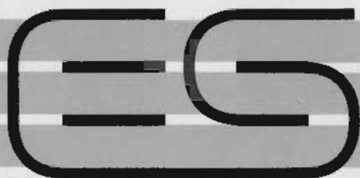

ECONOMIC SOCIETY OF AUSTRALIA
(Victorian Branch)

10th STAN KELLY MEMORIAL LECTURE

FREE TRADE AND THE INTERNATIONAL FLOW OF FUNDS

Delivered by:
Mr. Tony Cole, AO

Thursday 10 August, 1995
The Brisbane Room
The Regent Hotel
25 Collins Street
Melbourne 3000 Victoria

INTRODUCTION

The Stan Kelly Memorial Lecture is presented once every two years in Melbourne under the auspices of the Victorian branch of the Economic Society of Australia. The lecture is funded from an endowment established by Mr. Bert Kelly, former "modest" member of Parliament and retired farmer, in memory of his late father.

William Stanley Kelly, OBE, was a South Australian farmer and life long champion of free trade. He was a member of the Commonwealth Tariff Board from 1929 to 1939, an advisor to the Commonwealth Prices Commissioner from 1942 to 1948, chaired the Joint Industry Advisory Authority from 1951 to 1953 and was a member of the Consultative Committee on Import Policy from 1952 to 1960.

Commemorating Stan Kelly's dedication to the promotion of free trade, the Stan Kelly Memorial Lecture has as its theme "The desirability of maintaining free the channels of trade throughout the world". Nine distinguished speakers have accepted invitations to deliver the lecture, beginning with Sir John Crawford in 1977 and followed by Mr J. Uhrig, Mr J. Stone, Mr R.A. Johnston, the Rt. Hon. R.J.L. Hawke, Mr J. McDonnel, Sir Leslie Melville, Mr I. McLachlan, Professor R. Garnaut, and this year, Mr Tony Cole.

The text of Mr. Cole's address is reported here as a permanent record of the 10th Stan Kelly Memorial Lecture delivered in Melbourne on 10th August 1995.

At the time of giving the lecture, Mr Cole was Executive Director of the Life Insurance Federation of Australia. Prior to this, he filled a number of senior positions within the Federal public service, including as Chairman of the Industries Commission between 1989 and 1991, and Secretary to the Department of Treasury between 1991 and 1993.

The Council of the Economic Society of Australia (Victorian Branch) expresses its gratitude to Mr. Cole for his willingness to prepare and deliver the 10th Stan Kelly Memorial Lecture.

David Lansley
President

FREE TRADE AND THE INTERNATIONAL FLOW OF FUNDS

In his book "The End of Certainty" Paul Kelly argues that the 1980s were a crucial time for Australia. The central message was the obsolescence of the old order and the promotion of new ideas as the basis for a new Australia. Kelly says "The fundamental divide in Australian politics was no longer Labor versus Liberal . . . The real division is between the internationalist rationalists and the sentimental traditionalists".

In the 1980s Australia departed radically from the policy assumptions which had shaped its economic development since federation.

A key departure was the decision to abandon protectionism as the central plank of industry policy. As Paul Kelly reports, the final timetable for protection's virtual dismantling was announced by the Hawke Government in March 1991. But protection had been "under threat from an apparently irresistible anti-protectionist tide furious at the longevity of its denial" since McEwan's retirement in 1971.

As we all know another Kelly, Bert Kelly, son of Stan, was one of the people who called forth this tide. Bert Kelly and Alf Rattigan are two heroes of Australian economic history. Their boldness in exposing the costs of protectionism - the resource misallocation, the loss of competition and the creation of an unhealthy dependence of business on government - put their own futures at risk.

Their work was vital, not just because it helped build the antiprotectionist momentum but also because of the inspiration it provided for younger economic rationalists. I remember the joy with which we used to read Bert's Modest Member and then Modest Farmer columns in the Financial Review.

Tonight we remember Stan Kelly, Bert's Father. Bert dedicated his second book to the memory of his father, "who", he said "pushed me sternly along the road of economic rectitude". Bert says elsewhere that he always regretted not having studied economics beyond high school level. He was nevertheless confident enough to title his book "Economics Made Easy". This says a lot for his father who learnt his economics on the job as a member of the Tariff Board, an adviser to the Prices Commissioner during the second World War, an adviser in post war trade negotiations, as a rural representative on the Consultative Committee on Import Policy and, of course, as a farmer. Bert learnt from his father about the dangers of trade barriers for international relations and for efficiency. Bert's writing concentrated heavily on protectionism and subsidies but often roamed further. I am sure many of you recall David Henderson's piece on what he calls do-it-yourself economics which shows how lay people applying "common sense" often produce economic nonsense. It is a tribute to Bert, and to Stan, that this could not be said of the Modest Member.

Tonight I want to talk about some of the events and issues which made the 80s such a crucial period in our history. I will share some of the certainties and doubts we felt as participants in the process. I will also offer some thoughts on where we should go from here and how we should respond to the backlash from the people Paul Kelly calls "the sentimental traditionalists".

I date the start of rational economic reform as 1983, the year in which Malcolm Fraser, an arch traditionalist, lost office.

I was lucky enough to return to Australia in 1983 after two years at the World Bank and to be around as reform took place.

The World Bank is a wonderful place for an economic rationalist to visit.

The World Bank's role is to borrow money on world capital markets as a triple A credit (on the strength of capital and guarantees provided by developed countries) and on-lend it for development projects in poorer countries, many of which could not borrow on any terms in their own names.

But it is much more than a provider of capital. The Bank sees its role as promoting development. It researches projects and the development process itself. On the basis of this research it provides advice to member countries and attaches economic and other policy conditions to its loans.

