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Reflections on Globalisation

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Ladies and Gentlemen

I am grateful for the opportunity to deliver this address. I recall meeting Ian Little only twice and then briefly. Once, when he was at the ANZ bank and then when he had joined the Victorian Treasury.

The public service is a most honourable and necessary calling for the proper working of society. Good public servants have courage, independence and conviction. I am sure Ian Little was a worthy member of that group.

After graduating from Monash University, I joined the Australian Treasury in 1973. Tonight, I would like to look back over the past 30 years or so and tender a few observations on some issues.

In 1973, the first oil embargo struck the world paving the way for a period that subsequently was labelled “stagflation”. For finance ministers and central bankers, fighting two big evils - inflation and stagnation - at the same time was a novel battle. In several advanced countries, this battle slowly led to a realisation that more fundamental reform of their economies was needed. Much of this focussed initially on reducing direct public sector ownership of industry, reduced spending and taxation as well as moving to deregulation across a broad front. Margaret Thatcher in the UK and Ronald Reagan in the US set the standards for an “economic and social revolution” and many countries – though with different intensity and at a different pace – followed suit. Eventually, the battle against inflation and structural unemployment was won ... and the 1980s became a period of strong growth for most advanced economies. More fundamentally, the economic reforms of the 1980s were based on the recognition that the private sector provided a far better prospect for driving growth and that freer trade provided the better prospect for the less developed world than state- controlled planning. It would not have happened without strong political leadership and, in Australia, we were fortunate to have just that as well as a bipartisan push at the Federal level.

The results were spectacular. Large parts of Europe and the US economy sailed steadily out of the doldrums.

The 1980s was also the decade of Japan. As with Chinese corporations and state-controlled investment funds today, the then Western fear was about Japanese corporations “buying the world” before the “Japanese miracle” came to an abrupt end with the bursting of the real estate bubble and major dislocation of Japanese banks.

The 1990s brought ever more massive changes in the world.
The end of the Cold War raised hopes of greater peace and prosperity. A key part of this was the integration of ex-socialist countries into the capitalist world. But there was also the growing realisation of the common trade market in Europe which, in turn, paved the way for the launch of the Euro a few years later. Asia continued to be a growth engine but this time the key driver was the newly industrialised economies such as Korea and Taiwan along with a rapidly growing China.

An economically strong United States was able to provide both strategic and economic leadership through most of the 1990s. This included the gradual dismantling of trade barriers and the liberalisation of cross-border capital flows. In other countries, including Australia, there was also the recognition that the privatisation of state owned assets could bring substantial financial and economic benefits. The IT revolution provided a spectacular boost in productivity and the sharing of global information. Financial markets were able to digest information more quickly and economic policies were able to be scrutinised more readily.

The decade was not immune, however, from financial and economic shocks such as the downturn in the first half of the 1990s and the Asian crisis - but, by and large, growth and stock markets moved ahead strongly. All this was helped by, I believe, overly accommodative monetary policies in the United States and many other parts of the world. But there were few Cassandras.

Fiscal positions in most countries were greatly helped by the rise in asset prices and more general prosperity. In particular, the emerging difficulties caused by the aging of populations were papered over by rapid increases in revenue throughout most of the West. Unemployment trended downward as the service sectors expanded in the developed world while manufacturing and similar jobs were exported to China and other emerging economies.

The crises in Asia and elsewhere convinced many developing countries to embark on a course of accumulating more wealth. That prudence has proved very valuable in recent years.

The emerging economies were driven by the weight of their populations and the availability of cheap and efficient labour. They embraced globalisation as a means of driving their export-led economy. In short, globalisation led to a major change in political and economic philosophy even in those economies that were still regarded as totalitarian by the West.

According to an analysis by the World Bank:

- In the ‘globalising’ developing economies – those that most increased the ratio of trade to GDP - the average incomes per head increased most between 1990 and 2000: 67 per cent over this period... a compound rate of more than three per cent a year.

