

# Introduction

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Harold Wilson's dictum that a week is a long time in politics surely does not apply to economics. The significance of economic events often remains opaque at the time, and the process of separating the important from the ephemeral requires a period more like a decade than a week.

This volume examines developments in the Australian economy over the decade of the 1990s. In what ways was the decade different from its predecessors? What were the economic successes, and why did they occur? What aspects of the Australian economy were less successful? What are the prospects for the future?

The papers in the volume were commissioned by the Reserve Bank to address these questions. They focus on topics that have been of particular importance for the Australian economy in the 1990s.

## The International Environment

The economic landscape has changed quite considerably over the past decade, both within Australia and internationally. A recurring theme in discussions about the international economy a decade ago was the unprecedented success of the Japanese economy. Having witnessed this success over the whole post-World War II era, most observers a decade ago could see no reason why it would not continue. Indeed, it was widely argued that continuing Japanese economic success, in one industry after another, would come at the expense of the economic fortunes of other countries, notably the United States.

The experience of the 1990s has not been particularly kind to this crystal-ball-gazing exercise from a decade ago, to put it mildly. With the benefit of hindsight – that most powerful of analytical tools – it is now clear that the Japanese economic boom of the late 1980s led to an unsustainable bubble in asset prices. The bursting of that bubble in the early 1990s ushered in a period of economic stagnation that has lasted the whole decade and may only now be coming to an end.

By contrast, expectations formed a decade ago about prospects for the United States have turned out to be unduly pessimistic. The widespread expectation at the start of the decade was that the US economy would continue to grow at about the  $2\frac{1}{2}$  per cent annual rate that had been experienced in the 1970s and 1980s, as Bradford DeLong notes in his paper in the volume. But annual US growth over the 1990s was closer to  $3\frac{1}{2}$  per cent, and in the second half of the decade, above 4 per cent. Of equal significance, the sustainable rate of unemployment in the US at the end of the 1990s appeared to have fallen to levels previously thought to be unattainable.

Furthermore, the acceleration in US productivity growth in the second half of the decade has generated a rising level of optimism about the future, not only in the United States, but elsewhere as well. There are those who remain sceptical about the

extent and durability of the pick-up in productivity growth, since it has been observed primarily in the relatively small part of the US economy that *produces* computers and computer-related equipment, rather than in the rest of the economy that *uses* this technology. Nevertheless, most commentators share DeLong's optimistic perspective that the Solow paradox – 'you can see the computer age everywhere but in the productivity statistics' – may be in the process of being resolved.

A decade is indeed a long time in economics.

And yet there are aspects of the US economic experience in the latter part of the 1990s that may not be so benign. Are there some echoes of the Japanese experience in the late 1980s present in the US a decade later? For example, some analysts were of the view in the late 1980s that Japan was in the midst of a structural acceleration in productivity growth, as William White points out in his comments in the volume. Furthermore, by the year 2000, both the US stockmarket and the US dollar had reached levels that seemed unlikely to be sustained. Were a stockmarket correction to lead to a faltering in US growth, the implications might not be so benign for the rest of the world, especially for those English-speaking countries like Australia with business cycles so closely aligned with the US cycle.

## **The Australian Economy**

### **The macroeconomy**

Macroeconomic developments in Australia in the 1990s have turned out to be more favourable in many ways than would have been expected at the beginning of the decade. Economic growth averaged 3½ per cent, and over 4 per cent since the trough of the recession in mid 1991. Living standards, as measured by per capita GDP, improved at a rate not seen since the 1960s – a result shared only with Ireland among industrial countries. Inflation averaged 2½ per cent, again a return to a performance not seen in Australia since the 1960s. By contrast, the performance on unemployment was not so good; unemployment was higher on average than in any previous post-World War II decade, although by the end of the 1990s, it had declined to within sight of previous cyclical lows, with the prospect that it could decline further still.

In reviewing the 1990s, it is of interest to compare developments with those of the previous decade. In 1990, the Reserve Bank convened a conference on the Australian macroeconomy in the 1980s. The papers in that conference volume examined the macroeconomic policy issues of most importance at the time. Some of the topics that were then the focus of attention remain of central interest today, and they form the basis for some of the papers in this volume. Over the intervening ten years, there have of course been significant changes in institutional arrangements, economic outcomes, and the concerns of policy-makers and analysts, and this volume reflects those changes.

