

Sustaining Growth and Living Standards

Talk by Governor, Mr B. W. Fraser, to Australian Business Economists, Sydney, 28 March 1996.

I always enjoy talking to the ABE. More than most, business economists understand that government policies *do* make a difference, but they also understand that the fate of businesses ultimately rests in their own hands.

It is timely to reflect on this point as the economy continues one of its longest ever periods of uninterrupted growth, and as wage negotiations begin in the post-Accord environment. In a sentence, I believe Australia is in very good shape to sustain further solid growth, although that will, *inter alia*, require us to keep inflation under control, and to do something about our inadequate national saving.

I start from the obvious point that strong, sustained economic growth is central to our future well-being. It is growth which largely determines how well we live, and which gives us the ability to help those to whom fate might have dealt a difficult hand.

By the standards of other developed countries, we have not done badly. The economy has expanded by more than a third over the past decade, and a proper interpretation of the data – as well as casual observation – suggests that the vast majority of Australians are better off today than ever before. To be distracted by concerns that other countries (including some of our Asian neighbours) have caught up or surpassed us is to confuse the issues at stake. We should be pleased that other countries have come to

Table 1: Growth in GDP
(Average annual percentage change)

	Australia ^(a)		OECD countries		South-East Asian countries ^(b)	
	Total	Per head	Total	Per head	Total	Per head
1976 to 1985	3	1 ³ / ₄	3	2	6	3 ³ / ₄
1986 to 1995	3	1 ³ / ₄	2 ¹ / ₂	1 ¹ / ₂	7	4 ³ / ₄

(a) Growth rates in Australia were broadly similar in the two decades but Australia did a little better than the OECD in the most recent period. Inflation in Australia in the most recent decade averaged 5 per cent a year, compared with almost 9 per cent in the earlier period.

(b) Averages for Indonesia, Malaysia, the Philippines, Singapore and Thailand.

share our standard of living, and welcome the opportunities that this creates.

Current Growth Rates

Over the past year or so, the economy has behaved much as we might have wished. Helped by some 'pre-emptive' interest rate rises in the second half of 1994, growth slowed from an unsustainable $5\frac{1}{2}$ per cent in that year ($6\frac{1}{2}$ per cent in the non-farm sector), to around 3 per cent in 1995 ($2\frac{1}{2}$ per cent in the non-farm sector). With no serious imbalances in the domestic economy, and the international economy beginning to look a little stronger, growth is likely to pick up somewhat during the course of the next year or so.

In these days when it is fashionable to benchmark everything that moves, I think we would be doing quite well if, over the next three years, we could match the performance of the past three years. In that period, GDP growth averaged 4 per cent a year, and underlying inflation averaged $2\frac{1}{2}$ per cent.

This might be seen as an unfair benchmark, given that economies typically grow more quickly during the early stages of recovery. There is some truth in that, although the current recovery goes back almost five years, to the middle of 1991. In other respects too, the past three years carried their own burdens, such as severe drought conditions, low commodity prices and virtual economic stagnation in Japan, our largest export market.

Is 4 per cent a sustainable growth rate for Australia, or should we settle more prudently for 3 per cent? The difference is not trivial; assuming that population continues to grow at about $1\frac{1}{4}$ per cent per annum (as it has in the past decade), 4 per cent growth would see living standards double in 26 years, compared with 40 years in the case of the lower figure. Faster growth would also deliver larger wind-downs in unemployment.

I would like to spend a little time exploring this question. I do so not because I want to

advocate any particular target for growth – too many targets succeed only in confounding policy makers – but because a better understanding of the sources of, and constraints on, growth will help to demonstrate the difficulty of sustaining, say, 4 per cent growth. I would like to believe we could grow at such a rate, but it is not nearly as straightforward as some people might think.

Potential Growth Rates

When economists talk about 'potential' growth rates in the industrialised countries, they tend to come up with quite small numbers. The maximum rate which the United States, for example, can sustain without sparking inflationary pressures is usually put at 2 to $2\frac{1}{2}$ per cent a year. Estimates for Japan and Germany tend to be of a similar order. These low numbers are explained mostly in terms of the slow growth in the labour force and in measured productivity in 'mature' economies – the two main determinants of potential growth rates.

In Australia, 3 per cent is about the best growth rate we have been able to sustain over any length of time. For clues as to whether we have the potential to do better in future, we need to examine trends in the labour force and its productivity.

The *labour force* is set largely by growth in the working-age population, and by the participation rate. On the basis of current demographic factors and trends in participation, growth of the labour force is projected to decline from around its current 2 per cent to perhaps $1\frac{1}{2}$ per cent by the turn of the century. Over this period, however, we do have the opportunity to draw upon presently unemployed resources; if we could trim back the unemployment rate by, say, $\frac{1}{2}$ per cent each year, the labour force could continue to grow at 2 per cent or more for some years.