- By contrast, the “non-globalizing” developing economies - those that opted for engaging less in international trade and remaining closed to foreign
investments – only managed to grow income per head by 10 per cent over the same period ... a compound rate of only 0.5 per cent a year.

In the first decade of the new millennium, the world appeared to have found a “magic” formula for rising prosperity, falling poverty and a gradual integration of countries into the global economy. In what Francis Fukuyama famously described as the “End of History”, the world was gradually converging towards one universal socio-economic model, that of economic and political liberalism. Globalisation was the process through which this model was gradually expanding to all countries and regions, a win-win game that continued almost uninterrupted from the late 1980s. A triumph for all of us who had studied international trade theory.

And this process was not limited to the economic sphere but embraced the political dimension as well. One of the key features of globalisation and economic liberalism has been the gradual integration of more countries into the “democratic world”. In the past twenty years, we saw Central Eastern European authoritarian regimes collapsing... Latin American dictatorships transformed into democracies... South Africa abandoning apartheid.

The 11 September events shocked the international community and raised the spectre of a “battle of civilisations”. An unprecedented coordinated political, financial and military response against the terrorist threat was pulled together by the international community, once again under the leadership of the United States. On the economic front, the bursting of the dot-com bubble in 2002 abruptly ended one of the longest and deepest bull markets.

On reflection, this slowdown offered the opportunity for a little more sobriety but was lost after a little over a year of economic slowdown. Accommodative monetary policies saw financial markets resume a heady pace from early 2003 and were accompanied by a further rise in global trade.

We were quick to think that we had solved the art of macroeconomic management. The West continued to feed off the success of the emerging world and, importantly, soaked up savings from China and Middle East to fund increasingly unsound fiscal positions.

The dramatic rise of China, India, Brazil and Russia lifted globalisation to a new level: the majority of the world’s population from all the continents was now actively engaged in the global economy.

Even the laggards – such as the Middle Eastern and North African countries - joined the globalisation wagon as they opened up their economies to foreign investments and started liberalizing their economies. For the first time in decades, an oil price boom did not translate into the traditional boom-and-bust of the 1970s and 1980s but rather provided the opportunities - particularly in the economies of the Gulf region – to launch economic reforms and increase their integration in the global economy.
One of the main beneficiaries of globalisation was the expanding financial service industry. This is not surprising given the intermediary role traditionally played by the financial sector: as countries opened up their economies to foreign investments and international trade soared, the intermediary role of banks and capital markets also rose. Banks became more and more global.

Banks were delighted to expand their businesses with ‘under-priced’ capital. Finance was mis-priced, resulting in balance sheets growing too rapidly and, sadly, a sense of invincibility among bankers contributed to a heady environment in which risk was not adequately priced or considered in investment decisions.

But the dream was rudely interrupted and the much greater interconnectivity of a more globalised world was underlined. Over the course of 2007 and 2008, the US subprime mortgage market crisis demonstrated that globalisation can also magnify the negatives of poor policy. A crisis which started in a relatively minor market that had been driven by well-intentioned government measures to provide housing at unrealistic low cost to lower income sectors of the US economy extended its reach to all markets and most asset classes, putting the global financial system on the brink of collapse.

The following year, the financial crisis translated into the worse global recession since the Great Depression, with an unprecedented drop in the international flows of goods and capital. For the first time since the Second World War, global GDP fell.

In the immediate aftermath of the financial crisis, the international community came together and engineered a robust policy response that significantly contributed towards the avoidance of a global financial meltdown and a prolonged economic depression. There can be good arguments about whether this went too far or whether there would have been better ways of providing the necessary stimulus. But, to my mind, this response would have been better and less costly if done against the background of Western governments dealing from stronger fiscal positions. Greater prudence through the 1990s and the early part of the first decade of this millennium would have helped many Western countries.

