Inflation, Current Account Deficits and Unemployment

Talk by the Governor, B.W. Fraser, to CEDA Annual General Meeting Dinner, Melbourne, 29 November 1994.

This is the sixth opportunity I have had to address CEDA's AGM as Governor; for me it has been a long and happy association with CEDA.

Tonight I would like to stand back from the daily occurrences which excite the media and financial markets to observe some longer-term trends which, ultimately, determine standards of living in this country. I think we have come a long way over the past decade, but the road stretches ever onward. If we are smart enough to make the right policy turns, we will enjoy rising prosperity along the way.

Overview

Production of goods and services (GDP) in Australia rose by about one-third over the decade to 1993/94. This represents an average growth rate of just over 3 per cent per annum (Graph 1). Fundamentally, this growth reflects the combined effects of increases in the number of people in work, and rises in the productivity of that workforce.

Australia's growth over the decade is on a par with the average for OECD countries, although we have relied relatively more on increases in employment to hold up our performance; our average productivity growth has been unimpressive (Table 1). Compared

Graph 1

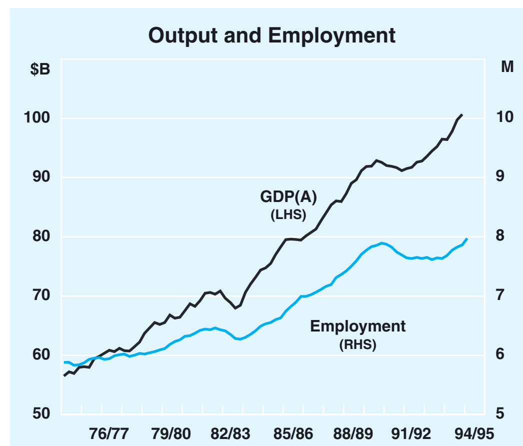


Table 1: Average Growth Rate Over Decade to 1993/94

	Employ-ment %	Prod-uctivity %	GDP %
Australia	2.0	1.1	3.1
G7	1.1	1.6	2.7
OECD	1.0	2.0	3.0
Asian Tigers	2.8	5.2	8.0

with the so-called 'Asian Tigers' (Singapore, Hong Kong, Taiwan, South Korea), developed countries as a group have been comprehensively outpointed.

The recent recession, of course, pulled down Australia's average growth rate (as did recessions in other developed economies). Our last recession has been described as the worst recession in 60 years. In fact, it was broadly comparable in severity with the early 1980s recession. The fall in GDP (excluding the farm sector) in the early 1990s recession (about 2.2 per cent) was somewhat smaller than that which occurred in the early 1980s recession (about 3.1 per cent), although the recovery was initially slower this time around. (*Total* GDP fell by 1.8 per cent in the early 1990s and by 4.1 per cent in the early 1980s, the latter figure in part reflecting the effects of drought on the farm sector.)

In terms of unemployment, rather than output, the early 1990s slowdown looks more severe, but there is not a lot in it. From a low of 5.8 per cent at the end of 1989, the unemployment rate rose to a peak of 11.2 per cent three years later. In the earlier episode, the unemployment rate increased from 5.4 per cent in June 1981 to 10.4 per cent in September 1983. Neither episode is comparable with the depression of the 1930s, when unemployment reached close to 20 per cent of the workforce.

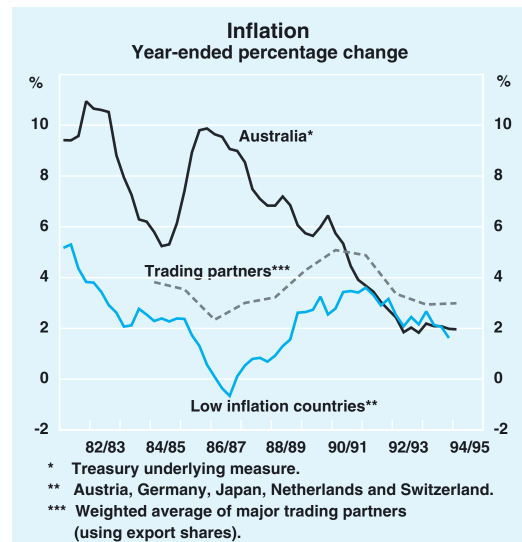
A point to remember about the rise in unemployment in the early 1990s is that it was exacerbated by unprecedented labour shedding. In both the public and private sectors, the pennies dropped that businesses had to reduce their costs and become more competitive, or risk going under. This labour shedding has helped Australia's longer-term competitiveness, but the short-term consequences for employment were severe.

