AUSTRALIA'S ECONOMIC OUTLOOK: THE CLAYTON'S CRISIS AND OTHER DEBATES

Address by the Hon. Gareth Evans Q.C. M.P., Deputy Leader of the Opposition and Shadow Treasurer, to Australian Chamber of Commerce, Hong Kong, 11 June 1996

I. Where you Stand Depends on Where You Sit....

Addressing some of the cream of the world's bankers at the International Monetary Conference in Sydney on 3 June, Australia's new Prime Minister, John Howard, said this:-

> "The incoming Government inherited an Australian economy.... that was a little better than just good in parts. ... We have had 19 quarters of positive economic growth.... low levels of inflation, and we continue to enjoy the benefits.... of very close geographic proximity to the fastest growing economic region in the world."

What a difference an election win makes! We had been hearing for months that the Australian economy was in miserable shape, experiencing no more than "five minutes of sunshine" and with no underlying strength....

The truth of course was otherwise. The economy inherited by the Coalition on 2 March was one in which fundamental forces were better balanced than at any time in the last 25 years. Labor's achievement just in the previous three years (confirmed by figures released over the last three months) had been economic growth averaging 4%, underlying inflation averaging 2.5%, and the creation of 700,000 jobs - bringing the jobless rate down from nearly 11% to 8.5%, and setting us well on the way to achieving the target of 5% unemployment by 2000. Moreover, all of this was achieved at a time of weak commodity prices; of our major trading partner, Japan, being in almost continuous recession; and of severe drought.

So there is a very simple benchmark by which the performance of the new Government can be measured - the performance of its predecessor!

It is ironic that while the message was being given to the international community that the Australian economy is in good shape, a very different message has been given by the Coalition Government to the Australian public in the context of the lead up to the August budget - viz. that there is something of a crisis in the Australian economy, involving an unsustainably high current account deficit, and an excessive anticipated Budget deficit which can only be addressed by a massive and very painful Budget expenditure reduction exercise.

What, then, *are* the current strengths and weaknesses of the Australian economy at the moment - and what *are* the appropriate policy responses that should be being made? Let me begin by revisiting, in a little more detail, the basic performance indicators.

II. The Numbers

So far as growth and associated indicators are concerned, the picture *is* overwhelmingly positive. After slowing down to 3% last year, the latest (March Quarter) figures show a surge to 4.8% - although most commentators believe that a figure closer to 4% would be a more accurate guide for the year ahead. Export performance has been strong, increasing by 50% in the last five years - particularly with Elaborately Transformed Manufactures, which have doubled over that period; and commodities are expected to improve, with the significant pick up now evident in the world economy (albeit with Europe still off the pace). Investment has been picking up after a slow period, with reported intentions being for a 20% plus increase in the coming year.

Wage growth has been holding so far at around 4.5% - within the limits set by last year's Accord with the trade union movement (viz. at a level consistent with underlying inflation being maintained at an average 2-3%). The key for business is that this has been accompanied by quite extraordinary productivity gains - running at 5% according to the latest March National Accounts figures.

The sixty-four dollar question is whether this wage moderation outlook can be maintained, given the Coalition Government's deliberate abandonment of the Accord and a co-operative wages policy in order to pursue an effectively deregulated labour market, supported by major changes to long standing industrial relations legislation. There are sufficient competitive pressures at work in the Australian economy at the moment to avert a major wages breakout, however uncooperative the union movement may decide to become in the face of the assault being launched against it, but it simply cannot be assumed that an outcome of around 4.5% will be maintained. One early casualty of the Government's abandonment of wages policy was the possibility of an interest rate cut - which there was every chance of the Reserve Bank initiating two months ago had it not been expressly concerned about the wages outlook.

Unemployment continues to hover around 8.5%, unacceptably high even in an environment where every industrialised country is wrestling with a similar problem. A significant factor in explaining higher unemployment is not only technological change (which has after all been with us at least since the beginning of the Industrial Revolution) but social and cultural change, in particular the dramatically increased demand by women to participate in the workforce: if Australia had the same participation rate as the Labor Government inherited in 1983, unemployment would in fact be running now at no more than 4%!

So far as constraints to growth are concerned, inflation continues to be well under control, with the underlying rate expected, on the basis of the latest National Accounts figures, to fall below 3% in the second half of 1996. Interest rates have been stable since the end of 1994, with no official movement likely in the next few months. Most analysts have been predicting that the next move, when it does occur, will be upward, but that could be confounded if the present optimism about growth rates is not sustained, if the pressure for wage increases does not build dramatically, and particularly if a strongly contractionary Budget is brought down in August - a question to which I will shortly return.

An important contribution to holding inflation at acceptable levels has been made by the strengthened exchange rate - which has been holding at around US80c, a level which seems likely to be maintained for the medium term with the positive impact of world growth on our commodity prices, and a likely continuing significant interest rate differential.

