AUSTRALIA: The New Economic Template
P J Keating
Planning Institute of Australia,
National Conference,
Hobart,
23 February 2004

Paul Keating's 2004 speech to the Planning Institute of Australia provides a history of the Australian economy as it was in the postwar years and how it came to be reformed by the seminal economic changes he presided over as both Treasurer and Prime Minister. The speech paints the colours and atmosphere of the old economy, as it does the reasons for the changes and the nature of the changes themselves. The speech carries the authenticity that could only have come from the author of the reforms. Paul Keating goes on to share his faith in the influence of long, technology waves as the key driver of world economic growth. He tells his audience that the current prosperity phase, which began in 1982 would, according to trend, be likely to end in 2007 or 2008. The last line of the speech warns the audience not to be exposed 'in or after 2007'.

Australia is now in its third economy.

Its first, the colonial one, was based almost exclusively around agriculture. The second also had a strong agricultural component but was augmented by mining and manufacturing. That economy, which started gathering momentum in the 1880s, more or less, lasted for one hundred years to the 1980s.

Its earliest stages saw the growth of the gold industry and later other minerals, as it did the nascent manufacturing industry which then prospered under protection.

Because that economy was protected, paying for its imports by resort to the primary-export sector, it was given a name: it was called the Australian Defence Model.

It earned that name from the principal characteristics of the economy. The Australian Defence Model ran on a triangle of policy: first, strong export income arising from high commodity prices under strong terms of trade; second, the high level of national income paid for a high tariff, which was set to protect manufacturing industry against imports; and third, the higher cost of goods inflated by the tariff was afforded by arbitrarily set wages—wages set by a national tribunal.

The Australian economy ran on those three legs for a century. The model was reinforced by an administratively determined exchange rate and interest rates. Quantitative restrictions were also set for the levels of lending by banks and lending institutions.

The model worked for so long because most people gained something from it. Farmers and miners occupied a place of primacy in the economic system; manufacturers lived and prospered under the tariff; workers garnered a living wage under Australia's unique system of industrial arbitration.

Because everybody had something from the model, in latter years it was given a new name: 'the Australian Settlement'.

All was well until the model broke down. It broke down when the 'terms of trade' moved sharply against Australia between the mid1960s and the mid-1980s. The prices of the things we sold the world experienced a secular decline in value while the prices of the things we bought from abroad rose in value. As our national income suffered this sustained decline, the first leg of the triangle broke down. The dramatic reduction in our national income meant that the tariff became unaffordable. Real wages were out of line with our national income while the central wage tribunals sought to maintain wages without adequate reference to our more straitened economic circumstances.

Our competitiveness was becoming more out of line with comparative countries while the onset of double-digit inflation for over a decade since the 1970s rendered the economy broadly uncompetitive.

That uncompetitiveness was compounded by an overly valued exchange rate set administratively to encourage import competition so as to apply downward pressure on local prices from import-competing industries. The exchange rate at these levels automatically militated against the competitiveness of our agricultural and mining producers, thereby reducing our national income even further.

This was the economy I inherited as Treasurer in March 1983: an economy that had simply run out of puff.

The model had made Australia an industrial backwater, relying on the lifeline of ever decreasing relative export income. The country had become an industrial museum, with manufacturers eschewing innovation, while unions used the centralised wage-fixing machinery to increase real wages. And not only that—to have the nominal growth of wages indexed to the inflation rate.

Of course, no such economic outcome, however glacial, could fail to be noticed. In fact, the terms of trade started their long secular decline around 1965—the year Robert Menzies retired as Prime Minister. Indeed, a succession of governments and, might I say, Treasurers, watched these outcomes over a twenty-year period.

In the early stages of this long 'terms of trade' decline, coupled as it was with a rise in protection, some could be forgiven for not comprehending that a secular change was underway and that the Australian Defence Model had outlived its usefulness.