Productivity growth, which depends on the level and quality of investment, and the skills

and cultures of labour and management, is much harder to measure, particularly in service industries.

In production-type operations it can be measured fairly reliably because output can, in a sense, be 'counted'. The Statistician publishes such data for the non-farm market sector; these are based on output per hour worked in a group of private sector industries which accounts for a little over 60 per cent of GDP. On this basis, productivity growth has averaged about $2\frac{1}{2}$ per cent a year in the 1990s, roughly double that in the 1980s. This lift tallies with other indicators – such as the exceptionally rapid growth in exports of manufactured goods – which also point to improved efficiency in many Australian industries.

'Counting' output in the services sector is much more difficult – so much so, in fact, that the convention for some services is to measure output in terms of labour input. In effect, statisticians assume *no* productivity growth in these industries, even though it is hard to believe that genuine productivity gains are not being made in many instances. As others have remarked of similar situations in the United States, '... we see technological advance everywhere but in the productivity statistics'.

The conventional measure of economy-wide productivity growth is probably an underestimate but it is the measure we have to use. It suggests an average increase of about $1\frac{3}{4}$ per cent in the 1990s. A continuation of that growth, combined with growth of 2 per cent or a little more in employment, implies that 4 per cent growth is potentially attainable through to the turn of the century – but only just!

The main purpose of this discussion, however, is not to dwell on the arithmetic, but rather to make three general points. First, good monetary and fiscal policies can help to raise economic growth by promoting productive investment, but they have little immediate influence on either the labour force or productivity. Microeconomic reform is the major spur to improved productivity, and government policy will need to make further progress in this area to sustain the recent

revival in productivity. That will be best achieved, in my view, by building on the measures already in place to promote efficiency and competition; it is not a matter of starting from scratch – not even on the waterfront!

The second point flows from the first. Given the clear difficulty of sustaining 4 per cent growth, it is not realistic to think that Australia can somehow embrace a new growth formula or culture which would permit us to match the 6 or 7 per cent rates routinely achieved by some Asian economies. The labour forces in those countries are growing about $1\frac{1}{2}$ times that in Australia, boosted by the mobilisation of workers from non-productive sectors. Their higher productivity growth rates reflect, in part, their greater scope to apply new technology (to 'catch up') in relatively large non-service sectors; in part also they reflect saving and investment ratios which are about double those in Australia.

The third point is to repeat that while an average 4 per cent growth rate is perhaps within our reach over the years ahead – if we are policy smart (and a little lucky) – it is not being advanced as a growth target. At any point in the cycle, the most pressing issue for policy makers is not the pursuit of some predetermined growth rate, but whether the economy is moving forward at a rate sufficient to absorb new entrants to the labour force and to reduce unemployment, without running into serious problems.

Two Familiar Constraints

Such problems, traditionally, have taken the form of blowouts of the current account deficit and/or inflation, which have necessitated strong and often painful policy responses. How should we view these two familiar constraints – and their implications for policy – in today's environment?

First, the *current account deficit*. Some people still get quite excited about monthly movements in the current account deficit. But

even quarterly and annual figures can be distorted by the effects of such factors as droughts which temporarily depress rural exports, or surges in business investment which temporarily boost imports of plant and equipment. Moreover, the cushioning provided by our floating exchange rate and ready access to global capital markets should make for a less obsessive focus on the current account today, compared with the days of fixed exchange rates and restricted capital mobility. I know it is a forlorn hope, but national stress levels would be lowered dramatically if commentators were more analytical and longer-term in their assessments of current account data!

For all that, we are continuing to run a current account deficit which is too high. The facts are well known. The deficit has averaged about 4½ per cent of GDP since the early 1980s; at its cyclical peak, it has typically reached about 6 per cent. The aim is not to eliminate the deficit altogether – we clearly benefit from being able to draw on foreign savings – but to reduce it to a more comfortable level.

I have suggested previously that we would be more comfortable with a current account deficit which averaged 2 to 3 per cent of GDP, rather than 4½ per cent. We would then be less dependent on regular, large inflows of foreign capital and, therefore, less vulnerable to being dumped in international financial markets. Players in those markets do not

always behave rationally and they often overreact; on the other hand, it is not irrational to be wary of countries with persistently high current account deficits and foreign debt levels.

It is now generally recognised that the current account deficit reflects a domestic saving/investment imbalance. We simply do not save enough ourselves to finance all the private investment we want to make, as well as all the government spending we vote for. The resultant gap is filled by foreign saving, the counterpart of which is the current account deficit. This imbalance has to be corrected by restraining consumption and lifting saving – not by reducing investment, which enhances productivity and contributes to higher living standards. Genuine increases in *private* saving are difficult to engineer, although compulsory superannuation arrangements now in place will, over time, help to raise national saving.

