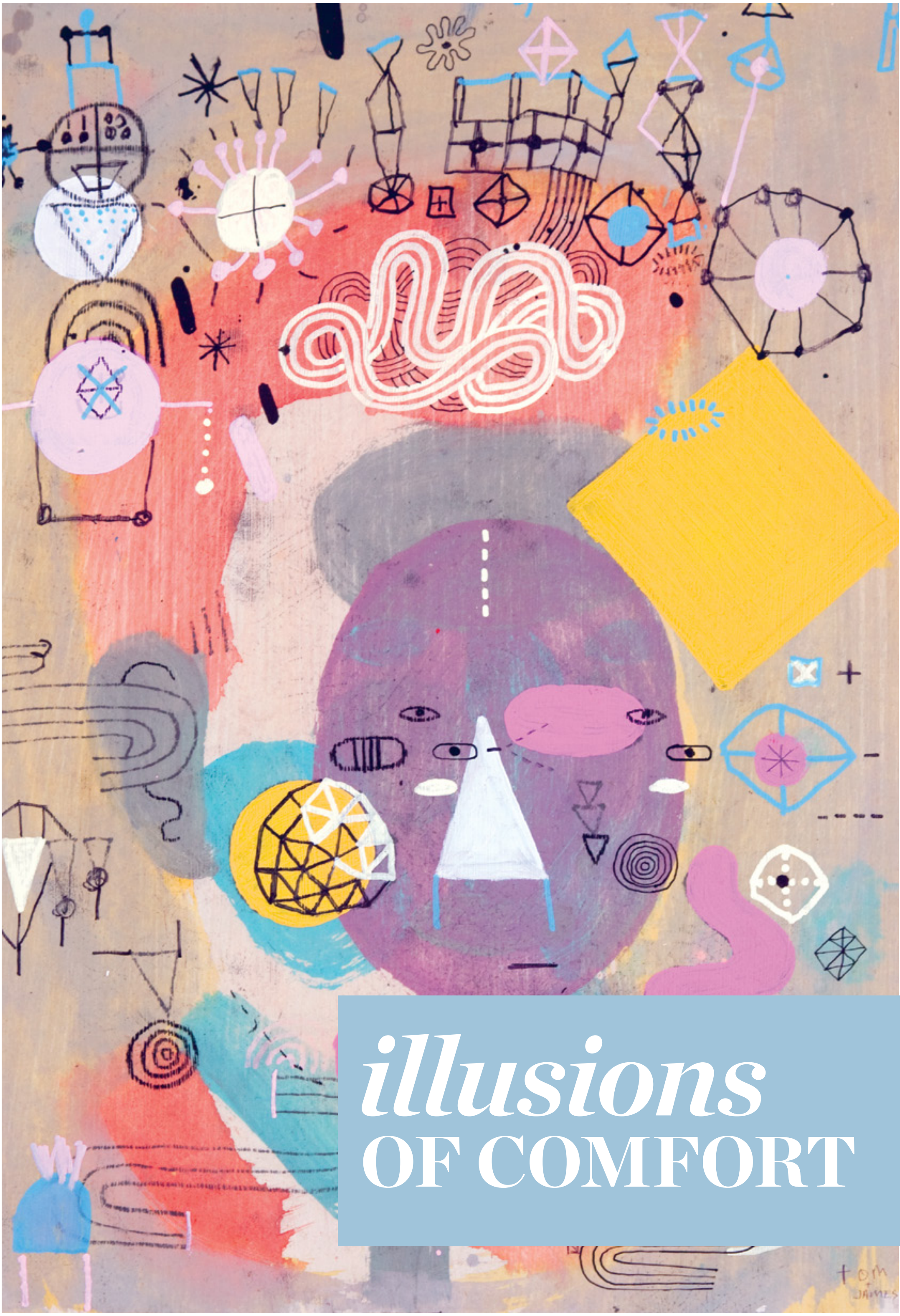

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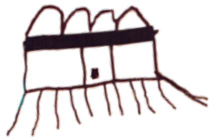

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Illustrations by: Tom and James Hancock, ***tomandjamesdraw.com***

CONTENTS

PREFACE

Twenty years of almost unremitting growth has indeed reinforced the characterisation of Australia as 'the lucky country'. While the fortune of our location and natural endowment can be celebrated, it is easy to forget that prior to the 'great financial unravelling' (GFU), countries like Spain and Ireland too were enjoying a financial boom they hadn't witnessed for centuries. They came unstuck not from careless government deficit spending but partially from their governments inheriting problems from their bank which had overindulged in a credit binge. As they try to adjust via an internal recalibration of wages and prices (unable to devalue on their own as members of the European Monetary Union), the disruption and pain felt by many is very real and unsettling.

The two building blocks of Platinum Asset Management's investment philosophy relate to human behaviour. Firstly, there is a natural predilection to over-emphasise the recent event and secondly, there is a tendency to extrapolate the current situation into the future. We have been questioning for the last 18 months the prospect of China maintaining the high growth rates of the past given the skewing of that country's economy towards an unparallel level of investment. The market is now coming around to our view and is starting to understand the degree to which credit and central allocation have contributed to the astonishing growth record achieved by China.

It was with this in mind that we chose an economic assessment of the Australian economy for this year's report. Some shareholders may find it a little gruelling to process on account of it being somewhat academic and certainly belonging to the Austrian School of Economics. However, there is no escaping the central theme that Australia has been sitting on its laurels for a good while now with the reforms brought in largely by Mr Keating being a fading memory. Without a new bout of reforms that intensifies competition, frees resources and trims down bureaucratic meddling, the message is that we run the risk of severe withdrawal symptoms once our terms of trade deteriorate. To rely on this rare and huge benefit is simply careless. For reference, our current account was in deficit to the tune of 4% of GDP in the first quarter of 2012; a time when the terms of trade are at a multi-decade high, last seen alongside the Korean War.

For those less interested in the text, there are some valuable tables and charts that tell most of the story. Industries that have been left to their own devices like agriculture, have eclipsed the field in terms of productivity while others with strong monopoly positions, like the utilities, have a pitiful record of labour productivity. In terms of new legislation, our esteemed leaders in Canberra have excelled in adding to our burden, with the now disbanded Australian regulation taskforce estimating that one quarter of managers' time is devoted to compliance with the government's rules.

This analysis has interesting implications for you as an investor. Even if you believe that the phenomenon of strong growth in the emerging markets persists, you should perhaps think carefully about the likely supply response that elevated prices will bring to our principal exports. This will also bear heavily on the Australian dollar and may lead you to conclude that investing abroad carries relatively low risk from an Australian dollar appreciation perspective.

Kerr Neilson

Managing Director
August 2012

UNIFORM MEDIOCRITY

...Or how Australia's *'Great Complacency'* will come back to haunt it.

By Justin Pyvis, Ausnomics

“GOVERNMENT CAN NEVER DUPLICATE THE VARIETY AND DIVERSITY OF INDIVIDUAL ACTION.

At any moment in time, by imposing uniform standards in housing, or nutrition, or clothing, government could undoubtedly improve the level of living of many individuals; by imposing uniform standards in schooling, road construction, or sanitation, central government could undoubtedly improve the level of performance in many local areas and perhaps even on the average of all communities. But in the process, government would replace progress by stagnation, it would substitute uniform mediocrity for the variety essential for that experimentation which can bring tomorrow's laggards above today's mean.”

