

I J Macfarlane: The Australian economy - past, present and future

Talk by Mr I J Macfarlane, Governor of the Reserve Bank of Australia, to 2002 Melbourne Institute Economic and Social Outlook Conference Dinner, Melbourne, 4 April 2002.

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It is an honour to be invited here this evening to give this address, although I must confess I am somewhat daunted by the task. We have heard so much in this conference on such a broad range of economic subjects by such a distinguished group of speakers that I have been presented with a difficult act to follow. I have also been given a very broad topic, so I will have to confine myself to making only a few comments on each part of it.

I would like to start with the proposition that Australians, on the whole, tend to be pessimists about the country's economic situation and about its future. This is not always the case as there are occasions, such as the present, where a degree of optimism breaks out, but these are the exceptions rather than the rule. While Australians are often optimistic about their personal economic prospects, they are seldom so about the economy's prospects. I have spoken about this before and produced various pieces of anecdotal evidence to support my view. More objective evidence is available in the form of answers to surveys¹, which show a clear propensity for respondents to judge the economy more harshly than their own economic prospects (about which they presumably know more).

Why is there such low confidence in our economic situation, even by people who are reasonably confident about their own economic circumstances and prospects? The usual answer is to blame the press, but I think this is a bit superficial. The allegation is true in only one sense: there are a lot more economic stories on the front pages of newspapers in Australia than in other countries. And since there is a natural tendency for the press to give more prominence to bad news than good – just as we hear more about war-torn countries than peaceful ones – this tends to increase people's exposure to bad economic news.

The Past

I think a deeper answer to why we tend to be pessimistic is to be found in our attitude to our economic past, which tends to be dominated by a strong element of nostalgia. While in other areas of our political and social history we may be revising downwards our assessment of our forebears' achievements, this is not so in the economic sphere. There is still a tendency to look back favourably on the economic peace and certainty of the past and contrast it with the perception of insecurity and instability that surrounds the present economy. Why is this so?

- (a) Those who know a little bit of history are aware of the fact that in about 1900 we were probably the richest country in the world in terms of income per head. Now we are in the middle of the pack of developed OECD economies. So this gives the impression of a country in long run decline, but from a somewhat artificial starting point. We were the 'Kuwait of 1900': a country with a very small population and a large resource endowment producing commodities which were very highly priced at the time. But like any prosperity based on scarcity prices it could not last², as the decline in our terms of trade during the century showed. I will return to this theme when I discuss the future.

¹ There are three surveys which ask respondents to report their confidence in (a) their own personal economic situation and (b) the state of the economy; these are the Westpac-Melbourne Institute Consumer Sentiment Index, the ACCI Survey of Investor Confidence, and the Yellow Pages Business Index. All three surveys show that nearly always the majority of respondents show less confidence in the economy than in their own personal economic position. In 97 per cent of occasions this is true for the Westpac-Melbourne Institute and Yellow Pages surveys, and on 94 per cent of occasions it is true for the ACCI Survey.

² An extreme example of changing economic fortunes as a result of changing terms of trade comes from 18th century French history, and the contrasting attitude of France to defending its two main American colonial possessions – Canada and Haiti. Canada was given up with relatively little resistance, but two costly wars were fought in a vain effort to retain Haiti. The ranking of Haiti as more valuable than Canada was purely an economic one based on the high price of sugar two hundred years ago. A similar story involves the English and the Dutch in the 17th century. Under the Treaty of Breda of 1667, the Dutch gave up their claims on Manhattan to the English in order to retain the island of Run (in what is now Indonesia). The superior value they placed on Run was due to it being the principal source of nutmeg.

- (b) For others, the nostalgia is directed at the 1950s and 60s. There is no doubt that around the world this period of post-war reconstruction was a 'golden era' for economic growth that had not been seen before or been equalled since. But we should remember that the Australian economy did not keep up with the rest of the world during this period: the growth in GDP per capita was lower than the OECD average in the 1950s and 60s. We also tend to underestimate just how poor we were compared with what we take for granted now. Much of the post-war housing expansion into the newer suburbs involved building two-bedroom-one-bathroom houses with external toilets: sealed roads, sewerage and telephones came years later. There are many other examples of the difference in living standards I could quote.

The Present

By the present I mean the economic expansion over the past decade which we are currently still experiencing. Fortunately we do not view the 1970s and 1980s with much nostalgia, so most people are willing to accept that the current expansion represents an improvement compared with those earlier decades. This can be seen in that:

- (a) The current expansion is longer. So far it has lasted for 41 quarters compared with 31 and 28 respectively for the expansions in the 1970s and 1980s.
- (b) Our rate of growth of productivity has picked up compared with earlier decades. We are one of a very small group (about 5) of OECD countries to have achieved this.
- (c) We have weathered two quite large contractionary external shocks without significant adverse effects. I am referring here to the Asian crisis of 1997/98 and the world slowdown/recession of 2001.
- (d) There is evidence to suggest that some economic distortions that seemed to be entrenched have been removed or at least improved. The most obvious of these is the reduction in inflation from the very high rates of the 1970s and the quite high rates of the 1980s. Indeed, if we had not succeeded in regaining low inflation in the 1990s, we would have had no hope of achieving the long economic expansion we have had. There has also been some success on the balance of payments. It is now clear that the pronounced deterioration in the external accounts occurred during the 1970s, reached a plateau from the early 1980s to the present, and may have shown its first, although tentative sign of improvement over the past few years. There is also evidence that progress is finally being made on unemployment, a subject I would like to cover in a little more detail.

