

A MODERN ECONOMY FOR AUSTRALIA'S FUTURE

LUNCHEON ADDRESS TO THE AUSTRALIAN INDUSTRY GROUP

SYDNEY

14 DECEMBER 2007

Thank you for inviting me here today, and thanks Trevor [Carroll, AIG National President] for that introduction.

It is an honour to address the Australian Industry Group — an organisation for which I have so much regard.

I want to acknowledge at the outset the role Heather [Ridout], Trevor and their AI Group colleagues play in the big economic debates of this nation.

It is such a privilege to speak to so many familiar faces now, in my first major speech on Australian shores, as Treasurer.

Finishing a campaign is a funny thing; however trying the physical demands, you do get a burst of energy after it's over — at least when you win.

Maybe that's what Australians expect of a new government — a new crew and a big jolt of energy, ready to get cracking on something big.

The Prime Minister and his ministers have not wasted any time.

I've just come from a few days in Bali at the Finance Ministers' meeting on climate change.

As you know, Bali was about confronting some big challenges and seeking a new way through.

The challenge confronted at Bali also brings to mind another significant challenge and that is our domestic challenge of inflation.

Both challenges will affect our national competitiveness in the years ahead.

I know I don't need to lecture this audience about competitiveness — you are out there dealing with the rigours of competition, never more so than now with our high dollar and strong international competitors.

But I know that you, like me, approach these challenges with optimism about what we can achieve together.

As you know, there are parts of Australia's economic story that we have cause to be optimistic about.

Unemployment is low, employment growth is still strong, and we are now enjoying our 17th year of economic expansion.

But as my overseas counterparts were saying in Bali, the global outlook has become more uncertain due to events arising principally out of the US, and world growth may not continue to be as strong.

We have also come to office at a time when inflationary pressures have been building for some time, and interest rates have risen ten consecutive times.

Supply is simply not keeping up with demand.

Inflation is a major threat to sustained Australian prosperity.

And let me be very clear, and very upfront with you today.

Even though we will start immediately to deliver the plan I'll outline here today, I warn you we face an extended period of elevated inflation.

Inflation with an inertia which has not been addressed at a structural level.

Inflationary pressures have been building for a long time and they will take a long time to turn around, as well.

That's why I've made addressing the inflation challenge one of my top priorities — and why we must begin to address the problem right now.

There is no question about the challenge posed by inflation; but there's also no question about our ability, with energy, commitment, cooperation and the right national leadership, to rise to this challenge.

I don't come to you today with a magic wand to beat inflation in a day.

What I *will* do today is answer four important questions:

What does the inflation challenge look like today?

Why is it a problem?

What has caused it?

And what will we do about it?

The Inflation Challenge

Let's deal with the nature of the challenge first.

There is certainly evidence that inflationary pressures have been building over a considerable time.

Recent measures of underlying inflation are running at around 3 per cent.

And in my discussions with Treasury, they have advised me that, following the September quarter CPI and National Accounts, inflationary pressures are likely to put further pressure on the underlying inflation rate over the next 18 months.

With the Reserve Bank's inflation targeting regime, the magnitude of the inflation problem we inherited is reflected in interest rate movements.

As a consequence of inflationary pressures, interest rates are now at their highest level in eleven years.

We do have the right monetary policy framework to deal with inflationary pressures — an independent central bank focused on maintaining low inflation.

Since the early 1990s, inflation targeting has formed the basis of Australia's monetary policy framework.

It has served us well, delivering average inflation near the mid point of the Reserve Bank's 2 to 3 per cent target range.

Last week the Governor and the Government announced a number of measures to enhance the independence and transparency of the Reserve Bank, through a new Joint Statement on the Conduct of Monetary Policy.

We believe these initiatives will assist the Bank with the job it does so well.

Why Inflation Matters

So why is inflation a problem?

Inflation is not just an abstract term, of interest only to economists.

It is one of those economic measures Australian families are intensely interested in.

They know, as we do, that inflation puts our prosperity — individual, business and national — at risk.

It puts families under financial pressure.

It hurts businesses by putting pressure on the cost of inputs — costs that hurt our competitiveness even before you consider the impact of a high dollar.

It creates uncertainty and distorts economic decisions.

It puts upward pressure on interest rates.

And inflation risks our long term sustained growth.

