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Macroeconomic Policy in Australia 1983-1996

William F. Mitchell

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Centre of Full Employment and Equity
The University of Newcastle, Callaghan NSW 2308, Australia
Home Page: <http://e1.newcastle.edu.au/coffee>
Email: coffee@newcastle.edu.au

Introduction

In 1972, Australia's inflation rate was 6.2 per cent, but following the first OPEC oil shock in 1974, aided by some large wage increases, the inflation rate reached 17 per cent in 1975. By the end of the 1970s, despite a period of subdued activity and rising unemployment, the inflation rate was still high in relation to our trading partners at 9.2 per cent. The wage increases that followed the breakdown of the period of wage indexation in the early 1980s pushed the inflation rate, once again above 10.4 per cent, and provided the background to the introduction of the Accord in 1983. At that time, the unemployment rate and the inflation rate were at around 10 per cent due to the sluggish economy.

The following period, the Labor years, were associated with strong employment and Gross Domestic Product (GDP) growth from 1983-84 to 1989-90, negative growth during the recession, and then a strengthening recovery after 1993-94. For the period 1984-85 to 1994-95, Australia's total employment growth per annum averaged 2.19 per cent, while the corresponding growth per annum for the OECD countries in total was 1.05 per cent. For the 1984-85 to 1989-90 period of expansion, the Australian figure was 3.43 per cent compared to 1.65 per cent for the OECD. Over the recession of 1990-91 to 1994-95, Australia's employment growth was 0.70 per cent per annum compared to the OECD outcome of 0.33 per cent per annum.

But the gains made in the 1980s were substantially sullied in 1990, when the Labour Government delivered the worst economic downturn for 60 years. The high unemployment that accompanied the recession was policy-induced in two ways.

First, it directly followed the high real and nominal interest rates that the government has deliberately created to slow down the economy, as the balance of payments became unmanageable. Second, the high interest rates were the product of a confused macroeconomic policy position that bedevilled the government throughout the 1980s.

At the basis of policy making is the need for internal consistency. Once a particular set of targets or goals are determined each policy component must support the next. A microeconomic industry policy, for example, designed to engender an internationally competitive value-added export sector will make little sense if high exchange rates are being used to control inflation and high interest rates are being used to control reduce activity as a means to reduce imports. The high interest rates will negate the competitive gains that a lower inflation rate might deliver and the

high interest rates will push the exchange rate even higher and further erode the competitiveness of the export sector.

This sort of policy position is inconsistent. Yet it is exactly what the Labor government had in place by the late 1980s. Following the recession, the Government never really recovered to take control of the economy again. The 1990s period of the Labor government was really an exercise in ad hoc firefighting. The coherence of their position was destroyed in the post 1987 period.

Why did the Labor government adopt rationalism?

To better understand the “Labor years” we must go back in time. Prior to the 1970s, ‘Keynesianism’ was the mainstream macroeconomic approach, which originated with J. M. Keynes’s path-breaking *General Theory of Employment, Interest and Money* in 1936. Keynes had argued cogently that the market would not produce a full employment level of output. The message was absorbed by post WWII governments, who assumed responsibility for aggregate demand management to stabilise fluctuations in the level of economic activity, which were largely due to variations in private sector investment spending.

In Australia, the 1945 White Paper stated that the goals of the Federal Government were full employment, price stability and balance of payments stability. Over the next 25 years, various configurations of spending, taxation, and monetary control were employed in an attempt to achieve these goals. In general, such stabilisation was highly successful in the sense that we experienced low unemployment rates, high rates of GDP growth, low inflation and satisfactory balance of payments outcomes.

Prior to WWII, for almost one hundred years, the industrialised countries had developed a marked cyclical pattern, characterised by the familiar alternating features of expansion, boom, crises and recession. After the war, for around thirty years this pattern was interrupted. Throughout the world, output growth accelerated with fewer fluctuations. Serious recession became unusual and downturns were merely times when growth slowed rather than became negative. The systematic use of demand management policies was largely responsible for this noticeable change in economic behaviour. The Keynesian approach was predominant because it worked.

The rise of monetarism

Severe disruptions were experienced by Western economies as a result of the oil price shocks in 1974 (and later in 1979). In 1974, for the first time, recession was accompanied by high inflation in Australia and elsewhere, which was a break in the post-war period of stability and growth. The prevailing Keynesian thinking had always considered inflation and unemployment to be mutually inconsistent forms of disequilibrium, a view refined by the Phillips curve analysis that considered the two ills as substitutes.

The basic Keynesian explanation of inflation sourced it to excessive aggregate demand. Even when cost-push pressures were identified, it was understood that a rise in costs affects both prices (through margins) and output levels. For output to be unaffected, demand side accommodation had to occur (either via a money wage rise adding to both costs and demand or through the government intervening to avoid output failure). So inflation could not persist unless demand expansion fed it. The Keynesian approach to inflation by the early 1970s thus involved a complex accounting of separate demand and supply (cost) factors and a determination of the degree of demand accommodation, which was going on.

At the same time, Milton Friedman and Edmund Phelps were spearheading a revival of neoclassical thought centred on the quantity theory of money, or monetarism, as it became known in the 1970s. The monetarist explanation of inflation was so general and simple compared to the complexities of the Keynesian analysis that it gained popularity and credence. The Keynesian-Monetarist debate appeared to become one of extreme views: the naive Keynesian view where unemployment was solely due to deficient demand, and the monetarist “natural rate” hypothesis which treated all unemployment as voluntary.

Monetarism was accompanied by the ‘new labour economics’ that provided a microeconomic justification for the claim that all unemployment was due to rigidities imposed by governments and/or trade unions or was the outcomes of voluntary maximising choices made by individuals.

So the Keynesian goals of full employment, price stability and balance of payments stability were considered simply to be automatic outcomes of price flexibility. Thus, thirty years of policy debate based on the fundamental premise that the private market could not generate outcomes consistent with these goals was rendered benign. The immense waste of resources due to the

output gaps when persistent unemployment occurred and which had motivated the 'Keynesian revolution' were now to be ignored.

It became an article of monetarist faith that stabilisation policy had detrimental consequences for the White Paper goals, basically because it interfered with the price adjustment mechanism. Incredibly, in the light of conventional accounts of history of scientific breakthroughs, no new argument was associated with the resurgence of monetarism. So in the period of uncertainty following the oil shocks, neoclassical thought, so thoroughly discredited in the 1930s, re-emerged as a new orthodoxy in macroeconomics.

The New Classical Approach

Despite the widespread failure of the monetarist policies, as unemployment rates continued to rise in OECD countries in the late 1970s and early 1980s, balance was not restored to the policy debate. An even more extreme free market view, called new classical or rationalist economics emerged. This approach argued that monetarism failed because it did not go far enough. In the Australia, this was cast in terms of microeconomic reform, which meant deregulation of the financial and labour markets and the dismantling of the welfare system.

Despite some fiscal Keynesianism in the first two years, the Hawke government became captive of rationalist approach. Perhaps this was in part to prove that they were serious economic managers and not in the discredited Whitlam mould. The manifestation of this policy focus was the reliance on a much narrower set of policy instruments. In particular, fiscal policy was severely constrained by the ongoing expenditure cuts and tax relief to companies and higher income groups.

