



ADC KEY ISSUES UPDATE NOVEMBER 2008

Welcome to the November 2008 edition of the ADC Key Issues Update prepared in conjunction with Oxford Analytica.

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ADC Infrastructure 21 Summit

On the 6th and 7th October 2008, ADC hosted the Infrastructure 21 Summit at the Hotel Sofitel in Brisbane with the support of the Federal Department of Infrastructure, Transport, Regional Development and Local Government, the Queensland Government, KPMG, nabCapital, Telstra Wholesale and Audi.

The Summit brought together key thinkers in energy, water, transport, urban design, regulation, skills and finance from industry, academia, government and community sectors. The Summit's content was driven by these participants who worked in groups to consider the issues in their particular sectors and formulate transformational solutions that would move Australia firmly into the 21st Century. Solutions and outcomes were submitted to Infrastructure Australia for their consideration.

After an intensive working day on Monday 6th October, the Groups presented their considered conclusions for change to the Summit on Tuesday 7th October. The Prime Minister, The Hon Kevin Rudd MP, opened the Summit with an address that presented the scale of the challenges facing the country and the opportunities well-planned infrastructure would potentially unlock. Minister Anthony Albanese provided an insightful address at lunch on Tuesday outlining his department's role in creating Infrastructure Australia and the way forward for greater Commonwealth participation in infrastructure provision. Wal King addressed the Summit as CEO of Leighton Holdings and President of the Australian Constructors Association outlining the challenges facing Australia as it positions itself to maximise the export boom. ADC Chairman, Michael Roux, hosted a private ADC Roundtable discussion with the Prime Minister, Minister Albanese and the foreign participants from Spain, the USA, Germany, Malaysia and the Netherlands.

The group submissions provoked insightful discussions from the plenary participants and provided

stimuli for the final break out session on Tuesday afternoon. The Summit concluded with dinner at which the Queensland Premier, The Hon Anna Bligh MP, gave a keynote address about the infrastructure challenges for Australia and Queensland, highlighting the importance of long-term vision and clear planning for the success and stability of the country's infrastructure market.

The Summit was a great success with many participants commenting favourably about the opportunity to create ideas for change. The groups continue to work enthusiastically towards the publication of the Summit report which is expected to be completed late this year.

Future Summit 2009

Future Summit 2009 will be held in Melbourne on 20th and 21st May. You can register your interest in attending now at www.futuresummit.org

Barack Obama: The Next Chapter

Michael Roux

Below is an unedited extract from an opinion piece by ADC Chairman, Michael Roux.

It may be widely anticipated, but nothing will dampen the worldwide media frenzy that will greet the election of Barack Obama as US President. Across the globe, his (almost certain) victory will trigger a wave of goodwill towards the US and optimism about the future that is simply without obvious precedent. The term "transformational" will be burnt into the global psyche as the twin themes of the Obama ascendancy – hope and change – begin to assert themselves in a revised template of American leadership. We can also expect a raft of commentary by those who argue that Obama cannot possibly live up to his promise; that the historical import of his election is overblown and unwarranted; and that we are bound to be disappointed. These cynics may turn out to be right, but they are far, far more likely to be wrong.

The US Presidency is the most powerful position on earth for reasons that have nothing to do with its modest constitutional powers. The words and actions of a President, for better or worse, have the power to shape the times over which they preside in real and profound ways. Two inaugural addresses from the last century come to mind.

Franklin Roosevelt told Americans in his first Inaugural address in 1933 that "the only thing we have to fear is fear itself", before embarking on the New Deal, an ambitious and expansive recasting of government that lifted the country out of the Great Depression.

48 years later, Ronald Reagan stood on the same steps and declared, "Government is not the solution to our problem. Government is the problem." With that, Reagonomics was born and FDR's New Deal consensus was usurped by a philosophy built around free markets, privatization, deregulation and lower taxes.

At this time of new turmoil, eyes are now trained on Obama. The confluence of economic upheaval, emerging global security challenges and the looming climate crisis create a kind of perfect political storm. One thing is for certain: this will not be a Presidency of increments. As with FDR and Reagan before him, the next chapter of American economic and political life is Obama's to write.

Obama's approach to climate change provides encouraging insight into his governing philosophy. To date, the debate has largely been waged between doomsayers who promote radical measures that threaten our economy and naysayers who support a status quo that imperils our environment. One side says the government needs to regulate us out of the problem; the other says that the market will self-regulate. It is an intractable green versus growth ideological stalemate.