Milton Friedman: Capitalism and Freedom

We have worried about the long-term prospects of the Australian economy for a while now. For two decades she has seemingly coasted on the back of the last major crisis which culminated in 'breaking-point' regulatory reform in the 1980s and 1990s, a global debt bubble and a rather fortunate emergence of China as a major trading partner.

We say 'breaking-point' reform because that is how major change has occurred throughout the history of Australia; nothing happens for a long period of time, people get complacent and simply ignore the elephant in the room until circumstances force someone's hand one way or another. It is as Saul Eslake (2011, p. 20[1]) recently noted, where "…historical precedent strongly suggests that Australians, and their political representatives, will feel no great compulsion to embrace a program of productivity-enhancing economic reforms for as long as the mining boom – and the various channels through which the income generated by that boom is recycled and redistributed throughout the Australian economy – delivers continued growth in incomes and high levels of employment".

This is both a blessing and a curse in Australia: on the one hand, problems are allowed to build up and damage is able to be done with almost no recourse; on the other hand, the "Washminster Mutation"[2] political system also allows mess to be sorted out with *relative* ease when the 'breaking-point' is reached.

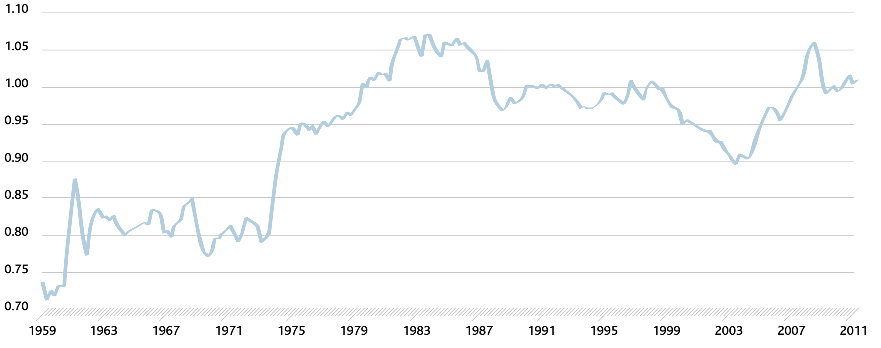
1 http://www.grattan.edu.au/publications/098_eslake_rba_productivity_august-2011.pdf

2 Elaine Thompson (1980), "The 'Washminster' Mutation", in Responsible Government in Australia, eds. P. Weller and D. Jaensch.

Baumol's Disease

One way to measure the productivity of government is through the relative price of government services when compared to the private sector, known as Baumol's Disease (Figure 1). This ratio only began to decline in Australia in 1983 after decades of complacency and the disaster that was the Keynesian revolution had culminated in a permanent growth in the size of government and the stagflationary period of the 1970s. According to former Australian treasury Secretary Ken Henry[3], "…the close to 6 percentage points of GDP expansion in government expenditure during the Whitlam Government has never been reversed. And I think I can safely say that it never will be".

FIGURE 1: BAUMOL'S DISEASE: RATIO OF PUBLIC TO PRIVATE CONSUMPTION DEFLATORS IN AUSTRALIA, SEPTEMBER 1959 – DECEMBER 2011



Source: Ausnomics, ABS

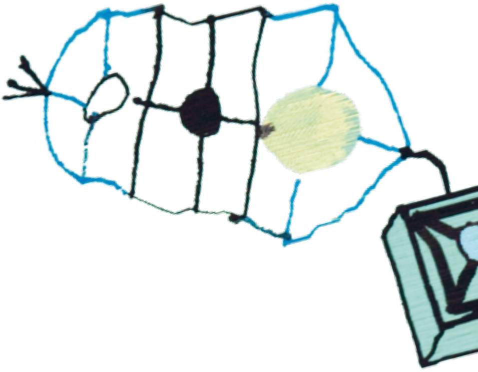
These events all culminated in 'breaking-point' reforms in Australia, starting with the extreme (by today's standards) move of the then Governor-General, Sir John Kerr, to dismiss the entire Gough Whitlam government in November of 1975 and replace it with Malcolm Fraser's opposition. However, it was not until Baumol's Disease peaked in the early 1980s and Paul Keating, then Australia's treasurer, declared that if Australia failed to reform it would become a "banana republic" that started what would eventually be two decades of reforms, floating the Australian dollar, deregulating the financial system, abolishing import quotas, cutting tariffs, freeing the labour market, privatising state-owned enterprises and reducing taxes.

3 Ken Henry (2009), "Fiscal Policy: More than just a National Budget", Address to the 2009 Whitlam Institute Symposium.

Baumol's Disease subsequently contracted until the start of the mining boom in the early 2000s, when the "Great Complacency" officially began.

We should add that while Baumol's Disease may have declined, government was still growing in absolute terms and while politicians had given up trying to run the country through state-owned businesses, they instead decided to regulate it to death; indeed, this could also affect the measured Baumol's disease, as the private consumption deflators we used also include a range of prices in sectors such as health and education which are subject to cost inflation due to inefficient government regulations, understating the extent of the disease.

Baumol's Disease subsequently contracted until the start of the mining boom in the early 2000s, when the "Great Complacency" officially began.



The regulatory burden in Australia has clearly been increasing. The growth in tax legislation alone has resulted in what Ken Henry[4] described as a tax system that "… vastly exceeds human scale… Australia's system now has no fewer than 125 taxes", and "…there could be as many as 160 different state taxes and 259 taxes nationally"[5]. This is why Australia has the world's third most complex tax system[6], with "…approximately 5,700 pages of income tax legislation, and that [sic] almost three-quarters of individual Australian taxpayers apparently need a registered tax agent to prepare their tax return". That is just income tax; Robin Speed from the Rule of Law Association estimated that if the Australian Federal Parliament keeps performing at the current trend, there will be "…830 billion pages of tax legislation by the turn of the next century"[7].

The costs to the economy are huge. Australia's Regulation Taskforce (which was wound up in 2006[8]) estimated that 25% of managers' time is devoted to compliance with the government's rules. This is before new regulation associated with the incoming mining and carbon taxes (plus the taxes themselves) are considered and we can be sure that these will serve to increase costs, raise Australia's risk profile and further discourage foreign capital, a source of funding that Australia being a vast, low-populated nation is dependent on for her future prosperity.

The increasing regime uncertainty means businesses (both existing and potential) cannot know or hope to comply with all the regulations in place and so instead simply wait to discover which rules they are expected to follow. This affects small businesses disproportionally, with risk-management experts Robyn Fairman and Charlotte Yapp finding that most small businesses simply ignore regulations until inspectors come knocking at which point they attempt to comply[9].