The major tool of adjustment adopted by the Labor government became the real interest rate. This policy stance really failed to achieve all but one goal – low inflation. Yet due to the pervasiveness of rationalist thinking in the senior levels of the Federal bureaucracy and the private sector 'think tanks' the Government was unable to free itself of its political straitjacket. By the time the recession hit in 1990, it had lost coherence in its policy. In political terms it also began to lose its traditional supporters.

The prevailing rationalist approach failed to deliver for Labor as it has for governments across the OECD. It deflated the economy successfully, but only at the cost of excessive unemployment, and it also inhibited structural change. The low inflation produced by this approach requires low

growth for its sustenance. The growth rates we have seen since 1990 have not been sufficient to make anything but the slightest dent on the high unemployment rates.

Charting the Labor Years

Figure 1 charts the growth of real GDP (per cent per annum) from March 1980 to March 1996. March 1980 represented a trough in the business cycle and so Figure 1 depicts 4 full cycles, with the troughs being depicted by the dotted lines. The hard red line denotes the election of the Hawke Government. Table 1 defines the cycles (from trough, peak, back to trough), over the Labor period.

Table 1 Business Cycles from March 1980 to March 1996

Business Cycle	Period
Cycle I	March 1980 to June 1983
Cycle 2	June 1983 to September 1986
Cycle 3	September 1986 to June 1991
Cycle 4	June 1991 to December 1995

The trough in March 1980 marked an end of a decade of high inflation and unemployment, low real GDP growth and declining productivity growth. The latter half of the 1970s was marked by Malcolm Fraser's monetarist approach of fighting inflation first and lower levels of activity followed.

To more fully comprehend what was going on with the major expenditure aggregates over the four business cycles identified, the Figures 2 to 5 decompose the real GDP growth its real consumption, investment, government and export and import components. They are highly illuminating in explaining the way the business cycle unfolded over this period.

Figure 2 shows that in the period prior to the March 1983 election. The first expansion began in the second quarter of 1980 as the Fraser Government revved up the economy on the back of a prospective mineral boom. Business believed the minerals boom rhetoric and invested heavily throughout 1980/81, mostly in base metals manufacturing and mining. The large metals industry pay rises in December 1981, which followed the return to decentralised wage bargaining, reflected the confidence in the mining sector. However, the world economy failed to grow as expected, partly as a result of the US reaction to the rising debt levels in less developed countries. Our metal export prices fell in 1982, investment then declined sharply and this triggered the

recession in 1982/83, which reached a trough in the quarter after the election of the Hawke Government.

Figure 1 Growth in real GDP per cent per annum

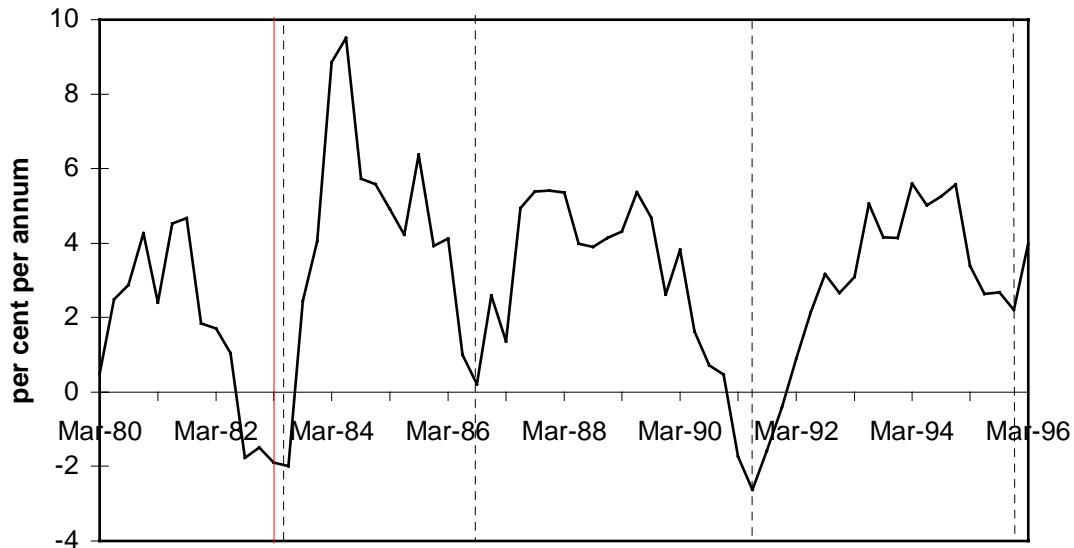
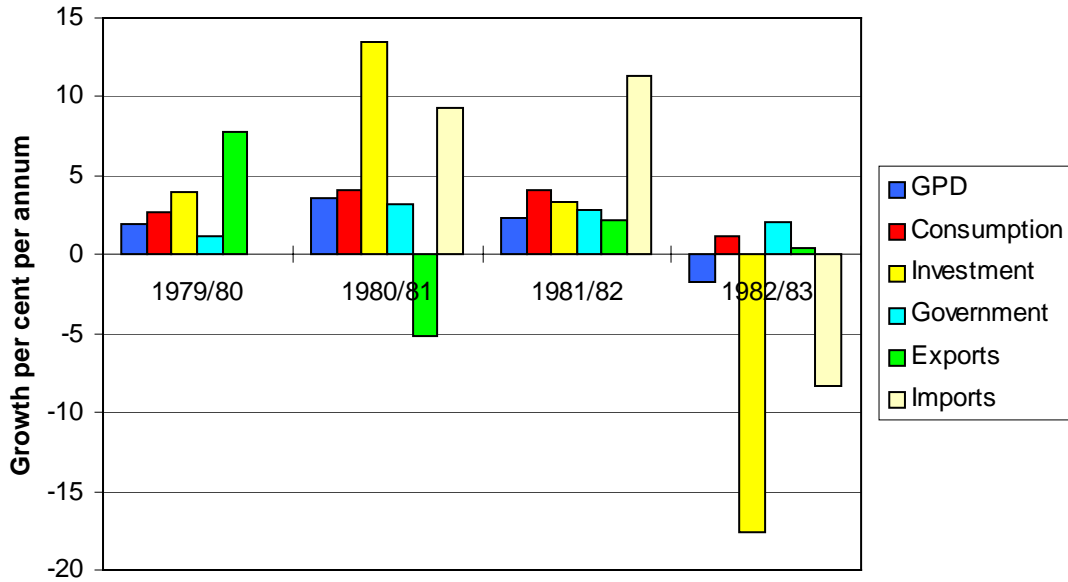


