Global Development: The Long-term Context of Australian Development*

Ross Garnaut

I am going to say a few things about the current state of the Australian economy and the international dimensions of that and then I am going to share with you some work in progress and things I am thinking through on big longer term developments in the global economy that will feed back strongly into Australian opportunities and challenges.

For the moment, these are hard days for the majority of Australians who mainly depend on work for their livelihood.

Wednesday's national accounts tell us what analysis told us to expect: real income of Australians has fallen for two quarters in succession. Our population growth makes that a large fall in average income. Regrettably, there is much more of that to come.

Your real income may have increased if you have many more assets and income from them than the Australian average. But for most Australians, employment and wages mainly determine the standard of living. Many others in small business have fared about as well as wage earners. The ratio of employment to population has sagged continuously since the China resources boom went into retreat in the third quarter of 2011. Real wages have fallen over the past year.

It is worse if you are young. Youth unemployment has grown much more rapidly relative to total unemployment than in earlier downturns.

Dog days indeed.

The good news is that the exchange rate is again heading down and wages are not rising to compensate for the associated rise in domestic prices. After the mismanagement of the China resources boom from 2003, the average Australian standard of living has to fall if we are to restore full employment and share equitably the pain of the dog days.

The fall in Australian living standards was rendered inevitable by how we managed the salad days—inevitable, but let no one kid themselves that it is easy for the people

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most affected by it. A wise government led by a wise society would be thinking of how it could cushion the blow to ordinary Australians by ensuring that discretion favours equity whenever there is a choice between policies with different distributional consequences.

We have had a big productivity growth problem since the early years of the century. Don't kid yourself by looking at labour productivity changes that are boosted by the huge investment levels of the resources boom. Capital has a cost. What matters most for sustainable increases in living standards is total factor productivity, and the latest numbers give us no reason for joy.

It is not an easy matter to define the policies that can contribute to re-establishing substantial growth in total factor productivity. It is harder still to build support for productivity-raising reform and to make it work in practice. I talked about candidates for reform in last year's book, *Dog Days: Australia after the Boom*. There are no quick fixes. Policies to lift total factor productivity have to be thought through carefully and implemented steadily over many years.

We have a long-term budget problem—a big one. We should be making sure that we are not doing anything to make it worse, that we are aware of how much ground we have to cover and planning and gradually putting in place the policies that will cover that ground.

But the priority for the immediate future is to restore enough growth in economic activity to stop the deterioration in employment relative to population and to start the repair. Apart from its importance to the living standards of ordinary Australians, this will do more than anything else to improve budget outcomes in the next couple of years. It will also help to re-establish a political basis for productivity-raising reform.

The centrepiece of a program to restore sustainable growth in employment is a big real exchange rate depreciation—a big fall in the nominal rate, without the price effects of depreciation being passed through into wages. Avoiding wage increases in these circumstances is important enough to make the Senate discussion of Defence Force pay and conditions a factor in the battle for restoration of full employment. Jacqui Lambie has full employment in her hands.

More than half a century ago, my athletics coach at Perth Modern School, Jerry Hare, used to teach me that time wasted over each hurdle was time wasted in the race. We have wasted a couple of years above the exchange rate hurdle. We now have to get the front foot on the ground quickly so we can start running towards the next hurdle. It is nearly two years since I first put a number on the amount of real depreciation that was

necessary for us to return to sustainable growth in employment. I said 20 to 40 per cent from the US$1.05 at the time. Twenty per cent would be 84 cents. We reached that number just minutes after the ABS released the national accounts on Wednesday and returned there yesterday. That is good news.

The middle of my range was 73.5 cents, and the most that might be required was 63 cents. That is the fall in our dollar. Excellent modelling by Janine Dixon and her colleagues in the Centre of Policy Studies at Victoria University for the Melbourne Economic Forum in July suggests that the middle of the dog days range is the real depreciation that we will need to restore full employment sustainably. With the depreciation of other resource currencies, the yen and the won against the dollar; the time wasted above the hurdle; and the limited response so far of investment in the trade-exposed industries, the middle of the range now may not turn out to be low enough.

