also holding the safe WA seat of Brand where MP Tim Hammond had quit politics for family reasons.

Despite the unfortunate turn things took in February, at least part of the government adviser's optimism had seemed well placed. Shorten had, indeed, come under pressure as the Braddon and Longman by-elections approached on a so-called super Saturday of five polls that included the seat of Mayo in South Australia, where the former Xenophon Team turned Centre Alliance MP, Rebekha Sharkie, would be re-elected.

Braddon and Longman were two highly marginal jurisdictions that Labor was seen as having to retain if it had a hope of victory under the not-very-personally-popular Shorten at the federal election in 2019. His critics within the Labor Party, particularly those in the New South Wales Right faction, began talking up a threat to his leadership should Labor lose both or even just one of those seats, positioning to promote the left-wing NSW frontbencher Anthony Albanese as a challenger.

While denying any intent, Albanese gave a speech that was seen as a personal manifesto and the pair of by-elections became a moment in time that would determine Shorten's fate.

And then his candidates in both by-elections romped home, Justine Keay in Braddon and Susan Lamb in Longman, the latter also securing a big swing in her favour and against the Liberal-National Party and exposing fully the danger that Pauline Hanson's One Nation Party posed to the Coalition in dragging votes from the LNP in Queensland. Rather than weakening him, those victories cemented Shorten's leadership position.

"Turnbull also lost his leadership, not to the primary challenger, Queenslander Peter Dutton … but to the late-run compromise candidate …, Treasurer Scott Morrison."

Another change of Prime Minister

Within a month, it was Malcolm Turnbull facing insurrection instead, sparked by fears of a bloodbath in Queensland but also by the longstanding view among some conservative Liberals that the self-made progressive republican Turnbull had never really been one of them.

Six months after Joyce had stepped down, Turnbull also lost his leadership, not to the primary challenger, Queenslander Peter Dutton – himself in an extremely marginal seat – but to the late-run compromise candidate, New South Welshman and Treasurer Scott Morrison.

By year's end, former prime minister Turnbull had quit politics altogether, heralding yet another by-election. In the progressive, heavily Jewish Liberal seat of Wentworth, the Liberals under Morrison

faced an unfolding nightmare scenario in the form of high-profile independent candidate Kerryn Phelps. A general practitioner and former head of the Australian Medical Association, Phelps was a prominent campaigner for both same-sex marriage and action on climate change, a practising Jew and a serious threat.

In a bid to wrest back the deserting vote, Morrison blindsided his own colleagues and Australia's regional neighbours by announcing as the campaign entered its final stage that he would consider moving Australia's embassy in Israel from Tel Aviv to Jerusalem. It followed the United States' controversial move to do the same early in the year and came despite security agencies and the Department of Foreign Affairs and Trade having warned strenuously against following suit because it would pose a security threat and carry an exorbitant price tag of at least $200 million.

"Phelps was a prominent campaigner for both same-sex marriage and action on climate change, a practising Jew and a serious threat."

It did not help his candidate in the seat, former ambassador to Israel Dave Sharma, that Morrison attributed the idea to him.

While many in the Jewish community supported such a move and still do, a considerable number also saw the promise for what it was – a cynical last-minute ploy to try to buy their votes. Whatever it was, it didn't work.

Morrison has since sought to climb halfway down from his promise, announcing his government would continue to investigate the possibility of moving the embassy and in the meantime would open a trade and defence office in Jerusalem instead.

He also announced it planned to recognise East Jerusalem as Palestinian territory and West Jerusalem as belonging to Israel, something most other countries have declined to do because it risks further derailing the peace process and is opposed by both the Israelis and Palestinians – thereby doubling the number of potential opponents of his decision.

The Government loses its majority

With Phelps' election in Wentworth, the one-seat parliamentary majority Scott Morrison had inherited from Turnbull after a disastrous 2016 election result was gone. In the final weeks of Parliament, Coalition whips had to maintain constant vigilance to ensure nobody missed a vote.

Phelps' arrival just as the year was ending proved a lightning rod for some female Liberal MPs who had complained after the August leadership challenge that they had been subjected to bullying and undue pressure from male colleagues and other Liberals outside the Parliament.

Victorian Liberal MP Julia Banks' announcements – first in August that she did not intend to recontest her seat as a Liberal at the federal election and then in December that she was quitting the party to become an independent, effective immediately – further shook the Coalition and made its grip on power more tenuous.

The Prime Minister approached the end of the year with personal poll ratings above those of his opponent, Bill Shorten, but with his party's ratings plunging.

He remained in need of good news, so the half-yearly budget update became an important vehicle to at least attempt to re-set the agenda.

"Victorian Liberal MP Julia Banks' announcement that she was quitting the party to become an independent, effective immediately – further shook the Coalition and made its grip on power more tenuous."

Shunted to mid-December after Parliament had risen, the mid-year economic and fiscal outlook (MYEFO) contained much more optimistic forecasts than its May predecessor, reducing a projected $14.5 billion deficit for this financial year to just $5.2 billion and foreshadowing a solid $4.1 billion surplus in 2019–20.

Those figures included $10 billion squirreled away under "decisions taken but not announced" and expected to be devoted in large part to a pre-election promise of personal income tax cuts.

Morrison, Treasurer Josh Frydenberg and Finance Minister Mathias Cormann used the MYEFO release to also announce they were bringing forward the 2019 Budget to 2 April, to allow it to proceed before an election to be called after that, for May.

Heading for the polls in 2019

But regardless of that big hint, an earlier poll remained a live option as the new year began. The latest the 2019 election can be held is 18 May and Morrison entered the year facing the difficult decision of every late-arriving Prime Minister: forego your final months in the job and go earlier to retain some element of surprise and take advantage of better times – or because things are only likely to get worse – or cling to the Treasury benches until the bitter end, even in the face of a looming loss.

Insisting he is sticking to the plan for May, Morrison has staked much on the Coalition's economic record, especially its record relative to Labor. But those MYEFO forecasts are heavily dependent on a projected revenue surge from corporate tax receipts and as 2019 got underway, economists were beginning to cast doubt on their strength.

Ratings agency Fitch warned in a report on 9 January that slower-than-expected growth would put pressure on those receipts and likely see the government struggle to attain its projected surplus. Although Fitch has previously underestimated the economy's strength, the warning has some worried.

As concern grew about a slowing housing market, stagnant wages growth and sluggish retail sales in the lead-up to Christmas, other economists were beginning to murmur their agreement. National Australia Bank's Alan Oster has predicted a surplus will be achieved but that it will be significantly smaller than forecast. And independent economist Saul Eslake suggests a slowing economy may force the Government to confront the need for a more direct form of stimulatory spending than personal income tax cuts to keep it out of recession.

That is likely to be anathema to the Coalition, which has consistently hammered Labor over its 2008 spending – albeit successful in staving off a downturn – on 'pink batts and school halls'.

The housing slowdown – which may help some voters, especially in Sydney's outer suburbs, in the form of lower rents – is at least partly the legacy of a tightening of lending practices in the banking sector in the wake of the financial services royal commission. Its report is due in February, just as the political year begins.

Retail sales figures for November published on 11 January were slightly better than expected, up 0.4 per cent, but some economists were warning this could mean December figures are down – likely a legacy of global online sales promotions becoming more prominent in Australia, prompting consumers to buy Christmas presents online in November rather than in stores closer to time.

Rising doubt about the MYEFO forecasts and the risk of a downturn as the year progresses increases the pressure on the Morrison Government to go to the polls earlier than May.

From the sidelines late last year, Malcolm Turnbull revealed that his plan, in office, had been to call an election in late January or early February, for March.

Morrison has also been under pressure from his state counterparts in New South Wales to go to an election before their own scheduled poll on 23 March and absorb the worst of any coming electoral backlash against the Coalition.

"Rising doubt about the MYEFO forecasts and the risk of a downturn as the year progresses increases the pressure on the Morrison Government…"

Calling an election ahead of Parliament's scheduled return on 12 February could allow for an election before the NSW poll, with the required minimum 33 days in between.

Any later, and Morrison would need to let the two parliamentary sitting weeks proceed first – one with both houses in session and one with just the House of Representatives – something that generally carries greater risk for the Government than the Opposition.

Home Affairs Minister Peter Dutton conceded as much in December. "I've always seen Parliament as a disadvantage, frankly, for sitting governments," Dutton told Sky News on 11 December, as the Government faced criticism over its lightweight sitting timetable for the early part of 2019. "Whatever happens, however messy it looks, tough decisions that need to be made are always sheeted home to the government of the day."

As of January, Morrison and his deputy Josh Frydenberg were still insisting, publicly at least, that a May election was their plan. They were also emphasising what they argue is the risk to the economy of Labor's proposed agenda, including phasing out negative gearing tax concessions for investment properties and allowing greater union influence over industrial relations laws and practice.

Shorten's closeness to some unions, including the militant Construction Forestry Mining Maritime and Energy Union, has some ill at ease, including within his own parliamentary party.

With the economy not necessarily providing as strong a campaign opportunity as Scott Morrison might have hoped, the Government is also falling back on its other old-faithful issue, law and order.

Dutton's surprise announcement that the Government was considering a public register of convicted paedophiles drew a mixed response – praise from Justice Party senator, former broadcaster and long-time anti-paedophile campaigner Derryn Hinch, but caution from others, including Bravehearts founder and fellow campaigner Hetty Johnston, who criticised it as a potentially dangerous political stunt without adequate consultation. Coalition critics labelled the announcement a sign of the Government's increasing desperation.

The sudden retirement announcement from Kelly O'Dwyer, Minister for Jobs, Industrial Relations and Women, citing family reasons, added to the sense of a government – already struggling to attract women – in decline.

Then came the dead fish and the inadvertent departmental photographic wrong-footing and Coalition MPs were struggling to find much to be cheerful about as the hot summer ground on.

"Whether or not Australians think the country is still alright or in need of adjustment will be clear by May, if not before."

The Government's messaging challenge

In the lead-up to election 2019, the Government faces a significant political messaging challenge.

The One Nation threat in Queensland and to some extent in WA has the Coalition reluctant to abandon its hard-line stance on issues such as immigration.

But the rise of extremist, neo-Nazi elements seeking to inflame that issue has also caused alarm, including among Liberals, and increasingly their constituents in previously safe blue-ribbon suburban Liberal seats are demanding a tougher stance against that, and pressing for the closure of Australia's offshore detention centres and more compassion for asylum seekers and refugees.

The case of young Saudi woman Rahaf al-Qunun, who claimed persecution at the hands of male relatives and appealed to Australia for asylum after being detained en route in Bangkok, provided a potential opportunity to boost the Government's compassionate credentials – and its support among women. But it was Canada that stepped in to grant her asylum.

The Government appears likely to seize on other opportunities to try to win back disillusioned moderates while simultaneously pushing other issues to target more conservative supporters.

This siloed approach to campaigning is a legacy of changing prime ministers mid-term, replacing the one who faced voters at the previous election with someone who has no record in the job. That requires a series of one-off attention-grabbing policy announcements and a heavy reliance on accentuating the negatives in your opponents.

The evidence of his Jerusalem embassy adventure during the Wentworth by-election suggests Morrison will fall back on his pre-politics marketing experience to draft a campaign micro-strategy to try and maximise the vote – or minimise the loss – in seats with particular sectional interests.

But based on current polling – and the electorate's mood – there are few, including among senior Liberals, predicting he can win, despite voters' ongoing hesitation about Bill Shorten.

As for Turnbull's "we're alright" barometer of good political health – a year down the track, he's out of politics and Joyce appears far from professionally happy, making it clear he's willing to take over from his successor, the unexciting NSW MP Michael McCormack.

Whether or not Australians think the country is still alright or in need of adjustment will be clear by May, if not before.

And the government adviser who dropped by a year ago? He's gone in search of a less depressing life.

Who can blame him?

3 International political overview

Sara James

Sara James is an Emmy Award-winning journalist and author. In Australia, Sara James' featured segment *An American in Oz* airs fortnightly on ABC News Breakfast. She covers a mix of politics, business, culture, and social issues.

Before moving to Australia in 2008, Sara was based in New York City for NBC for more than a decade. Sara's reporting duties took her across the US and round the world including Somalia, Sudan, Bosnia, Haiti, Israel, China, Japan and the UK. She served as a substitute newsreader on NBC Today and guest anchored on other NBC news programs.

Sara earned and Emmy for coverage of the shootings at Columbine High School in Colorado and the Overseas Press Club of America Citation for Excellence for her report on Australia's Stolen Generation.

The Trump tempest

January 2019

The winter storm which barrelled through Washington, DC in January 2019 offered the perfect backdrop for a swirling political tempest. President Donald Trump told reporters gathered on the South Lawn of the White House, "I never worked for Russia."

That denial – one no US citizen ever expected to hear, and no American president ever had cause to declare – came in response to a pair of shock-and-awe reports which exploded like fireworks left over from New Year's Eve.

"FBI opened inquiry into whether Trump was secretly working on behalf of Russia," read the headline in *The New York Times* on 11 January.[1] Two days later, *The Washington Post* published another stunner: "Trump has concealed details of his face-to-face encounters with Putin from senior officials in administration."[2]

Russian turbulence

Trump dismissed questions of whether he might be a Russian asset as a "big fat hoax" and "the most insulting thing I've ever been asked."[3] *Fox News*, Republican allies and the Trump faithful rallied to his defence.

But the ensuing frenzy over the very possibility of a US president as the pawn of a foreign power evoked comparisons to Richard Condon's 1959 novel *The Manchurian Candidate* and movie of the same name. "Like I said: A puppet," tweeted Hillary Clinton, Trump's Democratic opponent in the 2016 presidential election.

Special Counsel Robert Mueller's probe of Russian interference in that presidential campaign continued as this report went to press. In addition, there are investigations into the Trump Foundation, Trump's tax payments, his business associates, and other matters of concern to the president.

"Clearly this Senate race wasn't just about the personalities and policies of rival Texans. The 2018 US Midterm was a referendum on Trump."

