

Interview with David Hale

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Renowned global economist David Hale talks to Lateline.

Transcript

TONY JONES, PRESENTER: I'm joined by the renowned Chicago-based global economist David Hale who's been brought to Australia by the Commonwealth Bank and Austrade.

He joins us tonight from our Melbourne studio.

Thanks for being there, David.

DAVID HALE, GLOBAL ECONOMIST: Thank you.

TONY JONES: Now as I said, you're from Chicago. America may soon have a president from Chicago.

The story in that city and many others over the past few years have been for sale signs and financial meltdown. Now the real economy's going into recession.

What do you think the new president, whoever it may be, will be facing in the next few years?

DAVID HALE: He'll be facing some pretty awesome challenges. If Barack Obama indeed wins the election he will be taking office in the midst of what will be a meaningful recession.

The American economy has for the last year been able to sustain a growth rate of two per cent because of an export boom as well as tax rebates enacted in the spring that gave the American people \$110 billion of new money.

But the reality is this export boom is starting to weaken, the tax rebates are behind us and we're now experiencing our first decline in consumer spending since 1991.

This will tip the economy into recession; this recession will probably last for at least two or three quarters.

And it will produce, along with the bank rescue program that went through Congress last week, a federal budget deficit next year of \$1.3 trillion; Almost nine per cent of GDP.

A truly awesome number for America and any country and this will constrain the new president's freedom of action.

TONY JONES: Yet he has so many great plans. He has plans to reform the health system among others; very expensive plans.

Will America, will his administration have any hope of affording to do things like this?

DAVID HALE: I would say his plans will have to be deferred at least a year as we come to terms with this very large budget deficit.

He may attempt to enact tax increases on high income people to fund some of these spending plans.

Indeed, that's in his current campaign manifest. But the fact is to enact these tax increases could further depress the economy.

It's estimated for example, that his plan to raise marginal income tax rates will affect 950,000 taxpayers, but two-thirds of those people will be small businessmen, who are responsible for creating our employment.

So, the fact is all of his current plans will collide with this recession and will collide with this budget deficit.

TONY JONES: We don't know much about his economic advisers here in this country; I know you know some of them.

Are they people capable of taking the hard decisions which will need to be taken in an emergency, an economic and financial emergency that they will inherit?

DAVID HALE: I'd say the good news about Mr Obama is that he has a wide network of advisers on not just economic policy, but also foreign policy, who are reasonably confident and thoughtful people.

The key players are first his economic adviser of many years, Austin Goolsby, a University of Chicago professor, who's a very thoughtful free market economist, but who has no political experience.

The man with political experience who joined the campaign three months ago is Jason Furman, who was running a program before that at the Brookings Institution called the Hamilton project that was funded by Bob Rubin.

And he's very close to both Bob Rueben and Larry Summers, and that I think in turn will enhance their possible role in any new administration.

So, you'll have I think, reasonably competent, experienced people giving advice to President Obama. And I think they will help him come to terms with these very awesome challenges created by this recession and but this very large federal budget deficit.

TONY JONES: Some people are already talking about the need in the United States for a Roosevelt style new deal and a radical change to the way American capitalism is actually done.

They don't sound like the sort of people who would go down that path?

DAVID HALE: No, I don't think they represent what I'd call radical change. I think they would represent very much incremental change.

But the fact is that this has been a very unusual crisis here. It was brought on by very irresponsible lending behaviour for mortgages over the last three to four years.

Irresponsible behaviour that had the full of support of the Federal Government; the full support of Fannie Mae, which vastly expanded its own lending two or three years ago, sub-prime lending to promote home ownership for minorities and disadvantaged people.

So, this whole crisis is rooted part in America's cultural preoccupation with home ownership. We had a noble social goal, we went about it in a very irresponsible way, and now we are sitting on potentially \$1.4 trillion of bad bank loans in the year ahead.

TONY JONES: There may be worse to come too, because what we haven't talked about is the toxic derivatives market, and in particular one instrument called the credit default swap, of which there appear to be \$US55 trillion worth of contracts still floating through the global financial system.

