

The Challenges Ahead

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Overview

- Global Challenges
 - Short term/Medium/Long term
- Challenges facing Australia
 - Short term/Medium/Long Term
- All involve substantial changes in relative prices
- Key point – “policy should be designed to deal with enormous uncertainty about the future and not as if we face a deterministic world that we completely understand”

Some Fundamental Questions

- Role of private sector versus public sector
 - Market failure versus Government failure
 - Creating incentives to guide individual actions versus command and control
 - Optimal regulation
- Role of centralized global government versus coordination of national policies
- Role of institutions in limiting populist economic policies

Global Challenges

- Recovery - North Atlantic Financial Crisis
- Global macroeconomic imbalances
- Emergence of China and India
- Global Demographic Transition
- Climate Change and Energy needs
- Pandemics
- Water resources
- Global Governance reform
 - International institutions; financial architecture; world trading system; foreign investment; global environment (including climate change)

North Atlantic Financial Crisis

NAFC

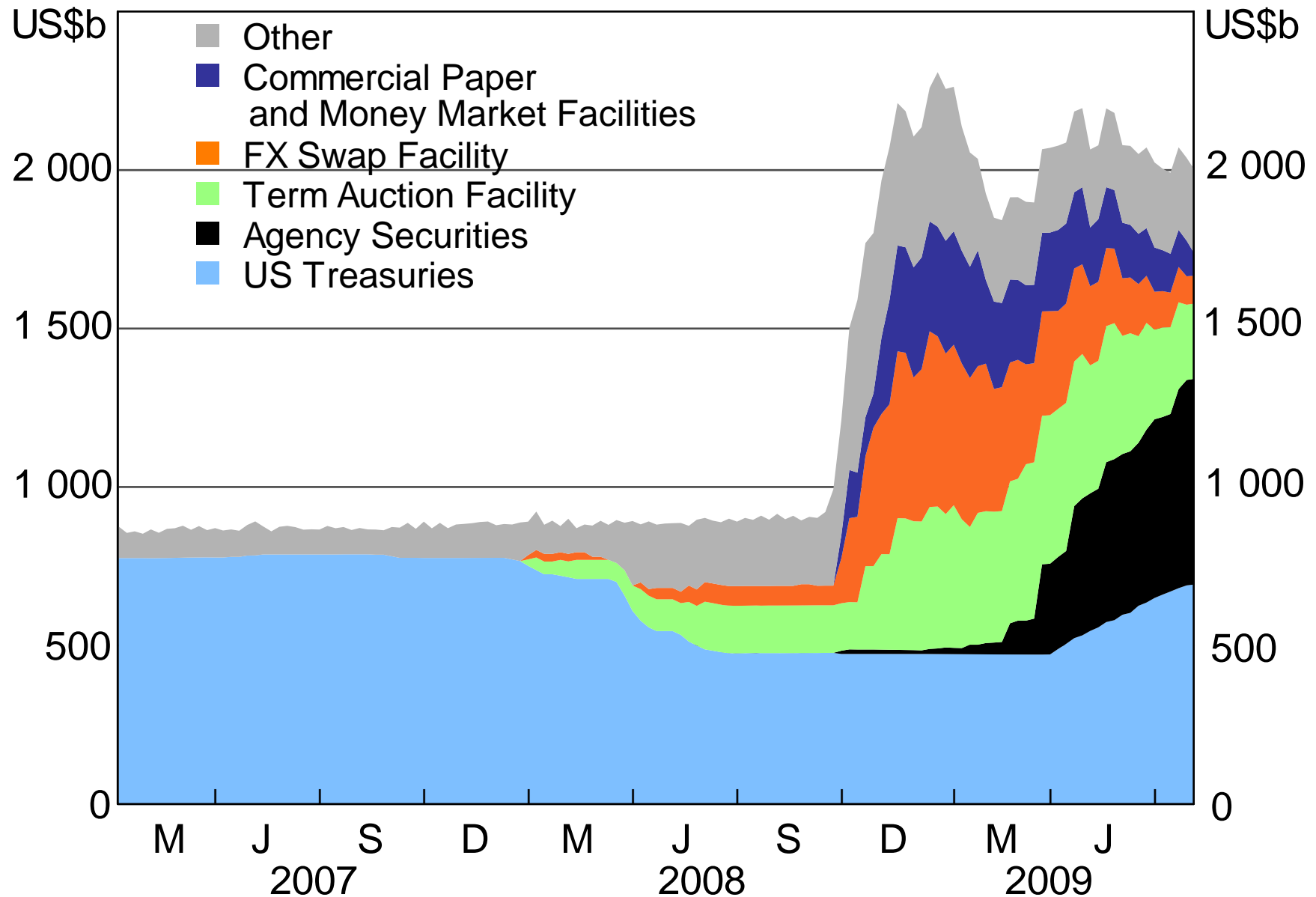
- Monetary Policies
- Fiscal Policies
- Trade Policies

Monetary Policies

- Very loose monetary policies in the US, UK and Europe
- Developing countries pegging to \$US imply loose policies globally
- Bubble in the making