4 http://taxreview.treasury.gov.au/content/Content.aspx?doc=html/speeches/01.htm
5 http://www.taxreview.treasury.gov.au/content/Paper.aspx?doc=html/publications/papers/report/section_2-03.htm
6 http://www.aph.gov.au/house/committee/jcpaa/taxation06/report.htm
7 http://www.smh.com.au/national/welter-of-laws-seen-as-threat-to-country-20091120-iqvo.html#ixzz1pcjhwcLz
8 http://www.regulationtaskforce.gov.au/
9 Robyn Fairman and Charlotte Yapp (2005), *Enforced Self-Regulation, Prescription and Conceptions of Compliance within Small Businesses: The Impact of Enforcement, Law & Policy* Vol. 27, No. 4, p. 491-519.

THE WORRYING SIGN IS NOT JUST THE GROWTH IN REGULATIONS AND THE COSTS OF COMPLYING, BUT THE FACT THAT AUSTRALIA HAS FALLEN BACK IN ALMOST EVERY MEASURED INDEX RELATIVE TO HER GLOBAL PEERS.

For example, in the OECD's integrated product market regulation indicator Australia dropped in ranking from an above-average 5th in 2003 to a below-average 13th in 2008, due to "...the rate of reform, relative to comparator countries, having slowed in recent years"[10].

Not to fear, Australia has started reforming. Reform in the shape of a carbon and mining tax that the outgoing chairman of Australia's Future Fund (a kind of sovereign wealth fund) David Murray described as "…the worst piece of economic reform I've ever seen in my life in this country", with the "…consequence of introducing that tax at that level in Australia today [sic] is very, very bad for this economy, particularly in terms of its international competitiveness…it raises costs further within Australia, it reduces our competitiveness for export of energy-related commodities and it therefore renders us less competitive in the future". As for the mining tax, he described it as "clumsy" and that "…the timing at the top of the terms of trade was not good". Whenever the government jumps on the bandwagon (in this case the mining boom), you can be sure that the cycle is close to if not at its peak; politicians gamble with other people's money and have a 'colourful' track record as far as investing goes!

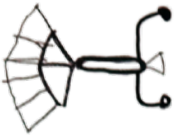
Australia is not doing well on the trade front either. In 2010 (prior to the mining and carbon taxes) the OECD ranked Australia's artificial barriers to foreign direct investment as the 7th highest among the 34 "advanced nations". In fact, it is easier for Australians to invest in Chinese real estate than it is for people from China to buy property in Australia[11]!

We are not alone in our thinking that Australia has been embarking on what Ross Garnaut dubbed[12] "…the great Australian complacency of the early 21st century", where Australia faces "…a period when there's very little economic capacity to increase per capita living standards". While we may disagree with a lot of what Garnaut preaches, we do agree that Australia is nearing the end of her "great complacency" where government largesse was allowed to grow unimpeded on the back of a growing economy and increasing living standards for the average Australian, with people preferring to believe that all of the growth in government was a tolerable 'free lunch' rather than something that will have to either reverse its course or detract from future living standards when the good times end.

10 http://www.treasury.gov.au/igr/igr2010/Overview/pdf/IGR_2010_Overview.pdf

11 http://resources.news.com.au/files/2010/11/15/1225953/995883-101116-aes.pdf

12 http://www.rossgarnaut.com.au/Documents/Breaking%20the%20Australian%20Complacency%20of%20the%2021st%20Century%202005.pdf



When will the good times end?

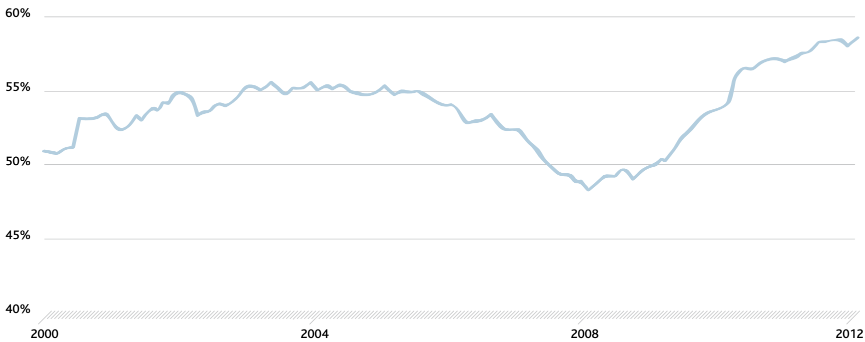
"Analysis, whether economic or other, never yields more than a statement about the tendencies present in an observable pattern. And these never tell us what will happen to the pattern but only what would happen if they continued to act as they have been acting in the time interval covered by our observation and if no other factors intruded."

Joseph Schumpeter: Capitalism, Socialism and Democracy

If there was a question on everyone's mind, it would be: how long can Australia continue to ride her luck before something triggers an event necessary to collapse the whole stack of cards?

It is a question we have been trying to answer for some time. As we pointed out earlier, Australia has performed poorly as far as implementing *beneficial* economic reform during the good times which means that when they end, the bust will be all the worse for it. Labour markets have become more inflexible, wages are 'stickier', resources have been misallocated *en masse* and the financial sector – on which any modern economy depends – has suckled on the teet of government for so long that it has created a pool of systemic risk meaning that a crash in one industry will likely be felt as an economy-wide recession requiring further assistance rather than a relatively isolated incident in one asset class (Figure 2).

FIGURE 2: AUSTRALIAN BANKS' RESIDENTIAL LOANS AS A % OF LENDING, JANUARY 2000 – JANUARY 2012



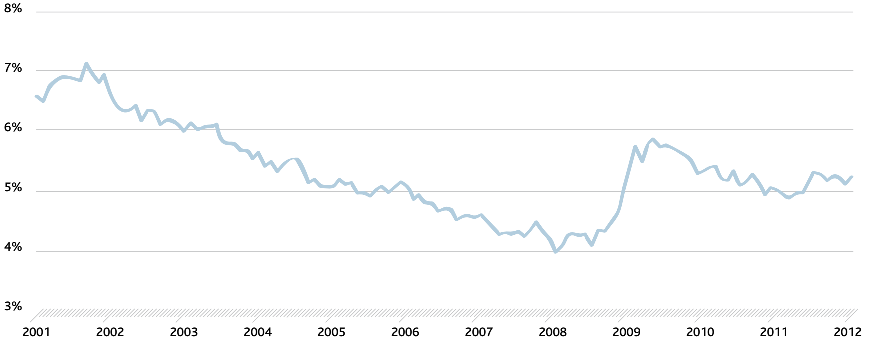
Source: Ausnomics, RBA

The Ricardo Effect

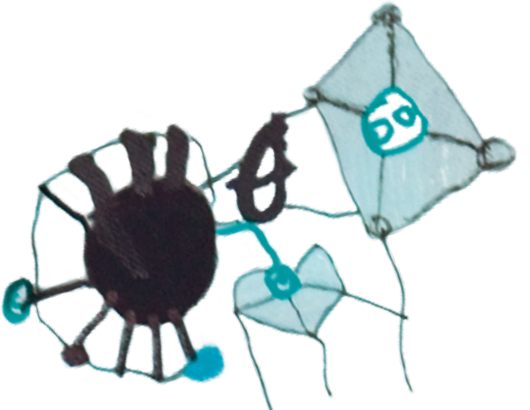
For an idea as to when the bust will come, we can find a clue in what Hayek dubbed the "Ricardo Effect" – the Ricardian (David Ricardo was an eminent British economist of the classical tradition) proposition that a rise in real wages will cause businesses to substitute capital for labour and vice versa.