Let us not waste any more time floating over the exchange rate hurdle. Let us decide to deal with any concerns about a housing bubble in the right way, with housing measures—first of all the removal of the irresponsibly low risk weightings for housing lending in assessment of the banks' capital adequacy. That will free the Reserve Bank to set official cash rates according to the needs of the economy as a whole rather than the risks of housing. That means moving cash rates down towards the lower levels currently in developed economies in the northern hemisphere. That is what will bring the exchange rate down.

Let me say one more thing about my old sports master Mr Hare, lest the modesty of my own achievements on the track encourage doubts about his authority. Jerry Hare had also been the coach of Chilla Porter, whose legendary struggle with American world record holder Charles Dumas in the high jump at the Melbourne Olympics kept us glued to our radios late into the Perth afternoon, as the evening shadows dimmed to night at the MCG before the lights. Most of you here are about my age, so you will remember how the previous Olympic record was equalled or broken 10 times before Dumas climbed half an inch higher to victory. Chilla's son, Christian, is a member of this parliament and can share more of the story with you.

So, when you hear Mr Hare telling you not to waste time over the hurdles, you had better take note of his advice.

I thought I would get the dog days out of the way at the beginning so that I could spend most of the lecture on longer term global development issues, with some reference to how these affect Australia. The rest of the lecture will focus especially on one big question of global development and its effects on Australia: how global

savings have been tending to exceed global investment in the twenty-first century, how this has led to unprecedentedly low real interest rates for long-term debt, and how new approaches in the developed countries to public investment at home and abroad are necessary to secure full employment in the developed countries. Judicious developed country investment in income-earning infrastructure in the developing countries can accelerate growth in the latter at a crucial time.

I find it useful to think of the world economy as having three parts. Obviously every country and every part of every country is unique, but we have to think in broader categories if we are to speak of the world as a whole. So, I find it useful to think about developed countries, developing countries and underdeveloped countries. The developed countries are those like us, which enjoy the high living standards that come from full absorption of the benefits and effects of modern economic growth. Ordinary people in all of the developed countries have standards of living—of consumption, of material comfort, of health and longevity—in many ways beyond those of elites of any earlier generation of humanity. For all of our problems, being in the developed countries of 2014 is a good place to be.

And then there are the developing countries, which are most of the world's people, which have put their foot on the escalator of modern economic development and are moving towards the income levels and material standards of living of the developed countries but at varying rates. Most that get on that escalator on average keep moving, but at different paces and with bumps in the road, with quite a lot of thought being given to what will determine whether they eventually get there. And then there are the underdeveloped countries, which have not succeeded in putting their foot on that escalator.

The developing countries are experiencing growth in living standards at varying rates, but usually at considerable rates and on average much faster than the rate of increase in living standards in the developed countries.

In the underdeveloped countries, on average, there is no growth in living standards at all. Here we are talking of around a billion of the seven billion members of humanity. I found very useful and interesting Paul Collier's book *The Bottom Billion*, talking about the phenomenon of the underdeveloped countries. Most of those are in Africa; some are in our immediate region—I will come back to that.

I see the only stable end point of global development as being the whole of humanity joining in the high standards of living that people in the developed countries currently enjoy. Obviously, there have to be major modifications of that or the pressures on resources would destabilise everything, not least through anthropogenic climate

change. But all the technical means are available to reconcile one day all of humanity having the standards of living that we enjoy without destabilising the fundamentally important dimensions of the natural environment.

It will be a standard of living with different components. Obviously, there will be much less consumption of fossil fuels—at least without major measures being taken to abate their environmental consequences. There will be different patterns of consumption. But everything we know about development and the way that humans can gain satisfaction from modern invention tells us that what I call the maturation of economic development is possible. Not only is it possible; it is the only stable end point of modern economic development.

For the developed countries, while our material standard of living is high compared with earlier generations of our species, we nevertheless are facing challenges of a kind that most people in developed countries have not faced for a very long time. We have seen in virtually all the developed countries, stagnation in living standards since the Great Crash of 2008. And yet everywhere there is still an expectation of each generation living better than generations before—an expectation created in earlier eras of economic development. So the stagnation in living standards is the source of some disappointment and tension.

