PESSIMISM AND OPTIMISM ABOUT AUSTRALIA'S FUTURE

Talk by the Deputy Governor, Mr I.J. Macfarlane, to WA Branches of the Economic Society of Australia and the Securities Institute of Australia, Perth, 18 February 1994.

When I agreed to talk to this forum three months ago and nominated as my subject 'Pessimism and Optimism about Australia's Future', I did not realise how topical it would become in the intervening period. There has recently been a remarkable improvement in confidence, which is as sharp as any I can recall. More importantly, it appears to be based on more than cyclical factors, and seems to reflect a favourable reassessment of Australia's medium-term potential. My earlier intention, which was to counter the prevailing pessimism by drawing attention to some neglected factors in Australia's favour, has been overtaken by events. Perhaps I should be trying instead to calm down over-exuberant expectations.

When I talk about Australia's future, I am referring to its economic future. This is the only aspect I feel qualified to comment on, and it seems to be the aspect most people are interested in. There is no country in the world that is as obsessed with economic issues as Australia. In other countries, the front pages of their newspapers are full of stories about civil wars, riots, racial tension, constitutional crises, etc. Ours are filled with balance of payments statistics, unemployment statistics, Budgets, etc. This is not an original observation – I have heard it again and again from overseas visitors.

As well as being obsessed with economics, we have usually been quite pessimistic about it. Certainly this has been the predominant mood over the past decade, not just the past few years. While a lot of businesses were often optimistic, or even overly optimistic, in their own commercial decisions, particularly during the asset price boom, general opinions on the economic predicament of the country tended to be pessimistic. This was certainly true of the bulk of economic commentators, and of businessmen when addressing public policy issues. Indeed, if you wished to be regarded as a sophisticated economic observer, a degree of pessimism was *de rigueur*.

There was a lot to be said for this period of introspection and self-criticism. The fear of economic oblivion it engendered helped the country to face up to some painful and politically-unpopular decisions. Governments at Federal and State level have found it easier to rein in expenditure, introduce competition, reduce protection, and privatise or corporatise public utilities in this environment; it also provided a spur to wage restraint. In short, pessimism was useful, but too much could become counter-productive. We were in danger of losing confidence in our ability to improve our position, which in turn was having adverse consequences for Australian investment.

THE PESSIMISTIC APPROACH

There were some longstanding and quite deep-seated reasons for the predominantly pessimistic outlook, and others which were based mainly on the experience of the mid 1980s. I will start with the former.

The long-run decline argument

A feeling that we have declined relative to other countries has pervaded a lot of our thinking. The most common form of this argument is based on long-run comparisons of income per head among developed countries, which showed Australia at number one at the turn of the century, but now back in the middle of the field. There is a feeling of disappointment that 'we used to be number one, but look how far we have slipped'.

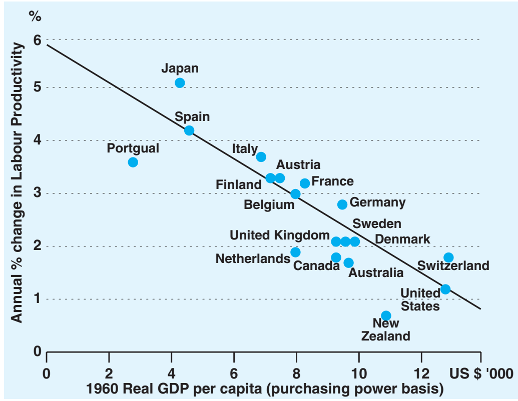
The immediate response to this line of argument is to ask whether we were really that good, or was there a large element of luck. It does not take a great deal of historical knowledge to realise that there is more substance in the latter explanation than the former. In a sense, we were the Kuwait of the 1890s in that we had a lot of land and a small number of people, and we were able to produce commodities that were relatively highly valued.

We were able to stay in a high position on the ladder for quite a while, but again we were helped by the accidents of history. The fact that most of the countries close to us in the rankings blew away their capital bases and a large part of their population in two world wars kept us near the top of the ladder for the first half of the century. We were bound to slip back for two reasons.

- First, there is a tendency among developed countries towards convergence. Countries with high income/output per head tend to achieve lower productivity growth than those with lower income/output per head. The countries near the bottom 'catch up' by importing the technology of the more advanced countries (Graph 1).

