

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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thebigpicture Economics
ABN 71 040 787 936
PO Box 333, Malvern
Vic 3144

DEMOGRAPHY AND INVESTMENT RETURNS

Lower fertility rates will eventually lead to weaker profit growth and reduced investment returns as well as the more widely accepted consequences of an ageing population.

There are many linkages between demographic changes and economic growth.

- The higher the absolute number of people the higher national output is likely to be.
- The larger the number of working age people in the population (relative to both the young and old of non-working age) the more savings will be available to fund investment spending, the better productivity and the stronger growth rates are likely to be.

These two effects are illustrated in the accompanying charts. The first chart is a very long term view of population and economic growth rates drawn from the work of Angus Maddison in *The World Economy: a Millennial Perspective*, published by the OECD. The period of strongest global economic activity has been associated with the period of strongest population growth in the second half of the twentieth century.

In the history of the world, the past four decades have been highly unusual. There might be little point in drawing on this experience to make judgements about the future unless the demographic connection illustrated in the chart is made explicitly.

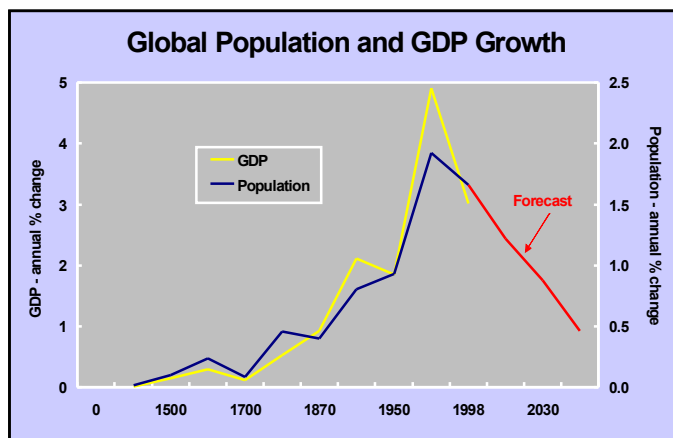
The second chart shows that, even within this period of unusually strong activity rates, increases in the relative importance of the working age population seem to be associated with stronger per capita GDP growth. The flip side is that per capita growth has been weaker where the importance of the working age population diminishes.

The Australian Treasury has estimated, against this background, that Australia's economic growth rate is likely to fall to less than 2% a year as the demographic impact is felt even assuming that relatively high productivity growth of the sort which Australia was achieving through the 1990s is sustainable.

The impact of this growth slowdown can be seen in the table. Over the long term, the

profit of Australian companies has risen at an average annual rate just under 10% (measured by the corporate gross operating surplus from the national accounts). This growth could be thought of as coming from two components: a 3.6% a year increase in volumes and a 5.5% a year increase in average prices. The effect of

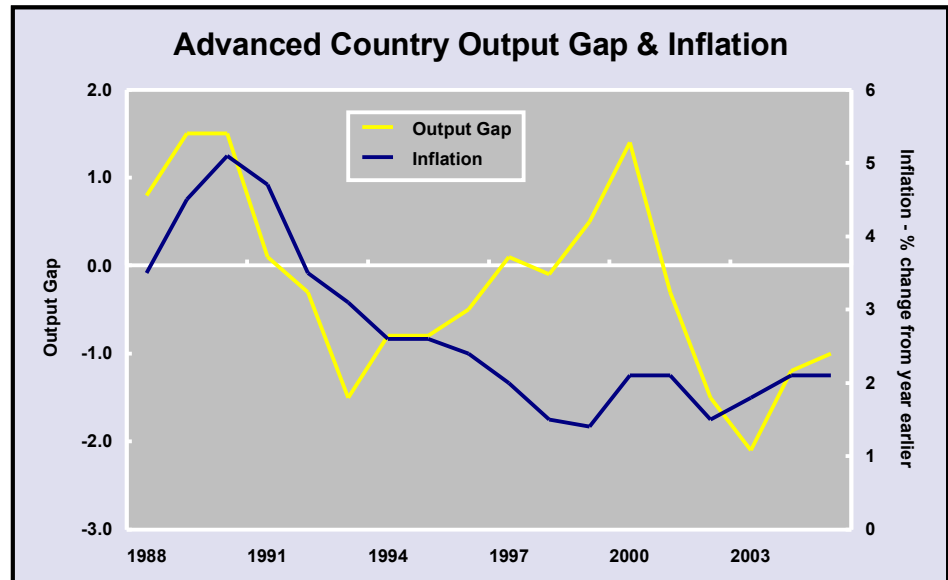
"...profit growth rates might be close to half what they have been historically."



