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2 Economic Policy in Crisis: a Proposal for Jobs and Growth

Roy Green, Bill Mitchell and Martin Watts

1 Introduction

The striking feature of Australia's current recession is not that so many economists have been discredited by it, but that so few have offered anything approaching a strategy for economic recovery. Such has been the triumph of the free market orthodoxy in recent years that when, to everyone's apparent astonishment, it disintegrated as thoroughly as it was originally promoted, there seemed to be no realistic alternatives in sight. But, of course, there are alternatives, which have simply been overshadowed in recent years by the extravagant claims made for the policy of deregulation and reliance on the free market.

This paper undertakes a reassessment of the economic ideas responsible for our present predicament and proposes an alternative set of measures to create jobs in the short term, while putting into place a framework for long-term investment and growth. Essentially, we argue for a shift in the stance of macroeconomic policy in the context of a more interventionist strategy to tackle Australia's fundamental economic problem—the balance of payments constraint.

Obviously, there are risks associated with a policy shift of the magnitude we are suggesting, but these are not nearly as great as the risk of continuing stagnation under current policy settings. Nor should they be used as an excuse for inaction and policy paralysis, for many of these risks lie simply in the imagination of the financial markets in whose hands they become a self-fulfilling prophecy. We

endorse the Prime Minister's declaration that taking risks is the essence of creative leadership. It is also an important factor in mobilising popular support for a vision of the future, such as those of the New Deal and post-war reconstruction.

Few would doubt that the present economic situation, coming as it does after a period of the most deluded speculative mania since the South Sea Bubble, is the bleakest in living memory. At the beginning of 1992, the Australian economy was experiencing stagnant growth, unemployment of over 10 per cent, a slowly stabilising foreign debt and a current account deficit which was set to worsen after some improvement. As recently as June 1990, the unemployment rate was still only 6.7 per cent, following the record rate of job growth under the initial policies pursued by the Labor Government.

It is now clear that this recession was induced by the blunt tool of monetary policy with a regime of high interest rates. The dramatic increase in the unemployment rate over the past fifteen months is convincing evidence that the downturn is characterised by demand deficiency. The conventional view of a massive structural shift in the economy is implausible, since there has not been a sustained growth in exports or import replacement. Moreover, real interest rates remain high, compared with other Western economies, although the differential has narrowed.

Economic commentators look forward to a recovery which is a consequence of private sector investment growth and the process of structural change, both at the workplace and between the traded and non-traded sectors of the economy. But what encouragement to investment in the traded goods sector is being provided at the level of the macro economy? The over-valued exchange rate has inhibited the transfer of resources to the traded goods sector, and high interest rates are discouraging new investment in the non-traded sector as well. The consequence is an economy blighted both by increasing unemployment and poor productivity growth, despite efforts at workplace reform, due to inadequate investment in new technologies and skills.

Moreover, there is little prospect of real recovery in the face of the existing balance of payments constraint, which appears to limit any fiscal boost by the Government. The concept of 'hysteresis' in economic theory reminds us that prolonged stagnation does not constitute a temporary departure from a robust high employment equilibrium, but influences the future path of the economy because

of skill atrophy and depressed capital accumulation in addition to the daily output loss resulting from unemployment and the underutilisation of capacity.

In the following sections, we show that government policy in the short term must be geared simultaneously to reducing unemployment and stabilising the external balance. The long-term objective must be to relax the external constraint on sustainable domestic growth, consistent with the maintenance of a high rate of employment. This will require a consistency, which has so far been lacking, between the macro emphasis on demand management and the micro emphasis on investment and productivity. The key to achieving this consistency, in our view, is a new approach to industry policy which links workplace reform to wider strategies for individual sectors of industry and the economy as a whole.

2 Crisis in Theory and Policy

How did the Australian economy find itself in such a deep recession? What are the factors which make this recession different from a normal economic downturn? We argue in this and the next section that the *causas causa* of this downturn can be located most immediately in the confused conduct of macroeconomic policy since 1985. Indeed, the excessive reliance on investment-choking high interest rate policy has been the principal reason why the downturn has turned into the worst recession since the Great Depression of the 1930s.

Economic policy should be internally consistent once a particular set of goals is specified. A policy stance makes no sense unless the goals are clearly outlined and are mutually attainable. A micro industry policy, for example, aimed at developing an internationally competitive value-added export sector, will not succeed if high exchange rates are being used to control inflation and high interest rates are used to control overall activity (and by implication the exchange rate). These policies are mutually inconsistent. Yet this is exactly what the Government has been doing since 1985. We argue that much of the current malaise can be traced to the Government's pursuit of incompatible goals with the wrong mix of policies.

To better understand the last six years of policy making, we must go back to the early 1970s. Prior to 1970, 'Keynesianism' was the

mainstream macroeconomic approach, which had originated with J. M. Keynes's path-breaking *General Theory of Employment, Interest and Money* in the mid-1930s. Since, as Keynes argued, the market left to itself would not produce a full employment level of output, Western governments took on responsibility for aggregate demand management to stabilise fluctuations in the level of economic activity, principally arising from variations in private sector investment spending.

The goals of aggregate demand stabilisation were clearly enunciated in formal policy statements following the Second World War. In Australia, the 1945 White Paper stated that the goals of the government were full employment, price stability and balance of payments stability. Over the next twenty-five 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 high employment rates, high rates of GDP growth, low inflation and satisfactory balance of payments outcomes.

To put the post-war period until 1970 into perspective, we should note that prior to the Second World War, for almost one hundred years, the industrialised countries had developed in 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 less 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.

Rise of monetarism

The current crisis in economic theory began in the early 1970s when severe disruptions were experienced by Western economies as a result of the 1973 (and later 1979) oil price shocks. In 1974, for the first time, recession was accompanied by high inflation in Australia and elsewhere, which was a break with 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, which 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) influences and a determination of the degree of demand accommodation which was going on.

At the same time, Friedman and Phelps were spearheading a revival of pre-1930s neo-classical thought centred around 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 with the complexities of 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 purely due to deficient effective demand, and the monetarist 'natural rate' hypothesis which absurdly treated all unemployment as being voluntary.

Between 1973 and 1979, unemployment rates across the world experienced large rises. The rises, accompanied by rapid inflation in the price level, confounded the naive Keynesian view. How could unemployment which is due to deficient demand be accompanied by inflation which was due to excess demand? The OPEC oil effects presented problems for a naive Keynesian view and more sophisticated Keynesian analysis was not widely disseminated. Nor, of course, was it appealing to conservative policymakers gearing up for cuts in the welfare state and restrictions on trade union bargaining power.

In fact, the reasons for the 'stagflation' were not inconsistent with the Keynesian view. The inflation was basically a supply-side phenomenon, which was highly autoregressive, and the unemployment could be explained in terms not solely related to deficient demand. The point was that labour supply behaviour had become more complex during the post-war period. Strong post-war growth rates and mass education had brought new demographic groups

into the labour force. While a 'core' of secure, well-paid employees was established within the internal labour markets of firms, it was also the start of a new phase of casual workforce attachments, shorter job tenure and increased job instability and vulnerability to unemployment for many workers.

The resurgence of neo-classical macroeconomics was met with great approval by the economists who called themselves micro specialists. The microeconomic orthodoxy has always been based on neo-classical market-clearing postulates. There was consequently a tension between the Keynesian macro approach and the prevailing neo-classical micro orthodoxy. The latter considered Keynesian macroeconomics flawed because it was *ad hoc* (by which was meant devoid of rigour) in that it imposed seeming 'irrationalities' on the behaviour of individuals in the system, such as, for example, nominal wage rigidity. Keynesians responded by arguing that compositional fallacies rendered an 'aggregation' of micro theory an inappropriate basis for macro reasoning.

Monetarism restored the postulates of rational maximisation to the centre of the macro stage. Key concepts like the 'natural rate of unemployment' implied that any imperfections which might inhibit market forces, including public stabilisation policy and trade union behaviour, would ultimately be thwarted by the decisions and actions of 'rational' individuals.

Within this framework, the goal of 'allocative efficiency' was given precedence, and 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 implied by Okun's accounting when persistent unemployment occurred and which had motivated the 'Keynesian revolution' were now to be ignored.

It became an article of faith of the return to pre-Keynesian economics that stabilisation policy had detrimental consequences for the White Paper goals, basically because it interfered with the price adjustment mechanism. In addition, it was asserted, rational agents would always render discretionary policy futile by anticipating government action and incorporating it into their decisions.

Incredibly, in the light of conventional accounts of the history of

scientific breakthroughs, no new argument was associated with the resurgence of monetarism. If Keynesianism had predominated since the Great Depression because it gave better explanations of the workings of the economy and the role of government, it was now to be dispensed with because of its association with the Phillips Curve. In the confusion of the early 1970s, neo-classical thought, so discredited in the 1930s, re-emerged as a new orthodoxy in macroeconomics.