The paper on the labour market in the 1990 volume focused on the Accord, the incomes policy that formed the centrepiece of Australian macroeconomic policy for much of the 1980s. The key development in the 1990s has been the gradual move

away from centralised wage-fixing arrangements to a more decentralised enterprise-based focus. This gradual transition, its implications for real wages and unemployment, and the case for further deregulation of the labour market, perhaps in concert with explicit measures designed to reduce (after-tax) income inequality, are taken up in the paper by Peter Dawkins in this volume.

A decade of current account deficits averaging  $4\frac{1}{2}$  per cent of GDP and the associated sharp rise in external liabilities convinced many policy-makers by the end of the 1980s that the state of the external accounts was perhaps the most important economic issue facing Australia at the time. The 1990 volume tackled this issue from two perspectives, with a paper on the balance of payments, and another on developments in national saving and investment.

Concern about the current account and the build-up of Australia's foreign debt probably reached a peak around the time of the 1990 conference. Over the ensuing decade, the current account deficit again averaged  $4\frac{1}{2}$  per cent of GDP, as it had in the 1980s. As a consequence, debate about the appropriate public policy response, if any, to the sustained current account deficit did not go away over the course of the 1990s – indeed it grew in intensity whenever the deficit was rising as a proportion of GDP. But there were gradual shifts of view and refinements of argument. The evolution of this intellectual debate over the past two decades is taken up in the paper by David Gruen and Glenn Stevens.

A further manifestation of concern about the current account has been the widespread support throughout the 1990s for the proposition that saving in Australia is less than its optimum. This proposition has been supported by the observation that saving rates in Australia have been in long-term decline, that Australia's national saving is low by international standards, and that prospective population ageing implies increased saving requirements. Malcolm Edey and Luke Gower discuss these longer-term trends in saving and their public policy implications in their paper.

The final elements of the 1990 volume's review of the Australian macroeconomy over the previous decade were papers on money and finance, and inflation. Monetary policy in the 1980s had been dominated by the complexities that financial deregulation had brought for the relationships between monetary aggregates and nominal income. Inflation had been fairly steady throughout the decade but, at an average 8 per cent rate, was well above the rates of inflation experienced by most advanced industrial countries at the time.

Although it was not clear at the turn of the decade, inflation was soon to fall sharply, to rates not seen since the early 1960s. Paul Kelly, in his contribution, argues that the subsequent gradual introduction of the medium-term inflation target – from the nomination by then Governor Bernie Fraser in 1993 of an average inflation rate of 2–3 per cent as an appropriate aim, to the gradual acceptance of the Bank's position by both sides of politics, to the formalisation of the policy in 1996 – represents one of the most important economic policy developments in the 1990s.

It has meant that the business cycle expansion of the 1990s was different from the one in the 1980s, because it was based on low inflation and therefore offered the potential for greater longevity than the 1980s expansion. But Kelly cautions that,

despite its success over the seven years since its inception, the permanence of the inflation-targeting framework should not be taken for granted. Macroeconomic outcomes have so far been good, and so it has yet to be faced with a stern test.

Despite the relatively short history of inflation targeting (the first inflation-targeting regime began in New Zealand about a decade ago), it is a framework that has already made its mark as an important intellectual advance in the design of monetary policy. Of course, it was not developed in an intellectual vacuum – it was instead a response to the perceived shortcomings of alternative frameworks for monetary policy. It is therefore of interest to examine, especially with the benefit of hindsight, the development of earlier intellectual advances in macroeconomics and monetary policy, a task tackled by Robert Leeson in his paper.

Leeson focuses particularly on the contributions to macroeconomics made by Milton Friedman and AW (Bill) Phillips. He argues that a careful reading of their original works demonstrates that the subtlety of their arguments was often lost (sometimes deliberately) in later summaries of their contributions. For example, Leeson argues that, notwithstanding the caricature of his position by later critics, Phillips was keenly aware of the dangers inherent in attempting to exploit the short-run trade-off between inflation and unemployment that bears his name. In Leeson's view, the mistaken belief that this trade-off could be exploited led to one of the most serious macroeconomic policy errors of the post-World War II era.

