

The Economy and Wages

Talk by Deputy Governor, Mr I. J. Macfarlane, to the Metal Trades Industry Association's National Personnel and Industrial Relations Group Conference, Canberra, 2 May 1996.

I would like to start by saying how much I appreciate the opportunity to speak to you this morning. Monetary policy in Australia, as in other countries, is increasingly focussed on the need to maintain low inflation, as we see it as a condition for continued growth. But it does not operate in a vacuum. It is important that we at the Reserve Bank spell out our message clearly, and that we speak directly with important price and wage setters in the community. That is why I was only too happy to accept Bert Evans' invitation to address the Metal Trades Industry Association today.

I want to spend a fair bit of my time talking about the economic environment of the 1990s, both in Australia and for the world as a whole. In particular, I want to remind you that we now live, work and aim to sell our output in a world which is characterised by low inflation and relatively low pricing power by business and labour. People who fail to recognise this, and who slip back into the habits of thought of the 1970s and 1980s, will pay a heavy price, and, by extension, so will the whole community.

The World Economy

The aspect of the world economy that is most relevant as a background to wage bargaining in Australia is the trend in inflation and wages. Here the picture is uniformly one of restraint. Inflation in major countries is back to the rates of the 1950s and 1960s, if not below them.

Table 1: Consumer Prices
(Year-ended percentage change
to most recent available month in 1996)

Australia	3.3	Japan	0.2
Austria	2.3	Netherlands	2.1
Belgium	1.6	New Zealand	2.1
Canada	1.6	Norway	1.1
Denmark	1.8	Spain	4.2
France	2.1	Switzerland	1.2
Germany	1.7	United Kingdom	2.9
Ireland	2.1	United States	2.8
Italy	5.6		
		Average	2.4

Source: OECD.

Two conclusions that come from Table 1 are:

- the average rate of inflation over the past year was 2.4 per cent, which is the lowest for 30 years; and
- the range around this average is very tight. Nearly everyone is within a percentage point of the average (the main outlier in the upward direction is Italy, and even it has had its lowest rate for 15 years).

There are a number of factors which underlie this low inflation, but there is not time to give a dissertation on them today, other than to say that the two most important are probably (a) increased competitive pressures as economies have become more open and as domestic competition has intensified, and (b) a determination by central banks to run firm monetary policy. They are still smarting from the criticisms they received during the 1970s and 1980s for being too lax, and are determined not to make that mistake again.

The recent record on wage increases in major countries is quite similar to that for prices in that they have slowed to be at their lowest rate for a couple of decades (Table 2). Virtually every country reports that its inflation performance is not being threatened by wage pressures, and the figures bear this out. The average increase in wages for these countries is less than 3 per cent, and in no case are wages rising a lot faster than prices.

Some observers might say that, by choosing OECD countries, the sample is biased towards low inflation, and that Asian countries should also be included. It is true that some Asian countries have relatively high inflation, but it is mainly confined to the ones whose cost structure is way below Australia's, such as China, Indonesia and the Philippines.

The ones that are closer to our standard of living and cost structure – and hence the ones our industries are most likely to compete with – have much lower inflation, just like the OECD countries. For example, Japan has 0.2, Singapore 1.5, Taiwan 3.0, Malaysia 3.2 and Korea 4.5.

What is Happening in Australia?

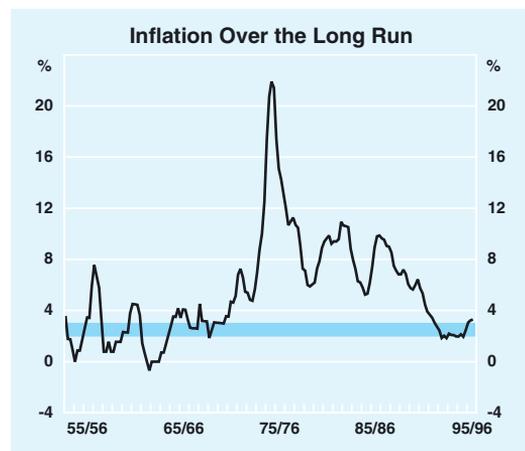
At the Reserve Bank, we are pretty happy with how things have turned out in Australia. Over the past five years, the underlying rate of inflation has averaged 2.5 per cent per annum (for those who are still not prepared to accept the concept of underlying, I should point out that the headline rate of inflation has averaged 2.4 per cent per annum over the same period). This is the best result over a five-year period for 30 years (Graph 1). At the same time, real GDP has grown at an average annual rate of 3.3 per cent. No-one