A tsunami

Trump also must contend with Congress. The 116th US Congress convened on 3 January, 2019. It is the most diverse in US history and includes a record number of women. Many newcomers say they ran because of Trump. While Republicans retained control of the Senate, Democrats got their 'blue wave' and won the House of Representatives. Democrats have promised to investigate Trump.

Trump is a pugnacious president who has proven time and again he has the will and the skill to stay in the ring. In addition to the controversy about Russia, Trump's populist approach and divisive style have prompted soul-searching about what his presidency means for America and the world. Such debates will intensify as the 2020 presidential race gathers steam.

I got a taste of what to expect on a visit to Houston, Texas in the days before the US Midterm Election in November.

Taste of Texas: Cruz v Beto

November 5, 2018

The Creekwood Grill in Cypress, Texas boasted a country-western décor and a down-home vibe. The US and state flags on the wood-panelled wall above the bar were crafted of corrugated iron. The suburban watering hole served frosty beer, fried pickles, and politics, as I discovered when I dropped in on a rally for Republican Senator Ted Cruz.

Although organisers sold merchandise emblazoned 'Cruz, Tough as Texas,' the most popular items were 'Make America Great Again' baseball caps and 'Keep America Great! TRUMP/PENCE' T-shirts. Cruz was an incumbent. A staunch conservative in a ruby-red state with Ivy League credentials. But as the polls made clear, he faced the fight of his political life.

The Democratic candidate who threatened to unseat Cruz was an affable rising star called Beto. Congressman Robert Francis 'Beto' O'Rourke shot to national fame based on liberal credentials and a grass-roots, media-savvy campaign. The one-time punk rocker live-streamed his tour driving through Texas and raised $70 million – more than any Senate candidate in US history – thanks in part to donations from the East Coast and the West.

Referendum on the president

Clearly this Senate race wasn't just about the personalities and policies of rival Texans. The 2018 US Midterm was a referendum on Trump. Trump knew it. He criss-crossed the country to campaign for Republicans, including former primary rival Cruz. "Pretend I'm on the ballot," Trump told crowds.

For the president's devoted followers, Trump is a secular Alpha and Omega. Other Republican candidates are viewed in large measures as the remaining letters in a populist alphabet with which to enact Trump's agenda and inscribe his creed.

"President Trump has held up his end of the bargain," a retired teacher said, explaining why she considered her vote for Cruz to be a vote for Trump, too. "What he promised he would do for us and our country, he is doing. As best he can. In amidst all the Democrats fighting him tooth and nail."

Weathervane

In Texas, Trump's benediction helped Cruz to defeat Beto. (Ironically, Beto's loss may be the Democrats' gain. He is now touted as a potential Democratic candidate for president.)

In other sections of the country, the Trump Effect worked in reverse. Fury at Trump drove Democratic voters to the polls. While Republicans increased their majority in the Senate, Democrats 'flipped' the House. They picked up 40 seats, the most for the party since Watergate.

The Midterm Election was like a political weathervane which indicated a significant change in direction, yet offered limited data on exactly where this blast of fresh air might take the country. But it does appear that the Trump whirlwind which swept into Washington in 2016 shows signs of abating.

Nevertheless, a consistent 35–40 per cent of Americans support the president. The 'Trump Base' views the president with a devotion uncommon in the annals of American politics. It remains to be seen if there is any factor or scandal which might shake their trust in Trump.

The months ahead will also illuminate the big Democratic field, as candidates jockey to become the party's nominee for 2020. It is far too early to predict who might win the primary, or the election.

The hard-fought Midterm did showcase new candidates, first-time voters, and a refreshing enthusiasm for the process of casting a ballot.

> "The hard-fought midterm did showcase new candidates, first-time voters, and a refreshing enthusiasm for the process of casting a ballot."

Democracy doldrums

Such enthusiasm was welcome, as Trump's presidency had prompted much soul-searching about the fate of democracy. How much had Trump himself been responsible for the slump in confidence in America's bedrock principle and most famous export?

A study by the non-partisan Pew Research Center concluded:

> "A majority says Trump lacks respect for democratic institutions. Fewer than half of Americans (45 per cent) say Donald Trump has a great deal or fair amount of respect for the country's democratic institutions and traditions, while 54 per cent say he has not too much respect or no respect."[4]

And how did average Americans feel?

A poll by news organisation AXIOS with Survey Monkey conducted in October 2018 showed that only half of Americans – 51 per cent – said they have faith in democracy, while 37 per cent say they have lost faith. AXIOS says the poll is noteworthy because, "It suggests that political turmoil has caused people to doubt the very foundation of American society, particularly leading up to election day."[5]

Fractures

Understanding the full impact of the Trump Effect on America and the world is complex, but several key factors are worthy of mention.

US politics is famously binary, but Trump's presidency has turbo-charged the animosity between 'us' and 'them.' Politics is red-hot and personal.

Trump supporters want the Wall. The Supreme Court. Tax Cuts. They resonate to Trump's pledge to, "Make America Great Again," or "MAGA."

Democrats worry about Affordable Health Care. The Supreme Court. Climate Change. DACA. (Deferred Action for Childhood Arrivals offers a path to citizenship for 'Dreamers' brought illegally to the US as children.) The Mueller Investigation.

America is a house divided over Trump's tone, tactics, and Twitter feed. The president's shoot-from-the-hip style. Scandals swirling around Trump and some members of his Cabinet. The administration's revolving door. The verbal napalm Trump lobs at those with whom he disagrees. Trump's intense focus on immigration and the administration's treatment of asylum seekers. The bewildering way in which Trump heaps scorn on America's allies and treats former foes like best mates. The ongoing investigation into Russian meddling in the 2016

Presidential campaign and its potential consequences for the president and his administration.

Americans loathe or love the president. There are few agnostics. Many contend Trump is both an expression of a bitterly divided nation and its provocateur-in-chief.

Former Republican Senator Bob Corker, among Trump's fiercest critics, said in November, "…instead of appealing to our better angels and trying to unite us like most people would try to do, the president tries to divide us." Corker said he believes Trump's divisive remarks "are not an act."

Corker warned Trump's conduct will, "Squander the well-earned good will that we have around the world at a time when our leadership is more important than ever."[6] Corker saw his popularity plunge in his largely Republican home state of Tennessee and chose not to run for re-election.

Fact and falsehood

Another striking feature of this administration is that President Trump frequently tells lies. Mainstream journalists struggle for the best way to report on this.

Other presidents have told lies. But President Trump stands out for the sheer number of his demonstrably proven falsehoods and for the way he repeats misstatements again and again, even when the truth has been pointed out.

President Trump's nonchalance about spreading misinformation was evident from the first days of the administration, when he blasted the media for underestimating the size of the crowd at his inauguration and his then-press secretary erroneously claimed, "This was the largest audience to ever witness an inauguration – period." Photographs clearly showed the opposite. In the brouhaha that ensued, the novel concept of 'alternative facts' was born.

As Trump's overstatements and misstatements piled up, journalists began to keep tally. *The New York Times* pointed out that Trump claimed millions of illegal votes cost him the popular vote in 2016 (false) and that NATO nations "owed" the US money, (nope). The president repeatedly claimed Supreme Court Justice Brett Kavanaugh graduated first in his class from Yale (he didn't) and that the Trump tax cut was the biggest in history (it wasn't). Then there was that head-scratcher in the *Wall Street Journal* on 24 October 2018. The article began:

> "'We don't have tariffs anywhere,' President Trump said in a recent interview with the Wall Street Journal. In fact, his administration this year has placed levies on more than $300 billion in imports."[7]

The *Washington Post* launched Fact Checker during the 2008 Presidential campaign and the feature became permanent in 2011. *Fact Checker* is a "verified signatory to the International Fact-Checking Network code of Principles." It's accountable. The *Post* ranks statements on a scale of one to four – from mild exaggeration to whopper – using 'Pinocchios,' a nod to the famous wooden puppet whose nose grew when he told lies.

By the time the Midterm rolled around, the *Washington Post* reported that President Trump had made 6420 false or misleading claims during his first 649 days in office. That's an average of 30 a day.[8]

There is no small irony in the fact that a president who dishes up falsehood with such relish popularised the term, Fake News.

In December 2018, The *Washington Post* launched the Bottomless Pinocchio for politicians who "repeat a false claim so many times that they are, in effect, engaging in a campaign of disinformation." The criteria include having made a statement which gets three or four Pinocchios at least 20 times. So far, President Trump is the only politician to have made the list.

"The *Washington Post* reported that President Trump had made 6420 false or misleading claims during his first 649 days in office."

"There is no small irony in the fact that a president who dishes up falsehood with such relish popularised the term, Fake News."

Disinformation

Disinformation is a sobering word, particularly when linked to a world leader. But Trump's disregard for accuracy has consequences.

In an article entitled, "Trump's Lies vs Your Brain," for *Politico* magazine in 2017, Maria Konnikova points out, "When we are overwhelmed with false, or potentially false, statements, our brains pretty quickly become so overworked that we stop trying to sift through everything."[9]

Falsehoods repeated can begin to *sound* like fact.

Truth decay

If a president, or anyone else, jettisons or ignores significant information, this can pose another sort of threat to democracy. We need facts and expert analysis to make informed judgments and the lack of it is a major worry. The respected, nonpartisan Rand Corporation calls this, "Truth Decay".

RAND defines Truth Decay as, "the diminishing role of facts and analysis in American public life…. RAND is concerned about the threat Truth Decay poses to evidence-based policymaking."[10]

I thought of that when I chatted to a loyal Trump supporter who expressed support for the president's decision to withdraw from the Paris Agreement for climate change. "There is no climate change," the man said emphatically. He saw no need to couch his opinion with a disclaimer such as "I believe," even though he was not an expert on the topic and his opinion was at odds with the conclusions of the world's top scientists.

In late November 2018, the US Government released its Fourth National Climate Assessment, which began, "Climate change creates new risks and exacerbates existing vulnerabilities in communities across the United States, presenting growing challenges to human health and safety, quality of life, and the rate of economic growth."[11]

The Trump Administration released the report the day after Thanksgiving, a decision viewed by many in the media as an attempt to bury the findings.

Feuds and insults

President Trump appears to relish a scrap, a feud, a rivalry. Trump's Twitter feed amplifies his message, including name-calling of rivals. The *New York Times* kept track.

Trump called Democratic Presidential Rival Hillary Clinton 'Crooked Hillary,' ''who loves to lie" – 'LOCK HER UP!'; former Florida Governor and Republican presidential rival Jeb Bush "lightweight", "desperate and sad;" and a "hypocrite;" and MSNBC co-host Mika Brzezinski "dumb as a rock," and "crazy," his insult for CNN Correspondent Jim Acosta and *New York Times* columnist Maureen Dowd, too.

Trump's negative comments about minorities, including comments directed at African-American politicians and public figures, have drawn condemnation. He called Democratic Representative Maxine

"Immigration and border security have become the defining issues of the Trump presidency."

Waters of California a "low IQ person," former White House aide, Omarosa Manigault Newman a "dog," and a "crying lowlife." Trump called gubernatorial candidate Stacey Abrams of Georgia, "not qualified," and Andrew Gillum, the African-American mayor of Tallahassee running for Governor of Florida, a "thief." The *New York Times* estimates that if Trump keeps up the pace, he will have insulted approximately 650 people, places and things by the end of his first term.[12]

The impact of Trump's comments is difficult to quantify. In Georgia, Democrat Stacey Abrams lost a close race to Republican Brian Kemp, whose ad, "So Conservative," said in part, "I got a big truck, just in case I need to round up criminal illegals and take 'em home myself. Yep, I just said that."

In Florida, Democrat Andrew Gillum lost to Republican Ron DeSantis, who carefully moulded himself in Trump's image. In one ad, DeSantis playfully encouraged his children to build a border wall out of toy blocks and read them *The Art of the Deal*. DeSantis was accused by some of employing a racist "dog whistle" when he told Floridians not to "monkey this up" by voting for Gillum.

President Trump denies any suggestion that he himself is racist. In January of 2018, after reports he described Haiti, El Salvador and several African nations as "shithole" countries, he told a reporter, "…I'm not a racist. I'm the least racist person you have ever interviewed, that I can tell you."[13]

Fear

Politicians of all stripes know fear is a powerful weapon. Many use it in political campaigns. But President Trump stunned fellow Republicans as well as Democrats when he launched his presidential campaign in 2015 vilifying Mexican immigrants. "They're bringing drugs. They're bringing crime. They're rapists. And some, I assume, are good people."[14]

Immigration and border security have become the defining issues of the Trump presidency. Prior to the Midterm, Trump decried drugs "pouring" across the border, railed against gangs from Central America, and raised fears about the "migrant caravans" of refugees fleeing Central America.

Trump claimed that members of the caravan were "criminals" and "Middle Easterners." *USA Today* reported in December 2018, that approximately 4.4 per cent of those who crossed the border without proper documentation were criminals, 0.3 per cent were gang members, and 0.8 per cent were "special interest aliens," according to the Customs and Border Protections authorities.[15]

Trump's language sounded substantially different, as when he told a crowd in Florida, "Democrats are openly encouraging millions of illegal aliens to break our laws, violate our sovereignty, overrun our borders and destroy our nation in so many ways."

As this article goes to press, a partisan debate over Trump's demand for billions of dollars to build a wall between the US and Mexico has shut down the US government.

Nationalism and beyond

President Trump has repeatedly challenged the accepted political vocabulary. At a mega-rally for Senator Cruz in late October 2018. Trump told the crowd, "You know what I am? I'm a nationalist, OK? I'm a nationalist, use that word."

The crowd responded with chants of, "USA! USA!"

CNN reporter Jim Acosta later grilled Trump about his use of the term, and whether it was a signal to those associated with the far-right. "There is a concern that you are sending coded language or a 'dog whistle' to some Americans out there that what you really mean is that you are a white nationalist?"

Trump said he'd "never heard that" – "I'm somebody that loves our country."