'New Classical' Approach

Despite the widespread failure of monetarist policies in the late 1970s and early 1980s, balance was not restored to the policy debate. Instead, an even more extreme free market view, called 'new classical' macroeconomics, has emerged. In essence, this view contends that monetarism did not go far enough. In Australia, the argument is pitched in terms of 'microeconomic reform', whose objective for this new breed of economists is the deregulation of financial and labour markets and the dismantling of the welfare system.

Far from returning to a modern Keynesian policy stance, which had recognised the supply-side problems of the 1970s, the Hawke Government allowed itself to be persuaded of the logic of the new classical approach from 1985. The manifestation of this shift is the reliance on a much narrower set of policy instruments. In particular, fiscal policy has been severely constrained by expenditure cut-backs and tax relief to companies and higher income groups.

Until the middle of 1985, counter-cyclical policy was adopted by the Government with Commonwealth outlays as a fraction of GDP *rising to* 30.2 per cent over 1984/85 from 29.5 per cent in 1983/84. This was accompanied by a fail in the average rate of unemployment from 9.6 per cent to 8.6 per cent. However, outlays were then pruned to 23.9 per cent of GDP in 1989/90, before rising marginally to 25.7 per cent in 1990/91 due to the effects of the recession. The full employment budget remains in surplus, while exchange rate policy has been constrained by the fear of inflation.

The major tool of adjustment adopted by the Government has been high interest rates. This policy stance has failed to achieve all but one goal—low inflation. Yet because the new classical paradigm has been embraced both by the private sector 'think tanks' and the senior levels of the Federal bureaucracy, the obvious remedies to our

current problems are not available to the Government. It has tied itself into a political strait-jacket.

There is now a crisis in economic theory and hence policy as well. The prevailing 'rationalist' policy approach has manifestly failed to deliver its promised economic and social outcomes. It deflates the economy successfully, but only at the cost of excessive and unsustainable unemployment, and it inhibits much needed structural change. The low inflation produced by this approach requires recession for its sustenance. Indeed, without a 'scorched' economy, it is claimed that inflation would reappear. It follows that an economic 'revival' pursued by the Government on the basis of this policy framework would inevitably be still-born.

Yet, until very recently, it was seen as unfashionable, even gauche, to propose an alternative based on Keynesian analysis. Any attempt to do so could be dismissed by economists who did not consider 10 per cent unemployment to be a problem and certainly believed that it was not a macro policy issue. With inflation down to 2 per cent, the new classical approach concluded that 10 per cent was probably close to our natural rate of unemployment. Thus, aggregate demand policy aimed at reducing the rate below this would cause inflation and would in real terms be futile.

The new classical economists claim that the economy must undergo sweeping microeconomic reforms aimed at improving relative productivity, because inefficient economies have high natural rates of unemployment irrespective of the state of aggregate demand. It is as though Keynesian macro policies and productivity improvement at the micro level were mutually exclusive. In fact, as we shall argue in a later section, industry policy and workplace reform in the context of a Keynesian macro approach may be directed to achieving a high wage, high productivity economy, by contrast with the new classical approach, whose policy of labour market deregulation would result in wage reductions for the majority of the workforce.

The point is that, by blaming Keynesian aggregate demand policy for what was essentially a massive supply-side shock which necessitated an adjustment process never before seen, we abandoned a valid and necessary arm of policy. A crucial element of this abandonment was the change in focus away from active stabilisation management. Macroeconomics has been subjugated by a naive and erroneous appeal to market clearing micro principles. Macro conduct

Panel: Rules vs Discretion

A key issue for economists is whether government policy should be conducted by fixed rules (policy announcements which are not varied until the goal is achieved irrespective of developments in related aggregates) or by discretion (policy varied to meet circumstances).

Conservative economists who oppose discretionary policy-making focus on the role of private sector expectations and their impact on the success of policy outcomes (see Kydland and Prescott 1977; Calvo 1978; Barro and Gordon 1983).

The Australian Labor Government has fallen prey to this logic. An examination of its inflation-unemployment approach since 1988 is instructive. A constant message coming from the Government is that it is driving inflation and inflationary expectations down to zero, in part presumably to improve international competitiveness. The price of this strategy, as we have seen, has been the rapid escalation of unemployment. This policy represents an about turn by a Government elected in 1983 on a platform of fighting unemployment and inflation simultaneously.

According to economists who eschew discretion, the problem facing the Government is that its 'inflation first' policy may lack credibility because of the political problems that the high unemployment presents. The private market will discount the inflation first policy if it believes the Government will adopt discretionary policies to counter the unemployment.

The logic then is to convince the private sector that the policy rule will not be diluted by discretionary attacks on unemployment. Thus the policy must be sufficiently firm, with no concessions, to allay the suspicions of the market. When the Government talks moreover, to disenfranchise union delegates and members at the workplace from the wage bargaining process.

is now pitched in terms of fixed policy rules (see Panel). We are now waiting for the market to work despite the fact that nothing has changed since it was demonstrated in the 1930s that the market could fail.

To sum up, the nature of the crisis is that, within the theoretical framework driving policy, the aggregates of high unemployment and low GDP growth are considered to be micro problems. Yet the macro costs of this approach are so large that social and political tensions have become extreme. Nor can the Government redress these macro costs while its advisers persuade them that such costs are solely attributable to micro factors which take long periods of time to change. The narrow new classical training reflected in policy advice to the Government is simply incapable of analysing a situation where the market fails and requires intervention. The consequences of this advice are illustrated by a closer analysis of the current recession.

3 The Policy-Induced Recession

A brief reflection on eight years of the most electorally successful Labor Government in Australian history provides some important clues to the problems in economic theory and policy we have outlined. At the forefront of policy initiative has been the Accord partnership between the Government and ACTU, which was designed to preclude the misunderstandings of the Whitlam years and provide a vehicle for a formal 'prices and incomes' policy.

So long as the Government delivered jobs growth and significant social benefits such as Medicare, the drawbacks of the Accord could be overlooked by the ACTU and its affiliated membership. Now, however, as these drawbacks begin to receive greater prominence in union as well as public debate, the ACTU is repositioning itself while it is the Government which appears to be running aground.

A major drawback of the Accord was that it was not a prices and incomes policy at all, since it was able to focus only on wage and salary earners. The incomes of professional and executive groups remained largely untouched by the policy, as did the prices set by the private sector for goods and services. The effect of the policy was to bring about an unprecedented shift in national income towards the profit share at the expense of the wage share (which has fallen from 62 per cent of GDP in 1982/83 to 58 per cent in 1990/91), and,

moreover, to disenfranchise union delegates and members at the workplace from the wage bargaining process.

A further drawback, which we discuss in the next section, was the lack of any mechanism within the Accord to ensure that profits were channelled into productive investment. The resources released by wage restraint, instead of laying the foundations for structural change and long-term prosperity, were dissipated in the 1980s financial debacle of asset inflation, takeovers and telephone number executive remuneration packages. There was no direct method for influencing company investment plans through tripartite industry policy or joint consultation arrangements at the workplace, since the establishment of such a method would constitute intervention and this, of course, ran counter to faith in the market.

The second key policy initiative by the Labor Government was its deregulation of the financial system, which not only abolished foreign exchange controls (thus liberalising capital movements), but also permitted foreign banks to compete locally. With sixteen foreign banks taking up the invitation, a corporate lending (borrowing) boom of massive and unmanageable proportions followed. The associated asset swapping (corporate script and real estate) was largely responsible for the threefold rise in the ratio of external debt to GDP. This rise has imposed long-term costs on the economy as our credit rating has fallen.

A direct consequence of this profligacy was the loading of debt, by the so-called and misnamed entrepreneurs, onto previously sound corporate entities like Elders-IXL and Carlton and United Breweries. The boom-bust cycle in asset prices was the precursor of recession. While financial deregulation was intended to generate increased competition and, via the text-book model, more services and lower prices to consumers, several negative consequences have occurred. The external debt has risen to unsustainable proportions, leading in turn to record levels of interest rates which have choked off investment in productive capital, and excessive mortgage rates as banks have squeezed their captive market to pay for their injudicious and disastrous foray into the world of 'entrepreneurial' excess.

The failure of the lending boom, or the massive increase in the profit share, to be channelled into gains in real productive capacity, is a serious indictment not only of Government policy but of the corporate sector in general, which is only too willing to criticise other

sections of the community for shirking microeconomic reform. The rapid rise in external debt would not be a problem if it was supporting the development of productive capacity, especially in export-oriented activities. Instead, it has largely been squandered on asset transfers or unproductive real estate accumulation.