I will return to the problem of unemployment later in this talk. But first, a few comments on two other problems. On one of these, a good measure of success has been achieved; on the other, despite some progress, we are still a long way from declaring victory.

Inflation

The area of success is, of course, inflation: economies work better with stable prices. How many of you envisaged in the early 1980s that Australia would be back in the low inflation league within a decade? (see Graph 2) Increases in the consumer price index have averaged 1.6 per cent over the past three years; in underlying terms – our preferred measure – the average has been a touch over 2 per cent.

Graph 2



The economic downturn in the early 1990s contributed to this inflation performance, but that could not have been the only factor. After all, we have now had three years of growth – and quite robust growth at that over the latter half of the period. Lower tariffs, deregulated financial and communications services, enterprise bargaining and other changes to boost competitiveness also have played a part. So too has monetary policy, which has focussed clearly on lower inflation; this has helped to lessen the inflationary mentality which has pervaded the community for so long (although that battle is not yet won).

As I noted earlier, we have paid quite a price, in terms of lost production and jobs, to get lower inflation. For that reason alone, we

should not countenance attempts by any group now to subvert that benefit.

What are the prospects for keeping inflation in Australia under control?

The financial markets are pessimistic, to judge from the sharp upward trend in bond yields through most of 1994. No-one is sure just what is driving bond yields higher in Australia (or elsewhere for that matter) but various factors are mentioned. These include the assignment of large risk premia to bonds and predictions of world capital shortages, as well as worries about future inflation. Factors of the former kind might well be valid, but they tell us little or nothing about inflationary pressures in Australia. To the extent that the higher bond yields reflect concerns about future inflation, they have to be sourced not in current trends but in Australia's more distant track record. And, it has to be conceded, we have not done particularly well in the past in combining strong growth with low inflation. In my book, however, that past track record is likely to be a poor guide to future performance.

This is not to deny the possibility that inflation could rise in Australia. The main risk to inflation is the pressure of demand on capacity, which is often reflected first in wage increases. Excluding the farm sector, the Australian economy is currently growing at an annual rate of the order of 5 to 6 per cent; at anything like this rate, such spare capacity as still exists will soon be taken up. In other words, the current rate of spending in the economy cannot be sustained over an extended period without generating higher inflation (and imports). It was to help bring about more sustainable rates of spending that official interest rates were raised by a total of 1¾ percentage points in August and October.

Similar pressures on capacity are emerging in several other countries, as growth in those countries picks up. This is being reflected in higher commodity and other material prices, which are themselves potential sources of inflationary pressures. In Australia, this avenue of 'imported' inflation is moderated to some extent by the floating exchange rate: higher commodity prices tend to push up the $A which, in turn, helps to hold down import prices.

How successful we are in bettering our past track record will depend critically on labour market developments. The past decade has been characterised by sustained wage restraint, which has contributed substantially to both low inflation and strong employment growth. At the same time, *real* wages have still managed to show increases; on average, they have risen by around 1 per cent per annum over the past five years (and by a little more in after-tax terms).

Looking ahead, productivity bargaining provides a vehicle for employees to share in the fruits of economic growth. As with other systems, however, any tendency for wages to run substantially ahead of productivity will, ultimately, diminish the harvest. Today, the parties directly involved have a greater responsibility than ever before to see that no major wage outbreak occurs. That really would be a wrong turn down a very dangerous road: once a wage breakout has occurred, it becomes largely a matter of *where* the 'damage' is sustained – in higher unemployment or higher inflation (or both).

As capacity utilisation rises and the labour market tightens, some increase in overall wage pressures can be expected over the next year. Recent rumblings in particular sectors of industry appear to portend some large wage increases, with uncertain productivity offsets. Like others, we are watching these developments closely. While we see no reason for panic, the Bank and the Government have made it clear that they would not sit on their hands if excessive wage and price pressures were to develop.

One disturbing aspect of the current wage negotiating environment is the argument that the effects of higher interest rates should be offset by increases in wages. This argument might be a handy hook on which to base claims that were already surfacing at the time interest rates rose. That does not mean, however, that the argument has any real validity. Indeed, with a little reflection, it is easy to see why following this argument would be self-defeating.