And no-one seems to know when the music stops what will happen.

DAVID HALE: Well, there's no doubt; it was credit default swaps destroyed AIG, the big American insurance company two weeks ago.

Because of losses on these instruments they were forced to seek a \$US 100 billion loan from the Federal Reserve board which could lead to the company ultimately going out of business.

We don't fully understand this market; it's brand new; it's grown dramatically; it's not centralised in any exchange. It's very much an over the counter market; there's tremendous counterparty risk.

One of the reasons the Federal Reserve and the Federal Government rescued Bear Sterns back in March was concern about their credit default swap exposure.

So, we're gonna learn a great deal. But I do think we're gonna see more regulatory intervention; there'll be attempts to try and centralise the market, perhaps move it on to an exchange and to get a better understanding and grasp of what it means.

Cause there's no doubt the uncertainties; the lack of information does pose systemic financial risk.

TONY JONES: Yes, very briefly, is there worse news to come on that front? Are there things we don't know about in this giant unregulated market?

DAVID HALE: I think the bottom line is we don't know. There are potentially new risks because of counterparty relationships and because we will have more defaults.

The fact that we're going into a recession, both in the United States and Western Europe, means we're going to have more corporate problems, and if we have more defaults that will, of course, test this market and see how it works.

TONY JONES: OK, let's move on to have a look at China, because you were pretty optimistic earlier this year, six months ago, about the prospects for China's economic growth.

It's now slowed; it's now under 10 per cent. Is that a blip or is that slide likely to continue?

DAVID HALE: It'll continue for a couple of reasons. First, China's been enjoying now for the last five years export growth rates of 25 to 30 per cent.

The new consensus is Chinese export growth next year could slow to five per cent because of the downturn in the US and European economy.

Secondly, China did impose credit restraints nine months ago on the real estate sector. That has led to a downturn in residential consumption, to a slump in home values, to a weak property market.

And if they don't reverse these policies in the next few months this will have an adverse effect on local governments, because local governments depend very much on real estate sales to fund their infrastructure spending.

So, after a period of restraint and clamping down I think China's heading now for a policy of stimulus.

I think we'll see in the year ahead China taking advantage of its budget surplus, to have tax cuts, more infrastructure spending, and we'll see a relaxation of the credit controls in the real estate sector.

But growth will slow from 12 per cent last year, 10 per cent this year, to maybe 7.5 or eight per cent next year.

TONY JONES: Yes, I mean it is interesting the housing market is driven, as you pointed out the last time we spoke, by this massive urbanisation; people coming from the country and settling.

But it appears... in fact one analyst has said supply finally caught up with demand just as demand collapsed.

DAVID HALE: Well, the answer is this movement of people from the countryside to the cities has many years to run; it's 10 or 12 million people a year.

But when you have credit controls, when you reduce bank lending, then people simply can't finance a home purchase; and that's what's happened here in the last nine months.

It'll have to be a relaxation of lending policies next year to revive the sector.

TONY JONES: Are we going to see an across the board look at asset prices in China, as in other places, and I don't just mean housing, but other assets as well?

DAVID HALE: Well, they've had in the last year a big stock market decline; we're down almost 65 per cent after a very buoyant bull market for two years.

That's also going to be an adverse factor for the economy. Chinese equities are not as wildly held as they are in this country, but the fact is they have lost a couple of trillion dollars in stock market value, and that's going to be a negative for consumption, a negative for growth.

TONY JONES: One of the worrying things, obviously, is the decline, the rapid decline, in the steel industry; closing of steel mills, the fall of the spot price for steel and so on.

How seriously could that impact? I mean it'd be very hard to gear it up again quickly. It's obviously driven by the downturn in construction originally?

DAVID HALE: Well, over the last six years China's had extraordinary growth in steel industry, from 100 million tonnes to over 500 million tonnes.

And while there's been a huge construction boom to facilitate this, the fact is as with any sector, you might over expand.

And I would say there may be a year now of consolidation in the Chinese steel industry just because the growth in capacity has been so dramatic.

