Some Observations on Current Economic Developments

Talk by Governor to The 500 Club Luncheon, Perth, 16 July 1996.

I am pleased to have this opportunity to speak to The 500 Club and, in effect, take up the challenge issued by John Paterson last October.

Australia has had five years of good economic growth with low inflation, which is a better experience than practically every other OECD country. Yet there is not quite the zip about things that might have been expected, given this macroeconomic performance. I would like to offer a few thoughts on why that might be so, and on some implications for policy.

Some Facts

First, a few facts.

Australia's economic recovery has been impressive by OECD standards (Table 1). We have now had five years of continuous growth since the recovery commenced in mid 1991. Since then, the economy has grown by about 20 per cent, an average of 3.6 per cent a year. Over the same period, inflation has averaged 2.4 per cent a year. Among OECD countries, only the United States and New Zealand have had similarly long and robust recoveries in this cycle.

Table 1: Economic Recovery in Selected Countries
Annual average percentage change over the past 5 years

	GDP	Core CPI
Australia	3.6	2.4
United States	2.5	3.2
New Zealand	3.7	1.7
OECD average	1.8	3.3

It has been an uneven recovery, both across time and across the economy. Growth was gradual to begin with, spurted ahead in 1994 and has since eased back. Large parts of the rural economy have been buffeted by drought, often in combination with low wool and beef prices. Housing surged for a couple of years, to be followed by a similarly protracted cyclical downturn. It has been a period of substantial change involving, inter alia, tougher international and domestic competition; the resultant pressures on prices, combined with relatively large wage increases, have squeezed margins – along with profitability and employment – in several industries, especially manufacturing. And low inflation, despite its longer-term benefits, has disappointed those who had become accustomed to big nominal increases in their pay packets and house values.

This backdrop of uneven growth and relentless change helps to explain the

disenchantment of particular groups which has been evident throughout the recovery. That discomfort has been real enough for the individuals and businesses affected, but it needs to be kept in perspective. At the moment, for example:

- measures of consumer sentiment, although well off their peaks of two years ago, have remained at levels consistent with solid growth in consumer spending. And that is what has been occurring, at least until recently. Consumer spending by households rose by $4^1/_2$ per cent in the year to the March quarter, outstripping the growth in their disposable incomes. Spending in the June quarter, however, appears to have been somewhat weaker; and
- surveys indicate that business sentiment is also subdued, but business investment spending has been rising strongly (up by about 12 per cent in the year to the March quarter), and seems set to grow strongly again over the year ahead.

One conclusion from all this is that, unlike some other countries, the 'feel bad' factor has not been strong enough to depress spending propensities. The main conclusion, however, is that even when the economy overall is growing robustly, there will always be some groups who miss out, and some problems which stand out. Time will help with some of these problems – such as the community's adjustment to the more competitive and lower inflation environment – but others will also require policy adjustments.

Two macroeconomic problems which have persisted throughout the recovery, and which continue to attract considerable public and policy attention, are the current account deficit and unemployment. These are the focus of my talk today.

The Current Account Deficit

The monthly current account figures are a regular reminder of a problem, but they are not a lot more than that. The current account deficit *is* a problem but it is a medium-term problem, not one to agonise over monthly, or even quarterly.

The deficit in 1994/95 totalled over $27 billion, equivalent to 6 per cent of GDP. This, to some extent, reflected a number of special factors, including the effects of the drought on rural exports, and of the surge in economic growth in 1994 on imports. In 1995/96 – a more 'normal' year in certain respects – the current account deficit totalled about $20 billion, equivalent to a little over 4 per cent of GDP. That figure is still too high, but it is moving in the right direction.

Looking behind the deficit bottom line, we see that exports grew strongly last year (by about 10 per cent), aided by a good rebound in rural exports after the drought. Other exports also continued their solid growth, especially exports of manufactured goods which rose by about 20 per cent. The growth in total imports last year (about 6 per cent) was less than that in exports. It was concentrated in capital goods and, to a lesser extent, intermediate and service imports, consumption goods imports have been fairly flat for some time. Further strong growth in capital goods imports is expected in the coming year.

