

**AUSTRALIA'S GEOPOLITICAL AND ECONOMIC POSITIONING
AN ABRIDGED VERSION OF A SPEECH
BY THE HON PJ KEATING TO
THE CONGRESS OF CERTIFIED PRACTISING ACCOUNTANTS
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The world is about to enter the final phase of the third long economic wave of the 20th century.

The first wave began in 1904 and lasted until 1929, ending with the Depression; the second ran from 1947 to 1974 ending with the OPEC oil shocks of that year. The wave we are now in, the one that began in 1982 has been overlaid by two business cycles, one from 1982 to 1990 the other from 1992 to 2000. We are about to go into the third leg, which should last until around 2007 or with some luck, a bit later.

The good news is that this cycle should see synchronised global growth in 2004 with the United States, Europe and Asia all growing together for first time since 1999.

The not so good news is that this third cycle will be less wealthy than the second one, the one which lasted from 1992 until 2000 and which brought with it huge lifts in stock market value.

Over the next half a dozen years, we are going to see people of my age fall out of the labour market in their droves. This will produce a profound tightening in the labour market. And will probably lead to strong increases in real wages. Unless productivity is there to pay for those increases, it will otherwise be paid for from profits. And if it is paid from profits, profits will be smashed, investment will fall. And a recession will ensue.

The moment central banks around the world get a whiff of wage inflation, they will lift interest rates and the party will end as wage inflation bites into economic activity.

The only caveat I can see to this analysis is China.

Before the rise of China, what happened in the industrial world was fundamentally the result of what happened in North America and Western Europe.

What is happening in China today is without precedence in world history. Never before have we seen a billion-and-a-quarter people lifting themselves from poverty at such a pace.

The US will continue to be the world economic driver, but China will be a completely new factor -- and there is just a chance that China will actually be a big enough influence to extend this third long economic wave.

The more likely outcome, however, is that China will be the epicentre of the fourth long wave, the one after this.

While the 20th century was the century of the Americas, the chances are the 21st century will be the century of Asia and we may see, for the first time, a real eclipse of American economic power.

China's economy will have eclipsed Japan's in the next half-dozen years and it is going to demand a huge volume of resources -- our Australian resource industries will be a clear beneficiary.

The decline in commodities we have seen in the world since the middle 1960s, which cut our national income dramatically by the 1980s, may see itself reversed as China changes the commodity equation around the world.

The other thing, is that China will emerge as the second strategic pole in the world. The only country with the cultural confidence and the military unity to deal confidently with the US is China. Europe is fractured politically and militarily; you only have to look at differences in Europe over Iraq.

Europe will never have the political unity which China is likely to have, has had -- nor does Europe have the cultural confidence. The Chinese know who they are and what they are. And they do not need the approval of the US to know what they should do or can do.

The most important thing for us to know about China is that it will be an economy built around the individual and small and medium enterprises. It will not be like Korea and it will not be like Japan.

In those countries they have what we call tops-down intermediation, that is tops-down capitalism which allocates resources through a banking system guaranteed by the national budget.

Domestic demand will be the principal driver in China. It will not primarily be an export economy, though it is a big exporting country. What the Chinese are going to do is give people a house, a refrigerator, a television set and CD player, plenty of telephones and lots of toys for the kids. That's the kind of economy they are going to have -- a real one, one much more like Australia's than Japan's or Korea's.

China is a phenomenon and it is our backyard. There is a chance China will change the whole commodity equation in Australia, but are we clever enough on the productivity front to capitalise on it.

I inoculated a generation of treasurers with the surplus needle and none of them have yet found the antidote. They always want to run budgets in surplus, regardless of economic conditions or economic needs, whereas they should be providing public infrastructure to lift our productivity performance. And government debt has never been cheaper. A lot of this investment can not be done in the private sector. Public investment has to keep up.

If we can keep our productivity up, we will keep the inflation rate down, and with it interest rates. Productivity is not the icing on the cake. It is the cake.

Governments in Australia have got to be interested in productivity, but they are

fundamentally not interested. We can not live only by the economic changes of the 1980s and '90s. We will run out of puff unless the underlying components to productivity are understood and improved.

The Americans are now clocking up 4 per cent productivity growth numbers, phenomenal numbers, because all that IT equipment is starting to give the average American business a real productivity boost.

That's the challenge for us: can China provide the lift? Will we slacken back on the oars? Will Australian productivity flag when we are most likely to capitalise on new international trading conditions?

This is an edited extract from former prime minister and treasurer Paul Keating's address to the CPA Congress in Melbourne yesterday.

FOLLOWING, IS EXTENDED NOTES WHICH ENCOMPASS THE POINTS AND REMARKS FOUND IN THE ABOVE ADDRESS:

It is my task, on the second day of your Congress, to provide some global positioning of economic and political affairs.