There were international recessions in the early 1970s, 1980s and 1990s. We have also just been through one in the early 2000s, although economists are still debating whether it was deep enough to be added to the list of its three predecessors. In the 1970s, 80s and 90s, Australia also experienced recessions roughly co-incident with the international ones. On each occasion our unemployment rate rose sharply – to 6.5 per cent in the 1970s, to 10.3 per cent in the 1980s and to 10.8 per cent in the 1990s. While we were able to reduce the unemployment rate during the later expansionary phases, each recession pushed it up again to a new peak (see Table 1). The real story behind the upward trend in unemployment was the shakeouts that occurred during the recessions, not the insufficiency of the growth rate during the expansions.

Table 1
Unemployment rate in recessions

	Rise in unemployment (percentage points)	Peak level (per cent)
1970s	4.9	6.5
1980s	4.8	10.3
1990s	4.8	10.8

During the international downturn/recession of 2001, Australia was able to avoid a recession so our expansion is still proceeding. Nevertheless, there was some slowing in the pace of economic growth and the unemployment rate rose by about 1 percentage point. Although I am always wary of counting chickens before they hatch, it now appears that over the past six months the unemployment rate may have peaked at, or a little above, 7 per cent. If this is the outcome, it will be the first time for three decades that we have been through an international downturn that has resulted in the peak unemployment rate in Australia being lower than its predecessor.

I hope that I am not premature in making this assessment, and am aware that it could all be unwound if we encountered a recession in the near future. But that is not likely in my view, at least not in the forecasting horizon. If my assessment is correct it will reinforce the view that the principal contribution that macroeconomic policy can make to reducing unemployment is to have the longest expansion possible (but not the fastest), and to have the mildest slowdown. It also suggests that the reduction in unemployment to an acceptable rate is a task that was always going to take longer than the timeframe encompassed by a typical economic expansion.

The Future

As you can see from the foregoing, I think Australians have tended to be quite hard on themselves when making judgements about the economy. This has its good side of course, because it has meant we have been more prepared to take tough decisions than many other countries, particularly European ones, when it comes to reducing government debt, opening up the economy, privatising, deregulating the labour market and imposing stricter competition standards.

When we look to the future, I see no need for us to retain our long held pessimism about our country's economic future. For a start, we should gain some comfort from the fact that in economic terms, there was a clear improvement from the 1970s to the 1980s and an even bigger one to the 1990s. This is true in absolute terms and even more so in relative terms: the 1990s was the first decade that we clearly grew faster in income per head terms than the OECD average. We should not be looking at ourselves as one of the laggards, but as one of the few pacesetters among developed OECD countries.

What about the longer-run trends? There is still a feeling in many quarters that "we were dealt a good hand to play in the world economy of 1900, but a bad hand for the world economy a century later". This is tied up with the view that we are mainly good at exporting resource-based goods (in which I include mining, metals and agriculture), and hence our terms of trade are bound to continue the deterioration that started a century ago. I think this fatalism is misplaced for two main reasons.

The first and conventional response to this charge is to point out how the economy is changing, and in particular, how we are diversifying our export mix. Over the past sixteen years, the fastest growing categories of exports in real terms have been manufactured exports and exports of services. The annual growth rates of each category of exports is shown in Table 2. We all know of some success stories, but each one is relatively small in itself. What we don't tend to realise, is just how many there are, and how widespread they are.

Table 2
Growth rates of export volumes
 1985 to 2001 – % pa

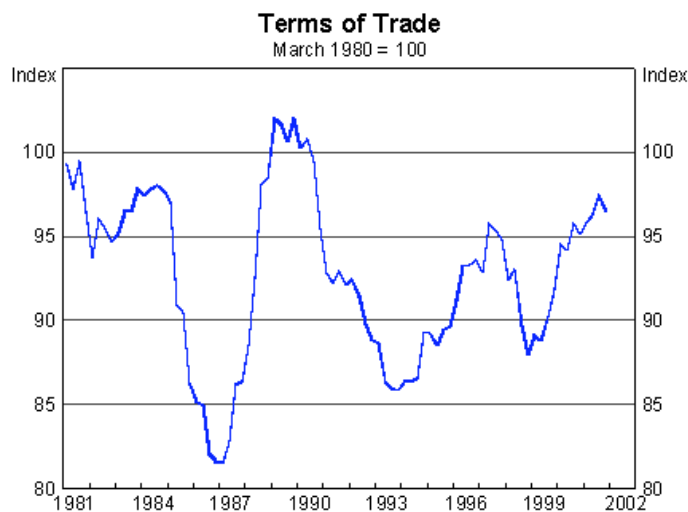
Manufactures	12.4
Services	7.5
Resource-based of which:	
– minerals and metals	6.4
– rural	3.4

There is a second and more interesting response, however, than the conventional one, and it is one I would like to spend a bit of time on. It concedes that even with export diversification occurring, we are still going to be a country with a high proportion of our exports coming from the resource sector. In twenty years of diversification, the proportion of exports, which is resource-based, has fallen from nearly 80 per cent of the total to 60 per cent of the total at present. This is still very high by the standards of an OECD country, and even if it goes down to 50 per cent in another fifteen years, it will still be high by the standards of developed countries. Is this something we should worry about?