But by 1975 nobody could fail to notice that the trends were deadly. At the end of the Whitlam government nominal wages growth had reached unprecedented levels, igniting a bout of double-digit inflation. This came courtesy of the ACTU under an accommodating policy set up by the Whitlam government minister Clyde Cameron.

But with the advent of the Fraser government and under the treasurerships of Philip Lynch and John Howard, no remedial policies were put into place. In fact, during Howard's period as Treasurer, tariff protection rose sharply while double-digit inflation was maintained by a wages breakout, facilitated by his own fantasies about how the labour market should work. He was promoting open wage outcomes in a structure which was still centralised and award-based. A structure that operated on the principle of comparative wage justice. So when metalworkers procured an increase under the Metals Construction Award, that same increase would leapfrog its way into other awards; for instance, into the Metals Manufacturing Awards. This was called a 'wage round'. Howard sat glibly by while all this happened around him. He finished as Treasurer with the place in economic ruin. Indeed, centralised wage fixation stayed in place until the Keating government abolished it for a system of enterprise bargaining in 1993.

The policy of the Whitlam and Fraser governments was to see no evil, hear no evil and certainly not mention any evil. For to mention it meant the structure had to change. And not change at the margins but change completely. No-one was prepared to take that on—no-one would own up. One broken piece was incapable of being repaired; because of the inter-relationships, the whole model had to be broken up.

Let me digress here and say this. Many senior people in public life speak of their regard and affection for the Australian public. You hear these things said all the time, by rote. But I am afraid there were hardly any whose regard and affection for the Australian people went so far as to provide those same people with the truth. The affection should compel one to give the public a real break: to tell them how it really is. For, in not letting the public in on the problem, the political system treated them like fools; worse, it allowed their prosperity to be hijacked by political convenience and calculated neglect.

The fact was, to take on the task of economic repair in earnest, required the dismantling of the old model.

As Treasurer and later Prime Minister, it fell to me and my colleagues in the Hawke–Keating government to do it. But the doing of it required the discerning of a new model, one which took account of our changing economic circumstances and which would serve the country better and sustainably.

That new model has been put into place. It took thirteen years, between 1983 and 1996, but it is now there.

Fundamentally, it is an open, competitive model, the obverse of the old defence model.

Instead of the country being ring-fenced with tariffs, with a managed exchange rate and exchange controls and with wages set in the aggregate by national tribunals, the Australian economy now has a completely international complexion. Its leitmotif is flexibility.

Gone are the old rigidities; the country now has open financial, product and labour markets, as free as any comparable country. And it now also enjoys endemically low inflation. The end result is that the economy enjoys a flexibility today which was unthinkable twenty years ago.

Indeed, the changes undertaken by the Labor government between 1983 and 1996 were so profound that they have, more or less, become the model for OECD member countries.

In short, in Australia, an economic revolution took place. One which has, on average, doubled Australia's economic rate of growth and doubled Australia's rate of trend productivity.

In the ten years to 1983, GDP averaged 1.8 per cent. In the ten years to 2003, GDP averaged 3.6 per cent—it doubled. And when an economy's growth rate does that, it produces a massive increment to wealth.

In the ten years to 1985, trend productivity averaged 1.25 per cent; it now averages 2.7 per cent—more than double. This productivity, along with the recession in 1990, broke the back of inflation.

We went into the 1990 recession with the broadest measure of inflation, the non-farm GDP deflator at 4.5 per cent; we came out of the recession with it at 1 per cent. In the twelve years since, inflation has ticked over at an average level of 2.5 per cent, largely held in place by the growth in productivity arising from the Labor government's structural changes. Most important among those was the move to enterprise bargaining in the labour market in 1993. But other express changes like competition policy have helped in keeping productivity up and prices down.

This has led to what I call the 'daily double'—rising real wages with falling unit labour costs.

As a result of these structural changes, real wages have grown by about 2 per cent a year since 1992. For the decade 1992 to 2002, this has meant an increase in real incomes, incomes after inflation of 20 per cent; the biggest increase in any decade of the twentieth century. Is it any wonder the place feels wealthier?

