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REMARKS AT THE LAUNCH OF MICHAEL KEATING'S BOOK
WHO RULES: HOW GOVERNMENT RETAINS CONTROL OF A PRIVATISED
ECONOMY (FEDERATION PRESS)

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An analysis of the oft-promoted view that (i) the role of government has been blunted; (ii) the scope for policy discretion reduced; (iii) the nation state has been hollowed out by financial markets; (iv) privatisations cut across or cut down the value of national institutions; (v) the growth of liberal markets and the aggregates that shape and foster this is inimical to a shared sense of community and communitarianism.

Or, as Michael Keating puts it, “many see marketisation as a substantial loss of state power”. The purpose of his book, he says, is to examine that contention. And, in the examination, he looks at the mutual dependence of the state upon markets, and vice versa, markets upon the state.

In the book Michael argues that “governments continue to be responsible for promoting a prosperous and egalitarian nation – where initiative and opportunity are encouraged”. But governments “can enhance their capacity” to meet society’s expectations by getting leverage and help by adapting to change – in technology, in economics and in social relationships. In other words, governments “sign markets up” as re-enforcements or “force multipliers”.

The critics he says, and I agree, confuse the capacity of government and even what is a good society with the size and imperatives of the public sector. His book, he says, proposes the middle way. Between those who say the state has “lost the capacity to manage” and those, like the Francis Fukuyamas of this world, who would “minimise the role of the state – in favour of unfettered markets”.

Michael Keating asks: Are the means and policy instruments the state now employs so different to the traditional values and goals? He makes the point that the “clearest measures” of government intervention i.e. the ratio of outlays to GDP and the ratio of revenue to GDP – have not fallen. And the level of government regulatory activity continues to increase. What has changed is the nature of the regulation. Today governments are more interested in what I have often termed “steering the boat” rather than “rowing the boat”.

Michael says – and I agree with this also – that it is misleading and wrong to say that governments have lost power or are withdrawing from responsibilities. Indeed his book aims to demonstrate that “while marketisation may have changed the instruments and policies of governments, governments can still

govern". They still command the power to determine a course of action and achieve their objectives. That is, government still has the capacity to manage aggregate demand so as to stabilise the economy or avoid major fluctuations in the level of economic activity. Look at Bush tax cuts and Greenspan's monetary policy.

- That the state "continues to play a leading role in fostering national development" but is now more focussed on "overcoming instances of market failure". It sees more value, these days, in well set up markets, competition and
- That "by recasting its role in the provision of human services", the state is better able to meet the "demands of a more individualistic society".

People get too caught up and starry eyed about traditional notions of government and especially the old model in Australia. The Australian Defence Model or, as it is called these days, The Australian Settlement. That triangle of arrangements which lasted for seventy odd years. High terms of trade, financing a high tariff – itself afforded by arbitrarily set wages. The problem was – one leg of the triangle seriously broke down. By the 1970s the things we sold were inexpensive – and the things we bought were becoming more expensive. Our national income was declining. So the policy of "protection all round" had lost its economic underpinnings - let alone notions of enhanced productivity.

The three most important prices in the economy – were uncompetitive and wrong. The price of foreign exchange, the price of capital and the price of labour. A decade and a half of high inflation had distorted all three.

Australia needed a new economic model. As a consequence, the Australian Defence Model had to be dismantled. And the unlikely happened. A Labor government walked away from centralised wage fixing, industrial protection and nominal control of the exchange rate in an unprecedented opening of Australia's financial and product markets – with productivity rising mostly from decentralised wage fixing being the device with which to lower unit labour costs.

Michael Keating argues that many of the former controls represented more "a display of symbolic power than they did real controls". And he is correct. For instance:

- With the managed exchange rate system, the government had some control over the nominal exchange rate – but not the real exchange rate.
- Through centralised wage fixing, it had some influence on nominal wage rates but not those subject of "over award payments".
- Through deposit maturity and lending controls it had some apparent command of bank resources – yet non-banks grew vigorously around the controls.

Let me give you some of my own impressions – those in general sympathy with Michael's point of view:

The Float: We moved from a price to a quantity based system. When the government stopped buying all the foreign exchange – those huge additions to primary liquidity stopped. All of a sudden it was possible to run a competent monetary policy as monetary policy did not have to target the exchange rate or mop up excess liquidity.

Monetary policy is now appropriately focussed on stabilising domestic demand. Following this change, the only additions to primary liquidity came from the Central Bank's own money market operations and the budget – if it was in deficit.

This removed a massive monetary mopping-up task – saving the budget huge PDI costs for years to come and further taking the pressure off domestic interest rates.