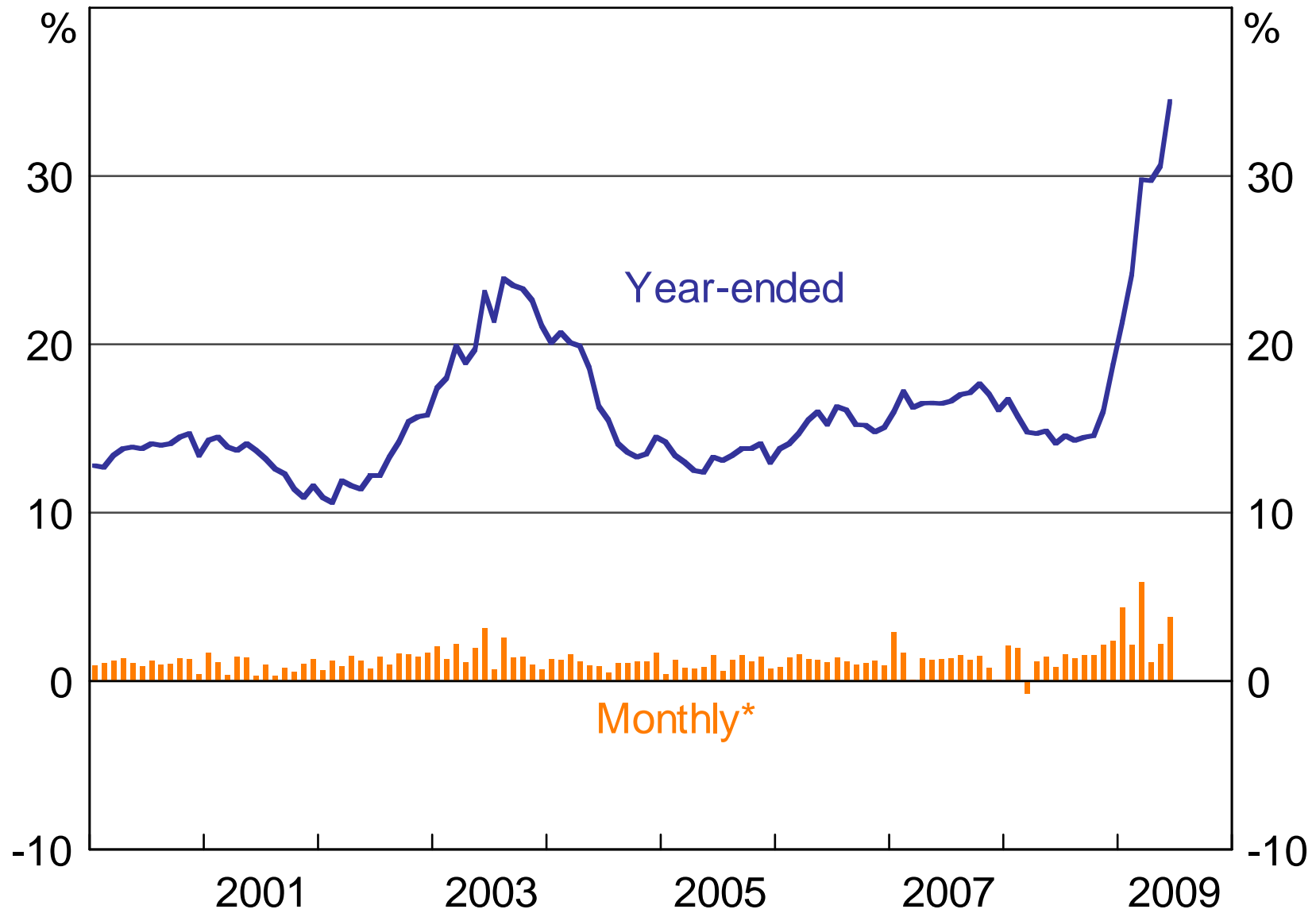
Federal Reserve – Composition of Assets

Weekly



Source: Board of Governors of the Federal Reserve System

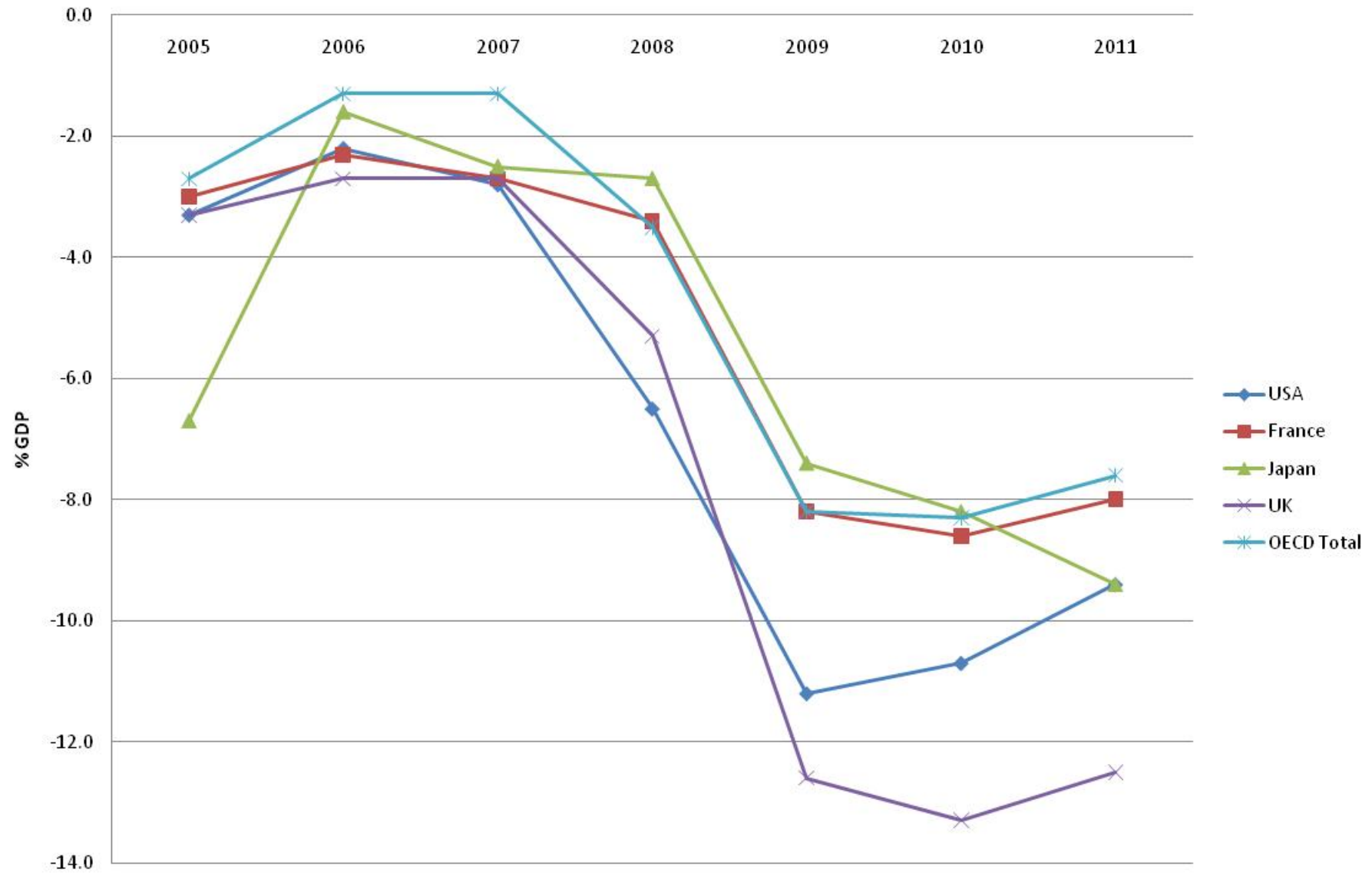