It is productivity which determines real income growth. The irony is that it took a Labor government to move the country to a productivity-based culture.

But higher real incomes are only part of the story. Higher disposable income is an altogether different story. Higher disposable income in Australia has been achieved by the interaction of three influences: the first, higher real wages; the second, falling prices through the tariff cuts and competition policy; and the third, falling interest rates following the resultant fall in inflation. Taken together, higher real wages, falling prices and lower interest rates have kicked along consumption and added mightily to the service sector of the economy. It has also kicked along property values.

This is why Australia feels better, because it is better.

Indeed, since September 1991, Australia's economy began its now continuous thirteen-year stretch of growth.

The size of the economy has doubled. Inflation, which had averaged 8.5 per cent a year throughout the 1980s, fell to an average of 2.5 per cent between 1991 and 2004. And the unemployment rate fell by half from 10.5 per cent to 5 per cent over the same period. These rates of continuous growth are not only remarkable by Australian historic standards—they are remarkable against all other developed economies. Growing at an average of 3.6 per cent a year over the period, Australia has easily outstripped the United States at 2.6 per cent, the United Kingdom at 2.3 per cent, Germany at 1.8 per cent and Japan at 1.4 per cent. And I am sure you will give me the latitude to say that none of this had anything to do with John Howard or Peter Costello. Apart from the Howard government's GST, no other important structural change has been put into place. And I do not regard a GST, a tax change, as having important structural influences. A GST does not change economic behaviour, it simply collects revenue. Howard and Costello have simply traded off the structural benefits bequeathed to them by my government. They have made hay while the sun has shone, providing buckets of revenue to the annual budgets in measures that they could hardly believe.

And endemically low inflation—2.5 per cent recurring—they simply put that in their pocket. Wouldn't have had the wit to put it into place themselves but smiled like Cheshire cats as each quarterly set of national accounts confirmed its maintenance.

Let me say a few other things about productivity.

Productivity, of its essence, is about getting more output from fewer people. But those people, in a growth economy, are then released to higher paid, more interesting jobs.

For example, in manufacturing, output has exploded while employment has shrunk. Products have therefore become much cheaper and because they are cheaper, our living standards rise. They rise because less of our income is spent buying them.

In fact, the decline in manufacturing employment is not unique to Australia—manufacturing is disappearing generally in developed countries. For instance, in the United States, manufacturing absolute employment today is at the same level it was in 1958, yet manufacturing production in the US is up by 358 per cent. Productivity has soared.

Coupled with that is a new division in the international division of labour. Old tech—manufacturing—now largely hails from the East, from North Asia, especially China. But this concentration of manufacturing output in North Asia is giving us lower prices and a huge increase in the value of our commodities.

Our national income is going up while prices are coming down. China is giving the world a wave of deflation; quality goods at lower prices.

All these changes are central to your conference topic because these changes are impacting on our cities.

The Fordist model of regional production has now largely gone. Towns and regions built on one factory or industry are becoming a thing of the past. 'Just in time' manufacturing and inventory management mean that production is decentralised—the digital economy facilitates not only a dispersion of product but higher productivity. The Internet, as it develops, will further revolutionise production and marketing. It is likely that people in centres of output will be able to remain remote from centres of production. This, in turn, will lead to changes in the distribution of population; remembering, that all the while, real income growth is pumping growth into services, our country's major employer.

As the centre of gravity of production shifts to the East, the division of labour becomes central. Ours must be shaped by education. The premium will be on knowledge, not on widgets. Creativity is where the premium will grow. Whether that will be in financial services, or software, or in film, leisure or care—this is where our bread will be buttered. It will be what is in our heads rather than in our hands that will matter.

I have long believed that product innovation and creativity drives long or extended waves of economic growth. For instance, Thomas Edison's electric lightbulb led to the building of power stations with electricity reticulated through sub-stations and cables. Twenty-odd years on, this led to the development of domestic heaters and radios. A decade or two after that, it became washing machines and air-conditioners. These world-changing innovations and discoveries say and do more for the pattern of economic growth than only macroeconomic management by national governments.