As the price of products that businesses sell increases (starting with commodities in Australia in this case), real wages fall and thus the level of profit rises provided that nominal wages do not increase by as much. This has had the effect of keeping Australia's employment near what economists call its 'natural rate', or maximum, for years (Figure 3).

FIGURE 3: AUSTRALIAN UNEMPLOYMENT (% OF LABOUR FORCE), FEBRUARY 2001 – FEBRUARY 2012



Source: Ausnomics, ABS



For the purpose of our analysis, the key is *real wages*, the *relative* profitability of industries in Australia and the movement of the interest rate in response to these signals. Hayek (1939, p. 27-28), in his essay *Profits, Interest and Investment*, pointed out that:

"If the rate of interest had been allowed to rise with the rate of profit in the prosperous industries, the other industries would have been forced to curtail the scale of production to a level at which their profits correspond to the higher rate of interest. This would have brought the process of expansion to an end before the rate of profit in the prosperous industries would have risen too far, and the necessity of a later violent curtailment of production in the early stages would have been avoided".

In the case of Australia, the prosperous industries Hayek speaks of are those directly involved in and related to the mining sector. The other industries are those that came along for the ride even when they should not have, the prime examples being housing and related industries (e.g., construction and finance, Figure 4)[13].

FIGURE 4: % CHANGE IN TOTAL EMPLOYMENT AND $ VALUE ADD FOR SELECTED AUSTRALIAN INDUSTRIES, JUNE 2000 – JUNE 2011

INDUSTRY	VALUE ADD	EMPLOYMENT	VALUE ADD PER HOUR WORKED
Mining	336.30	181.36	57.27
Finance	150.60	27.39	101.45
Construction	138.74	50.33	61.96
Transport	125.33	27.54	84.83
Public Administration	106.17	48.95	42.49
Real Estate Services	104.71	41.04	54.07
Electricity, Gas, Water	87.98	89.57	-1.24
Retail Trade	86.41	22.90	59.39
Agriculture	73.35	-25.43	134.45
Manufacturing	37.66	-10.32	56.44

Source: Ausnomics, ABS

Interestingly, sitting at the bottom of the table is the much bemoaned Australian manufacturing industry, adding just 38% value add in a decade (and it is probably negative when you remove subsidies). However, an industry *just as exposed to an appreciating dollar* in the form of Agriculture (Australia exports over half of her food production) has not only managed to almost double in value add over the same period, but has almost tripled in productivity (value add per hour worked) compared to that of manufacturing. We have no doubt in our mind that this relative success is owed to less government intervention in agriculture, less union meddling and therefore a far more flexible and vibrant industry, able to adapt to changing times by investing in labour-saving capital equipment. How long this can last we do not know; the government has taken notice and is developing a "National Food Plan"[14], something you can be sure will add a bit of manufacturing-style "uniform mediocrity" to the industry.

"If the rate of interest had been allowed to rise with the rate of profit in the prosperous industries, the other industries would have been forced to curtail the scale of production to a level at which their profits correspond to the higher rate of interest. This would have brought the process of expansion to an end before the rate of profit in the prosperous industries would have risen too far, and the necessity of a later violent curtailment of production in the early stages would have been avoided".

13 And as we have argued before, we believe that the exogenous shock that is fuelling the mining boom is itself built on a bubble in China and artificially cheap credit thanks to the 'liquidity' provided by the US along with the combination of fiat currencies and the structural flaws in the global financial system that allows this 'hot money' to find its way into Australia where it is treated as if it were real savings, fuelling domestic asset prices.

14 http://www.news.com.au/breaking-news/australias-food-sector-enjoys-healthy-growth/story-e6frfku0-1226316641893

While the mining boom initially helped to reduce real wages in manufacturing, the global financial crisis (GFC) in 2008 put an end to that as a strong Australian dollar and a general lack of international competitiveness in Australian manufacturing caused real labour costs to soar.

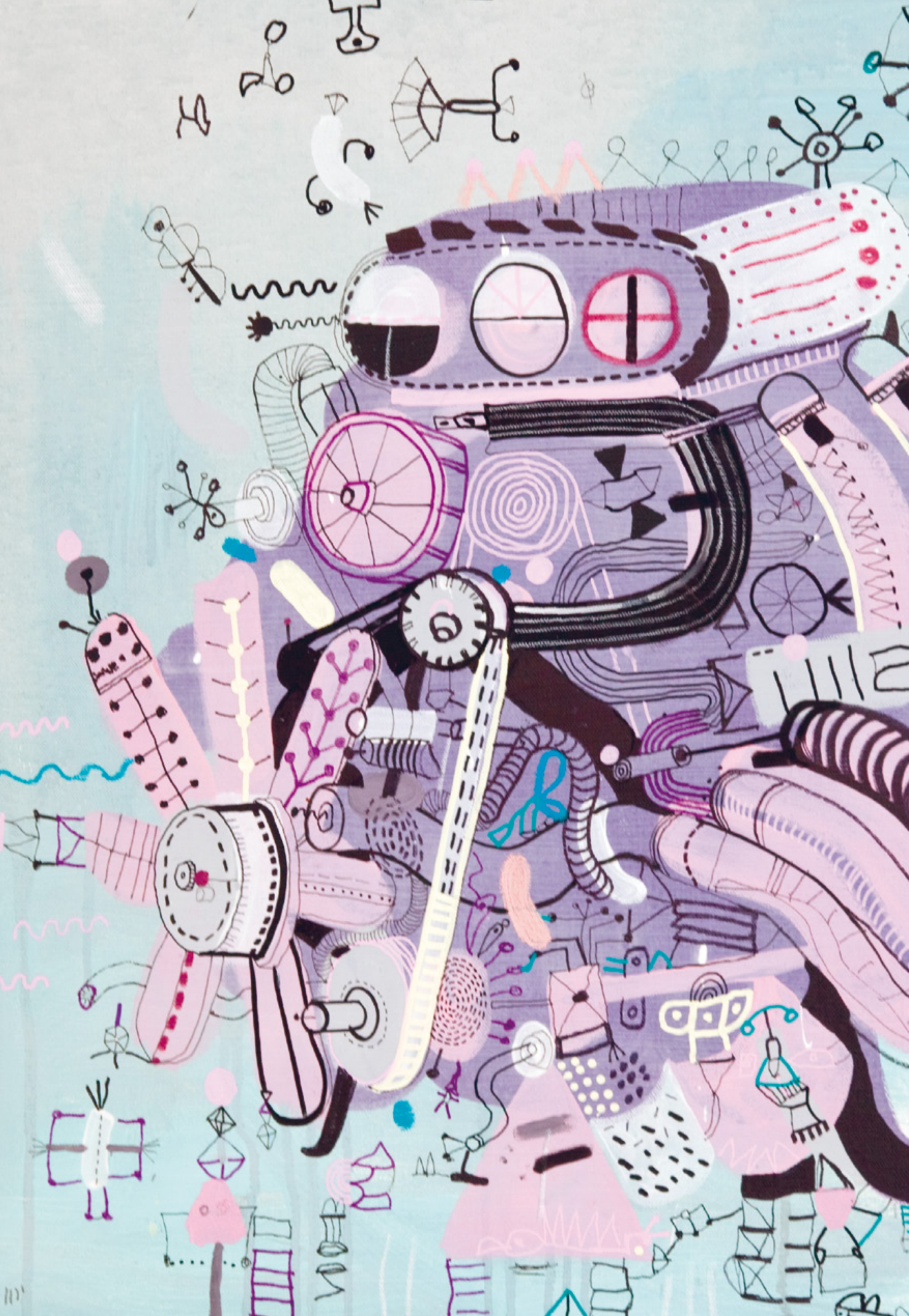
Productivity?