China – Credit Growth



* Monthly growth rates are RBA estimates
Sources: CEIC; RBA

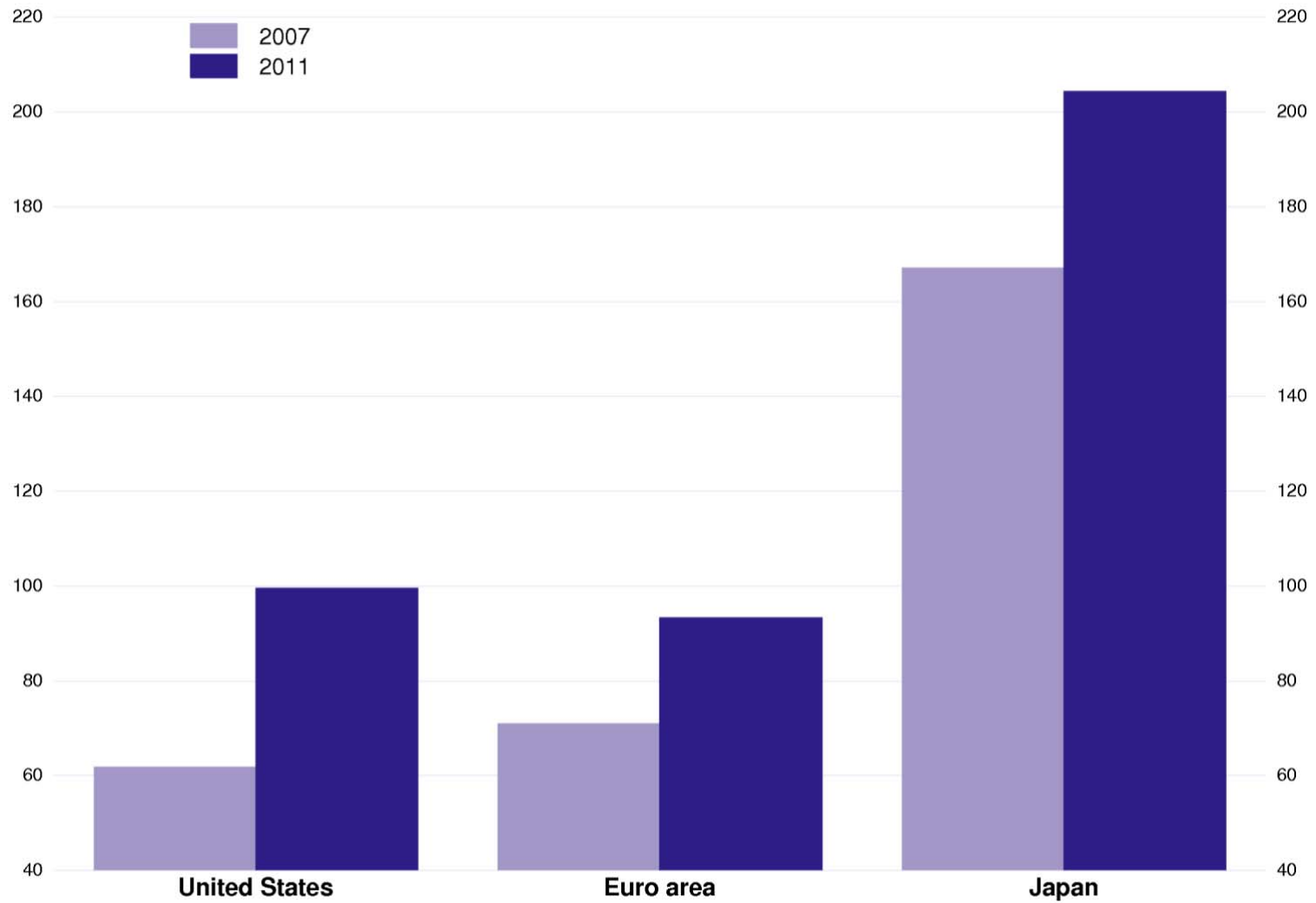
Fiscal Policies

Fiscal Deficits in OECD Economies (%GDP)