A lot of people would say yes, because resource-based goods are "commodities", and this means their prices will fluctuate widely in a cyclical sense, but more disturbingly, their trend will continue to show a long-run decline. This is the same assumption I have referred to a few times in my talk, namely, our terms of trade will continue to decline.

But I think we have to doubt this assumption. The products whose prices will show long-run declines are likely to be those whose production can be expanded most easily. And nothing fits this description better than large areas of manufacturing. Governments around the world, particularly in Asia, are competing to build larger and larger plants, and companies from developed countries are assisting them through private direct investment. We all know how far the price of computer chips has fallen, but this is only one example of many. Large areas of manufacturing, such as textiles, clothing, footwear, electrical equipment and even automobiles have shown downward trends in prices. These are precisely the sorts of things that we in Australia import, and increasingly what developing countries export. In a recent study, the World Bank pointed out that manufactures now make up 80 per cent of developing country exports, compared with only 25 per cent as recently as 1980.

Over the past three years the prices of 26 out of 29 categories of our imports have fallen (when adjusted for exchange rate effects). In other words the stigma of the word 'commodity' could now be more appropriately applied to our imports than to our exports. This may be the reason that for the first time in memory, our terms of trade actually rose during a world recession (i.e. over the past three years). It is also consistent with the fact that the low point in our terms of trade was in 1986: there have been cyclical lows since, but they have been at successively higher levels.



Now I don't want to get into an argument about whether it is better to put our scarce investment resources into the resource sector or into the manufacturing sector. In fact, I would strongly resist the government setting out to decide the answer to this question. All I am saying is that we shouldn't assume that our future is unfavourable just because we happen to have started with the industry mix we have. A corollary of my view, of course, is that it would be very unwise for the government to provide incentives for the private sector to move out of one activity into the other. It could easily end up being seen the same way as the decision of the South Australian authorities in 1986 to pay grape growers to pull up their red wine vines (some of which were the now highly-prized old growth shiraz) and get into something more promising.

We have had a history of being told that we have the wrong model for our economy, and that we should change it to the one currently in vogue. I can remember in the 1970s when the continental European (including Swedish) model was seen as the way forward. In the 1980s there were numerous books and articles predicting that Japan would soon overtake the US as the world's largest economy, and by implication that its corporatist approach was superior to more market-based approaches. In the first half of the 1990s Australia was regularly criticised for lacking the vigour of the emerging-market Asian economies (the Tigers) with their activist government-led development approach.

In the past few years, it has been American triumphalism. The extreme expression of this was the recent infatuation with the 'New Economy' and denigration of activities regarded as 'Old Economy'. Two years ago at the World Economic Forum meeting in Melbourne, Australia was being heavily criticised for not making enough of the IT and telecommunications investments that are currently being written off by the former stars of the NASDAQ. As you can gather from the above, I am extremely sceptical that we can identify a 'new economic model' and have the government move us to it. But, on the other hand, I recognise that as a country we have to be continually adapting in order to exploit emerging economic opportunities, including at the more sophisticated and high-value added end of the spectrum.

This is a job not just for the private sector, but a challenge for public policymaking. Among the purely economic policies with which I am familiar, such as monetary policy, fiscal policy and financial supervision, I think there has been enormous improvement over the past decade or two, and we can claim membership of the relatively small group of countries that represent world best practice. But good economic performance as we move into the future will depend on more than purely economic policies; it will depend on the incentives provided by our whole political, legal, social and educational environment. It is somewhat disturbing therefore to read the recent assessment by the Vice-Chancellor of Melbourne University that Australia no longer has a university that could be ranked in the top one hundred in the world. I have no reason to dispute his opinion as I have heard similar views from other academics. What it suggests is that, although we have made great progress in the breadth of our education system, we cannot make the same claim about the depth. At the highest level of higher education we are not keeping up.

I am usually reluctant to stray into areas of public policy outside my immediate area of expertise, but I am prepared to do so tonight in keeping with the broad range of issues discussed at this conference. I do not have a shopping list of suggestions, but I am happy to conclude my address tonight with a plea to all those involved in higher education – governments, bureaucrats, academics and their spokespersons, taxpayers and businesses to do something about this situation. The remedy will almost certainly involve the overthrow of some long-held conventions that attempt to impose uniformity. It will probably also elicit the old catchcry of 'elitism', but far better that, than the complacency which accepts that our higher education can slip further behind world best standard.