No-one can responsibly promise to maintain stable interest rates over time. Interest rates are an *instrument* for managing the economy and as such they are inevitably adjusted over time, rising *and* falling through the business cycle. Increases in interest rates are intended to restrain the growth in spending, including in particular household spending. To the extent that wage earners try to offset that impact through higher wage claims, this simply means that interest rates would need to rise even further to contain inflation, ultimately undermining the capacity of employers to sustain output and jobs in the process. On the other hand, what we *can* responsibly promise wage earners and others is that early and appropriate adjustments of interest rates will result in lower interest rates over the course of the cycle than would otherwise occur.

One further comment on wages and inflation. In May 1993, the ACTU committed itself to 'work to wage outcomes which are consistent with Australia maintaining an inflation rate comparable with those of our major trading partners'. This has been an important symbolic demonstration of the anti-inflation resolve of the Accord process. But is it quite the right standard for today? Inflation in our trading partners is probably averaging 3 to 4 per cent (pushed up by China and pulled down by Japan). The 'best practice' inflation standard, however, is more like the 2 to 3 per cent average for OECD countries (where wage restraint, which has been a central element in lowering inflation in these countries, seems set to continue).

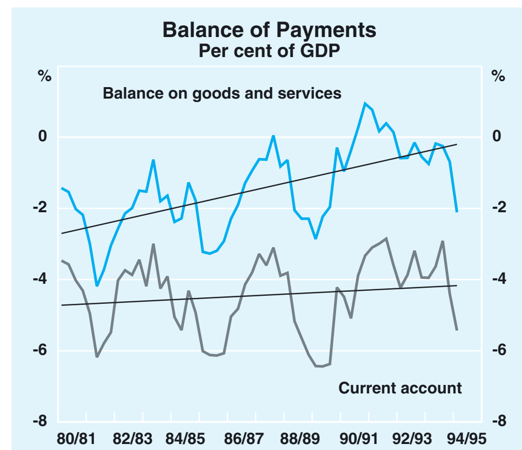
A reasonable benchmark for wage *and* salary rises in Australia, consistent with both the commitment to 2 to 3 per cent underlying inflation and the productivity based enterprise bargaining arrangements, would be for rises to be no more than 2 to 3 per cent *plus* any genuine productivity increases. General adherence to such a 'norm' would help to hold inflation around the 2 to 3 per cent mark, while providing for higher (and lower) wage increases in some sectors.

Current Account Deficit

The second problem I want to discuss is one on which some progress was made in the past decade but which is still there. This is the current account deficit.

Evidence that the long-term balance of payments has been responding in a broadly appropriate way is suggested in Graph 3. The balance on goods and services has moved towards surplus over the past decade, and this trend has largely offset the rise in debt service payments. This longer-term improvement in the trade account reflects, *inter alia*, strong growth of manufacturing and tourism exports, both associated in part with greater access to expanding (non-Japanese) Asian markets. These developments demonstrate that appropriate long-term adjustments can be made.

Graph 3



At present, the deficit is once more expanding cyclically around the trend, as it has in the past. Everyone now expects the current account deficit in 1994/95 to be a good deal higher than the $18 billion (or 4 per cent of GDP) forecast at budget time. This is partly for 'special' and unpredictable factors, such as the effects of drought on rural exports (adding perhaps as much as

$1.5 billion to the deficit), and the impact of higher world interest rates on debt service payments (adding perhaps a similar amount). It is partly also because of faster-than-expected growth in all categories of imports, which is another indicator that domestic demand is running faster than earlier forecast.

The drought apart, these are basically cyclical influences. They raise important questions for the management of the economic cycle, but that is not my concern tonight. The more important question is the longer-run trend in the current account. It is in this sense that the problem remains before us.

Is a current account deficit equivalent to $4^1/_2$ per cent of GDP, which was the average over the 1980s, optimal – or even sustainable – in the longer term?

There is a spectrum of opinion about this. One view is that accessing foreign savings to fund domestic investment is a perfectly sensible course to follow, provided the returns from doing so are sufficiently high. Another view is that even small current account deficits somehow indicate a structural problem which has to be addressed.

I prefer some middle ground. I believe there is a case for accepting an on-going deficit of modest proportions, but it is more likely to be 3 per cent of GDP, rather than 4 or 5 per cent. That is not a target so much as a judgment about what is comfortably sustainable over the long term. It seems to me unlikely that we can continue indefinitely to absorb world savings at the high rate we have over the past decade. Australia does not have the highest debt ratio among developed countries, but we are clearly in the top half of the ladder (Table 2).