In all the developed countries, there has been a marked slowdown to very low levels in productivity growth since 2000. In the most advanced countries, productivity growth since 2000 is proceeding less rapidly than at any time at the frontiers in the leading countries since the early days of modern economic development from a millennium ago. This has been the subject of some discussion in the economic literature.

A famous paper by Robert J. Gordon published by the National Bureau of Economic Research in the United States has put forward the data and some hypotheses that in his view suggested we may not see again the rises in productivity and therefore of living standards that we had seen in earlier periods of modern economic development.[1]

It is worse than that for ordinary people in many developed countries, and in the United States, living standards of people at the median, in the middle of the distribution, are actually lower now than they were three decades ago. It is not quite so stark in Japan and Europe but it is heading in that direction.

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1 Robert J. Gordon, 'Is US economic growth over? Faltering innovation confronts the six headwinds', National Bureau of Economic Research working paper no. 18315, August 2012.

In Australia and in other English-speaking countries plus Spain, the consequences of low productivity growth were masked for a while by an extraordinary housing and consumption boom from the turn of the century to the Great Crash of 2008 that was unsustainable. It was funded by our banks borrowing abroad in wholesale markets. It had to come to an end. Well, it came to an end in cataclysm in other developed countries. It didn’t end in catastrophe in Australia. The better end here was partly a result of quick-footed policy, but that policy was only viable because of our special fortune in being beneficiaries of an extraordinary China resources boom—the strongest period of growth over a long period in any country ever, in a country that happened to be the world’s most populous country and the most energy and metals intensive growth that any country has ever had. That all generated growth in demand for those commodities which Australia was especially well placed to supply.

So that postponed the effects of declining productivity on the Australian community until all those changes in China changed again. One can date the second change from the September quarter of 2011. The change was not so much a reduction in the Chinese rate of growth. There has been a reduction of a couple of per cent in the average rate of growth in China since then, but much more importantly there was a change in the nature of Chinese growth. From 2000 to 2011, Chinese growth was more investment intensive, more energy and metals intensive than growth anywhere has ever been. This was part of a brilliantly successful growth strategy that turned China into a great economic power and raised average living standards of most of its people by large amounts. But this pattern of growth had adverse consequences, to which there were political reactions and which led to a reshaping of priorities.

One consequence was the old pattern of growth was associated with rapidly widening inequality in the distribution of income. The Chinese Government, by 2011, had decided that that needed to be corrected. The old pattern of growth had to be modified. And the old pattern of growth was very damaging to environmental amenity and stability, both within China and in the world as a whole. And so, local and global environmental amenity became an important objective of Chinese policy. The Chinese economy is a big ship. It takes a long time to turn around. You see discussion of new policies going back as early as 2006.

The new approach was embodied in the 12th five-year plan from 2011 to 2015, and during that period we have seen more and more policies put in place to reflect the new priorities in China. With each passing year, these new policies have stronger effects, and these effects have been apparent in the statistics on Chinese development since about 2012. Broadly, the changes that the Chinese Government wants in the pattern of growth are being implemented successfully. It is very hard; there is resistance politically from parts of the Chinese polity. Some things can and will go wrong,

because you can't make change on that scale without taking risks with economic stability. But so far you would have to say the changes are in the direction the government is seeking.

One consequence is that what had been extraordinarily rapid growth in Chinese demand for metals and energy turned into more moderate growth in demand from 2011, especially from 2012. In fact, for the two central commodities in our resources boom—coal and iron ore—there is now very little growth at all, and looking into the future there may be relatively little growth. So in the first decade of the century Australia had a big cushion against some of the challenges that were facing other developed countries, but that cushion has been pulled away in the last few years. It is still being pulled away—and we are going to take a while in getting used to the consequences and managing the consequences of all of that.