Table 2: Wages
(Year-ended percentage change to most recent month or quarter in 1996)

Australia	4.2	Japan	2.0
Austria	4.3	Netherlands	2.8
Belgium	1.6	New Zealand	3.0
Canada	1.7	Norway	3.2
Denmark	3.0	Spain	3.6
France	2.6	Switzerland	1.5
Germany	2.0	United Kingdom	3.7
Ireland	3.2	United States	3.0
Italy	4.3		
		Average	2.8

Source: OECD and National Sources.

Graph 1



can say that the low inflation was maintained by continuing to hold the economy down. It is true that the first six months of this five-year period were influenced by the recession, but the past 4¹/₂ years had seen pretty steady growth.

As you know' the Reserve Bank has an inflation target and this target is fully endorsed and supported by the Government. The target aims to achieve an average rate of inflation of between 2 and 3 per cent over the course of the cycle. That is, it aims to average 2-point-something per cent, although it concedes that underlying inflation will sometimes go outside the 2 to 3 per cent range. We have never believed that it was going to be easy to achieve our long-run aim, but we have always been prepared to do what is necessary to give it our best shot. That explains why interest rates were raised decisively in the second half of 1994.

Even with this significant and pre-emptive tightening of monetary policy, we knew (and publicly acknowledged a year ago) that

inflation would exceed 3 per cent at some stage of the cycle. In fact, in the middle of last year' a lot of forecasters thought it might go as high as 4 per cent by the middle of 1996, and the Budget forecasts were for 3³/₄ per cent. A lot of sceptics were not confident that it would drop down to 3 per cent or below within a foreseeable period. As you will be aware, the economic mood was very different in the middle of last year in a number of ways.

The events of the past six months have therefore been very good news to us. The first signs that inflation was slowing did not come from the CPI, but from the other price indices that the ABS collect. Table 3 shows a summary of all these various measures.

It gives the most complete picture of what is happening, and' if you look at the second column of figures, it gives the most up-to-date reading, ie what has happened over the most recent three months. Things to note are:

- if the figures in the last column are multiplied by four, they yield an annual rate, which in all cases is below the

Table 3: Selected Price Measures

	Latest observation	Rate of increase over past year	Rate of increase over past three months
Broad measures			
Consumer Price Index	Mar 1996	3.7	0.4
Treasury underlying measure	Mar 1996	3.3	0.4
GDP deflator	Dec 1995	2.9	0.3
Private final demand deflator	Dec 1995	2.4	0.2
Private consumption deflator	Dec 1995	2.8	0.2
Manufacturing prices			
Raw material inputs	Feb 1996	-1.9	-1.7
Domestically-produced intermediate goods	Feb 1996	1.7	0.0
Domestically-produced final goods	Feb 1996	1.6	0.2
Intermediate imported goods	Feb 1996	8.3	-0.6
Final imported goods	Feb 1996	-1.7	-1.6
Construction prices			
House building materials	Feb 1996	-0.6	-0.3
Other building materials	Feb 1996	1.7	0.1
Import prices			
Import price index	Feb 1996	0.9	-1.3
Imported items in the CPI	Mar 1995	0.9	-0.1

3.3 per cent given by the past year's underlying inflation;

- the five indices that cover the manufacturing sector are very low – varying from -6.8 per cent to +0.8 per cent.

As a result of looking at data such as shown in Table 3, we were able to bring our forecast of the peak rate of underlying inflation down to 3¹/₂ per cent. We published this a month ago, and also stuck our neck out by saying that we thought inflation would be down to below 3 per cent by the end of the year. Now that we have the CPI for the March quarter, it appears that the growth in the 12 months to March of 3.3 per cent will be the peak. This is a much better outcome than seemed to be in prospect in the middle of 1995.