The other main constraint to growth, the current account deficit, has been attracting significantly more attention than inflation, although the latest figures indicate that the deficit this year is likely to come in at some $7 billion less than last year, with it falling as a percentage of GDP from around 6% two years ago to a figure closer to 4.5%.

The problem with the current account continues to be not with merchandise trade, which has been more or less in balance, or even with services, but rather with net income, in particular interest payments to service debt borrowed overseas. All that said, Australia's net foreign debt is not especially dramatic by international standards - at 38.8%, it is less than in a number of other OECD countries (including New Zealand), and has only some 8.5% of it owed by the Commonwealth Government (60% being private). Moreover the debt service ratio - the proportion of our exports needed to pay interest on outstanding debt - is presently a comfortable 11.6% (way down on the peak of 20.6% in June 1990).

Apart from all these numerical indicators, there is another dimension to the economic legacy of the Labor Government which deserves to be mentioned, and that is the way in which we have created, through a whole variety of policies and programs, the capacity for both businesses and the workforce to take advantage of the growth opportunities which our fiscal, monetary, wages and savings policies have generated.

Without stopping now to spell them all out in detail, I am referring to:-

- the deregulatory and structural policy reforms implemented steadily since

1983 which have both forced, and enabled, Australian business to become much more internationally competitive;

- the business support and assistance programs, either industry-specific or more general like the 150 per cent R&D tax concession and Export Market Development Grants (EMDG), which have given crucial assistance, especially to small and medium enterprises, in encouraging both innovation and efficiency, and in getting firms into export;

- foreign affairs and trade policy, in particular in relation to the East Asian Hemisphere and the wider Asia Pacific, which has fundamentally repositioned Australia as an insider in the most economically dynamic region of the world;

- and our education, training and job readiness policies and programs, which have dramatically lifted Year 12 retention rates, tertiary participation and the capacity of Australians of all ages to meet the skills demands of the post-industrial and information revolutions we have been living through.

III. To Slash or Not to Slash: the Current Australian Economic Debate

While perfectly manageable for the present and foreseeable future, there is no doubt that it would be more comfortable for our current account deficit to be running at around 2-3% of GDP, rather than the 4.5% which it presently constitutes.

The key to achieving longer term improvement in the current account deficit is of course greater national *saving* - assuming that it is in no one's interest to go down the path of reducing domestic investment. (The economists among you wouldn't need reminding that that conclusion follows simply as a matter of basic national economic accounting principles: any excess of domestic investment over domestic saving means a requirement for outside finance; this means a net inflow on the capital account of the balance of payments; and this in turn must be matched, arithmetically, by an equivalent deficit on the current account. Our current account deficit problem is the product of our investment - savings imbalance.) Gross national saving is only around 17.5% - below the OECD average and significantly less than is prevailing around East Asia. There is general agreement that a figure about 20 % would be desirable.

Saving has both private and public sector dimensions, and over the years both have contributed to our saving problem. Private saving has been notoriously low for many years. The Labor Government made a major assault on the problem with a new national superannuation policy requiring effectively compulsory contributions from employers and employees that will build by 2002 to a total 15% of each employee's wages or salary.

In the public sector, government dissaving - through Budget deficits - was a major factor in our low saving performance (and high current account deficits) from the early 1970s to the late 1980s, but the huge effort made by the Labor Government to achieve four consecutive Budget surpluses in the 1980s turned that equation around.

Interestingly, in the context of the current Australian debate (which I will come to in a moment) the elimination of public sector borrowing was *not* reflected in any significant improvement in the current account deficit - private investment spending boomed, and private sector saving did not pick up the slack.

The truth of the matter is that simplistic "twin deficit" theories of the kind popular in the mid 1980s - that you could fix the current account deficit by fixing the Budget deficit - simply don't work in a real world where private saving and investment behaviour cannot be assumed to stay immutable. (As the old line has it, how many economists does it take to screw in a light bulb? The answer: eight - one to screw in the bulb and seven to hold everything else constant...)

It is instructive in this context to note the example of New Zealand - which seems to be most conservative economists' idea of a model of fiscal rectitude (helped by a taxation regime which, if applied in Australia, would generate us some $30 billion of extra revenue!): The latest OECD forecasts are that in 1997 it will have a larger current account deficit, measured as a proportion of GDP, than Australia! And I have just come from Malaysia, where despite a comfortable Budget surplus (and a national saving rate of over 32%), the current account deficit this year is running at a disconcerting 8.8% of GDP!