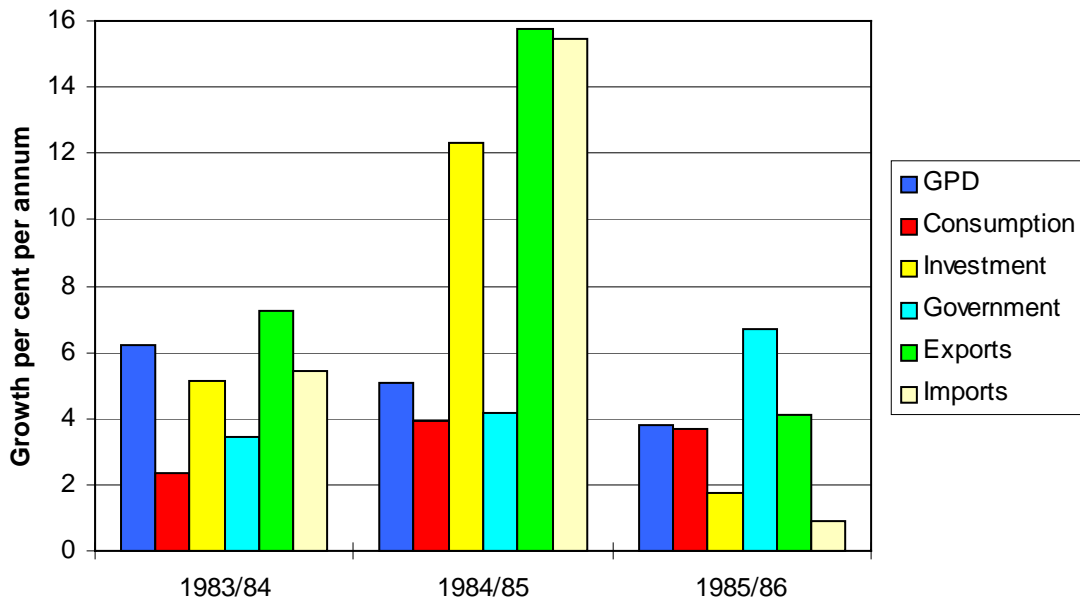
Figure 3 shows the first expansion following the election of the Hawke Government in March 1983. Real GDP bounced back strongly in the first year of the Labour Government led by a strong export performance and private capital investment. The contribution of government also rose.

However, there were other major developments in 1983. The National Economic Summit Conference held soon after the election delivered a so-called consensual approach to macroeconomic policy including wages policy. Notably, the consensus was only between the Federal Government and the Australian Council of Trade Unions (ACTU) with the business sector choosing not to enter any formal tri-partite agreement. The agreement restored national wage fixation under the *aegis* of the Accord, which included a dubious strategy to initially cut real wages to restore profit margins and thus encourage investment. An important adjunct of the agreement was that it also defined an active macroeconomic role for the Government in sharp contrast to the monetarist Fraser years. Part of this intervention was to create services which would boost the “social wage”, an explicit recognition that the government would pay some of the real income back to workers that they lost in the Accord restraint.

**Figure 2 Composition of real GDP growth
Business Cycle One**



**Figure 3 Composition of real GDP Growth
Business Cycle Two**



The use of taxation policy particularly in the wage setting process was a highlight of the Labor Government's approach to macroeconomic management. While it allowed the private sector to experience lower labour costs and gave workers some gains (or lower losses), it also acted as a proxy industry policy, which provided broad and unjustifiable subsidies to higher cost firms.

Argy (1992, p.203) says that:

In its first budget in office the Hawke government reverted to a Keynesian strategy. A fight inflation first strategy was officially replaced by a strategy of combating unemployment.... the Treasurer said 'while ... private sector spending is at a low ebb the government has accepted the need for a more substantial role for the public sector...[the budget]... is designed to provide a floor of activity to the economy while the private sector recovers.'

Figure 3 shows the expansion in government spending in the first two years of the Hawke Government. In 19981/82 Government spending was around 26 per cent of GDP. In 1984/85 it had risen to 30 per cent on the back of a sharp rise in the Federal budget deficit. Calculations by Nevile (1995, p.115) show that the structural deficit in 1983-84 was 2.9 per cent of GDP a jump from the -0.9 per cent of GDP in the 1982-83 budget.

Private investment and consumption also accelerated reflecting the new period of growth. The GDP growth rate was sufficient to make inroads in the high unemployment rate. The June 1983 peak was 10.2 per cent, and two years later it had fallen to 8.3 per cent.

Real Wages

Figure 4 shows that the planned redistribution of income towards profits was highly successful in the early Accord years. The reduction in real wages was unprecedented and saw the wage share in national income go from 63.3 per cent in March 1983 to 59.4 per cent a year later, dropping to 56.4 per cent in June 1989 and remaining at around 57 per cent until the present day.

An upsurge in government spending (see Figure 3) also accompanied the strong employment growth and the falling real wages in this period. The combination of events meant that economists could not use the data to test whether Keynesian or neoclassical employment theory was the most appropriate.

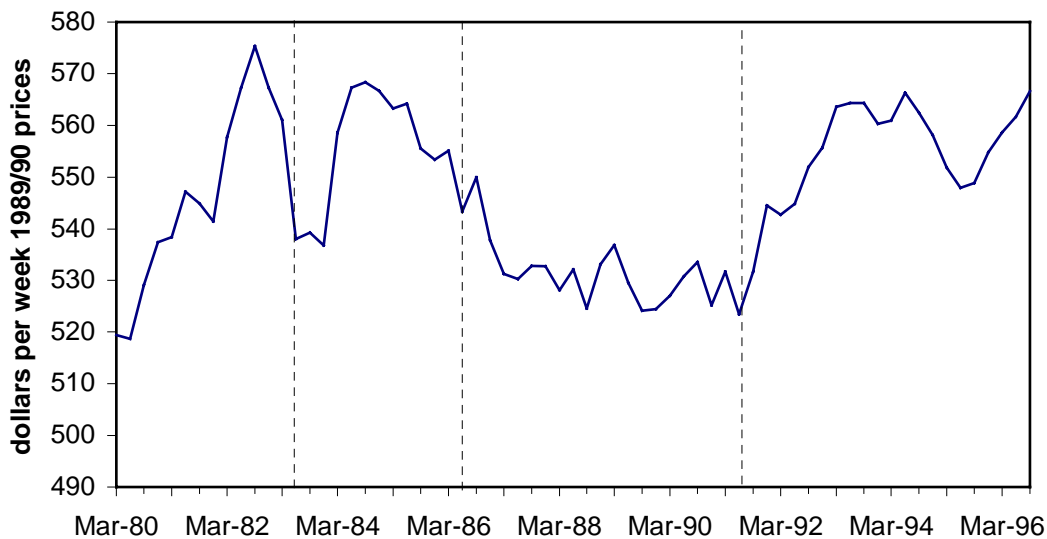
Over the Accord period, the wage share showed a downward trend until the strength of the 1990s recession countered the trend. The correlation between the rising wage share and the rising

unemployment in the 1970s and the early 1980s seemed to conform to the predictions of neoclassical employment theory. King (1990, p.168) says that

Many neoclassical economists argue that this is what occurred in the mid-1970s, and again in 1980-82. In both cases, it is suggested, trade union wage pressure led to a reduced profit share, lower investment and increased unemployment, making the elimination of this so-called real wage overhang the chief target of macroeconomic policy (Corden, 1979).

The ‘real wage overhang’ debate dominated labour market discourse in the 1970’s. The debate polarised the economics profession into two extremes with little common middle ground (see Covick, 1984; Gruen, 1978). At one end of the divide stood the ‘neoclassical’ economists who held, that given their adherence to the principles of marginal productivity theory as a working model of the aggregate labour market, real wages growth in excess of labour productivity growth created an overhang, which resulted in unemployment. Yet, using this logic, it was hard to argue how an overhang could persist, given that the unemployment would increase the (marginal) productivity of the existing employed labour force to match the higher than ‘full employment’ real wage.