But Trump's language unnerved many. Writing in *The Washington Post* in October 2018, Aaron Blake quoted George Orwell, who wrote that, "Nationalism…is inseparable from the desire for power."[16]

Meantime, white nationalism has been on the rise in the US. In January 2019, House Republican leaders took the extraordinary step of stripping Iowa Representative Steve King of committee assignments following an interview with the *New York Times* in which he said, "White nationalist, white supremacist, Western civilization – how did that language become offensive?"[17]

"Berger says his analysis of 30,000 Twitter accounts shows that there are many splinter factions."

The picturesque university town of Charlottesville, Virginia is still recovering from a deadly 'Unite the Right' rally by hundreds of neo-Nazis and white nationalists in 2017. One Hitler-admirer drove his car into the crowd of counter-protesters and killed a woman. Trump ignited a firestorm when he told reporters, "...you had some very bad people in that group, but you also had people that were very fine people, on both sides." It is widely considered one of the worst weeks of his presidency.

Hate crimes

It is important to note that hate crimes are on the rise in the US. In November 2018, the FBI reported that hate crimes in 2017 were 17 per cent higher than in 2016, and that hate crimes rose for the third year in a row.

The FBI noted that nearly 60 per cent of victims were targeted, "…because of the offenders' race/ethnicity/ancestry bias; 20.6 per cent were targeted because of the offenders' religious bias." Other victims were targeted based on sexual orientation or because they had a disability.[18]

In October 2018, two African-Americans were killed in a racially-motived attack in Kentucky. Several days later, 11 people were massacred at a synagogue in Pittsburgh, Pennsylvania. The alleged killer was a neo-Nazi.

The Anti-Defamation League (ADL) says anti-Semitic incidents increased 57 per cent from 2016 to 2017[19] and several organisations called on politicians to refrain from partisan attacks. "The reality is words have consequences," said the ADL's George Selim.

Speaking on National Public Radio (NPR), Emory University Professor Deborah Lipstadt attributed some of the increase in anti-Semitism to opposition to the rise of Barack Obama, the first African-American president. "I never say that President Trump and those around him created this, they didn't. But they lit a fire under it."

J.M Berger, author of *Extremism* and co-author with Jessica Stern of *ISIS: The State of Terror*, writes about white nationalism in the October 2018 issue of *The Atlantic*.

Berger says his analysis of 30,000 Twitter accounts shows that there are many splinter factions. But what united white nationalists, he says, are opposition to immigration or Muslims, conspiracy theories and support for President Trump. Berger notes as evidence the use of #maga and #trump, and entitles the article, "Trump is the glue that binds the far right."[20]

Trump of the Tropics

There are signs that Trump's presidency, in particular his hard-line approach to immigration and embrace of nationalism, may embolden nationalist and far-right movements outside of the US.

On New Year's Day, 2019, the newly elected president of Brazil, a former Army captain and far-right lawmaker dubbed the Trump of the Tropics, received a shout-out from the original Trump on Twitter. "Congratulations to President @JairBolsonaro who just made a great inauguration speech – the USA is with you." Reeling from a recession and a high crime rate, Brazilians elected a politician who once said he wouldn't rape a fellow lawmaker because she was "very ugly" and told *Playboy* he'd prefer a son "die in an accident" than be homosexual.

Poland's nationalist Law and Justice party has skirmished with the European Union over what the EU views as anti-democratic efforts to pack the courts and restrict free speech. When nationalists and far-right groups scheduled a march in Warsaw in November 2018 to celebrate Polish independence, the government first tried to ban the event, then scheduled its own independence parade simultaneously.

In April 2018, Viktor Orban won a decisive victory in Hungary with an anti-immigration platform. The country's Prime Minister is turning, "this former Soviet bloc member from a vibrant democracy into a semi-autocratic state under one political party's control," reported the *New York Times*.[21] The newspaper reports that the US ambassador says Trump "admires strong leaders and looks forward to this relationship going forward."

In October 2018 in Australia, *ABC Background Briefing* reported it had uncovered a plot by an obscure alt-right group to 'infiltrate' political parties in Australia, like the New South Wales Young Nationals. The ABC said the group had a Facebook page, shared "alt-right talking points," "racist in-jokes: with coded references to Hitler and had a hard-line, racist stance on immigration. The ABC also reported that the National Party said "hate and racism" had no place in its party and senior leaders would "not rest" until all extremists were expelled.[22] As of November 2018, 19 Young Nationals had resigned.

When President Trump gathered with European leaders in November 2018 to commemorate the end of WWI, he received a lecture from French President Emmanuel Macron. "Patriotism is the exact opposite of nationalism, nationalism is a betrayal of patriotism...In saying 'our interests first and who cares about the others,' we erase what a nation has that's most precious, what makes it live, what is most important: it's moral values."[23]

In *How Fascism Works, The Politics of Us and Them*, philosopher and Yale University professor Jason Stanley says a nation's leader also needs to be honest about history and warns against those who paint in too rosy a hue.

> "In order to honestly debate what our country should do, what policies it should adopt, we need a common basis of reality, including about our own past. History in a liberal democracy must be faithful to the norm of truth, yielding an accurate vision of the past, rather than a history provided for political reasons. Fascist politics, by contrast, characteristically contains within it a demand to mythologize the past, creating a version of national heritage that is a weapon for political gain."[24]

"There are signs that Trump's presidency, in particular his hard-line approach to immigration and embrace of nationalism, may embolden nationalist and far-right movements outside of the US."

Friend or foe?

President Trump's frostiness to allies and cosiness to adversaries has confounded many.

Former Australian Prime Minister Malcolm Turnbull encountered Trump's mercurial wrath in a testy phone conversation about a refugee swap just days into Trump's presidency.

The US president took a swipe at Canadian Prime Minister Justin Trudeau after the G7 summit in Quebec and accused him of making false statements. This prompted a former Canadian ambassador to the US to label Trump a bully.

Trump's impulsive, transactional approach has its fans. It has also infuriated and bewildered world leaders and some in his own administration. Trump withdrew the US from the Iran nuclear deal and the Paris climate agreement. He announced the pull-out of US troops from Syria, a decision which prompted the resignation of Defence Secretary James Mattis in December 2018. Retired US General Stanley McChrystal told CNN, "The kind of leadership that causes a dedicated patriot like Jim Mattis to leave should give pause to every American."

Trump has sparred with respected outgoing German Chancellor Angela Merkel, yet shown surprising deference to Russian leader Vladimir Putin. At an infamous press conference in Helsinki in July 2018, Trump appeared to take the word of the former KGB agent over that of American intelligence agencies regarding Russian interference in the 2016 US presidential election. The late Senator John McCain called it "one of the most disgraceful performances by an American president in memory."

President Trump's maverick approach has also met with success, notably with North Korea. His relationship with North Korea's Kim Jong Un has improved since their historic summit. As this report goes to press there is word that a second summit could take place as soon as February.

But Trump's frequent criticism of NATO – the military alliance of the US, UK, Canada and Europe which assures mutual defence and is credited with keeping the peace in Europe since WWII – has alarmed America's allies and many within the US government. Weakening NATO is a goal of Putin's.

On 14 January 2019, the *New York Times* reported that Trump discussed withdrawing from NATO in 2018, to the alarm of national security officials. The newspaper quotes the former supreme allied commander of NATO as calling any such plan a gift for Putin and "a geopolitical mistake of epic proportion."

"Reporters and presidents spar, but President Trump's antagonistic relationship with mainstream media has been more dramatic."

Media

Finally, the president has had a contentious relationship with mainstream media.

A free press is central to any democracy and this liberty is protected in the First Amendment to the US Constitution. Reporters and presidents spar, but President Trump's antagonistic relationship with mainstream media has been more dramatic.

In CEDA's 2018 EPO, Dr David Glance noted that, overall, social media has had a negative impact on news quality. We now see entire news stories based on a single Tweet – a hallmark of the Trump presidency – or Facebook post.[25]

When Trump tweets, the world takes notice. Twitter has given the president a pulpit from which to preach to the world.

On February 17 2017, the President fired a blistering tweet at the media: "The FAKE NEWS media (failing New York Times, NBC News, ABC, CBS, CNN) is not my enemy, it is the enemy of the American people!"[26]

Trump's attack prompted swift condemnation. David Axelrod, President Obama's former advisor, said, "Every president is irritated by the news media. No other president would have described the media as 'the enemy of the people'".

Trump has derided the media as "fake" and an "enemy" on Twitter and in front of crowds ever since, despite expressions of alarm from journalists.

In June 2018, a gunman opened fire at the *Capital Gazette* in Maryland, killing five people. The president condemned the attack. The newspaper's staff released a letter. "We won't forget being called an enemy of the people...Because exposing evil, shining light on wrongs and fighting injustice is what we do."

"As 2019 unfolds, two major factors could alter the trajectory of the Trump presidency. The first is that investigation into Russian interference in the 2016 presidential race."

In October 2018, a fervent Trump supporter was charged with sending a dozen pipe bombs to critics of the president, including outspoken Democrats and CNN. CNN president Jeff Zucker said, "There is a total and complete lack of understanding at the White House about the seriousness of their continued attacks on the media. The president, and especially the White House press secretary, should understand their words matter."[27]

In August 2018, UN and Inter-American Commission on Human Rights experts David Kaye and Edison Lanza called Trump's attacks on media "…strategic, designed to undermine confidence in reporting and raise doubts about verifiable facts…".[28]

Trump's contentious relationship with the media continues. CNN White House reporter Jim Acosta had his credentials revoked after a news conference. A federal judge ruled the press pass must be reinstated, a victory to all news organisations.

Final forecast

As 2019 unfolds, two key factors could alter the trajectory of the Trump presidency.

The first is that investigation into Russian interference in the 2016 presidential race. President Trump has repeatedly said there was no collusion and called the investigation a witch hunt but the inquiry has resulted in a raft of guilty pleas and indictments. Mueller hasn't said when he might finish. In January, Trump's nominee to be the new US attorney general, William Barr, told Congress, "I think the Russians interfered or attempted to interfere in the election" and he repeatedly said Mueller must be allowed to complete his probe.

Virtually every organisation Trump has led is under some sort of investigation. The publication *Wired* details 17 different court cases stemming from seven sets of prosecutors, and says, "Donald Trump faces a legal assault unlike anything previously seen by any president."[29]

The second factor is the Democratic majority in the House of Representatives. As mentioned, the Democratic-led House will have the power to investigate Trump. How will they use it? There are rumbles of impeachment, although that political move also carries significant risks for Democrats. Furthermore, a Republican-controlled Senate is extraordinarily unlikely to vote to remove a Republican president.

For 2019, Trump's top priority is getting funding for the issue that galvanises his base – a wall along the border between the US and Mexico.

Democrats have their own agenda. Under Democratic House Speaker Nancy Pelosi, their to-do list includes infrastructure spending, protecting voting rights, prescription drug prices, and background checks for gun owners.

But the government shutdown caused by the partisan divide over a border wall serves as a stark reminder of perhaps the greatest problem facing everyone in Washington. In a democracy, it takes negotiation and consensus to get things done. And those are qualities in short supply.

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4 Domestic policy overview

Dr Jenny Gordon

Jenny Gordon is Nous Group Chief Economist. Jenny has spent much of her post-academic career applying economics to public policy questions. She previously worked with the Productivity Commission, where she was principal advisor, research for 10 years. Prior to that, she spent 14 years at the Centre for International Economics (CIE); where her work ranged from strategic planning to program design and evaluation, and focused largely on agricultural and other research, financial market development, and industry policy. Much of Jenny's work has expanded the traditional cost-benefit analysis to include environmental, health and social impacts.

Introduction

In the last year the Australian Government has kept big policy reforms off the table, much to the regret of many in the commentariat (for example Jennifer Westacott at the Business Council of Australia). But tinkering to make ongoing, if minor, adjustments to policy can be a good strategy if it improves outcomes for Australians.[1]

The question, of course, is whether the tinkering of 2018 has taken the economy and the Australian population toward better outcomes, not just in terms of economic efficiency, but making the system fairer. We are not all doing it tough no matter what we are regularly told. Despite low real wage growth, employment is up, and many Australian households are doing nicely. But many are concerned about the future as the digital economy changes the nature of work, and some really are doing it tough – NewStart has not increased in real terms in 24 years.[2]

When it comes to the future we are leaving our children the risks posed by climate change, and how to fund expensive spending commitments on pensions, aged care and health services with relatively fewer taxpayers, have been kicked down the road. Whether 2019 will see more action on the policy front appears to be contingent on the results of the next federal election.

Interest rates

The Reserve Bank continued to hold rates steady, helping dampen the Australian dollar's response to the rising terms of trade.

Cash rates were held at 1.5 per cent throughout 2018, making it 25 months without a rate change, putting the cash rate below the rate of inflation (CPI excluding volatile items) since the end of 2017.[3]

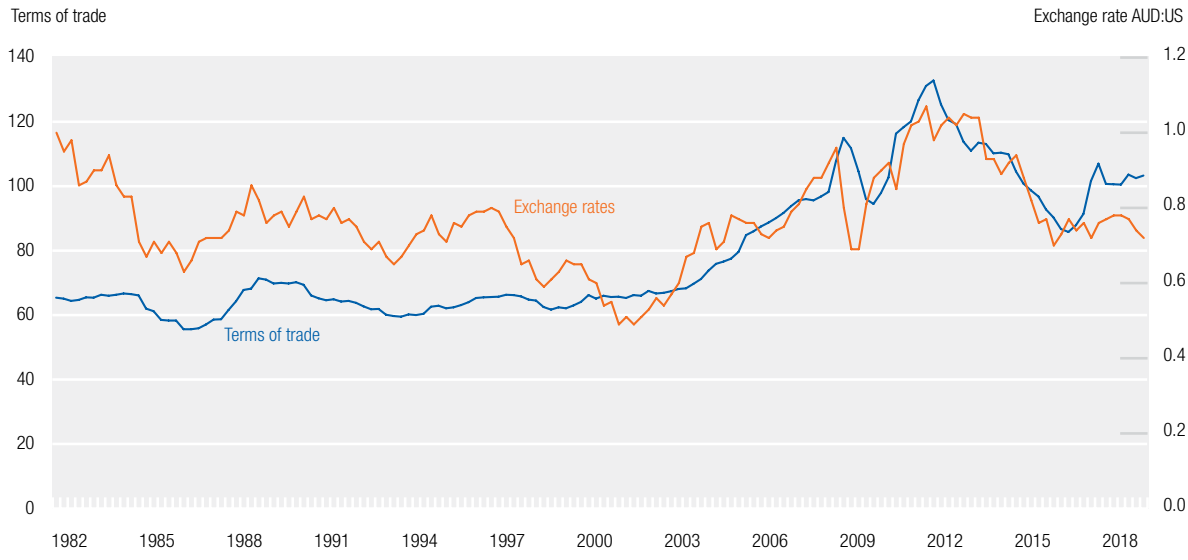
This negative real rate contrasts with the US Federal Reserve rate, which rose from 1.5 per cent at the end of 2017 to 2.5 per cent at the end of 2018, with US inflation in 2018 at 1.9 per cent.[4] The difference means that the Reserve Bank's stance has gone from largely neutral to easing. The lower relative rate has seen the Australian dollar weaken slightly over 2018, despite the rise in the terms of trade (Figure 1).