Source OECD Economic Outlook 86 Database (November 2009)

Government Debt Relative to Nominal GDP



Source OECD Economic Outlook 86 Database (November 2009)

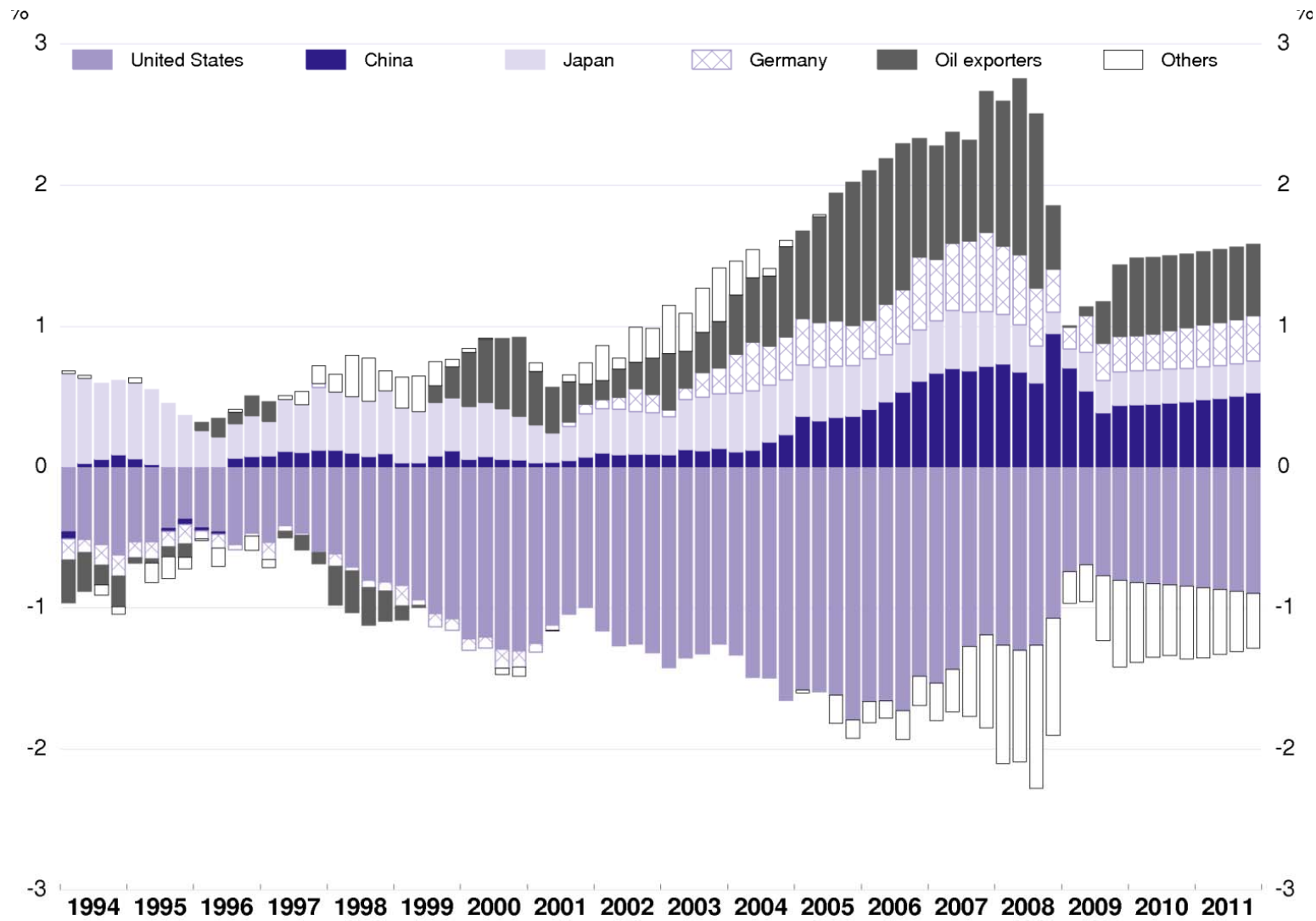
Trade War

Global Macroeconomic Imbalances

Before the Crisis -Rising Global Imbalances

- Global Savings in excess of global investment
 - low long term real interest rates
- National savings and investment imbalances
 - Countries with national savings greater than national investment run current account surpluses
 - Countries with national investment greater than national savings run current account deficits

Current Accounts as a percent of World GDP



Source OECD Economic Outlook 86 Database (November 2009)

