

Change and the Australian Economy

Talk by the Governor, Mr B.W. Fraser, to BZW's Australia Day Seminar, Tokyo, 5 September 1996.

Introduction

This is the fourth opportunity I have had to participate in BZW's annual Australia Day seminar in Tokyo. On each occasion in the past I have been telling a story of progress in the Australian economy. And, happily, subsequent developments have tended to support this story – which probably explains why I have been invited back!

Over the past five years, Australia's real GDP has grown by more than 3¹/₂ per cent a year, while inflation has averaged 2¹/₂ per cent a year. This combination of good growth and low inflation is quite impressive by the standards of the major industrial countries, as Table 1 indicates.

Solid growth and low inflation are set to continue in Australia for some time yet. I will say more about that outlook shortly. But first, I would like to reiterate the point I have been emphasising in my earlier talks – namely, that the Australian economy today is very different from what it was a decade or so ago. Today, it is much more productive and competitive and outward looking. It is those changes, which I expect to be sustained and built upon, which

Table 1: GDP and Inflation
Averages over past 5 years

	GDP Per cent p.a.	Inflation Per cent p.a.
Canada	2.1	1.4
France	1.3	2.0
Germany	1.2	3.1
Italy	1.1	4.5
Japan	1.5	0.8
United Kingdom	1.9	2.6
United States	2.6	2.9
Australia	3.6	2.5

make me confident about Australia's future. They should, I suggest, also boost the confidence of Japanese investors in Australia.

A Different Economy

In many respects, the interests of the Australian community and foreign investors coincide, with returns on investments and rising standards of living both dependent largely on sustained economic growth. Improvements in the way economies operate are as important as sound macroeconomic policies in sustaining growth, although they

can take years to show up. We are now, however, seeing some of the benefits of the many profound changes that have occurred in Australia over the past decade, often as a consequence of policy actions.

Productivity Growth

Productivity growth is the key to sustained economic growth. As Paul Krugman puts it:

‘Productivity isn’t everything, but in the long run it is almost everything. A country’s ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.’

On this point, we have grounds for optimism about Australia. If we measure productivity in the 1980s and 1990s from the low points of the recessions which occurred early in each decade, we see that productivity growth in the initial years of each cycle was quite robust. But, later in the cycle, when it becomes more difficult to sustain fast productivity growth, we see that productivity has continued to grow strongly in the 1990s, while in the 1980s it languished (Graph 1). In the current cycle, productivity in the market sector of the economy has grown at an average of $2\frac{3}{4}$ per cent a year, compared with 2 per cent a year in the corresponding period of the 1980s cycle.

Graph 1



Measurement and other problems can complicate the interpretation of trends in productivity, but there does appear to have been a structural lift in productivity growth in the 1990s. Indeed, it would have been most disappointing if such a lift were not occurring, given the substantial microeconomic reforms which have been implemented over the past decade.

I will not catalogue those reforms, but some of the underlying forces warrant a mention because they have on-going implications for the Australian economy and investors in it.

International Integration

More intense competitive pressures in Australia have provided a major spur to better productivity performance. Reductions in tariffs and other trade barriers have been important here. So too has a range of other policy actions, from floating the Australian dollar and deregulating the financial system to privatising many services provided previously by government bodies. These and other reforms have been reinforced by the emergence of more confident and more outward-looking attitudes in most sections of the community.

Several measures show how the structure of the Australian economy has changed over the past decade. In the area of trade, for example:

- exports of goods and services as a share of GDP have grown from 16 per cent to 20 per cent;
- the share of rural and other commodities has declined from 74 per cent of total exports to 58 per cent; and
- exports of high value-added manufactured goods have shown the strongest growth – averaging 16 per cent a year over the past decade – followed by tourism and other service exports.

As a by-product of this export diversification, Australia’s terms of trade are becoming less sensitive to fluctuations in commodity prices. The gradual decline in the share of commodity exports also raises the prospect of less volatility in the exchange rate; this could be a significant change for long-

term investors, although it has not yet been widely perceived in foreign exchange markets. I will say a little more about the exchange rate later.

