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Declining dollar makes it essential to lift productivity through reform

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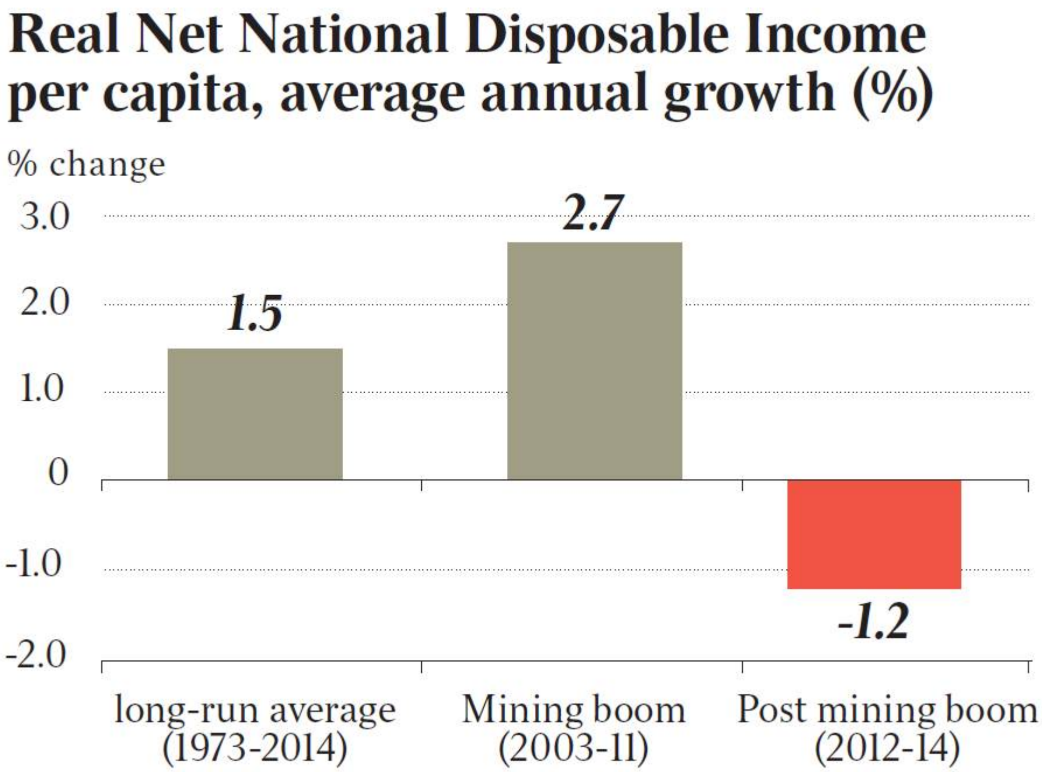

WHILE Canberra focuses on the big issues, such as whether Prince Philip should have been awarded a knighthood, the Australian dollar burns.

For sure, the currency's fall, which received further impetus this week from the Reserve Bank's surprise cut in the cash rate, will help the economy adjust to the end of the mining boom.

However, the fact each dollar of Australian production buys so much less from the rest of the world tells us just how great the adjustment challenge is. Underscoring that point, RBA governor Glenn Stevens, in his statement four days ago, said the dollar "remains above most estimates of its fundamental value"; but that merely emphasises just how parlous those fundamentals are.

Not that there is any mystery about what needs to be done. With the prices international markets are willing to pay for our major resources exports now at one-third below their boom-time peaks, it is only by increasing productivity, and so squeezing more output and earnings from the nation's resources of capital and labour, that we can get income growth back on track.

But as a dysfunctional Senate baulks at reform, productivity growth remains at historic lows, with each $100 of inputs generating barely 40c more output in 2013-14 than in the previous year. In other words, instead of growing at 1.5 per cent to 2 per cent a year, as it did in the era of micro-economic reform, multifactor productivity increased by a microscopic 0.4 per cent.

At that rate, doubling per capita productivity levels will take 175 years: what should happen twice in each person's lifetime would require seven generations. And just as printing money cannot cure the structural inefficiencies of the European economies, so no amount of monetary easing, and resulting depreciation in the exchange rate, can offset the constraints stagnating productivity will impose on the growth of our living standards.

Yet public recognition of the importance of improving efficiency remains scant, while the willingness to accept pain in the process is even slighter.

That is at least partly an effect of the mining boom itself, as the boom uncoupled increases in real incomes from underlying trends in productivity. With mineral prices quadrupling in US dollars from 2003-04 to 2011-12, Australia's terms of trade increased by over 80 per cent, meaning a given volume of exports could be exchanged for nearly twice as many imports. The result was to boost Australian incomes by 10 per cent to 14 per cent above and beyond the growth they would otherwise have achieved. It was, however, even better than that, as the rise in the exchange rate — which saw the Australian dollar double in value relative to the US dollar — spread the gain widely. With the exchange rate soaring, exporters received fewer Australian dollars for their foreign currency earnings, dampening the big miners' profits. But consumers got far more for each dollar they spent on imports, be it buying cars, computers or holidays overseas.