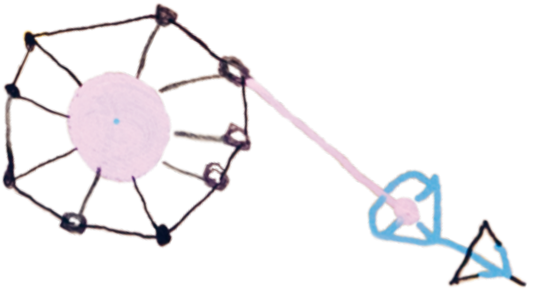
A lot has been written about Australia's declining multifactor productivity[15]. Most studies use the ABS's figures on multifactor productivity (MFP) and bemoan the lack of productivity growth in Australia (there was significant negative MFP growth over the past decade), but we find these productivity indexes of questionable use given that they overlook the role prices play. For example while MFP has declined drastically in the mining sector (ABS estimates put it at negative 24.3% for the early boom years between 2000-01 and 2006-07[16]), our preferred measure of dollar output per hour worked had risen almost 60% over the same period.

This is because high commodity prices and soaring profits in the industry have allowed 'less productive' – that is, marginal mine sites – to be mined and for 'less productive' labour to be drawn from other areas of the economy with high *nominal* wages. Thus while MFP declines, the total incomes and thus the standard of living of the people involved increases. However, if the increasing numbers of marginal mining projects (which have long lead times before they produce anything) are met with a slowdown in commodity price growth, i.e. a China slowdown, then the largely immovable capital sunk in these mines will have to be written off and the productivity gains will fail to materialise.

15 See for instance the Productivity Commission's *Long Term Trends*, http://www.pc.gov.au/research/productivity/estimates-trends/trends

16 http://www.pc.gov.au/__data/assets/pdf_file/0005/84911/mining-productivity.pdf

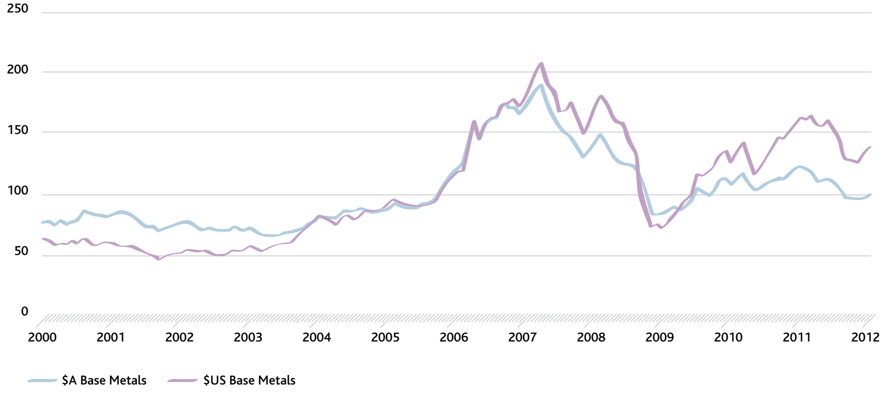




So long as the dollar value of output per hour worked and real wages continue their inversely-related trends, we would expect the current boom in Australia to continue. We can see what happens to an industry when this trend reverses; jobs are lost and the industry concerned either stagnates due to an inability to adjust (reallocate resources) or simply declines.

While the mining boom initially helped to reduce real wages in manufacturing, the global financial crisis (GFC) in 2008 put an end to that as a strong Australian dollar and a general lack of international competitiveness in Australian manufacturing caused real labour costs to soar. This is something we would expect to happen in other industries when the China story comes to an end, which will eventually be signalled through a reversal in the trend of commodity prices and the Terms of Trade (Figure 5; Figure 6)[17].

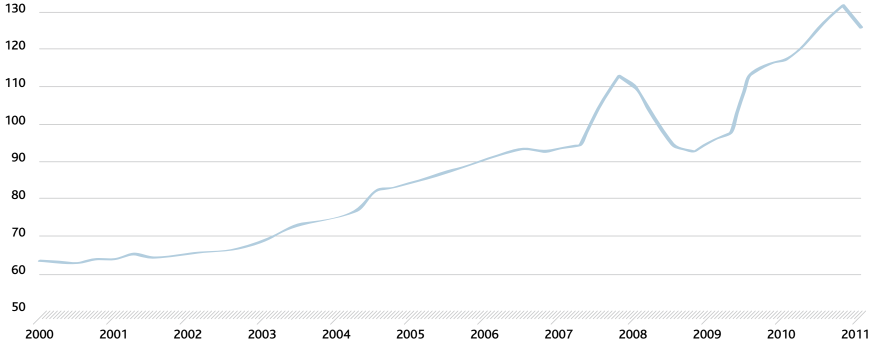
FIGURE 5: BASE METAL PRICES, FEBRUARY 2000 – FEBRUARY 2012



Source: Ausnomics, RBA

17 We must add that these charts are more backwards-looking than usual – unfortunately the ABS only publishes annual data every June for one of the data sets we rely on so that is all we were able to use.

FIGURE 6: AUSTRALIA'S TERMS OF TRADE, DECEMBER 2000 – DECEMBER 2011



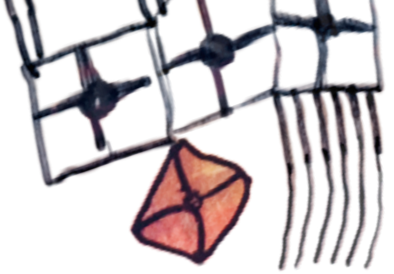
Source: Ausnomics, ABS

Our theory tells us that in the boom phase the real wages faced by miners and all industries carried along for the ride (some more so than others) should be declining – those areas furthest removed from final consumption – and profits relatively high, something we have witnessed.

While in a perfect world[18] the interest rate would have adjusted to reflect the demands coming from the mining sector, forcing other sectors to *expand less quickly*, in reality the *relative* rate of interest – that is, the deviation from the natural rate – did not rise as much as it would have had it not been for the price-fixing of the Reserve Bank (RBA) and its international colleagues. When the rate of interest is too low[19] – *even if rates have been cut, they may still be too low* – some things become relatively cheaper than they would have been otherwise, in particular more capital intensive and risky investments. Cantillon effects exist and the structure of production is distorted and it is only down the road that people realise those investments cannot be sustained at the same level as they were before.