I might begin with the economics

§ The US recession ended in November 2001

§ The industrial recession has only just ended – about May

§ In the US – the 'real' recovery has begun

- not just consumption
- but business investment too

§ The US bear market ended on 10 October 2002

§ The US recession was very mild

- with only 3 quarters of negative growth

§ The reasons:

- Greenspan's monetary easing
- George Bush's tax cuts
- the war against terror

This is pumping billions of dollars into the US economy

§ Capital spending is growing again for the first time since 1998

§ Productivity is sustaining low inflation in America

- as it is in Australia

- Europe is bumping on the bottom, it is still in recession

§ Europe will again depend on the US and Asia for its recovery

But:

- domestic demand is weak
- there is little government fiscal stimulus
- productivity growth is low
- the labour force is growing only slowly

§ 2004 should be the first year in this new business cycle to see synchronised global growth

- the first year since 1999

§ Things are looking better and a new cyclical bull market is underway but beginning at high valuations

§ Earnings will have to be quite strong

§ So the good news is:

- i. there will be a third leg to the current long economic wave
- ii. the “not so good” news is that it will be much weaker than the second leg 1992-2000

§ There were three long economic waves in the twentieth century

1904-1929

1947-1974

1982-until now

§ These waves are overlaid by business cycles

- business cycles, are of their essence, investment cycles
- we will have had three in this long wave

1982-90

1992-2000

2002-to say 2007

§ The waves mostly last 25 years

§ This one began in 1982. By this reckoning it will end about 2007

§ The depression finished the first wave in 1929

§ The OPEC oil shocks and inflation finished the second in 1974

§ Demographics and tightening labour markets is the most likely candidate for finishing this one

§ Wage inflation will kill off profits unless high productivity can be sustained

§ Central Banks will come in to end the party – and the third wave will end

§ The only caveat to that is China

§ What is happening in China has no precedence in world history

§ 1.25 billion people lifting themselves from poverty

- \$3 trillion of GDP

- growing at 7%

- \$200 billion of new wealth each year

§ China will be the epicentre of the next fourth long wave

§ Its economy will have eclipsed Japan's, demanding a huge flow of resources

§ This is an outside chance of extending the third wave

- more likely underwriting the fourth

§ Australian resources will be a beneficiary of this outcome

§ It has the capacity to turn around the secular decline in commodities Australia has suffered since 1965

§ China will emerge as the second pole in the world

§ It is the only country with the cultural confidence and military unity to deal with the United States

§ And it will run an economy built around the individual and SMEs

- it will not be like Japan or Korea

- with “top down” capitalism run through banks ultimately guaranteed by the budget

- it will not be “state capitalism”

- domestic demand will be its principal driver, and

- it will have a competent capital market, its investments will not be intermediated solely by banks

§ China is a phenomenon and it is in our backyard

§ It's why we should look hard at free trade agreements with the US

§ Which bring me to the non-economic risks

§ And much of this is about how the world and the United States in particular responded to the end of the Cold War

§ The fact is, a decade was lost

§ The Berlin Wall came down in 1989 and the Americans declared victory and walked

off the field

§ The Clinton Presidency, over eight years, failed to see the opportunity and to put a new more representative model in place for a new world order

§ The world was left set up as it was in 1947

§ Membership of the UN Security Council was left to the victors of World War II and their membership was co-terminus with the possession of nuclear weapons

§ Neither Germany, the largest European state, nor Japan, the second largest economy were permitted to have a role

§ Within a few years of the Wall coming down, the Americans had expanded NATO up to the border of the Ukraine

§ No Cold War but plenty of Cold War structures

§ The great states of China and India were left marginalised on the edges

§ The G8 economic grouping had within it Italy and Canada, but not China nor India

§ The world continued to be run UN representatively

§ But then after a decade of economic triumphalism
- the World Trade Centre was hit

§ Then and only then did the Cold War end for the Americans

§ And the response?
- to eschew 50 years of liberal internationalism
- and to adopt the aggressive knee jerk response of pre-emption
: in Afghanistan
: in Iraq

§ Walking away from the multilateral organisations and treaties it had earlier helped to construct
- the United Nations
- the Comprehensive Test Ban Treaty
- the Anti-Ballistic Missile Treaty
- not meeting commitments under the Nuclear Non-Proliferation Treaty
- the Kyoto Protocols

§ The Americans have given a signal to the rest of the world that it can be part of a resumed nuclear arms race

§ There is every chance the Americans will have led us into a Mad Max world
- while the US seeks to cocoon itself behind a screen of national missile defence

§ This week President Putin's Government in Russia declared its own version of pre-emption, similarly eschewing multilateral covenants and rules
- a policy catching by contagion

§ Where does this leave Australia?
- a small state that has a vested interest in a rules-based system
- it leaves us somewhat alone and palely loitering
- looking wistfully for US protection
- while watching our accelerating marginalisation in our own region

§ The key strategic question in Australian public life has, pretty much, always been the same
- do we find our security in Asia or from Asia

§ I believe and have always believed we must find our security in Asia

§ We maintain our alliance structure with the US
- but essentially, we make our own luck

§ We don't lose sight of what is most useful and fundamental
- while pinning all on a strategic guarantor
- now the United States, in the last century Britain and the British Navy

§ We pinned our hopes on Britain in 1942 and we very nearly paid the ultimate price

§ We need to do a number of things – but do them at once

§ Not just one thing only

§ Betting the shop on one stakeholder

§ Australia, as now an open competitive economy with many multicultural strengths must engage the world ambitiously - and that world is, most particularly, the one in East and South East Asia – Indonesia, China, Japan

§ And we must go to the world – unambiguous about who and what we are
- not as a vicar of empire
- or a deputy of the United States
- or borrowing the monarch of another country

§ Rather, a nation confident in ourselves, at peace with ourselves, and with our neighbourhood – with open minds, and dare I say, open hearts