The major considerations cited by the Bank for their stimulatory settings over the year were inflation remaining within the band (and a fall in the third quarter), slow growth in real wages, softening of housing prices, and high levels of household debt.[5] They anticipate a rise in inflation through 2019, with more pressure on wages as the labour market tightens further, but cite uncertainty around continued growth in household consumption as a reason for caution.[6]

A contributing factor to the slowing house price growth was the 30 per cent market ceiling on the share of housing mortgage loans that were interest

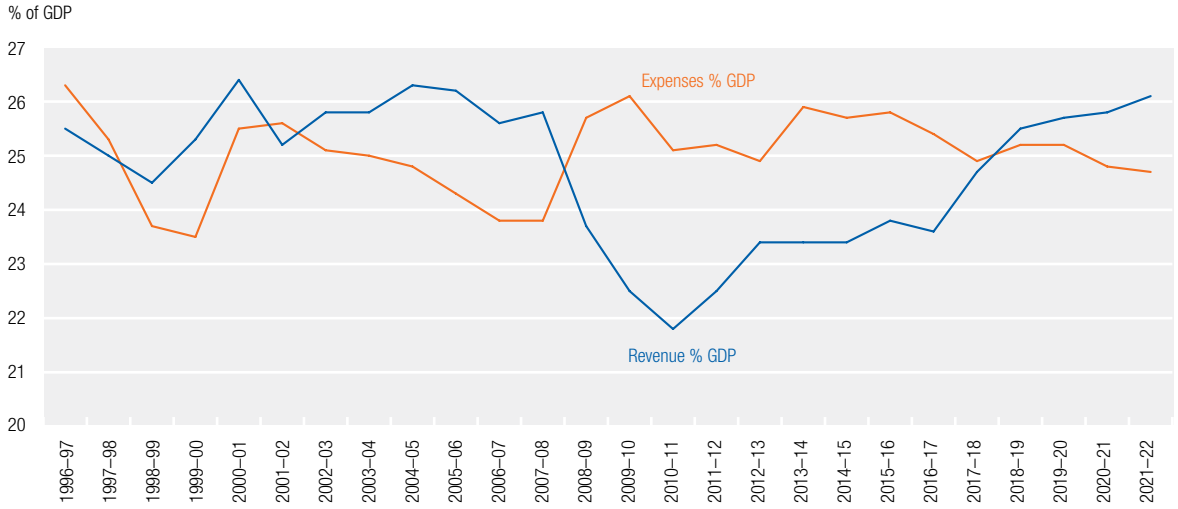
"The Reserve Bank continued to hold rates steady, helping dampen the Australian dollar's response to the rising terms of trade."

FIGURE 1
The Australian-US exchange rate and the terms of trade 1982 to 2018



Source: RBA Statistical data https://www.rba.gov.au/chart-pack/commodity-prices.html, https://www.rba.gov.au/chart-pack/exchange-rates.html

FIGURE 2
Australian Government revenue and expenditure as a share of GDP



Source: Australian Government Budget Papers 2018-19

only, set in early 2017 by the Australian Prudential Regulatory Authority (APRA). This signalled the regulator's concerns about system stability that, along with the cooling of the housing market, has seen the rates of interest-only (I-O) loans drop well below this ceiling to 16 per cent in late December 2018.[7] The modest drop in house prices in Sydney and Melbourne has yet to pose any real concerns about mortgage default, and is needed to start to improve housing affordability.

Unexpected revenue growth reduced the deficit

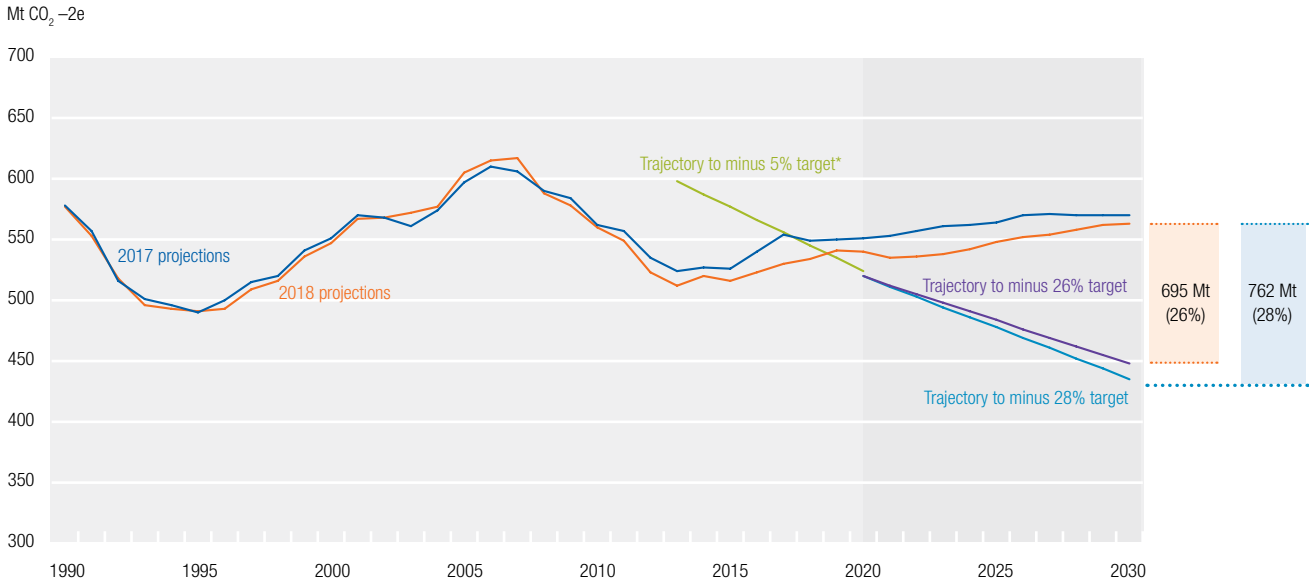
The deficit reduction is due to revenue growth rather than the modest expenditure restraint, with Australian Government funding still playing a mildly stimulatory role in 2018.

Improvements in revenue reduced the projected 2018–19 budget deficit from a forecast 0.8 per cent of GDP ($14.5 billion) to 0.3 per cent of GDP ($5.2 billion).[8] The expected improvement comes from a range of sources, with higher company profits, particularly mining companies, making the biggest contribution. Payments to GDP fell from 25.4 per cent in the 2018–19 budget to 24.9 per cent in the Mid-Year Economic and Fiscal Outlook (MYEFO), which was a result of stronger than expected growth in GDP rather than expenditure restraint (Figure 2). With the budget projected to come into surplus in 2019–20, fiscal policy stance is neutral, although

"The modest drop in house prices in Sydney and Melbourne has yet to pose any real concerns about mortgage default."

election promises could well see a fiscal stimulus in the later part of 2019. Under current policy settings, the budget remaining in surplus is conditional on continued strong growth in GDP (three per cent real) over the next five years driving revenue growth, and some relatively unlikely expenditure savings coming to fruition.[9]

FIGURE 3
Australia's emission trends 1990 to 2030 and projections of the trend required to meet the Paris target



*Note: Australia's 2020 target is accounted for using Kyoto Protocol reporting categories (see the "Kyoto Protocol Categories" tab).
Source: Australia's emission projections 2018, Figure 4, p.12, Australian Government

Energy policy unseats another Prime Minister

Malcolm Turnbull was replaced for a second time in part for his stance on energy policy, this time it was the National Energy Guarantee (NEG). The very effective 'axe the tax' campaign by Tony Abbott has left the federal political parties unable to contemplate any policy that does what economists have long been recommending as the most efficient emissions reduction policy, which is to put a price on carbon.[10]

Even the third best policy recommended by the Chief Scientist Alan Finkel as a way out of this impasse was judged by the Coalition as too anti-fossil fuels. With the change in Prime Minister to Scott Morrison (well known for bringing a lump of coal into Parliament), the Australian Government stepped away from the hard-fought NEG.

The current policy (Powering Forward – delivering more affordable, reliable and sustainable energy) focuses on bringing down electricity prices by carrying a big stick. The Australian Competition and Consumer Commission (ACCC) and Australian Energy Regulator (AER) were provided with $50.2 million in MYEFO to enforce the new Retailer Reliability Obligation, which is a program to underwrite new generation, and address electricity market misconduct. While any government support for new generation is meant to be technology neutral, some in the current government are advocating public subsidies for new fossil fuel generation.

Looking forward to 2019, the Labor Party has committed to adopt the NEG with a higher renewable target (50 per cent power from renewables by 2030). Despite claims that Australia will meet its Paris emission reduction target at a canter, the report released by the Department of the Environment on 22 December suggests otherwise (Figure 3).

While electricity should easily meet the 26 per cent reduction on 2005 levels, this sector needs to do more of the heavy lifting as it is more expensive for other sectors to reduce emissions.[11] The use of credits from the Kyoto 2012 target to meet the 2030 Paris target is controversial (other countries have ruled out doing so). In any case, this will leave Australia with a much greater task of emission reduction to achieve the next round of targets.

"Like energy, tax reform has become too hot for most politicians."

Major tax reform remains in the too hard basket

Like energy, tax reform has become too hot for most politicians. In 2018 there was relatively little change, with the Australian Government finally abandoning its attempts to legislate the company tax cuts for large (greater than $500 million turnover) businesses. The 37 per cent personal income tax bracket is set to be abolished in 2024–25, with increases in the thresholds phased in over seven years (May Budget). This change will flatten the tax system and mean that an estimated 94 per cent of taxpayers will have a marginal tax rate of 32.5 per cent or lower.[12]

Decisions made in 2018 that will play out in 2019 include changes to the way the Goods and Services Tax (GST) is distributed between the states and territories.[13] In changing the formula (which aims to adjust the allocation for the relative cost of providing services as well as the ability of the jurisdiction to raise their own revenue) the Australian Government allocated an additional $9 billion over the next 10 years (MYEFO).

The company tax rate reduction (to 25 per cent) for small to medium sized businesses (SMEs) has been brought forward from 2026–27 planned in the May Budget. The roll out of the 16 per cent tax discount for unincorporated businesses will be similarly fast tracked. The $20,000 instant asset write off for small business was extended in the May Budget to 30 June 2019.

Looking to 2019, a change of government would likely see negative gearing restricted to new dwellings, grandfathering existing owners of rental properties and a reduction in the capital gains tax discount to 25 per cent from 50 per cent. Labor has also proposed removing the cash rebate on dividend imputation, and to raise the top marginal tax rate by two percentage points.

TPP11 the key trade policy development

The signing of the TransPacific Partnership Agreement (TPP11) was the main change in trade policy in 2018. The impact of trade agreements on the Australian economy are generally overestimated, and the impact of the TPP11 is expected to be mildly positive.[14]

Australia has nine trade agreements in negotiation. On the multilateral front, Australia is in the process of accession to the World Trade Organisation (WTO) Government Procurement Agreement, and the Environmental Goods Agreement.

"The most ambitious agreement in negotiation is the Regional Comprehensive Economic Partnership (RCEP)."

The most ambitious agreement in negotiation is the Regional Comprehensive Economic Partnership (RCEP). An extension of the Association of South East Asian Nations (ASEAN), RCEP involves the 10 ASEAN countries and Australia, India, China, Japan, the Republic of Korea, and New Zealand. Reducing barriers to trade between RCEP countries should be of substantial benefit to Australia in the absence of a wider multilateral approach to reducing barriers to trade and investment. Negotiations on the Indonesian CEP were recently impacted by the announcement of Australia's position on the location of the Australian Embassy in Israel.

Security prompts spending and regulation

Security was one area of expanded spending in 2018.[15] One of the last actions of the Australian Government in 2018 was to pass the Assistance and Access Bill that allows selected law enforcement agencies to require Australian companies to decrypt encrypted messages. While the aim is to help fight serious criminal activity and terrorism that use encrypted channels, there are valid concerns that the legislation will open up encrypted messaging apps to malware and can undermine the ability of Australian firms to sell their products abroad.[16]

A review has been included, but the legislation continues a trend toward government legislating their access to data (for example, the metadata retention scheme) and a more punitive approach to people who have embarrassed the government. The adoption of the mantle of security to justify these erosions of the ability to criticise the government of the day, or reveal misdeeds, has been supported by both sides of the political spectrum.

Action on a national integrity and anti-corruption commission is likely in 2019.[17] As sunlight is the best remedy to poor behaviour by governments, it is to be hoped that the current government proposal will be strengthened to deliver an anti-corruption body that can be effective in exposing undue influence over policy, procurement, and other behaviour that undermines democracy.[18]

Progress in unlocking better use of data

On a more positive front, 2018 saw the introduction of the Consumer Data Right (Open Banking) which requires banks to provide people with their personal data, helping them shop for better value services.[19] There are plans to extend this right to other services. A requirement that businesses provide their customers with access to their data in an easy-to-use form has been included in the ACCC's Consumer Data Rights Rules Framework.[20]

The other data related change on the 2019 agenda is the introduction of the *Data Sharing and Release Act*.[21] The legislation aims to unlock the value in administrative data by facilitating sharing of administrative data between government agencies for the purposes of research to improve policy and service delivery.