Table 2: Net External Debt, 1993*
Per cent of GDP

Country	Per cent of GDP
New Zealand	61.6
Finland	59.4
Sweden	58.9
Canada	44.4
Ireland	44.1
Australia	41.5
Denmark	34.5
United States	16.3
Italy	9.1
Norway	7.1
Spain	5.3
Austria	3.2
France	—
Germany	-7.4
Netherlands	-13.3
Switzerland	-107.4

* End 1992 for Austria, Italy and Spain.

On-going current account deficits of 5 or 6 per cent of GDP would not be conducive to improving our external debt position. In fact, they would worsen it, increasing our vulnerability to the vagaries of sentiment in international financial markets – something which many people already find unsettling when it starts to go against Australia.

Coping with the legacy of foreign debt built up over the past 15 years requires that our trade accounts be in at least modest surplus for a sustained period. That means, in the parlance of the production and spending sides of the economy, improving our productivity. Wage costs are obviously important here but so too are other factors, including management and other skills, infrastructure efficiencies, and government regulations. The closer we get to 'best practice' in these areas, the more investors will locate and produce here, making use of our talents and resources, for sales into global markets.

From the perspective of the saving and investment sides of the economy, the required adjustment involves greater national saving (unless we want to invest less, which I doubt). My views on the part which lower budget deficits can play in improving national savings are well known. Tonight, I would just add two rather obvious points.

First, we cannot rely on faster economic growth to close the budget gap. As noted earlier, the economy is already growing at a faster rate than is sustainable over the medium term, so a further acceleration is out of the question. At some stage, *slower* growth than now will need to be factored in. In any event,

to the extent that rapid growth reduces the budget deficit faster, it is also likely to be associated with stronger investment spending in the private sector, which adds to the calls on national saving.

Secondly, I think it is time we faced up to the fact that attempting to manage the budget without the capacity to vary taxes is not a winning strategy. There are always areas where government spending can be trimmed but possible tax increases should not be ruled out. In current circumstances, where aggregate spending is in danger of overstepping the crease, there should be no presumption that only public spending needs to be restrained. Tax increases (like interest rate increases) can help to manage private spending through the cycle. More generally, people who talk about substantially lower budget deficits but who are not prepared to contemplate increases in taxes do not deserve to be taken seriously.

The bottom line on deficits – both current account and budget – is ultimately a matter of sovereignty. If, in the globally competitive market place, we want to enter the next century with a greater measure of control over our own destiny as a nation, economically as well as politically, we need to lift our efforts both at being productive and innovative, and at saving.

Unemployment

I want to end with some observations on the complex problem of unemployment – which, at more than 9 per cent, remains a blight on the policy landscape. As an institution charged to pursue price stability *and* 'full employment', we obviously feel some sensitivity on the latter score at this time.

About a year ago, the Bank made a submission to the Committee on Employment Opportunities in which we made two fairly simple, but important, points. The first was that much of the then unemployment rate of about 11 per cent was cyclical – i.e. it reflected the weak demand for labour – and could be expected to decline as economic activity recovered. That has been happening, and the 2 percentage points fall in the unemployment rate over the past year exceeds anything recorded in the 1980s recovery.

In absolute terms, the number of people unemployed fell by 160,000 over the past year, of whom about one-third were people who had been unemployed for a year or more. This experience indicates the potency of strong economic growth in lowering the unemployment rate, including that for long-term unemployed people. But it takes time. This is why, of course, we are so keen to see the economy stay on a sustainable growth path, and for real wages not to run ahead of productivity increases.

The second important point in our submission was to acknowledge that there is a large 'structural' core of unemployment, which mainly has to do with problems on the supply side of the labour market, and which policies aimed at stimulating demand cannot do much about. This has led to the notion of a 'natural' rate of unemployment, or what economists have called the Non-Accelerating Inflation Rate of Unemployment, or the NAIRU – either way, a terrible mouthful. In simple terms, it is a minimum unemployment rate below which the economy cannot operate for any sustained period without generating wage pressures and pushing up inflation. No-one knows precisely what this minimum rate is, but different researchers have suggested a range of 6 to 8 per cent for Australia, with most estimates towards the top of this range. Estimates for some European countries tend to be higher still, at 8 to 9 per cent; for the United States, it is generally thought to be around 6 per cent.