As I said at the outset, it's a major threat to the prosperity that Australian families deserve into the future.

Inflation Causes

Now, where have these inflationary pressures come from?

We have high inflation as a result of policy failure, which I'll come to in a moment, combined with the rapid rise of China and India.

As you know, in the past few years, the Australian economy has experienced a surge in global demand for energy and minerals.

Australia's terms of trade — the price of our exports relative to imports — are higher than at any time since the Korean War wool boom in the early 1950s.

According to the RBA the increase in the terms of trade over the last four years has lifted real national income by approximately \$80 billion in the last year alone.

In a highly employed economy like Australia's, operating at close to the limits of its capacity, the risk is that the demand created by this very strong growth in income will stoke inflation.

Inflationary pressures have also come substantially from a decade of neglecting the big challenges our Government is now charged to meet, and the important investments that have needed to be made.

Now, I don't intend to be one of those first-term Treasurers who only ever talks about the evils of his predecessors.

But I do think it useful to have a sober audit of where our economy falls short and a hard-headed assessment of what the squandered opportunities of the last decade have cost the economy.

My main point is that our predecessors didn't grasp the opportunities of the mining boom to invest in the productive side of the economy.

They lacked the foresight to know that in boom times it is prudent to invest in new economic platforms, which take time to build.

They failed to fully understand the importance of lifting participation and improving productivity growth to meet Australia's current and future economic needs.

This is reflected in what I call the twin investment deficits of today's economy — in infrastructure and skills — which so many of you come up against.

Anyone who talks to business as much as I do, or reads the business surveys, knows the availability of suitably qualified employees is the biggest constraint across small, medium and large businesses.

This is the greatest constraint on expanding supply — and therefore expanding growth and prosperity.

Over the last three years, the Reserve Bank of Australia has warned on 20 separate occasions that skill shortages were threatening growth and contributing to higher inflation and higher interest rates.

The former Department of Employment and Workplace Relations identified persistent trade skills shortages over much of the past ten years across the economy — from toolmakers to air conditioning mechanics to chefs.

It also recorded widespread persistent skills shortages over the past ten years in the professions — from registered nurses to computing professionals.

Unfortunately in infrastructure, things are not much better.

The economy is being held back by bottlenecks in our eastern seaboard coal export supply chains, urban congestion in our major cities, and chronic water shortages in rural and urban areas.

In the shadow of these twin investment deficits, labour productivity growth in the market sector has declined markedly.

Labour productivity growth has fallen from an annual average of 3.3 per cent over the five years to 1998-99, to 2.1 per cent over the five years to 2003-04 — and in the three years since then it has averaged just 1.1 per cent a year.

These are just some of the challenges and shortfalls we inherited.

And together they have contributed to the inflation challenge.

Fighting Inflation

So what are we going to do about high inflation?

We can't fix inflation immediately, but we will do two main things to support the Reserve Bank as it goes about its job of keeping inflation in check.

First, we'll enforce a new era of strict fiscal discipline, which means cutting wasteful spending to strengthen the budget and invest more responsibly and effectively.

And second, we'll start implementing a comprehensive, multi-faceted plan to build the productive capacity of the economy.

Let me deal with these two arms of our inflation fighting package in turn.

New Era of Fiscal Discipline

This new era of fiscal discipline we impose will replace the flabby, undisciplined fiscal policy settings of the past, with a leaner, more accountable, more responsible model of budgeting.

Since 2004-05 Commonwealth spending has grown on average at over 4 per cent per year in real terms.

This is more rapid growth than at any time in the last decade and a half.

There has also been no energy put into finding savings.

In fact, the real value of savings measures has declined, from \$14.7 billion in 1997-98 to around \$2.3 billion in recent years.

In part, this reflects the strong fiscal outlook.

But in the face of strong domestic inflation, even with a strong fiscal outlook, we must monitor spending to ensure it is well targeted, and compliments other macro-economic policy settings.

That is why we are implementing a rigorous review of existing spending — a new era of fiscal discipline.

We have already found more than \$10 billion of savings, but we need to do more.

We have already kicked off a process that will see us announce substantial additional savings in the 2008-09 Budget in May.

Through this exercise we will identify expenditure items in the Budget which do little to expand the productive base of the economy — looking very carefully at the effectiveness of current spending.