The truth is that, despite the redistribution of income to profits via the Accord and the easing of access to funds, the private sector has failed to function as its rhetoric suggests. Deregulation, privatisation and the reduction of the public sector are all catch-cries of the 'free market' lobby. While the policy agenda has been 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 the fundamental element in this story is completely missing in Australia. With perhaps a handful of exceptions, we have no creative corporate sector. The failure of business in general to exploit the competitive advantage delivered by the Accord makes the move to a deregulated economy dangerous and short-sighted.

Inflation first

Although the Government has clearly sustained political damage from rapidly rising unemployment, it was apparently prepared to 'wait out the recession'. Why, it might be asked, would the Government permit the recession to continue? The two problems targetted by the recession are inflation and the current account deficit. The implication is that "this is the only way, or at least the socially least costly or politically least inconvenient way, in which those aims could be achieved" (Perkins 1991: 4). The extent to which the Government is ready to change tack will be indicated by forthcoming economic policy, but its room for manoeuvre is already limited.

Initially, official 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, if 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), then an already over-restrictive wages policy would collapse as import price rises caused further reductions in the real wage. 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 directly.

While the consequences of this singular strategy have been severe, despite the then Treasurer's claim that all we should expect was a 'soft landing', the lack of policy creativity is one of the most striking aspects of recent years. 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 results in a 'scorched earth', where unemployment rises and business investment falls to near replacement levels. Further corporate bankruptcy proves to be contagious as companies succumb to unsustainable debt levels.

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 cut-backs had left very little 'fat' in the public sector. In other words, any further pruning of expenditure would start to impact on the viability of programmes.

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 pay packet wages. 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, however, 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 National Wage decisions. The consequences of this approach have been significant. First, by reducing the revenue base of the Government, pressure on

spending restraint intensified, purely as a matter of accounting exigency. This was in addition to the ideological attack on public spending, which was having its own 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 policy amounted to a crude industry policy in the sense that the loss to the budget was subsidising the private sector in an indiscriminate fashion. Thus, ironically in view of the rationale for tariff reductions, inefficient industries were given incentives to stay in operation at the expense of the national economy. The obvious point is that if the Government is going to operate an industry policy anyway, it should be more self-consciously designed and targeted.

'Soft Landing'

While the then Treasurer insisted that the restrictive monetary policy would result in a 'soft landing', it became 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 money policy became evident. However, this could only have occurred if wages policy had been more independent of tax and spending. It can be argued that by placing the costs of employment more fully on the private sector, more rapid structural adjustment and productivity growth would have been realised.

The important point here is that the Government failed to maximise the flexibility of its policy instruments. By following, explicitly or otherwise, a '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 new evidence that an unconstrained market will generate full employment and price stability. The theoretical crisis of the 1980s and the Government's consequent reliance on the market has resulted in a disastrous level of unemployment.

Finally, as we shall argue in the next section, there is nothing to suggest that deregulated product and labour markets will reduce

unemployment to its previously low levels. If deregulation is tantamount to wage cutting, then the debate is exactly where it was sixty 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 main reason for hiring 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 an obligation to increase public expenditure to make up the shortfall. Later, we present some estimates of the scope for the Government to adopt a more activist role in boosting jobs and growth.

4 Reform of Product and Labour Markets

A fundamental precondition for the success of the Government's microeconomic reform agenda is said to be an assault on Australia's cosseted product and labour markets. While this contention as it stands cannot be denied, the assumptions behind its application in current policy are suspect. The assumptions are those of the neoclassical and 'new classical' orthodoxy to which we have already referred. They state that optimal efficiency is achieved only by creating perfectly competitive markets, including those for factors of production (such as labour). Essentially, this means removing 'impediments' to the operation of markets and eschewing any form of intervention which may 'distort' the necessary competitive signals.

The impediments these economists have in mind in the product market are tariffs and other protectionist (and 'new protectionist') measures and, in the labour market, the traditional wage fixing role of the Industrial Relations Commission. Ideally, they would also include in these impediments the 'monopoly' power of trade unions, but, unlike the Thatcher Government's notorious 1985 Employment White Paper and its local counterpart in the Australian Opposition's industrial relations policy, Labor's Accord with the ACTU precludes any attempt to free up the labour market in this way. Instead, neo-classical economists here must be satisfied with the decentralisation of wage fixing, as a means of approximating the

'price of labour' to its marginal product, rather than its wholesale deregulation with the removal of minimum legal rights and standards.

It is not our intention to argue that the Government's reforms of product and labour markets have been futile. Far from it. What we would suggest, however, is that progress in this area since 1983 has been achieved *despite* rather than because of the assumptions which underlie the policy. Moreover, the current policy paralysis is due in large measure to the failure of the Government either to follow these assumptions through to their logical conclusion, which is found in the Opposition programme, or, on the other hand, to jettison the assumptions explicitly in favour of a more interventionist approach. The first approach implies an open confrontation with the trade union movement and, as a consequence, a further step towards a low wage, low productivity economy in Australia, whereas the second, as we shall see, would permit the Government to regain the momentum towards the high wage, high productivity future which its rhetoric rightly treats as a desirable goal.

While the efficacy of wages and industry policies is open to debate, there is no doubting their common origin, unique to Australia, in the nexus between industry protection and centralised arbitration in the early part of the century. Arguably, at the time, this nexus permitted a higher level of output and employment in manufacturing and a growth of real wages which would not otherwise have been possible. Indeed, while the 1929 Brigden Report on tariff policy made the point that "the maximum income per head for Australia would probably be obtained by reducing it to one large sheep-run with the necessary subsidiary and sheltered industries", it concluded that "there is more to be said for protecting an industry because it employs labour at good wages than for any other reason" (Brigden 1929: 70, 119). Initially, this objective could be secured by a policy of import substitution, which redistributed surpluses from primary export industries to manufacturing, but in the long run the deterioration in international markets and terms of trade for primary producers made the policy untenable.

The main problem was that there was no incentive in the tariff policy arrangements, or in the associated strategies of multinational firms in Australia, to develop world competitive manufacturing technologies and work practices. The problem was accentuated in the post-war period not only by the secular downward trend of

primary commodity prices, which contributed to macro instability as well (the 'stop-go' cycle), but also by the increasing trade dominance of high value-added, complex factor manufactured goods.

While manufactures in general were already established as the fastest growing area of world trade at the onset of the post-war boom, by the mid-1980s, according to recent calculations published in the *Midland Bank Review*, high 'research-intensive' manufactures were the fastest growing specialised segment of trade in manufactures. This has become known as the 'new competition' (Best 1990). If the case for comprehensive tariff protection has disintegrated in this environment, the question still remains what should replace it—the free market or a new outward-looking approach to industry policy.

Industry policy debate

The policy response in Australia to the growing significance of high value-added manufacturing in world trade was of two types. The first, largely developed by the Industry Commission and its predecessors, was a free market approach based on the old classical theory of 'comparative advantage'. By reducing, and ultimately eliminating, tariff protection, it was argued that this approach would permit only efficient and competitive firms to survive, thus bringing down the cost of all goods and services to Australian consumers and enhancing general economic 'welfare'.

The potential gains, however, are modest even in its own terms. It is estimated, for example, that the reduction in the effective rate of assistance from 12 per cent to 5 per cent by the year 2000, announced in the Government's 1991 economic statement, *Building a Competitive Australia*, will result in a net gain to GDP of only 0.5 per cent of GDP or $1.7 billion at 1988/89 prices.

The approach is epitomised by the Garnaut report, *Australia and the North-East Asian Ascendancy* (1990), which recommended not 5 per cent but an ideologically pure zero tariff régime by the year 2000. Any approach of this kind has costs and drawbacks, however, which are usually downplayed. The main drawbacks in the Garnaut approach are firstly that there is no mechanism, apart from spontaneous entrepreneurial combustion, by which inefficient firms can become efficient and competitive, second, that the closure of

'inefficient' manufacturing firms tends only to reinforce Australia's dependence on primary commodity exports and, third, that the reduction in tariffs does not necessarily lead to lower prices for consumers if firms are able to increase their margins and thereby gain windfall profits.

Perhaps most importantly, the inconvenient fact which proponents of this approach fail to address is that world trade today is characterised not by comparative advantage but rather by 'comparative disadvantage' for resource-based economies. This describes the tendency for the exchange rate to rise above the level at which manufactured exports and import substitutes can become competitive, even with significant efficiency improvements. The problem is compounded by the fact that depreciation, particularly where it occurs as a result of an unfavourable reversal in the terms of trade, can also prove counter-productive due to the combination of a sudden and unpredictable cost pressures and the belief that the potential advantages offered by depreciation may only be temporary.