In our time, the development of microprocessing and, with it, the personal computer, has now led to a revolution in direct communication via the Internet. This has and will produce much more investment, as it will productivity.

Technology drives not simply economic growth but waves of economic growth. As technologies mature, they promote another cycle of investment.

The twentieth century saw three long waves of economic growth, each technology-driven. These were in the years 1904 to 1929, 1947 to 1974 and 1982 until now.

The 1904 to 1929 wave was driven by electricity and petrochemicals, the 1947 to 1974 wave was driven by motor vehicles, aviation and plastics, while the international economy from 1982 until now has been broadly shaped by telecommunications and digital technology.

One has to construct a picture of the extended nature of technological influences and to see them in a continuum. And overlaying these long, driving technology waves are business or investment cycles. These are known as Juglar cycles. That is, the technology is providing the locomotive reason to the general propensity to invest. But all periods of investment tend to run in cycles and run over. When conditions are propitious to invest, companies tend to invest all at the same time. We then find that we have had a glut of investment, so this is generally followed by an investment recession to bring the stock of capital back to a point of equilibrium.

In this current long wave, we have already had two investment cycles: 1982 to 1990 and 1992 to 2000. The third investment or Juglar cycle began in May 2003, when business investment in America restarted after a three-year business investment recession.

In the twentieth century these cycles—the underlying buoyancy or upswing from technology—have lasted approximately 25 years. By this reckoning, this current long wave and this, the third business cycle, would end around 2007 or 2008. By this time, the digital technology may have drawn down much of the productivity which the technology facilitates. At the moment, it is keeping incomes up and unit labour costs down. For instance, in America in the September quarter of 2003, productivity rose by 9.6 per cent, while unit labour costs fell by 5.6 per cent. No wonder profits are big—these are truly staggering numbers and they should fuel the US economy for the next few years. But buoyant as these figures are, they will die when the endgame comes, so we should be keeping our eyes peeled for the natural decline, which, as I say, on past trends, should be in three to four years from now—2007 or 2008.

It is also prudent to understand that there are other influences on growth at the moment which go beyond the technology imperative. In the United States, fiscal policy is now hugely expansionary, with the Bush tax cuts and the defence spending working its way back through the military industrial complex into the economy. As well, US monetary policy, courtesy of Mr Greenspan, is similarly accommodating.

Through a series of events from the Asian crisis in 1997–98, through the Russian debt crisis, through September 11, 2001, through the accounting scandals like Enron, through SARS, the US Federal Reserve has kept monetary conditions soft so as not to slow US or world growth. This has led and is leading to a great compression in the risk premium attached to certain categories of investment. There is very little difference in the yields between investment-grade bonds and junk bonds. And not simply with investment-grade bonds; the differential with Treasury bonds is similarly compressed. At some point, the official interest-rate structure will have to change, to return to something more normal. But with the party having begun again just a year ago, Mr Greenspan is probably reluctant to take the punchbowl away just yet.

Finally, I want to say something about China.

A new factor in the world growth equation is China. What is happening in China today knows no precedence in world economic history—one and a quarter billion people pulling themselves from poverty. China is already a growth engine of the world economy. As I said earlier, its goods are lowering prices around the world. We have had the happy position of rising real wages and falling prices: wages up, widgets down.

There is no doubt that China, by way of its exports, is providing a strong subsidy to the inflation rate of the developed world.

I will conclude on this note.

There is every chance that Mr Greenspan will keep the party going for a fair bit longer. But whether he does or he does not, the natural end of the long wave will eke its influence anyway. China is a new influence and not one that was around during the two previous long waves. Will the advent of China and its burgeoning economy alter the otherwise pre-destined technological end of the current wave? For my part, I don’t think so.

So, in the next few years, I think investment levels will start to fall off. The moral of that story has to be, don’t be exposed in or after 2007.

It could be dangerous.