In the face of the inflation challenge, we must modernise our spending priorities.

Australians deserve smarter, more accountable fiscal management.

That's why the new government will keep a tight reign on spending, improve the quality of spending, and focus more on investment than consumption.

Our strong, credible and transparent monetary policy framework is an essential tool for keeping inflation low.

But there are things we can do to help the RBA with that role they fill so well.

The new Government is determined to ease some of the burden that has been placed on monetary policy in recent times.

That's why I ask you to take this away from my speech today:

Wasteful spending will be a thing of the past — our savings will strengthen the budget and make room for better investments in the future.

Capacity Building Investments

Which brings me to the second component of our plan — better investments in the capacity of a more productive, more modern economy.

In an economy with close to full capacity utilisation, discretionary spending needs to be carefully focused on expanding capacity.

And it needs to encourage participation.

That's why we will invest in education, and support people's ability to participate in the workforce, with our tax and child care policies.

Policies that recognise we cannot afford to waste the talent or potential of any Australian.

Policies that recognise the hard work of millions of Australians built national prosperity, and they deserve to be rewarded for it.

Which brings us to tax.

Our tax plan fits well within the bounds of a responsible fiscal envelope, and maximises the participation incentives for those groups that we know are most responsive to tax cuts.

This is particularly true of the Low Income Tax Offset and the increase in the threshold of the 30 cent rate.

Treasury modelling suggests these key components of our tax plan will encourage around 65,000 people into the workforce in the medium-term.

This includes many part-time workers, secondary earners and people who are marginally attached to the labour force.

The tax plan will also encourage many people in the workforce to work more hours.

Together, the increase in workers and the increase in the effort of existing workers, will mean that an extra two and a half million hours of labour will be supplied each week due to the tax cuts.

For these reasons we will deliver our tax plans in full.

These plans go hand in hand with our initiatives in skills and child care.

Child care policies are far from peripheral — **we consider skilled mums to be one of the great untapped resources of our economy.**

Our child care policies will be implemented quickly to help boost workforce participation.

The ABS has estimated there are almost 100,000 Australians who are not in the labour force due to poor availability, quality or affordability of child care.

We need to make it as easy as possible for all who wish to, to participate in the workforce to expand the capacity of our economy.

That's why we will lift the Child Care Tax Rebate to 50 per cent; establish 260 new long day care centres; invest \$77 million in the training and education of the child care workforce, and set tougher standards for child care providers.

To invest in productivity and participation we will also immediately begin addressing a 'bug bear' of many of you in this room: skills training.

As so many of you have told me, action is required on the skills front now.

I couldn't agree more.

Consistent economic growth in Australia has driven up demand for labour, especially skilled labour.

The training system has not been able to keep up — we have not trained enough workers and training has not given trainees sufficient levels of skills, or skills which match up with industry needs.

That's why we will deliver 450,000 new vocational education and training places and ensure that 90 per cent of them will be funded at a level *above* what is currently considered to be year 12 equivalent training.

It is also why we'll place industry demand at the heart of the training system.

You have been telling governments about the need to expand and deepen the skills base of the economy for some time; and that is why we will move immediately to act on delivering the reforms you have been calling for.

It's the way we will do business — engaging with and listening to different sectors of the economy to deliver better outcomes across the board.

Facilitating **geographic mobility** is another pressing priority we intend to act upon as we go about modernising this economy.

As you know, the mining boom has created strong demand for more workers in mining and construction, particularly in Western Australia and Queensland.

Employment in mining and construction has grown ahead of other industries and mining and construction wages have as well.

Differences in relative wages and the opportunity to earn a higher incomes encourages people to move from one state to another.

But there are some road blocks in the path of labour mobility which our Government in cooperation with the States intends to tackle.

For example, the problems with recognition of professions and skills training between states may also mean people are reluctant to move.

And differences between school systems may create problems for families who shift to another state.

Housing affordability — or lack of it — can also be a problem for geographic mobility.

In areas which are growing and where there is strong demand for labour, it can often be difficult to find housing which is sufficiently affordable to make moving worthwhile.

The Government's comprehensive suite of policies to address the national housing affordability crisis will help restore housing affordability across the country, including in growth corridors.

Measures like these — along with introducing a national school curriculum — will help increase the supply of labour in the resource-rich states.