GRAPH 1

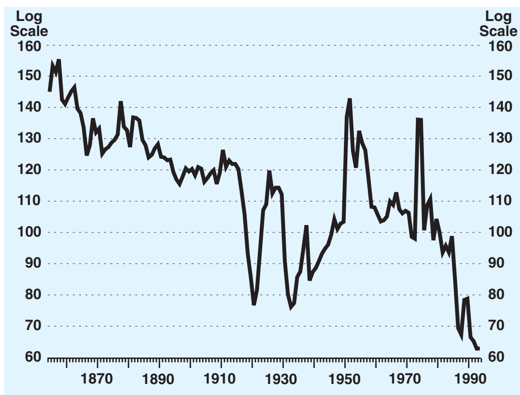
PRODUCTIVITY GROWTH & INITIAL INCOME
1960-90



- Second, as the scarcity value (or economic rent) of what we exported fell, it constrained the rate at which national income could grow. The graph below from the IMF measures the price of commodities relative to the price of manufactured goods at the broadest level. It shows that there has been a noticeable downward trend in the relative price of commodities, which has been more pronounced since the mid 1970s. Countries, like Australia, who owed their former high ranking to a large resource sector have tended to slip in the rankings, particularly over the past two decades.

GRAPH 2

Relative Price of Commodities, 1854 - 1993
(1980 = 100)



Relative price = commodity price index divided by manufactures price index multiplied by 100

Source: James M. Boughton (1991),'Commodity and Manufactures Prices in the Long Run', *IMF Working Paper* WP/91/47, May.

The recent decline argument

There is also a version of the theme that we are not as good as we used to be which is based on post-war experience. People point to the good economic performance of the 1950s and 1960s and ask why are we not doing as well as that now? Isn't this evidence that we are not as good as we used to be?

We certainly did well in terms of economic growth, low inflation and low unemployment in the 1950s and 1960s, but so did everyone. Angus Maddison, who is the main compiler of long-run, income-per-head rankings going back a century and a half, refers to the 1950s and 1960s as the Golden Age – a set of historical circumstances for most countries which gave rise to an economic performance not seen before or since.

It is not widely known, but during the 1950s and 1960s, although in absolute terms our performance was good, it did not keep up with the OECD average. Our growth in income per head averaged a per cent per annum lower than the OECD average, a bigger shortfall than over the past two decades (see Table 1).

TABLE 1: GROWTH RATE OF REAL GDP PER CAPITA

	1950-73	1973-89
Australia	2.4	1.7
Average of 16 OECD countries	3.8	2.1

Source: A. Maddison (1991), *Dynamic Forces in Capitalist Development*, Oxford University Press.

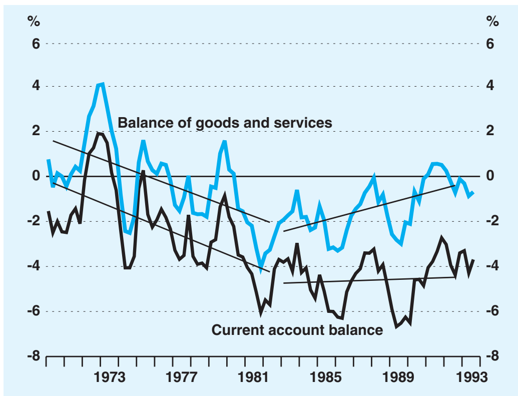
The re-assessment of the mid 1980s

The fullest recognition that our performance was wanting came in the mid 1980s, and was heavily influenced by perceptions about the balance of payments and the growth of external debt. It was brought to everyone's attention by the 40 per cent fall in the exchange rate (which incidentally also pushed up our external debt to GDP ratio and caused us to fall a few rungs in the international GDP per head rankings). This pessimism dominated most commentary on the Australian economy until very recently. It tended to reinforce the view that our economic performance was getting progressively worse. For example, it implied that the most recent decade's performance was worse than the one that preceded it.

I think you can make a pretty good argument that this was not the case. While economic pessimism reached its peak in the 1980s, it was a lagged reaction to our economic performance, which had its most serious period of deterioration in the 1970s. For example, if we look at the balance of payments, it is now clear that the period of deteriorating performance (ie. increasing deficits) was from about the early 1970s to the mid 1980s (Graph 3). Since then, there has been a slight upward trend in the trade position and a stabilisation in the current account position. Since debt is, to a large extent, the summation of past current account deficits, it is not surprising that this ratio lagged behind and did not begin to rise sharply until the mid 1980s.