**Figure 4 Real Wages
March 1980 to September 1996**



At the other end, stood the non-neoclassical economists who held that the marginal productivity link between the real wage and employment was flawed, and, particularly, failed to account for the role of aggregate demand. The latter, it was argued, could simultaneously create

unemployment due to a deficiency of sales volume and the real wage overhang (measured as a rise in the wage share) due to the pro-cyclical nature of productivity (the denominator in the real wage overhang measure).

The Accord was conceived as part of the prevailing overhang logic and clearly aimed to redistribute or realign factor shares so that they might resemble the 1960s levels. The 1960s period of low inflation and low unemployment and steady GDP growth was seen as the benchmark for economic well being, despite the fact that supply conditions in the world economy, principally as a result of the oil shocks, had changed irrevocably.

Chapman (1990, p.33) says that

“The ‘real wage overhang’ argument of the 1970s has all but disappeared with the overhang itself, the debating points probably not going to either of the extreme positions. As well, there is an emerging consensus that, at least in the Australian institutional environment, an incomes policy has the potential to deliver propitious aggregate, but not necessarily microeconomic, labour market outcomes.”

In the distributional sense, the Accord was spectacularly successful, especially in the early years when the wage share fell sharply throughout the period of rapid employment expansion. The rise again in early 1990s was recession driven. The fact that employment growth and falling wage share were correlated gave strength to the real wage overhang arguments. However, the picture is far from straightforward. Real wages fell over most of the Accord period while productivity largely increased. Combined, the result has been a declining wage share (or RULC). Employment change has exhibited three phases: strong growth, a sharp decline, and then some growth again. Further, the cycles in investment and private consumption spending have closely matched the phases of employment growth.

The crucial change in policy stance

By 1984-85, the Government had stopped its expansionary phase and became committed (during the December election campaign) to a falling deficit/GDP over the next three years. Despite the 1985-86 budget being mildly expansionary, the five budgets from 1984-85 to 1989-90 were on the whole contractionary.

Figure 4 shows the changes associated with the third business cycle since 1980 and the plunge into serious recession in 1990. The preceding slowdown in 1985/86, which endured into the 1986/87, was caused by a sharp dip in our terms of trade. Between March 1985 and March 1987,

the terms of trade fell by around 14 per cent. The terms of trade decline and the persistent current account deficit led to a staggering 37 per cent fall in the trade-weighted index (the exchange rate) between the beginning of 1985 and the middle of 1986.

While the dollar had floated relatively cleanly since 1983, the Reserve Bank began to defend it in the foreign exchange market and argued “the fall in the Australian dollar over the previous 18 months had provided an adequate basis for progressively correcting Australia’s external accounts” (Reserve Bank, 1987).

The Government sought to maximise the competitive advantage derived from the ‘real’ depreciation. With inflation still persisting at high levels despite the wage moderation, they feared that the imported price rises accompanying the exchange rate depreciation would destroy the Accord and set in process a renewed wage-price spiral. Accordingly, there was a terms of trade discount in the wages round and a signal that indexation would be abandoned in favour of productivity-based increases.

Given the strong growth over this time, the fiscal stance of the Government was reasonable over the 1983-89 period. The real mistakes were made in the conduct of monetary policy. Argy (1992, p.214) argues that:

There was probably a need by end 1984 to reverse persistent public sector deficits; as it happened tight fiscal policy was appropriate on two counts: the rapid growth of the economy and the persistent current account deficits. On the wages front too, it exhibited remarkable flexibility, adapting as conditions changed.

Its biggest failure was undoubtedly on the monetary front. Even allowing for the serious difficulties it encountered in implementing monetary policy because of financial deregulation its attempts at finetuning failed. Monetary policy should, it appears, have been tightened earlier and eased much earlier.

Reflecting the increasingly influential rationalist pressures, the Hawke government had set about on a path of microeconomic reform. The period 1983 to 1988 was one of heavy financial deregulation. The largest changes occurred in the 1983-84 period, which coincided with the full float of the dollar (as the Reserve Bank abandoned attempts to sterilise the heavy capital inflow in the first months of the Hawke Government). All exchange controls were abandoned in late 1983, and all controls on bank deposits were abandoned in August 1984. Foreign banks were invited to enter in early 1985 and interest rates deregulated in 1986. The last of the big changes saw the SRD ratio, which was a primary prudential control instrument fully, replaced by the Prime Asset Ratio (introduced in 1985 to replace the LGS, and then the SRD in 1988).

In earlier periods it was possible to gauge the conduct of monetary policy by the growth in M3 compared to the growth in real GDP and the inflation rate. A large increase in the annual M3 growth rate signalled a loosening in monetary policy and vice versa. However, during 1984 it became clear that the relationship between M3 and GDP was no longer stable.

The Hawke Government had maintained the monetary targeting approach of the Fraser Government. But with significant domestic financial deregulation occurring in 1984, which expanded the demand for money (all controls on bank deposits abandoned which restored their competitive against the non-bank financial intermediaries), it was no longer possible to accurately target monetary growth.

**Figure 4 Composition of real GDP growth
Business Cycle Three**

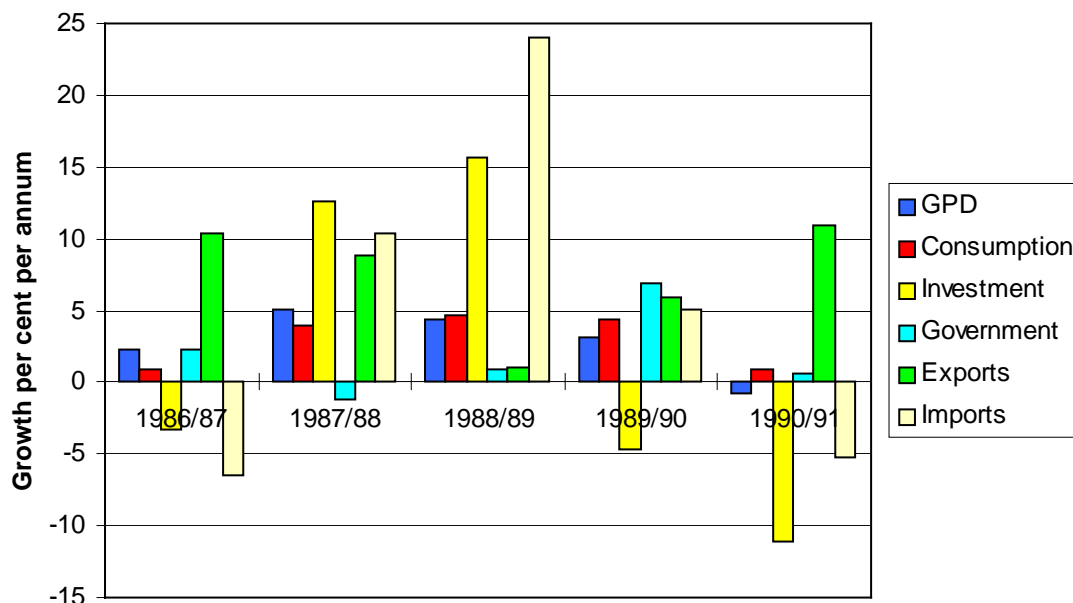


Table 2 summarises the decade of monetary policy aggregates from 1980. Base money refers to the sum of the Reserve Bank liabilities (cash and reserve deposits by banks). It is also called high-powered money and is the target of monetary policy because through this the Reserve Bank attempts to control the money supply. The money supply (variously defined in increasing order of broadness from M1 to Broad Money) is a multiple of the base. A change in the base changes currency and/or the assets of the private banks, which then multiplies through to changes in the

money supply. A standard method of manipulating the base is for the RBA to conduct an open market bond trade.