I see a marked slowing of productivity growth as an underlying problem of the developed countries—which means we can't rely on average incomes rising in the future as they have for many generations. But there are other changes going on that are also putting stress on the developed countries. For productivity, there are things that we do not understand about where it is likely to go next. There is even a question of whether we properly can measure productivity, because in some areas of our life we have had new commodities and new services that greatly improve the quality of life, but those qualitative factors are not properly represented in the statistics. But nevertheless, measured well or not, the reality of low and—in the case of Australia since 2005—negative total factor productivity growth of the traditional kind means that there is much less incentive for investment, business investment, in activities of the traditional kind, giving employment of the traditional kind. Levels of business investment have been low this century, and especially since the Great Crash of 2008, in all of the developed countries.

Amongst the other challenges, a common theme across all the developed countries is the consequence of ageing. People are living longer and having less children and, as a result, average age of population is growing very rapidly. In the early years—and this looks like it is going to be a long period in most countries—that leads to increases in savings rates, as people prepare for longer retirements.

So we have lower incentives for business to invest, lower investment, at the same time as we have higher savings. And since the Great Crash of 2008 we have seen both household and government tendencies to save more, and in the case of governments there has been a fairly general wish to consolidate budgets, to reduce deficits, in response to the increased indebtedness that was incurred during the financial crisis.

And, in the case of private households and businesses, there has been a tendency to want to reduce debt, for precautionary reasons, after the disruption of 2008.

A combination of all of these things is leading to substantially higher levels of savings and substantially lower levels of business investment, and that means a tendency towards reduced demand in all of our economies, higher unemployment and lower economic growth. So that is a common story across the developed countries. The consequences of ageing are not as severe in those countries which have high levels of immigration, and Australia is one of those. In fact, Australia is in the front of the developed countries for that, but the factors behind the tendency for savings to run ahead of investment are important even in those countries.

One consequence of higher savings and lower investment in the developed countries as a whole is tendencies to lower interest rates. There is a bit of a tendency, after the global financial crisis, to see a period of very low interest rates as simply being part of the process of recovery from the financial crisis, to see the central bank interventions keeping cash rates low, short-term interest rates low. In the case of, at various times, Britain, Europe, Japan and the United States, a new phenomenon called quantitative easing has been introduced, where central banks are exchanging assets that can be turned into cash as they buy back government bonds from the private sector. Quantitative easing has been putting more money into the community with a view to reducing interest rates and encouraging business activity.

There has been a tendency to see lower interest rates over the last half-dozen years as being significantly a result of the crisis and to the policy response to the crisis. But I think there is a fair bit of evidence that more than that is happening—that we are entering a world in which long-term interest rates are much lower on an ongoing basis than they used to be. The most common long-term government security in most countries is a 10-year bond, and the interest rates on the 10-year bond are lower in real terms than they have ever been in almost all of the developed countries: last night, at 2.23 per cent in the US; 1.99 per cent in the UK; 0.77 per cent in Germany; 0.44 per cent in Japan; and, this morning in Melbourne, 3.01 per cent in Australia. That is the rate at which the private sector is prepared to lend to government on a 10-year basis, and in some of these cases these are negative rates in real terms. We have not been in this territory before. But we were actually getting into it before the financial crisis.

Amongst the evidence for that, you might remember the celebrated, now discredited, Chairman of the Federal Reserve, Alan Greenspan, talking, about a decade ago, about the conundrum that the Reserve was trying to raise interest rates by raising the cash rate and finding that long-term interest rates did not move at all or actually fell. I think we can now interpret that as an early sign of this new world in which the weight of

savings in excess of investment was depressing long-term interest rates. And, recently, we have had the United States Federal Reserve withdrawing quantitative easing, withdrawing the unusual monetary policies of buying up government bonds. But long-term interest rates have actually fallen since they stopped quantitative easing. So we are in a new world of, I think, for a long time, if not permanently, much lower long-term interest rates.