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THE WEEKLY CHART SPOT

“The downward movement in inflation has probably finished. A cyclical upturn does not necessarily follow but any closing of the output gap could signal a change in the momentum of inflation.”



Source: International Monetary Fund, World Economic Outlook

Advanced economies are suffering from excess capacity, one of the reasons global inflation rates are being kept down and monetary policy has not been tightened aggressively despite near record global growth in 2004.

The yellow line in the chart is a measure of excess capacity. It shows, for the world's 29 advanced economies, the difference between actual GDP and what it would have been if it had grown consistently at its potential. The difference is expressed as a percentage of the potential GDP level.

A reading below zero indicates growth has been below its potential and there are unemployed resources available for use. A positive reading means an economy has been growing above its potential and that recent rates of growth have been unsustainably high.

Periods of relatively strong growth which push the economy beyond a sustainable growth path create inflation risks. Conversely, periods of excess capacity are consistent with relatively subdued inflationary pressures.

The slack in the major economies through the first half of the 1990s helped constrain inflation although other factors were also subsequently in play. New sources of lower cost labour have become available in Asia and eastern Europe. Strong productivity growth in these areas associated with foreign capital investment and the emergence of new market economies has kept a lid on prices of traded manufactured goods. Technological changes have been playing a key role in keeping costs down.

Now this group of advanced countries is moving through a transition. The downward movement in inflation has probably finished. A cyclical upturn does not necessarily follow but any closing of the output gap might be taken as a signal that the momentum of inflation is about to change.

Looked at from this perspective, whether inflation moves higher will depend on how well governments and business manage the transition. The greatest risks usually arise if business has failed to invest adequately or train sufficient people. Then, a surprise upsurge in demand is more likely to leave them short of capacity.

Generally, those deciding monetary policy have few forward looking indicators to guide them in setting interest rates. Signs that an economy might be approaching capacity limitations, as in Australia, would be one of the few leading indicators of budding inflationary pressures. On the other hand, avoiding bottlenecks is possible and increasingly dependent on management skill in a decentralized market economy.

The risk for policymakers whose priority target is inflation is that they misjudge how well this transition is managed and unnecessarily raise interest rates or do so prematurely. ■

DEMOGRAPHY AND INVESTMENT RETURNS CONT'D

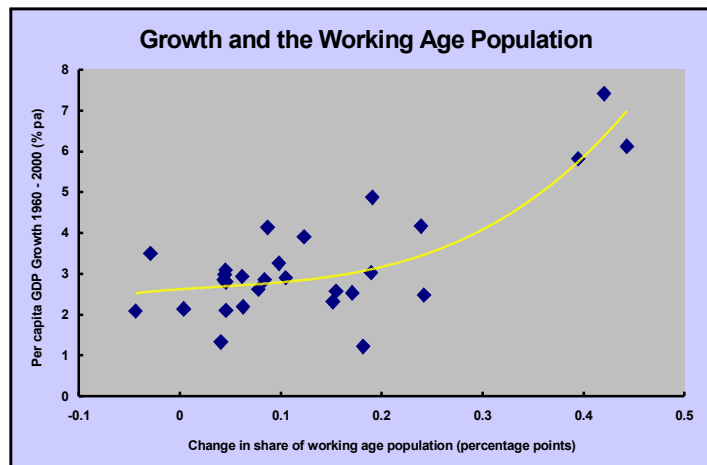
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other factors, such as costs, has been negligible on average across the economy.

The Changing Profit Landscape		
	1960-2003	Prospective
Volume	+3.6%	+2.0%
Prices	+5.5%	+3.0%
Other - costs	+0.8%	0%
Profit	+9.9%	+5.0%

Looking ahead, the price and volume growth environments seem likely to be very different in the coming 20 years than they were in the twenty years previously.

Not only might demographics push volumes lower but the likely rate of price increase could be lower. Policy makers are more determined to keep price inflation below 3%. A restructured Australian economy and more dynamic competitive conditions throughout the region mean inflationary pressures are more subdued and likely to remain much lower than in the inflation-plagued 1980s.



The combination of lower output growth and less pricing flexibility imply that profit growth rates might be close to half what they have been historically.