Over time, the current account should benefit from Australia's improved international competitiveness and its closer integration with the fast growing markets of Asia. One illustration of the on-going effect of these changes is the sustained growth in exports of manufactured goods, these have grown by an average of 18 per cent a year over the past decade, and are now comparable in value with total exports of rural commodities and total exports of services.

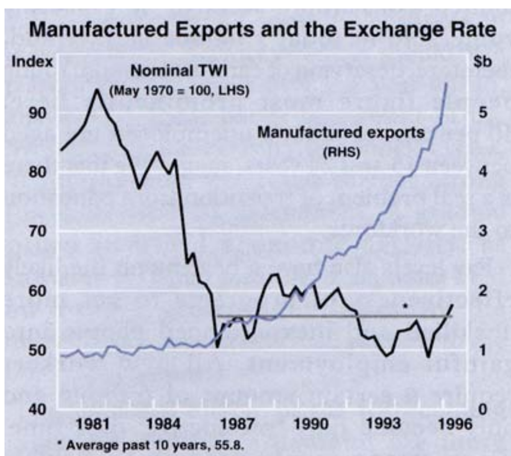
The exchange rate is an important influence on competitiveness, but it is one of many and, over time, other influences – such as cost controls, quality and reliability, marketing skills – are likely to be of greater consequence. In the past year, the Australian dollar exchange rate has rebounded from the unusually low level reached in mid 1995. That was the time

when a number of negative factors came together: world growth had slowed, commodity prices had softened, and expectations of further interest rate rises in Australia had evaporated as the economy slowed. On top of those factors, the outlook for the current account deficit worsened, shaking the confidence of foreign investors. Since then, however, most of these worries have largely dissipated: the world economy is looking a little stronger and this is helping to underpin commodity prices, while earlier concerns about the current account have settled down. We should, therefore, expect the exchange rate today to be a good deal higher than it was a year ago.

Has the rise in the exchange rate been overdone? This is difficult to judge but, in trade weighted index (TWI) terms, the exchange rate today is only slightly (about 5 per cent) above its average level of the past decade – a period which has seen a fivefold increase in exports of manufactured goods (Graph 1). Against the United States dollar, it is about 6 per cent above its average level of the past decade. I can understand that some exporters would prefer to see it lower, but around current levels the exchange rate could not be said to be badly out of alignment with the 'fundamentals' – including trends in commodity prices and interest rate differentials.

Maintaining our international competitiveness is obviously important in tackling the current account deficit problem. In a more fundamental sense, however, we also need to increase national saving so that we can fund more of our investment ourselves, and reduce our dependence on foreign capital inflow, which is the flipside of the current account deficit. We are moving in this direction, through both compulsory superannuation arrangements to increase private saving, and reductions in the budget deficit to curtail public sector dissaving. But it takes time to boost national saving, even with the 'right' policies.

Graph 1



Stripped of special transactions, the 'underlying' budget deficit in 1995/96 appears to have been equivalent to about 2 per cent of GDP. This is down from the peak of a little over 4 per cent in 1992/93, but it nonetheless represents disappointingly slow progress after such a long period of economic recovery. On current projections, it will take another two years to get the underlying budget into balance.

No-one pretends it is easy for governments to cut budget deficits, and how they go about that task is essentially a political matter. As a matter of practicality and equity, however, the task would appear to be more manageable if the net was cast on the tax side, as well as on the expenditure side. That seems an unexceptional argument to me, for the following reasons.

- With a relatively large current account deficit and relatively low private saving, it is incumbent on the Government to take the lead in increasing national saving and reducing reliance on inflows of potentially volatile foreign saving. We need to get the budget into surplus as quickly as we can, and keep it there as long as we can.
- To this end, low priority and poorly targeted expenditure programs should be weeded out (not just the people who administer them), but it is a mistake to assume that ineffective programs do not exist also on the revenue side; they too should be weeded out.
- Perhaps when all such programs are weeded out, the budget will be safely in surplus. If it is not, the options then are to

cut into priority expenditure programs, or find additional revenue. If health care programs, for example, are judged to be essential to the quality of life we want in Australia, but Australians are not able or prepared to save voluntarily for them, should those programs be curtailed, or should they be funded by 'compulsory saving' through higher taxes?