Emergence of China and India

Top ten countries by population

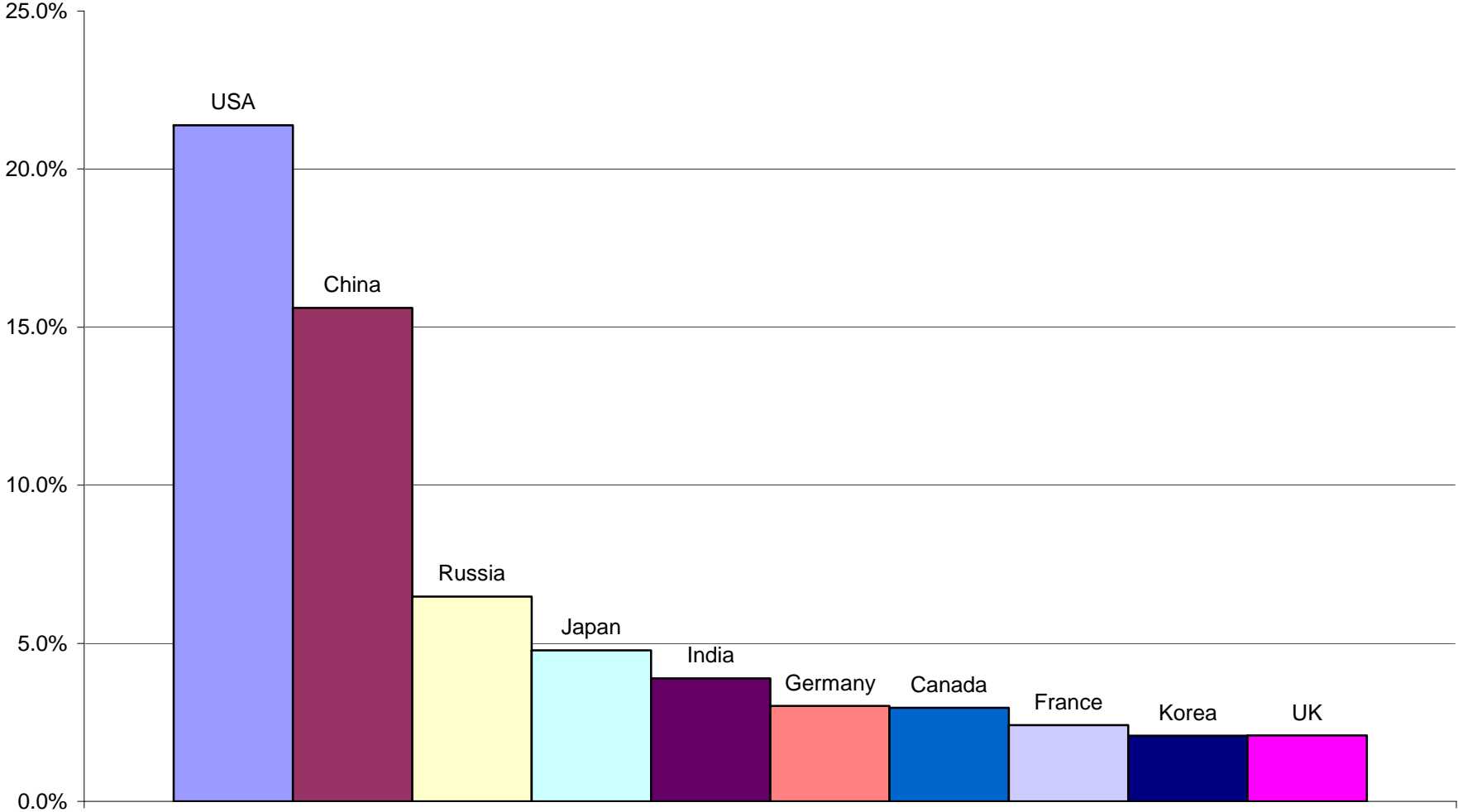
		1950			2005			2050	
		Pop'n (bns)	Cumul. %		Pop'n (bns)	Cumul. %		Pop'n (bns)	Cumul. %
1	China	0.56	22.0	China	1.32	20.4	India	1.59	17.5
2	India	0.36	36.2	India	1.10	37.4	China	1.39	32.9
3	USA	0.16	42.5	USA	0.30	42.0	USA	0.40	37.2
4	Russia	0.10	46.6	Indon	0.22	45.5	Pak	0.31	40.6
5	Japan	0.08	49.9	Brazil	0.19	48.4	Indon	0.29	43.7
6	Indon	0.08	53.0	Pak	0.16	50.8	Ngeria	0.26	46.6
7	Ger	0.07	55.7	Russia	0.14	53.0	Brazil	0.25	49.4
8	Brazil	0.05	57.9	Bangla	0.14	55.2	Bangla	0.24	52.0
9	UK	0.05	59.9	Ngeria	0.13	57.3	Congo	0.18	54.0
10	Italy	0.05	61.7	Japan	0.13	59.2	Ethpia	0.17	55.9

Source: UN Population Projections mid range projections (Mark Thirlwell)