Following the problems with Robodebt and My Health Record, ensuring that the public appreciate the value to them of better use of administrative data, as well as the restrictions in place to protect privacy and prevent the misuse of data by government, is a critical part of this legislative process.

"It has become clear that the problem is less with the law, than the failure of regulators to uphold the law, and of courts to apply penalties that would be an effective deterrent."

What of financial services post Royal Commission?

As the Royal Commission into misconduct in the Banking, Superannuation and the Financial System nears its conclusion, it has become clear that the problem is less with the law, than the failure of regulators to uphold the law, and of courts to apply penalties that would be an effective deterrent.[22] In anticipation of the final report the Australian Government boosted the funding of the financial system regulators in MYEFO.[23] The response could see a tightening of credit in 2019, casting further doubt about the GDP forecasts.

The Australian Government has moved to fill what it sees as gaps in the access to finance for small and medium sized businesses (SMEs) by establishing the $2 billion Australian Business Securitisation Fund. This will provide funding to small banks and non-bank lenders to on-lend to small businesses. It also established the Regional Investment Corporation to provide subsidised loans to farmers to help them through drought (an additional $1 billion was allocated in MYEFO).

Employment growth in health, disability and aged care

Demand-driven programs – such as Medicare and the Pharmaceutical Benefits Scheme (PBS) – continue to grow with the population and the coverage as new items are added, particularly to the PBS. The Australian Government signed a new hospitals funding agreement with the states and territories in 2018. The big impact on employment has come through the announcement of an additional 14,000 high-level home care packages and the continued roll out of the National Disability Insurance Scheme.

Looking to 2019, there are two major inquiries that should result in policy change. These are the Productivity Commission's inquiry into Improving Mental Health to Support Economic Participation and Enhance Productivity and Economic Growth and the Royal Commission's inquiry into Aged Care Quality and Safety.

Beyond the responses to these inquiries, the lack of a common view on the best system mix makes it unlikely that major reform in Australia's health system will be pursued in 2019. Building a consensus for

fixing the system is a slow process. While there is still plenty that can be done to improve the efficiency and health outcomes in the current system,[24] the recently announced Community Health and Hospitals Program ($1.3 billion over four years) is not the best way forward.

Australian Government investments need to be coordinated with state and territory governments, which have delivered improvements in their service models to reduce demand and better meet the needs of users with chronic conditions.[25]

One step forward, half a step back in education policy

Education took a step forward toward equity with the Gonski model being adopted, and half a step back with the additional funding for Catholic schools.

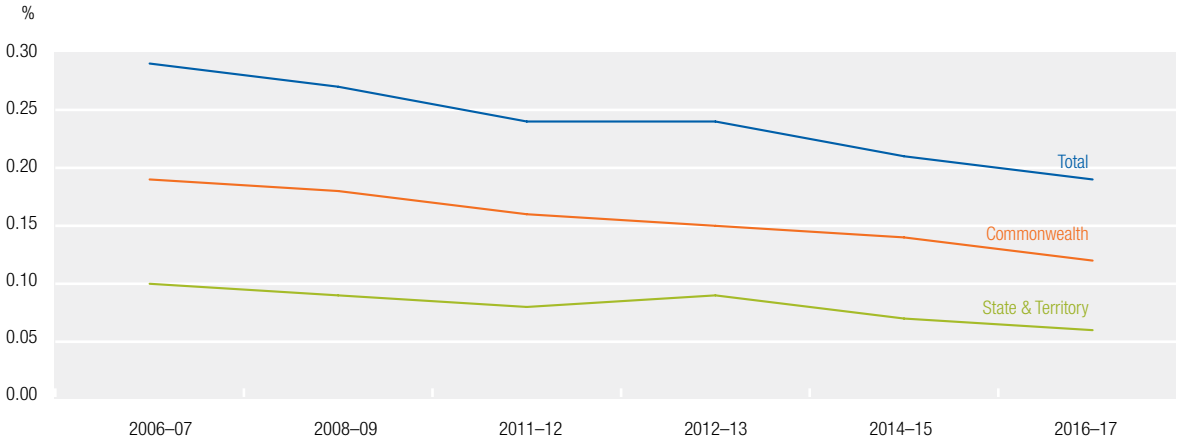
Both political parties now support a needs-based funding model, taking the Gonski recommendations as the starting point. Both also have capitulated to the non-government schools lobby with commitments to raise their funding. The Australian Government package proposes linking Commonwealth funding for non-government schools more closely with parental income from 2020 (currently postcode socioeconomic measures are used). Behind the support for the needs-based funding model, the Australian Government sought to implement an 80:20 rule, where the federal government funds 20 per cent of public school education and 80 per cent of private school education. Victoria has yet to sign onto this rule.

The funding debates are likely to continue in 2019, but more attention needs to be paid to how additional funding is best used to deliver improvements in educational outcomes across the population, and particularly for those students in the bottom quarter of the educational outcome profile which is going backwards faster than those at the top (according to PISA results).[26] A review planned in 2019 will hopefully focus in on this and how better to move students into more appropriate tertiary education pathways, and support life-long learning.

The New Child Care Package, which rolled the childcare rebate and the means tested childcare benefit into one and established an hour rate cap (but did not remove the annual cap as recommended by the Productivity Commission), was introduced in July 2018.[27] The Australian Government preschool funding (for the states and territories to deliver 15 hours for four-year olds) was re-funded in the May Budget for one more year. The Labor Party platform is to extend access to three-year-olds, but providing funding certainty beyond a one-year horizon for four-year-olds would be a good first step.

"Both political parties now support a needs-based funding model, taking the Gonski recommendations as the starting point."

FIGURE 4
Public expenditure on R&D in Australia, 2006-07 to 2016-17



Source: ABS, Research and Experimental Development, Government and Private Non-profit Organisations, Australia, 2016-17, 5, July 2018, http://www.abs.gov.au/ausstats/abs@.nsf/mf/8109.0

Higher education and research funding goes backwards

The Australian Government froze funding for university supported places in the May Budget at 2017 levels for 2018 and 2019, effectively removing the demand-driven system.[28] Labor has pledged to return to the demand-driven system, which had to a reasonable degree responded more to market signals than the previous fixed-place system.

A more critical question, that is unlikely to be but should be addressed in 2019, is whether students are getting value for their and the public's money by pursuing a university degree. Some students would do better, and the Australian economy benefit from, greater investment in vocational and educational training (VET).[29] Given the convergence of reviews, – the Australian Qualifications Framework (AFQ), Higher Education Provider Category Standards, the current VET Review, and Labor's promised tertiary education review – with any luck, 2019 could see the start of a principles-based discussion of what a coherent post-secondary education sector should look like.

Public funding for research as a share of GDP has fallen consistently over the last six years and is now down to 0.18 per cent of GDP (Figure 4). The recently announced reduction in the Research Block Grants (of just over $197 million over the forward estimates) in MYEFO, after a decline of $131 million (over four years) in the May Budget, continues this downward trend.

The much-needed reforms to the Research and Development Tax Incentive designed to more effectively induce additional R&D, were estimated to reduce the cost to the budget by $2.4 billion over the forward estimates.[30] This saving has notionally been diverted to industry programs, such as the Growth Centres Initiative. Labor has pledged to increase the total expenditure on R&D in Australia from the current 1.8 per cent to three per cent by 2030.[31]

Strengthening investment in infrastructure

After the hiatus on investment in infrastructure by the states and territories post the GFC, 2018 saw further strengthening in investment in infrastructure, much by the states and territories, and with a focus on public transport.

Early growth was supported by the Australian Government's asset recycling program, but this has expanded to a $75 billion 10-year infrastructure package over the next decade. The May Budget included $24.5 billion for new nationally-significant transport projects. Most of the federal spending leverages the states and territories, with major commitments to roads in the major cities, notably WestConnex in Sydney ($1.5 billion and a concessional loan of $2 billion), M80 Ring Road in Melbourne ($500 million), and connecting airports to cities – Western Sydney Airport ($5.3 billion), Melbourne Airport Rail Link ($5 billion announced in MYEFO), and the $490 million for the Forrestfield Airport Link in Western Australia.

The Australian Government has had to go it alone on other projects, notably the Inland Rail project – Brisbane to Melbourne ($9.3 billion), and many of the 'Roads of Strategic Importance' ($3.5 billion) – which includes $1.5 billion for the Northern Australia Package.

No coherent rural policy agenda

A mix of policies relate to rural Australia – but do not form a coherent agenda.

In 2018 there was further allocation of public funds towards rural and regional development in the Building Better Regions Fund ($200 million for a third round) and the Regional Growth Fund ($272 million with a focus on regions facing structural adjustment). Funding to adapt the City Deal framework to pilot Regional Deals announced in MYEFO will ideally provide more effective direction to the investments being made under the $641.6 million Building Better Regions Fund, $272.2 million Regional Growth Fund, and $222.3 million Regional Jobs and Investment Packages.

On the agricultural front, an additional $1.8 billion in assistance and concessional loans to support drought affected farmers and communities was allocated under MYEFO.[32]

These policies continue to maintain the fiction that drought is an unusual event, when even the National Farmers' Federation is on the record as concerned about climate change.[33] The $3.9 billion Future Drought Fund (scheduled to grow to $5 billion) continues the trend of setting up investment funds (Future Funds) to provide funding for ongoing activities, in this case projects focused on building drought resilience, preparedness and recovery.

Little to see in environment, multicultural or foreign aid policy

In 2018 there was little to see in environment, multicultural or foreign aid policy developments, with a nod to gender and rejection of an important opportunity for kickstarting real reform in Indigenous affairs.

There has been little action on environment policy other than a large donation to an unlikely organisation with The Great Barrier Reef Foundation receiving a grant of $400 million (and $44 million to cover their costs of management) to invest in research and activities such as water quality, and community engagement and monitoring to improve the health of the Great Barrier Reef.[34]

"The Australian Government has had to go it alone on other projects, notably the Inland Rail project – Brisbane to Melbourne ($9.3 billion)."

"In 2018 there was little to see in environment, multicultural or foreign aid policy developments, with a nod to gender and rejection of an important opportunity for kickstarting real reform in Indigenous affairs."

After the removal of funding for programs that supported multicultural celebration in the 2014 Budget, the Australian Government funded a new program in 2018, entitled Mutual Understanding, Support, Tolerance, Engagement and Respect (MUSTER). This grant program will support community groups in disadvantaged communities to promote social cohesion.

Despite Australia seeking to play a greater role in the Pacific (to counter the influence of China), the funding cuts in foreign aid announced in previous years remain in place. The Indo-Pacific Special Visits Program was expanded, as was the Expanded Pacific Information Network.

The removal of the GST on tampons was a win for women, as was the Women's Economic Security Package. Announced in MYEFO, this is $119.2 million to fund measures including more flexibility in and access to Parental Leave Pay for primary carers, and funding for the Future Female Founders and Boosting Female Founders programs. While these are in the right direction, they do look tokenistic.

One area where even tokenistic changes are largely absent is in Indigenous policy. The outright rejection of the Uluru Statement from the Heart of the Nation has made it implausible for the federal government to do anything with credibility in the Indigenous space.[35] Despite many well-meaning people trying to improve services on the ground for Indigenous people, when the main change in Indigenous policy is an extension of the trial of the cashless debit card, it is very clear that the Australian Government needs to do better. If 2019 sees meaningful engagement to reform the Community Development Program, that tackles the problems inherent in its predecessor, while undoing the punitive and ineffective elements, this would be policy success indeed.

Tinkering on the policy front can be the right approach when the economy is doing well. But ignoring the big known and emerging risks and taking a 'she'll be right' attitude is not good policy. Hopefully governments will decide that 2019 is the year to start the serious conversations that are needed to develop bipartisan approaches to tackling the more fundamental economic and social challenges including efficient revenue raising to fund promised services, ensuring a health system that is accessible to all, tackling climate change, and building solid foundations for more effective Indigenous programs.

Endnotes

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9 For example, social welfare debt recovery is estimated to deliver savings of $316.1 million, and self-sufficiency for migrants $204.6 million, while the reductions in the level of foreign aid contribute savings of $110.5 million in in 2021–22 despite none of these delivering more than $10.2 million of savings in the previous years (foreign aid), and imposing small costs for the other two. On the revenue side, combatting illicit tobacco is estimated to deliver an additional $3.25 billion of revenue in 2019–20, but less than $200 million in the subsequent years. Another concern is that Australia's GDP growth projections are sensitive to the price of commodities. A major downside risk is an escalation in the trade war between the Unites States and China, which could hit the demand for iron ore and coal, and hence prices. The Budget projections in MYEFO include a softening in the terms of trade in line with the modest decline projected in export values of bulk commodities.

10 For an excellent timeline on Australia's carbon price policies from 1997 to 2014, see ABC News 'Carbon tax: timeline of its tortuous history in Australia, 17 July 2014. Accessed from: https://www.abc.net.au/news/2014-07-10/carbon-tax-timeline/5569118

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12 The Australian Government, Tax relief, Budget 2018-19, Overview. Accessed from: https://www.budget.gov.au/2018-19/content/overview.html

13 The move is from equalising to the jurisdiction with the greatest capacity to provide services to the stronger of New South Wales or Victoria. This is largely a response to Western Australia's record low share of GST received in 2016–17 (30 per cent of the GST paid in the state), which was the effect of the three-year revenue averaging passing through the system combined with record mining royalties. While the Commission did not find any evidence of state and territory governments failing to taking up revenue raising opportunities, this possibility was viewed as a case to change the GST sharing formula. Productivity Commission, Horizontal Fiscal Equalisation, 5 July 2018. Accessed from: https://www.pc.gov.au/inquiries/completed/horizontal-fiscal-equalisation#report

14 This is mainly due to improvements in access for dairy and sugar into Canada, Japan and Mexico and a reduction in Japan's tariffs on beef. Australian Government Department of Foreign Affairs and Trade, Comprehensive and Progressive Agreement for the Trans-Pacific Partnership (CPTPP). Accessed from: https://dfat.gov.au/trade/agreements/in-force/cptpp/outcomes-documents/Pages/tpp-11-outcomes-at-a-glance.aspx

15 Border Security received $294 million to increase Australian Federal Police (AFP) presence at airports, and to strengthen screening at regional airports and inbound cargo and mail. The Department of Home Affairs got $130 million to upgrade its ICT for visa processing, identity management and threat analysis.