All of which brings us to the current major Australian economic policy debate - the justification or otherwise for a major slash and burn expenditure reduction exercise in the forthcoming August Budget. The new Government argues that, on current predictions, there will be an "underlying" Budget deficit of some $8 billion in 1996-7 - the so-called "Beazley black hole"; that the country's highest economic priority is to redress that with equivalent expenditure reductions; that it is only by an all-guns-blazing assault on Commonwealth government dissaving that the current account problem can be solved; and that any pain involved for particular groups will be outweighed by wider gains for the Australian community.

Our position, in opposition, is one of contesting every one of these claims. We argue that:-

- there *is* no "$8 billion black hole";

- to the extent that there may be a higher than ideal likely Budget deficit, notwithstanding five years of economic growth, this is explicable not in terms of fiscal indiscipline but rational, and defensible, policy choices;

- that there is an extraordinary degree of pain involved in the Budget cuts now being proposed, which quite apart from their macro-economic contractionary impact and their devastating impact on the careers and lives of many thousands of public servants who will lose their jobs, will decimate labour market programs, vandalise higher education, emasculate our export drive, damage our relations with our Asian neighbours (with the unilateral termination of aid arrangements), and cause pain and hurt to vulnerable and needy members of our own Australian community; and

- there will *not* be gains to outweigh all this pain: rather responsible management of the Australian economy at the present time demands a different policy approach: one that puts people first, goes for enhanced growth now, and adopts a longer time frame for addressing deficit reduction and related saving issues.

This is not the occasion to develop all these points in detail, but let me at least sketch out the major ones.

As to the "$8 billion black hole", the alleged deterioration of this order of magnitude in the starting Budget deficit for 1996-7, as compared with what was predicted at the time of last year's Budget, has always been overwhelmingly the result of changes in growth and inflation forecasts rather than any expenditure blow out. Late last year growth forecasts were revised downwards from 3.75% to 3.25%, but the most recent quarterly National Accounts figures show the economy growing at 4.8% in the year to March, and it is now clear that there will be a significant downward revision for the expected 1996-97 Budget deficit. Inflation predictions were also revised downward late last year, with significant revenue reduction consequences. If inflation were 1% higher next year, we would see Budget revenue increase by another $1.5 billion or more, but the present inflation rate is a measure of policy success, not failure: nobody seems to be proposing that the note-printers get to work to redress that particular dimension of the deficit problem!

While we don't yet have the benefits of the Government's own fully-revised forecasts following the latest National Accounts figures, we do have at lest the official "National Fiscal Outlook" figures prepared for this week's Premiers' Conference which show, even on the most cautious growth estimates, the underlying deficit (i.e. excluding asset sales, and debt repayment by the States and the like) falling to just 0.5% of GDP in three years time without any expenditure cutting at all.

As to why the Budget is, nonetheless, not in substantial surplus after nearly five years of sustained economic growth, the point should be made that this was the product not of Labor Government mismanagement, but deliberate policy choice, viz.:-

- our success in holding down inflation, eliminating the easiest revenue gains of all to achieve, those from "fiscal drag": in fact, rather than having tax increases, explicit or disguised, we had a very explicit tax cut;

- our progressive tariff reforms - which have denied us increasing amounts of revenue each year, amounting to a loss of some $6 billion in 1996-97;

- our decision to shield the States from the largest impact of the fiscal fall-out of the recession by maintaining the general purpose payments in real terms while Commonwealth revenue collapsed; and

- our decision to make, and maintain, a massive commitment to expenditure on education, training and job readiness programs, building a skilled human capital base for the future.

Even if the putative underlying Budget deficit for 1996-7 were to be something close to the $7.6 billion that the new Government announced in March, a point we don't concede for a moment, it is important to be absolutely clear that this would not in any sense constitute an economic crisis for Australia. A deficit of this order of magnitude would only be around 1.5% of GDP - and this is not massive, or even very large, by international standards. Moreover, our structural deficit - what is left when you wash out cyclical factors - is estimated by the OECD to be the second lowest (after Finland) in the OECD: ours is around one quarter of the average, and if we had the average deficit of the OECD countries our starting headline deficit in 1996-97 would be $15 billion, not the $4.9 billion presently calculated by the Government.

Some of these comparisons can't be made too often. Our public sector expenditure is the second lowest (after the USA) in the OECD; our tax/GDP ratio is the second lowest after Turkey; and our public debt in Australia is the fourth lowest in the OECD (after Japan, Norway and Finland).

If we have any crisis at the moment, it’s a Clayton’s crisis: the kind of crisis you have when you are not having a crisis.

