

The Economy in the Nineties: Through the Slump to Prosperity?

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Abstract

There is general agreement that the economy is in slump. There is also general agreement that the slump is the product of macroeconomic policy. In an attempt to redress the adverse balance of payments public policy has dampened economic activity through tight fiscal and monetary policy. The need to contain the growth in imports will have a vital bearing on the economic growth facilitated by public policy in the short and medium term. The paper details the factors determining the appropriate levels of growth in the short term which will enable a "soft" landing for the economy. However, the paper doubts that this "soft" landing will be achieved. The paper also examines the longer term prospects. It argues that, given the appropriate policy framework, a period of prosperity is achievable.

1. Introduction

This article examines the prospects for the Australian economy in both the short run (the 12 to 18 months to the end of 1991) and the long run (the subsequent five years or so). There is no doubt that at the moment the economy is in a slump, and will remain in the slump for the next three to six months. At the time of writing (April 1990), the latest national income statistics show virtually no change in constant price GDP in the December

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quarter 1989. A fall for three successive quarters in constant price private business investment in equipment, and for two quarters in constant price private investment on dwellings, indicate that this is much more than a temporary pause in growth. Other indicators, even lagging ones like unemployment which has been rising since December, also point to the fact that the economy is in a slump. The Westpac leading indicator of economic activity has now had a downward trend for 12 months.

The fact that the economy is now in a slump is completely uncontroversial and needs no further documentation. Equally uncontroversial is the fact that this slump was induced by macroeconomic policy. In 1988-89 Australia had a fiscal policy stance that was probably tighter than in any other OECD country (Neville, 1989). Given the usual lags one would expect that to show up in a downturn in economic activity by the second half of 1989. Monetary policy has been even more severe. Short term interest rates (the ones most directly determined by government policy) rose to 17 per cent in February 1989, traded upwards until October and were still above 17 per cent in February 1990.

This contractive monetary and fiscal policy was the inevitable government response to the surge in imports and the deteriorating current account policy. Similarly, unless the recent tentative improvement in the current account continues the government will reverse the current mild relaxation of both monetary and fiscal policy, damping down any rise in economic activity. The need to contain the growth in imports sets a limit on the economic growth that Australia can afford, and that the government will allow, over the next 18 months.

The next section sets out in detail the factors determining how much growth the Australian economy can afford in the short run, and argues that if this growth is achieved the economy will have a soft landing in which unemployment rises by no more than one percentage point. It also argues that this is the best possible outcome, which is unlikely to be achieved, and that unemployment is more likely to be near eight per cent by December 1991.

The third section looks at the long term prospects, and asks whether, after the economy emerges from the slump the rest of the nineties will be a decade of prosperity. It argues that such an outcome is feasible, but will not be achieved easily. A policy framework, which will increase the likelihood of prosperity is set out.

Finally, the threads are drawn together in a brief conclusion.

2. The Short Term Outlook

This section addresses three questions concerning the 12 to 18 months to the end of 1991:

1. What rate of economic growth can the Australian economy afford, given the external constraints of the balance of payments position?
2. What are the consequences of this rate of growth?
3. What is the likelihood of Australia achieving this rate of growth?

With regard to the first question, "affordable" economic growth is defined as a rate of growth in aggregate production which is consistent with the aim of stabilisation of the level of foreign debt.

Current account deficits (a result of a series of trade deficits over the eighties, recently aggravated by dramatic increases in debt servicing deficits), and the consequent levels of foreign borrowing necessary for their financing, have become the overriding economic policy concern in Australia.

Some commentators have argued that since the bulk of foreign debt is private sector debt, representing market-based decisions, it is not in itself a matter for policy concern, particularly if increased borrowings are used to finance private investment.

Since borrowing transactions generally involve the \$A exchange market, and international creditors typically assess "country risk", the implications of rising levels of foreign debt for the exchange rate and domestic interest rates, and the potential for periods of crisis, do involve national policy issues. Therefore the majority and official view is that the ratio of foreign debt to GDP needs at least to be stabilised in order to reduce Australia's vulnerability to external shocks. This in turn requires a tailoring of domestic economic activity to the performance of the trade account.