16 There has been considerable backlash from the tech sector, as reported by Koehn, E. and McDuling, J. (2018). 'From ideas boom to innovation bust: How Australia turned against tech', *Sydney Morning Herald*, 22 December 2018. Accessed from: https://www.smh.com.au/business/companies/from-ideas-boom-to-innovation-bust-how-australia-turned-against-tech-20181218-p50n1l.html

17 See for example, Crowe, D. (2018). 'Morrison backs national anti-corruption commission following Labor demands', *The Sydney Morning Herald*, 13 December 2018. Accessed from: https://www.smh.com.au/politics/federal/morrison-backs-national-anti-corruption-commission-following-labor-demands-20181213-p50lzf.html, and Easton, S. (2018). 'Federal ICAC back on the agenda in federal parliament' *The Mandarin*, 29 October 2018. Accessed from: https://www.themandarin.com.au/100531-federal-icac-back-on-the-agenda-in-federal-parliament/

18 The case for transparency is made well by Wood, D., Chivers, C., and Griffiths, K. (2018). 'States and territories have improved integrity measures, but Commonwealth lags far behind.' *Grattan Institute*, 2 November 2018. Accessed from:https://grattan.edu.au/news/states-and-territories-have-improved-integrity-measures-but-commonwealth-lags-far-behind/

19 The next sectors to be required to provide consumers with their data are electricity and telecommunications, although these already have some requirements for data provision. Australian Treasury, Consumer Data Right - Fact Sheet. Accessed from: https://static.treasury.gov.au/uploads/sites/1/2018/02/180208-CDR-Fact-Sheet-1.pdf (accessed January 1, 2019).

20 See section 10 (page 46) of the ACCC's Consumer Data Right Rules Framework paper. Accessed from https://www.accc.gov.au/system/files/ACCCpercent20CDRpercent20Rulespercent20Frameworkpercent20percent28finalpercent29.pdf

21 An issues paper on this proposed legislation is available from Prime Minister and Cabinet. Accessed from: https://www.pmc.gov.au/resource-centre/public-data/issues-paper-data-sharing-release-legislation

22 Financial Services Royal Commission, Interim Report, Executive Summary. Accessed from: https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-exec-summary.pdf

23 Additional funding was announced in MYEFO for:

- $70.1 million to the Australian Securities and Investment Commission (ASIC) to reduce misconduct in the financial services industry.
- $58.7 million to the Australian Prudential Regulation Authority
- $35.6 million to the ACCC over 4 years from 2018–19
- $51.5 million to the Commonwealth Director of Public Prosecutions and the Federal Court of Australia to 'enable court actions for corporate and financial services misconduct to be dealt with effectively and expeditiously' (MYEFO p.6).

24 For a discussion of the issues see Australian Health Coalition Reform Alliance (2018)., 'Health Budget fails prevention, equity and reform goals'. Accessed from: http://www.healthreform.org.au/wp-content/uploads/2018/05/MR-Budget-2018-16-May-2018-2.pdf, for suggestions on policy reforms within the current system see Productivity Commission (2017) *Shifting the Dial: 5-yearly productivity review*, chapter 2, Healthier Australians. Accessed from: https://www.pc.gov.au/inquiries/completed/productivity-review/report/productivity-review.pdf and for some more significant changes see for example, PWC (2018). 'Reimaging Healthcare in Australia, Budget 2018 - Progress towards reform'. Accessed from: https://www.pwc.com.au/health/federal-budget-health-8aug18.pdf, and Swerissen, H., and Duckett, S. (2018). 'Mapping Primary care in Australia, Grattan Institute, 29 July 2018. Accessed from: https://grattan.edu.au/report/mapping-primary-care-in-australia/

25 For a commentary on this program see Duckett, S. (2018). 'Morrison's health handout is bad policy (but might be good politics), Grattan Institute, 14 December 2018. Accessed from: https://grattan.edu.au/news/morrisons-health-handout-is-bad-policy-but-might-be-good-politics/

26 Gonski 2.0 had a strong focus on data-driven instruction and personalised learning to ensure that each student in any year achieves at least 12 months equivalent of progress. For a discussion see Goss, P. (2018). 'Two steps forward, one back in march towards fair outcomes for schools'. Grattan Institute, 12 October 2018. Accessed from: https://grattan.edu.au/news/two-steps-forward-one-step-back-in-march-towards-fair-outcome-for-schools/

27 For details see Australian Government, The New Child Care Package, 2 July 2018. Accessed from: https://www.education.gov.au/ChildCarePackage

28 From 2020 this will be applied under Performance-Based Funding for the Commonwealth Grants Scheme, which will allow universities to access funding in line with population growth if they meet performance requirements. These requirements are currently under review. Accessed from: https://www.education.gov.au/performance-based-funding-commonwealth-grant-scheme

29 See, for example, Norton, A. (2018). 'To fix higher education funding, we also need to fix vocational education, Grattan Institute, 5 September 2018. Accessed from: https://grattan.edu.au/news/to-fix-higher-education-funding-we-also-need-to-fix-vocational-education/

30 The legislation has yet to be passed, but the budget savings have been booked to consolidated revenue. Australian Government, Budget 2018-19, Reforming the R&D Tax Incentive. Accessed from: https://www.budget.gov.au/2018-19/content/factsheets/6-tax-integrity.html

31 Mannix, L. (2018). 'Labor will 'defend science'. Bill Shorten tells researchers,' *Sydney Morning Herald*, 28 November 2018. Accessed from: https://www.smh.com.au/national/labor-will-defend-science-bill-shorten-tells-researchers-20181128-p50ixq.html

32 This includes extending the Farm Household Allowance (FHA) threshold test from $2.6 million to $5 million, expanding eligibility from three to four years and introducing a one-off Special Drought Supplement of $3600 for singles and $3000 each for couples (MYEFO, p.150).

33 Murphy, K. (2018). 'We've turned a corner: farmers shift on climate change and want a say on energy,' *The Guardian*, 20 June 2018. Accessed from: https://www.theguardian.com/australia-news/2018/jun/30/weve-turned-a-corner-farmers-shift-on-climate-change-and-want-a-say-on-energy

34 Australian Government (2018). 'Record investment in the Great Barrier Reef to drive jobs', 29 April 2018. Accessed from: https://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id:percent22media/pressrel/5935805percent22

35 Uluru Statement from the Heart (2017). Accessed from: https://www.referendumcouncil.org.au/sites/default/files/2017-05/Uluru_Statement_From_The_Heart_0.PDF

5 Europe policy overview

Dr Hubertus Bardt

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Introduction

The economic situation in Europe has improved over the last years. Although the problems of the financial crises in Greece have not been completely solved, growth rates have increased in most countries. Average growth within the Eurozone reached 2.4 per cent in 2017. Countries like Spain, France and Germany with 3.1, 2.3 and 2.2 per cent have pushed economic development in Europe. On the other side, Italy and the UK reached lower growth rates of 1.5 and 1.7 per cent.

However, expectations for 2018 and especially 2019 are a little bit lower. Two per cent and 1.5 per cent can be expected for the Eurozone in 2018 and 2019. Growth in the UK will reach 1.5 per cent in 2019 after 1.2 per cent in 2018 – as long as an economic shock caused by a no-deal Brexit can be avoided, Italy will grow by only one per cent.

The economic consequences of Brexit for the EU and the UK on the one side and future fiscal policies of the populist government in Italy are the most significant internal risks for short-term economic development in Europe.

In Germany, GDP growth rates have been at or above potential growth for a number of years. However, the economy will expand by 1.2 per cent only in 2019 after 1.5 per cent in 2018 due to growing global risks like trade restrictions. Scarcity of qualified labour has emerged as a central obstacle for further investment and growth. Unemployment has shrunk from more than five million in 2005 to below 2.5 million in 2018. The high level of employment has become the main driver of domestic demand and therefore the current growth performance.

Brexit and trade restrictions

The German economy is one of the most open industrialised economies in the world. The business model of many successful companies is based on international trade. Large parts of the German Mittelstand are highly specialised in their respective niche which is only large enough to survive when the world is the market. These success stories are threatened by any attempts to increase trade barriers in the world.

Additional tariffs or other trade restrictions have been in place for a couple of years. Export restrictions for natural resources have been of significant concern for about five to 10 years. The British Brexit

decision in the summer of 2016 and the election of an openly protectionist US president increased uncertainty regarding the future of world trade. Growing tensions and threats of massive import tariffs (e.g. on automobiles) reduced business confidence and reduced the short-term growth perspective for Germany.

After two years of negotiations, there was still no fixed agreement on the terms of Brexit as of mid-January. All extreme scenarios from a no-deal Brexit to a new referendum were still possibilities less than three months before the Brexit date at the end of March. Uncertainty became a major obstacle for investments in the UK. Companies with significant business in the UK have been prepared for the no-deal scenario as they had to face interference of supply chains at the harbours and other short-term consequences. A number of companies reacted by moving capacities to the continent or by stockpiling spare parts in order to keep production running. The long-term effects of Brexit will be significant and will probably be more harmful for the UK than for the EU. Growth perspectives and investment in the UK have already decreased significantly.

While Brexit negotiations were about keeping trade barriers as low as possible, Europe and especially Germany were faced with a US president who does not see international trade as mutually beneficial and therefore follows a protectionist agenda.

The threat of the US administration to introduce significant tariffs on manufactured goods from Europe has been put on hold after a meeting of the President of the European Commission, Jean-Claude Juncker, and US President Donald Trump.

"The British Brexit decision … and the election of an openly protectionist US president increased uncertainty regarding the future of world trade."

The deal between the President of the European Commission and the US President was a ceasefire that prevented an escalating trade war with tariffs on European cars and car parts on one side and retaliation measures on the other side. In this deal, Europe agreed to let more natural gas from the US into the EU and import more soybeans. US soybeans will find their way to Europe as prices dropped significantly due to Chinese tariffs introduced in response to protectionist measures in the US. As far as natural gas is concerned, there are plenty of unused LNG import capacities in Europe to progress more US gas and to distribute it within the EU.

There are no European trade restrictions, though. The first American natural gas arrived in Portugal in 2016. Whether imports from America can increase mainly depends on price developments. LNG shipping is more expensive than gas transport in an existing pipeline network, therefore US fracking gas has to be cheaper than gas produced in Russia. At the bottom line, gas trade is market based and not a political decision between leaders from the US and Europe. Again, this was a moderate concession, but politically valuable for the Trump administration.

The outcome of the ongoing negotiations about future trade relations is very unclear. The transatlantic trade relations are critically dependent on US domestic politics. Therefore the ceasefire could end from one day to another, which adds uncertainty to economic opportunities in the short and medium term.

Scarcity of qualified personnel and demographic change

The demographic development in Germany will lead to an ageing of the society, while the number of people living in Germany will be higher in the mid-2030s than it is today. The society will grow for the next few years, and then start shrinking in the 2020s. However, the ratio of working population to total population will continue to shrink as life expectancy will continue to grow.

Today, people receive payments from the public pension scheme for almost 20 years. In the 1960s, it was less than 10 years. The strong labour market performance helped to generate the necessary contributions to the pay-as-you-go pension scheme, but a longer working life has to be open for discussion if the level of pay-outs from the system is to remain stable and contributions not be increased drastically.

Political decision-making currently is hardly addressing the demographic challenges, although

"…the unsolved distribution of migrants from Africa is a major challenge for the EU.

the baby-boomer generation will reach retirement age in the early 2020s. The strong labour market and record tax revenues make it difficult for political decision-makers to discuss reforms of the pension system. Instead, the last government introduced benefits for mothers with children born before 1992 – a second stage of this costly program has been announced.

Furthermore, employees who have worked for 45 years have the opportunity to choose early retirement without deductions. When this opportunity was introduced in 2014, companies lost well-qualified employees, who are difficult to replace.

Scarcity of qualified personnel has become a central obstacle for many companies in Germany and other European countries. This is true for computer experts or engineers, but also for qualified metal workers, lorry drivers, or geriatric nurses.

Surveys show that a shortage of qualified personnel is one of the most important reasons for not investing more, even if market opportunities are there.

The demographic development will make this problem more pressing. As a consequence, the GDP growth potential for Germany will shrink from 1.7 per cent in 2017 to 0.7 per cent in 2035. A combined strategy to increase labour supply and to increase investments and technical progress can bring growth back to previous levels.

However, a later retirement age, longer working hours, higher labour market participation of mothers and the elderly and increased productivity and innovation are not easy tasks to deliver. Digitalisation can bring some relief and should be seen as a positive development. And migration of qualified personnel is essential to close some of the gaps. After many years of discussion, the German government wants to decide on an immigration law which makes migration into the German labour market easier.

Migration and populist parties

Politically, migration from outside the EU is one the most discussed topics in Europe. This is not obvious as the number of refugees heading to Europe has shrunk drastically and is far below the levels of the refugee crisis in 2015. However, the unsolved distribution of migrants from Africa is a major challenge for the EU. Eastern European countries do not want to accept any migration, the current Italian government presses for a solution where refugees who cross the Mediterranean Sea do not stay in Italy. Europe must find a solution before the number of people asking for asylum may rise once again. In the meantime, many countries need foreign people with good qualifications to fill some of the job vacancies.

The ongoing discussions about migration and refugees help populist and right-wing parties in many European countries to succeed. In Hungary and Poland, these parties have formed government for several years now. Austria has a coalition with a right-wing party, while the Italian government consists of two populist parties. In Germany, a populist party won 12.6 per cent of the vote in the last general elections, but they are excluded from any coalition. There are similar movements in France, the Netherlands, Finland, Sweden and other countries.