Obama's head is neither in the sand nor the clouds on climate change. Instead, he sees an opening for a new era of opportunity in clean energy. He envisages a green gold rush with \$150 billion to support private sector efforts to develop and commercialise wind, solar, geothermal and other technologies. He believes that this will create 5 million 'green collar' jobs to compensate for the decline of old, unsustainable industries. He imagines yesterday's auto workers in Detroit building tomorrow's wind turbines and solar panels. He also believes that, by replacing oil imports from the Middle East with domestic sources of alternative energy, there is national security and balance of trade pay-offs as well.

Obama resets the table by tackling climate change as an engine for economic prosperity as much as an environmental imperative. George Bush's ambivalence on the issue has seen America fall to the back of the pack, and Obama is determined to surge to the front through massive government and private sector investment in technology, innovation and infrastructure.

Much has been and will be written about how Obama is a unique figure in American politics. However, his vision of a new clean energy economy owes much to the dual legacies of FDR and Ronald Reagan. It simultaneously embraces the New Deal belief that government is a positive force for economic change while tapping into Reagan's unshakeable confidence that the innovation and entrepreneurial instincts of the American people will prevail through any crisis.

OXFORD ANALYTICA

UNITED STATES: Obama wins, as Democrats cement control

Wednesday, November 5 2008

EVENT: Barack Obama yesterday was elected president of the United States, and the Democrats have extended their majorities in Congress by gaining at least five seats in the Senate and 18 in the House.

SIGNIFICANCE: The Democrats are in a strong position to implement legislative change, but there will be important divisions over mandates and priorities between the Obama White House and the Democratic leadership and party rank-and-file in Congress.

ANALYSIS: Barack Obama defeated John McCain by an approximately 53:47 percentage margin of the popular vote, and sailed to victory in the Electoral College. He is the first Democrat since former President Jimmy Carter in 1976 to capture more than 50% of the vote, and his 53% share is the highest for a member of the party since former President Lyndon Johnson's landslide victory of 1964. Nevertheless, efforts to enact his political priorities when he arrives in Washington will face significant challenges, not least from within Democratic ranks.

Obama's winning coalition. Obama's victory is somewhat more substantial than the result in 1992, when former President Bill Clinton defeated the elder George Bush by a five-point spread:

State-by-state. However, the Electoral College coalition assembled by Obama was subtly different from Clinton's collection of states. Obama ran notably stronger than Clinton in states such as Virginia, North Carolina and Indiana, but was significantly weaker in states including Arkansas, Louisiana, Kentucky, Tennessee and West Virginia.

Core supporters. This reflects the fact that the demographics of Obama's core constituencies are highly distinctive. Obama improved on his party's 2004 showing among almost all groups, but achieved almost unanimous support among black electors, a much higher proportion of the vote among younger electors (below 35 years) and a substantially better showing among comparatively affluent white electors. Hispanics backed Obama by more than two-to-one.

Wealthy and poor. Much as was the case in his nomination victory over Hillary Clinton, the Obama camp consisted mainly of the relatively poor -- attracted to him by a desire for economic 'liberalism' -- and the relatively rich, who aligned with him on the basis of social liberalism. Those in the middle (whites on median to slightly below median incomes) were the least receptive to him.

'Culture wars' continue. While the symbolism associated with the election of the first African-American president is enormous and the claim that



this represents an end to the 'culture wars' that have dominated recent US elections is superficially enticing, the white electorate was arguably more divided on the basis of cultural identity in 2008 than it was in either 2000 or 2004. Over the longer term, maintaining Obama's current coalition -- which has potential internal tensions -- and reaching out to those he could not win over yesterday, will be significant challenges for the incoming administration.

Democrats' congressional gains. The congressional election results will, on paper, produce a balance of power in Congress that is also very similar to 1992:

Strengthened majorities. The Democrats are likely to extend their edge in the Senate to a range of 57-59 (against 41-43 for the Republicans) pending the final outcomes of exceedingly close races in Minnesota and Oregon. The House will probably feature a Democratic caucus of approximately 255-260, alongside 175-180 Republican members. This is almost identical to the situation that Clinton inherited in 1992.

Unusual successive victories. However, this analogy with the beginning of the Clinton era masks a crucial difference. Despite capturing the presidency in 1992, the Democrats only gained one additional seat in the Senate and actually lost seats in the House (primarily due to the impact of redistricting). This time the majority party has made striking gains in both chambers of Congress for the second election running, an achievement not witnessed since the 1930 and 1932 elections.

This situation creates what is, in effect, a dual set of victories -- Obama's individual presidential triumph, and a separate, collective party triumph.

Post-election political environment. This outcome should serve to highlight the initial political challenges that Obama will have to face when he assumes office. However, there are also obvious opportunities:

- Democratic dominance in Washington should allow him considerable scope to change policy tack and push his preferred legislative agenda.
- He will be assisted in this regard by the fratricide that is likely to engulf the Republicans in the aftermath of their latest defeat.