Some simple growth arithmetic can demonstrate the point.

Given the significant contribution of debt servicing to the current account deficit, debt stabilisation in the short to medium term requires a series of trade surpluses. The extent by which export growth must exceed import growth depends upon the level at which debt is to be stabilised, the time period within which the target is to be achieved, the terms of trade, the time profile of the debt, and the level of real interest rates. Assuming that a reasonable target is debt stabilisation between 34 to 40 per cent of GDP by 1993-94, and that the exchange rate, the terms of trade, and real interest rates remain at their current levels, EPAC (1989) estimates imply that the economy would be on track for this target if growth in export volumes exceeded growth in import volumes by an annual rate of 3.0 percentage points. (The EPAC arithmetic may be somewhat optimistic, and over the longer run a higher rate of growth in net exports will probably be required to stabilise the foreign debt /GDP ratio, even by 1995 - see Section Three below.)

A forecast for export growth would then imply an estimate of "affordable" import growth which is 3 percentage points lower. An estimate of the elasticity of imports with respect to aggregate domestic production (i.e. the

relationship between growth in GDP and growth in imports, both via higher consumer imports with higher national income, and via increased imports of capital goods and material inputs at higher levels of production), would then provide an estimate of "affordable" GDP growth.

Export growth

Although growth in export volumes was disappointing for the year ended June 1989 (1 per cent), by the September quarter export growth was running at an annual rate of 5.1 per cent. A variety of forecasting organisations give optimistic outlooks for export growth for 1990 and 1991. The last budget papers predict export growth of 7.5 per cent for the year ended June 1990. This may be an overly optimistic estimate given the Treasury tendency to present Australia's current account problem as simply the excess of growth in domestic expenditure over the growth of national production. According to the Secretary (Higgins, 1990, p8), the intention of government policy "is to slow domestic demand so that net exports can take up a greater share of output", and "as the level of domestic demand eases, more of that enhanced productive capacity will be available to sell in foreign markets and to replace imports: net exports will rise." (ibid, p4). Although Treasury acknowledge that, with a slowing of domestic demand, activity will fall in those sectors whose production is directed toward the domestic market, there is an implicit assumption that there are significant sectors of Australian industry whose export performance is supply constrained by the need to satisfy the demand pressures of the domestic market. While treating exports as the residual surplus of production over domestic demand is a feature of some overseas economic models, it does not seem a useful approach for analysis of the Australian situation, given the current composition of Australia's exports (70 per cent are rural or mineral resource based). With regard to manufacturing, the sectoral composition of the recent investment surge correlates with the pattern of domestic demand growth, rather than evidencing any significant restructuring to exploit new export potentials (see Stegman, 1990). There may be more scope for optimism with regard to exports of services, whose share of exports has increased over recent years to around 20 per cent.

In the short term it is more appropriate to see Australia's export performance as determined largely by factors outside our control: the vagaries of the conditions of international markets for commodities and our access to them (and the weather).

Current short term forecasts for international economic conditions, and hence for Australia's exports, appear cautiously optimistic, the average of nine official and unofficial forecasts reported by EPAC (1989) being for around 6.5 per cent p.a. growth in export volumes over 1990 and 1991. Accepting the assumptions underlying this estimate with a nervousness that reflects the basic nature of the balance of payments problem (our vulnerabil-

ity to external shocks), the implication is that Australia can afford a rate of growth in import volumes over the next 12 - 18 months of about 3.5 per cent per year.

"Affordable" GDP growth

In attempting to estimate the rate of GDP growth which is commensurate with growth in import volumes of 3.5 per cent, our simple growth arithmetic breaks down. Although the ratios of imports to GNE and to GDP have exhibited reasonable stability over the medium term, the short run elasticity of imports with respect to GDP (measured as the ratio of the proportionate change in imports to the proportional change in GDP) is very volatile. This is because the extent of the induced increase in imports resulting from an increase in domestic activity depends on the sectoral composition of the increase in production, and the differing import propensities of different categories of domestic expenditure. While, as has been argued above, it is dangerously simplistic to assume that a deceleration in domestic demand and expenditure will fall entirely on imports, there are reasons for thinking that the rate of growth of import volumes - 10 per cent over 1987-88 and 24 per cent over 1988-89 and running at an annual rate of 20 per cent at the September quarter 1989 - can be dragged back to a rate of growth of 3.5 per cent per year without too drastic a reduction in GDP growth.

