Mining windfalls belong in a wealth fund

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The case for establishing an Australian sovereign wealth fund (SWF) seems stronger every day, as the exchange rate sits persistently above parity, hollowing out our non-extractive tradable-sector industries such as tourism and export of professional services.

The macro-economics is compelling. Without a SWF, the resources boom will keep the exchange rate at uncompetitive levels while-ever commodity prices are this strong. Inflationary pressure on activity will put upward pressure on interest rates. As the structure of the economy shifts more towards resource exports, the current account will become even more sensitive to the vicissitudes of world resource prices, with massive price swings over the course of the resources cycle.

The politics, however, seems gloomy. The former Finance Minister spoke of a SWF as a vague possibility, a decade or two away. It did not form part of the still-born discussion on a resources tax. It seems quixotic, then, that a group of senior businessmen have recently advocated establishing a SWF. Of course, when it comes to the specifics, there is agreement on just one aspect: wherever the SWF's funding comes from, it shouldn't be from them or their industry. But the businessmen have at least set the scene for policy debate.

This debate should start from a bed-rock of three points:

- If it is designed to smooth the spectacularly cyclical nature of resource earnings, the windfalls of this same industry must form the funding base of the SWF. Any other source would be defeating the point of the fund.
- If it is to address the appreciation-induced hollowing-out of the tradable sector, the fund will have to be invest in *foreign currency* assets, not be spent on infrastructure, as suggested by ANZ's Mike Smith. That said, it might make sense to spend the money on infrastructure (including mining infrastructure) at the low point of the mining cycle.
- Decisions about when the funds are drawn down cannot be left to the usual parliamentary process. Governments of all persuasions will try to spend the entire fund in order to ensure that 'the cupboard is bare' when they lose office. A SWF presents harder problems than the Future Fund, which has a clear expenditure objective (bureaucrats' pensions) which determines the draw-down profile. This will also be harder than the long-term non-renewable-resource funds such as Norway's Petroleum Fund, because this SWF has important shorter-term cyclical implications.

Senior Treasury official David Gruen's recent speech to CEDA touches on this last issue. The Australian situation is not exactly a 'Dutch Disease' (aka Gregory Thesis) problem: Australia's mineral resources will last for many generations and growth prospects of China and India will ensure expanding demand for decades ahead. But, while our export *volumes* are likely to continue to grow, the current abnormally-high commodity *prices* can't last. After the usual long lags, prices will fall back toward the cost of production and stay there until the next production imbalance occurs.

It is this extremely cyclical nature of resources earnings that presents a serious challenge to macro-policy in Australia. This cycle is not a major concern for the resources sector itself, as the exchange rate buffers the effect of the price cycle on their income. But this is not true for the rest of the tradables sector. A SWF which lops the tops of the cycle and fills the troughs would help. If, in the process, the SWF shifts the composition of production towards non-extractive exportables, so much the better.

Of these issues, clearly the most difficult is finding a source of money to put in the fund. A golden opportunity was lost when the Mineral Resource Rent Tax was emasculated in the middle of last year. A weak government responded to the mineral sector's blackmail: revenue variously estimated at $60-100 billion over ten years was left in the hands of the mining sector, which has so much money that it can't think of anything better to do than give part of it back to shareholders

Consideration might be given to reneging on the deal done with the big miners last year, starting re-consideration with a clean page. Clearly this deal was done under duress: without it the government would not have been re-elected. Now that the $22 million advertising campaign has faded and the public have had a time to ponder just how much sympathy they have for the mining magnates on whom this manna has fallen, the voters might be less sympathetic to the miners' plight. As the investment boom distorts prices, pushes up interest rates and forces cut-back in other parts of the economy, the threat that the miners would shift all their investment into other countries will increasingly be seen as hollow. Many of these alternative hosts are countries with well-established reputations for effectively nationalising successful discoveries. And in any case, if some of the current investment boom goes elsewhere, that will relieve pressure on an already overstretched domestic economy.

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