Economic Impacts

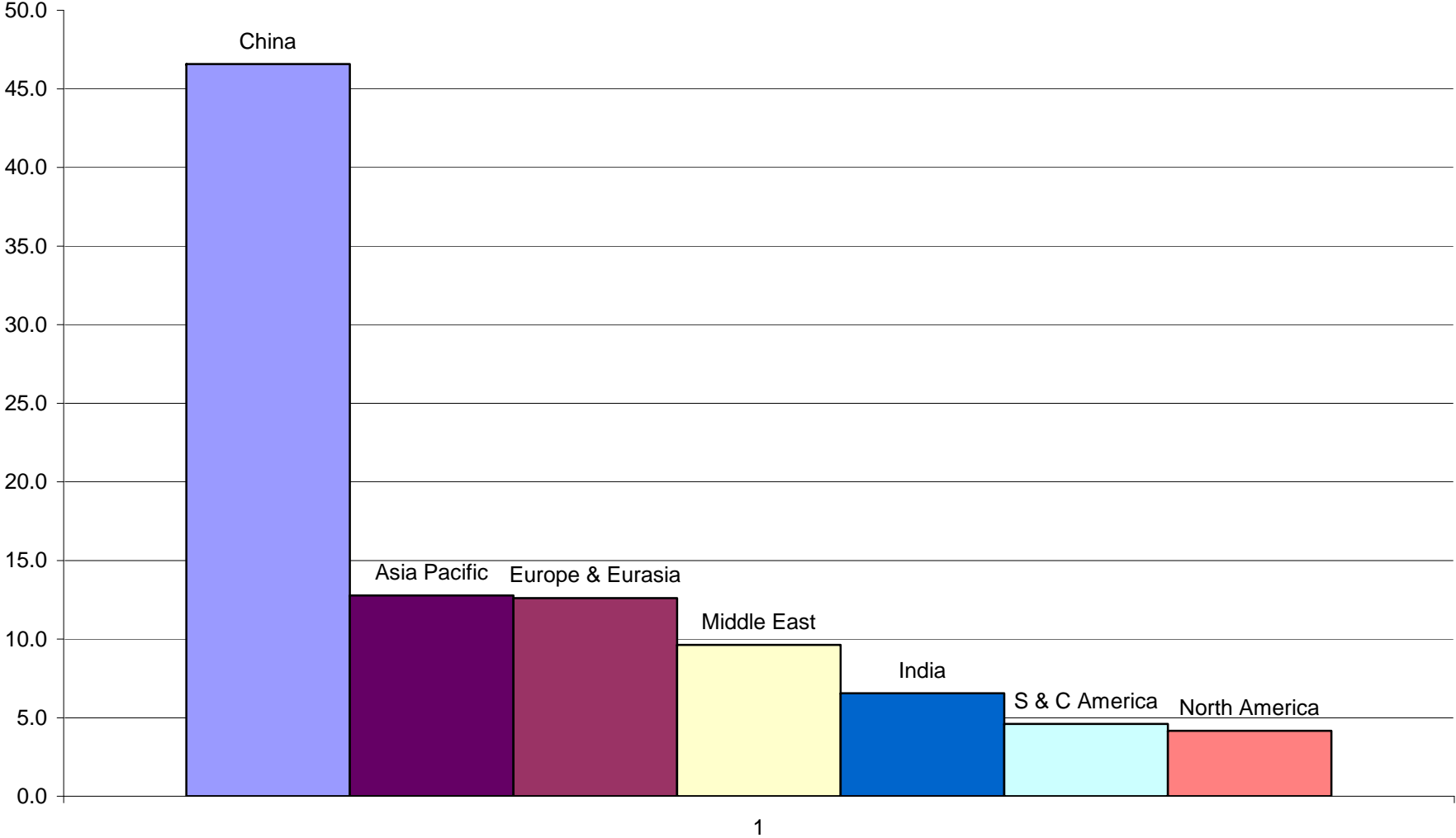
- **Scale** of the world economy in production and consumption
- **Composition** of global production
- **Composition** of global consumption
- Rising demand for non renewable resources
- Sources of global savings and focus of global investment
- Sources of major environmental damage and opportunities

Share of Global Energy Consumption 2006



Source: BP Statistical Review of World Energy

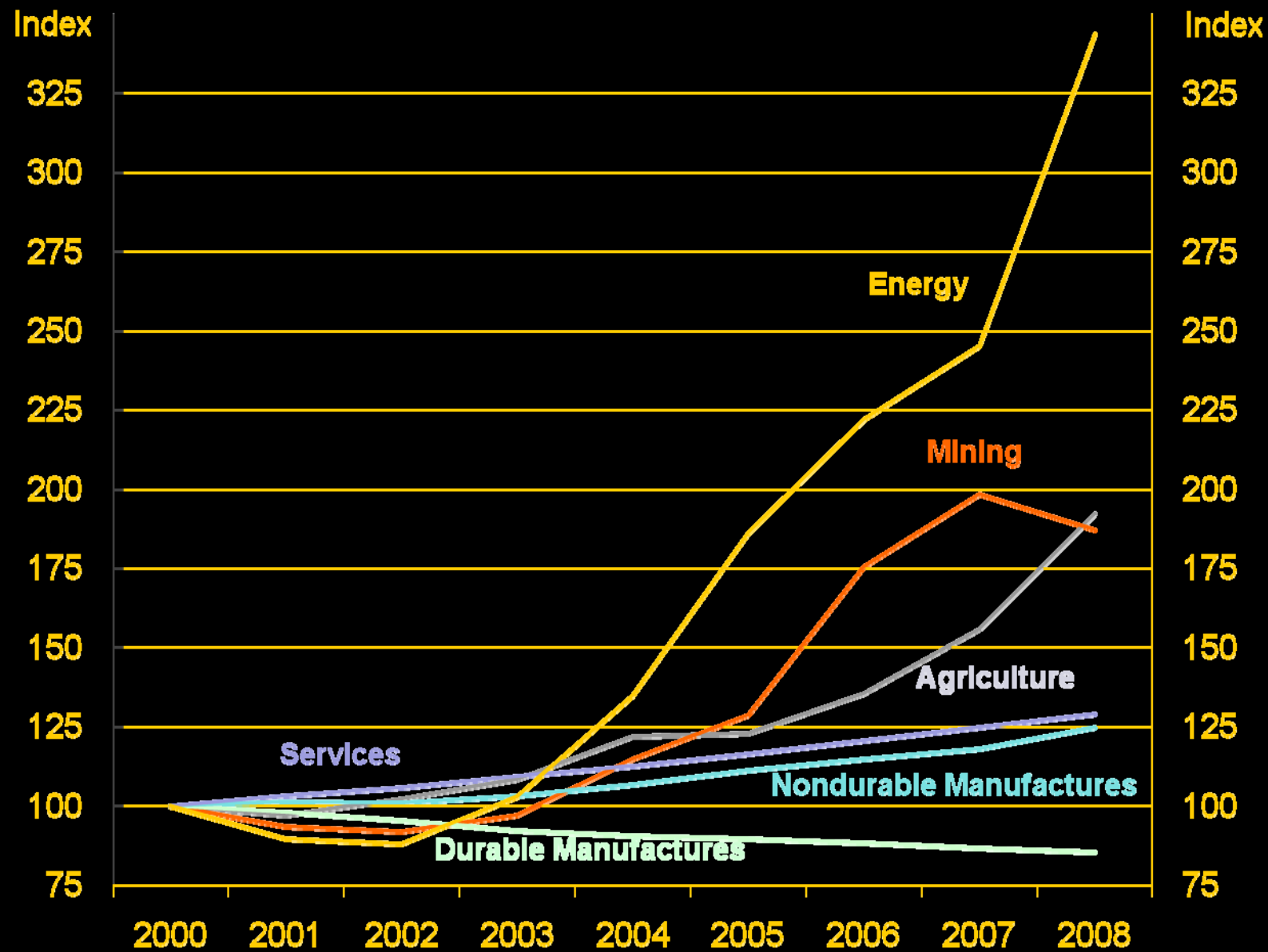
Contribution to Growth in Global Energy Consumption 2000 to 2006