Higgins (1990) provides evidence that short run growth rates in "endogenous imports" typically exhibit expansions and contractions which are of greater amplitude than those of GNE over the cycle.

Recent increases in import volumes have had a high capital goods content reflecting strong private investment. With resultant high domestic industrial capacity coincident with slowing domestic demand, and restrictive policy operating through higher interest rates, the rate of private investment can be expected to bear the brunt of expenditure deceleration.

Econometric models invariably postulate a higher import propensity for capital goods than for intermediate and consumption goods. (For example the IAESR forecasting model sets the respective import propensities at 0.460, 0.065, and 0.062. (IAESR 1989))

Whatever the longer term detrimental implications for future productivity and the restructuring effort, the greater the burden of a given rate of expenditure restraint that falls on investment, the stronger will be the immediate reduction in import volumes. In the short term, the more the rate of investment spending falls compared to consumption, the higher can be the rate of aggregate expenditure, and hence aggregate domestic activity, which is consistent with the trade account target.

The ORANI model, in its medium term forecasts for the period 1988-89 to 1994-95, estimates the average annual output elasticity of imports at 0.62, although this estimate is based on more optimistic export growth forecasts than above, and a fall in the real exchange rate and consequent favourable

relative price effects for "traded goods" sectors (IAESR 1990). Being less sanguine about the short term possibilities for import replacement in consumption and intermediate goods industries, but assuming that it is investment expenditure which bears the brunt of expenditure restriction, would make an estimate of the short run elasticity of imports with respect to GDP of around 1.5 seem not unreasonable.

This would imply an affordable growth rate in GDP of about 2.5 per cent per year over the next 12 to 18 months, and a GNE growth rate of just under 2 per cent. This rate of growth would need to be supported by growth in private consumption and government expenditures, the latter with a low import propensity (but ideally a propensity to provide infrastructure for export expansion).

The implications for employment and unemployment rates of 2.5 per cent GDP growth will depend on movements in average hourly labour productivity, average hours worked, and labour force growth. Assuming that labour force growth continues to run at around 2.5 per cent and output per worker increases at the modest rate of 1 per cent per year, the "Okun's Law" benchmark for no increase in the rate of unemployment is GDP growth of 3.5 per cent per year. Thus the estimate of "affordable" economic growth implies some increase in the unemployment rate, which might be expected to rise to around 6.8 per cent per year by December 1991.

In summary then, on the basis of a series of generally optimistic assumptions, Australia can in the short run, afford a rate of economic growth which represents a "soft" adjustment.

Whether this rate of growth is likely to be achieved over the next 18 months is, however, highly problematic. The obvious danger of a policy of domestic expenditure restraint is that, when it begins to bite, the "multiplier" effects, and the effects on consumer and business confidence, may lead to a continuing contraction in domestic activity far greater than policy needs or desires. The view that since the current slow down was policy induced it can be swiftly policy reversed, while having the attractiveness of symmetry, has little logical basis.

With hindsight, the stubbornness of domestic demand expenditure in responding to tight fiscal and monetary policy during 1989 is not hard to understand. Under a monetary policy regime which has abandoned the targeting of credit aggregates and seeks to act through direct influence on the level of interest rates; in an environment of high corporate profitability, where a nominal interest rates of 20 per cent imply a real after tax cost of borrowing of only around 6 per cent; and when the banks and other financial institutions have been enthusiastically willing to supply unrestricted credit at market rates to both business and consumers; the impact of higher interest rates on the level of aggregate expenditure and the demand for credit could have been

expected to be substantially delayed. Now that the high interest rate policy has finally started to bite, it will not be easy to reverse or fine tune. With activity and demand for credit slowing, and (as anecdotal evidence suggests) the banking sector reassessing the need for rationing on the basis of credit worthiness, the ability of cuts in official interest rates to provide any stimulus is doubtful. Just as over 1989 we witnessed interest rates and credit aggregates rising together, the next 12 - 18 months is likely to see interest rates and credit aggregates fall together. The old adage about expansionary monetary policy being like "pushing on a string" seems particularly apt in the current Australian context.