The priority route, however, has to be more *public* saving. Relative to GDP, Australia's public sector debt and budget deficits are low by international standards, but they are large relative to our domestic saving. We have made some progress recently, but not enough. How much ground has been made and lost, and how much remains to be made up, are difficult questions to answer. As the figures released by the incoming Government three weeks ago showed, budget estimates are very sensitive to the forecasts of economic growth and other

Table 2: Changes in Underlying Budget Balance^(a)

	1995/96 \$ billion	1996/97 \$ billion	1997/98 \$ billion	1998/99 \$ billion
May 1995 estimates	-6.75	-0.59	+2.69	+8.04
Current estimates	-9.04	-7.64	-7.33	-3.28
Change	-2.29	-7.05	-10.02	-11.32
Of which economic parameters				
\$ billion	-2.07	-6.35	-8.77	-9.84
% of total change	90	90	88	87

(a) The underlying budget balance is the headline balance less net advances. Net advances consists primarily of asset sales and net repayments by the States of debt.

major parameters. Of the \$7 billion deterioration since May 1995 in the budget estimate for 1996/97, for example, 90 per cent reflects revisions to the economic forecasts.

The latest parameter forecasts are subject to further changes. My own hunch is that growth in 1996/97 will be a bit stronger than 3 $\frac{1}{4}$ per cent, implying a lower starting point deficit. Should it occur, any 'dividend' from faster growth should go straight to improving the budget's bottom line, not to reducing the fiscal consolidation task. Next year will mark the sixth year of economic recovery; in terms of the economic cycle, we should already be in underlying surplus, and – in terms of our large current account deficit and low private saving – a substantial surplus at that.

The Government proposes to make savings on the latest budget estimates of \$4 billion in each of the next two years, with the aim of delivering an underlying budget balance in 1997/98. Such reductions would be broadly comparable – relative to GDP – with those achieved in the late 1980s; and, like those earlier efforts, they will require a lot of hard pounding by all members of the new Expenditure Review Committee. Coming fresh to the task should, however, be an advantage.

I hope that the foreshadowed cutbacks can be achieved in ways which protect those genuinely in need. Just how they are made is, of course, a matter for the Government, although I personally think it is a pity that tax measures have been ruled out, both because these are a legitimate instrument of fiscal consolidation and public saving, and because they can bear upon the fairness of the whole exercise. And fairness is important.

What does all this mean for monetary policy? The short answer – accepting that the foreshadowed fiscal restraint will be delivered – is probably not a lot. With the economy likely to be growing quite strongly in 1996/97, the impact of the cutbacks in government spending on aggregate demand should be well cushioned. Moreover, experience in Australia in the late 1980s – when there was also good underlying growth in the economy – suggests that large and sustained deficit reduction

programs might actually stimulate private spending by more than they reduce public spending. There can, therefore, be no presumption at this time of any trade-off between fiscal restraint and interest rate reductions – and certainly not in the short term.

This brings me to that other potential constraint on growth, *inflation*. To grow as fast as we can, and for as long as we can, we need to keep inflation under control, basically because economies work better with low inflation. Once inflation starts to slip it tends to go on slipping, necessitating measures to slow the economy until inflation is brought back on track.

Things have been under control lately, with underlying inflation of 2 $\frac{1}{4}$ per cent on average over the past four years. In the year to the December quarter the increase was 3.2 per cent, a little above the target of 2 to 3 per cent. Underlying inflation is the best measure for policy makers to track, but broader measures tell a similar story; the price deflator for private consumption expenditure, for example, shows an average increase of less than 2 per cent over the past four years, and a rise of 2.8 per cent over the course of 1995.

In twelve-months-ended terms, underlying inflation is likely to rise a little further in the March quarter – perhaps to around 3 $\frac{1}{2}$ per cent – but should come back after that. The stronger exchange rate, and the inventory adjustment, are providing some assistance to this end but neither can go on forever. The longer-term trend will be determined mainly by what happens to labour costs.

Our best guess is that, adding in about $\frac{1}{2}$ per cent for employers' superannuation levies, these have risen by 5 per cent, or a little more, over the past year. The comparable increase over the previous year was about 4 $\frac{1}{2}$ per cent; the acceleration, in part, reflects a lagged response to the economy's surge in 1994. On-going increases in labour costs at their recent rate would not be consistent with the 2 to 3 per cent inflation target.

The recent slowdown in the economy would normally be expected to be accompanied, with a lag, by slower wages growth. To date,

however, there are few signs of any moderation. How then should we view the outlook for wages in the post-Accord environment?