The global financial crisis resulted in the almost doubling of debt in advanced economies. The public sector deficit to GDP ratio in the US and in the UK rose to two digit levels while some European countries effectively defaulted and emergency financial packages were agreed by the EU and IMF. The fact is that, in far too many developed countries, the prosperity of these decades had been squandered.

The results are now starkly evident. The Sovereign debt crises in Greece, Ireland and Portugal – not to mention Iceland in earlier years – are very real. They pose a broader challenge to their own political systems and they pose a challenge to Europe as a whole. They will be repaired because they have to be. These countries cannot afford to fail. That is a reality for their governments whatever their political bias.
We now face a long period of fiscal austerity in Western Europe and, eventually I suspect, in the United States. This is necessary and will increasingly involve unpopular measures. It is surprising that many of the issues that Australia successfully addressed in the 1980s — such as university education fees — are only now being addressed in the UK. The better targeting of welfare payments and measures to reduce welfare fraud as well as retirement saving issues are still novel in many parts of Western Europe. We have seen the very clear benefits of these policies in Australia and we have also seen that, if properly executed and sustained, these so-called hard policies more often result in pleasant surprises. It is difficult to find examples of countries that have had pleasant surprises since WWII when they have avoided these tougher policies.

That said, there is now a risk that the European Union — faced with implementing these tougher measures — may become more inward looking. Debate is lively at the moment on a number of issues that have implications for the openness of these economies and, possibly, leading to protectionism in a vain attempt to insulate its economies from the competition of emerging markets and better run economies.

The possible discipline of flexible exchange rates is not available to help the correction process in Europe. In Australia, we had that clear benefit in the 1980s and 1990s. I suspect this will make the repair task more difficult for many European nations.

The fiscal situation in the United States is more worrying. The pre-crisis decades of globalisation were in fact characterised by two central factors: American power and free-market ideology. The two were closely interlinked as the expansion of free market ideology across the world was mostly associated with the economic, financial, political and military dominance of the United States.

The financial crisis was not only a blow to the “intellectual” prestige of the American economic and financial system. It has also seriously undermined the global leadership position of the US and done so at an especially difficult juncture.

The US spends more than any other country on defence but these expenditures may become unsustainable. The risk is that the role of “policeman of the world” traditionally played by the US will be constrained. Many may welcome this on ideological grounds but, as we have seen in the recent debate on the “no-fly-zone” in Libya, the role of the United States is crucial and a lessening of this role runs the risk of turning too many regional or national crises into bigger geopolitical risks.

As we speak, the recovery in the US appears to be gaining speed and the unemployment rate is falling after flirting with the ten per cent level. This is good news for the US and for the whole global economy. However, it would be naive to expect that the return of economic growth or what looks like a competitive exchange rate depreciation will resolve the US fiscal and economic problems alone. One trusts that the US authorities will introduce fiscal measures to bring the US debt on a sustainable path over the next decade.

This economic challenge to American power could not have come at a worse time, given the increasingly assertive stance taken by the new or reborn superpowers in Asia and in Russia.
Decades of relying on China and other surplus economies to fund their public sector debt weakened the US political position in the world and reinforced that of China. As rhetorically noted by Hillary Clinton during the last Presidential campaign: “How do you get tough on your banker?”

While not reversing the growing trend in international trade, the global crisis has challenged some of the assumptions about the workings of the global economy and we now are at an inflection point in terms of economic philosophy.

The global crisis has increased the role of governments in most advanced economies either through re-regulation or takeover of individual companies previously held in private hands. This has included the de-facto nationalisation of financial institutions and the blank cheques written by governments to “strategic” industries.

The sudden turn in advanced economies over the involvement of governments in economic affairs - while probably temporary and closely related to the risk of a further escalation in the crisis - gave legitimacy to those emerging economies already relying on a sort of “state capitalism”. This includes China, Russia and some Middle Eastern countries where the government is not only in charge of politics but also of economic and financial affairs.

