Managing the Recovery

Talk by the Governor, Mr B.W. Fraser, to the Australian Business Economists, Sydney, 30 March 1994.

INTRODUCTION

It is a pleasure to be with you again today.

It is almost a year to the day since I last spoke to you. At that time, I said that I enjoyed speaking with business economists because they tended to be 'practical and pragmatic people who are interested in policies which actually work, rather than theoretical or ideological prescriptions'.

I could have added, I trust, that they are also less prone than some in the financial markets to fear economic growth - less inclined to anticipate, Pavlovian-like, runaway inflation at the first whiff of stronger growth.

A lot has happened since I was last with you, most of it good. A year ago, I said:

'I expect the economy to be growing at an annual rate of about 4 per cent by the end of 1993. Growth of at least that order is needed over a sustained period to provide jobs for all those people who want them. Jobless growth is inadequate growth.'

That turned out to be one of my better forecasts! At the time, I recall, it was seen as a trifle optimistic. The recovery was still finding its feet: growth was a modest 2 to 3 per cent, unemployment was still rising, firms were still deferring investment, and the OECD world was still stalled.

My relative optimism sprang from a belief that Australia's 'fundamentals' were coming together. Company profits were rising strongly, as were exports. Inflation and inflationary expectations had fallen to low levels. Micro-economic reforms were changing attitudes and practices in many sectors of the economy. The main thing missing was confidence; that arrived in the latter part of 1993, and growth accelerated.

The Economic Outlook

The present 4 per cent growth rate could go a little higher in the year ahead, with signs of strengthening in several areas of previous weakness. Employment has risen strongly - by 150,000 or about 2 per cent - since last August, and unemployment has begun to decline. By underpinning consumer spending, this will help to make growth more self-sustaining.

Judging by the forward indicators, business investment is set to surge over the next year or so. This is what we would expect, given rising sales and confidence, and better company profits and balance sheets. It is also what we need to boost the nation's capital stock and productive capacity.

Faster growth, to this time, has not caused any acceleration in inflation. If anything, inflation has continued to come in below expectations. The balance of payments also has been doing better than expected, despite faster domestic growth and a generally difficult world environment. In the first seven months of 1993/94, the current account deficit has been running at an annual rate of $16 billion, compared with the Budget forecast of $18 billion.

So far, then, so good: the broad policy strategy adhered to consistently over several years is now delivering visible results. It makes sense to stay with a strategy which is working, although there is always room for improvement.

The task now is to sustain strong growth. That is the best way - indeed, the only way - to ensure that permanent jobs are available for people who want them and, in that and in other ways, to raise living standards across the community. Growth which creates jobs and improves living standards for ordinary Australians is what makes sometimes painful economic changes socially, and therefore politically, acceptable.

Today I would like to offer some observations on managing strong and sustainable growth. I do so from a Reserve Bank perspective, so that 'sustainable' growth is synonymous with 'low inflation' growth. As any central banker will tell you, low inflation helps to facilitate growth by holding down interest rates and encouraging longer-term investment in productive assets.

The Unemployment Problem

The measure of success now being enjoyed is no cause to lose sight of the job still to be done. Most prominent, of course, is the unconscionably high level of unemployment, especially among young people. At a time when various remedies are currently being prescribed for this problem, I would like to reiterate a few common-sense points:

(i) Sustained growth is not (quite) everything, but it is essential to getting unemployment down.

- The trend slowing in the growth rate since the mid-1970s is an important reason why unemployment now is higher than 20 years ago. In my view, the surest way to provide jobs for the great bulk of those who want them, including people unemployed for long periods, is through sustained higher growth.
- Business economists know this but those who blithely support increasing the regulatory and taxation burden on businesses, or who advocate a re-allocation of existing jobs and incomes through work sharing and early retirement schemes, do need to be reminded.
- Others who see current unemployment entirely in structural terms, and advance the simple solution of cutting wages, are also wide of the mark; part is structural but much is cyclical.
- Even with sustained growth, however, the problem will take years to solve; in the strongest years of the late 1980s, the unemployment rate fell only by about one percentage point a year.

(ii) Sustained growth is the key but well targeted measures can help long-term unemployed people.

- Evidence on the effectiveness of labour market programs is not strong either way, so it would be unwise to be dogmatic here.
- Training and other programs which enhance the employability (or 'job readiness') of the long-term unemployed are likely to be helpful, particularly in the context of a growing economy. Apart from their social spin-offs, such programs - if they are successful - increase the supply of labour and lift the economy's potential growth rate.
- The qualification that has to be heeded, of course, is that their benefits not be negated by the adverse effects of any new measures necessary to fund them.