Source: BP Statistical Review of World Energy 2007 and author's calculation

Commodity, Manufacturing and Services Prices

US\$, 2000=100



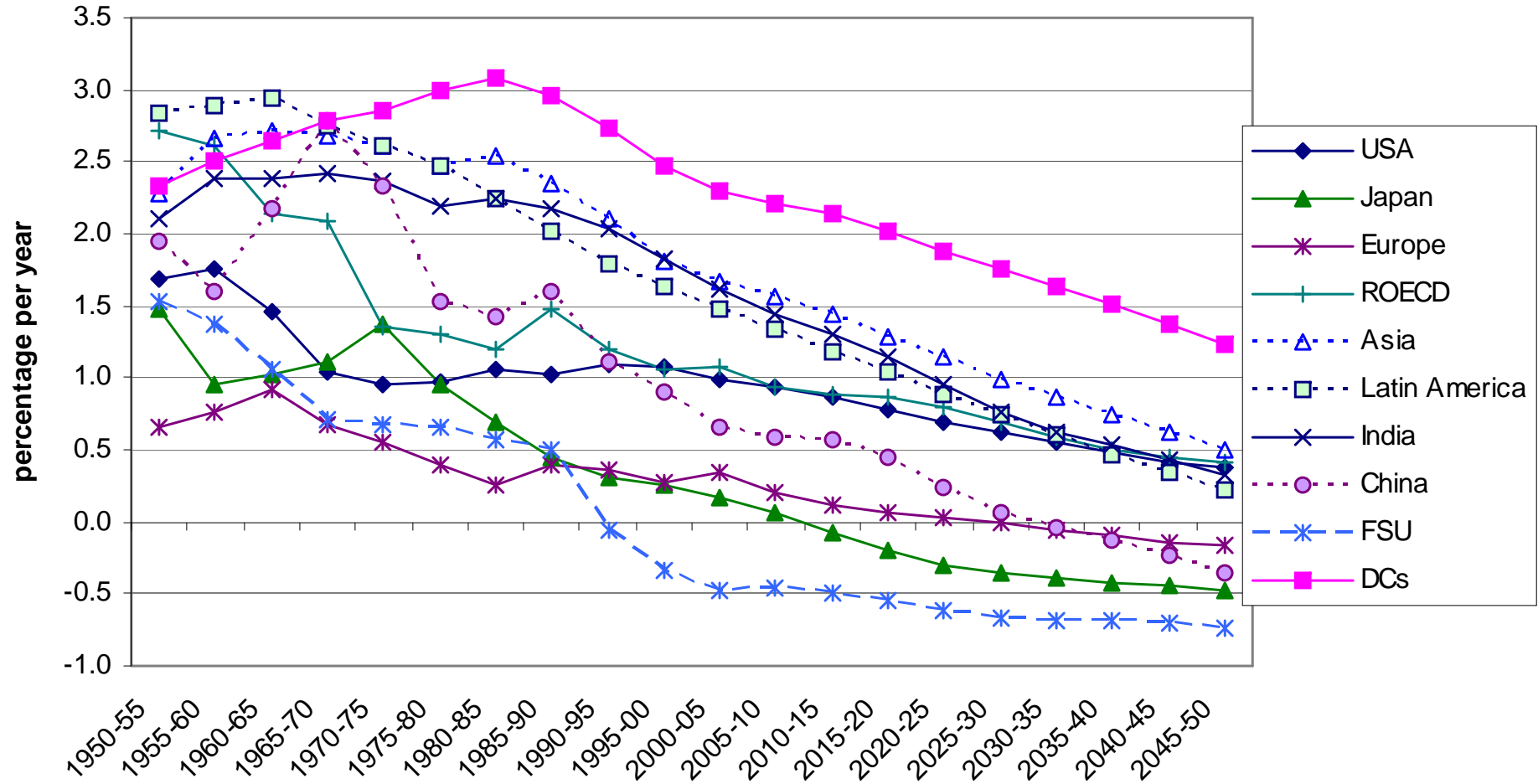
Source: Cagliarini and McKibbin (2009)

Will the World run out of resources?

- Unlikely
 - Question is how quickly and in what form the supply side and the demand side respond
- More important question is what will be the environmental consequences if environmental valuations not in market decisions?