Indeed, despite the Democrats' failure to secure a filibuster-proof 60-seat majority in the Senate, the capacity of a demoralised and ideologically adrift Republican party consistently and effectively to practise such parliamentary obstructionism is likely to be limited, unless Obama makes serious early mistakes in office.

Obama's challenges. Nevertheless, Obama will face several serious political hurdles after his inauguration:

Managing expectations. Given the state of the economy and the dire opinion poll ratings of the lame-

duck president, George Bush, Obama's margin of victory was comparatively modest. In neither popular vote terms, nor in the Electoral College, could it be described as a landslide. However, the exceptional symbolism of Obama's rise, and the manifest, if unfocused, public desire for change from the Bush era, mean that the media may create expectations that an Obama White House may find almost impossible to fulfil.

Obama is also likely to face a clash between Washington insiders on his team who will favour a more centrist approach to office, and his considerably more liberal core supporters. This division will surface acutely in foreign policy, with some in Washington urging him to draw down US troops in Iraq very deliberately over an 18-24 month period, while his base will want to see bolder, swifter action. (He is likely to err on the side of caution, on this issue.)

Competing mandates. Both the president-elect and the Democratic congressional leadership will consider that they have emerged from this election with strong, distinctive mandates. There will be a contest of interpretation over the extent to which Obama led the Democrats to victory, or a Democratic wave propelled Obama to victory. (The battle for the Oval Office may have been somewhat closer than many House or Senate contests.) While the party's congressional hierarchy may be more than willing to stand back and allow Obama to dominate the foreign policy agenda, domestic matters will be more hotly contested.

Alternative policy priorities. Congressional Democrats have a lengthy list of legislative priorities in domestic policy that have been honed over more than a decade -- but frustrated initially by Republican control of the House of Representatives and then, since 2006, by their wafer-thin margin in the Senate and the prospect of a Bush veto, their preference will be to use their enhanced majorities to concentrate first on measures such as healthcare reform and to expect a compliant presidency.

Obama, by contrast, is likely to want to make economic recovery his highest priority and take time over measures such as healthcare reform -- so that what is crafted more closely reflects his preferences. While the president and Congress will cooperate peacefully during the Obama 'honeymoon period', some very hard bargaining on domestic policy can be anticipated once Obama has completed the task of forming his administration.

CONCLUSION: Democratic party priorities -- such as economic stimulation, healthcare reform and education spending -- will dominate politics in Washington at least through the 2010 mid-term congressional elections. Internal differences across political institutions, rather than challenges from the demoralised Republican party, are likely to be the main impediments to substantial legislative progress.

OXFORD ANALYTICA

PROSPECTS 2009: Deflation risk stalks global economy

Monday, November 3 2008

SUBJECT: The outlook for the global economy in 2009.

SIGNIFICANCE: Unwinding the largest credit boom in history will exact considerable stress on the real economy in 2009, as write-downs in previously healthy asset categories further undermine risk appetite, impairing credit extension. Without aggressive fiscal expansion, major economies risk seeing an outright decline in the price level, with significant adverse consequences for growth and employment.

ANALYSIS: The credit boom from which the global economy is now unwinding is unprecedented. The collapse of the Soviet Union in 1991 initiated a positive supply shock to the world economy, accommodated by monetary expansion under conditions of remarkable macroeconomic stability in the main OECD economies. In the United States in 1990, domestic credit was roughly equivalent in scale to the economy itself. This ratio doubled by 2000 and reached 344% in 2007. Global stability meant the United States was not alone in enjoying generous access to credit; emerging markets saw a boom in lending, as did the domestic economies of several OECD members.

Key insights

- World GDP growth will be 1.5% (at market exchange rates) in 2009.
- Aggressive fiscal expansion in key economies will offset sharp slowdowns in consumer spending.
- Emerging markets will be supportive, particularly in the second half of 2009.
- Deflation poses a material risk to the central outlook, as it would accelerate the rate of debt default and asset spoilage.
- Flight to cash and flight to safety represent the key factors in a price fall, perhaps exacerbated by a Chinese devaluation in the event of a severe downturn there.

Great unwind. Reducing the global economy's pyramid of credit, a process known as 'de-leveraging', will be prominent in 2009:

Asset deflation. A sharp rise in demand for cash balances will drive intermediaries to liquidate positions in asset classes, which otherwise may have performed well. This 'flight to cash' will acquire a self-fulfilling quality, as asset prices fall in response to liquidation, triggering further liquidation. The process is likely to be strengthened by episodic failure of intermediaries.