## **Microeconomic reform**

One of the enduring features of the Australian economic landscape over the past two decades has been the gradual implementation of a widespread program of microeconomic reform. The major reforms over this time include the dismantling of barriers to foreign trade, financial deregulation, corporatisation and privatisation of government business enterprises, competition reform including new regulatory arrangements for natural monopoly utilities, and labour market reform. (One could add the floating of the dollar to this list, although it is more natural to think of it as a macroeconomic reform.)

Most microeconomic reform is designed to improve economic efficiency, and there has been a longstanding expectation that the reform undertaken in the Australian economy would lead to an improvement in productivity growth. The evidence from the 1990s is that this improvement seems to have occurred. Whether examined for the market sector of the economy (which accounts for about two-thirds of the economy because it excludes those industries for which output is derived directly from inputs) or for the whole economy, measures of labour and multifactor productivity for the business cycle expansion of the 1990s show stronger growth than for any comparable period since the 1960s.

Most commentators, including Charles Bean, Peter Forsyth, David Gruen and Glenn Stevens, and Richard Snape in their contributions, attribute much of this improvement in productivity growth to the broad range of microeconomic reforms over the past two decades. While it is not possible to draw a direct link between particular reforms and the economy-wide improvement in productivity, the timing

of the productivity acceleration is suggestive that it was a consequence of microeconomic reform.

This interpretation stands in contrast to the explanation for the productivity acceleration in the United States over the past five years. The US experience is widely thought to be a consequence of the 'new economy', associated with heavy investment in computers, computer-related technology and the internet. While the 'new economy' may significantly boost Australian productivity growth in the years to come, there is little evidence that it has done so over the 1990s, as both Charles Bean, and David Gruen and Glenn Stevens conclude in their papers.

One of the sectors experiencing particularly extensive reform and deregulation in the 1980s was the financial sector. Marianne Gizycki and Philip Lowe argue in their paper that this deregulation now looks much more successful than it appeared a decade ago. In the early 1990s, deregulation appeared to have delivered relatively little, other than a speculative boom in commercial property prices and a lot of wasted investment. Over the remainder of the 1990s, however, the allocation of resources for investment appears to have been much more soundly based. Furthermore, strong competitive pressures – brought to the marketplace by new entrants rather than the existing incumbents – have delivered substantial benefits to consumers. Examples of these benefits include a fall in the interest-rate margin charged on housing loans from around 4 percentage points in the early 1990s to around  $1\frac{3}{4}$  percentage points at the end of the decade, and a fall in the commission charged to retail investors for share transactions from 2 per cent in the early 1990s to as low as 0.1 per cent today.

Broader issues concerning the whole range of microeconomic reforms are taken up by Peter Forsyth in his paper. In his judgement, the benefits of reform have been substantial and have accorded quite closely with what had been expected. But he cautions that the benefits have been unevenly distributed – as was also to be expected, although this aspect of reform was less often highlighted. Consumers have usually benefited, although in some cases reform has required them to conduct more extensive search for suitable products and services than was previously necessary. Taxpayers have also benefited, especially with the improved performance of public enterprises. Workers in industries subject to significant reform or deregulation, however, have often lost out, through job losses and more demanding working conditions. Looking to the future, many of the sectors of the economy where performance could be improved are those that pose particular difficulties in the design of appropriate reform; these include education, health and infrastructure.

An alternative overview of microeconomic reform in Australia is presented by John Quiggin, who argues that one of its most significant effects has been to substantially increase unmeasured work hours and work intensity. Although he is hampered by a lack of data, Quiggin presents some guesstimates of the extent of the increase in work intensity, and argues that if these numbers are realistic, then the improvement in measured productivity in the 1990s is illusory as it can be explained entirely by increased work intensity. Quiggin also argues that there has been widespread community opposition to microeconomic reform, which he views as being a consequence of the increased work effort that has been required from the workforce.