This was the effect of large North Sea oil and gas discoveries on the Netherlands and UK, where the decimation of manufacturing firms (mainly in the-price-sensitive engineering and capital goods sectors) by policy adaptation to commodity-based exchange rate fluctuations became known as the 'Dutch disease'. It was avoided to some extent in Norway where an interventionist industry policy in association with a supportive macro stance made use of resource surpluses to develop a small but competitive manufacturing base, but not, of course, in Australia, where the phenomenon became popularly known as the 'Gregory thesis'.

By contrast, economies without a significant resource sector, such as Germany and Japan, have been able to adjust exchange rates to the goal of long-term competitiveness in high value-added manufacturing, thus maintaining continuity in their investment, training and research and development strategies. Ironically, instead of using agricultural or resource surpluses to subsidise employment in 'sheltered industries', these economies are able to subsidise their farmers and (in the case of Germany) grossly inefficient coal producers out of the surpluses generated in manufacturing.

The 1970s energy crises, while offering temporary current account relief to the resource-based economies, simply gave added incentive to the export-oriented manufacturing economies to develop energy

efficient technologies and a competitive edge in research intensive products and services. The point was inevitably reached where countries like Australia could no longer rely on an efficient primary goods sector to compensate for the lack of manufacturing competitiveness without a relative (and now absolute) decline in personal living standards. The continuing attempt to do so, which is the only possible rationale for 'resource security' legislation, is counter-productive from the viewpoint of both the economy and the environment.

The second type of policy response to the problems faced by resource-based economies, initiated publicly in Australia by the 1979 Crawford report on structural adjustment, was to recognise the necessity of "gradual reductions in some Australian protection levels", but only as part of an "industrial development policy" (Crawford 1979). This approach is now identified with the Australian Manufacturing Council (AMC) report, *The Global Challenge: Australian Manufacturing in the 1990s* (1990), which, although not theoretically explicit in its assumptions, nevertheless places the emphasis on making domestic industry competitive in conjunction with reducing tariffs rather than undertaking tariff reform in isolation from other instruments of policy.

The AMC approach also retains an important role for wages policy. Whereas in the free market approach the aim is simply to deregulate the labour market so that wages find their own level in product markets exposed to international competition, the proposal here is to use wages policy to promote a 'new workplace culture' through, for example, productivity bargaining as an integral part of a coherent, tripartite industry policy. What this means in practical terms will be examined shortly.

It is claimed, of course, that the 'new' approach to industry policy is nothing more than an attempt to resurrect the old, discredited protectionist arrangements in a different guise. This is a disingenuous claim whose lack of evidence is matched only by the enthusiasm with which it has been embraced by newspaper editorial writers and officials in the Federal bureaucracy. The new approach stems both from modern theories of how markets work (or don't work, as the case may be) and from the recent experience of more successful industrialised nations (Dertouzos et al 1989; Porter 1990). In particular, there are two features of this approach which distinguish it fundamentally from previous attempts at industry policy in Australia.

The first feature is the shift in the rationale for tariff protection and industrial assistance from the retention of jobs in manufacturing industry, however uncompetitive, to the preparation of firms and sectors for carefully targeted export strategies in world markets. The second, as already stated, is the transformation in the primary role of wages policy from centralised pay fixing, which characterised the 'historic compromise' between labour and capital in the early part of the century, to support and facilitation of work reorganisation, training and joint consultation at the workplace.

Labor's approach

Since 1983, the Labor Government has shown little sign of accepting the case for an outward-looking industry policy, except, as we shall see in a moment, at the margins where it may be tolerated on the grounds of demonstrable 'market failure'. Curiously, however, it has offered less resistance to the idea of permitting the vacuum to be filled by wages policy, particularly in its most recent incarnation as 'award restructuring'.

The result of this accommodation between the prescriptions of neo-classical orthodoxy and the power relationships of the Accord has been internal inconsistency at best, with the ever-present danger of the whole strategy collapsing under the weight of its own contradictions. With the good fortune of the demand expansion phase of the strategy now evaporating in the recession along with Labor's popularity, the contradictions are laid bare and require a resolution if disaster for the Government is to be avoided at the next election. To understand the steps which must now be taken, it is necessary first to retrace those already taken in the two phases which characterise the Government's approach to industry policy and labour market reform so far.

In both phases of policy, the Government's product market reforms were largely centred on across-the-board tariff cuts, but in the initial phase they also included a number of *ad hoc* industry plans to reinvigorate traditionally protected areas of manufacturing. However, these modest plans were not sustained or extended to other sectors. Nor were they matched by support from labour market policy, which at this stage consisted mainly of employment and training measures and an abstract commitment to 'industrial

democracy'. The 1986 Heavy Engineering Plan, for example, had to make do with a provision making assistance to firms conditional upon jointly negotiated changes in work practices.

The reason for the limited approach to industry plans and labour market reform in this initial phase of policy lay in the reliance by the Government upon macroeconomic strategy to deliver jobs growth and upon incomes policy to effect wage restraint, which in turn, it was hoped, would transfer resources from consumption to investment in accordance with the need to tackle world markets. As we saw earlier, with increased profitability, the analysis went, employers would invest in new plant and equipment, and, with goodwill from the unions, the workplace would sort itself out in the process.

The problem with the Government's approach in this phase of policy was that despite, and to some extent because of, its prodigious record of job creation, the rate of growth in labour productivity stagnated. The resources released by wage restraint certainly boosted corporate profits but were not channelled into much needed investment, due partly to the 'substitution effects' of relatively cheap labour and partly to the greater prospective gains available from asset price inflation together with the new sources of borrowing opened up by financial deregulation.

Crucially, apart from the handful of industry plans, there were no formal industry policy structures established to ensure that company decisions on investment were open to wider scrutiny and accountability. Nor were legal rights and opportunities provided for workers to influence those decisions, despite the debate surrounding the Federal Government discussion paper on *Industrial Democracy and Employee Participation* (1986). The Government's approach at this time proceeded on the assumption that once the macroeconomic settings were in place the market would deliver the necessary investment in new technologies and skills. But, to the Government's evident surprise, the assumption was found wanting.

The terms of trade collapse of 1985/86 created the conditions for the second phase of policy, which signalled the Government's recognition of the limitations of macro policy by shifting the focus to 'microeconomic reform'. The problem was that whatever intentions some may have had of using the micro reform agenda to bring back industry policy to centre stage, its dominant thrust became accelerated tariff reductions and the removal of transport bottlenecks,

especially on the waterfront—with which landlocked Canberra has been obsessed for decades.

The conclusion drawn from the first phase of policy was not that the market had failed to operate in accordance with the theory, but that the impediments to its operation had not yet successfully been eliminated. The only area where outright 'market failure' was openly acknowledged and met with intervention was training, on which expenditure by companies clearly lagged international best practice. However, the reason why an exception had to be made there was not that the case for industrial policy had been conceded, but rather that training was essential to progress in award restructuring, and, as a result of initiatives taken by the union movement in the context of the Accord, award restructuring had become the central mainstay of wages policy.

Workplace reform

Indeed, it is a peculiarity of Australian economic management in recent years that wages policy and labour market reform has been made to bear the weight that in other countries would be carried, or at least shared, by industrial policy. Just as the focus of economic management shifted after the trade crisis from a macro growth strategy to micro reform, so the emphasis of wages policy changed from aggregate wage restraint to workplace productivity improvement through industry and enterprise bargaining.

Since wage restraint had not contributed to the investment needed to increase productivity, more direct measures were required at the workplace, where the growth of unit labour costs is the key variable. These measures were first signalled in the 1987 two-tier wage system, which opened the way for workplace negotiations on 'restructuring and efficiency', and then more comprehensively in the Industrial Relations Commission's award restructuring decisions of 1988/89, which established a framework for genuine productivity bargaining.

The measures were supplemented by the Federal Government's Workplace Reform Program, established by the Department of Industrial Relations (DIR), which featured a network of Workplace Resource Centres as well as more traditional assistance packages to union and employer organisations engaged in the rewriting of awards. These Centres anticipated the need to translate the new

awards into action at workplace level, without which award restructuring would have been futile. They were designed to provide advice and information on a commercial basis to firms in the process of restructuring, but only on condition that the process was operated through joint consultative machinery.

In addition, largely as a result of the AMC report referred to earlier, the Government announced in its 1991 economic statement, *Building a Competitive Australia*, the introduction of a Best Practice Demonstration Program, which would encourage selected firms to adopt international best practice approaches at the workplace. This programme, to be run jointly by the AMC and DIR, is a further indication of the degree to which industrial policy may be pursued legitimately only in the guise of workplace reform.