Now, being in this world has a lot of consequences. One is a very fundamental consequence for the distribution of income within societies. Some of you may have read the celebrated recent book by the French economist Thomas Piketty, *Capital in the Twenty-First Century*. It has been the best-selling economics book of our time. If you take the first couple of years after publication, it is, I think, the best-selling economics book ever. Not many people bought and read *The Wealth of Nations* in the first few years! Piketty argues that we are in for a world, in future, of widening and widening inequality and income distribution because we are going to have a rate of interest above the rate of growth—that those who already have capital will be accumulating it at that high rate. He notes a lot of historical data that shows that there has been a tendency for rates of return on low-risk investment, like government bonds or land, to be around four to five per cent in real terms, after inflation, right back to the eighteenth century; and he quotes extracts from Balzac and Jane Austen to show their principal characters talking about the wealth that the man you marry will have to have if you are going to live in the style a gentlewoman wants to live in—and that is all premised on long bond rates or yields on land assets of around four or five per cent in real terms. Piketty says that will stay there like that forever, and therefore we are entering a period—and he talks about structural reasons why this will be the case—where inequality will grow wider and wider and we will be back to the inequality of the Belle Époque in Europe.

That is a very different perspective from that of a number of other economists. The greatest public intellectual of the twentieth century, John Maynard Keynes, wrote a couple of important things in the 1930s that talked about this issue: what will happen to the rate of return on investment into the long-term future? He came to this theme in two places—an essay in his lovely collection of essays, *Essays in Persuasion*, and then in the last chapter, chapter 24, of his main book *The General Theory*. He talks about modern economic development being so productive that there will be productivity growth for a long time. He sees quite a lot of income being saved, especially by current owners of capital. So he says that, so long as we do not make a mess of it with war—well, there was a big war just a decade after he wrote it (or unnecessary depressions) and he wrote a book about how we could stop having them—then the long-term future for the global economy is one in which capital is abundant. The rate of return will fall to very low levels. There will be no special

advantages in income for those who have a lot of capital. For those who are interested in the important things of life—and he would have had in mind the London opera and French champagne—there will be an abundance, so that questions of inequality will not matter very much. He talked about the 'euthanasia of the rentier'—the person who earns income simply from ownership of capital—with the rentier ending up not having a substantial income. The world he points to is almost the opposite of the world that Piketty anticipates in his book.

If you look at the data in the last decade, it looks a little bit as if Keynes was right. Well, that is only a bit of the story. Keynes had some weaknesses in his view of the world, but the big one was that his world was the world of, if not England, the developed countries—for some purposes the Empire, but not much the colonies of the Empire. Even his interest in Continental Europe was constrained. Friedrich Hayek once criticised him for not being interested in anything that was not published in England. But certainly Keynes did not see a world in which China and Indonesia and India would be enjoying the living standards of the developed countries. If he had, then he would have had to have wondered about whether this huge abundance of capital would come for the world as a whole so early. That was a gap in his thinking. Those are the economic challenges of the developed world.

I will say a little about the developing countries. I have talked a lot about China already. For the purposes we are talking about, we should think of China as a developed country. I think it will be in the range of incomes of developed countries within a decade. It has the tendency towards savings over investment like the developed countries. In all of the developed countries—and I am including China in that category—to maintain full employment and economic growth in the period ahead, you are going to need a lot more investment promoted by the public sector. In some countries, there will be opportunities for that to be in infrastructure, but in many countries we will have to see large-scale investment in income-earning assets in the developing countries if we are going to see significant yields on investment. And that will be helpful to maintaining employment and economic growth in the developed countries.

If this starts to happen, we will see a tendency towards net exports exceeding imports in the developed countries, capital outflow into income-earning development activities in developing countries and greater activity for employment in the export industries in the developed countries.

I think that is the way the developed world will need to shift for its own development reasons and it will be highly advantageous for the developing countries. And there will be opportunities in the developing countries because those developing countries

that have put their foot on the escalator of modern economic growth—the big ones being India and Indonesia, but lots of others—have the capacity to absorb a lot of that sort of capital.

It is a bigger challenge in the underdeveloped countries, roughly corresponding to Colliers' *Bottom Billion*. Today, the bottom billion include all of Australia's island neighbours in an arc of instability, intensifying poverty, high fertility and population growth, at least through Papua New Guinea to Fiji. Collier did not include Papua New Guinea in his bottom billion in 2007 and the persistence then of the struggle for good governance within the leadership justified his hesitation at that time. Regrettably, there is a Gresham's law of corruption in a country with weak institutions. When the currency has been debased, bad money drives out good. The good is forced out of circulation until there has been transformational institutional change.

