Resources policy leaves nation vulnerable
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The emasculation of the resources tax has left Australia in a macro-economic bind. Is it sensible to restructure the economy, making it still more dependent on resource exports, and vulnerable not only to changes in commodity prices but to flighty foreign funding as well?

The terms of trade are 60 per cent higher than the average for the past century. Our national income is now 12 per cent to 15 per cent higher than it would have been if the trend of the past century had continued. The last time commodity prices were anywhere near these levels was during the 1950-53 Korean War. That was a short-lived boom. While current prices are likely to last longer and not fall so much, minerals production all over the world is being stepped up.

With pell-mell global expansion, overinvestment in minerals is likely. Excess capacity will make it easy for buyers to play suppliers off against each other to bid down prices.

A commonsense response to this prospect would be to put aside a significant part of the temporary windfall. It should go into a sovereign wealth fund that is out of reach of political populism. Governments of all kinds are tempted to spend all current revenues, to ensure that the cupboard is bare when they lose office.

Instead, the usual policy-passive boom-time scenario is now playing out. Investors are elbowing each other aside to be the first to market additional output. The states are competing with each other to attract the extra capacity to their home territories.

Miners, which were putting only about 2 per cent of gross domestic product into investment 10 years ago, are already doing well over twice that, and the boom has only just begun. The incentives are compelling: their profits, as a percentage of GDP, have more than doubled in that time. Meanwhile, their royalty payments have fallen from 30 per cent of their revenue to just 10 per cent.

The labour and capital needed to implement substantially higher investment have to come from somewhere. The economy is already running close to full steam. Substantial adjustment of the rest of the economy is needed.

How are these shifts brought about? One automatic response is a higher exchange rate. This makes room for minerals investment by shrinking other tradeable sector industries -tourism and education are just two examples.

Pressure on wages will require higher interest rates, which frees up labour and capital by contracting interest rate-sensitive industries such as housing construction. This, however, leaves housing falling further behind demographics, putting upwards pressure on house prices.

The watering-down of the resources tax also provides some of the wherewithal for the mining and gas investment. The lost revenue could have been used for boosting superannuation, or the myriad demands for more government services such as public transport. Now this revenue is left with the miners to fuel the investment boom.

A wider current account will also help provide the resources for mining investment. Of course this has its downside. More of the farm has to be sold off to fund the larger deficit. The contraction in non-minerals exports leaves Australia more vulnerable next time the New York money market dries up. When New York financial markets collapsed in 2008 the Australian government stood behind the banks, which were the main conduit funding the external deficit

at the time. We were also lucky that, thanks to China's continuing rapid growth, commodity prices took only a momentary downward blip.

But this experience and the subsequent problems in Europe should remind us that international financial markets are prone to dramatic revisions of credit assessments. Ireland was the Celtic tiger and every bank's favourite borrower one day. The next day, it was the sick man of Europe, facing decades of austerity.

Next time, we may not be so lucky. Oversupply of minerals or slower growth in China would exert downward pressure on the exchange rate (there was a tiny taste of this in October 2008). It will be harder for the government to come to the rescue next time. Australian banks are now getting a smaller proportion of their funds from overseas. The deficit still has to be funded, so it will be supported by non-bank borrowers.

It was relatively easy for the government to stand behind Australia's well-regulated banks when they were funding the deficit. It would be harder for the government to guarantee the external funding if the conduit was an amorphous group of non-bank borrowers.

A stronger resources tax would have made our macro-economic position more secure. Mining and gas investments would still have increased, but perhaps not so dramatically as to require a restructuring of the rest of the economy. The exchange rate would be lower and the current account deficit smaller.

What about growth? If the resources euphoria proves correct, then crimping some of the investment with a higher tax would mean some sacrifice of growth. But history tells us that the commodity price cycle is hard to pick. The extra investment might well leave us with white elephants rather than more growth. The pity is that we couldn't debate these complex issues. Instead, a weak and vulnerable government caved in to the mining industry's blackmail threats of an investment drought.

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