It was with considerable unease, however, and after some delay, that the Industrial Relations Commission was prepared in October 1991 to issue formal guidelines for productivity bargaining with no overall pay limit. While the guidelines are still very much at the experimental stage, by stipulating the need for joint consultation arrangements at the workplace they provide workers and unions with a further opportunity to widen the bargaining agenda, possibly to encompass decisions on investment as well as training and work reorganisation (Green 1991).

This could, if handled correctly, become a source of strength for workplace managers, rather than simply a threat to their decision-making prerogatives, particularly in the light of evidence from the Australian Workplace Industrial Relations Survey (AWIRS) showing that a major constraint on workplace performance in Australia is not union obstruction but the policies of management beyond the workplace (Callus *et al* 1991). Nevertheless, there are potential limitations in the operation of workplace bargaining from the viewpoint both of distributional fairness and of broader economic strategy considerations.

In the first place, in the absence of labour market regulation, workplace bargaining would tend to favour well-organised groups in high productivity manufacturing firms at the expense of weaker groups, especially those in service activities with no measurable output, whose terms and conditions of work could be undercut by employers. Even to the extent that legal regulation is maintained through a revamped award system, which we believe is necessary on efficiency as well as equity grounds, there will still be an important

role for the Commission in setting minimum standards, removing anomalies and enforcing fair wages and comparability for groups which fall significantly out of line with the rate for the job.

The second limitation of workplace bargaining, despite the opportunity it provides for greater accountability in company decision-making, is its uncoordinated character. It is this limitation which reinforces the need, which we have already identified as a necessary adjunct to macro policy, for wider, preferably tripartite structures to promote the development of coherent sector-based strategies.

A new approach

The relevance of the sector level as an organisational focus for industrial policy has been enhanced in recent years by the trend from traditional mass production industries, where economies of scale were the crucial factor, to more flexible manufacturing systems whose effectiveness requires carefully managed interdependence between smaller units of production. This interdependence has given rise to the much admired 'clusters' of competitive industrial success in places like Emilia-Romagna in northern Italy and Baden-Wurttemburg in southwest Germany (Mathews 1990).

It is true that such clusters cannot be imposed by state planning, but nor do they emerge spontaneously from the actions of individual entrepreneurs. Their growth and development must effectively be coordinated within structures which guide and assist firms with production techniques, personnel practices, producer-user linkages ('networking') and marketing strategies. The idea that these structures would have to 'pick winners' is a relic of past debates about planning versus the market, where the state is assumed to be the agency of planning. In this new approach to industrial policy, it would be more accurate to say that the winners have the opportunity to pick themselves within the framework of a sector strategy which they have collectively devised in cooperation with the Government (Eatwell and Green 1984).

The appropriate agency for industrial policy in the Australian context must be a tripartite institution with not merely advisory but executive powers, which is based on a network of sector planning bodies with representation from unions and employers. The role of

the Government is then not to impose a blueprint on industry, but to discuss and agree on a range of strategies in each sector, encompassing, for example, export facilitation measures, which would be supported by advisory and information services and, where related to the fulfilment of an agreed strategy, direct assistance to firms.

The national tripartite forum would have the task of ensuring that sector strategies are consistent both within industry itself and with the Government's broad macro settings. This would imply, for example, particularly in the recent period, that a current account improvement would not be sought by using monetary policy to depress demand. The reason is obvious. Not only are firms affected by high interest rates, but the influx of capital, as we have seen, drives up the exchange rate, making even relatively efficient firms uncompetitive. It is a classic case of inconsistency between macro and micro objectives, which would not arise if industry policy were to be assigned a central role.

There are many tripartite institutions in Australia, perhaps too many, which might be considered as candidates for the role we have described. The development of a new approach to industrial policy may well be the occasion for imparting a sense of purpose and coherence to the 'alphabet soup' of such bodies. In particular, a merger of the Economic Planning Advisory Council with the AMC to form a new 'Australian Planning Council' would be desirable, because it would not only permit the macro and micro dimensions of economic policy to be fused, but would also establish a 'transmission mechanism' to firms through the AMC's industry councils, which, at least potentially, form the basis of the proposed sector planning bodies. A similar approach has been proposed in recent years in the UK in relation to the future role of the tripartite National Economic Development Council (Green and Wilson 1984; Sugden 1991).

The main task of the Government, then, is not to intervene directly in the running of industry but to create the necessary 'supply side' framework for investment in long-term growth and jobs. This means developing representative tripartite structures, so that the elements of an agreed industrial policy may be developed, and providing legal rights for workers to information and consultation, so that the resulting sector strategies may be matched by strategies at the workplace. A new industry policy which releases the initiative and creativity of the workforce in this way may well be

the key to a high wage, high productivity economy in Australia, and hence to the long-term growth of output and employment.

5 Balance of Payment Restraints

In this section, we analyse the balance of payments, which, as we have already indicated, is considered to be the fundamental constraint on economic growth in Australia. Irrespective of the exchange rate regime, problems originating in the trade sector can constrain growth through trade deficits adding to external debt or exchange rate depreciation adding pressure to domestic prices.

We are primarily interested in the answers to two questions for the purpose of our analysis: first, to what extent does the current state of the balance of payments constrain the growth of output? and second, do current policy settings inhibit the attainment of this sustainable growth rate?

The first question requires an assessment of the present position, taking policy settings as given, though it raises the further question, which we address in the next section, as to whether intervention is warranted to relax the constraint on the growth rate. The second question focuses directly on current policy and, in the event of an affirmative answer, demonstrates the scope and necessity of expansionary measures within the parameters of the balance of payments constraint.

Debt stabilisation

We begin by evaluating the sustainable growth of output in the context of the stabilisation of the ratio of net debt to GDP within three years. For those who are interested, or who disbelieve an economic proposition without mathematical proof, the algebra of this form of stabilisation has been explored with some sophistication in the literature (Branson and Papaefstratiou 1978; EPAC 1986; Dixon and MacDonald 1986).

The debt to GDP ratio, f, can be written as

$$f = b + f_{-1} - \{1 + r^* (1 - k) + rk + e (1 - k)\}/(1 + p + g + pg) \quad (1)$$

where b, r^*, r, k, p, g, e denote, respectively, the ratio of the deficit on goods and services and interest on net foreign equity to GDP, foreign and domestic interest rates, the fraction of debt denominated in domestic currency, the rate of domestic inflation, real domestic growth and the rate of depreciation of the domestic currency (EPAC 1986, p 53).

Writing h as the percentage change in the real effective exchange rate and p as the foreign inflation rate yields

$$e = p - p^* - h \quad (2)$$

Now, utilising equation (2), equation (1) can be rewritten as

$$f = b + f_{-1}\{1 + (r^* - p^*)(1 - k) + (r - p)k + p - h(1 - k)\}/(1 + p + g + pg)$$

If foreign and domestic interest rates and inflation rates are equal and the real exchange rate is constant, then, since pg ≈ O

$$\begin{aligned} f &= b + f_{-1}(1 + i + p)/(1 + p + g + pg) \\ &= b + af_{-1} \end{aligned} \quad (3)$$

where i denotes the uniform real interest rate.

Under debt stabilisation,

$$f^* = f = f_{-1} = f_{-2} = \ldots.$$

Thus,

$$b = (1-a)f^* = f^*(g - i)/(1 + p + g) \quad (4)$$

There are two ways in which the debt ratio can be stabilised. One way, which follows from equation (4), is if the domestic economy grows faster than the rate of return on foreign liabilities. Consequently $\alpha < 1$, so that $b\{= (M - X)/Y\} > 0$. This scenario would mean that the economy could run an ongoing deficit in external trade in goods and services, which adds to the debt, but it could not be regarded as realistic in the long term.

The problem is that, in a deregulated environment, sustained current account deficits would put pressure on the exchange rate, which in turn would lead to a revaluation of the debt via an increase in h (since a large percentage of debt is denominated in foreign

currency), and thus require a faster growth of domestic output. Alternatively, foreign lenders would demand higher premiums to maintain the capital inflow needed to achieve the balance of payments. In the 1980s, for example, despite rapid domestic growth, the debt ratio increased in the context of high interest rates.

Another way to stabilise the debt ratio would be to aim for a more modest domestic nominal growth rate, which would need to be accompanied by a surplus on the external balance of goods and services and equity income since $\alpha > 1$. In this scenario, the return on net foreign debt would exceed the nominal domestic growth rate.

Let us consider, for the purpose of the argument, the objective of stabilising the ratio of Australia's net foreign debt to GDP, which in the June quarter 1991 stood at 34.6 per cent, at say 36 per cent. Then we can see from Table 1 the required long-term balance on net equity income and trade in goods and services, expressed as a fraction of current price GDP, for different rates of real GDP growth and average real interest rates on Australia's net foreign debt.