It now seems likely that if we do not do something stupid – by we, I mean we as a country – we should be able to look forward to further solid growth of output and the achievement of our low inflationary aim, ie the rate of inflation averaging two-point-something per cent in the long run. This brings me to the subject of wages.

Wage Developments in Australia

I will not go through these in great detail, because I think you are familiar with them and are closer to them than I am. Basically, what has happened in Australia is the following.

The most general level of wages that we look at is AWOTE – average weekly ordinary-time earnings of adults working full-time.

- This had been growing at an annual rate of 3 per cent between mid 1991 and mid 1994.
- There was a noticeable jump late in 1994 which pushed this rate up to 4 per cent, and by the second half of 1995 it was growing at around 5 per cent.

No doubt this jump was helped by the extremely strong growth of output and demand that occurred in 1994. In the year to

the September quarter of 1994, non-farm GDP grew by 6³/₄ per cent and manufacturing output by 12 per cent. Both have since slowed, but until recently it appeared earnings had not. This was a very worrying development, and had an important influence on our thinking about the task for monetary policy. It still does, but the recent fall in AWOTE to 4.2 per cent in the 12 months to March provides some degree of comfort.

The second measure of wages that we pay attention to is the average rate achieved in enterprise agreements. This involves following particular bargains, as well as the average calculated by the Department of Industrial Relations. This was also worrying because it showed average rates of 5 per cent in the private sector, and a number of 'high profile' agreements that were higher. This is a forward-looking indicator, so we take it very seriously even though it is not easy to interpret. Overall, however, it reinforced the message coming from AWOTE.

Wage Bargaining in Manufacturing

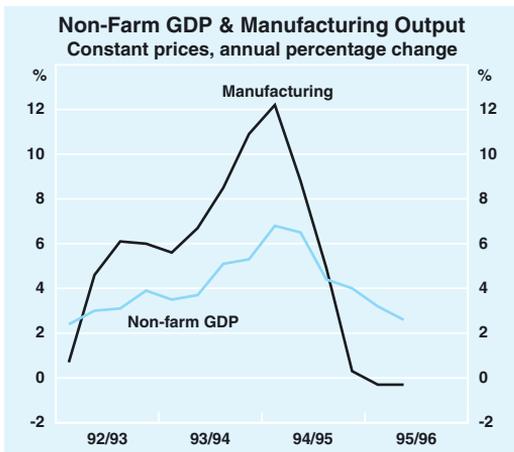
I cannot claim to be an expert on the particular conditions in the manufacturing sector or the metals and engineering industries, but I can say that I agree with the thoughts contained in the April 1996 MTIA Chief Executive Briefing. In a sentence, the wage agreements that were reached when manufacturing output and employment were booming, and when the Australian dollar was at US70 cents, are a lot higher than the wage agreements that we should be looking at now.

The main reasons are:

- manufacturing output is more cyclically sensitive than the rest of the economy. Just as it grew faster during 1994 than the whole economy, it is now growing more slowly than it. In fact, over the most recent 12 months for which we have data (to December 1995) it declined slightly;
- with inflation also slowing, and with manufactured output prices virtually

stable, the average manufacturing business is looking at sales that are either flat in dollar terms, or up a percentage point or two. In such an environment, it seems hard to justify wage increases any higher than the present average of 4.2 per cent in the 12 months to March 1996, unless there are very large productivity considerations;

Graph 2



- about 25 per cent of the Australian elaborately-transformed manufacturing sector's output is exported and a bigger figure again is subject to competition from imports. This makes for a very competitive sector. The exchange rate for the Australian dollar has risen appreciably over the past 12 months – although from a low base – which has intensified these competitive pressures. I do not want to get into the business of forecasting exchange rates, but we cannot rule out further rises in the Australian dollar and some further increase in competitive pressures; and
- I am reasonably confident about growth in the world economy over the next 18 months, but businesses should not expect this to bail them out. If the world economy is stronger than most people think, it will be a two-edged sword. On the one hand, businesses will benefit from the increased demand' but a strengthening world economy nearly always puts upward pressure on the Australian dollar.