While the relationship is never exact in the shorter term, the rate of profit growth is likely to be an important driver of equity markets over the longer haul. In other words, the interaction of demographic and economic changes suggests returns from equities in Australia are likely to be substantially lower than many might be expecting based on their personal experiences from the past thirty years.

Paradoxically, just as targeted investment returns need to rise to cope with longer periods of retirement, the economy's capacity to deliver is likely to be falling. This

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will be one of the great challenges for people planning their financial futures. ■

GST: ANOTHER CUNNING IDEA CONT'D

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On the introduction of the GST there were some inconclusive debates about whether it was good or bad policy. However, what was more clearly questionable was the Commonwealth's decision to relinquish power over the GST and its willingness to leave responsibility for it in a fiscal limbo. No government was accountable to an electorate for its collection or the way the proceeds were to be spent.

The government now thinks, rightly but probably for the wrong reasons, that this is undesirable. To compensate, it is unfurling another layer of bad policy by seeking to have the governments responsible for spending (i.e. the States) accountable to another jurisdiction and not to their own

electors.

For practical purposes, the government is trying to get back to the position it started from, namely, raising the taxes, disbursing them and holding the States accountable for the effectiveness of the spending. But that was changed when John Howard thought he liked State governments and the alternative suited his purposes.

Now, with Labor governments arrayed against him, political pragmatism is spawning a convoluted system of fiscal management where responsibility is divided and hidden. The ideal of the same people raising taxes being responsible for spending the proceeds has been lost in a maze of ideas too smart and cunning by half. ■

GST: ANOTHER CUNNING IDEA

Bad policy has a way of perpetuating itself. Smart and cunning ideas have a way of coming back to bite the perpetrator. The GST is now a good example.

Partly as a ploy to have the legislation implementing a goods and services tax (GST) passed by the parliament in 1999, the government decided to dress up the GST as a State tax. The tactic was designed to reassure electors that the initial rate of 10% was not going to be the thin edge of a fiscal wedge.

By contriving to make the GST a State tax, the rate could not be increased without agreement across seven major political jurisdictions. Since the States and Commonwealth were unlikely to ever act in concert, for all practical purposes, the rate could never be increased. That was the message the government strived to leave.

To maintain the fiscal façade, the government has refused to include GST collection data in its own budget papers with other revenue items and has been prepared to suffer successive qualifications to its own accounts by the auditor general who has criticised the government for not adhering to appropriate accounting standards in reporting its GST collections.

Of course, despite the façade, the tax has been collected by the Australian Tax Office, administered and policed by the Commonwealth and recognised by the States as a Commonwealth tax whose proceeds are handed over for their use just as they had once been entitled to a share of personal income tax revenue.

The States signed up to the GST agreement because they wanted a tax capable of expanding with the economy and whose incidence would not be as industry or sector specific as so many State taxes had tended to be.

The growth aspect has been more spectacular than anticipated with strong domestic demand fuelling a rising base on which the tax is levied.

The Commonwealth is suggesting that collections this year will amount to \$35 bil-

lion, equivalent to 20% of the total revenue collected and attributed to the Commonwealth in its budget documents, \$2 billion more than the States had expected to receive when they first signed up to the deal and \$10.5 billion more than the \$24.3 billion taken in 2000/01, the first year of collections.

GST collections have been growing at 11% a year, clearly ahead of the 5% annual expansion in the value of Australian output.

The GST windfall for the States has made Canberra's politicians nervous at their potential loss of fiscal power and envious of the States' rising flexibility.

Now, the Commonwealth is accusing the States of failing to spend their GST revenue in the same way as the Commonwealth would have been spending it and, by definition, inappropriately. The Commonwealth now wants a say in how the States spend the GST revenue despite explicit statements such as those in the annual budget papers that "States can spend the GST revenue according to their own budgetary priorities".

Once upon a time, a long time ago, John Howard was presented himself as a State-friendly politician and against centralisation of political power in Canberra. Contrary to earlier political mythology, the evidence has been unfolding regularly that overriding any strong philosophical principles is a devout pragmatism making him the least ideologically driven Prime Minister in living memory. 'Do what works' seems to be the government's motto.

Centralisation of industrial relations, health and education have all been on the government's political agenda in recent months. The Labor Party, through its State parliamentary leaders, is now the bulwark against extension of the Commonwealth's powers. Admittedly, some of them are ambivalent on some issues. Nonetheless, John Howard and his ministers are the ones leading the way in a radical restructuring of the Australian political landscape as the accretion of centralised power proceeds.

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