

What's the impact of Australasian LNG projects on the shaping of the LNG market and Australia?

Challenges and Opportunities: LNG projects and the Australian economy



A conversation with Saul Eslake

“Undoubtedly the impact of the completion and further development of LNG projects will be positive in terms of Australia’s overall economic growth, the balance of payments, employment and the revenue flows it will generate. However, it will also place strains on some parts of the economy through its demands on finance, infrastructure, and skilled labour. Further, there will undoubtedly be a political debate over how revenues should be distributed between shareholders, employees and, through the taxation system, the broader community.” Saul Eslake

Saul Eslake is one of Australia’s leading analysts of the Australian economy, and a well recognised commentator. He is renowned for explaining the complex interrelationships of our open, resource-based economy in a way that all can understand.



Saul Eslake

After 14 years with Australia & New Zealand Banking Group Ltd (ANZ) as Chief Economist, Saul is devoting his considerable energy and intellect to some of the economic and social issues facing Australia. He is now Director of the Productivity Growth Program at the recently established Grattan Institute, a ‘think tank’ affiliated with the University of Melbourne, and a member of a number of boards and committees. He has also joined PwC as a part-time Advisor in its Economics and Policy practice.

There is expected to be more than A\$300 billion invested in LNG projects in Australia over the six years to 2015 – a period where there is also substantial investment in other large resource projects, such as coal and iron ore. This unprecedented level of major project development will have significant implications for all Australians. To shed light on the important issues, PwC asked Saul Eslake to consider the broad impacts of such large development projects on the Australian economy and society.

PwC – *Starting with the immediate future, does the Australian financial sector have capacity to fund these large projects?*

Saul – History tells us that Australia cannot finance all of the debt and equity requirements associated with these large projects out of its own savings. We have not been able to in the past, and there is no compelling reason to think we should be any different over the next 10 or 20 years. The capacity of Australian banks to expand their balance sheets will also be constrained, including by higher funding costs and (in all probability) by more onerous regulation. And although they have provided surprisingly large amounts of equity capital in recent years, Australia’s superannuation funds cannot provide all of the equity required by these projects. Inevitably, therefore, foreign investment will play a significant role in funding these projects.

PwC – *Are there issues of concern in securing overseas finance?*

Saul – Although there is nothing new about foreign involvement in Australian major resource projects, the sources of it may well be somewhat different from in the past. We are accustomed to working with American, European and Japanese companies and investors, but in the years ahead, more equity capital is likely to be sourced from the sovereign wealth funds of Middle Eastern and emerging nations, and from state-owned enterprises in China. The Australian people, and the Australian Government, will be concerned to ensure that these investments are motivated by commercial considerations, as opposed to political or strategic ambitions.

We need to develop clear and transparent rules for ensuring that foreign investment remains consistent with Australia’s national interests, and to administer the rules in a transparent and non-discriminatory way, in order to manage the ‘politics’ of foreign investment from these emerging sources. This transparency needs to extend to the activities of the Foreign Investment Review Board (FIRB). It is not always clear how the FIRB reaches its decisions, and it would

be of benefit to the community if the Australian Government, through the FIRB, was obliged to state the criteria used and explain why a particular investment is, or is not, in the national interest.

PwC – *Assuming these projects go ahead, mostly funded by foreign debt and equity, what does this mean initially for the balance of payments?*

Saul – Perhaps surprisingly, the initial impact is often to worsen the balance of trade, because of the significant imports of plant and equipment needed in the development phase. However, as projects come onstream, export volumes and values should increase substantially. The extent to which the overall balance of payments improves depends on how the revenue generated is distributed through the community - how much is saved and how much is spent. Overall, however, I expect the medium-term impact will be positive for Australia’s balance of payments.

PwC – *What about the economy more broadly?*

Saul – I am confident that the net effect on the Australian economy from the expansion in the LNG sector will be positive in the medium and longer term. It will be positive in terms of overall economic growth, employment, and government revenue. The challenge for those responsible for the management of our economy will be to optimize the benefits for Australia as a whole, in terms of jobs, investment, exports and returns to the broader community. This task includes being able to manage the strains and tensions which the rapid expansion of the resources sector may create elsewhere in the economy through the effect on finance, infrastructure and skilled labour, and the indirect effects on the broader economy. In particular, the ‘resources boom’ is creating pressure on exchange rates and interest rates, which in turn creates problems for other sectors of the economy such as manufacturing, agriculture, and tourism.

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PwC – *What is the outlook for the exchange rate over the medium term?*

Saul – The value of the Australian dollar is influenced by many factors, of which movements in commodity prices are among the more important. Although I'm no longer in the business of attempting to give precise forecasts of the exchange rate at particular points into the future, I think it's reasonable to expect the Australian dollar to trade in a range of about US\$0.85–1.10 over the next three to five years, assuming commodity prices remain at elevated levels during that period. That said, history tells us that the Australian dollar is a particularly volatile currency. Hence, if something unexpected happens – such as another major financial shock, or sharp movements in commodity prices – then the Australian dollar will move through a relatively wide range in a short period of time.