It should also be remembered that the freedom of action with respect to lowering domestic interest rates is limited by the perceived need to protect the exchange rate. (Whether a depreciation of the exchange rate is in fact desirable in terms of Australia's medium term interests is discussed in the next section).

On the basis of these arguments and the most recently available indicators, it seems overly optimistic to expect that the "affordable" GDP growth rate of 2.5 per cent per year will be achieved over the next 18 months. A growth rate in GDP of around 1.0 per cent - 1.5 per cent per year over this period seems a more realistic prediction. This would imply a larger increase in unemployment, which, on the basis of the assumptions stated above concerning productivity and labour force growth, would rise to about 7.8 per cent per year by December 1991.

Given that the optimistic assumptions concerning external economic conditions and consequent export growth hold, a slower rate of domestic expenditure and activity will, of course, imply a greater immediate improvement in the trade balance. However, a period of stagnation and low levels of private investment will have unfavourable effects on the medium term prospects of the Australian economy and its balance of payments position, retarding restructuring and the alleviation of vulnerability to external shocks.

3. The longer run: will the nineties be a decade of prosperity?

The answer to this question depends very much on whether Australia can solve the balance of payments/foreign debt problem. If we do not reduce the current account deficit to a level which stabilises the ratio of foreign debt to GDP, the balance of payments situation will dominate policy making and prevent sustained prosperity. Whenever the level of economic activity stays high for long, and our imports grow relatively rapidly, the government of the day will have no option but to put the brakes on the economy, producing a rerun of 1989. While the consequent slump will remove for a time the excessive current account deficits, this will only be a temporary solution.

When the economy returns to prosperity, imports will again grow rapidly, the current account deficit will again become uncomfortably high and the whole process will be repeated once more. This painful stop-go pattern can continue for decades, as the United Kingdom proved, to its cost, before North Sea Oil gave the Thatcher Government a chance to break the cycle.

The ratio of the foreign debt to GDP is not as meaningful a relationship as the ratio of interest payments to export receipts, but the former is the one on which the world focuses its attention. At the very least it is necessary to stabilise the ratio of foreign debt to GDP before we can feel comfortable about balance of payments trends. To do this by, say, the mid-1990s, two interrelated goals will have to be achieved over the next five years. Exports will have to grow more rapidly than imports, and the gap between domestic savings and domestic investment will have to be greatly reduced.

Not only are these two goals interrelated, but the second is more fundamental than the first. One reason for the disappointing performance of Australia's import replacement industries, and also of manufactured exports, is that the exchange rate for the Australian dollar is too high, making much of Australian secondary industry uncompetitive compared to overseas producers. The reason the exchange rate is so high is because of the capital which flows in each year and finances that part of investment in Australia which cannot be financed from domestic savings. The balance of payments current account deficit, over which we anguish so much, is exactly the same thing as the net inflow of foreign capital into Australia. This in turn is identically equal to the gap between domestic investment and domestic savings.

The gap between domestic investment and savings could be cut either by reducing investment levels or by increasing domestic savings. Choosing the first option would be disastrous. Remember that we are talking about physical investment in buildings and equipment, not financial investment in shares and bonds. Investment in both the public and private sectors must remain high, indeed must be increased, if Australia is to achieve the restructuring of industry and productivity gains necessary to increase exports relative to imports.

The need for a sustained high level of investment is widely accepted and does not need to be defended at length. However, what is not widely realised is that investment in the public sector is just as important in this context as investment in the private sector. Some public investment contributes directly to productivity growth in the private sector. This type of investment varies from very mundane things, like roads and railways, to very sophisticated technology like satellites which can send back "geological" pictures of remote areas and aid the search for minerals. Other public investment, for example, in schools and universities, contributes indirectly to productivity in the private sector.