GRAPH 3

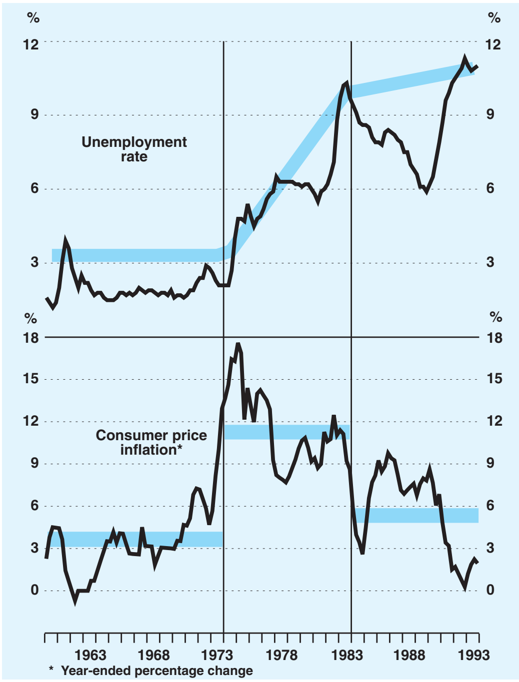
CURRENT ACCOUNT
Per cent of GDP



Similarly if we look at inflation, it is clear that the damage was done in the 1970s and early 1980s. The average rate of inflation between 1973 and 1983 was 11.3 per cent, whereas in the most recent decade it has been about half that, and over the most recent three years has been less than 2 per cent. More importantly, the trend over the past decade has definitely been downwards (lower panel of Graph 4).

GRAPH 4

UNEMPLOYMENT AND INFLATION



Even unemployment shows the same picture of major deterioration between 1973 and 1983, followed by a much smaller deterioration in the past decade. In the 1960s, the unemployment rate reached a peak of about 3½ per cent early in the decade. First in 1975 and then in 1983, the peak was pushed up to about 10½ per cent (upper panel of Graph 4). In the following decade, the unemployment rate fell and then rose in 1993 to a peak of 11.3 per cent. It is true that this represented a higher rate than the previous peak, but the shift up was small compared to what had occurred in the previous decade.

Overall, I think that on the basis of these three key variables – the rate of inflation, the balance of payments and the unemployment rate – the period of deteriorating performance was the 1970s rather than the 1980s. What is disappointing about the 1980s, I suppose, is that we did not make as much progress in correcting the imbalances of the 1970s as we might have hoped for. We eventually had success on inflation, made only small gains on the balance of payments but none, in net terms, on the unemployment rate. But it is misplaced to blame the policies of the past decade for creating the problem.

Where does that leave us?

The first thing to say is that we should not lose too much sleep about small changes in our position in the international rankings of income per head. These rankings are extremely approximate. For example, the two most quoted rankings of recent years give very different results. In the year they overlap – 1988 – one has Australia in 13th place and the other has us in 6th place.[1] If you are in the middle of the field, where a number of countries are clustered together, a small change in GDP or the exchange rate can move you up or down four or five places in one year.

I think the best way to view Australia is as a middle-income, middle-sized, developed country that is going to have to work hard to keep its place in the world. The other countries that would fit this description are ones like the Netherlands, Belgium, Austria or Sweden. These are the sorts of countries, by the way, that we regularly change places with in the middle of the field of OECD countries, but which we used to be above in the first half of the twentieth century.

THE OPTIMISTIC APPROACH

The optimistic approach would say that there is not much use focusing on long-term trends that include the distant past. It is the very recent past, and the future, that matters. If you take this approach, there are a number of factors which make for considerable optimism about Australia's medium-term future.

1. The first is in OECD National Accounts 1960-1991, Paris, 1993; the second is in R. Summers and A. Heston (1991), 'The Penn World Table: An Expanded Set of International Comparisons 1950-1988', *Quarterly Journal of Economics*, May.

The first is one for which we can take no credit – we are in the right position. We are closer to Asia than are Europe and North America; we are in the same time zone but a different hemisphere. In many respects, we are the perfect complement to Asia, and close enough to take advantage of it. This has given us enormous opportunities over recent years: opportunities that will no doubt continue to increase. Asian dynamism – which was once confined to Japan – has spread to Hong Kong, Singapore, Taiwan and Korea in the first instance and is now spreading through Thailand, Malaysia, Indonesia and, most important of all, China.

All the countries of the OECD area have recently been through a recession and we have been waiting to see what impact this would have on the dynamic Asian economies. The answer is that it seems to have had almost none; they are still growing at rates higher than the boom rates of OECD countries. It is now reasonable to assume that the dynamic Asian economies will continue to grow on average at 6 to 7 per cent in the future. When I say this I do not include Japan, which has already become a conventional OECD country with a potential growth rate of about 3 per cent.