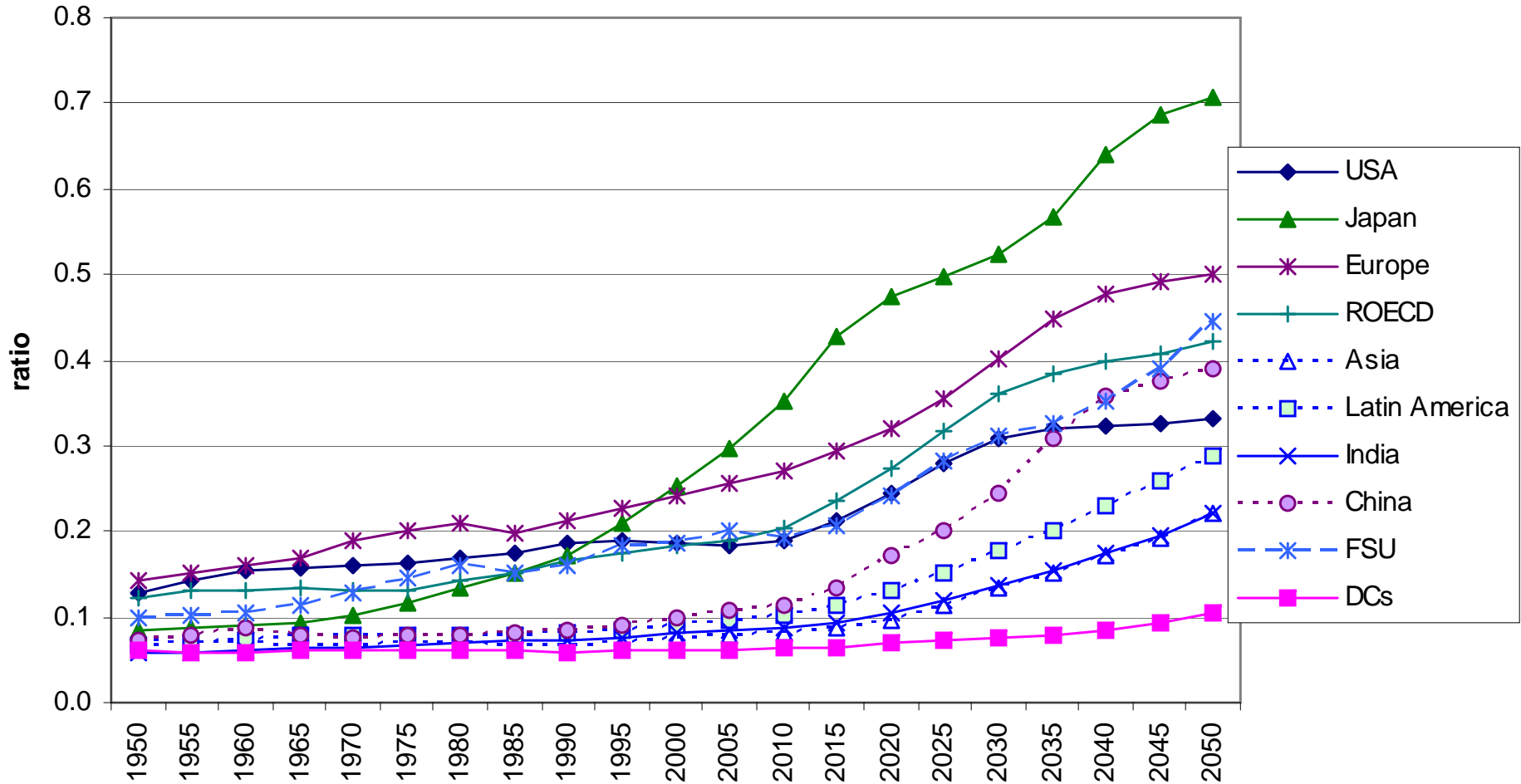
Demographic Change

Figure 1: Population Growth Rate 1950-2050



Source: UN, World Population Prospects: The 2004 Revision (Medium Variant)

Figure 2: Elderly Dependency Ratio 1950-2050
 (ratio of adults 65+ to adults 15-65)



Source: UN, World Population Prospects: The 2004 Revision (Medium Variant)

Climate Change

Climate Change

- Critical question
 - Is it better to have a tops down global government approach to policy or a coordinated system of national policies?
- Climate Change Policy Frameworks have the wrong focus
 - Equal targets versus comparable effort
 - Must be a balance of concentrations of greenhouse gases and equalizing the cost of reaching an uncertain target

Challenges Facing Australia

- Climate Change – should Australia adopt the CRPS or is there a better way?
- Large relative price changes driving structural adjustment in Australia

Climate Change

- Policies should focus on risk management and how to get industry to finance the investments to reduce greenhouse gas emissions
- Need long term price signals to encourage innovation
- Need long term markets where risks can be hedged so risky investments can be undertaken
- Need an independent central bank of carbon to manage climate policy and remove politics

Climate Change

- The CPRS has key flaws that can be fixed
 - Balance sheets of households and firms should be maintained by allocating long term emission permits with annual rights that evaporate over time
 - Large deep cut long term targets should be accompanied by fixed short term maximum and minimum permit prices (price collar)
 - All revenue/expenditure should be quarantined from the fiscal budget
 - Hybrid Approach preferable to the CPRS

Australia and the terms of trade boom

- A long period of adjustment
- How should Australia respond?
 - Domestic demand management
 - Is monetary policy enough?
 - Need a way to dampen domestic demand and to hedge against the risk of the boom eventually disappearing
 - Perhaps a sovereign wealth fund investing in foreign currency assets?
 - Or allocate revenue to individual retirement accounts in foreign currency?

Summary

- Many economic and political challenges facing Australia and the world in the short, medium and long run
- Key is to devise strategies for risk management in policy design – we should not just hope our forecasts will be better next time
- Key is to make sure institutions are well designed and private incentives appropriately focussed
- Key is to balance expected costs and expected benefits of policies rather than exploit short term political opportunism

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