18 Hayek in *Profits, Interest and Investment: "…in the absence of an automatic mechanism making rates of interest move with rates of profits it would require superhuman wisdom to adjust them perfectly by deliberate policy".*

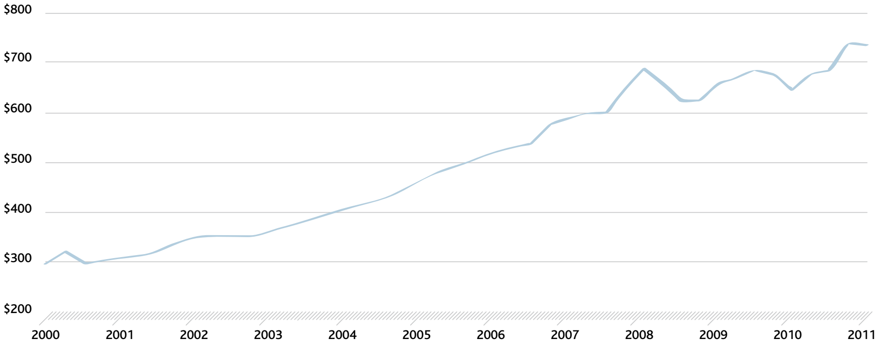
19 Vice versa, if the rate is too high we get a stifling of growth, or a rate of growth below the optimal rate.



The recent announcement by BHP Billiton[20], the world's largest miner, that it plans to invest $100bn over the next 8 years – a sum larger than its total CapEx in the past 20 years – is an example of the kind of 'bubble peak' signal we are always looking out for.

Rather than an exogenous boom in China being solely-related to the mining sector,[21] the boombust cycle spread throughout the real economy thanks to the intertwining of the financial system with the whole economy, something exacerbated by the oligopoly grant provided to the nations' banks (meaning that failure is likely to be systemic rather than isolated and therefore the government will be forced to intervene). Debt levels built up and consumption (housing is a consumer good) and investment (businesses) were largely financed through increases in debt and speculation in ever-rising asset prices (Figure 7; Figure 8; Figure 9; Figure 10).

FIGURE 7: AUSTRALIA'S NET FOREIGN DEBT, DECEMBER 2000 – DECEMBER 2011 ($ BILLIONS)

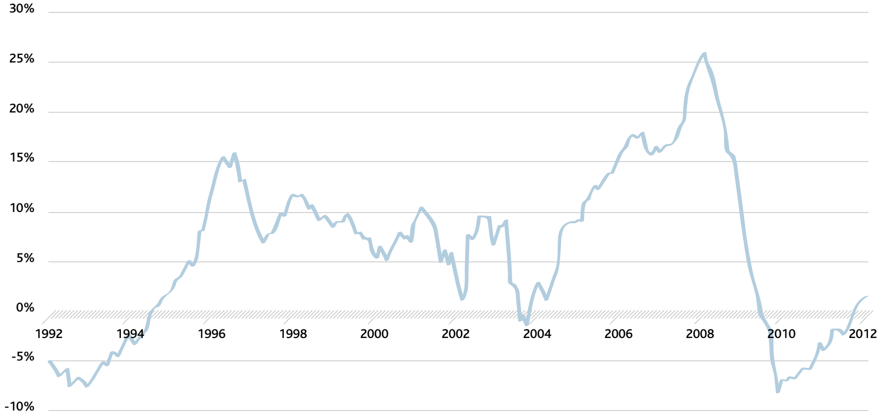


Source: Ausnomics, ABS

20 http://afr.com/p/business/companies plans_attract_more_scrutiny_odhifVKqinsSGSthHXd5tK

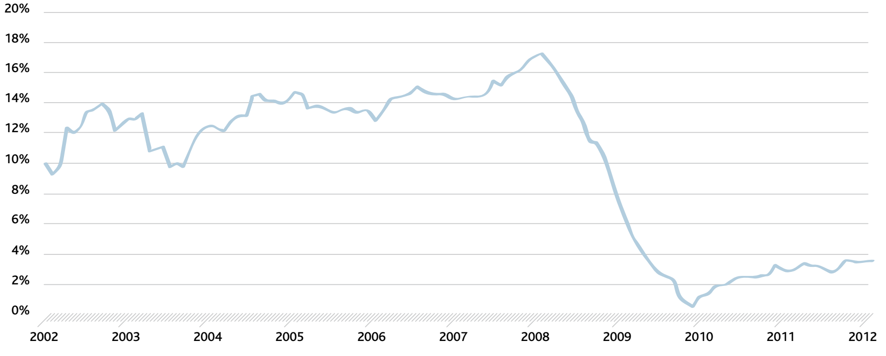
21 We must again stress that 'hot-money' induced booms cannot spread across borders to the extent that they can today if the recipient country was operating with a (or several) less 'facilitative', sound currency.

FIGURE 8: AUSTRALIAN BUSINESS CREDIT GROWTH: JANUARY 1992 – JANUARY 2012 (%YoY)



Source: Ausnomics, RBA

FIGURE 9: TOTAL AUSTRALIAN CREDIT: JANUARY 2002 – JANUARY 2012 (%YoY)



Source: Ausnomics, RBA

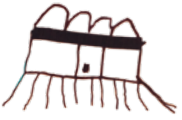
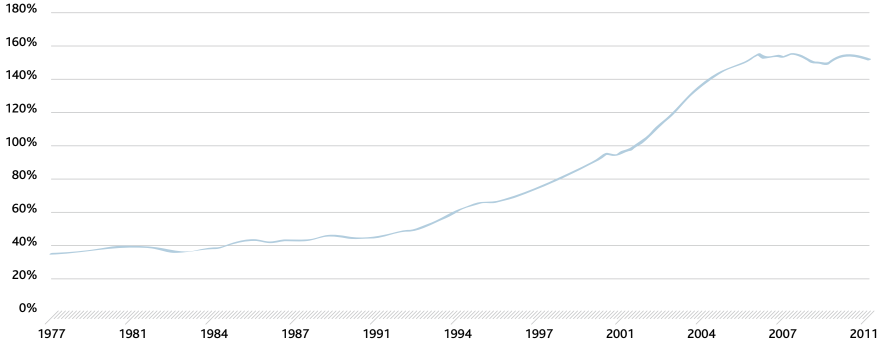