Credit contraction. Driven by the need to shrink balance sheets, lending institutions will oversee a net reduction in credit as they take in more money through repayment than they extend in new loans. Recent research suggests that, in the United States, a fall in the bank capital/asset ratio by one percentage point reduces real GDP by 1.5% via reduced credit availability. This work also finds that a fall in demand of 1% of GDP is ultimately raised to 2% through financial feedback effects.

Macro consequences. There are several channels of macroeconomic fallout:

Employment. Finance for operations -- let alone expansion -- will be tighter for small business in 2009. For example, in the United States, this sector employs more than half of private sector workers, making the consequences for employment material. Higher unemployment will put further pressure on some asset prices, particularly housing.

Consumption. In the OECD economies in particular, declines in household wealth associated with falling home prices and equity share portfolios will entrench a slowdown in consumer spending growth, with contractions in the biggest economies.

The continuance of de-leveraging will see the global economy slowing appreciably in 2009, with growth of about 1.5% at market exchange rates. The US economy will see outright contraction of at least 1% as the export contribution weakens and consumer spending contracts sharply. Bolstered by mostly positive net foreign asset positions, emerging markets will be supportive through a turn to domestic spending in the second half of 2009, despite a negative shock from diminished commodity prices.

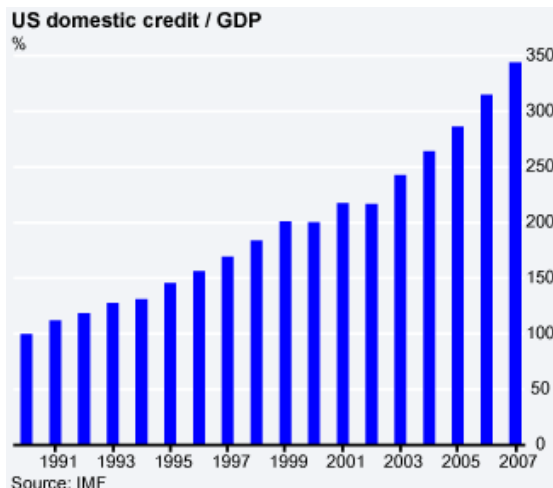
Perspective. It is important to keep this financial contraction in perspective:

- High-rated firms will retain access to the credit market through bond issues.
- The fiscal stance will be expansive in the largest economies, including emerging markets with large positive net foreign asset positions.
- Central banks are mostly free to set policy interest rates to serve domestic targets.

The latter point contrasts with the Great Depression. As the United States lurched into recession in 1929-30, adherence to the gold standard obliged other central banks to contract their monetary bases in order to maintain statutory minimum coverage of the currency with dwindling gold supplies. This was a recipe for transmuting the US contraction into a global contraction. Today, there is more flexibility to allow exchange rates to adjust to the needs of domestic monetary stability.

Deflation threat. Markets risk overlooking the interaction of policy variables with financial variables. For example, Beijing in the first half of 2009 is likely to respond to weaknesses in the exporting sector in ways that exacerbate current downward OECD price pressures. Should it face a sharp downturn, perhaps linked to a domestic crisis of its own, the authorities are likely to reach for the external sector as a pressure valve. This will take the form of administrative devaluation (e.g. issuing export rebates) and outright nominal currency devaluation through heavy foreign exchange intervention. There is a significant risk of feedback here onto the developed economies. As the Chinese devaluation is essentially an outward shift in the supply curve (an increase in Chinese exports), it would further depress international prices. Moreover, many of China's trade partners similarly will need to depress the value of their currencies.

Debt deflation. One of the key sources of weakness in the Great Depression was the combination of falling prices and nominally fixed debt levels -- a phenomenon dubbed 'Debt deflation' by Irving Fisher. When prices are falling, incomes fall as well. Yet these falling incomes must support repayment of debts that do not fall. This was a leading cause of credit failure in the Great Depression. Today, commentators frequently use the term 'debt deflation' to refer to falling asset prices, but 'debt deflation' as Fisher meant it does not yet exist. However, it is the threat of it that explains the excitability behind the Federal Reserve's pledge to do anything to prevent a generalised decline in the price level.



Significant fiscal expansion will determine whether this situation comes to pass. Market demand for government debt will remain high in 2009, suggesting adequate means of finance. The central outlook is for a marked fiscal expansion in 2009 in the United States, Japan and the United Kingdom, joined by China in the second half.

CONCLUSION: The world economy will see growth of 1.5% at market exchange rates in 2009, with slowdowns in some of the largest OECD economies attenuated by aggressive fiscal expansion and supportive emerging markets. The key risk is an emergence of generalised deflation, adding to debt loads and raising the default rate.

If you have any questions or comments about this newsletter and its contents, please contact us at ADC:

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