We assume in the table that the real exchange rate remains constant and the rate of domestic price inflation is 3 per cent. It is also assumed that the ratio to current price GDP of net equity (and other

Table 1 Required Surpluses on Goods and Services Expressed as a Percentage of GDP

Real Interest Rate	*Real Growth Rate of GDP*					
	0%	*1%*	*2%*	*3%*	*4%*	*5%*
2%	0.70	0.35	0.00			
3%	1.95	1.59	1.24	0.00		
4%	2.30	1.94	1.59	1.24	0.00	
5%	2.65	2.28	1.93	1.58	1.24	0.00
6%	3.00	2.63	2.27	1.92	1.57	1.23

investment) income which is presently about -1 per cent declines to -0.9 per cent. (Implicit in these calculations is that addition to net foreign liabilities take the form of debt rather than equity.) The results are little changed by considering higher inflation rates.

Short-term adjustment

Now let us assume that debt stabilisation is required within three years. Then, given a projected trend rate of export growth adjusted for the terms of trade, it is possible to compute the constant annual growth rate of gross national expenditure (GNE), and hence gross domestic product (GDP), over the three years, consistent with the achievement of a particular surplus for a given income (GNE) elasticity of demand for imports, rate of real depreciation and real interest rate.

The surplus on goods and services, b, satisfies

$$b(1 + g_{GDP})^3 = x_o\{(1 + g_x)^3 + D_X\} - m_O\{(1 + g_{GNE}z)^3 + D_M\} \qquad (5)$$

where D_X. D_M denote the cumulative impacts on export and import volumes of a depreciation of the Australian exchange rate, g_X is the trend rate of export growth, z is the income elasticity of import demand, x_O, m_O are the initial export and import shares of real GDP and g_{GDP}, g_{GNE} are the respective real rates of growth of gross domestic product and gross national expenditure respectively.

The relationship between the real growth rates of GNE and GDP can be written as approximately

$$g_{GDP} = g_{GNE} + x_oG_X + m_OG_M \qquad (6)$$

where G_X, G_M, denote the gross annualised rates of growth of exports and imports, inclusive of the effects of any real depreciation, which we discuss further below.

The income elasticity of import demand is assumed to be 1.2, which is the figure used by EPAC (1986, p. 39) in their calculations. The initial real ratios of exports and imports to GDP are set at 0.2039 and 0.2092, respectively which correspond to the ratios prevailing in 1990/91. The price elasticities of exports and imports are assumed to be 0.3 and -0.5 respectively. Hence a 10 per cent real depreciation of

Table 2 Real Percentage GDP Growth Based on a Zero Surplus

	Real (not adjusted) trend growth of exports					
	0%	*1%*	*2%*	*3%*	*4%*	*5%*
No depreciation		0.29	1.11	1.94	2.76	
10% depreciation		2.43	3.21	3.99		

the Australian dollar leads to a cumulative (overall) increase in exports of 3 per cent and a reduction in imports of 5 per cent over the three years. For these initial conditions, Table 2 denotes the annual rate of GDP growth consistent with a *zero* balance on goods and services, for different growth rates of exports adjusted for the terms of trade (tot).

It can be seen that, in the absence of a real depreciation or government intervention into the arena of foreign trade, the rate of domestic growth merely to balance the goods and services account in three years is too low to make any significant inroads into the pool of unemployment, currently standing at 10.6 per cent. In the vernacular of Britain of the 1960s, Australia would face a permanent situation of 'stop', particularly in the light of predicted negative real export growth for this year.

As we have already noted, high interest rates have been underwriting the exchange rate, which most commentators believe is overvalued (RBA 1991). If we are to have compatible policy aimed at restructuring with low unemployment. then investment in the traded goods sector is essential. It follows as a central argument of this paper that the obvious compatible policy mix would include lower real interest rates and a lower exchange rate.

Looking again at Table l, however, a zero surplus is consistent with a growing net foreign debt to GDP ratio, unless the real interest rate equals the real growth rate of GDP. The calculation of the rate of GDP growth compatible with debt stabilisation requires the simultaneous solution of equations (4) and (5), which cannot readily be done. A search procedure must be employed, whereby lower rates of GNE (GDP) growth are considered than those shown in

Table 3 Possible Debt Stabilisation Scenarios

Growth of Exports	2.00%	4.00%	3.00%	2.00%
Real Interest Rate	2.00%	3.00%	4.00%	3.00%
Surplus/GDP	0.7%	1.58%	0.76%	1.23%
Growth of GDP	0.0%	1.2%	3.23%	2.0%
	No Deprecation		Real Depreciation of 10%	

Table 2. This allows the corresponding surplus to be calculated, so that the new figure is compatible with that shown in Table 1 for a given real rate of interest on debt. Using this procedure, the scenarios set out in Table 3, with and without a real depreciation, are consistent with debt stabilisation in three years.

Table 3 reveals a very depressing picture. Even under the most optimistic scenario of 3 per cent trend export growth per annum there will be only a marginal decline in the unemployment rate, since the natural rate of growth, associated with a constant labour force participation rate, is also about 3 per cent, which is a little less than the rate of GDP growth. In the more realistic scenario of 2 per cent growth of exports, GDP growth of only 2 per cent per annum is possible over the three year adjustment period. Moreover, further calculations reveal that reducing the income elasticity to 1.0 has no significant impact on the possible growth rates of GDP over this period.

Clearly, the short-term constraint on real GDP growth can be pushed out by a larger depreciation, but even if this were feasible, given the inflationary consequences, the basic parameters, namely the elasticities involved, would remain unchanged, thereby placing limits on the long-run capacity of the economy to grow and, as a consequence, on the sustainable rate of unemployment. For example, if labour force participation is treated as constant, then GDP growth of 3 per cent would only manage to stabilise the unemployment rate. With an income elasticity of 1, imports would grow at 3 per cent which would require, in the absence of any further depreciation, a 3 per cent trend real growth of exports.

These observations point to the need lor a fundamental shift of policy if the Australian economy is to create jobs and reduce unemployment in the coming months. Not only have policy settings over the late 1980s inhibited the rate of economic growth, but, with deregulated financial markets, the modest requirement of debt stabilisation within three years would be enough in the present environment of slow export growth to undermine the objective of a return to the high levels of employment previously experienced in this country.

Our conclusion, therefore, is that import controls and export subsidies may be needed in the short term to increase the sustainable rate of domestic growth, though in the longer term, as we have seen, it will be industry policy which plays the central role in relaxing the balance of payments constraint. In addition, we shall demonstrate in the next section that there is a powerful case for direct job creation measures to reduce unemployment and boost growth, bearing in mind that the effect of these measures will be maximised within the less binding constraint implied by a more interventionist approach.

Finally, a substantial currency depreciation will also be essential to provide an additional stimulus to growth as well as further reducing the constraint on the growth of GDP over the period of adjustment to debt stabilisation. The point is that while depreciation on its own may have limited real impact, it has an important part to play in a wider programme of expansionary measures.

6 Scope for Job Creation

We have argued that a return to strong rates of GDP growth is imperative given the slack in the labour market, but the dismal projections for export growth imply a severe balance of payments constraint. For this reason, we have suggested the use of export subsidies (or tax credits for exports) and import controls as a means of shifting the constraint and providing greater scope for job creation measures.

The usual criticism of subsidies is that they offer an incentive to over-produce, in that more production leads to more subsidy income. However, in the case of exports, the encouragement to produce more output should be seen as a virtue rather than a cost. In addition, the implied lower cost of export output would have the further

advantage of negating any incentive producers might have to divert production away from the export market towards the domestic market once growth increases.

It is also now widely acknowledged that, in order to reduce the pressure on the price level as expansion takes place, while at the same time stimulating exports, there is a strong case for reform of the wholesale tax structure. Rebates for exports, common in European economies, are an essential first step. Moreover, it has been shown with some persuasive analysis that a reduction in indirect taxes will give the best real GDP-inflation trade-off (Perkins 1991).

The point is that macro policies can complement micro initiatives of the kind outlined in Section 4, and are indeed essential, to provide long-term incentives for export sales in non-primary commodity output. However, in the short term, the balance of payments constraint may have to be pushed out even further by controls on imports.

Our calculations show that, on conservative assumptions about the distribution of income and propensities to consume, there are substantial budgetary savings to the Government and a stimulus to employment resulting from successful policies directed towards import replacement. For example, a comparison of output figures for the manufacturing subdivisions, transportation equipment (TE) and paper, printing and publishing (PPP), for the September quarters of 1989 and 1991 suggests the existence of significant excess capacity in each sector.