Debasement occurred in Papua New Guinea this year with the serial dismissal of the anticorruption commissioner and a Law Minister who defended him, of a Public Prosecutor who took his recommendations seriously, and the replacement of an independent with a compliant Police Commissioner—all around the question of whether the system of justice should take action when the anti-corruption commissioner draws attention to prime ministerial breaches of the law. When the head of government is above the law, there is no rule of law. The struggle is now over for the time being in Papua New Guinea and the country's categorisation as part of the bottom billion is unambiguous.

My observations from experience of development in the island countries of the south-west Pacific correspond to those of Collier in Africa and support his main conclusions. Underdevelopment has its origins in problems of governance, which are far-reaching and intractable. Making headway on the problems of governance sets a path to development, but it is hard to get started.

Democracy is often an illusion until institutional weaknesses have been removed by education and drawing on external institutions. The exploitation of valuable natural resources can temporarily create the statistical illusion of development but is usually associated with kleptocratic corrosion of established institutional strengths.

The magnitude of the challenge does not mean that progress is impossible—just difficult, requiring institutional stability, wisely directed institution-building over long periods and often intrusive external support. A number of bottom billion African countries are making headway in the twenty-first century so far, led by Ethiopia with large Chinese support for infrastructure and agricultural and industrial development.

The bottom billion are more important than their current numbers suggest because much higher fertility makes them a rapidly increasing proportion of humanity. We could be confident that the global population will be on a downward path within a few decades despite increasing longevity with all of its benefits if and only if a large proportion of the bottom billion were headed towards entry into the ranks of the developing countries.

International support for development in the bottom billion must take the form of transfers rather than income-earning investments and be justified on development and security grounds. It can contribute to lower real exchange rates and net exports, and therefore on employment in the developed countries, but not to future income for an older population in the developed countries.

Whether we are successful in the maturation of global economic development with all the benefits that come from that really depends not only on the continued success of the developing countries but on getting onto the economic development escalator the people of the underdeveloped countries.

That is a hard task and, failing that, we cannot even be certain that the proportion of people on earth enjoying high living standards will increase over time, even if countries like China and Indonesia and India are growing very strongly. There is a danger that a failure of development in the bottom billion will catch humanity in a Malthusian bog.

Rosemary Laing — Thank you very much, Professor Garnaut. No wonder they call it the dismal science!

Ross Garnaut — Our profession was given that name by the historian Thomas Carlyle because the classical economists were deadset against slavery. They thought it was a terrible institution that defied all of the premises upon which they did their work. Carlyle was a defender of established institutions, of which slavery was venerable and had widespread support. Economists were 'dismal' because they said that that venerable institution had to go.

Rosemary Laing — I stand chastened! It is a very depressing picture you paint of the developing world on our doorstep. And from a parliamentary point of view I know that a great deal of work is being done by this parliament and Australasian

parliaments generally in capacity-building in our south-west Pacific neighbours to try to help create the institutions that will strengthen governance and accountability in those societies. I know this is a very broad question, but a successful economy does not have to have its base in democratic institutions, does it? Would you care to comment on that thesis?

Ross Garnaut — That is true; it does not. And of course China is the exemplar of that point. We do not know if we can have a successful developed country without democracy. We will learn that over the next decade or so in China. The Chinese leadership, under the General Secretary of the Communist Party, Xi Jinping, is setting out to improve the Communist Party, to constrain corruption, which is seen by the Communist Party leadership as undermining support and legitimacy, making it more efficient and effective. And I think the model that he has in mind is a model of the platonic guardian. Now, Karl Popper in his great book *The Open Society and Its Enemies* identified Plato as the source of enmity to the open society. He contrasted the platonic view of the world with the democratic open society, where you had government by an elite—and Plato, with his aristocratic background, an aristocratic elite—that had the interests of the community at large and governed benevolently in the interests of the community at large.

Well, I think Xi Jinping was seeking to build a Communist Party around that ideal of autocratic government. We do not know if that will be successful. If it is successful, it will be a very big challenge to democracies which are going through problems of political culture.