This is not to say that all public investment contributes equally to growth in output, or even that all such investment has a positive effect on output growth.

Some public investment aids productivity growth much more than others; and, like some investment decisions in the private sector, some public investment decisions are misguided and result in white elephants. Obviously, care must be taken in selecting public investment projects; but there is no doubt that public investment has contributed significantly to the growth in output and productivity growth in Australia. In fact, public investment has been more important in increasing productivity growth in Australia than in many countries. Public sector investment has a continuing role to play in promoting growth.

Growth in capital equipment per head is a very important source of productivity growth, or growth in output per head. In the postwar period approximately half of the increase in labour productivity in Australia has been due to increased capital. The other half has been due to intangible factors such as technological change. The methods used to estimate sources of productivity growth are fairly crude and not much weight should be put on small differences between various estimates, nor on the exact figure. Nevertheless, the general picture is clear. A study by Kaspura and Weldon produced figures, quoted in EPAC (1986) which imply that 48 per cent of productivity growth in Australia over the period 1946-47 to 1978-79 was due to increased capital per head. This conclusion is in line with figures in an unpublished study by W.D. Scott which estimated that in Australia, over the period 1950-51 to 1973-74, 58 per cent of the growth in productivity was due to increased capital per head. These proportions of the percentage of productivity growth due to increased capital are rather larger than the figures obtained in studies for various overseas countries. Thus, the significance of the figure of approximately 50 per cent is twofold. It shows both the importance of investment as a source of productivity growth, and that it has been relatively more important in Australia than in many overseas countries for which studies of the sources of productivity growth have been made.

Increased capital per head comes from both public investment and private investment. The second point is that in Australia public investment is typically a greater proportion of total investment than is the case in many countries. Typically, Australian public investment is about a third of total investment compared with less than 20 per cent in the United States and between 20 and 30 per cent in Japan, Canada and most non-Scandinavian European countries. (In Sweden and the United Kingdom the ratio was around 40 per cent. It still is in Sweden but has been cut to about 25 per cent in the UK).

Thus, in Australia, not only is investment more important in contributing to productivity growth than is generally the case, but public investment is a greater proportion of total investment than in many countries. Public investment has been an important source of productivity growth in the past, and must be an essential part of efforts to increase productivity growth in the 1990s.

Australia also needs to increase its investment in social infrastructure, which has been run down during the years of fiscal austerity. Recent events in the grossly overcrowded prisons in Britain should serve as a stark warning of the dangers of neglecting even the least glamorous parts of our social infrastructure. The need to spend more on such things as an adequate sewerage system is much more obvious, at least to residents of Sydney.

How much investment do we need? In the period from the slump in 1974-79 to the slump in 1985-86 gross fixed capital investment (both public and private) in Australia averaged 24 per cent of GDP. This was higher than the OECD average over the same period, which was 22 per cent. However, it was not enough, and by 1986 our capital stock was aging and inadequate. Because of our rapid population growth compared to most OECD countries, Australia needs to invest a greater proportion of its output than do OECD countries on average. In the "golden age" of the second half of the nineteen sixties gross fixed capital expenditure in Australia was around 26 per cent of GDP. In 1988-89 this ratio was again 26 per cent, but unfortunately, because of the replacement backlogs that have built up, we will need to do better than that over the next five years, and probably for the entire decade. While it is impossible to name a very precise figure with any confidence we argue that another percentage point of GDP is the minimum before we can feel that the amount of output devoted to investment in fixed capital equipment is satisfactory. Allow another half of a percentage point for investment in inventories, and one gets a total investment target of 27.5 per cent of GDP. This is what is required if we are to have a reasonable chance of achieving the structural change and productivity growth required to increase exports enough relative to imports to stabilise the foreign debt ratio by the mid-1990s, and to escape from the cycle of stop-go macroeconomic policies.