(iii) The current reassessment of unemployment should extend to the

appropriateness or otherwise of existing support programs for the unemployed.

- This raises emotional issues but it is a legitimate area for review in circumstances where consideration is being given to major new expenditures to assist people genuinely seeking employment and where strong growth will be creating more job opportunities for those who want them.

At the broadest level, what is needed most is not so much a 'jobs compact' but a 'growth compact' - a view on the part of policy makers, businesses, unions and opinion leaders that strong and sustainable growth is a desirable objective, backed by a commitment to pursue it. Labour market programs are really an appendage to this - to help it happen, to help those who have been missing out to come on board.

For the next year or two, strong growth (4 to 5 per cent) with modest inflation (2 to 3 per cent) seems within reasonable reach. Can this combination be achieved over the rest of the decade? I think it can, but it is no easy task; it will require good policies, as well as a little luck. In particular, the inflation and external constraints which have checked growth in the past have to be pushed back. Unless this happens, the recovery will run into problems early in the upswing which are likely to necessitate tighter policies, leading to lower production and employment.

PUSHING BACK THE INFLATION CONSTRAINT

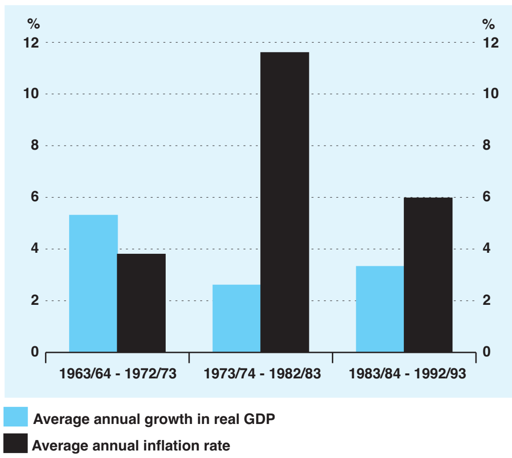
On our recent performance, we should be positive about the outlook for inflation. As measured by the CPI, inflation has averaged around $2^1/_2$ per cent per annum over the past four years. In underlying terms, it is currently about 2 per cent.

Yet doubts persist that low inflation can be maintained as growth quickens. This scepticism has resurfaced recently in financial markets, as part of a worldwide reaction to a small, well timed and well telegraphed lift in the US Federal funds rate, and to perceptions that US inflation is on the rise.

The extrapolation of these concerns to Australia is difficult to defend. To do so is to rely on some very simple and questionable rules linking growth and inflation. The experience of the past 30 years is that any number of combinations of inflation and growth is possible (see Graph 1). In the 1960s, for example, high growth rode in tandem with low inflation, while the 1970s was a decade of low growth and high inflation. The 1980s saw somewhat better growth but only a mediocre performance on inflation. These outcomes were influenced by the environment at the time, and within each period there was some cyclical variation in inflation. But the basic point remains that strong growth should not, automatically, evoke fears of higher inflation.

Graph 1

Growth and Inflation in Australia



Several reasons can be advanced for expecting low inflation to be maintained in Australia, even with stronger growth:

(i) One reason is the starting point. It is easier to maintain low inflation if inflation and inflationary expectations are low to begin with. Underlying inflation has held around 2 per cent for several years now, despite some factors which might have been expected to push it higher. The sharp fall in the Australian dollar last year, for example, risked blowing us off course (as it did in the mid-1980s), but we withstood that storm quite well. The dollar has since recovered part of last year's fall.

(ii) Another reason is our highly competitive environment. Tariff reductions and closer integration with world markets will continue to exert powerful competitive pressures on Australia's trading sectors. At the same time, on-going micro-economic reforms are making for a more efficient non-traded goods sector (including government services). In all sectors today, attitudes towards cutting costs and raising productivity are streets ahead of what they were ten, or even five, years ago.

(iii) A third reason is the considerable slack still in the economy. This is most evident, of course, in the labour market and parts of the property market. Many firms also are still working well below their capacity limits but this gap is likely to close somewhat over the next year or so. That is why an early spurt in capacity expanding business investment is so important.