Table 2 shows how futile the Hawke government's maintenance of the monetary targetting was. The relationship between the base and the various measures of the money supply was not at all stable. The RBA could not control the growth of the money supply following deregulation and the movements in capital inflow. In January 1985, monetary targetting was abandoned in place of the checklist approach (see Argy, 1992, p.203).

Table 1 Monetary Policy Aggregates in Australia, 1980-1990, Annual Percentage Changes

Year	Base Money		M1		M3		Broad Money		CPI Growth One Year Later
1980	7.8		14.6		10.0		13.4		9.7
1981	10.8	E	9.7	VT	14.2	E	15.7	E	11.1
1982	9.8	N	1.7	VT	7.3	VT	13.9	T	10.1
1983	8.1	T	6.6	VE	22.3	VE	11.4	T	4.0
1984	11.8	E	10.8	VE	10.4	VT	11.5	N	6.7
1985	14.8	E	10.8	N	3.4	VT	16.1	VE	9.1
1986	10.3	T	4.7	VT	14.9	VE	13.4	T	8.5
1987	9.2	N	17.1	VE	5.0	VT	10.1	T	7.2
1988	11.8	E	24.0	VE	8.4	E	12.0	E	7.6
1989	5.6	VT	20.8	T	10.9	E	18.8	VE	7.3

E = Easy, VE = Very Easy, N = Neutral, T =Tight, VT = Very Tight
Source: IMF, International Financial Statistics

Did the Labor government have to deregulate the financial system?

Was their zeal to introduce financial deregulation at a rate faster than most countries that were initiating similar reforms a reflection that they were captives of the free market lobby? Or was the deregulation inevitable, and therefore responsible?

Argy (1992, p.214) says:

One might argue that domestic financial deregulation may have proceeded too rapidly. ... Japan and many European economies deregulated at a slower pace with less disruptive distortions in their monetary aggregates. Deregulation not only made the task of monetary management more difficult but also in part produced some of the excesses of credit expansion (and asset inflation) of the second half of the 1980s.

The major justification for the deregulation was that it was inevitable given the developments of the 1970s and early 1980s. Following the period of high inflation, consumers increased their awareness of real interest rate returns. With the banks heavily regulated under the Reserve Banks prudential requirement, new institutions like the building societies and cash management trusts emerged to offer a number of new financial products to consumers. These developments reduced the ability of the Reserve Bank to control the monetary system. In the light of these changes, the 1981 Report of the Committee of Inquiry into the Australian Financial System (the Campbell Committee) recommended widespread deregulation. While largely, and curiously, ignored by the Fraser government, the Hawke government embraced it with fervour. This was the first clue of Labor's market orientation and not the first time it would 'betray' its traditional support base.

There was a rapid credit expansion in the next few years and banks, ill equipped to handle the sudden plunge in to unregulated wholesale trading, soon began to show signs of stress. Milbourne (1995, pp.120-121) said:

As a result, provisions for doubtful debts doubled as a percentage of assets from 1984 to 1988, bank profits were severely squeezed and interest margins (the borrowing-lending differential) stopped (sic) its downward trend and rose somewhat after 1986.

If deregulation was meant to restore the Reserve Banks prudential effectiveness it failed. The Reserve Bank actually lost control of the money supply and the exchange rate after deregulation. The major crashes and high bank charges now levied on consumers is further evidence of banking dysfunction.

The Reserve Bank could have easily restored control despite the rising importance of the non-bank financial intermediaries by simply bringing them into the prudential framework. The reason the Government did not pursue this option is more to do with its rationalist leanings than any economic argument.

Further, it was claimed that deregulation would deliver competitive benefits to consumers. The mergers of the local banks following deregulation seemed to be counter to the competitive model that relies on the existence of many small firms. And while many new services have been offered to customers over the last decade or so, it would be a mistake to attribute them to deregulation. Technological advances, which allowed new innovations like electronic banking, widespread credit card use and the like, would have occurred independently of the degree of regulation.

Both Harcourt (1992) and Stretton (1987) have shown that the deregulation was not beneficial to the economy. It introduced more instability and has penalised the small consumers. It has also reduced the effectiveness of monetary policy.

The move towards recession

With the breakdown in money stock targetting, the RBA turned to controlling the interest rate. Figure 5 shows the movements in real interest rates with the four business cycle periods indicated by the vertical lines. Prior to the 1970s, real interest rates had averaged around 2.00 per cent. Following the OPEC oil shocks in 1974 the real interest rates became negative because the nominal rates could not adjust quickly enough to the surging high inflation rates. Significantly, the real interest rates have risen sharply since the early 1980s.

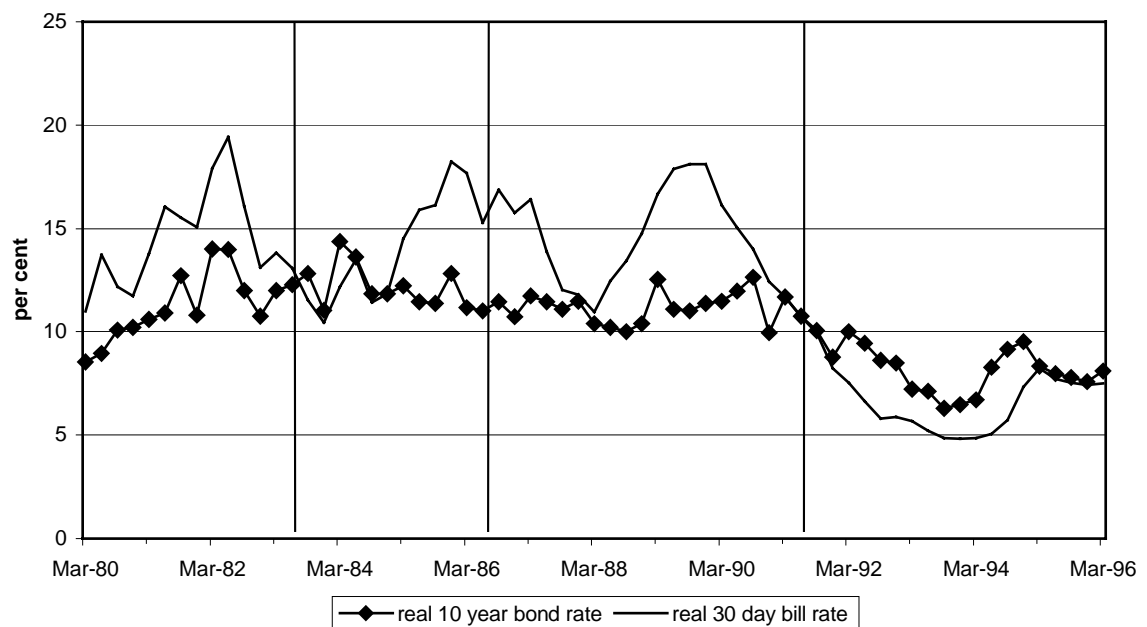
Argy (1992, p. 204) concluded that the real interest rate became a more reliable measure of monetary policy.