I speak, as you know, as a consistent supporter of the Accord process. I believe it has helped to moderate wage increases over the past decade. This, in turn, has contributed to job creation, lower inflation and a higher profit share. It has helped monetary policy to maintain growth in activity and employment while delivering lower inflation, and it has also helped to reduce the incidence of industrial strife.

Table 3: Wages, Profits and Industrial Disputes
(Annual averages)

	1976 to 1985	1986 to 1995
Average weekly earnings (%)	10.2	4.7
Profit share (% of non-farm GDP)	13.4	15.6
Working days lost (Per '000 employees)	482	176

In recent years, the role of the Accord as a device for centralised wage fixation has diminished, and the focus has shifted to a system of wage negotiation which seeks to incorporate productivity improvements and to reflect the rigours of the market place. These are, as I understand it, the essential characteristics of a deregulated labour market, and all the participants have been gaining some experience in this new environment.

There is growing – although still far from perfect – understanding of the realities of the bargaining environment, and of the implications for jobs, profits and interest rates if wage rises get out of kilter with genuine productivity gains. On-going tariff reductions and other microeconomic reforms are working to emphasise the changes in the environment for so many firms, as is the fact that a quarter of manufacturing output is now sold in export markets. Against this background, I expect that the parties most directly involved – namely, the managers and

employees – will want no more than to continue to get on with their task, Accord or no Accord.

The Government has an important role here to see that this framework operates as effectively and fairly as possible. Some proposals to this end are reported to be in gestation.

The Reserve Bank too has a role. The particular ‘reality’ we bring is a firm commitment to hold inflation to an average of between 2 and 3 per cent over the course of the business cycle. Wage and price setters should heed this: those who build in higher increases could find themselves with real wage rates which make them uncompetitive (putting their jobs at risk), and prices which are out of line with the competition (in domestic and export markets). If in this environment of 2 to 3 per cent inflation there is no room for large, across the board, price increases, then there can be no room for large, across the board, increases in wages or executive salaries.

I have talked about the 5 per cent increase in labour costs over the past year being inconsistent with sustained 2 to 3 per cent inflation, and of the need for these to be wound back a ‘notch’. What is a ‘notch’? In terms of aggregates, if we take the mid-point of the 2 to 3 per cent inflation objective and allow (at best) 2 per cent for economy-wide productivity growth, then all-up wage costs should be increasing by no more than 4½ per cent. This is a notch below the average increase in labour costs over the past year. It is also several notches below some recent settlements (in parts of the banking sector, for example) and below what is in danger of becoming the going ‘ask’ in current wage rounds.

It is helpful to talk in terms of these aggregates and averages for purposes of illustration. In my view, however, it is not appropriate to be seeking to lay down such ‘norms’ for individual wage settlements in the kind of deregulated labour market we have been moving towards over recent years, and which seems destined to be pursued more vigorously in the post-Accord period. In that

kind of labour market, we would expect quite a range of wage outcomes.

Several points seem to me to be worth emphasising at this point. First, inflation is in sight of coming back within the 2 to 3 per cent target; price and wage setters should take fully into account both this expectation and the Bank's commitment to keep inflation under control. Secondly, genuine productivity gains provide a basis for above-average wage increases but there is no basis for the whole of any such gains being pre-empted by increases in wages, salaries or bonuses. Rather, part of the gains should be shared throughout the community in the form of lower prices. This is the process through which we *all* move to a higher productivity/higher wage economy. Effective competition (either domestic or international) is probably the best hope for delivering these kinds of price reductions. Thirdly, while it is understandable that people in one sector will have regard to wage and salary arrangements in other sectors, increases determined or rationalised on this basis – and perhaps disguised by phoney productivity ‘gains’ – do not make for either viable businesses or viable jobs.

As I indicated earlier, in the system we are now moving towards, these difficult issues are best resolved by the parties most directly involved. Ideally, management and employees will work more closely together to effect

changes which will warrant higher wage rises. With the passing of the Accord, however, I expect that the onus will be on employers to a greater extent than before to resist unwarranted rises in wages and salaries.

Notwithstanding the size of some recent wage settlements, and of some claims in the pipeline, we are not in panic mode. It is still possible that the recent slowdown in growth, the continuing high levels of unemployment, the improved outlook for inflation, and the effects of on-going micro reforms will cause wages growth to moderate. That needs to occur during the current phase of slightly slower growth, before the economy starts to move forward again at a faster pace.

If the good sense of negotiators and the pressures of competition do not bring about the necessary moderation, however, then we will need to respond with tighter monetary policy. 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. That might well put paid to aspirations of sustaining 4 per cent growth and making significant reductions in unemployment, but any resumption of large increases in prices and wages would have even worse consequences for growth and employment. For that reason alone, monetary policy cannot allow the hard-won gains on inflation to slip away from us.