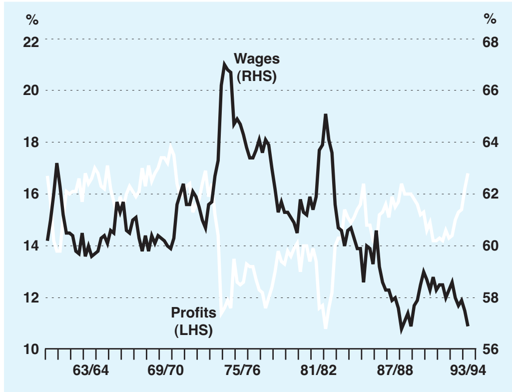
Wage Settlements

What happens to wage costs is critical. The wage breakouts of the 1970s and early 1980s caused inflation to rise sharply, and output and employment to contract. Those events took many years to correct and were extremely damaging to the long-term prosperity of Australians. (Graph 2 shows the big imbalance which occurred in the wage and profit shares of national income in the 1970s, and its correction during the 1980s.)

Fortunately, a whole new approach to wage setting has evolved over the past decade, driven by some quite profound changes in attitudes and institutions. It is now more widely appreciated that living standards can only be raised by improving productivity, and that wage increases in excess of productivity increases are more likely than not to result in declining profits, investment and jobs. These changes have helped to deliver an extended

Graph 2

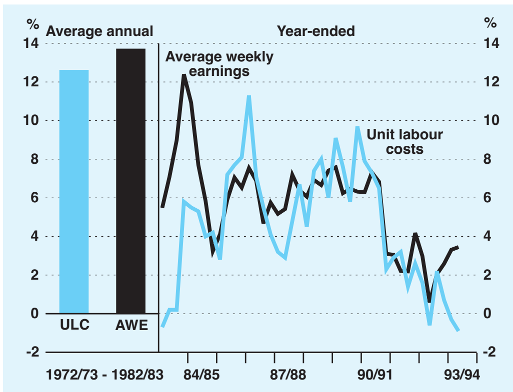
Factor Shares of National Income



period of wage moderation, including in the late 1980s when the labour market was quite tight. This has continued into the 1990s, partly under the influence of high unemployment, but also through the good sense of the main players (see Graph 3).

Graph 3

Labour Costs (% change)



The evolution of the wage fixing system is, by necessity, changing the way we think about wages. In the days of a more centralised system, the focus was on achieving aggregate wage outcomes which were consistent with broad economic objectives, taking some account of the competing interests of those at the bargaining table. While that system achieved considerable success during the late 1980s, we are now moving to a system which, appropriately in my view, places greater emphasis on a culture of productivity enhancement in the workplace, and changes in wage relativities. This is a major step forward.

As the role of the centralised arbiter recedes, however, the question arises of how to ensure that the multiplicity of settlements does not result in unacceptable cost pressures or additional unemployment. The question is further complicated because the consequences of any particular settlement are more difficult to judge under the new arrangements; the extent to which individual settlements are based on genuine productivity changes, for example, will be uncertain in many cases.

The overall test we must apply is ultimately the 'bottom line' one: is low inflation being maintained? That cannot be known with much certainty before the event, of course. It is, therefore, important that wage and price setting processes occur in an environment where low *expected* inflation is a key assumption. The Reserve Bank has to do what it can to condition acceptance of this assumption, especially by making sure everyone understands the rules of the game. The cardinal rule is that the authorities will act decisively, when necessary, to keep inflation under control.

This does not mean that minor fluctuations in headline inflation rates should elicit draconian responses which threaten to plunge the economy into recession for the sake of taking a fraction of a point off the CPI. It does mean, however, that developments which are fundamentally at odds with holding inflation at around 2 to 3 per cent over a run of years will bring forth an appropriate monetary policy response. Those involved in setting wages *and* prices (ie. business executives as well as union officials) should plan on this basis, and not build wage or price claims on expectations of higher inflation. Similarly, company boards should not maintain inappropriately high hurdle rates of return for investments because of expectations of higher inflation.

Current wage developments pass the test of being consistent with continued low inflation. In underlying terms, wages appear to be rising by about 3 per cent per annum. With trend productivity growth of close to 2 per cent, these figures do not pose a serious threat to inflation at this time.

Looking ahead, growth in unit labour costs should remain moderate as the economy grows faster and the pool of unemployed grows smaller. The structural changes which have been occurring - including the move to enterprise bargaining, productivity improvements and internationalisation of the economy - are conducive to that outcome. Beyond that, it is up to all the parties involved to behave sensibly.