Added to this, State-controlled corporations and so-called Sovereign Wealth Funds – mostly concentrated in emerging markets – have become active players in the global economy. The role of SWFs, their often understandable lack of transparency and concerns about the true nature of their “strategic” investments in Western corporations were already a hot policy issue before the crisis erupted.

The conflict between the two competing models – a form of state capitalism and free-market capitalism – could not be more evident than in the global struggle to secure and control access to energy. Governments already control the majority of the world’s energy reserves and Western oil companies have already been pushed from many of the more promising markets. For many emerging superpowers, foreign policy is increasingly driven by its fast rising energy needs and state-controlled corporations are an important part of this process.

The risk is that measures aimed at curbing “hostile” investments by emerging markets ultimately leads to a reversal in cross-border capital flows. Nobody wins. A re-commitment to economic liberalism is required.

This also extends to the financial sector. It is totally understandable that governments and taxpayers look askance at the global financial sector. But we must not lose sight of the longer term imperatives.
Banks will have to hold more capital and adjust to a lower return on equity but there is a risk of fragmentation in the solutions being adopted at national level. Ultimately, such an outcome would damage the global economy as it could undermine the banks’ ability to provide credit. In a worst scenario - where countries compete to attract a lower global level of credit - national barriers to the movement of capital and credit across borders could be erected.

Strong leadership is required across the world to chart a course that restores public sector finances, increases growth and makes sure that the driver of growth rests in freer trade and capital flows.

Globalisation also disguised a growing social problem.

One of the most significant failings in our thinking was to under-estimate the mobility of labour in many developed nations as we deregulated, reformed and otherwise globalised. A key benefit of these reforms was to facilitate greater mobility of capital, technology and labour. The reduction in protectionism and the move to free trade was meant to - and did - allow more productive and cheaper labour in the developing world to contribute to the spectacular growth rates of the 1990s and the early part of this decade.

Conversely, in the developed world, the service industries burgeoned and unemployment was a tolerable problem. However, longer term unemployment was too often addressed by greater reliance upon social welfare programs designed principally for those who had little, if any, chance of returning to the workforce. Welfare programs designed for longer term disabilities became an easy response to sticky unemployment.

As growth rates have slowed, the short-sightedness of these policies is being exposed. Pockets of unemployment in many developed countries are now becoming far larger and intractable creating a range of social issues. At the same time, the migration from Eastern Europe to Western Europe has been breathtaking and there has been mass internal migration in China as well as from the Indian sub-continent to countries in Africa and the Middle East.

The impact of the lack of domestic labour mobility and prolonged unemployment is especially evident in the UK and some other Western European countries. My eldest son has a real job – he is a primary school teacher. He taught for five years in the UK and is now teaching in Victoria. The contrast between the behaviour of parents in his state primary school in London and those in Australia is stark. The number of parents in the state primary school in England who were working was small ... and this was reflected in the attitude of his pupils to their work and potential career... low expectations, ridicule of hard work and narrow ambitions to be soccer stars, pop idols, fashion models or designers.
That was a reflection of their community. Generations of families or households in the UK now exist where employment has never been evident let alone the norm. Iain Duncan-Smith (now Secretary of State for Work and Pensions and former Leader of the Tories) cites figures that one in five households have no member that has ever been employed. This ranges from single parent households to those where three generations are living under a single roof on welfare. It manifests itself in generations seeing prolonged welfare dependency as acceptable. There is no one rising early in the morning to prepare for work... no concept of punctuality and regular attendance at work... no concept of career development or ambition. People are not stupid and, as a result in many cases, are responding to the attractiveness of welfare.

These attitudes are also reflected in the lack of investment by my generation in proper public transport over the past decades. By all reports, public transport is a key factor in determining willingness to search and accept work beyond a “reasonable” commute. Sadly, what is regarded as a “reasonable” commute pales by comparison to what aforementioned immigrant workers undertake to secure jobs in Western Europe.