In 1988-89 the net borrowing from overseas was \$17,304 million or 5.1 per cent of GDP. If we are to stabilise the ratio of foreign debt to GDP by the mid-1990s this will have to be reduced to 3 per cent at the most. In other words we will have to maintain gross domestic savings at a level equal to 24.5 per cent of GDP.

Over the last decade, after allowing for the using up of capital equipment, savings by the corporate sector has generally been negative, but in both 1987-88 and 1988-89 it was positive. 1988-89 was a very strong boom year in which profits were high. High profits lead to corporate savings and one could not expect to maintain corporate savings at the level of last year. If the decade of the nineties does prove to be a decade of prosperity, it is not unreasonable to expect corporate savings to be at the average level for the last two years, i.e. one per cent of GDP.

Government savings net of consumption of capital were 2.3 per cent of GDP in 1988-89. This will have to be increased, not through tighter fiscal

policy, but through more public expenditure on fixed capital equipment. Taxation receipts as a proportion of GDP will need to rise by 0.7 of a percentage point, with all the extra taxation receipts being spent on fixed capital. Because of bracket creep this need not necessarily mean a rise in nominal taxation rates.

"Consumption of fixed capital" can be expected to continue at about 15 per cent of GDP so that household savings will have to rise by one percentage point from the 1988-89 level to 5.5 per cent of GDP if the required savings ratio is to be achieved in the economy as a whole.

This rise in all household savings ratio is a feasible, if not easily achievable, goal. There are policy moves which will make it more likely. For example, the Commonwealth could push for more wage rises to be in the form of superannuation payments. Since a rapidly aging population saves less, the migrant intake should be kept at its present level, and indeed gradually increased throughout the nineties, to slow down the rate at which the Australian population ages. Interest rates should be reduced further to stimulate private investment, but if the rise in the household savings ratio is not matched by sufficient private investment, public sector investment should be increased without a corresponding increase in effective rates of taxation.

Raising gross domestic savings to 24.5 per cent of GDP is only half the battle. The other half is to increase net exports. If the ratio of foreign debt to GDP is to be stabilised by the middle of the nineties exports will have to grow 4 to 5 percentage points more rapidly than imports in each of the years between now and then. As we argued earlier this will probably happen in 1989-90 and 1990-91 because of the depressing effect of the slump on the demand for imports. The challenge is to make it continue to happen as economic activity picks up.

It is more likely that exports will grow by 4 to 5 percentage points more than imports each year over the next 5 or 6 years, if there is a real devaluation of the Australian dollar of about 10 per cent. That is, the nominal rate of exchange for our dollar should fall by 10 per cent in the near future, with a further fall in each successive year by an amount equal to the difference between Australia's rate of inflation and that in our trading partners. This devaluation is not only desirable to encourage a significant expansion of manufacturing exports. It will make all exports both more profitable and more competitive on international markets. Most importantly it will discourage imports and is a precondition for rapid growth in import replacement industries.

In the short run the price elasticity of demand for imports is very low. One only has to look at the events of 1988-89 to document this. Despite the rapid fall in the price of imports relative to Australian domestic prices caused by the revaluation of the Australian dollar, the amount spent on imports actually fell

as a proportion of gross national expenditure in the year ending June 1989. This occurred during a very strong boom in which gross national expenditure grew by 16.6 per cent (and by 9.2 per cent in constant price terms). However, in the longer run the price elasticity of imports is somewhat greater. Recent estimates range from that of the Treasury's NIF model of 1.4 to the EPAC's AMP's model estimate of 0.6). A figure half way between the two, of about 1.0, is probably the best guess. Thus, in the medium term a devaluation of 10 per cent would produce a 10 per cent drop in the volume of imports (and in the amount of foreign currency spent on imports). This will give an immediate boost to the import-replacement industries, but, if local entrepreneurs believe the fall in the value of the Australian dollar (and hence the higher prices of imports) to be permanent they will invest more and expand capacity, slowing the rate of growth of imports significantly in the longer run (say 3 to 6 years).