The elections for the European Parliament in 2019 will show how strong the anti-European group in Parliament will be. However, with populist and right-wing governments in the European Council it has already become very complex to govern the EU and to solve the important problems from Brexit to trade and from financial stability to migration.

6 United States policy overview

Dr Joseph Minarik

Dr Joseph Minarik is Senior Vice President and Director of Research at the US Committee for Economic Development (CED). He was the chief economist of the Office of Management and Budget for the eight years of the Clinton Administration. Prior to his service in the Clinton Administration, Dr Minarik worked closely with Senator Bill Bradley on his efforts to reform the federal income tax, which culminated in the Tax Reform Act of 1986, writing Making Tax Choices in 1985; and served as Chief Economist to the House Budget Committee in 1991–92 and 2001–05, and staff director of the Joint Economic Committee in 1989–90. Recently, he served on the Bipartisan Policy Center's Debt Reduction Task Force and the National Academy of Science's Our Fiscal Future project, two national efforts to reduce the federal budget deficit.

The beat of a different drum

The United States has always marched to the beat of a different drummer. In 2018, the US economy, and economic policy, did so with a flourish.

In the closing instants of 2017, the US Congress passed a sizable tax cut, almost precisely 180 degrees out of phase from what all of the macro-economic stabilisation text books would prescribe. A different drummer, indeed.

That fiscal fizz was felt throughout the US economy. The real Gross Domestic Product (GDP) perked up from a 2.2 per cent growth pace in 2017 (and in the first quarter of 2018) to 4.2 per cent in the second quarter, and 3.4 per cent in the third.

These latest growth figures are beyond the economy's current potential growth rate (about 2.0 per cent for the next five years, according to the nonpartisan Congressional Budget Office, or CBO).

A buoyant job market

Accordingly, the job market has been going gangbusters – which remains a mystery of sorts. From an already satisfyingly low rate of 4.5 to 4.0 per cent in 2017, unemployment fell to the high threes for most of 2018.

After the discouraged exodus from the labour force during the financial crisis, where have these workers come from? Adult civilian labour force participation, which was as high as 67.3 per cent in January of 2000 and still 66.4 per cent in January of 2007, plunged to 62.9 per cent in January of 2017, and has barely budged to 63.1 per cent in December of 2018.

And another mystery: The US popular press is full of stories about the dawning of an age of robots that will take over a broader and broader range of jobs. The future of work is a hot topic. And yet, measured US productivity growth remains puzzlingly slow.

Some argue that the US national accounts mis-measure output, on the low side. And yet, the missing income from the national accounts certainly does not show itself in consumption (or on tax returns). Perhaps all of this missing income is realised in leisure-time enjoyment or quality of life. But if so, the puzzle is why we are all not happier. Or perhaps we are, but somehow do not notice it.

Meanwhile, employers who are facing this tighter job market have begun increasing wages, if very gradually. Yet so far, inflation rates remain low. Has competition in an economy that compares prices in nanoseconds in cyberspace become so intense that inflation will remain dormant? And yet…

Trade uncertainty

Economic policy is, to some, problematic. In 2017, the US withdrew from the Trans Pacific Partnership, just as the nation needed every friend to mount an attack on questionable trade practices by China. And the US Administration began heated argument with the nation's two leading trade partners and neighbours, Canada and Mexico.

The dispute with China remains in the shouting stage, while the renegotiated North American Free Trade Agreement (the original was undeniably in need of revision, having been written before the general availability of the Internet) remains stalled in a balky US Congress. US trade volumes fluctuated more than normal in 2018, as some flows have increased to beat anticipated competitive tariff increases and then ebbed thereafter.

A wild ride on the stock market

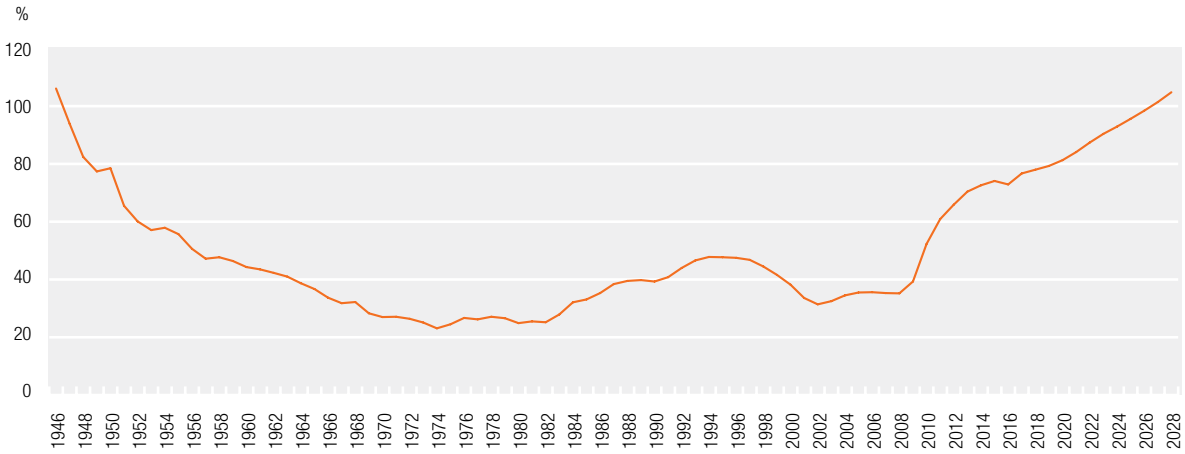
Some might think that trade uncertainty is the cause of the wild oscillations in the US stock markets at the end of 2018. Others would cite instead slowly rising interest rates as the culprit.

A full decade of crisis-restrained low interest rates is finally coming to an end, leaving many observers seemingly disoriented as the numbers have shifted for the first time in so long. Rates remain extremely low from an historical perspective, which might suggest that the Federal Reserve's critics are over-reacting.

The Fed itself would argue that maintaining low interest rates over long periods of time would create distortions in the financial structures of business firms, twist incentives, and lead to financial bubbles. Monetary authorities also quite naturally prefer that rates are high enough that they can be cut to bolster any future economic downturn. But others fear that the economic downturn may be already upon us, witness the stock market slide, and that increasing interest rates too soon may make that downturn unnecessarily worse.

"Some might think that trade uncertainty is the cause of the wild oscillations in the US stock markets at the end of 2018."

FIGURE 1
US ratio of debt held by the public to GDP



Source: US Congressional Budget Office. The Budget and Economic Outlook: 2018 to 2028

December 2018 brought intense focus on those minute-by-minute gyrations of the stock market, with frequently articulated fears that the downsides might portend or even cause an early recession. But more-quiet concern about the more distant future may be even more important.

A troubling budget outlook

President Trump has declared that he will not cut the US Medicare and Social Security programs, which arguably are the leading causes of a highly troubling federal budget outlook. There we return to the December 2017 tax cut, which by one year's evidence seems to have had the predicted effect of worsening the budget deficit picture.

Factoring in that tax cut and a number of likely fiscal developments (most but not all of which, including extending legally expiring tax cuts, worsen the baseline outlook), leads the CBO to project a public debt outlook (see Figure 1) that in 10 years would virtually match the highest US debt burden in history from 1946, at the end of World War II.

Obviously, the 2028 economy and budget are likely to prove not at all the match for the post-World War II US environment for economic growth and budget savings. In 1945, for example, the US federal government spent almost 37 per cent of the US GDP on defense; by 1948, it was 3.5 per cent, contributing an enormous reduction in public spending. In 2018, defense spending is estimated at only 3.2 per cent, rendering a 33-per-cent-of-GDP reduction rather difficult.

"President Trump has declared that he will not cut the US Medicare and Social Security programs."

Likewise, among other changes in the potential for economic growth, in 1946 the troops were marching home to join the labour force, whereas in 2028 the oversized baby-boom generation will still be wobbling off toward retirement.

President Trump has been quoted (from private setting by unattributed sources) as when presented with this budget outlook, having acknowledged the issue, but to have added, "Yeah, but I won't be here." Such reports may not be credible, but they do convey well the reality of the US economic and budget outlook at the end of 2018.

7 China policy overview

Associate Professor
Jane Golley

Associate Professor Jane Golley is an economist and Acting Director of the Australian Centre on China in the World (CIW) at The Australian National University (ANU). Her research over several decades has covered a wide range of Chinese transition and development issues, including industrial agglomeration and regional policy; demographic change and economic growth; rural-urban and gender inequalities; and the Belt and Road Initiative. Jane is actively engaged in public policy and media debate regarding the Australia-China relationship.

Contradictions, conundrums, contention and conflict

In 2018, China entered its 40th year since economic reforms and opening up commenced under Deng Xiaoping in 1978. During that period, the country's economic achievements have been phenomenal. With GDP increasing from 369 RMB in 1978 to 82.7 trillion in 2017, China has become the world's second largest economy, and is predicted by the International Monetary Fund (IMF) to be the world's largest by 2030.[1]

An average annual GDP growth rate of 9.5 per cent has seen China's share in world GDP increase from 1.8 per cent to 15.2 per cent. Import and export volumes have risen from a paltry US$20.6 billion to over US$4 trillion, making China the world's largest trading economy, with the highest foreign exchange reserves, at US$3.1 trillion in January 2019.[2] Hundreds of millions of Chinese people have been lifted out of poverty and, according to the Hurun Global Rich List 2018, 819 Chinese have become billionaires – the highest number in the world, with the US coming a distant second, with 571.

These achievements gave Xi Jinping, President of the People's Republic of China, much cause for celebration in 2018. On 18 December 2018, President Xi marked the 40th anniversary with a speech reaffirming China's commitment to the path of economic reform and opening up to the outside world.[3] Describing the reforms as a "great reawakening" of the Chinese Communist Party (CCP), he credited the Party with "the most profound and the greatest social transformation in Chinese history". He also stressed the need to adhere to his 'Four Confidences' – in following the path, theory, system and culture of Socialism with Chinese Characteristics – in order for China to achieve the "great rejuvenation of the Chinese nation".

Throughout 2018, however, it became increasingly clear that not everyone shares either Xi's confidence, nor his vision for China's future. Instead, the year abounded with contradictions, conundrums, contention and conflict – a very different Four Cs to the ones espoused by Xi.

These were evident in the ongoing slowdown of the Chinese economy, the extent of which, alongside the causes and appropriate policy responses, remain highly contested. There was growing international criticism of Xi's two signature policies – the Belt and Road Initiative, the centre piece of his foreign policy, and Made in China 2025, the crux of his domestic industrial policies. On top of all this was the most significant conflict of all, the US-China trade war, which escalated throughout the year. Viewed in this context, as 2019 commences, it is difficult to have confidence in anything much at all.

Socialism with Chinese characteristics

In 2013, shortly after rising to power, Xi signalled his serious commitment to embarking on wide-ranging reforms to rebalance the economy and to "redefine the relationship between government and market", with the market being assigned a "decisive role". While this led to great (albeit unrealistic) expectations at the time that the state was finally going to retreat and the market would thrive, this had clearly not materialised by 2018.[4]

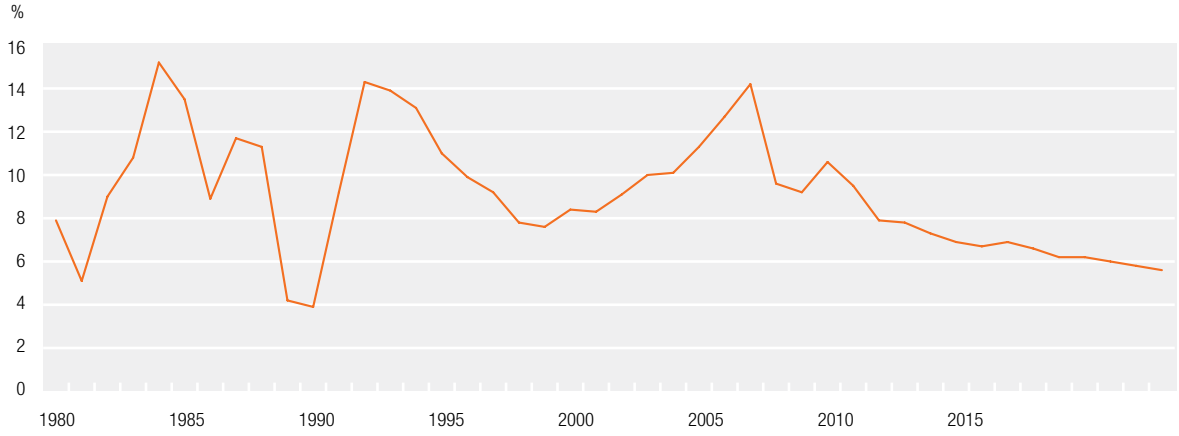
Instead, the National Party Congress (NPC) in March formally recommended that Xi Jinping's "Thought for the New Era on Socialism with Chinese characteristics" be written into the constitution, along with a clause rescinding the two-term limit on the PRC presidency, effectively giving Xi life-long rule should he choose it. This epitomises the centralisation of power that Xi has pursued during his first six years in office, with his tightening grip being evident across the party, government, military, economy and civil society. These changes all seem to contradict Xi's ongoing claims that he remains committed to reforming the economy (a process that remains far from complete 40 years into the transition), and that China is an economy based on openness, transparency and mutually-beneficial free trade.

These changes have generated growing anxiety across the globe, and in the West in particular, about how China's wealth and power are challenging the global status quo and the rules-based order that has been defined and led for more than half a century by the US – until the election of President Donald Trump in late 2016. Internally, a number of Chinese academics are expressing their concerns about China's future path as well, despite growing efforts by the state to curb academic freedoms and ensure that the party line is adhered to by all.[5]

Slowing growth, growing debt

In 2018, real GDP growth continued on its downward trend (Figure 1), although the extent of that trend remains hotly debated. China's National Bureau of Statistics confirmed in January 2019 that the government's official target of 6.5 per cent will be met – as it has consistently confirmed about all its official targets in the past. The starkest contrast with this reported figure came from Renmin University professor Xiang Songzuo, who gave a speech in December 2018 (soon after blocked from the Chinese internet), claiming that a secret government research group had estimated GDP growth at 1.7 per cent for the year.[6]

FIGURE 1
Official real GDP growth of China, annual per cent change, 1980–2018



Source: IMF World Economic Outlook.