So, I think that we got this very wrong. We failed - but not through any ill intent. The desire to provide strong social welfare support has been at the expense of reducing the attractiveness of employment. Perhaps, we were all too quick to reject the notion of a negative income tax. Welfare reform is hard and that is why revisiting the notion of a negative income tax may be a sensible adjunct to tackling this problem.

A negative income tax has the benefit of encouraging people to become part of the tax system. In that respect, it has a discipline of its own. The benefits to society and, more importantly, to the individual of becoming part of the employed workforce are well worth subsidising. This is more a problem for Europe and parts of the United States than for Australia. But it is a very real problem and one that is currently being manifested in suggestions that we should accept much higher rates of unemployment, such as close to 10 per cent or so, in western Europe and in the United States.

So for most of the Western world, there remains a lot of work to be done. Fiscal consolidation, re-commitment to economic liberalism and enhancing the attractiveness of employment. All manageable but not without strong political leadership.

And for Australia, the situation is somewhat different but, perhaps, not totally.

Life is about hard work, intelligence and luck. It is a great attribute to recognise luck when it occurs. By any measure, Australia has been better served by economic policies than most countries for the past three decades. We have also had a fair share of luck – a low exchange rate until recently and now a commodities boom that looks far more sustainable than a few years ago.

We have a choice.

We can position our economy to live off the proceeds of that boom through tax reductions, annual dividends of Sovereign Wealth Funds or cross subsidies to other parts of the economy or combinations thereof.
Alternatively, we can recognise that this will create a more unbalanced economy and strive for greater growth and a broader productive base. For my part, the latter makes far more sense from both social and strategic points of view.

We want to offer people – young and not so young – the opportunity to realise their ambitions by providing a wider spread of employment opportunities and gain the very real social benefits of having a vibrant broader-based economy. As we are now seeing in many parts of the world, nations rely unduly on their natural resource endowments but often see very broad social problems.

We should also be very mindful that we live in the fastest growing region in the world and where our influence may wane if we do not keep up the pace. A quiet life may be the attractive option in the shorter term but, perhaps, not as viable for the generation ahead.

Around 80 per cent of Australian GDP is in the non-traded sector. Our unemployment rate is low but should be lower and our productivity outside the mining sector is not great. And, like many other countries, we have spread our welfare dollars too broadly. Growth is enhanced by investment, an expanding workforce and a reliance on the private sector to increase productivity.

For Australia, this may also argue for continued high levels of enthusiastic or skilled immigration. But immigration requires better infrastructure – it is not good and not fair to place immigrants or, for that matter, young people more generally in distant suburbs without adequate transport, health and schools. The traditional lower income housing available in the income suburbs has now, of course, been gentrified in virtually every major city.

All this requires strong political leadership. We have one of the strongest fiscal positions of the advanced economies. And our gross debt is the second lowest in that group. And we will be back in budget surplus in two or three years.

It is therefore a very difficult message to say that we can do better. But, if we are to have a broader based economy and we are not just to live on the proceeds of our resources sector, we need to spend far more on infrastructure. We need to make room for this spending by continuing to assess the best use of our outlays. By and large, we have done a good job in terms of providing a long overdue and necessary reduction of marginal tax rates.

On the other hand, outlays have grown by around $70bn between 2003/04 and 2009/10. Those outlays have grown on an annual average of 7.9% in excess of GDP growth of 6.8%.

The growth in these outlays has been broad-based and, for example, social security payments as a share of GDP have been unchanged over the past couple of decades despite more than a halving in the unemployment rate.
Over the past three decades, Australia has under invested in infrastructure and there are many reasons for this. Now is the time to start redressing this imbalance in the non-resource sector of our economy; to improve the number and quality of employment options; and to improve our overall quality of life. There is ample scope to invest more in infrastructure and to do this while still ensuring that the public sector finances are restored to a world leading position.

In short, strong political leadership is needed to make sure that Australia makes the most of the resources boom by investing in our own future and not taking the easier option of living off the proceeds of our very fortunate resources endowment.

Thank you.