This is not to say that wages cannot grow (or that they should be cut across the board, which is what some people appear to have in mind when they speak of greater wage 'flexibility'). Most people are in favour of upgrading the skills and pay of workers in return for greater productivity. But the logic of more flexible wage setting arrangements has to be allowed to work: wage increases should be related to genuine productivity gains and should reward the workers responsible, not be translated into generalised increases.

The longer wage moderation is sustained, the longer monetary policy can remain supportive of growth - and hence jobs. On the other hand, if there were to be a return to the adversarial and cost increasing mentality of the past, the consequences for inflation would not be something that monetary policy could ignore.

I cannot believe, however, that anyone genuinely committed to economic and social progress in Australia would wish to see a reversion to the earlier era. If we have learned anything over the past couple of decades, it is that restrictive monetary and fiscal policies cannot, on their own, deliver wage and price restraint without also creating intolerably high unemployment. Without effective wage setting procedures and institutions, based broadly on trust and fairness, we stand little chance of achieving the twin goals of low inflation and low unemployment. Everyone needs to realise this, and to spare no effort to make enterprise bargaining work.

PUSHING BACK THE EXTERNAL CONSTRAINT

The other potentially important constraint is the 'external' constraint. By this we do *not* mean the old idea, emanating from the world of fixed exchange rates and limited capital mobility, that growth faster than our trading partners leads to a flood of imports and a payments crisis which brings on contractionary policies. (These old ideas have a habit of hanging around long after their use-by dates, perpetuating the myth that Australia is more prone to boom/bust occurrences than most countries.)

Nor do we mean that current account deficits as such are disasters. Some of the more simplistic comments we hear about 'every month another billion dollars in debt' imply that Australians are getting poorer month by month. That is untrue; our net wealth has increased roughly three-fold over the past decade. A current account deficit essentially means that part of our investment is being funded by foreign saving; that means we are not as wealthy as we would be if we had been able to fund it all ourselves, but it does not mean we are poorer. By tapping foreign capital, we can take advantage of more investment opportunities to boost our wealth.

The real issue is how well we use the foreign capital, and how vulnerable our reliance on it makes us in a volatile financial world. The external constraint emerges because, simply, there are qualifications to the 'consenting adults' view of the world in which deficits do not matter.

Foreign and National Savings

If there are doubts about the viability of overseas funded investments, these could give rise to concerns about the sustainability of the debt burden. It might be argued that we should not worry too much on this score because sharp-pencilled investors would not undertake investments that could not meet the associated debt repayments. Unfortunately, that is not always the case, as the over-building of office blocks in the 1980s testifies.

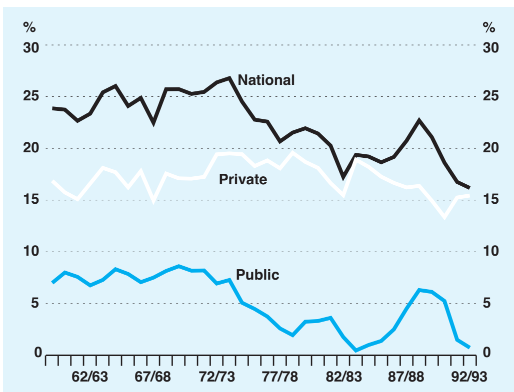
A heavy reliance on foreign savings also means that we are more susceptible to potentially abrupt swings in financial market sentiment. If markets were to doubt our on-going capacity to service foreign debt, and were to unload Australian assets, they could probably enforce a sharp and costly economic adjustment. It is in this sense that there is still an external constraint. If the current account deficit widens too quickly during the expansion phase of the cycle, and creditors lose confidence in the conduct of our affairs, sharp changes in market sentiment could bring on measures to cut short the recovery.

It is for policy to try to pre-empt that possibility. Now is an opportune time to be thinking about this, given the likely pressures on national savings to fund a big expansion in investment over the years ahead. The more of this investment that can be funded from national savings the less we will have to call upon foreign savings, and the better our chances of fending off the external constraint.

National savings are affected by developments in both the private and public sectors. Private saving is affected by the cycle but, in trend terms, has been fairly steady over the past 30 years (see Graph 4). Lower inflation and (over time) the Superannuation Guarantee Charge could add to private saving, but it is difficult to be prescriptive about measures to boost private savings.

Graph 4

National Saving
Per cent of GDP



The situation is clearer with public sector saving. This is where most of the long-term deterioration in national savings has occurred. It is also where dissaving during the recent recession has been most pronounced when, appropriately in the circumstances, the budget deficit was allowed to expand. With the recovery gathering momentum, however, it is just as appropriate now to be winding in the budget deficit.