TONY JONES: Is it as simple as that? Because I mean, the reports of the decline are really quite worrying.

I mean, we've got dozens of steel mills going belly up and one third of the blast furnaces have been shut down in the steel making centre of Tang Shan.

I don't know the details of individual companies that are in trouble. The big companies on the stock exchange have still been reporting profit growth and things like that.

So, there may be individual mills that are in trouble because the fact is they have older technology and aren't fully competitive.

One of the goals of the Chinese Governments here in the last half dozen years has been to produce consolidation in the sector; to get rid of the older plants, which are not energy efficient, which generate a lot of pollution, and move upmarket to higher quality plants through mergers and things like that.

So, part of this adjustment may also be an attempt to weed out the older weaker players.

TONY JONES: OK, at a broader level what, is this slowing of growth and the decline in the construction industry, the steel industry, et cetera, mean for big exporters of resources to that economy, like Australia?

DAVID HALE: Well, the clear risk in the next year is that Australia will have a deterioration in its terms of trade; that these buoyant export prices in the last two or three years for iron ore and coal could weaken.

Already we can see a big gap in the market between spot steel prices and the contract prices negotiated several months ago by BHP Billiton and RTZ.

If we do have a price decline that will mean for Australia weaker exports, and it will mean for the Federal Government major funding problem, because this government's benefitted greatly from huge growth in corporate tax receipts.

If the price decline is big enough, the downturn is long enough, it may produce in two years for the first time in many years a federal budget deficit in Canberra.

We just don't know how far it's going to go yet, but clearly that's the risk looking out 18 months.

TONY JONES: Yes, and what about the other Asian giant economies Japan, South Korea, India obviously.

DAVID HALE: Well, they're all slowing down. Japan's growth was never very robust to begin with; it was 2.5 per cent a year and a half ago, now it's heading to 1 per cent or less.

India's going to slow from nine per cent to seven per cent because India's had very high inflation this year; The Reserve Bank is raising interest rates, and that's dampening credit growth and dampening gains in consumption and investment.

But it's not a huge decline; it's a moderation in growth because India is committed over the next five years to a \$500 billion infrastructure spending program.

Korea's very dependent on world trade as are all the ASEAN countries. And with world trade slowing, Korea's growth will slow as well.

I would say in general the countries of ASEAN will see growth rates slow from five and six per cent recently maybe to 3.5 or four per cent next year.

Not catastrophic like the East Asian financial crisis 10 years ago but still a moderation, still a slowdown, one which will on the margin lessen the demand for Australian commodity exports.

TONY JONES: A final question, David, we're about a year away from a global meeting effectively to try and set carbon price and carbon reduction targets and a worldwide carbon market.

How much is that going to be affected by the current economic crisis?

DAVID HALE: I think the concern is very simple; when you have a recession, when you've got an economic downturn people are less willing to spend lots of money on the environment, or impose large tax increases on themselves to protect the environment.

And the fact is the introduction of cap and trade, the global carbon tax will two or three years from now increase the cost of burning coal, increase the cost of producing electricity.

It will be a new burden on the economy; no way we can avoid that. It will be effectively a tax increase even though we'll call it a trade driven change in the price.

So it'll be a constraint; it'll be a burden on growth. And if we are in a recession for the next year it'll lessen political support.

And then when things improve we'll once again want to focus on the issue of global warming and the environment.

There's a cyclical dimension to this, and when you have a bad economy there's no doubt it has an effect.

We saw this in the Canadian federal election last week; the Liberal Party was campaigning for large increases in carbon taxes promising to recycle them.

But the Conservative Party was able to portray this as a huge tax increase and the Liberals lost 20 seats. They did badly in Canada's Federal election cause they could not turn their proposals for green taxation into a winning issue.

TONY JONES: OK, we're going to have to leave you there. It sounds like you might in fact agree with Peter Costello's analysis that it would've been better for him to have the election this year.

Anyway, we'll leave you there David Hale. Thank you very much, once again, for joining us, and we'll see you next time.

DAVID HALE: Thank you.