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An Assessment of the 1990s

David Gruen and Sona Shrestha (eds), ***The Australian Economy in the 1990s****, Reserve Bank of Australia, Sydney, 2000*

Reviewed by ***Graeme Wells***

Each year the Reserve Bank of Australia invites a group of economists to a conference organised around a theme of topical interest. The volume presently under review records proceedings of the third in a sequence of conferences, held in 1979, 1990 and 2000, that provides an overview and analysis of the main developments in the Australian economy and economic policy over the previous decade. Taken as a whole the papers in this volume succeed in providing a very useful and accessible overview of the Australian economy in the 1990s. Its non-technical style will ensure a wide readership.

As in earlier conferences, contributors are drawn from the staff of the Bank and a wide variety of other sources, with about half of the papers being commissioned from economists outside the Bank. Three contributions from the Bank survey decade-long developments in macro performance and policies (David Gruen and Glenn Stevens); the Australian financial system (Marianne Gizycki and Philip Lowe); and national saving (Malcolm Edey and Luke Gower). Other contributions include an analysis of microeconomic policies and structural change (Peter Forsyth), the politics of economic change (Paul Kelly), developments in the Australian labour market (Peter Dawkins), the historical interaction between theory and advocacy in the development of policy (Robert Leeson), and perspectives from the UK and the US on Australia's economic performance (Charles Bean and Bradford DeLong). Discussant's comments and a brief record of general discussion follow each of the papers.

A brief review cannot do justice to these varied contributions - a more useful approach, perhaps, is to highlight a small number of themes running through the conference. Consider first the evolution of the policy debate. Two good examples are the evolution of monetary policy towards inflation targeting, and the policy significance of the current account and foreign debt position.

Leaving aside the difficulties engendered by instability in relationships between broader monetary aggregates and nominal income the attempt to target monetary aggregates, interest rates, and the exchange rate was always likely to end in failure in a world of increasing capital mobility. So was the 'checklist' approach which replaced it in the second half of the 1980s, after the float of the dollar. This volume has scant discussion of the role of monetary policy in precipitating the recession, but some of the outside participants don't pull their punches. As Kelly puts it '... the 1980s ended in failure, a monetary policy failure – a deep recession

provoked by interest rates of 18 per cent resulting in unemployment above 11 per cent' (p. 225).

Little wonder, then, that in the early 1990s the search was on for a new policy framework. Many of the proposals under discussion outside the Bank, including the inflation targeting approach that eventually emerged, shared common characteristics. Having a clearly defined nominal anchor, whether it be the monetary base, the US dollar, or the rate of inflation, was important. Increased transparency in monetary policy was important. So too was the independence of monetary policy. As Gruen and Stevens describe the approach in Australian policy-making circles, 'more attention began to be given to the model which combined an inflation target and clear central bank independence. Both [in New Zealand] and in Canada the idea of an explicit, numerical inflation target took shape, and was implemented' (p.54). In the view of this reviewer, the Australian definition of the inflation target is an improvement on the New Zealand practice of a narrow band with 'hard edges'. It is also to the Bank's great credit that it eschewed the Canadian and New Zealand practice of paying attention to a 'monetary conditions index' in setting monetary policy.

Gruen and Stevens also discuss changing policy perceptions regarding the current account and foreign debt. At the beginning of the decade the 'consenting adults' view – that, in the absence of externalities, saving, investment and financial market decisions are best left to persons in the private sector – was thought to be contentious. But as the decade progressed current account deficits continued, net foreign liabilities rose from the low 40s as a percentage of GDP to the low 60s, and the foreign debt position proved to be 'the dog that didn't bite'. For this reason, and the force of the underlying logic, the 'consenting adults' view gained ascendancy.

But Gruen and Stevens (and, more directly, other contributors such as Bean and Edwards) point out that it cannot be taken for granted that the rest of the world will wish to accumulate our foreign liabilities at the same rate, and at current exchange and interest rates. Surprisingly, they fail to indicate a possible qualification of the 'consenting adults' view. Over the 1990s the proportion of foreign debt intermediated through the banking system has grown significantly, to the point that the gross foreign debt of depository institutions is now more than one third of annual GDP. To the extent that foreign lenders perceive these institutions to have an implicit government guarantee, an externality is lurking in the background which may encourage more foreign borrowing than would otherwise be warranted.

Now turn to other contributors whose main focus is on the evolution of policy ideas. At first glance the chapter by Leeson appears to be a rambling exercise in self-citation. It is replete with irritating acronyms such as DAFF-O-DILS (Dynamically Alliterate (sic) Flatlandia Formalists). The important issue buried in the paper is a variation on the aphorism that those who do not understand history are condemned to repeat it. Leeson argues that understanding the origins and development of economic ideas, and the process by which they gain acceptance in policy circles, would have had a salutary effect on recent policy debates.