Thus, the government should indicate forcefully its belief that the new lower level for the exchange rate is appropriate, and state firmly that it will not push up interest rates to the extent that would induce sufficient capital inflow to make the exchange rate appreciate again. If, as seems likely, overseas interest rates rise this promise should not be too hard to keep, as it is the difference between Australian and overseas rates which affects the exchange rate. In any case it is very important that interest rates should be kept as low as possible to encourage investment.

Secondly, to make feasible strong growth in exports and import replacement industries, it will be necessary to boost the rate of growth of productivity. The consequent need for microeconomic reform has been well canvassed by many commentators, and generally the major reforms advocated are highly desirable. The only exception is complete deregulation of the labour market which is advocated by some academics and business economists. Continuing wage restraint will be essential. It will ensure that the initial devaluation of 10 per cent or so is not immediately offset by higher wages. Wage restraint will also keep Australian industries competitive in the long run and help to prevent a devaluation-inflation-devaluation vicious circle. In our judgement the necessary wage restraint will not be forthcoming in times of prosperity unless some version of the Accord remains firmly in place.

In recent years labour productivity (or output per person hour) has only increased by about one per cent a year. This is what one would expect with declining real wage rates, which encourage firms to increase employment and substitute labour for capital. However, if this figure holds for the next five years there will be no room for real wage growth if the target of something like 5 per cent growth in net exports a year is to be achieved in a period of prosperity. Since the Second World War labour productivity growth in Australia has averaged over 2 per cent a year and with microeconomic reform we should be able to achieve at least this rate of growth over the next 5 years.

If we do, real wages could grow at a little over one per cent a year. If productivity grows more rapidly, real wage growth can be correspondingly higher.

4. Conclusion

There is no doubt that the economy is now in a recession which will last for the rest of this calendar year. Unless the world economy slows down much more than we, or most other commentators, expect, the economy will pick up next year. In 1991 some growth can be expected, although this will not be enough to prevent unemployment rising over the next 18 months. After that what happens depends very much on how successful we are in solving the balance of payments problem.

There are three possibilities:

1. This government, and more importantly the next one, could keep in place such firm contractionary macroeconomic policy that aggregate demand and real output do not rise very much. Unemployment would increase substantially and, with the stagnant level of aggregate demand, imports would decline, or fall and then remain at the low level. This would certainly solve the balance of payments situation. Equally certainly, in no way could it be described as a state of prosperity.
2. We may continue to borrow large amounts overseas, with the foreign debt steadily rising relative to GDP. This would allow times of prosperity but only for relatively short periods. The stop-go nature of the economy will increasingly undermine confidence and discourage investment as will the high interest rates necessary to attract foreign funds. Even more important, sooner or later the growing level of foreign debt will cause a crisis in which overseas lenders stop lending to Australia. This will cause a large abrupt fall in the exchange rate which will probably overshoot and the consequent adjustments will be very painful, causing the closest thing to a real depression that we have seen in fifty years.
3. The third possibility is the one in which employment grows strongly in 1992 and subsequent years, domestic savings rise substantially, exports grow much faster than imports, and the current account deficit is at the most, only 3 per cent of GDP. This possibility is not only the most desirable it is also perfectly feasible as long as appropriate policy is put in place by government, and management and unions work together to improve productivity.

The required policy framework is necessarily complex, but can be summarised as follows:

1. A further substantial reduction in interest rates and a fall in the exchange rate. (This fall will help both to increase net exports and is an inevitable consequence of the substantial fall in interest rates).
2. Substantial wage restraint. Real wages will probably be able to increase at a little over one per cent a year. The figure may be less if the pace of microeconomic reform is slow and could be greater if there is rapid productivity growth.
3. An increase in government capital spending, financed by a small increase in taxation receipts.
4. A very tight rein on government expenditure on current goods and services and transfer payments (such as social security benefits) with any increases (as a proportion of GDP) financed by increased taxation (in addition to the increase already postulated in point 3).
5. Measures to increase the domestic savings rate, e.g. the payment of as much as possible of wage rises in the form of superannuation payments, and a strong immigration program to prevent the population aging too rapidly.
6. Vigorous pursuit of microeconomic reform, carried out in such a way that it does not make impossible the wage restraint mentioned in point 2.

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