## The future

Crystal-ball gazing is a hazardous exercise, even when times appear tranquil. The experiences of Japan and the United States in the 1990s that were discussed earlier provide support for this proposition, if any were needed. And yet, several brave souls have been willing to commit to paper their visions of what may be the important and distinctive features of the Australian economy in the coming decade.

Had one engaged in such an exercise at the beginning of the 1990s, one would not have expected that economic outcomes in Australia would turn out as well on so many fronts as they did, an observation that Ross Gittins finds encouraging when he considers the prospects for the coming decade. He nominates fiscal policy as an area in which there will be particular challenges ahead. While The New Tax System represents, in his view, a structural improvement in fiscal policy that should generate buoyant growth in government revenues in the years to come, there will be areas of spending in which growth will be particularly hard to restrain, including defence, education and health care. Yet Gittins argues that there are grounds for optimism because, despite signs of 'reform fatigue', governments understand that they will not survive if they simply preside over changing circumstances – instead, they must be seen to be tackling the important public-policy issues of the day.

Although the overall performance of the Australian economy was impressive in the 1990s, some aspects of that performance were more worrisome. Among these were the relatively sluggish growth of full-time employment, the rising share of welfare recipients in the community, and the increase in inequality of earnings throughout the decade. Bob Gregory, in his contribution to the volume, argues that these trends represent grounds for concern about the future. Aside from a concern for equity in its own right, it may be that for economic reforms to have a long-run chance of surviving, they must be seen to be inclusive and to benefit a broad cross-section of the community.

Before looking forward, Rob Ferguson looks back and celebrates those aspects of societal change and technological advance that have transformed Australia for the better over the past few decades – changes that have enriched the culture, enhanced its diversity and reduced, if not eliminated, the 'tyranny of distance'. He takes issue with a prominent fear about the future, that globalisation will generate an exodus of talented people and head offices away from cities (or countries) on the world's periphery; a development he dubs 'the Adelaide effect'. Challenging this pessimism, he argues that globalisation provides more opportunities than threats, and that Australia must continue to demonstrate its capacity to thrive in this new world.

Based on the recent performance of US productivity, and an assessment of the portability of this improved performance to other countries with similar institutions and industrial structures, one can be optimistic about the prospects for strong productivity growth in Australia over the coming decade, as Bradford DeLong suggests. If this analysis turns out to be correct, it seems plausible that this improved performance will occur on the back of heavy investment in computer-related

technology, as it has in the United States. With greater requirements for investment, however, Australia may well experience, in DeLong's view, another decade of high current account deficits, similar to the previous two.

Another place to search for clues about the future is in countries that have had similar experiences to those of Australia. The state of the British economy in the late 1980s bears some resemblance to the current state of the Australian economy, as Charles Bean argues in his paper. Britain at that time had experienced an extended period of strong economic growth and declining unemployment, and measures of productivity suggested a structural improvement on the back of significant microeconomic reform. Households' balance sheets had expanded rapidly, with a big rise in indebtedness funding sharp increases in the real value of housing. The 1980s upswing in Britain ended unhappily, however, with a sharp economic downturn, precipitated in part by a rise in saving as households came to realise that their expectations of income and asset-price growth were unrealistic.

As there are echoes of these developments in the long 1990s expansion in Australia, the British experience early in the decade should serve as a cautionary tale for Australia. But while the comparison is instructive, Bean stresses that it should not be taken too far. The signs of excessive optimism about the future were clearer in Britain in the late 1980s than they are in Australia currently, and furthermore, there were constraints on both monetary and fiscal policy in Britain a decade ago that should not apply to Australia.

Overall then, the Australian economy performed well in the 1990s, both compared to its past and to the experiences of other countries. The gradual relative economic decline that had been a feature of so much of the 20<sup>th</sup> century – and had been the cause of so much soul-searching about Australia's perceived inadequacies – was not in evidence in the 1990s. Instead, Australia often found itself among a small group of countries, including the United States and a few smaller European countries, whose performance others sought to emulate. Although economic outcomes were not impressive on all fronts – with rising inequality being an obvious more worrisome development – the notable successes of the Australian economy in the 1990s suggest that there are good reasons to be cautiously optimistic about the future.