"The true growth rate for 2018 will likely never be known by anyone."

In contrast, according to Professor Yiping Huang of Peking University, even if the official growth rate of 6.5 per cent is overestimated, the 'Li Keqiang index' (attributed to Chinese Premier Li Keqiang and based on indicators like electricity output and freight volumes that are less vulnerable to manipulation) still indicate a growth rate of "six per cent or slightly below".[7] The true growth rate for 2018 will likely never be known by anyone.

Regardless of the precise figures, there was broad consensus that the growth slowdown in 2018 could be attributed to a number of factors. Following an infrastructure boom in 2016–17, a toughening stance on local government borrowing resulted in a sharp slowdown in credit flows, with the most dramatic impact on growth in infrastructure investment, which plummeted from 19.8 per cent in 2017 to just 3.3 per cent in the first three quarters of 2018 (year-on-year).

Consumption growth also slowed through 2018, underpinned by falling consumer confidence, along with retail sales and industrial output. Export growth also began to slow as the trade war with the US intensified, and despite a depreciating RMB, from a peak of 15.4 per cent in February (year-on-year) to a low of 5.4 per cent (year-on-year) in November.

While slowing Chinese growth was met with despair in the international media,[8] growth rates over six per cent are still very impressive, and consistent with the government's strategy over the last decade to rebalance growth towards the domestic economy (and away from the investment- and export-led growth strategy of the past), and to achieve 'new normal' rates of growth (of between six and seven per cent). The slowdown also reflects the transition towards higher value-added industries in the context of an ageing population and rising wages, and the relatively austere macro policies since 2016, attempting to mitigate the growing debt risks. Stricter enforcement of environmental regulations has also contributed to a slowdown in economic activity, but is consistent with the drive towards greener, more sustainable and high quality growth.

But the risks for even slower growth are real and rising, with debt posing one of the most significant threats to China's growth prospects in 2019 and beyond. Corporate sector debt has stabilised since 2016, but remains worryingly high (according to the IMF, at around 135 per cent of GDP by the end of 2017). Government and household debt have risen steadily since 2014, reaching close to 135 per cent and 125 per cent by the end of 2017. According to S&P Global Ratings, the country's total non-financial sector debt, which includes household, corporate and government debt, could rise from 242 per cent in 2016 to close to 300 per cent of GDP by 2022.

They estimate off-balance-sheet debt in Chinese local governments as high as RMB 40 trillion (US$6 trillion): a debt iceberg with titanic credit risks.[9] Although the precise figures remain highly

contentious,[10] few would disagree with Xiang Songzuo's assessment that China's current financial risks are "hidden, complex, acute, contagious, and malevolent. Structure imbalances are massive, and violations of law are rampant."[11]

Many analysts fear that the Chinese government will attempt to counteract slowing growth with expansionary monetary and fiscal policies that will exacerbate the debt problem in 2019. The People's Bank of China's pledge to reduce the reserve requirement ratio by one percentage point in January 2019 (giving the banks leeway to lend an additional RMB1.5 trillion, or US$218 billion) and a substantial boost to spending on high-speed rail infrastructure (with the state-owned China Railway Corporation planning to expand track by 6800 kilometres in 2019, up 45 per cent from the expansion in 2018) are two early indications that these fears may be valid.[12] The appropriate mix of macroeconomic policies to steer China's economy through what is likely to be a turbulent year will remain hotly contested.

The Belt and Road Initiative

First announced as the One-Belt-One-Road (OBOR) Initiative in 2013, the renamed Belt and Road Initiative (BRI) continued to expand in 2018, encompassing 68 countries that cover the entire Eurasian zone. The initiative calls for a multi-dimensional infrastructure network, which will include a number of economic corridors (including the China Pakistan Economic Corridor, China Mongolia Russia Economic Corridor and the New Eurasian Continental Bridge), combining land, sea and air transportation routes with major railway, port and pipeline projects. The initiative will also create mechanisms for policy dialogue, infrastructure connectivity, tariff reductions, financial support and people-to-people exchange across the participating BRI countries – the so-called Five Connectivities.

With the BRI now written into the Chinese constitution, there is no question that it will remain a key policy priority in 2019, and well beyond that. But significant questions remain over the motivations, outcomes and impacts of the initiative, with little agreement on any of these – including the projected value of BRI projects, which begin at around US$1 trillion, but with one estimate going as high as US$8 trillion.[13]

China's official stance is that the BRI offers the world a mutually beneficial win-win opportunity to engage in free trade and promote prosperity for all. This contrasts with fears expressed in Western newspapers that BRI-recipient countries will become saddled with rising and unsustainable levels of debt, which will enable China to extend its political influence and power in undesirable ways – in what has become known as debt-trap diplomacy.

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While recent scholarly evidence has discredited the debt-trap diplomacy thesis,[14] it has fuelled mistrust in the BRI in many countries across the Asian region. In June 2018, former Foreign Minister Julie Bishop declared that Australia (which has declined to formally align with the BRI, with the exception of Victoria) will compete with China's infrastructure projects in the Pacific to offset China's greater political and strategic influence in the region, and to ensure that unsustainable debt burdens are not imposed on Pacific nations.[15]

The 2018 election loss of former Malaysian prime minister Najib Razak was at least in part because of accusations that he was selling out the country to China. Newly elected Prime Minister Mahatir Mohammad has pledged to review all Chinese projects and renegotiate any unequal treaties.[16]

Closer to China's borders, Japan signalled a shift towards greater cooperation with China, following a meeting between Prime Minister Shinzo Abe and Chinese Premier Li Keqiang in June, at which they agreed to establish a joint committee to coordinate economic cooperation in third countries – a remarkable shift given the tensions that have dominated this bilateral relationship in the past.[17] Other regional responses have varied from all-embracing and friendly ones, as in Kazakhstan and Pakistan, to extreme wariness, as in India, with many countries – like Russia, Japan and Malaysia – changing their stance over time. This makes it very difficult to predict how the BRI will evolve in the year ahead, short of noting that it won't be straightforward.

Trade and technology tensions

The trade war between the US and China began in earnest on 22 January 2018 with the US imposing tariffs worth US$8.5 billion on imported solar panels and US$1.8 billion on washing machines. By March, Trump had authorised tariffs of 25 per cent and 10 per cent on steel and aluminum, and by 1 April, the PRC began retaliating with tariffs affecting US$3 billion of American goods. And on it went, with US tariffs on Chinese imports skyrocketing to US$200 billion by September, when China's retaliatory tariffs on US imports reached US$60 billion. The 90-day truce reached by the leaders of the two superpowers in Buenos Aires in December amounted to an agreement to halt further escalation of tariffs, with negotiations on the final deal due to be completed in March 2019. Whatever that final deal is, trade tensions between the world's two largest economies are unlikely to fade away, and the global economy will suffer as a result.

In conjunction with increasingly higher tariffs, the Trump Administration also tightened technology controls on China throughout 2018, prompting former US Treasury Secretary Hank Paulson to warn of a looming Economic iron curtain between the US and China.[18]

One major source of tension is China's Made in China 2025 (MIC2025) program, which prioritises 10 high-tech sectors including space and aviation, maritime equipment and high-tech ships, high-end computerised machines and robots, and energy equipment. Initiated in 2015, MIC2025 aims to make China one of the world's most innovative countries by 2020, and a leading global science and technology power by 2049.

"MIC2025 aims to make China one of the world's most innovative countries by 2020, and a leading global science and technology power by 2049."

In Europe, Canada and Australia, China's technological collaborators became increasingly cautious of its rapidly growing technological capability – and use of industrial policy to achieve its goals – with worries about industrial espionage and forced technology transfers dominating media headlines in 2018.[19] The Trump Administration even considered banning Chinese students from US universities, although has taken only more limited measures, including shortening the visa duration for Chinese students studying in some high-tech fields. As Andrew Kennedy puts it:

> "What is clear is that China can no longer count on the level of international exchange and collaboration it has enjoyed in the technology sphere in the past. China's rise as a techno-power will continue, but Beijing could well find it a lonelier ascent in the future."[20]

This is not where China would have expected to find itself after 40 years of economic reforms and opening up.

Conclusion

While these first 40 years could broadly be considered as providing win-win opportunities for the vast majority of Chinese citizens – and substantial economic benefits for much of the rest of the world as well – the future seems far more likely to be characterised by the issues that have plagued China throughout 2018. The number one contradiction will continue to centre on whether the market will be given an increasingly decisive role or whether, as current trends suggest, economic activity will be encroached upon by an increasingly authoritarian and controlling state.

Conundrums and contentions will remain over how best to respond to slowing economic growth and growing debt. And there will continue to be conflict between China and the rest of the world, and most of all with the US, as they grapple with how to respond to an increasingly powerful and rising China, with Xi Jinping at the helm in his new era of Socialism with Chinese Characteristics. It is hard to have confidence in much at all in this context, except to know that the years ahead will be plagued with uncertainty.

Endnotes

1 See 'China's Economic outlook in six charts', IMF News, 26 July 2018, Accessed from: https://www.imf.org/en/News/Articles/2018/07/25/na072618-chinas-economic-outlook-in-six-charts

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4 For a fuller discussion of this point see Golley, J. (2014). 'Great Expectations', in Geremie Barmé with Linda Jaivin and Jeremy Goldkorn (eds). *China Story Yearbook 2014: Civilising China*, Canberra: Australian Centre on China in the World, Accessed from: https://www.thechinastory.org/yearbooks/yearbook-2014/chapter-1-great-expectations/

5 For two scathing examples, see Xiang Songzuo, 'A great unseen shift over the last forty years', 28 December 2018. Accessed from: https://chinachange.org/2018/12/28/a-great-shift-unseen-over-the-last-forty-years/ and the series of speeches given by Xu Zhongrun, translated by Geremie Barmé. Accessed from: http://chinaheritage.net/journal/imminent-fears-immediate-hopes-a-beijing-jeremiad/

6 See Xiang Songzuo (2018) 'A great unseen shift over the last forty years', 28 December 2018. Accessed from: https://chinachange.org/2018/12/28/a-great-shift-unseen-over-the-last-forty-years/

7 Wildau, G., and Fleming, S. (2019). 'Nervous markets: how vulnerable is China's economy?', *Financial Times* 5 January 2019. Accessed from: https://www.ft.com/content/5839f5dc-0fdd-11e9-a3aa-118c761d2745

8 In January 2019, these headlines included: 'Nervous markets: how vulnerable is China's economy?' 'The future might not belong to China', 'Xi Jinping begins his most important year at his weakest point', 'Beijing dithers as the economy declines', and 'China's faltering economy gives US stronger hand in trade talks, says Trump'.

9 Reported by Martin, W. (2018). 'China's hidden $6 trillion debt pile is an 'iceberg' posing a 'titanic risk', 17 October 2018. Accessed from: https://www.businessinsider.com.au/china-debt-crisis-6-trillion-off-balance-sheet-debt-poses-titanic-risk-2018-10.

10 For example, while the National Audit Office puts local debt at around 17.8 trillion RMB, a vice-director of the National People's Congress Financial and Economic Affairs Committee concurs with S&P that it is likely over 40 trillion. The true figures, like China's GDP growth rates, may well never be known.

11 See Xiang Songzuo (2018)., 'A great unseen shift over the last forty years', 28 December 2018.

12 This expansion is more than the total amount of track laid in Spain, the world's second-largest high-speed rail network with a total of 3,100km. Tang, F. (2019) 'Full speed ahead for China's high-speed rail network 2019 in bid to boost slowing economy.' *South China Morning Post* 10 January 2019. Accessed from: https://www.scmp.com/economy/china-economy/article/2180562/full-speed-ahead-chinas-high-speed-rail-network-2019-bid-boost

13 See Hurley, J., Morris, S. and Portelance, G. (2018). 'Examining the debt implications of the Belt and Road Initiative', *Center for Global Development (CGD) Policy Paper* 121, March 2018. Accessed from: https://www.cgdev.org/sites/default/files/examining-debt-implications-belt-and-road-initiative-policy-perspective.pdf

14 Rohan Fox and Matthew Dornan examine the levels of debt distress in 15 Pacific Island countries, finding that just six faced high levels of debt distress, and only one of those six – Tonga – possibly gave some basis to the 'debt-trap diplomacy' thesis, and even then, they are emphatic that it was not the Chinese government that had driven the poor loans but the Tongans themselves. This echoed the findings of another important report published in March by the Centre for Global Development (based in Washington DC), which found that of the 68 BRI recipient countries, only eight (Djibouti, Kyrgyz Republic, Lao, Maldives, Mongolia, Montenegro, Pakistan and Tajikistan) were in the category of being 'highly vulnerable' to BRI-related debt distress. For further details see Fox, R., and Dornan, J. (2018) 'China in the Pacific: is China engaged in debt-trap diplomacy?', 8 November 2018. Accessed from: http://www.devpolicy.org/is-china-engaged-in-debt-trap-diplomacy-20181108/ and Hurley, J., Morris, S. and Portelance, G. (2018) 'Examining the debt implications of the Belt and Road Initiative', *Center for Global Development (CGD) Policy Paper* 121, March 2018.

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19 See Andrew Kennedy's (forthcoming) chapter in *China Story Yearbook 2018: Power*, due out in April 2018 (and available online for free download).

20 See Andrew Kennedy's (forthcoming) chapter in *China Story Yearbook 2018: Power*, due out in April 2018 (and available online for free download).

acknowledgements

CEDA would like to acknowledge the following members and individuals who contributed to CEDA's general research fund between 1 January 2018 and 1 January 2019.

CEDA undertakes research with the objective of delivering independent, evidence-based policy, address critical economic issues and drive public debate and discussion. It could not complete its research agenda without the support of these contributions.

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