The geographic base of Australia's exports has also changed. Japan remains Australia's single most important export market, accounting for almost a quarter of total exports of goods and services. Since the mid 1980s, however, the share of exports destined for non-Japan East Asia has risen from 20 per cent to 35 per cent; this growth has been partly at the expense of Australia's more traditional markets in the United States and Europe. Including Japan, seven of Australia's top ten merchandise export markets are now in East Asia. This closer trade integration with the fast growing economies in Asia has supported Australia's relatively strong growth in recent years, and this support should continue in the period ahead.

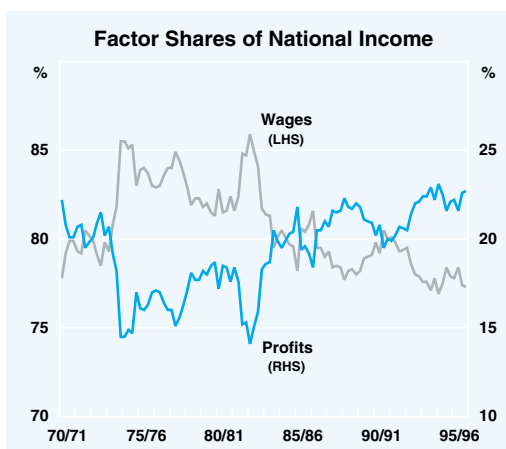
Healthy Corporate and Banking Sectors

The corporate and banking sectors in Australia have come through the changes – and occasional turbulence – of the past decade in good condition. Ten years ago, Australian companies were in the middle of a gearing up phase which ended with the recession of the early 1990s. This phase reflected a number of factors, including the deregulation of financial institutions, which encouraged banks and others to lend vigorously, and a long period of strong economic growth and rising asset prices, which encouraged investors to borrow just as vigorously.

Despite high nominal and real interest rates, corporate borrowing continued to rise in the second half of the 1980s, reaching a peak equivalent to almost 70 per cent of GDP in 1990. After the bubble burst, businesses set about repairing their balance sheets and restoring their gearing ratios to more comfortable levels; corporate debt is currently about 57 per cent of GDP. In the past couple of years Australian corporates have returned to the debt market, showing a willingness to grow their business through both debt and equity.

The share of corporate profits in national income, which fell to dismal levels in the 1970s, recovered during the 1980s; it has sustained these higher levels in the 1990s (Graph 2).

Graph 2



The banks were significant contributors to the 'bubble', and they suffered heavy losses when it burst. Generally speaking, however, banks in Australia adjusted quickly to this turn of events; in contrast to some other countries, their adjustment was assisted by an early and sustained recovery in economic activity from mid 1991. Banks in Australia have returned an average of 16 per cent on shareholders' funds in the past two years, and bad loans have declined from a peak of 6 per cent of total assets in early 1992 to around 1 per cent at present; the average capital ratio for all banks in Australia is currently about 11 per cent, which is comfortably above the BIS minimum of 8 per cent.

Australia's 'bubble' experience was not unique, as this audience knows only too well. That episode, however, is now well and truly behind us, although bankers, borrowers and supervisory authorities are all likely to remember its lessons for a long time to come. In the meantime, the current sound financial structure of Australian corporates, including banks, is another reason for expecting solid investment and economic growth to continue in the years ahead.

The Labour Market

The Australian labour market has undergone a good deal of change over the past decade. In the eyes of some people, deregulation of the labour market has lagged far behind that in the product and financial markets. Perhaps it has, but advocates of rapid labour market reforms sometimes overlook the point that people have to be handled with more sensitivity than chattels or financial 'products' if changes are to endure.

The Accord – or incomes policy – agreed jointly by the previous Government and the trade union movement in the early 1980s initially involved a centralised wage fixing system. This system generated uniform wage rises across the economy which, at the time, were consistent with strong growth in employment and a decline in inflation. The same discipline also helped to restore the corporate profit share mentioned earlier.

Over time, wage setting moved gradually from this centralised system to a less rigid, more decentralised model of enterprise agreements, and the Accord process evolved to permit these changes to occur in an orderly way. Today, formal enterprise agreements negotiated by employees and managements of individual enterprises determine wage outcomes for about one-third of the workforce. Another third of employees has its wages regulated by industrial awards, while the remaining third (which includes executives) generally relies on individual contracts.