FIGURE 10: TOTAL AUSTRALIAN HOUSEHOLD DEBT TO DISPOSABLE INCOME: SEPTEMBER 1977 – SEPTEMBER 2011



Source: Ausnomics, RBA

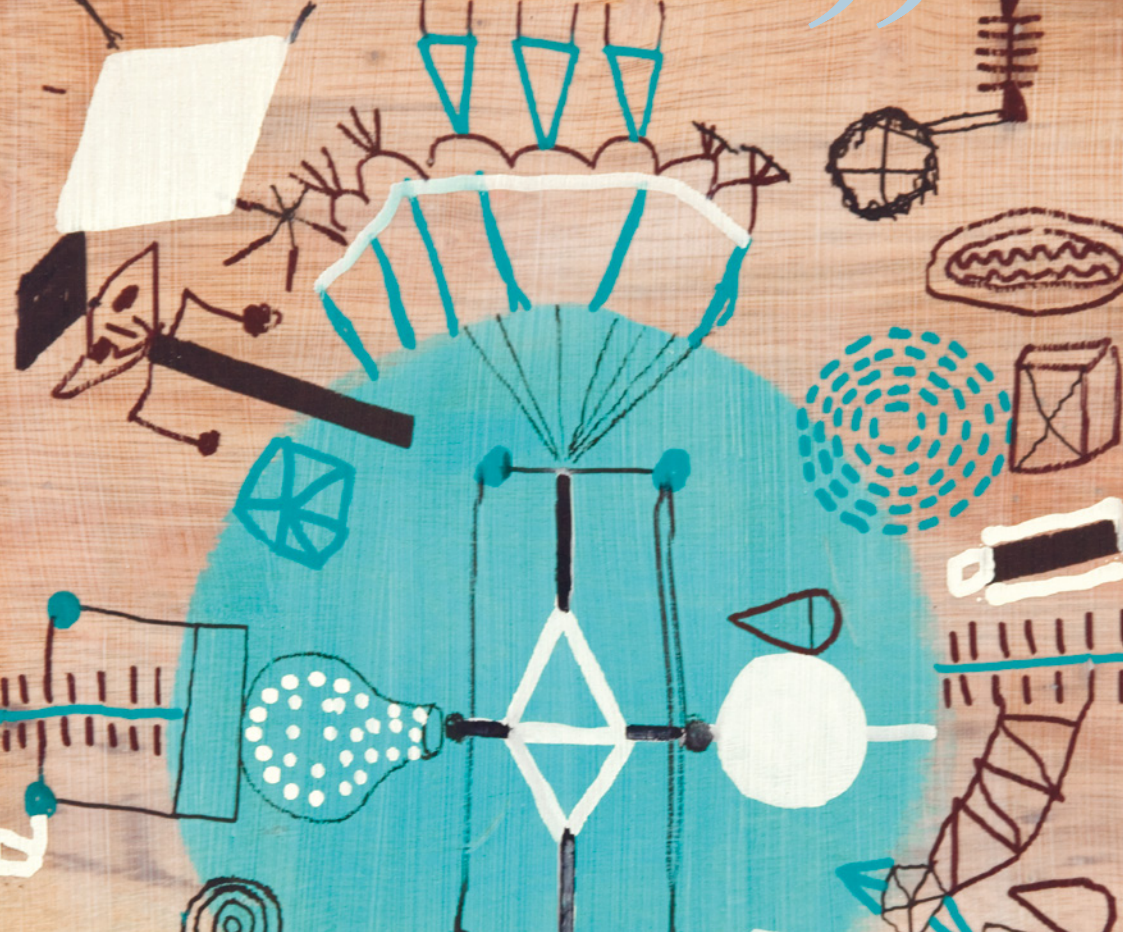
Both consumption and investment expanded as the production possibility frontier (excuse the economic jargon, think of the total 'mix' of potential economic output) was pushed outwards beyond what is sustainable. While a normal, healthy economy will always be pushing outwards with investment and consumption increasing in accordance with real savings and eventually lower prices, an unsustainable one follows a different path where the economy is still growing but the manipulation of the interest rate sends entrepreneurs an incorrect signal and so both investment and consumption expand beyond what is sustainable, creating misallocations and sowing the seeds of the future bust.

It is at that point where the economy, through the price system, tries to move back to the old, sustainable path that a recession ensues (as some of the expansion was 'good' growth, this does not mean a contraction to the level of consumption and investment before the boom started).

IT IS A CUMULATIVE PROCESS, INDEED AN EXPLOSIVE PROCESS,

leading further and further away from an equilibrium position till the stresses become so strong that it collapses.

F.A. Hayek, Profits, Interest and Investment



> "Argentina became very rich, despite its extractive institutions, because of a resource boom. And that then came back to bite it. If you become very rich because of a resource boom, but your institutions are deeply extractive, the moment that resource boom goes away, or even before, the conflict is there and people [politicians] are going to use these institutions for enriching themselves."

Daron Acemoglu, Why Nations Fail

Conclusion

Australia is not Argentina; at least not yet. Her fundamental institutions are still strong despite a gradual erosion in various freedom and business indexes over the "great complacency". However, to draw from Acemoglu again, certain industries are built on "extractive" institutions, where growth comes not from increasing the size of the pie but from extracting rents from society. One such industry is banking, where the concentration of risks such as mortgage finance in a small number of banks results in local disruptions being transmitted across the country. It is where [sic] "…the financial sector through its political influence distorted the rules of the game, benefiting executives in the industry, which in turn led to outsized rewards and ultimate instability in the financial industry"[22].

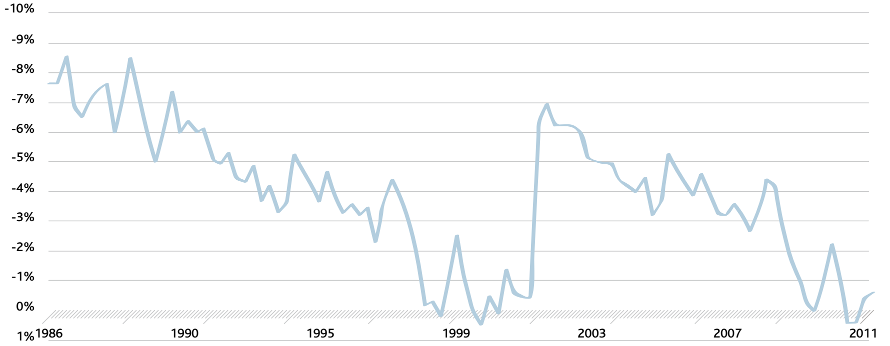
Australian banks have grown to their gargantuan proportions not through innovation and efficiency gains but by capturing government support available only to the largest banks – something that they have even managed to have enshrined in their 'four pillars' policy. Combined with the incentives provided by the Basel regulations which nudged banks into real estate, this institutional structure has mutated what should have been a local issue into a potential national disaster.

22 http://www.econtalk.org/archives/2011/02/acemoglu_on_ine.html

Speaking of housing, the housing industry is still flat lining and is showing no real signs of reigniting despite a slight downwards movement in the Current Account Deficit and the best effort of the government[23] and the banks', with RateCity reporting that "Nearly 70 per cent of lenders are writing home loans with deposits as low as 5 per cent of the value of the property", compared "…to just 50 per cent of lenders two years ago"[24].

However, while property might fizzle for decades, the real trigger for the bust – that is, declining commodity prices as a result of a slowdown in China which will cause *real* wages to increase and therefore force businesses to switch to more capital-intensive, labour-saving means to survive – looks like it could be just around the corner (Figure 11).