This argument can be sustained without recourse to the idea of 'twin deficits' – the notion, popular in the 1980s, that higher public saving is reflected commensurately in a lower current account deficit. That particular debating tool appears to have backfired, to the extent that it has generated the counter-argument we hear today that higher public saving did not deliver a lower current account deficit in the 1980s so it will not work now.

This is all too simplistic. What is true (by definition) is that the aggregate of the private sector's spending balance (ie the excess of its investment over its saving) and the public sector's spending balance (ie its budget deficit) is always equal to the current account deficit. The linkage between the public sector deficit and the current account deficit, however, is more tenuous because the private sector balance can also change. This is what happened in the late 1980s when business investment boomed, spurred by high profits, better terms of trade, rapid bank lending and rising asset prices. In effect, the increases in public sector savings stemming from budget surpluses were offset by increases in private sector investment, rather than by reductions in current account deficits (foreign savings).

Public Sector Savings

That does not mean, of course, that the policy of public sector restraint was misguided. On the contrary, it was entirely appropriate, and the current account deficit would have been much worse if it had not occurred. In addition, the budget surpluses that were generated later allowed scope for a responsible expansion of government spending during the recession: fiscal discipline during the good years allowed some latitude when things were less good. Many countries today do not enjoy the latitude we have had in recent years.

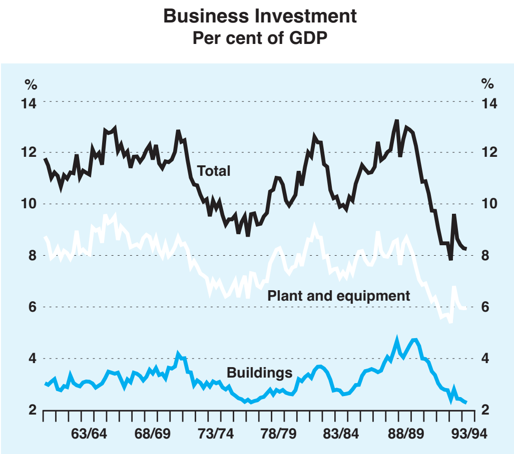
The situation today is quite simple. We need a big lift in business investment, and we think it is coming. We should fund as much as possible of this from domestic saving. We could continue to draw heavily on foreign saving for a time – that is, run higher current account deficits – but ultimately there are limits to how far this is feasible. Without more domestic saving, these limits would probably be reached before we had all the investment we needed. By increasing our own saving efforts, and in particular public sector saving, we can push out the external constraint to sustainable growth.

Fiscal policy is moving in the right direction. The federal government's goal of reducing the budget deficit to around 1 per cent of GDP by 1996/97 is a useful benchmark, but given the present outlook, the case is for doing more, rather than less. Calls to use any higher revenues flowing from a stronger economy – the so-called 'growth dividend' – to boost spending rather than reduce the deficit are misguided in my view. For a start, while growth is looking stronger than was expected last August, inflation will be lower than was assumed and windfall revenues are likely to be fewer than is commonly anticipated.

More importantly, effective management of the recovery requires not just relying upon cyclical adjustments to the budget numbers. It also requires the progressive unwinding of the *discretionary* fiscal stimulus of the last few years, to provide more room for increased business investment.

Two further points can be made in the context of the external constraint. The first is to underline the earlier emphasis on the quality of investment. If we are to argue in favour of containing government demands for credit and resources to 'make room' for private investment, we have also to be sure we get the right kind of investment, and not repeat the mistakes of the late 1980s. That does not appear to be a major issue at this time. To date, the modest recovery in business investment has been concentrated in plant and equipment (see Graph 5), and that is likely to be the case for some time – partly because no early resumption of new investment in office blocks is in sight, and partly because low inflation and a more chastened financial system should favour longer-term productive investments ahead of speculative investments.

Graph 5



International Competitiveness

The second point concerns our competitiveness, which is relevant to the other side of the current account coin, our trade performance. As a nation, we need to save more and we need to remain internationally competitive.

Staying competitive will obviously help to keep the current account deficit manageable. On simple measures, Australia is now roughly 30 per cent more competitive than it was a decade ago. Much of this reflects the decline in the nominal exchange rate but other factors have contributed – in particular, the fact that for some time our inflation rate has been lower than that of many of our competitors.