The Accord framework ceased to exist with the change of Government in March this year. The new Government is proposing to amend the industrial relations legislation in ways which will increase the scope for employers and employees of individual enterprises to bargain their wage and other conditions, and reduce certain legal protections currently afforded to the unions. To the extent that these amendments, when implemented, help to better align wage increases with productivity increases, they will improve the prospects for sustained growth and low inflation.

Whatever the impact of these legislative changes, however, the on-going effects of the

more fundamental changes mentioned earlier – and particularly the growing exposure of Australian producers to international competition in both domestic and export markets – will remain. Employers and employees who attempt to ignore these seemingly irreversible changes are likely to suffer heavy penalties in terms of squeezes on profits and jobs, and lost opportunities for both. I think that most of the parties involved are coming to understand this fundamental point.

Industrial disputes have declined markedly during the past decade, notwithstanding the considerable workplace dislocation associated with many structural changes. Over the decade since 1986, an average of 170 working days a year were lost per 1,000 employees in Australia; this is 60 per cent fewer than the average of 440 days a year lost in the previous decade. In recent years, days lost through strike action have been at historical lows, and Australia has been roughly in the middle of the pack of OECD countries on this measure. Trade union membership is now down to 35 per cent of the workforce in Australia – compared with 45 per cent ten years ago – but the process of structural change will still need to be managed sensitively if the downward trend in industrial action is to continue.

Low Inflation

Another major change has been Australia's return to the ranks of low inflation countries. As noted earlier, inflation in Australia has averaged 2½ per cent in the past five years; this compares with an average of 8½ per cent in the 1980s. Higher levels of productivity growth are helping the economy to grow more quickly than in the past without setting off inflation alarms.

The prospect of sustained lower inflation has also been strengthened by certain institutional changes, most notably the Reserve Bank's explicit commitment to keep inflation under control – a commitment which has been endorsed by current and past governments. The commitment is expressed in terms of a target to hold underlying inflation

to 2-3 per cent a year, on average, over the course of the business cycle.

We see several advantages in formulating our inflation target in these terms. To begin with, 2 to 3 per cent represents about as low a rate of inflation as any country is likely to be able to achieve over a sustained period of reasonable economic growth. It is worth repeating that Australia has met this inflation target over the past five years while achieving relatively strong economic growth; this is in contrast to the experience in several other countries where low inflation in recent years has coincided with very slack economic conditions.

A second advantage is that, our formulation helps to achieve a reasonable balance between the Reserve Bank's twin objectives of low inflation and sustained growth. It does this because it recognises that inflation has a cyclical component which will tend to rise as growth strengthens, and to fall as growth slackens; in our view, any attempt to eliminate these cyclical movements in inflation would involve unwarranted losses in production and employment.

Finally, our formulation avoids conveying the impression – as a narrow, 'hard-edged' target might – that inflation can be contained within bounds which, realistically, central banks cannot achieve if they are also to support growth in activity and employment.

National Saving

In each of the areas I have mentioned so far, good progress has been achieved over the past decade. One area where we have not done so well – indeed, where we have gone backwards – is our national saving performance. As a nation, we simply have not been saving enough to fund all the investment we have been undertaking. As a result, our reliance on foreign saving has been increasing. One manifestation of this has been the rise in Australia's current account deficit; this has averaged 4½ per cent of GDP over the past 15 years, about double the average over the preceding 15 years.

These figures do not imply that we are facing a debt or any other kind of 'crisis'. Far from

it. The increased capital inflow – which comes with increased current account deficits – has actually supported a higher level of investment in Australia than would have been possible from domestic saving alone. Moreover, although the level of Australia's net external liabilities – that is, both debt and equity – has risen sharply over the past decade, it has tended to stabilise in recent years at levels around 60 per cent of GDP. Interest and dividend payments on these liabilities are currently equivalent to about 18 per cent of annual export earnings, well down on the peak of 26 per cent in 1989/90.

There is, then, no impending 'crisis'. Rather, the problem is our vulnerability to possible adverse shifts in foreign sentiment about Australia which comes with such a heavy reliance on foreign investors to fill our saving gap. The best way to reduce that vulnerability, and avoid the potentially severe policy consequences which go with it, is to increase our national saving (rather than reduce national investment, which is the main source of improvements in productivity and living standards). Over time, as higher national saving comes to be reflected in lower average current account deficits, the risk premiums which Australian borrowers currently have to pay for funds would also tend to decline.

