# Australia must learn to pick its fights with China

**Geopolitics**
**Power is still the essence of international relations. That is the reality Canberra needs to grasp to manage in the new Asia.**

Hugh White

Everyone loves a David and Goliath story. That is why we have all been cheering plucky little Canberra for standing up to the big bullies in Beijing. But how does the story end? In the Bible, David strides triumphant over the humbled Goliath. In reality, it is much more likely that David gets a sharp lesson in the realities of raw power.

But it is too late to back out now. China's crude threats of economic retaliation have made it impossible for the Morrison government to abandon its proposal for an independent international inquiry. That would make it look pathetic.

Nonetheless, we need to ask how Australia found itself in a stoush with China that we cannot abandon and cannot win, and try to learn some lessons. Because we are going to face this kind of problem again, often, in the new Asia of the 21st century.

The first lesson is to not needlessly antagonise China, especially when we need its co-operation. However good it may make us feel, Australia's bold defiance of Beijing has been spectacularly counterproductive.

Our goal is to ensure the world learns all it can about how this pandemic began, which makes perfect sense. But the Morrison government framed its call for an independent inquiry as an investigation of Beijing's culpability for the outbreak. That was a major blunder, because it absolutely guaranteed China would reject the idea out of hand. And without China's co-operation, we will never learn what really happened in Wuhan in November and December last year.

It is probably true that China deserves blame for mismanaging the outbreak when the virus first appeared. But that's not the point. Effective diplomacy is not about saying what you think is true. It is about saying what you need to say – and *not* saying what you *don't* need to say – to get a result. By saying what it did, our government made sure it wouldn't get the inquiry it was after. And that really hurts the world's ability to manage the next pandemic better.

Why did our government make such an

China now has power in abundance which Australia must manage. PHOTO: BLOOMBERG

obvious blunder? Until now Scott Morrison has been very careful in his dealings with Beijing, trying to make sure that the tense "deep freeze" he inherited from his predecessor doesn't get any worse. It is strange that he chose this moment to turn confrontational, when the pandemic so obviously calls for co-operation.

The most likely explanation is that he did it to please Washington. The Trump administration is plainly determined to talk up China's responsibility for the pandemic, both to deflect domestic criticism of its own woeful and at times farcical mismanagement of the crisis, and to score points against Beijing in its escalating geopolitical contest for influence in Asia and globally.

It is easy to imagine the White House urging Canberra to help out by joining its chorus of accusations against Beijing. Agreeing to do so would certainly accord with the call last week from our new

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ambassador in Washington, Arthur Sinodinos, to do whatever we can to help America "push back" against China.

But that is only sensible if Washington is acting wisely, with a credible strategy that serves Australia's interests. That means managing China's assertiveness without unnecessarily exacerbating tensions or precluding co-operation where it is needed. Alas there is no evidence of that from the Trump White House, or anywhere else in Washington. On the contrary, the pandemic has further stoked the rising anger towards China across the political spectrum in America – mirrored by rising Chinese animosity towards America.

All this is making it harder and harder to see how this all-important relationship can be managed in future. Indeed the risk of a catastrophic US-China conflict is increasing sharply. Washington shares the blame for this, and so do we if we encourage it and echo its messages. So the second lesson we should learn from the crisis in our relations with Beijing is not to allow our policy on China to be dictated from Washington.

And the third lesson? We need to wake up to the new realities of power in Asia and learn how to navigate them. Alas, contrary to our fond hopes, the so-called "rules-based global order" has not replaced the exercise of raw power in international affairs. And the power is now in new hands.

For the first time in our history, the most powerful country in Asia, and the most important country in the world to us, is not an ally, or even a friend. It is a country that views us coolly, at best. Nothing in our experience has taught us how to deal with a country like this.

And let's not delude ourselves that China has blundered by threatening us. Of course it hasn't made us like it, but that is not what it wants. It wants to display its power by showing us, and others, that it can impose big costs on us at low cost to itself. That is the essence of power in international relations, and the Chinese have it in abundance.

So, whether we like it or not, we now face hard choices whenever we want to oppose China. As a sovereign state, we have the right to do as we wish, but we must accept the consequences of our choices. It is our sovereign right to criticise China, and China's sovereign right to retaliate. No one likes to be pushed around, especially by a known bully, but power has its own logic which cannot be denied. So we need to learn to pick our fights.

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# Why the RBA needs a new post-virus monetary policy game

**GDP target**
**An inflation target made little sense before COVID-19, and none after it.**

Richard Holden, Warwick McKibbin and John Quiggin

The COVID-19 crisis has caused a global rethinking of fiscal policy. Australia has not been immune. The focus on achieving a budget surplus and reducing public debt has given way to large targeted fiscal measures aimed at sustaining Australian households and businesses through the pandemic. With the Australian government able to borrow for three years at 0.25 per cent and for 10 years at 0.85 per cent, the interest cost of these measures is small, and it lays the foundation for an economic recovery post COVID-19.