What About Productivity?

The movement from a centralised system of wage determination to a decentralised one based on individual productivity bargaining agreements is clearly a good one. It should help to provide flexibility' and to unlock productivity gains that were formerly not accessible. It should thus help to provide more growth and, if applied properly, should also help in holding inflation down. There are, however, a couple of constraints that should be borne in mind – the first is about average productivity, and the second is about the distribution of the rewards from productivity gains.

No outsider like myself can tell what productivity gains will be yielded by any particular productivity bargain. However, recent history suggests that, on average, productivity increases of somewhere between 1½ and 2 per cent should be expected for the whole economy (and the figures for other developed economies bear this out). If the average rate of wage increase contained in all productivity bargains is to be consistent with a rate of inflation somewhere near 2½ per cent, it really cannot exceed about 4½ per cent. This does not lay down a rule for individual productivity bargains – clearly some could be expected to exceed this and some to fall short of it – but it reminds us that everyone cannot expect to have above-average performance.

The significance of productivity in influencing wage outcomes is that, when productivity gains are in prospect, an additional wage increase may have to be offered in order to obtain the cooperation of the workforce to bring about the extra productivity. This is because the workforce is required to put in extra effort or acquire new skills. In other cases, where the improved productivity is not intrinsic to the workforce, but results from superior machinery or the elimination of 'feather bedding', the case for

this inducement is problematic. In any event, the size of this inducement should be considerably smaller than the productivity gains achieved; most of the benefit of productivity should flow through to the wider community in the form of lower prices, rather than being captured by the wages, salaries or bonuses of the people in the industry concerned. In this way, the whole community receives the benefit of being part of a high-productivity, high-wage economy.

This is a rather subtle point and I might make it clearer with an example. The computer industry has experienced truly extraordinary productivity improvements, reflecting the pace of technology. A process worker in the industry might feel some claim on these productivity increases. But why should there be a difference between his/her wage and that of an essentially similar process worker in the factory next door? A well-functioning labour market, plus competition in the goods markets, would not, in practice, allow relativities for workers of essentially the same skill to change much, so we get the outcome seen over the past 10 years or more – the productivity gain is passed on to the *consumers* of computers. This is not only the market solution, it is a fair solution as well.

The Big Picture

We are optimists about the future of the Australian economy. We think that we will achieve a lot more years of sustainable growth, as long as prices and wages remain under control. Our chances of doing this are good, and have improved during the course of 1996 as a stream of lower inflation figures have come in. On wages, there has also been recent good news in the form of the March quarter

earnings figures. But we cannot rule out the possibility of an upsurge in wage claims, or that some employers will take the line of least resistance and agree to them. Logically, the rates of increase contained in enterprise bargains should come down a bit from the rates achieved in the second half of 1995 for the reasons I have outlined in this talk. If that happens well and good, but if that does not look like happening, then we will be forced to act, as has already been pointed out by Bernie Fraser when he said:

‘In other words’ if wages growth continues to pick up, rather than come back a notch’ there will be little option but to raise interest rates.’

Some people may think that this is a hard-hearted approach, but we think it is the only realistic one, and the only one consistent with maintaining reasonable long-run growth. I hesitate to say that we can escape the business cycle, but at least we should be able to make the expansionary phase last longer if we pursue sensible policies. In the past, expansions have ended because action has had to be taken after inflation has got out of control. Usually, the inflation refers to ordinary wage or price inflation, but on some occasions there may also be a large dash of asset price inflation. In any event, when the expansion ended, it was followed by a painful recession. If inflation can be prevented from getting out of control in the first place by early monetary policy action, there is no reason why expansions could not go on a lot longer than the six or seven years we have been accustomed to in the past. In essence, prevention is a lot better than cure. Even if preventative action causes the economy to slow appreciably, and results in unemployment edging up for a while, it would be a small price to pay if it allows the expansionary phase to last longer, and pushes back the prospect of a real recession.