For these reasons, the Reserve Bank and others have argued consistently that Australia must raise its national saving, through both private and public channels. This argument has been accepted by governments, and steps have been taken in recent years to gradually raise private saving through compulsory provisions for retirement, and public saving through reductions in the budget deficit.

The main focus is on public saving, where most of the deterioration in national saving over the past 20 years has occurred. Last year, the Federal Government's underlying budget deficit was around 2 per cent of GDP; this is estimated to decline to around 1 per cent in the current year, and to be close to balance in two years' time. In addition, the present Government has committed itself to a fiscal strategy which seeks to balance out budget deficits and surpluses over the course of the

business cycle – and thereby avoid any net increase in government debt over the course of the cycle.

If it is realised, this budget strategy, in combination with the planned increases in compulsory retirement provisions, will go a long way towards reversing the deterioration in national saving which has been on-going since the 1970s. But it will take time.

Economic Outlook for 1996/97

Turning to the short-term outlook, Australia is now into its sixth year of uninterrupted economic growth, and this phase is set to continue for some time yet. Interruptions to growth in Australia usually occur as a result of a slowdown in the world economy, or a severe shock to the domestic economy – such as a surge in spending or a blowout in wages – which threatens to bring on inflation or current account problems.

No such threats are on the horizon at this time. Although some economies in Asia are coming off the boil, the indicators for most countries, and particularly the United States, are reasonably encouraging. Our domestic forecasts suggest that 1996/97 will be a year of reasonable growth in Australia, with inflation comfortably within the 2-3 per cent target and the current account deficit relatively subdued.

The main key to achieving the 3½ per cent GDP growth forecast for 1996/97 is business investment. This is estimated to grow by 14 per cent in real terms in 1996/97, after growing by 10 per cent last year, and by 17 per cent the year before. Consumer and government spending are both forecast to grow by about 3 per cent. The current account deficit is forecast to be 4 per cent of GDP, compared with 4.2 per cent last year. Unemployment, however, is forecast to decline only slightly from its current high rate of 8½ per cent.

Underlying inflation in the year to the recent June quarter was 3.1 per cent, slightly above our 2-3 per cent target. When the figure for the year to the September quarter is released next month, however, we expect it to be well within the 2-3 per cent band, and to remain there over the year ahead. It was this encouraging inflation outlook, together with the less promising outlook for unemployment, which prompted the Reserve Bank to reduce official overnight interest rates by half a percentage point (to 7 per cent) at the end of July.

Unemployment aside, the official forecasts for 1996/97 look fairly comfortable, indicating as they do another year of 3½ per cent growth and 2-3 per cent inflation. At face value, they suggest little need for early monetary policy action. Like all forecasts, however, they are subject to many risks – in both directions. Policy makers understand these risks, which is why monetary policy remains under constant review; in their monitoring of economic developments, the Reserve Bank will be alert for any early signs that business investment or wages growth or unemployment, for example, might be diverging significantly from the current forecasts.

Developments in Financial Markets

I will end with a few comments on some developments in financial markets. Here too, major changes are evident – partly as a result of changes in the domestic economy, and partly reflecting international developments.

Over the ten years from September 1986 to September 1996, for example:

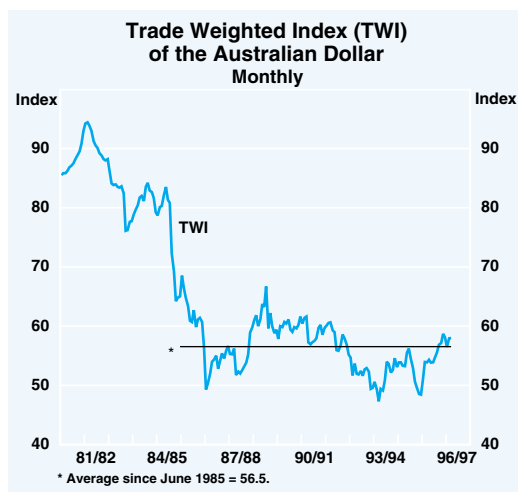
- yields on 10-year Australian bonds have declined from about 14 per cent to about 8 per cent;
- short-term interest rates have declined from around 18 per cent to 7 per cent; and
- the Australian dollar has moved from being worth around US62 cents and 99 yen ten

years ago, to around US79 cents and 86 yen today.