I will not stop now to describe in lurid detail the kind of pain that is now being proposed to be inflicted - not least on business groups (through for example, the elimination of DIFF and the likely attack on EMDG and R&D programs), to meet the Coalition's $8 billion deficit reduction target. The key point I want to emphasize is that this pain is simply unnecessary, and that responsible economic management of the Australian economy does not demand that it be inflicted. An increasing number of commentators are coming to accept this view - and even to embrace what has been our argument from the outset, viz. that the whole "economic crisis/massive necessary cuts" scenario has been deliberately created by the Coalition Government for political rather than economic reasons - to ensure that Labor receive the blame for the pain involved in finding cuts to fund the $7 billion worth of irresponsibly underfunded pre-election promises, and more generally, the implementation of a Thatcherite small-government ideology.

But back from the politics to the economics. The point that needs to be driven home is that a major contractionary exercise of the kind on which the Coalition Government has embarked is simply not economically necessary, and not economically responsible.

What the economy needs now is not $8 billion worth of fiscal contraction but to consolidate the gains of almost five years of economic growth, and make a major new assault on unemployment, by ensuring that the economy holds to a growth rate of 4 per cent or better.

Until the March Quarter, the Australian economy had been growing over the last year at an annual rate of around 3 per cent. We are one of the fastest growing economies in the OECD. But 3 per cent growth is not enough to cut unemployment. To reduce that further Australia needs growth of around 4 per cent. It may be that the March figures demonstrate that we are now running at 4 per cent or better, but that rate has to be sustained.

Private sector economists, including Westpac and Access Economics, estimate that the Government's cuts will mean 0.5 per cent less growth next year, and a further 0.5 per cent less growth the year after that. Instead of working to help the economy maintain 4 per cent or better growth, the cuts will actually work in exactly the opposite way - against the maintenance of strong economic growth.

All this cut in economic growth will translate into lower jobs growth. We can easily quantify it: taking 0.5% off growth next year will mean that over 40,000 jobs that could have been created next year will not now be created, and over the next two years the Government is throwing away the opportunity to create more than 80,000 jobs.

There is very little scope for other economic forces - in particular interest rates, the exchange rate and "confidence" factors - to come to the rescue and offset the impact of the Government's planned cuts on the economy.

The effects of a fiscal contraction on economic growth could be offset in an environment where interest rates were falling and the exchange rate was depreciating. However, the Government is planning its cuts in an environment where (because of its abandonment of the Accord and wages policy) interest rates are more likely to rise than fall. A depreciation in the exchange rate, which might in the normal course be expected to follow from an interest rate cut, would make Australian goods more competitive on world markets and so boost our exports, but in the real world at the moment the exchange rate is being driven up because of expected increases in commodity prices.

The effects of the fiscal contraction might also be offset if somehow the cuts were to translate into a massive rise in consumer and business confidence. But these are already high, so any further boost in confidence would have at best only a marginal impact on the economy. The latest figures show that business is planning to increase its investment spending by around 20 per cent in the coming year. With business investment expectations already so buoyant, there simply is not the scope for an additional increase in private investment of the kind of magnitude that would be sufficient to soften the blow of the proposed Budget cuts on the economy.

The only possible justification for further Budget cuts takes us back to where I began - with the argument that Australia needs more national saving, and that the Government has to contribute to this task by reducing the Budget deficit. But while one can readily agree with an enhanced national saving objective, an unbalanced approach to economic management is not the way to go about successfully achieving it. The best way to get more national saving is to have a strongly growing economy, which means that people have the extra income to build their private saving. More economic growth means more people in jobs and less government spending on unemployment benefits - with more tax revenue, less expenditure, and more public saving. There is a very strong and clear relationship between unemployment and national saving: the best way to get national saving up is to get unemployment down.

It is crucial in economic policy, as everywhere else, not to confuse means and ends. The first priority for economic policy should always be people. The objective is to improve people's living standards - through providing sustainable full employment and rising incomes. Everything else - controlling inflation, reducing current account deficits, bringing Budgets into surplus, reducing public debt, reducing foreign debt and improving saving - are all second and third order objectives by comparison. They are means to the achievement of the primary objective of improving people's living standards.

There are times - real crisis times - when absolute priority attention has to be devoted to bringing inflation under control, or hauling back absolutely unacceptable levels of current account deficit. But that is not the situation of the Australian economy at the moment in the view of any serious-minded economic commentator. Inflation is comfortably within the average 2-3 per cent range; the current account deficit has been reduced from 6% to 4.5% of GDP and is being comfortably serviced at present and foreseeable export levels.

So it is not necessary at the moment to mount a Vietnam-like crusade - to destroy the economy in order to save it. It is possible, while being absolutely economically responsible, to choose a different path. We in the Labor Party say the priority choice for economic decision makers in Australia today should be to ensure that growth of the order of 4% is achieved and sustained, and to make, accordingly, a new assault on what is the only really worrying problem in the Australian economy today: unemployment.

Unfortunately, as a result of the turn of the democratic wheel, my Party is not presently in a strong position to translate these principles into practice. But, let me tell you, we are working on it!