In China and in Australia we both face problems of maintaining integrity in government, maintaining public purpose in policy-making, against the pressures of private interests as private interests become less constrained in the pressure that they apply to public policy-making. You see in our current Senate manifestations of those pressures of a kind that we would have thought that we would never see. In recent times, we have seen an influence of vested interests in the policy-making process that certainly is larger, less constrained, more effective, at least than in the late periods of the twentieth century, where public policy and the public interest seemed to be more firmly established.

If Xi Jinping succeeds and our own political systems continue to be more deeply corrupted over time, it won't be felt as an existential challenge to our own form of government in our own society—there will be deep commitment to our democratic institutions in our society. But in other societies that are still making up their minds about political systems, then a successful China will not look so bad against corrupt democracies.

I think we can do much better than we have in recent times. I think it is the responsibility of all of us to make sure we do much better than that. I do not think that Xi Jinping's challenge is an easier one. He may very well fail. We just do not know if you can have an autocratic, developed, market economy that he is seeking to build. That is very important.

I think that when you speak about the pessimism you are thinking about the small countries of the south-west Pacific. I cannot see any system of government that is more certain to work in the interests of broadly based development than a democratic one, in the south-west Pacific. One can dream of a Leninist state emerging and sponsoring effective development like in Ethiopia. One can dream of an efficient—a more or less efficient—military government along the lines of the Suharto regime, in the period leading up to Indonesian democracy, but I think these are foolish dreams in the south-west Pacific. I think that for all of their weaknesses the challenge is to make current institutions work. But let us recognise that current institutions are not working, that there are profound problems, that we Australians have stood by and watched with little demur the disintegration of the rule of law in Papua New Guinea this year. So I think that is a problem for all of us.

Question — You referred in your speech to the housing bubble. In terms of this problem, do you perceive it to be something that regulators should be interested in because it detracts from productive investment or because a correction will create volatility, and whether you think we have got to the point where it is a lean or clean decision and, lastly, whether you think the macro-prudential regulation we have seen in New Zealand is suitable for Australia.

Ross Garnaut — My view of the housing problem is a very simple one: the economy as a whole needs lower interest rates, which will bring about a lower exchange rate. Some people say, and some readings of what the Reserve Bank has said, suggest that they think that the constraint on lowering interest rates is that we have got a bubble in the housing market. I am not so sure, but I sure don't want worries about a bubble in the housing market to stop us from lowering interest rates when the rest of the economy needs it. So, if there is a housing problem, deal with it in the right way, with a housing solution—and a form of macroprudential management of the housing sector is the right way of dealing with it.

My first priority would be normalisation of the extraordinary arrangements we have for risk weighting, for capital adequacy purposes, of bank lending for housing, where banks really have a considerable discretion in how they weight the risk of lending to housing, which means that you have much more highly leveraged lending for housing than for other activities. Banks make a lot more money as a return on investment of

lending to housing than to anything else for this reason, and so you get an artificial focus of lending in that sector.

So I am all in favour of cleaning up that weakness in our regulatory system, which will free the Reserve Bank to reduce interest rates and to thereby bring down the exchange rate so we can get over that hurdle, start employment growing again, and then we can turn our minds to the harder and longer term issues of productivity and the budget.

Question — Staying on housing: the Chinese problem about the vacancy rates in building and housing—what is going to happen there?

Ross Garnaut — I do not know much more than the analysts who follow those specific issues and write about them have been saying. I myself do not see a likelihood of a major disruption of growth in China. The most important thing, from Australia's point of view, that is happening in China is the structural change, which is intended and which is working as intended, which is reducing growth in demand for iron ore, for coal, for some of our other energy and metals products. I think that that will be more. That planned structural change is of more fundamental importance for Australia than the problem of the housing market.

China is now to a very large extent a market economy, and market economies spring surprises; and it would be surprising if some of the surprises to Chinese development are not large, now that it is a market economy. So this might be the first of the big ones, but my basic judgement is that it is not a fundamental threat to ongoing growth in the way the Chinese leadership wants it to unfold.

Question — Just very quickly, following up from the G20 and particularly the finance ministers' G20—I am not sure if they are F20 or what—something called bail-in provisions. There seems to be some very low level chat going around and very bad press on the extension of something called bail-in provisions, globally. Could you comment on that and is it something we ought to worry about?