The quantity based, moving exchange rate – free of major Central Bank interventions – allowed the exchange rate to find its own competitive rate. Whole new industries sprang up because the exchange rate was appropriately priced. Tourism, wine and, of course, financial intermediation are examples.

Removal of deposit maturity and lending controls – and the deregulation of housing finance – in 1984 and 1986 respectively.

Under the controls, banks were rationers of credit – not creators of credit. The Reserve Bank of Australia controlled the ration – occasionally it would induce a credit squeeze. This would affect all business including housing and construction.

Banks would only lend to their best customers. Non-banks grew around the controls – permanent building societies, cash management trusts etc. Banks could not bid for deposits on the market and on-lend them as they saw fit with risk and price being their only constraint. Small business could not get finance. Housing was restricted to loans of \$30,000 at a fixed rate of 13.5 per cent. The housing and construction industry went up and down with credit squeezes. “Off the plan” selling, which now finances so much development, – was not possible. People could not themselves guarantee to put the loan together. Housing supply was intermittent and bank margins were high. Under the old rules, housing margins were up to 350 basis points. Now with open markets and competition and from the mortgage lenders it is more like 140 basis points. A lot of social benefits and social self determination there.

The government nominally had control of financial aggregates and price under the old rules. But it was a chimera – the rules strangled social benefit.

Tariffs and Protection: With the tariff, government notionally protected industry. But it protected it with a tax on the rest of us. The effect was to misallocate resources for investment (i) where the protection was more lucrative, (ii) where the barriers to imports encouraged low quality and low productivity and (iii) where the burden of their protection fell on the really internationally competitive industries we had (the good ones had the monkey on their back).

When I became Treasurer, the effective rate of protection on a car was 97 per cent. Today it is more like 7 per cent. The result is, today, you can buy a reasonable quality small car for under \$15,000. That would have been nearer to \$30,000 under the previous system.

For those who argue that materialism is hollowing out our social cohesion and happiness, one has to ask – will people have better “values” and be better “put together” if their car costs twice as much? Is that extra call on their disposable income going to provide some astringent moral effect?

We lift people’s real disposable income in two ways – lifting real incomes while lowering the price level. Getting rid of tariffs lowered the price level. Productivity lifts incomes while lowering unit labour costs – making goods cheaper which means incomes go further. Those old controls – that paternalism in fact – made us poorer.

Wage Controls: Centralised wage fixing nominally gave the government some handle on incomes – but with over award payments, not really. And aggregate wage adjustment left no place for incentives and inducements or scope for productivity enhancements.

Productivity is the principal source of income growth. When the government I led abandoned general centralised wage fixing to create the private bargaining stream along with other supply side changes, productivity took off. It went to 3 per cent (or near enough) over all the 1990s. The trend rate for the decade to 1985 as 1.25%. Two percentage points of that 3 per cent went to labour and up to 1 per cent went to profits. Ten years multiplied by 2 per cent equals a 20 per cent real increase in incomes. The highest rate of real income growth in any decade of the 20th century. And profits rose too. So we had the real “daily double”. Rising real wages and falling unit labour costs.

What commentary has the Michael Puseys of this world got to say about that? The government lost control of an inflation prone, tear away wages system. It is enough to make a John Langmore sit down and cry.

The Privatisations. The Commonwealth Bank of Australia and Qantas.

The State Banks of Victoria and South Australia were both failure prone. Qantas was a debt laden regional carrier. The State Bank of Victoria was rolled

into the Commonwealth Bank to become one of the strongest and best managed banks in the country.

Qantas is now one of the most adequately capitalized, best performing airlines in the world.

Both institutions have made the Australian Stock Exchange and the All Ordinaries Index much more robust.

As government instrumentalities they failed to serve the public either as adequately or as well as they are able to do now. Their ownership was a secondary issue.

Perhaps a final example of government being in charge or government being creative. When I became Treasurer (John Howard was my predecessor) we taxed debt once and equity twice. This gave us a system where the dynamic production of income was penalised – and people took capital profits free.

The really great increments to wealth occur in stock markets. The tax system was locking ordinary people and institutions out of this medium. The introduction of dividend imputation meant that people were only taxed once. This change has induced participation in our stockmarket – where people these days can live on dividends – 5 per cent to 6 per cent – and have some capital growth. With the superannuation funds locked into equities through imputation this has turbocharged our capital market while guaranteeing access and equity to the community at large to the wealth of the stockmarkets.

Governments can be masters of the national destiny. It is just that the mastery has to be creative –about steering the boat not rowing it. Michael Keating has done us a service with Who Rules. It is a timely check on the sloppy analysis that is too often proposed.