Little wonder the volume of imports per head doubled in real terms from 2002-03 to 2011-12, rising 70 per cent faster than real gross domestic product.

Despite a steep slowdown in productivity growth, living standards, measured in terms of what money could and did buy, therefore rose sharply, underpinning the nation's sense of prosperity.

But with export prices falling by 9 per cent last year alone, that process is now in reverse. And yet again, the change in the exchange rate is spreading the consequences. As the Australian dollar, which is worth nearly 30 per cent less in US dollar terms than it was a year ago, depreciates, exporters get more Australian dollars for their foreign earnings, helping them cover their costs despite the decline in world prices; but consumers have to pay more for the imports that have become an integral part of our lifestyle.

As a result, real incomes will no longer be lifted above the underlying growth rate of productivity by the manna of cheap imports, as they were during the mining boom; and though the collapse in oil prices is offsetting some of the pain, as are lower interest rates, those effects will wear off.

Indeed, on the Australian Bureau of Statistics' best measure of per capita incomes, the decline since the peak of the boom is matched only by that experienced at the height of the global financial crisis and in the 1983 and 1991 recessions.

Last year's budget papers starkly highlight the consequences, estimating that for incomes to return to rising at their historic trend, labour productivity has to grow more than twice as rapidly as it has over the past decade.

Conversely, were the growth rate of labour productivity merely to revert to its long-run average, Australians would each be $13,000 a year worse off in 2025 than under a high productivity growth scenario.

Yet there is no shortage of opportunities to improve productivity. Cutting wasteful public spending would help, as would reducing the deficit, thus freeing up resources that could be used more efficiently in the private sector.

So too would privatising inefficient government-owned corporations, with all their gold-plating and featherbedding.

But every bit as crucial is ensuring we make full use of the mining boom's greatest legacy: a capital stock 75 per cent larger than it was a decade ago, with the capital stock in mining alone nearly trebling. Unfortunately, the productivity with which we use that capital has plummeted, with each unit of output now requiring nearly 30 per cent more capital than in 2003-04.

Yes, some of that decline will be reversed as production increases at facilities that are still being built or that are only in the early stages of ramping up, such as the major liquefied natural gas plants.

However, it is also apparent that work practices deteriorated during the boom, as the Fair Work Act, and the rush to get volumes out the door, allowed unions to extract concessions on matters such as rosters for shift work.

Under the FWA, new workplace agreements were to deliver productivity improvements; but a study of 52 mining companies in August 2013 by the Australian Mines and Metals Association found those agreements had yielded no productivity gains for almost 90 per cent of the companies surveyed, while for 75 per cent, the industrial relations system caused productivity losses.

The exchange rate's recent depreciation doesn't come close to removing the cost penalty those regulations and others impose on Australian exporters.

After all, while the Australian dollar has declined, so have the exchange rates of the countries with which we compete, including Brazil, Canada and Indonesia.

Thanks to those changes and to falling oil prices (which make transport cheaper), Brazil's Vale, for example, now ships a tonne of iron ore to China at an overall cost about $US6 ($7.67) lower than that of Australian producers, threatening the viability of Fortescue and of smaller Australian exporters.

But onerous regulation doesn't merely increase costs at existing facilities: it also makes it unnecessarily expensive to build new ones.

A 2012 report by Port Jackson Partners found that thanks to Australia's regulatory labyrinth, the average Australian thermal coal project is delayed an additional 1.3 years relative to projects elsewhere.

It also found that the average delay had been increasing by three to four months each year.

There is, however, little prospect of improvement on that front, particularly at a state level.

In NSW, delays to mining approvals have actually increased since the Coalition was elected. And in Queensland, Labor leader Annastacia Palaszczuk is committed to more than reversing the Newman government's efforts to strip away red tape, even though that is sure to increase the costs of current operations, deter investment and eliminate jobs.

None of that is to deny that investors have sovereign risk concerns about some of Australia's competitors, as even Indonesia becomes embroiled in disputes with mining companies about domestic processing.

But with assistant opposition Treasury spokesman Andrew Leigh re-emphasising the ALP's attachment to the mining and carbon taxes as revenue sources, as well as to the FWA, attracting investment to resource industries will be harder than ever.

Combined with the virtual collapse of the “small cap” exploration sector, which has seen metres drilled fall to levels last reached before 2004-05, a reduction in the nation’s share of global exploration expenditure and a decline in the number and quality of resource discoveries in Australia, the danger is that we will not only suffer disproportionately in the downturn but be poorly placed when the upturn comes.

All that calls for a determined push on the path of reform. Otherwise, monetary policy can only make the best of fundamentals that are nothing to be proud of, while the exchange rate drops to levels that indicate just how far our productivity levels are from best practice.

And as our wealth, measured at world prices, declines, so the burden future generations will bear in paying off this generation’s debts rises.

If that is the inheritance we want to leave our children and grandchildren, we are doing a great job.

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