The much lower interest rates in Australia today reflect mainly the dramatic reduction in inflation which has occurred over the decade, and widespread expectations that low inflation has been locked in. This has reduced the inflation premium built into domestic interest rates, especially at the longer end, and allowed nominal rates to fall.

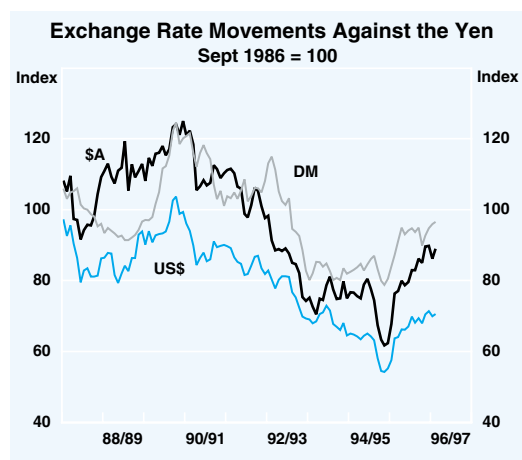
The exchange rate of the Australian dollar, in trade weighted index (TWI) terms, has fluctuated in quite a wide range over the decade, usually in response to fluctuations in commodity prices. A country like Australia has to expect considerable fluctuations in its exchange rate, notwithstanding the gradual decline in the share of commodities in total exports. Significantly, these fluctuations over the past decade have been around a flat trend (Graph 3). Although the Australian dollar has rebounded strongly over the past year, the current TWI rate of about 58 is only 3 per cent above its 10-year average (56.5).

Graph 3



Against the yen, the Australian dollar has depreciated over the past decade, but so have most major currencies. In fact, the performance of the Australian dollar against the yen over this period has not been significantly different from that of the German mark and the US dollar (Graph 4).

Graph 4



With inflation at low levels, the budget moving towards balance, substantial structural change achieved and the prospect of more to come, the Australian dollar exchange rate today looks to be more solidly based than it did a decade ago. It will – and should – continue to respond to ‘fundamental’ factors, including cyclical changes in commodity prices and interest rate differentials, but it can also be expected to be more stable in the face of other pressures than it was ten years ago.

Over the past decade, Japanese holders of Australian bonds were amply rewarded for the perceived risks they incurred. As well as receiving high coupon income, they benefited from the capital gains flowing from the large fall in long-term yields in Australia, which more than offset the effects of the Australian dollar’s depreciation against the yen. In yen terms, Japanese investors in long-term Australian government bonds would have earned 12.8 per cent per annum over the past ten years, compared with 7.1 per cent on comparable Japanese bonds. That is, after allowing for changes in the exchange rate, a large additional return would have been earned on Australian bonds. The ten-year period of this comparison was particularly favourable for Japanese investors in Australian bonds, but Japanese investors would have earned some additional returns on Australian bonds purchased in all but two of the past ten years.

Of course, to the extent that sound policies are followed in Australia, we can expect the premium paid on borrowed funds to be rather lower over the years ahead. The progress being made in this regard is reflected in the narrowing of interest rate spreads shown in Table 2. The spread on 10-year bond yields relative to the United States, for example, has narrowed from around 250 basis points a year ago to around half that margin today.

Table 2: Australian 10-Year Bond Yield Spreads

Against	Sept 1986	Sept 1995	Early Sept 1996
United States	630	250	120
Canada	460	80	60
Germany	770	220	170
United Kingdom	270	90	20
New Zealand	-160	90	-20
Japan	810	570	510

Conclusion

When I first addressed this Seminar in 1993, I offered the view that:

‘... the structure of the Australian economy is changing in ways which will create favourable investment opportunities for those prepared to see and seize them.’

I believe that view remains relevant today. We have a very different economy in Australia today compared with a decade, or even five years, ago. In particular, we have lower inflation and a medium-term policy framework to keep inflation low. This suggests that there will be further gains for those investors willing to show confidence in that framework.