Long slowdown ahead

The SLOWDOWN

How deep it will be, how long and why this time it's different

If you think the Australian economy will be running full speed ahead in the coming decade, you'd better think again.

When economists start talking about soft landings, it pays to have your head wedged firmly between your knees. And if you're a chief executive or an investor hooked on growth, maybe you should be prepared to keep it there for quite a while.

The Australian economy will slow. If US recession and the global credit crunch don't slow it, the Reserve Bank will. To get inflation back under control, the RBA wants to cut the non-farm economy's annual growth rate from 4 per cent to less than 3 per cent. That's a noticeable slowdown, the equivalent of slowing from 80 kilometres to 55 kilometres an hour.

Unfortunately, that is not the end of the challenging news. Australia will not be bouncing back to the long-term growth rates to which its CEOs and investors have become accustomed.

Australia is entering an era of slower economic growth — one in which profits grow more slowly and, possibly, lose some of their share of national income.

But first things first. The main question for the immediate future is whether the RBA can, in fact, achieve a soft landing from the recent unsustainable rates of spending growth.

So far the news is encouraging. The International Monetary Fund is predicting a relatively shallow global slowdown with continuing strong growth from the emerging economies, particularly China and the developing economies of Asia.

At the same time, Australia's overheated economy is finally beginning to slow and official interest rates are now on hold.

But there are risks in the short-term economic outlook, and they have been increasing. The global financial crisis is rated by the IMF as the worst since the Great Depression.

According to the IMF, there is now a 25 per cent risk of a world recession. At the same time, the RBA estimates that Australia's terms of trade will rise by another 15 per cent in the middle of this year. That would rapidly translate into a large increase in real incomes.

In the right economic circumstances (a period of calm on the financial markets, and a revival of business confidence), that terms of trade shock could renew pressure on inflation and interest rates.

So, resume the brave position.

Indeed, even a soft landing is likely to be pretty bumpy. Non-mining profits will take a hit because sales will slow more than costs. That happens in every slowdown. For most moderately geared businesses that will be a painful but not fatal experience.

The bigger worry is what happens on the other side of the slowdown. Economists are warning us to expect the next decade to be noticeably different from the past one.

Australia's economic growth will be very much slower because the economy has used up most of its spare capacity, because of demographic change, and because productivity growth has slowed.

There will also be large-scale structural change, the mining sector increasing its share of economic output by more than a third while manufacturing output is reduced to a rump of its former self, just three times the size of the farm sector.

The likely evolution of the Australian economy over the next decade or so has been sketched out in two published papers by highly regarded private-sector economists. Their work builds on that of the Australian Treasury published in the Intergenerational Report.

The most recent of the papers, published by the Australian Industry Group, is How Fast Can Australia Grow? It was compiled with the assistance of the economist Barry Hughes, economic consultant and former adviser to Paul Keating.

The second private-sector paper, Drivers of Structural Change in the Australian Economy, is by Andy Stoeckel and Paul Dowling of the Centre for International Economics. It was published at the end of 2006, but it gives industry projections of the economy through to 2015 and 2020 that are largely unaffected by the events of the past year.

All these papers warn that gross domestic product growth could slow to less than 3 per cent over the coming decade.

The arithmetic is spelled out simply in the AIG paper. There has been a clear step-down in productivity growth, now expected to average about 1.7 per cent over the next 10 years. Labour supply is expected to grow by only around 1.25 per cent a year, even with continuing strong immigration over the next decade.

The trend of labour productivity and labour supply puts average GDP growth at slightly under 3 per cent a year.

The Intergenerational Report, with more conservative immigration assumptions, projects slightly slower growth of 2.5 per cent over the decade to 2020.

Either way, it will be a big comedown on the past decade when the average growth rate was 3.5 per cent, and growth exceeded 4 per cent in five of those years.

Slower GDP growth, as the CIG warns, also means slower profit growth. Profits have risen sharply in recent years and are now only slightly below their highest
recorded share of total income. The profit share will rise again this year as the big jump in iron ore and coal contract prices boosts company incomes. But profits cannot grow faster than the rest of the economy indefinitely. Indeed, in the decade ahead, they may surrender a significant part of their income share.