This will help build an efficient labour market that is less exposed to upward wage inflation pressures.

The flexibility associated with our **fair and balanced IR system** — with enterprise bargaining at its core — also means any increases in wages associated with the mining boom are less likely to spill over into other parts of the economy.

An IR system where wage increases are tied to productivity gains at the enterprise level will mean we can avoid the aggregate inflationary pressures and increasing unemployment that came with wage spill-overs in earlier periods of strong growth in the terms of trade.

There's also a role for far better Federal-State relations in our plan to fight inflation over the long-term.

That's why the entire Rudd Government will inject itself, Treasury included, into the process of renewing federal relations — **to forge a New Federal Compact.**

This is such a big priority for us that the Prime Minister has called a COAG meeting to be held just 5 days before Christmas.

And given the pressing nature of the economic challenges we face, the Prime Minister has invited Treasurers for the first time in twelve years.

Improving the way our federation works is central to our broader agenda of building a platform of low-inflationary long-term growth.

There is a mood across the country for a new cooperative approach to Commonwealth-State relations and the Government is not about to let this opportunity pass by.

Moving forward on important issues like investing in education, health and infrastructure and the efficient regulation of key national markets — such as water — will require an effective cooperation across governments.

We will provide sorely needed national leadership on national infrastructure — ensuring that there is national coordination and planning.

Achieving efficient and sustainable use of, and investment in, water, energy, and transport infrastructure, is critical to enhancing the productive capacity and flexibility of the economy.

To ensure sustainable use of energy we need to review the efficiency of the current energy market reform process and regulatory arrangements.

We need to consider whether we can go further in achieving a national approach: recognising the national scope of our energy markets, the long term development of those markets, and the requirements of effective greenhouse gas reductions policies, including an Emission Trading Scheme.

We need to harmonise road and rail regulation to create an efficient national transport market, and ensure that the incentives are in place to encourage investment in the different transport modes.

As a nation we've lost a lot of time in tackling these challenges.

We can't afford to keep squandering the opportunities presented by the global commodities boom.

We need to act on a long term plan for national infrastructure.

The same goes for education and health.

Our education and health policies are crucial to our vision for human capital, a more productive economy, and improved Commonwealth-State relations.

Effective, well-targeted investments in education and health will boost productivity and participation — but only with State-Federal cooperation.

Getting federalism right is critical to getting health and education right.

This is fundamental to our future prosperity, but also central to our commitment to spread opportunity across Australia.

Australia's prosperity gives us a golden opportunity to achieve major improvements in our education system — from early childhood to university.

We have already begun implementing our Education Revolution.

And in **health**, as many of you know, we are establishing the National Health and Hospitals Reform Commission.

This will allow the Government to work closely with the States and Territories to improve health care delivery, particularly in our public hospital system.

Conclusion

As a Government, we take very seriously the responsibility of building a stronger, more modern Australian economy.

This means tackling head-on the big economic challenges facing Australia today and into the future.

Like the inflation challenge I've talked about today.

Challenges like tackling climate change and securing water.

Challenges like lifting workforce participation and productivity and making our workforce among the most highly skilled in the world.

Challenges like delivering world-class infrastructure, improving our export performance, and ending the blame game.

Our Government is determined to rise to the economic challenges of our time.

What I have outlined here is an inflation fighting package of reforms, extending from immediate actions to a long term agenda.

An agenda to build prosperity, modernise the economy, and lift the 'speed limits' on sustainable economic growth for the future.

A broad agenda that encompasses:

- enhancing RBA independence and transparency;
- a new era of fiscal discipline and quality spending to take pressure off monetary policy;
- tax, child care and training measures to increase labour supply;
- measures to enhance labour mobility; and
- a new Federal Compact to invest in our human capital and infrastructure and drive low inflation growth for the years ahead.

Let me finish by reiterating this point:

The impact of these changes will not be felt immediately.

The task is difficult and we have a long way to go.

These inflation pressures have grown for several years, and will take several years to properly address.

But we must begin immediately.

I have said many times that I am optimistic about the future. I am.

And I want to harness your optimism and ambition as well.

Because if we engage the talents and energies of industry, of state governments, and of the Australian people — we can fight inflation, meet our economic challenges, and build the modern economy Australia needs.

Thank you.