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A bumpy ride ahead: Australia's economy and the 'new normal'

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What goes up must come down: Australia's economy is in for a wild ride ahead. AAP Image/Dave Hunt

As the federal government prepares to hand down its 2015 budget, it's clear declining revenue from the mining sector will have a significant impact on the bottom line. In this 'Economy in transition' series, we explore the new economy facing Australia and the opportunities available to help the country shift from a minerals-led powerhouse, to a smart competitor in emerging global sectors.

Australians, fasten your seat belts and prepare for a bumpy ride ahead. We have had an early taste of the new normal for the Australian economy – and there are more painful changes on the way.

The early signs have been impossible to ignore: a sharp and continuous drop in commodity prices, a slump in the value of the Australian dollar. Prospects for the budget position are weak (with the AAA rating on the line) and productivity is stagnant. Unemployment is hovering above the 6% comfort zone, asset prices are rising but the real economy is sluggish.

Australia emerged relatively unscathed from the global financial crisis, but has to confront some of its long term implications. Those implications are bound to transform the structure of the global economy and Australia's place in it.

Australia and the global imbalance

Before the GFC, the structure of the world economy was dominated by an imbalance between global supply and demand. This had resulted in a polarised concentration of surpluses and deficits within creditor countries (such as China, Japan and Germany) and debtor countries (the United States). To put the scale of the imbalances in perspective, the gross surpluses and deficits have accumulated from roughly 50% of global GDP in 1995 to about 150% of global GDP in 2011, and absolutely from US$15 trillion to US$100 trillion.

Simply put, it was an imbalance in which China produced much more than it could consume and the US piled up much more debt than it could service. That only made sense because China financed the US debt that was, in turn, used to purchase Chinese exports.

As one of the major providers of energy and resources to East Asia, Australia benefited handsomely from the rise of China. Soaring commodity prices drove the biggest mining and energy investment boom in Australia's history.

Instead of a banana republic that former Prime Minister Paul Keating once warned of, Australia found itself the envy of the developed world.

The global rebalance

However, the global financial crisis prompted a painful process of rebalancing. Two structural and strategic trends that emerge in the post-crisis era are of particular relevance to the Australian economy.

First, the global economic gravity has decidedly shifted from the Atlantic to the Indo-Pacific area. The US is likely to recover from the mess but its long term growth will trail that of China, as it needs to deleverage its debt through an increase in productivity and (more conveniently) monetary manipulation.

Discontent has wracked European Union over austerity measures arising from the GFC and the Euro debt crisis that followed, going so far as to threaten the integrity of the union altogether. The long term challenge there will be to rebalance inequities between wealthy industrial nations like Germany and less well-off EU members in the south, as well as boosting productivity.

For the Indo-Pacific economies, there are other factors at play. Even under a slower rate of growth, China is set to eventually overtake the US as the world's largest economy in both nominal and real terms. As China attempts to climb up the value chain, part of its manufacturing capacity will be relocated largely within the Asia Pacific region, making the latter an increasingly dynamic environment for production and innovation.

In addition, if well managed, India could become a second engine of world economic growth under Prime Minister Modi's ambitious national initiative of Make in India, which aims to transform the country into a new global manufacturing hub.

Australia will stand to benefit from these structural changes. Australia has established itself as a key member in the emerging bilateral and multilateral trade and investment regimes in Asia.

Bilateral free trade deals with regional powerhouses, China, Japan and Korea will further strengthen Australia's role into the production network. The negotiation of the Trans-Pacific Partnership, of which Australia is a member, is likely to gain momentum this year.

China's strategic move to recycle part of its foreign reserves into funding infrastructure expansion in Asia (through the newly established Asia Infrastructural Investment Bank), and the potential rise of India, will generate renewed demand for commodities. Australia, with its expertise in agriculture production and processing, has strategic advantage in servicing the emerging middle class in Asia.

The "new normal"

The recent buzz word in China is the notion of the "new normal". Chinese president Xi Jinping used the phrase to describe a new phase of economic development in the post-crisis era that is centred on moderate but stable growth.

For the Chinese leadership, the most crucial challenge is to shift from investment and exports to domestic consumption, and generate more output from innovation and technological progress. That would help achieve a more sustainable and higher productivity growth.

Between 1978 and 2014, China's real GDP has been growing at a phenomenal 9.7% year on year. It is not clear at this stage how that number will change over time. Some predict it could be as low as 5% under the "new normal" conditions of the future.

But think of it this way: if the soon-to-be largest economy in the world achieves an annual growth of even 5% for the next decade or so, that is still great news for its trading partners – particularly Australia.

As China heads for the "new normal", so to will Australia – and we had better prepare for it. The mining boom is over, yet the demand from China will continue. It will be more moderate but sustainable.

As a result, Australia's two-speed economy will be more or less rebalanced as the non-mining sectors gain increased access to labour and capital. The free trade agreement with China will boost our capacity in agriculture and the service sectors, opening those sectors to a massive and increasingly wealthy population that is seeking a higher quality of life.

There will be adjustments for a transition to the new normal, in economic and political terms, and plenty of uncertainty ahead for both advanced and emerging economies.

Some changes are easy, but many are structural and far-reaching. Now is not the time for complacency. Australia must be on the front foot if it wants to make the most of the "new normal."

China **Resources** **Chinese economy** **Global economy** **Mining boom** **Australian economy** **Federal Budget 2015** **Economy in transition**