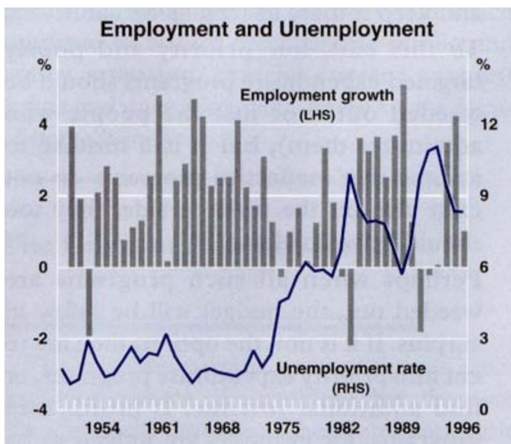
As I say, these kinds of questions have to be resolved at the political level, but they are reasonable questions to ask.

Unemployment

Unemployment is the second problem I want to talk a little about. It is rightly seen as a serious qualification to the good growth and inflation performance of the past five years. Just how serious, however, is difficult to assess, not least because there is no clear 'full employment' benchmark any more.

In Australia, the major deterioration in unemployment occurred in the mid 1970s, when we changed from being an economy which could function without inflationary pressures with unemployment of around 2 per cent, to one which, as we entered the 1980s, generated inflationary pressures with unemployment of around 6 per cent (Graph 2). Most policy makers know better than to try to predetermine a precise rate of unemployment below which inflation begins to accelerate. This is because the level of unemployment at which inflation starts to spiral depends on a host of factors, including expectations about inflation, rigidities in different markets, the pace of growth in employment, and wage bargaining conditions. Moreover, whatever the full employment rate is, it can be expected to change over time in response to attitudinal and institutional changes.

Graph 2



Nonetheless, this conceptual framework of 'full employment' – in which the test of what is 'full' employment is the inflationary consequences which arise if the economy operates above that level – is useful. It serves, for example, to divide the policy dimensions of unemployment into two parts:

- how to reduce the 'full employment' rate of unemployment through institutional and attitudinal changes; and
- how to operate the economy closer to the 'full employment' rate through macroeconomic policies.

On the first, I believe well-targeted employment support and training programs, properly administered, can make a difference. Good targeting is the difficult part: the challenge is to find an acceptable path between forcing unemployed people into poverty-level paid employment, and encouraging them to rely on unemployment benefits. The fact that we have not yet found an acceptable middle way is no reason for giving up the search.

People with no work experience and only limited skills would seem to be especially vulnerable in today's labour market and, therefore, deserving of careful targeting. Young people figure most prominently here; 40 per cent of today's unemployed are aged between 15 and 24 years, suggesting that there is a real problem of transition from education to the workforce.

Pay levels also have a bearing on the likely effectiveness of programs to get more unskilled and inexperienced people into gainful employment. All new workers require a certain amount of training and only become fully 'productive' over time. Wage

arrangements need to be flexible enough to reflect this situation, with appropriate safeguards to protect people from being locked permanently into low paid employment.

The second dimension has to do with macroeconomic management – with trying to ensure that sufficient new jobs are created to provide opportunities for people seeking work. This means sustaining a rate of employment growth sufficient both to absorb new entrants to the labour force, and to make inroads into the ranks of the unemployed. Over the past year, employment growth has been fairly modest – about 1 per cent in the year to June; over the past six months, it has been virtually flat. This growth has not been fast enough to make any impact on the unemployment rate, which has stuck at around 8½ per cent, having declined steadily from over 11 per cent during the two preceding years.

As I noted earlier, the actual rate of unemployment at which inflation starts to accelerate is not something that can be known in advance. We can be confident, however, that it is not the 2 per cent figure which Australia averaged in the 1960s, and we can be reasonably confident that it is somewhat less than the current figure of 8½ per cent.