“On this measure we can represent the evolution of monetary policy as follows: monetary policy was tight to late 1986, eased substantially to late 1988 then tightened sharply and did not ease again till late 1990.”

Macfarlane (1990) argued that the monetary authorities did not predict the credit and that it largely went to finance asset purchases that fuelled the asset inflation of the late 1980s.

However, as Figure 4 shows, the loosening monetary policy after 1986, led to a sharp rise in investment spending. The problem with a reliance on monetary policy to control the cycle is that the effects are indirect and subject to unknown lags. At the time the Reserve Bank was easing interest rates, the terms of trade recovered substantially. The export expansion complemented the investment surge and the strong GDP growth not only reduced the unemployment rate to around 6 per cent but also worsened the already parlous current account. The current account deficits became the political and economic issue of the second half of the 1980s for the Government. The reason it assumed a central importance lies in the accompanying rise in external debt.

Figure 5 Short and long term real interest rates
per cent



By 1988, net exports were falling because import growth was so strong. The inflation rate was also persistently high, partly due to the asset boom, and, partly due to the fact that the business firms took full advantage of the wage restraint by pocketing larger margins.

This period showed the problems of having the monetary policy conducted by the RBA independently of the Federal Government. The Treasury claimed the increase in real interest rates generated by the RBA increasing nominal interest rates in 1988/89 was to fight the current account deficit. The RBA stated it was to fight inflation (see Milbourne, 1990).

Milbourne (1995, p.139) said

...1989 began the great output growth decline and Australia went into a long recession. A number of factors contributed to this decline, most notably the adverse terms of trade situation in those years, but argument still remains on what role the period of high and sustained interest rates had on dampening economic activity...Needless to say, many economists believe that the high sustained interest rates did contribute to the subsequent decline of output.

Another negative from the deregulation showed up in this period. In October 1988, Statutory Reserve Deposits were abandoned by the Reserve Bank. The M3 measure of money grew quickly as a result because 'on-balance-sheet' banking proliferated. The confusion between the rising

cash rates and the growth in the money supply meant that the Government could not accurately monitor the extent that the economy was reacting to the rising interest rates.

The policy induced recession

The 1980s period of rapid growth and increased social wage benefits allowed the Government to run a wages policy that redistributed income to profits via real cuts. It was palatable to the unions as long as the economy was growing. A major drawback with this strategy was the lack of any mechanism within the Accord to ensure that profits were channelled into productive investment. The resources released by the Accord, instead of laying the foundation for structural change and longer-term prosperity, were dissipated in the 1980s financial debacle of asset inflation, takeovers and large executive remuneration packages.

There was no direct method for influencing company investment plans through tri-partite industry policy or joint consultation arrangements at the workplace, since the establishment of such a method would constitute intervention and this ran counter to the faith in the market (see Green, Mitchell and Watts, 1992).

In addition, the corporate borrowing boom that followed financial deregulation (with 16 new foreign banks taking up the invitation to compete locally) led to an asset boom that was largely responsible for the threefold rise in the ratio of external debt to GDP.

A direct consequence of the wasteful spending practices was the loading of debt onto previously sound corporate entities (like Elders-IXL). The boom-bust cycle in asset prices was the precursor to recession. While financial deregulation was intended to generate increased competition and more services and lower prices to consumers, several negative consequences actually occurred. The high external debt ratio led to the increase in real interest rates, which choked off private investment in productive capital.

The failure of the lending boom and the massive redistribution towards the profit share to be channelled into gains in real productive capacity was a serious reflection of the Government's diminishing grasp on the economy. It also showed the corporate sector in a poor light. The latter had argued trenchantly that the major problem was the rigidity in the labour market. However, the rapid rise in external debt would not have been a problem if it had supported the development of productive capacity, especially in export industries. The problem was that it was largely squandered on asset transfers and unproductive real estate accumulation.

The reality that the Government failed to see was that despite the redistribution of income to profits via the Accord and the easing of access to funds, the private sector failed to function as its rhetoric suggests. Deregulation, privatisation and the reduction of the public sector are all consequences of the free market stance that the Government adopted. While the policy agenda was heavily biased towards this ideology, the fact remains that a successful market must have creative entrepreneurs who utilise capital resources to produce value-added goods and services. Yet this fundamental element was missing in the 1980s.

The failure of the corporate sector to exploit the competitive advantage delivered by the pro-business Labor Government and produce benefits for all Australians made the move to a deregulated economy a dangerous and myopic strategy.

The conduct of monetary policy was deplorable in the late 1980s. Initially, cash rates, which effectively set the interest rate structure, were increased from just below 9 per cent in December 1987 to over 17 per cent by January 1989 as a means of stabilising the exchange rate by encouraging capital inflow. The fear was that the exchange rate was to depreciate in line with our trade fundamentals (that is, the underlying relationship between our export potential and our import propensity). Yet, as the high interest rates began to choke off new investment projects, and the GDP growth rate became negative (that is, the level of output actually fell), the Government position was that cash rates were high in order to restrain demand and hence inflation.

While the consequences of this singular strategy were severe, despite the then Treasurer's claim that all we should have expected was a 'soft landing', the lack of policy creativity is one of the most striking aspects of that period. It was obvious that an excessive reliance on high interest rates to subdue activity would be difficult to control. The constraining effects work slowly as investment projects are reappraised and curtailed. However, by the time we receive information that the policy is working, the intervening period of high rates has further eroded demand. So instead of inducing a gentle fall in activity, the policy resulted in a 'scorched earth', where unemployment rose and business investment fell to near replacement levels only. Figures 4 and 6 show this investment decline.

Why was the Government so reluctant to use fiscal policy instruments to achieve its objectives? There are two ways of looking at the conduct of fiscal policy in the latter years of the 1980s. On the one hand, it can be argued that the Government had to rely on interest rates to restrain the

economy because previous spending cutbacks had left very little 'fat' in the public sector. In other words, any further pruning of expenditure would have impacted on the viability of programs.

On the other hand, it could also be argued that the Government had blurred the distinction between fiscal policy and wages policy. At the outset, when the Accord was initiated, it was stated that if wage restraint was delivered through the Accord, fiscal measures could be used to maintain the standard of living of workers. In this respect, the emphasis was on the real 'social wage' rather than the narrower concept of take home pay. The idea was that universal health cover and other social benefits would reduce the cost of living and therefore free income for consumption and saving. At the time, the social wage concept implied more public spending, not less.

What finally happened was that the Government tried to deliver on the social wage through lower taxes, notably through a series of wage-tax trade-offs in conjunction with the National Wage decisions. The consequences of this approach were significant. First, by reducing the revenue base of the Government, pressure on spending restraint intensified, purely as an accounting exigency. This was in addition to the ideological attack on public spending, which was also having a powerful influence on budgetary policy. Second, the concern about the expansionary consequences of the tax cuts placed more pressure on monetary policy to restrain growth.

Finally, the tax cut amounted to a crude industry policy in the sense that the loss to the budget was providing subsidies to the private sector in an indiscriminate way. Thus, ironically in the view of the rationale for tariff reduction, inefficient industries were given incentives to stay in operation at the expense of the national economy.