Ross Garnaut — Well, I like bail-in provisions. Bail-in provisions are a way of ensuring that if banks run themselves imprudently and get themselves into deep trouble and we have to bail them out—as we will because it will damage the rest of the economy if we don't—that their shareholders pay a fair bit of it, rather than the rest of us. And, naturally, existing proprietors of banks do not like the idea of them being the big losers if they have to be bailed out with government guarantees or government provision of capital.

I think it is important to set out the rules for a bail-in, well in advance of a crisis so the managers of banks and their shareholders know the consequences of running too close to the wind. If we had that we would see less running close to the wind; it would be less likely that a future prime minister will be called upon to do what Kevin Rudd was required to do one October afternoon in Canberra in 2008, and extend a blanket guarantee to all of the wholesale debt of all of our banks, and put on the balance sheet of the Commonwealth of Australia, $178 billion of contingent liabilities. We do not want that to happen again. It is less likely if we have careful plans, set out in advance, of the conditions under which the Australian Government will bail out the banks.

Question — Ross, I would like to draw you out a little bit more on the medium to longer term trajectory of growth in the Chinese economy, because it is obviously so important, as you said, to the global economic outlook, but particularly to the economic environment in which Australian policy will have to be made over the coming five, 10, 15 years or so. The expectation that I heard in your presentation was for China transiting, effectively, to high income levels in the next decade or a bit more. But you raised some questions in response to a question about the governance system that will make that effective.

China has a lot of problems, including the problem of growing old before it has become rich. We have seen that advanced economies have not been too successful in reforming the social and economic institutions to manage that problem. So I would like to hear a little bit more about how you think China is going to effect that transition into higher income levels over the next decade or so, and manage the sorts of problems implied in that aphorism. Maybe—because that is too easy a question!—you can tell me a little bit about what you think about where India is going too.

Ross Garnaut — India first, or I will forget if I give a long answer about China. I think that modern economic growth, internationally oriented, is now pretty well established in India. They have got the problems of a democratic polity—good problems to have, but they are real, large. They have got problems of money and politics like we do and like the Indonesians do. That makes it difficult, sometimes, to introduce first best policies in the public interest. One consequence of having those policies now is that there is not so much uncertainty about political transition as there is in China.

But I think we are likely to see a continuation of reasonably strong growth in India. The short-term challenges are very large. Some of the external payments and public debt issues are quite large. I think India could be helped a lot by large-scale investment in infrastructure from the developed countries and China. So I think the Indian prime minister is wise to be as positive as he is about China's proposed Asian

Infrastructure Investment Bank. I think that that type of thing—that type of institution, that type of lending—can make a very big difference to India. India needs a lot of international capital. It does not need a lot of short-term, volatile capital; it needs long-term investment in things like infrastructure. So that would reduce the risks.

The cooperation between China and India on this question improves the chances that India will come smoothly through the challenges ahead. It is hard for India to grow as fast as China for a lot of reasons. It is a very different society. You do not have the capacity for central control. You might never have had it. The Qing emperor had a different kind of control to the Mughal emperor. And tendencies in the Chinese society lend themselves more easily to very high rates of savings, which were the motor of that extraordinary period of growth in the first 11 years of this century. But, nevertheless, there is a basis there for reasonably strong growth.

On the China questions, when you give a brief discussion of China's long-term prospects, then it comes out glibly, and I do not want to be glib about the challenges that China faces. But my feeling is that all of the purely economic problems are manageable and are more or less in hand. On the problem of ageing, China has been making a big effort in recent years to put in place a broadly based social security program, including large transfers to low-income people in rural areas. There is a very large problem of differential access to basic services in different parts of the country—a very strong urban bias. The current policies are putting quite a lot of effort into correcting that, which is quite important for the issues that you are raising. If those changes work, those reforms, you will have some easing of the labour constraints with people from rural areas able to work for longer in urban areas.

I would see the biggest challenges to China's transition to being a developed country being the challenges of managing the political pressures that will be associated with continued rising incomes, internationalisation of information. And I think we are in unknown territory. I do not know how manageable those challenges are going to be.