As I said earlier, we cannot take credit for our position or for the fact that Asian growth is so strong. We can, however, take some credit for the fact that we have taken advantage of the growth opportunities arising from Asia. Two examples illustrate this point:

- we are already much more 'Asianised' than any other OECD country in one important respect. The share of our exports going to Asia is much higher than Canada, the United States, New Zealand or even Japan (Graph 5). If an investor wants to put funds into a developed country that has a big exposure to Asia, then Australia is the one;
- the other thing we have going for us is we actually run a balance of payments surplus with Asia and with each of the major Asian regions; our deficit is with the United States and Europe (Table 2). Thus, we have a surplus with a fast-growing region and a deficit with the slower-growing ones. That has to be good for us in the medium term.

These trading patterns are a promising starting point, but whether they are translated into sustainable growth will depend on our flexibility and willingness to innovate. We do not enjoy a great reputation for either of these attributes, but again we have probably underestimated our capacity for adaptation.

The best-known example of our capacity to adapt is the remarkable growth in exports of elaborately-transformed manufactures. These have grown at a rate of 19 per cent per annum for the past seven years, which means they have more than trebled in that time. A few

GRAPH 5

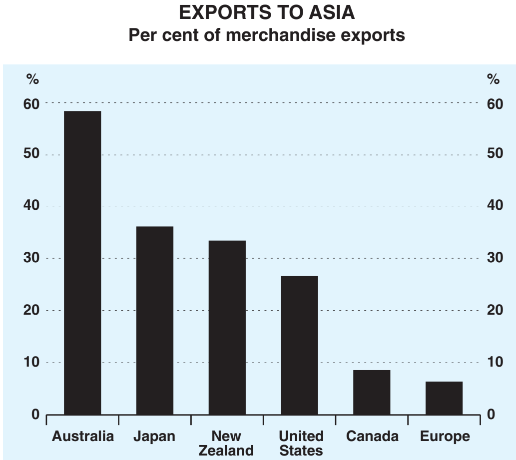


TABLE 2: AUSTRALIAN TRADE BALANCE BY REGION

$ billion in 1992/93

Deficit Regions	
North America	-7.9
EC and EFTA	-6.3
OECD (excluding Japan)	-13.7
Surplus Regions	
Asia	12.2
of which	
Japan	4.1
Other rapidly-growing Asia*	8.1

* Hong Kong, China, South Korea, Taiwan and ASEAN.

years back, when these figures were first produced, they were greeted with a good deal of scepticism and it was assumed they must be the result of some special factor. But as the good performance continued year after year and became more widely reported, it gave a boost to the self-confidence of the corporate sector. Now the business magazines are full of success stories and the export culture is becoming more widely accepted and imitated.

THE PRESENT BALANCE

Excessive pessimism is unhelpful because it discourages us, and others, from investing in expanding our capital base. Fortunately, the period of excessive pessimism seems to have passed and been replaced by a general air of optimism. On balance, this must be good for us, but there is a risk that the turnaround in sentiment has been too rapid. There is a risk that we have recently witnessed 'too much of a good thing'.

Some of the recent turnaround is cyclical – we have been through this before in 1976 and 1984 – and we know that the benefits do not last all that long. The other part of the turnaround is structural and is mainly due to our belated recognition of the benefits of Asian growth and our capacity to share in it. We have to be on our guard, however, against taking the benefits for granted. There is a risk that we see this as a gigantic updraught that will automatically lift us onto a higher growth plane. It will if we play our cards right, but not if we think it will solve all our problems.

There will be two forces at work. While overall we will benefit from increased demand for our products from growing Asia, many of our industries will also come under intense pressure from newly-emerging Asian competitors. A lot of adjustment will still be required; some industries will expand quickly, others will have to adopt more productive practices in order to meet best international standard and so survive, and some will inevitably fall by the wayside. We need to ensure that we have enough flexibility to make sure that the expansion of the first two groups outweighs the contraction of the third.

Obviously this will be a big challenge for business, but it will also be a challenge for governments and our institutions more generally. The first requirement is a big increase in physical investment, which is now underway. Another is that we achieve enough flexibility in our labour and goods markets to allow firms to reach best international practice. That will require further moves to increase competition and flexibility of wages and conditions. Governments, too, will have to continue working towards making the delivery of publicly-provided services more efficient and economic.

In other words, the turnaround in our cyclical position and return of optimism about our medium-term future does not mean that we can now afford to stop the process of improving our standards. Perhaps it is more difficult to make the hard decisions in the good times than it is in the bad, but we should guard against this mentality. In principle, it should be less painful to make adjustments in a growing economy than in a stagnating one. While we should welcome the return of optimism, we should also retain our capacity for self-criticism and a distrust of those who think success will quickly and easily fall into our hands.