PwC – *Does the labour market hold the key to what happens to the rest of the economy?*

Saul – It will be a very important factor. The expansion in the resources sector will require more skilled labour, which can be met through a combination of education and training, and skilled migration. To the extent that the supply of skilled workers does not increase sufficiently, there is likely to be greater upward pressure on wages. The resources sector may be sufficiently profitable to absorb that pressure, but some of the other sectors, already confronted with a stronger exchange rate and higher interest rates, will be less able to do so, and may be forced to shrink.

This is a well known phenomenon that has been described as the 'Dutch disease', based on the experience of The Netherlands in the early 1980s. Rapid development of gas resources in the North Sea pushed up the exchange rate and put such pressure on labour costs that there were real concerns that the other sectors of the Dutch economy would not survive the energy boom. Papua New Guinea may be another example closer to home.

PwC – *Is Australia at risk of losing the economic diversification that it has strived to achieve over many years, or will it be enhanced through regional development?*

Saul – Economic diversity may be at risk if the pressures we've been talking about here are not carefully managed by Australian governments and industry. It will be critical to improve the productivity performance of many sectors of the Australian economy if they are to be able to cope with these pressures.

On the other hand, geographic diversification through regional development will be unequivocally positive. It will be much easier to accommodate population growth (35 million people by 2050 according to the Australian Government's intergenerational report) if some of that growth occurs outside the capital cities. Assuming of course that 'fly in/fly out' is not the preferred model for all projects, regional development is an opportunity to manage population growth in a sustainable way. It will require substantial investment in community infrastructure – housing, schools, health care facilities, and the like – and raises questions of how this infrastructure will be funded and the extent to which its development detracts from the rest of the country.

If we consider these far-reaching implications in the context of the revenue that is generated by the resource boom, it comes down to how that revenue is distributed between shareholders, employees and, through the taxation system, the broader community. I think it would greatly assist Australia's ability to maintain a diverse economy through this challenging period if the government saved a large proportion of the revenue from taxation and royalties in a sovereign wealth fund.

PwC – *Where have sovereign wealth funds been established in economies similar to Australia? How would such a fund work here?*

Saul – Many commodity-based economies have established 'sovereign wealth funds' to preserve some of the wealth generated by resources development for future generations and, in some cases, to alleviate some of the upward pressure on their currencies that a high level of resources exports might create. Norway and Chile are two good examples of democracies with relatively high income and diversified economies which have established such funds.

In many of these cases, state-owned enterprises play an important part in the resources sector, and the government therefore has a much larger influence on how the revenues generated from the resources sector are distributed. The position is different in Australia. Nonetheless, the Australian Government could save a significant proportion of the revenue that does come to it through taxes on resources sector activity, both directly and indirectly, in a wealth fund. We already have a vehicle to achieve this in the form of the Future Fund that was established by the previous Government.

Indeed, prior to the recent financial crisis, I had been arguing that we should have been saving more of the revenue windfalls that kept turning up in the Government's coffers each year, instead of giving it away through income tax cuts and middle-class welfare. Right now, of course, the Government's major budgetary priority is to erase the deficit created by the financial crisis and the fiscal stimulus measures undertaken in response to it. But once that task is accomplished, which it will be in a few years, the question will arise again of what to do with the large revenues generated by the exploitation of our energy and mineral resources.

A sovereign wealth fund would take some of the pressures off the exchange rate, inflation and interest rates. Diverting prospective budget surpluses into such a fund would amount to a somewhat tighter fiscal policy, and thus not leave the entire responsibility for policy tightening to the Reserve Bank, as happened in the years leading up to the financial crisis.

The other compelling argument is the one economists call 'intergenerational equity'. Is it right for all the benefits from developing our natural resources to flow to the current generation of taxpayers or should some of the benefits be preserved for future generations? This saving could be in the form of cash for them to draw from at a future time or in the form of infrastructure that will provide benefits to future generations as well as jobs today.

PwC – *This point brings us to our final question – does Australia have the infrastructure, and do governments have the capacity, to facilitate the development of the unprecedented number and size of LNG projects that are currently under consideration?*

Saul – At this stage I think not. This is not necessarily a criticism of governments. They too have been surprised by the speed at which demand for LNG has expanded and the extent to which Australian projects can meet that demand. There are a number of areas where governments need to put more into planning and development:

1. **The FIRB** – needs to be expanded to respond to more requests so that projects are not unnecessarily delayed by the process.
2. **Public infrastructure** – to support industry (power, transport, environment) and to support communities (schools, health care facilities, public administration).
3. **Education and training** – in the engineering and other skills that industry needs.
4. **Migration** – in particular, encouraging permanent skilled migrants and their families to live, work and pay taxes in Australia.
5. **Productivity** – particularly in the other sectors of the economy that employ a large number of people in politically significant locations.

The rapid development of large-scale LNG projects in Australia presents not only challenges but also opportunities. Although it might make sense for some of industry's needs to be serviced from offshore locations such as Singapore, it is highly desirable for Australia to develop the capacity to deliver the services that the expansion of the LNG sector is going to require. Australian companies have participated in previous expansions in the resources sector by developing considerable expertise in areas such as geological services, construction, manufacturing and servicing equipment. In turn, they have taken these capabilities to the world. I think here and now is an excellent opportunity to develop skills in areas such as petroleum engineering, which will continue to serve our country well after the peak construction period of these projects is long past.

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