While the then Treasurer insisted that the restrictive monetary policy would result in a 'soft landing', it was apparent that this was simply a matter of faith. No one could predict the effects in size, timing and duration of the broad and long-lagged interest rate rises. If the Government had not tied its fiscal policy down, it could have ensured a softer landing by progressively inflating the economy, as the effects of the tight monetary policy were becoming evident.

However, this could only have occurred if wages policy had have been more independent of tax and spending policies. It is probable that if the Government had have placed more of the costs of employment on the private sector, then more rapid adjustment and higher productivity growth would have been realised.

The important point is that the Government failed to maximise the flexibility of its policy instruments. By following explicitly or otherwise the rationalist approach, it lost the potential to be creative and to respond to changes in the economy. This approach, as we have seen, eschews discretionary policy action and thus places the burden of adjustment to changed circumstances on the market place. Accordingly, the less the Government does the better. However, there is no evidence that an unconstrained market will generate full employment and price stability.

One major lesson the 1980s is that the rationalist approach did not generate sustained full employment. Some will say that the Labor government did not go far enough and avoided labour market deregulation. It is hard to argue, however, that labour costs were a constraint on employers given the large shifts in national income shares that occurred. There is nothing to suggest that further deregulation would have reduced the unemployment to low levels. If deregulation is tantamount to wage cutting then the debate is exactly where it was 60 or more years ago. At that time, wage cuts were tried and failed to stimulate employment. The fact remains that while lower wages lower the price of labour to employers, they also reduce aggregate demand and remove the reason for hiring more labour – to produce saleable output.

The lesson of the Great Depression is still valid. If the private sector cannot maintain adequate levels of demand, then the Government has the obligation to increase public expenditure to make up the shortfall.

The Recovery

Figure 6 charts business cycle four that began in the second quarter of 1991 and lasted until the end of 1995. The recovery following the despair of the 1990/91 was prompted by two events, one external and one policy-induced. First, export growth was very strong on the back of a world recovery and the net export component of GDP was positive. Second, the lower interest rates gave some boost to consumption spending but private capital formation continued to decline. The lower interest rates were due to the freeing up of monetary policy in 1990 - belated but beneficial. Fiscal policy remained curiously constrained.

The rise in the structural deficit in 1991/92 was largely due to tax cuts. Only modest spending was made. It is interesting to note that the structural deficit that Keating used to combat the 1990-91 recession was only 2.2 per cent of GDP whereas John Howard, as Treasurer has used a structural deficit of 2.9 per cent of GDP in the 1983/84 recession.

In 1993/94 there was an easing of fiscal policy as indicated by the relatively higher structural deficit. Nevile (1995, p.117) says that:

Although the structural deficit to GDP was still below that in 1983/84, it was larger than in any other year in the last 25 years. Three years after the recession started there was an adequate response in the fiscal policy area.

The question that has not been satisfactorily answered is why did the Federal Government wait for three years to implement significant fiscal expansion? The budget of 1992/93 was of similar shape to that of 1991/92. All through this period, the Government was firmly captive of the Balanced Budget lobby that argued that any expansion would be self-defeating because it would crowd out private sector spending. Nevile (1995, p.117) concluded:

To argue this in 1992 was to allow ideology to blind one to the facts...international responses to the last major world recession, that of 1982, had shown that expansionary fiscal policy was effective. A number of countries, notably the United States and Australia, adopted expansionary fiscal policy with large budget deficits. These were precisely the countries in which employment expanded strongly and the unemployment rate fell substantially. By contrast, in countries with less expansionary fiscal policy, unemployment only fell very slowly. For example, in the United States the unemployment rate was 9.5 per cent in 1983 and 5.4 per cent in 1988, whereas in Germany the unemployment rate was 8.2 per cent in 1983 and it was still 7.6 per cent in 1988. The crowding out argument is no longer credible.

Since 1992-93, with the strengthening of investment and private consumption growth, employment prospects again improved although there has been a disturbing lack of full-time jobs created. The data for the entire period suggests that demand conditions and employment growth are strongly related. However, they do not provide any unambiguous relation between real wage movements, real unit labour costs and employment. Figure 7 charts the course of fiscal policy over the last 20 years.

Another possible explanation for the constrained fiscal response to the recession lies in the 'twin-deficits' hypothesis. By constraining public expenditures, the Government claimed it would reduce its call on domestic savings and improve the current account. In the 1990 Budget speech, Paul Keating emphatically declared, "Fiscal policy must remain the principle instrument of adjustment in the savings balance between our savings and those we rely upon from abroad."

But Nevile (1995, p.118) is critical of this position.

This does not mean that expansionary fiscal policy is never appropriate. In a recession it is usually more important to reduce unemployment than to reduce the current account deficit which has probably already fallen as the result of the recession. If the balance of payments situation is absolutely desperate, which it was not in 1992 and 1993, some stimulus can be given to the economy by increasing both government expenditure and taxation without increasing the savings gap.

Once again, the rationalist straitjacket prevented the Government from raising taxation. The contribution of taxation to the Federal budget had fallen from 27.8 per cent of GDP in 1986/87 to 23.5 per cent of GDP in 1993/94, although there were some cyclical elements in that decline. The successive reductions in taxation over the period of growth were inconsistent with the Government's savings gap rhetoric. It would have been more responsible to increase taxes systematically as the economy was growing and to maintain some public spending, particularly in capital infrastructure.

A model of full employment and price stability for new Labor

If the Labor Party is to present itself as a viable alternative then it has to distance itself from the rationalist approach. The approach did not deliver sustainable improvements to the economy and ultimately forced the Government into an excessive reliance on monetary policy with destructive outcomes.

Most importantly, it has to develop a model of full employment that does not violate price stability. In this section, the bare bones of such a model are outlined. Certainly, models like this have to be debated within Labor as part of its policy development in the lead up to the next election.

During the early days of the 1991 recession, a proposal was made to reduce unemployment via public job creation (see Green, Mitchell and Watts, 1992). The Government chose to ignore this proposal and insistent on pouring more money into training and wage subsidy schemes. The results were not impressive.

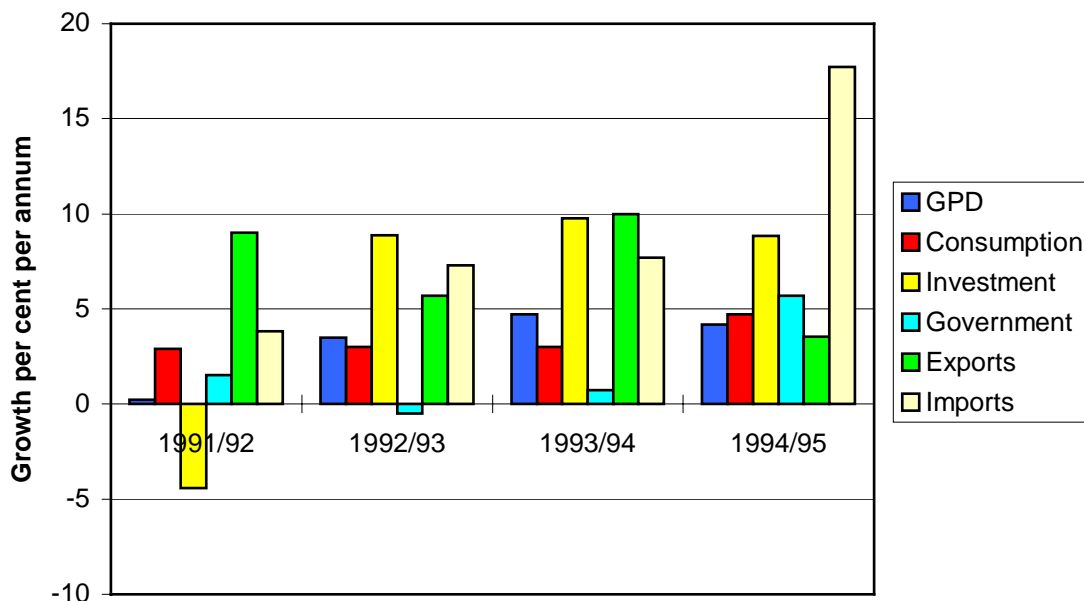
Work has been done since to develop a model of the government acting as a buffer stock employer (BSE), absorbing the unemployment into paid employment (see Mitchell, 1996). A recent paper by Mosler (1997) has developed a similar model called the employer of last resort (ELR). Mosler argues that it is ironic those governments seeking two primary economic