The question which next arises is whether economic and employment growth during 1996/97 is likely to be strong enough to make a further dent in unemployment.

The national accounts to be released with the budget next month are likely to show good growth in GDP in 1995/96 as a whole (productivity has been rising faster than employment), despite some sluggishness in the June quarter. Activity generally should pick up from current levels over the year ahead. This should occur partly as a result of the unwinding of the housing and stock cycles, but mainly from projected further strong growth in business investment. A gradual upturn in world economic activity, as recoveries in Japan and Germany take hold and robust growth continues in the United States, should also lend support to the domestic economy.

The potential effects of the forthcoming budget on aggregate demand are more difficult to predict: they will depend on the extent to which the direct contractionary effects of lower government spending are offset by more confident private spending. Any negative short-term impact which the budget might have on economic activity, however, is unlikely to detract significantly from the other positive influences at work in 1996/97. Over the longer term, on-going fiscal consolidation can be expected to have a positive effect on both national saving and interest rates.

In summary, activity is likely to pick up a little from current levels over the year ahead. Given that starting point, employment could grow more quickly than it has in the past year without running any serious risk of the economy 'overheating' and inflation accelerating. In contrast to the United States, a good deal of surplus capacity remains in the labour market and elsewhere in Australia. Wage outcomes will still be important for employment; businesses facing strong competition and narrowing margins will be hesitant about hiring more staff if wages rise too quickly.

Monetary Policy Implications

The Reserve Bank has a two-dimensional charter which requires it to take account of trends in growth and employment, as well as in inflation. I happen to believe that this is the right approach, and that monetary policy should be managed in a way which simultaneously keeps inflation under control and helps to sustain good growth in employment. We are different in this regard from some other central banks which are more narrowly focused on inflation, although continuing high levels of unemployment are compelling central banks in those countries to pay more attention to that problem.

Each month, as part of its review of monetary policy, the Reserve Bank Board assesses the scope for the Australian economy

to grow faster without setting off an inflation spiral or other problems. So far in this cycle, we have had five years of non-inflationary growth, but we need several more to help get unemployment down: these are within our reach, provided we all do the right thing.

The short-term outlook on inflation is quite encouraging. The figures to be released next week should show underlying inflation in the year to the June quarter falling to around 3 per cent. We expect inflation to be comfortably within the 2-3 per cent objective in the second half of 1996, and into 1997. Others are coming to share this outlook, including international bond investors. In the second half of the 1980s, yields on Australian long-term bonds were typically 5 or 6 percentage points higher than US yields, but the differential now is under 2 percentage points.

How far into the future we sustain this low inflation performance will depend on developments in a number of areas, including the exchange rate. State taxes and charges, and the labour market. Labour costs are the largest single influence on the price of most goods and services, which is why we worry most about them. After rising by around 5 per cent in 1994/95, labour costs across the whole economy are estimated to have grown by about $4^{1}/_{4}$ per cent over the past year. Some additional data on earnings will also be released next week.

The recent rate of increase in labour costs, if sustained, would be broadly consistent with an inflation rate a little below 3 per cent. The intensification of global and domestic competitive pressures flowing from a decade of structural change will be working in this direction, and these are potent influences. The expected falls in inflation over the quarters ahead should also be making for some moderation in wage and salary increases. If wage negotiators (on both sides of the table) were to seize this rare opportunity to entrench low-inflation expectations in Australia, unemployment could fall a long way without triggering a return to higher inflation.

If we could be more confident that these influences would win the day, it would be easier for the Reserve Bank itself to adjust to low-inflation. That confidence has not evaporated but it has to be qualified. To judge from the size of settlements in some recent enterprise agreements, and the size of some current wage claims, there is not a lot of evidence at the moment that wage negotiators generally are factoring in lower-inflation expectations.

You will appreciate that I cannot talk more explicitly about possible changes in monetary policy. I hope, however, that my comments today will give you a better understanding of the issues which confront the Reserve Bank Board, and the kinds of pragmatic judgments it has to reach.