Using figures from the Australian National Accounts, it may be seen that there is considerable scope for import replacement, and hence additional employment, in the areas of motor vehicle engines, instruments and electrical equipment in TE and paper board and felts in PPP (Input-Output Tables, Cat 5215.0, 1986/87). The results of our calculations, which are based on newly employed persons previously receiving unemployment benefits, are as follows.

We find that $100 million of import replacement in *each* subdivision would yield (1) an additional 3860 direct jobs, (2) 1470 indirect jobs via induced domestic expenditure, (3) additional output of $267.7 million, (4) an improvement in the Government's budgetary position of $120 million and (5) an reduction of net imports and hence improvement in the balance of trade of $170.5 million. The calculations could be applied to other manufacturing subdivisions with similar results.

A jobs program

In our view, as already indicated, the stimulus to domestic activity afforded by the proposed depreciation of the dollar is unlikely in isolation to be sufficient to achieve a high rate of domestic growth, given the current stagnation in the economy. The problem is that, with an export share of GDP of about 20 per cent, the 3 per cent growth in exports, induced by a depreciation of 10 per cent, would add only about 0.6 per cent to the rate of GDP growth. Clearly, aggregate demand policy must generate sufficient expansion to push the growth rate towards the new constraint on the sustainable rate of domestic growth.

Table 4 depicts some job creation arithmetic, involving an initial government outlay of $1 billion over a year, which supports the case for policy activism in the short term, as well as in the context of longer term industry policy measures aimed at improving competitiveness. The exercise is based on directly employing unemployed workers on the lowest unskilled local government wage rate to undertake projects such as road repairs, foreshore reclamation, soil conservation and the like. The projects have inherent value in that they add to the social infrastructure and reduce private costs and future public costs.

After all, an important objective of microeconomic reform is greater efficiency in the provision of key 'inputs', such as transport and communications, for the conduct of value-added activities. This can be achieved to some extent by workplace reform, but it also depends upon an improvement in the stock of infrastructure through investment. Indeed, infrastructure investment is the necessary backdrop to most productive private sector investment. Significant public sector projects are particularly appropriate in a recessed economy, where the likelihood of demand pull inflation is necessarily reduced and the physical crowding out of private sector activity can effectively be minimised.

Our calculations underline the important point that the net cost of creating 'direct' employment for the Government is relatively low, due to the savings in unemployment benefits and the receipt of income taxes and the Medicare levy. Moreover, the direct increase in employment promotes indirect employment, and hence a further reduction in government outlays, through the propensity to spend on domestically produced consumer goods.

It is shown in Table 4 that a stimulus of $2 billion would create 206 892 direct jobs and 32 250 indirect jobs, based on conservative assumptions about propensities to consume. The *net* expenditure by the Government, however, would be reduced by $740 million, as we have just indicated, due to lower benefit payments and higher tax receipts. In the table, a number of scenarios are considered, which correspond to different assumptions about the participation rate and the growth of current employment, associated with private sector expansion. (The assumptions underlying the table are set out in Appendix 1, and an algebraic treatment of the calculations may be found in Appendix 2.)

The job creation programme we are proposing must be considered in the context of a government pursuing a full employment budget surplus, yet with an unemployment rate higher than at any

Table 4 Job Creation Policies : Unemployment and GDP Growth

	TWO BILLION DOLLARS		
Emp Growth[a]	ΔP^b	UR^c	g^d
0.0%	0.00	9.19	1.44%
	0.50	9.90	
	2.00	10.60	
0.5%	0.00	8.75	1.98%
	0.50	9.47	
	1.00	10.17	
1.0%	0.00	8.31	2.52%
	0.5	9.03	
	1.0	9.74	
1.5%	0.0	7.87	3.06%
	0.5	8.59	
	1.0	9.30	

Explanatory notes on the table:
(a) Rate of private sector employment growth.
(b) Percentage point change in the labour force participation rate, currently 63.3%.
(c) Rate of unemployment resulting from the job creation programme and the private sector employment growth.
(d) Total GDP growth at current prices, inclusive of the assumed private sector growth of employment. (Each 0.5% growth of total employment in 'total manufacturing' is equivalent to 0.54% growth of nominal GDP.)

time since the Great Depression. To the extent that such a programme promotes increased labour force participation, the fall in unemployment will be lower and the budget deficit will tend to increase in the short term. In our assessment, the programme would reduce the unemployment rate by about 2.70 per cent, but each 0.5 per cent increase in the participation rate would have the opposite effect, raising the unemployment rate by 0.7 per cent.

In addition, each 0.5 per cent increase in the participation rate increases outlays on unemployment benefits by $682.2 million per annum, based on the composite individual who was previously *not* receiving any government transfer payments but now receives unemployment benefit of $9,780.10 per annum. However, this problem will tend to characterise any recovery from recession, whether induced by the private or public sector. Another way of looking at it is that the budget deficit would be much higher now had measured unemployment been associated with a levelling off of the participation rate, rather than its decline with the onset of the recession.

It is sometimes argued that wage subsidies should be introduced as an alternative to direct job creation. However, there are at least four reasons why such subsidies would not be appropriate or cost-effective in current circumstances. First, wage subsidies are predicated on the assumption that unemployment is due to excessive real wages, rather than a lack of demand in the economy. Second, the elasticity of employment with respect to real wages is low in any case, which reduces the effectiveness of subsidies. Third, firms would have an incentive to dismiss marginal staff in order to rehire staff who would attract the subsidy.

Finally, and perhaps most importantly, wage subsidies are a disguised form of industry policy in the sense that they provide indiscriminate assistance to the private sector. If the case for industry policy is accepted, surely it would be more effective from the viewpoint of long-term productivity improvement to ensure that any assistance measures to firms are carefully targeted and, from the viewpoint of short-term job creation, to provide resources directly for a public sector stimulus.

Stabilisation policy

There is, of course, a long-standing objection to government stabilisation of the economy. We define stabilisation in terms of a focus on the aggregate performance of the economy as distinct from

intervention, which relates more properly to micro concerns. When stabilisation is advocated, it is assumed that the macroeconomy is inherently unstable and not just subject to transient random shocks. Alternatively, it may be reasonable to assume, as did Keynes in elaborating his principle of effective demand, that the market economy is stable but can generate 'equilibrium' outcomes which do not satisfy certain macro objectives such as a full employment level of output.

The Government is currently considering 'fast-tracking' major infrastructure projects as a means of stimulating the economy. Such carefully targetted spending, however worthwhile in the long run, has the problem that the planning process is necessarily prolonged, which negates its use in short-run stabilisation and also imposes higher on-costs. Nevertheless, we can learn here from the Swedish and Japanese approaches to infrastructure programmes. Both countries have programmes which involve large scale infrastructural development but which can be adjusted to accommodate short run discretionary stabilisation (Taylor 1982).

In Sweden, the government operates an Investment Fund which encourages firms to deposit up to 20 per cent of their profits. Deposits are not taxed. The fund then provides low interest investment finance when activity is low. This scheme helps stabilise private investment and consumption behaviour because the automatic stimulus is built into expectations. Investors and consumers know that any downturn will be shortlived and moderate. This sort of fiscal initiative is an example of how discretion can combine with expectations to stabilise activity.

Another example is Japan's Tokyo Bay Expressway project, which has been under construction for the last thirty years, with no end in sight. As economic activity slows, more funds are allocated to the project, which both eliminates any lag in spending and ensures that public expenditure is allocated to building vital infrastructure. The Pacific Highway in northern New South Wales, or any number of other projects, might be appropriate candidates for such 'perrnanent' counter-cyclical expenditure.

7 Conclusion

We have considered in this paper the profound crisis in economic theory and policy in Australia, and we have shown how this crisis is reflected both in the abandonment of Keynesian demand management policy at the macroeconomic level and the failure to develop a dynamic approach to industry policy at the micro level of the sector and individual firm. The new economic orthodoxy believes in the operation of markets, which, left to themselves, would give rise to optimal and efficient outcomes. In the face of evidence in the real world, notably high rates of unemployment and low productivity growth, that the market does not produce efficiency, this orthodoxy finds fault not with the theory but the real world, where 'distortions' and 'impediments' to its operation abound.

The impediments the orthodox approach has in mind are, of course, Government intervention of almost every conceivable kind and the 'monopoly' role of trade unions in the labour market, which is why the Opposition's policy platform represents the logical conclusion of this approach. We have argued that the Labor Government, through its Accord with the unions, has the opportunity to develop a coherent and feasible alternative to the free market orthodoxy. Essentially, the Government must

1. introduce an emergency jobs programme in the short term to reverse the rise in unemployment and, at the same time, meet pressing economic and social needs;
2. use export subsidies and import controls, as well as currency depreciation, to the extent necessary to overcome the balance of payments constraint to expansion; and
3 implement a new, more interventionist, industry policy to improve the long-term productivity and competitiveness of Australian firms.