Important as that argument is, it would have more force if it were developed, not in the context of the policy debates of the 1960s, 1970s and 1980s, but in terms of current policy issues.

Kelly also examines the evolution of policy, comparing the reform agendas of Commonwealth governments of the 1980s and 1990s. He argues that, with the exception of the tax package, Prime Minister Howard's economic reform agenda has been modest by comparison with the Hawke-Keating years. For Hawke and Keating the groundwork for some of the reforms was laid earlier — the Campbell Inquiry that underpinned deregulation of financial markets, for instance. They were also able to use the Accord and the tax and transfer system to offset most of the income inequity that would otherwise have resulted. Kelly refers to changes in the role of the Senate and respective Opposition parties between the two periods, and also makes the case that the political cost of reform has been raised. Howard's draw down of the fiscal surplus to over-compensate groups affected by the introduction of the GST is offered as one example of the latter effect. While Kelly offers an intriguing analysis, this reviewer would put more emphasis on the role of the States in any overall analysis of the political economy of economic reform. For example, the States played an important part in the move to overall fiscal surplus during the 1990s. In many of the areas not yet subject to significant reform such as health, education and urban transport infrastructure, political difficulties are increased because it is necessary to gain the cooperation of the States.

Many of the contributors explore aspects of the long Australian expansion that began in the second quarter of 1991, and this is a second major theme of the conference. A recurring, and ultimately unanswered question, concerns our strong productivity performance over the decade. Does it reflect, as Forsyth suggests, a transitional increase resulting from the reforms of the 1980s? What are the effects of the information technology revolution, or the removal of distortions to investment engendered by high inflation? For Bean, Australia's performance in the 1990s looks very much like Thatcher's productivity boom of the 1980s. In the British case it all ended in tears, largely because monetary mismanagement (in the form of an exchange-rate peg which implied a fall in competitiveness) coincided with the recession that affected most OECD economies at the time of the war against Iraq. He is cautiously optimistic that Australia's long growth cycle will avoid the same ending.

Whether measured by labour productivity or multifactor productivity, the pickup in Australian productivity growth in the 1990s began several years earlier than the much-remarked upsurge in productivity in the United States. Arithmetically, the counterpart to this is that, although the track of GDP growth rates in the two countries over their 1989-91 recessions was similar, labour market outcomes were significantly different. Australian unemployment rose from under 6 per cent in mid-1989 to over 11 per cent in early 1992, while in the United States the corresponding figures are 5.2 per cent and 7.8 per cent. Another point of reference is the Australian growth cycle in the 1980s. In the 1990s, the Australian labour market delivered higher real wage growth and lower employment growth - particularly, as Gregory notes, relatively low growth in full-time jobs. In its early

stages, the Australian growth cycle of the 1990s was characterised as the 'jobless recovery'. Contributions by Gruen and Stevens, Bean, and Dawkins, all analyse aspects of the Australian labour market. Evidently disentangling the effects of productivity change, recovery from recession, and industrial relations reform, is a difficult and unfinished task. But these papers offer a good summary of the state of play.

In Australian financial markets, the 1990s were characterised by a number of clear trends. The increasing impact of compulsory superannuation and a number of privatisations and demutualisations meant that, for an increasing number of Australians, savings were mediated through equity markets rather than banks. As Edey and Gower tell it, there has been something of a recovery in the national saving rate over the course of the 1990s with both the private and public sector contributing to this trend. Gizycki and Lowe trace through the impact of changes in savings patterns on the banking system, and how it has led to banks becoming large borrowers on overseas financial markets, and expanding into the funds management business. Their contribution also discusses prudential supervision of banks and the way in which changing financial markets are leading to changes in the risks facing the banking industry.

It has become rather common for the resilience of the Australian financial system during the Asian crisis to be attributed to recent reforms. Gizycki and Lowe do not make this claim and, for this reviewer, a more prosaic explanation is to be found in the recession of the early 1990s. The Australian banking system spent the early part of the 1990s recovering from the lax credit standards they had applied in the 1980s, the results of which came to roost in 1990, 1991 and 1992. It was too soon, in 1997, for these lessons to have been forgotten by Australian bankers. As to the future, Gizycki and Lowe would, I think, argue that arrangements flowing the Wallis inquiry have yet to be tested. They refrain from revisiting old arguments as to whether the Reserve Bank or an independent regulator should have primary responsibility for prudential supervision, but they do make an argument for deposit insurance.

Graeme Wells is Reader in Economics at The Australian National University.