objectives: price stability and full employment, have used “monetary and fiscal policy that utilises excess capacity, including unemployment, to maintain price stability, obviating the possibility of simultaneous achievement of both objectives.”

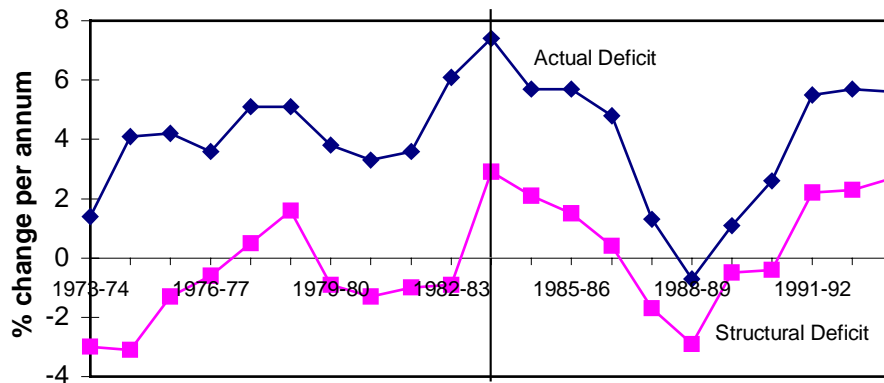
He shows that if the government acts as an ELR, it can eliminate involuntary unemployment and maintain price stability by “restraining the price it pays for the proposed supplementary ELR labor pool.” The wage would not interfere with the labour market because it would be close to the minimum. The ELR proposal “would be a counter- cyclical influence, automatically increasing government employment and spending as jobs were lost in the private sector, and decreasing government jobs and spending as the private sector expanded.”

But the idea would be initially criticised because it implies rising budget deficits in a climate where balanced budget mania is prominent. So why should we ignore the deficit implications?

**Figure 6 Composition of real GDP Growth
Business Cycle Four**



**Figure 7 Actual and Structural Deficit
1973-74 to 1993-94**



The first important point is that the ability of the government to purchase is only a function of what is offered for sale in exchange for money. The private sector doesn't discriminate between a public dollar and a private dollar. What creates a demand in the private sector for dollars? Mosler (1997) argues convincingly that:

The U.S. dollar is not legally convertible into anything by the government on demand. It is, however, designated by the government as the only means of discharging federal tax liabilities. Tax liabilities are an ongoing debt the private sector owes the government, and they create a continuous need for dollars. The private sector obtains the needed dollars primarily as payment for the transfer of real goods and services to the government, and it is government spending or lending that provides the dollars needed to pay taxes.

Therefore the sale of government bonds serves to support the overnight interest rate that is exogenously set by the Central Bank. Mosler (1997) says that:

Deficit spending without security sales from the Treasury or the Fed would create a reserve excess and result in a "0 bid" for overnight deposits. The economic difference between the government issuing securities and not issuing securities is the economic difference between a '0 bid' short term interest rate and some positive short-term rate of interest. Consequently, the offering of government debt to the private sector coincident with deficit spending is a necessary condition for the government to maintain a positive overnight interest rate.

Without the understanding that the dollars used to purchase government securities would otherwise reside overnight in non-interest bearing reserve accounts, fears such as 'roll over risk' (problems relating to possibility of the government issuing new bonds to replace maturing bonds, and not finding any borrowers) and financial 'crowding out' (the notion that sales of government bonds use up money that would have been available for other borrowers) can surface and block fiscal policy options that include increased deficit spending."

The price stability arises because the government constrains the wage paid to buffer stock employees. Once the wage is determined the government lets the market determine all other resource allocations. When the economy is buoyant, there would be a net transfer of employees to the private sector in search of the higher paying positions. When the private sector goes into decline, workers would be released back into the public sector positions. The scheme has similarities with the Howard government's 'work for the dole' scheme except that it would encompass all unemployed workers, pay award wages, and also set a constraint on the price level.

Conclusion

It is always dangerous to try to draw lessons once you know the facts better. How much was obvious at the time is debatable. But there are a few clear conclusions that can be drawn which were also the subjects of fairly vigorous debate at the time.

First, using monetary policy to target both the inflation rate and the current account deficit is not sustainable. The high real interest rates of the late 1980s certainly slowed investment spending and hence the economy, but it also pushed the exchange rate higher than it should have been and had a negative impact on exports and import-competing industries thereby working against the external account.

Further, the use of monetary policy became difficult given the exchange rate fluctuations that followed financial deregulation and the float. With more fluid capital mobility post 1983, the differential between our interest rates and those prevailing in the rest of the world has become more important and places more restrictions on the conduct of monetary policy. Every time the exchange rate falls, the RBA felt obliged to increase interest rates to encourage investors to keep their funds in Australia.

Any future Labor government should not rely on monetary policy to stabilise the business cycle. There is no precision in such a policy. Labor has to break the entrenched view that tax rises are politically impossible. In the early days of the Labour government, Treasurer Keating claimed that the electorate would not penalise them for introducing the capital gains tax and fringe benefit tax reforms. He was correct in his assessment. The Government forgot this wisdom later in the 1980s. To manage the business cycle a government has to be able to use all its fiscal and monetary instruments. It would have been better to use tight fiscal policy, whose impact is much easier to predict and looser monetary policy in the late 1980s.

This paper did not consider wages policy in great detail. However, it is clear that if the Labour government had have passed the costs of the wage rises onto the private sector and avoided absorbing them via tax cuts, both the fiscal position would have been more flexible and the structural adjustment process more rapid.

The next Labor government will also have to use the public sector more creatively as an employer. The private sector has shown comprehensively that cannot fully employ the available labour force and increasingly prefers to casualise the job opportunities that it provides. There are many functions that can be served by public sector employment schemes, such as environmental projects, which the private sector will never provide.

The major change that Labor has to make is to jettison the baggage that to be a good economic manager you have to listen to the Treasury Department and the private capital market players. These groups reflect the narrow sectoral interests of business. They are interests that are at odds with the general welfare of the population. Rationalist policies have not worked to enhance the prosperity of the nation as a whole. The Labor government embraced them out of insecurity with its past. To regain the faith of its supporters and to present a vision of a future that includes all sectors of the economy as recipients of the gains to be made, it has to overcome this insecurity and adopt innovative policies.

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