As a first step, we calculate that an initial outlay of $2 billion will create about 239 000 jobs both directly in local council public works and indirectly through the multiplier process. The net cost to the Government would be much less, at around $1260 million, after taking into account lower unemployment benefit outlays and higher tax receipts from those in work. A larger stimulus may well be appropriate, but we use these figures as an example of what can be done at the present time.

Panel—Counter-Inflation Policy

In recent months, interest rates have been cut, in part to promote investment, and the long overdue depreciation of the Australian dollar has begun to occur, which will also assist in the process of structural change. However, depreciation will have the additional effect of raising the domestic price level through higher prices for imported final goods and higher imported raw material prices. Moreover, any sustained recovery will encourage firms to increase margins, further contributing to inflation.

Inevitably, a higher rate of domestic inflation is going to impose strains on wages policy, particularly with the move to enterprise bargaining and the associated relaxing of the authority of the Industrial Relations Commission. Although inflation is low enough to be ignored at present, it could well become a problem again at a future stage. One method of dealing with the problem is indexation, which we believe may have a role to play in counter-inflation policy.

In Australia, apart from a brief period of tax indexation, the main experience of indexation relates to nominal wage indexation. Pure wage indexation renders the nominal wage inflation-proof. In general, any nominal (money) contract could be inflation proofed through appropriate indexation. For example, unemployment benefits, pensions, tax brackets and tax thresholds could be increased in nominal terms in proportion to the inflation rate. Monetary contracts, where the interest rate is a factor, could be specified initially in terms of a real interest rate and the nominal rate adjusted accordingly with inflation.

Indexation has been proposed by economists as a means of reducing inflationary biases. For example, where inflation is unanticipated, the actual real interest rate deviates from the expected real interest rate. If unanticipated inflation is positive, then the expected real interest rate overestimates the actual rate. Savers gain less than expected returns, while borrowers have to pay less than expected. For the Government, which is a large debtor, less interest would be paid than the private sector anticipated. If debt indexation was to be applied, there would be no such redistribution and the costs of inflation would be reduced.

Additionally, indexation can reduce inflation. Where expectations rather than actual events influence the formation of nominal contracts, indexation can break the nexus between contractual bargaining and expectations. This only occurs, however, when expectations exceed the actual inflation rate.

The best time to introduce indexation is when the actual rate is low. At present in Australia, the only way inflationary expectations can go is up. The recession has driven them close to zero. With the actual rate low and expectations likely to rise if expansion and exchange rate depreciation occur, indexation provides the ideal circuit breaker to supplement other macro policy settings.

As far as the balance of payments constraint is concerned, the achievement of external equilibrium through the stabilisation of the net foreign debt to GDP ratio at 36 per cent requires the transformation of the external balance on net equity income and on trade in goods and services from a deficit of over 1 per cent of GDP to a surplus of 1 per cent of GDP. Recent projections of real export growth net of the terms of trade suggest that external stability can be achieved within three years only at the cost of low GDP growth and rising unemployment. This is the rationale for a substantial currency depreciation, but there are limits to this approach which may be overcome by more direct measures such as export subsidies and import controls.

Finally, industry policy is the key to the success of our proposals in the sense that it can link the macro objectives of growth and employment to the micro concern with investment. We have suggested a new tripartite body, the 'Australian Planning Council', based on a merger of the Australian Manufacturing Council with the Economic Planning Advisory Council, which could devise and implement such an integrated approach to the conduct of policy. It would also carry the potential, through its sector planning groups, of acting as a 'transmission mechanism' for the development of national and sector strategies which involve Australian workplaces more fully in the process of change.

Appendix 1: Job Creation Assumptions

The following assumptions underlie the calculations of the effects of the job creation measures in Table 4.

1. On-costs and administrative costs of the direct job creation are assumed to be 20 per cent of the gross weekly wage. A distinction is made between net cost for each (direct) job for the Government, z ($9666.9), which includes the on-costs, and the net addition to disposable income for each directly employed individual, z* ($6018.6), which does not include on-costs. It is assumed that jobs are provided to single and married persons in proportion to their respective levels of unemployment, that is 43.7 per cent married and 56.3 per cent single, at $350.8 per week.
2. Workers indirectly employed through the jobs programme have labour productivity $52 313.9 at current prices which corresponds to total manufacturing but receive economy wide Average Weekly Earnings (AWE) of $488.90 per week. This assumption about AWE is conservative, and reflects the difficulty of measuring economy-wide productivity. These individuals are assumed to be previously unemployed and receiving unemployment benefits. Their increase in net disposable income is denoted as z**.
3. Based on comparisons of GDP and GDP at factor cost, it is assumed that value added through indirect employment is 88.96 per cent of nominal output. This enables the calculation of the share of annual labour productivity which is accrued as profit (0.404), which in turn is taxed at 39 per cent.
4. The propensities to consume on domestically produced goods out of disposable income are assumed to be 0.8 for wage earners and 0.4 for profit earners.
5. Over the next year, the labour force is assumed to grow at 1.5 per cent from its December 1991 magnitude of 7779.5 thousand, in the absence of any change in the participation rate.
6. No account is taken of productivity growth and nominal wage growth over the year. Other Government receipts from this programme, including sales tax and pay-roll tax, are not computed.

Appendix 2: Mathematical appendix

The following is an algebraic treatment of the calculations used in Table 4.

$$z = W(1 + C) - T - UB - MCL \qquad (A1)$$

where W denotes the value of the minimum award over a year, C is the rate of on-costs, T is total income tax, MCL is the medicare levy and UB denotes the unemployment benefits foregone.

On the other hand, z*, the increase in net disposable income of the newly employed individual on the minimum award, is

$$z^* = W - T - UB - MCL.$$

z^{**} is similarly defined for those workers on economy wide AWE. Workers have a propensity to consume on domestically produced goods of c_w.

Then, the direct employment created,

$$\Delta N_1 = \Delta G/z \qquad (A3)$$

where

$$\Delta N_2 = (\Delta G/z)z^* c_w/\pi \qquad (A4)$$

denotes the additional non-wage income by $a^{**}\pi\Delta N_2$, where a^{**} is the fraction of nominal productivity per worker in total manufacturing, π, in the form of non-wage income. Assume a fraction, $c_p(1 - t)$ of non-wage income, is spent on domestically produced goods, where t is the corporate tax rate. Then

$$\Delta N_3 = \{(\Delta G/z)z^* c_w/\pi\}(z^{**} c_w + (1 - t)\, a^{**} \pi c_p)/\pi \qquad (A5)$$

$$\Delta N_i = \{(\Delta G/z)z^* c_w/\pi\}\{(z^{**} c_w/\pi)\{z^{**} c_w + (1 - t)\, a^{**} \pi c_p)/\pi\}^{i-2} \qquad (A6)$$

so that the total increase in employment, ΔN, can be written

$$\begin{aligned}\Delta N &= \Delta N_1 + \Delta N_2.\ \pi\ /(\pi - z^{**} c_w - (1 - t)\, a^{**}\pi c_p) \\ &= \Delta N_1 + (\Delta G/z)z^* c_w/(\pi - z^{**} c_w - (1 - t)\, a^{**} \pi c_p) \qquad (A7)\end{aligned}$$

where ΔN_j denotes the ith round increase in employment (i = 1, 2, ...).

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3 Unemployment and Non-Standard Employment

Iain Campbell and John Burgess

Introduction

Unemployment is rightly a major theme of contemporary debate in Australia (Dixon, 1992; Social Justice Consultative Council, 1992; EPAC, 1992). It is widely recognised that unemployment is a central contributor to social and economic deprivation and that it entails substantial costs to the economy and the society as a whole. The increased incidence of large scale retrenchments together with the rapid rise of measured unemployment in the current recession to encompass almost a million people, over 11 per cent of the labour force, has initiated a renewed cycle of public and policy concern. This has overlapped with the electoral cycle to generate a widespread, if somewhat inchoate, discussion of unemployment causes, consequences and possible policy responses.

The official figures for the absolute number of unemployed and the ratio to the labour force as a whole (perhaps complemented by a look at job vacancy rates) are at the centre of attention in this discussion. But it is increasingly apparent that these measures are incomplete as a platform for investigation of many of the key issues. Thus it has long been clear that any discussion needs to add notions of hidden unemployment and underemployment (for example, Stricker and Sheehan, 1981). Moreover, it is clear that there is no direct relation between unemployment figures and social and economic deprivation. As evidence of the limited impact on poverty of the rapid job growth throughout most of the 1980s indicates, the focus on individuals in the basic data can be misleading and there is