As part of a co-ordinated macroeconomic response, the Reserve Bank of Australia (RBA) cut rates to effectively zero and embarked upon a bond-buying program to keep three-year bond rates at 25 basis points. This is a good start. But, as with fiscal policy, the entire monetary policy framework needs rethinking. This was clear before COVID-19 tested the existing macroeconomic frameworks. It is even clearer now.

The current monetary policy regime in Australia is "inflation targeting" – keeping inflation in a band between 2 per cent and 3 per cent over the cycle. Inflation targeting served Australia well for a long period from its adoption in the 1990s. It defeated the wage-price spirals of the 1970s and 1980s, when the expectations of high inflation caused high wage demands, which in turn led inflation to be high.

The rationale behind inflation targeting by central banks focused on setting stable price expectations for consumers, businesses and markets. The target was set by trading off the costs and benefits of inflation. The RBA put it this way:

"The governor and the Treasurer have agreed that the appropriate target for monetary policy in Australia is to achieve an inflation rate of 2–3 per cent, on average, over time. This is a rate of inflation sufficiently low that it does not materially distort economic decisions in the community. Seeking to achieve this rate, on average, provides discipline for monetary policy decision-making, and serves as an anchor for private-sector inflation expectations."

The question that needs urgent attention is: what is the right monetary framework in a post-COVID-19 world?

> *The inflation target is no longer credible – yet credibility is its raison d'être.*

The world in 2020 is very different from earlier decades. Well before COVID-19 struck it was clear that many countries, including Australia, were suffering from what former US Treasury secretary Larry Summers – picking up on an old idea due to Alvin Hansen – termed "secular stagnation".

This is the idea that the so-called "equilibrium real interest rate" – the real interest rate consistent with a stable macro economy for countries like Australia – has fallen substantially in recent decades and is now probably negative. This is due to an increasingly large volume of global savings chasing fewer large-dollar investment opportunities. Not surprisingly, Australia has been below the 2-3 per cent target inflation band for the entirety of RBA governor Philip Lowe's term. The inflation target is no longer credible – yet credibility is its *raison d'être*.

Inflation has been stubbornly below, rather than above, the target rate in recent years. This was a problem not envisaged when inflation targeting was introduced in the 1990s. But it makes the achievement of a sufficiently negative real interest rate impossible. The nominal interest rate can be pushed a little below zero, as has now happened in many countries, but only to around 0.5 per cent. Combined with inflation below 2 per cent, the real interest rate cannot go below minus 2.5 per cent.

COVID-19 will only make this worse. Evidence from 15 pandemics dating to 1347 suggests that COVID-19 will put further downward pressure on the equilibrium real interest rate. Depressed economic conditions will also push down the rate of inflation, given constant policy settings.

In light of these considerations, rather than targeting inflation, a better approach would be for central banks, including the RBA, to target some measure of nominal income such as the level or growth rate of nominal gross domestic product. The economy's nominal income is the money value of what the economy produces each year, including both the volume of goods and services (or real GDP) and changes in the prices of these goods and services (or inflation). This is still a clear policy rule that can be used to anchor expectations, like inflation targeting, but it has several advantages compared to inflation targeting.

First, targeting nominal GDP is more robust to imperfect knowledge of the economic environment. A central bank following nominal income targeting does not need to have real-time knowledge of potential output, whereas an inflation-targeting bank does, and imperfect knowledge can lead to policy errors.

Second, it allows the economy to adapt better to productivity shocks. Consider a fall in productivity (equivalent to a rise in input costs). An inflation-targeting central bank would tighten policy in response to rising inflation. A central bank following a nominal GDP target would combine the rise in inflation with the fall in real GDP and not tighten policy. It might even cut rates if the expected fall in real GDP is larger than the expected rise in inflation. The resulting outcome for the real economy would be better.

Third, in a severe crisis when real interest rates need to fall sharply to stabilise falling output, a nominal GDP target automatically allows expected inflation to rise well above the long-run inflation goal, without damaging policy credibility.

The global economy, including Australia's, will be transformed after COVID-19. Fiscal policy is already beginning to adjust to that reality. The monetary policy regime that served many countries well, including Australia, in the 1990s and 2000s was probably obsolete pre-COVID-19, but it certainly is now.

It's time for central banks, including the RBA, to use this moment to move decisively to a regime that is more suited to 2020. The core of that regime should be a new monetary framework with a target for nominal income.

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