It is a fuzzy concept and of limited practical value. But the idea that there is a hard core of unemployment which is very difficult to reduce, and that this has risen over time, seems to be borne out by the long-term trend in the unemployment rate. Unemployment in Australia reached around 3 per cent in the recession of the early 1960s, and successive peaks have tended to be higher, peaking at 10.4 per cent in the recession of the early

1980s. It took a run of good years of solid growth in the mid-1980s to lower this peak to just under 6 per cent at the end of 1989.

Many factors bear upon the extent of structural unemployment in an economy, including the degree to which wages are responsive to labour market conditions, the effect of welfare safety nets on incentives to work, as well as social mores, attitudes to work and leisure and so on.

In considering what might be done to reduce structural unemployment, it is interesting to compare the approach of the United States on the one hand, and that of many European countries on the other. The United States has a minimalist welfare safety net but considerable wage flexibility; this combination has produced the relatively low natural rate of unemployment mentioned earlier. The United States is one of few countries where the trend rate of unemployment today is not too different from what it was 20 years ago. On the other hand, many working Americans are paid wages which, in real terms, are lower today than they were 10 or 15 years ago, and inequalities among wage earners have widened. These trends, together with the limited support available for unemployed Americans, are understandably substantial sources of worrying social tensions.

In Europe, labour markets tend to be much more inflexible but welfare safety nets tend to be much more generous. This combination has produced trend levels of unemployment and natural rates of unemployment which are much higher than they were 20 years ago. Indeed, double digit unemployment appears to be commonly expected to be a routine feature of European life for the rest of this decade.

Neither of these approaches is particularly attractive to me. Greater labour market flexibility which results in low market wages for some (mostly unskilled) workers and widening income inequalities does not have much to commend it. Nor does the more ‘caring’ approach, if the main result of its generous welfare support arrangements is persistently high levels of unemployment and all the economic and social consequences of that.

Again, the best place to be is somewhere in the middle, which Australia is. We have less flexibility but more generous support arrangements than in the United States, and more flexibility than many European countries but broadly similar support systems. That said, however, our current arrangements could not be said to strike an ideal balance among such objectives as wage flexibility, incentives to work, skill upgrades and welfare support: there is always scope for improvements in at least some of these areas.

To its credit, the Government has not given up on structural unemployment as an unsolvable problem. It has not said that the best we can expect to do in future is reduce unemployment to 7 or 8 per cent. Rather, it has responded to the challenge with training and other programs estimated to cost $6.5 billion over the next few years. In principle, training and work experience programs have to be steps in the right direction, given that it is mainly unskilled and inexperienced people who bear the brunt of rising unemployment (and of relatively low wages in the United States). This problem is likely to grow as technology makes skilled people more valuable, and unskilled people increasingly redundant.

Training programs are, however, quite expensive and the results in some countries have been mixed. If they work, of course, they will more than pay for themselves by allowing a bigger economy and enhancing budget revenues (not to mention the social gains). As always, a lot will hinge on their implementation.

At the same time, people need to be motivated to make training programs work, and to get off the welfare system. There is an obligation on the part of the unemployed to take advantage of the programs and to accept reasonable job offers, with penalties (such as the loss and/or limitation of benefits) for refusing offers. As I understand them, the Government’s programs are mindful of both the incentives and budgetary cost aspects. Hopefully, these will have come into even

sharper focus over the past year, as the economy has gathered momentum, job vacancies have reached record levels and signs of wage pressures have started to emerge.

The Reserve Bank too has a continuing obligation to do what it can to promote sustainable employment. We have not given up either, and I do not see any need to change the Bank's charter, although all of us obviously have to rethink what we mean by 'full employment'. But we should not accept 7 or 8 per cent as the 'full employment' or 'natural' rate of unemployment: there is something very unnatural about such a rate, not to mention the criminal waste of resources involved.

Conclusion

A good deal of progress has been made over the past decade in adjusting to some harsh realities of life in a competitive world. In the process, we have left behind the old, unsustainable ways of earlier times. At the same time, we have managed to retain the basic attributes of a fair and decent society.

But we have not yet reached a sustainable long-run position. Completing what has been described by some as an historic transformation will test our reserves of tolerance and ingenuity. Mostly, it will take a good deal of plain commonsense.

Many hazards will have to be negotiated over the coming years, most of which will be beyond our capacity to anticipate. Unlike some others perhaps, I have enough confidence in the virtues of our basic system – our economic and political institutions, and the good sense of Australians – to be optimistic about our ability to make the right turns.