FIGURE 11: AUSTRALIAN REAL NON-FARM LABOUR COSTS, SEPTEMBER 1986 – DECEMBER 2011 (INVERSED; % CHANGE YoY)



Source: Ausnomics, ABS

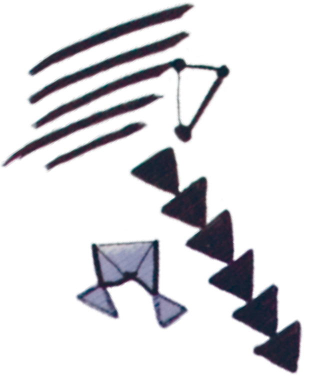
23 As we reported in our last *ExposAsia*, zoning in Australia is some of the worst in the world. For a recent example, Urban Development Institute of Australia WA said that developers in Western Australia must put their plans through 13 different government agencies for approval, a process which "…was taking between seven and 14 years to complete, adding thousands of dollars to the cost of a home", http://www.watoday.com.au/wa-news/housing-shortage-and-costs-to-worse-industry-body-20120329-1w09f.html

24 http://www.news.com.au/money/banking/borrowers-lured-with-high-risk-loans/story-e6frfmcr-1226300561296

How long can Australia rely on falling real labour costs? The data would seem to indicate that her time is just about up, with the rate of decline decelerating throughout the 2000's and even turning positive briefly during the 2009 financial crisis (Figure 11). While real labour costs have fallen slightly since then, we believe that Australia is at the end of the most recent credit-induced boom and that government efforts to kick-start it will – unlike in 2009 – fail. The result will be rising unemployment and house price declines, the extent of which will depend on whether the government and RBA decide to let the economy restructure (which will result in short-term unemployment and a rapid decline in asset prices) or a long, drawn-out and possibly stagflationary period where the structural problems in the economy are not solved efficiently through the price system but are maintained in 'limbo' with only the most marginal businesses being forced to reallocate their resources.

While interest rates will be slashed, they will not be able to fix the structural problems in the economy and will at best keep mortgage holders from defaulting and marginal businesses above water. The Australian dollar, relying on the carry trade and China for its strength, will collapse when the bust comes as the smart money looks for safer yields elsewhere.

> **"Once a certain point is passed, although the decline of investment may be postponed for a long time by keeping the rate of interest low, it is bound to come, and that the further the point is put off, the greater will be the rise in the rate of profit and consequently also the ultimate decline of investment."**
>
> *F.A. Hayek, Profits, Interest and Investment*



Labour in Australia (with the exception of manufacturing) is still cheap in real terms. But when wages begin to rise whether as a result of higher nominal wages or lower profits (e.g. commodity prices) it will result in rising unemployment and all of the usual suspects that follow including a weaker dollar and short-term deflation in both consumer goods and asset prices. Deflation will occur because in spite of the inevitable efforts to inflate by the RBA and spend by the government the combination of deleveraging and, in the short term, the excess of unused resources ready to 'soak up' the liquidity will outweigh their efforts. As Ludwig von Mises[25] said:

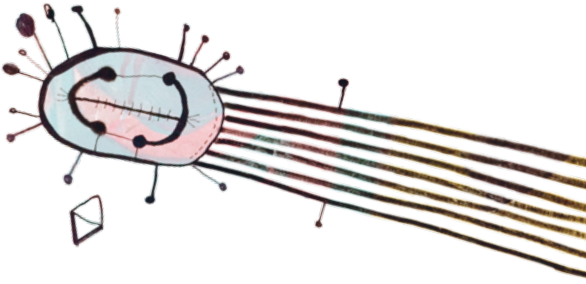
> **"Even on an unimpeded market there will be at times certain quantities of unsold commodities which exceed the stocks that would be held under static conditions, of unused productive plant, and of unused workmen. The increased activity will at first bring about a mobilisation of these reserves. Once they have been absorbed the increase of the means of circulation must, however, cause disturbances of a peculiar kind".**

It is only once the "unused" productive resources begin being put back to work[26] that we will begin to see the inflationary effects of the stimulus efforts, where the employment created through 'stimulus' is inherently unstable, accentuating future problems.

That an external shock such as the China boom could cause such distortions is not to say that all business cycles are exogenous and therefore unavoidable. No, it is the combination of an exogenous shock when combined with flawed domestic institutional structures that allows them to continue unabated to the extent we see today. Today it is a boom in China's demand for Australian resources; tomorrow it could be anything. If domestic institutions are unsatisfactory, then the boom-bust cycle must ensue.

25 1928, *Geldwertstabilisierung and Konjunkturpolitik*

26 Note that a significant stagflationary period in the medium term is possible if real wages remain high and profits remain low, as businesses choose to utilise a large amount of capital per worker. This effect combined with the inflationary forces of a depreciating currency and monetary stimulus should eventually offset the natural deleveraging and deflationary (caused by unemployment) effects.



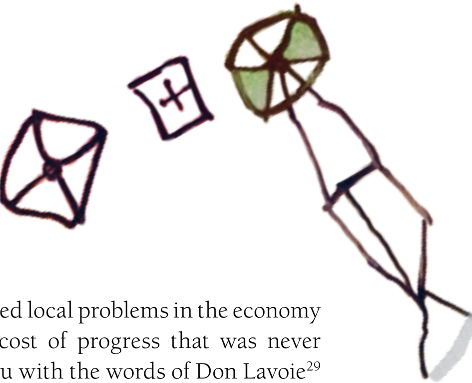
Australia had a fantastic opportunity over the past decade to implement important reforms that would liberate labour markets and reduce the burdens that certain state-controlled industries (e.g., electricity and water) place on households as well as lower entry barriers to allow competition to improve efficiencies across the board (e.g., banking and retail). In the retail sector, for example, Mr Weickhardt of the Productivity Commission has said there were "troubling signs" that larger retailers were relying on barriers to entry to protect their profitability[27]. This was in response to a Productivity Commission report[28] that put the poor performance of the retail sector into context, producing estimates suggesting that labour productivity in that sector in 2007 was some 38% lower than in the United States, some 20-35% below that in Germany, the United Kingdom and France, and *only marginally higher than in Spain or Greece!*

The Commission concluded that "…it appears likely that the size of the gap between Australia and the US has been increasing; nor has Australia made any significant gains in its position in regards to other leading countries".

While we would love to be able to tell you that x will happen at y point in time, that would be an impossible task and one that – unlike some of our colleagues – we are not prepared to commit to. However, we hope we have pointed out that there are some very serious problems in the Australian economy that will almost certainly result at the very least in a long period of subdued growth, with the more extreme long-term alternative being hyperinflation. Unfortunately we simply cannot predict the actions that those in power will decide to take when confronted with a situation in which they must act.

27 "What we've said is the government needs to lift restrictions that inhibit new competitive retailers from coming in here, and lift restrictions stopping existing retailers from responding and adapting to that new competitive environment."

28 http://www.pc.gov.au/projects/inquiry/retail-industry/report



Centralised, 'pro-active' attempts at alleviating the perceived local problems in the economy will result at best in uniform mediocrity, the unseen cost of progress that was never achieved to be cast aside and simply ignored. We leave you with the words of Don Lavoie[29] who summed up the failure of 'planning through regulation' the best (what Australia has been using since the 1980s), where:

"**THE SAME LACK OF KNOWLEDGE ON THE PART OF ANY SINGLE PERSON OR ORGANIZATION**

which makes it impossible for comprehensive planning to replace the market also makes it irrational for a non-comprehensive planning agency to try merely to 'guide' the market. If the guiding agency is less knowledgeable than the system it is trying to guide – and even worse, if its actions necessarily result in further undesired consequences in the working of that system – then what is going on is not planning at all but, rather, blind interference by some agents with the plans of others."

29 1985, *National Economic Planning: What is Left?*

Justin Pyvis, *Ausnomics, ExposAsia,* No. 8/2012, 10 April 2012. Edited extract.