The big structural fall in the exchange rate occurred in 1985 and 1986, when the TWI fell by about 40 per cent (from 82.5 in November 1984 to 50.4 in August 1986). Since that time, the exchange rate has fluctuated within a moderate range around an average TWI of 57. Over that period, exports have grown strongly, with total exports averaging 7 per cent per annum (in volume terms), and manufactured goods no less than 16 per cent per annum.

As the world economy gradually picks up, we can expect to see some improvement in Australia's terms of trade, and some upward pressure on the $A (but probably less than in the late 1980s, given that Australia's inflation and interest rates now are more in line with those of other major countries). This should not do any lasting damage to our competitiveness.

We understand that a sustained exchange rate appreciation has implications for the ability of our exporters to compete. We have no wish to see an overvalued (or undervalued) exchange rate as a persistent situation. Intervention can help at times, and we will continue to use that tool (in both directions) when we judge the rate to be departing substantially from the 'fundamentals'. But there is little the Bank can or should do through intervention or in other ways to prevent well-based and sustained moves in the exchange rate. At the end of the day, our international competitiveness depends on our productivity performance relative to other countries, not on attempts to engineer particular exchange rate outcomes.

This is another way of saying that we need on-going micro-economic reform so that Australia can, at least, keep up with the growth in productivity and innovation occurring in other countries. Progress is being made in several areas but no end of challenges remain. Many require a concerted, national approach. If 'co-operative federalism' and competition policy can be carried beyond the rhetoric, we could expect to see substantial productivity gains in transport, power generation and many other activities in the years ahead.

IMPLICATIONS FOR MONETARY POLICY

What are the implications of all this for monetary policy?

It is quite clear to everyone now that the policy environment has altered. The recovery has reached the point where policies must focus on managing the growth phase of the cycle – keeping it balanced and sustainable, seeking to deliver both low unemployment and low inflation. Present policy settings are broadly appropriate for an economy where growth is picking up, without significant pressures on inflation.

As the cycle matures, and confidence and borrowing and spending rise further, we can expect to reach a point where these settings will begin to look too accommodating. At that point, and notwithstanding good policies in the meanwhile, short-term interest rates may well need to rise to help keep growth at sustainable rates.

In many respects, our broad approach is similar to that of the US Fed, including the belief that monetary policy should be tightened *before* inflation rises to unacceptable levels. As Alan Greenspan said recently: 'If the Federal Reserve waits until actual inflation worsens before taking counter measures, it would have waited far too long.'

Although parallels can be drawn between the Australian and US situations, some important differences must also be noted. First, official short-term interest rates in the US were much lower than ours to start with and, two Fed adjustments on, they are still significantly lower. Secondly, the US recession was milder than ours and its recovery thus far has brought it closer to full capacity constraints; unemployment, for example, has fallen to within less than a percentage point of what is generally regarded as the US 'full employment' level.

So while we have a similar approach to the US, we have a different starting position. This means that while upward adjustments in interest rates will probably be required in due course, the time to begin that adjustment is still some way off.

To emphasise the main point once more, we have little to fear from stronger growth as such. The financial markets might take fright from more vigorous growth but that seems to me to reflect an erroneous view that stronger growth will automatically generate 1970s style inflation. Ultimately, it is the host of other businesses which produce the bulk of the community's income and wealth, and they need growth and a stable inflationary environment in which to expand. Good policy making has to have regard to those broader economic and social considerations. (Perpetual sedation of the economy is hardly in the financial community's own best interests anyway, because any prolonged period of poor economic performance will eventually elicit policy responses which are likely to be detrimental to the financial markets.)

We expect strong growth to continue but we cannot *assume* it. We have to remain alert to potential constraints of the kind mentioned in this talk. At the end of the day, the role of monetary policy in helping to manage the recovery will depend on the behaviour of all the main players, including businesses, workers and governments.

To the extent that sufficient business investment is forthcoming to avoid any early onset of physical capacity constraints, that will help in deferring the onset of tighter monetary policies. Sustained wage and price moderation, and progressive reductions in the budget deficit, will have similar effects. Through sensible behaviour in these areas the potential inflation and external constraints can be held at bay, and monetary policy can remain generally supportive of growth and employment – lower interest rates can be sustained longer. If, however, shortcomings in one or more of these areas were to threaten to push underlying inflation noticeably above the 2 to 3 per cent range, corrective action would have to be implemented. After a 20-year struggle to regain the low inflation key to sustained growth, it would be irresponsible to lose it now.