Commodity prices, which have fuelled the share rise in profits in recent years, will fall back as global surging activities to meet the additional demand of China and the other fast-growing emerging economies.

That decline in commodity prices may take some of the exchange rate pressure off manufacturing profits, but it will be unhelpful in profits in the mining and service sectors.

At the same time, the slower growth and tight labour market of a fully employed economy may put pressure on profits generally, particularly if the increase in workers' bargaining power is significantly reinforced by the Rudd government's industrial relations reforms.

A number of other factors may also weaken the growth in profits. These include a return to slower trend growth in the finance sector, the end of the privatisation boom, and a slowdown in the shift to the incorporation of businesses.

Of course, the pressures certainly will not be all one way. Apart from the last cycle boom in iron ore and coal prices, aggregate profits will be helped by structural change in favour of mining.

Mining is projected by the ABS to expand from just under 5 per cent to about 7 per cent of GDP as the boom in investment translates into expanded output.

Because mining is highly capital intensive, profits account for a massive 63 per cent of the total income generated by the mining industry. That is about twice the level of the manufacturing and service sectors.

Obviously the strong growth of capital intensive industries such as mining and communications will tend to increase aggregate profits as a share of total income.

But on the other hand, the basis of profit growth will be harder in the next decade than it was in the last not least because of the changing nature of productivity growth.

Australia's dramatic productivity growth in the 1990s was an exercise in catching up with the other rich industrialised economies after decades of low growth.

Between 1950 and 1992, Australia's labour productivity slid from the third highest to the fourth lowest among the member states of the Organisation for Economic Co-operation and Development.

This catch-up in productivity and employment has been partly the result of the economic reforms that began under the Hawke government in the 1980s and continued under the Keating and Howard governments.

But, as the chairman of the Productivity Commission, Gary Banks, recently pointed out, the gains largely involved cost-cutting as well as a step-up in innovation, particularly in the service industries.

Catch-ups are essentially one-off events. After averaging 3.3 per cent a year in the second half of the 1990s, labour productivity growth has slowed to just 1.6 per cent a year in the past five years, and, as Hughes and the AIGroup point out, the slowdown is widespread across the economy.

Average labour productivity growth over the past five years was lower in 11 of the 12 broad industry groups of so-called market sector of the economy.

Productivity growth should accelerate as agriculture booms from the drought and the mining sector increases its output to match its expanded production capacity. But Australia's labour productivity growth appears some way to go to something more like its average over recent years of about 1.75 per cent.

Doing better will require Australian businesses to exploit the so-called dynamic gains of reform - the greater dynamism and entrepreneurial vigour that are the keys to success in a deregulated and competitive economy.

This, Banks explains, involves the entry of new players and the exit of poor performers. It also involves innovation across industry, and not just by the technological leaders.

A crucial issue for the Rudd's government relates to the policies needed to maximise productivity growth. According to the Productivity Commission, these should include completing competition reform, reforming government regulation, and policies directed at enhancing education, skills and general health - what the economist call human capital.

Enhancing human capital also has a role in increasing labour-force participation rates.

Research has shown that education and training play an important role in labour-force participation decisions.

So far the government policies has been to cut the workforce by about 400,000 by matching participation rates for the key population groups - the young and men.

The Productivity Commission estimates that Australia could potentially increase its workforce by about 600,000 by matching participation rates for the key population groups - the young and men.

The demand for tradespeople peaks with the construction cycle. Many will shift into management and sales roles.

2020 vision

What will the economy actually look like in 2020? The Centre for International Economics has projected the economy's growth through to the second half of the decade. Industry share values will change dramatically as mining growth accelerates. Agriculture will slow sharply.

Average growth projections Years to Jun (%)


Mining

Utilities

Construction

Wholesale trade

Retail

Accommodation, restaurants, etc

Transport & storage

Communications

Finance & insurance

Business & property services

Government admin & defence

Education

Health & community services

Culture & recreation

Other services

-2 0 2 4 6 8 10

The next decade will belong to the skilled. Professionals and other highly skilled workers will further increase their share of employment. Blue-collar workers will be in less demand because of both technological and structural change.

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This is shown by the changes unfolding in manufacturing. Less-skilled production increasingly moves offshore. Australia specialises now in the high value-added end of manufacturing.

Manufacturing's workforce (%)

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