The Australian Treasury argues that this aspect of the Bank's operations is far more important than the volume of finance it manages to deliver to developing countries. Development will never succeed regardless of the volume of concessional capital inflow, if the economic policy framework is inappropriate. With the right policies in place there will be little need for concessional flows as private capital will flow in to take up profitable development opportunities.

This is clearly a very convenient argument for a Treasury trying to reduce the aid vote and government spending. But there is a strong element of truth in it.

I remember attending the Interim and Development Committee meetings of the IMF and World Bank with Treasurer Dawkins in Washington in 1992.

Historically, the Australian Treasury and Treasurers have concentrated their attention on the Interim Committee which discusses the big picture issues of world liquidity, exchange rates and their volatility, and the supposed need for international economic policy co-ordination.

Australian Treasurers rarely spend more than half an hour or so at the Development Committee, using the day for bilateral meetings with their counterparts from other countries and meetings with the host government or bankers. This allows one of the

developing country members of our constituency (eg. Korea, PNG, Thailand) to participate directly in the mainly World Bank agenda which is seen to be more directly relevant to them.

In 1992 Treasurer Dawkins spent as much time as possible at the Development Committee meeting. He was fascinated to hear Finance Ministers from one developing country after another tell of the remarkable improvements which had occurred in their economies. As he told a business group in New York a few days later, their success has been precisely because they either voluntarily embraced advice from the IMF and World Bank or had to accept such advice in return for financial assistance from those institutions.

Essentially the advice was about liberalising their economies. It was about imposing greater market discipline by liberalising trade and reducing protection, by reforming their budget processes and by reducing the size of the public sector through privatisation and contracting out.

Dawkins told his New York audience how this prescription, which had been impressed upon them by the industrialised countries, had been followed with quite startling success by so many developing countries.

He lamented that the developed countries have increasingly denied their own policy prescription. Instead of embracing the disciplines of the market many industrialised countries have increased trade protection and subsidies and failed to pursue structural adjustment within their own countries. They have not reformed their budget processes and seem incapable of dealing with their large structural deficits. Developed countries need to follow these strategies not only to improve their own economies but also to provide a functioning world economy as a whole.

Let me return the story to Australia in 1983.

A few days after I arrived back in the country I had my first ever conversation with Paul Keating. He had just become Treasurer and was looking for a Senior Private Secretary.

We met for an hour. My memory is that we spent almost all that time discussing economic growth. We agreed that Australiaís performance had been woeful.

We spent some time on macroeconomic policy. I was concerned at the damage poor macroeconomic policy had been doing to the structure of the US economy. The Federal Reserve Bank had imposed very high interest rates to offset recklessly loose fiscal policy. This had caused the $US to appreciate, putting enormous strain on export and import competing industries.

We both thought that union leaders understood that the recent wages surge had played a major part in increasing unemployment so that the accord should produce more moderate

approaches in the upturn but to ensure such an outcome firm (but not tight) monetary policy would be required.

We also agreed the $A had been kept a little too high under the managed exchange rate system but that it was important the foreign exchange markets retained confidence in Australia. Against the background of the previous Labor Government's record, a responsible approach to fiscal policy was essential.

We did not say much about microeconomic policy. I remember Paul saying the financial system was the engine of growth and ours was not firing very well. We also mentioned tariffs and subsidies and agreed on the importance of better education. Keating told me that he did not think that the ALP policy of requiring all new foreign investors to find a 51% Australian equity partner would be implemented. For the present he would continue to follow the Fraser Governmentís policy.

One of the first items in the World Bank's - or for that matter almost any economist's - prescription for a successful economic growth strategy is a stable macroeconomic policy environment. Unfortunately this is one bit of economics which cannot be made easy.

The business cycle seems to have been no less erratic over the twelve years of the Hawke and Keating Government than in earlier periods. In the main, this does not reflect want of trying by the Government. For political reasons Bob Hawke adopted a somewhat less responsible Budget in 1984 than most advisers were comfortable with and Paul Keating did much the same a decade later. For the rest, fiscal strategy pretty much fell within the ambit of the advice provided. By this I mean the bottom line number announced on budget night was usually within the range of numbers proposed by the central coordinating departments (Treasury, Finance and Prime Minister and Cabinet), albeit at the soft end of that range. Of course there was always some fudging at the edges with some measures taken which had a much smaller impact on the economy than on the bottom line and there was fiscal slippage after the budget as new expenditures were approved and some budget measures unravelled due to public pressure or Senate difficulties. Similarly, although there were occasional delays while advice was considered or debated, monetary policy decisions have generally been within the ambit of official advice.

With the benefit of hindsight its clear policy was not always appropriate. But this largely reflects the difficulties of economic forecasting (partly reflecting external events such as sharp movements in commodity prices) and the uncertain impact of policy measures rather than lack of political will or wanton disregard of the stability objective.

One of the difficulties with macroeconomic policy is the heavy reliance placed on monetary policy as the so-called "swing instrument". Monetary policy has a very uneven impact, exaggerating the wasteful volatility of sectors such as housing and having a severe effect of newer businesses which are attempting fast growth. The difficulty could be eased if Governments were prepared to consider short term variations in personal income tax

rates as a policy instrument. Alternatively, as I have suggested elsewhere, contribution rates for compulsory superannuation could be temporarily varied. Singapore uses this device as part of its macroeconomic policy armoury.

Labor explicitly rejected inflation first as a macroeconomic policy objective in favour of fighting inflation and unemployment simultaneously. In the event inflation has been brought under control while unemployment remains stubbornly high despite periods of very rapid job creation. Apart from the personal tragedies this wrought on the unemployed, the nation as a whole paid a heavy price in foregone output.

Another major failure in macroeconomic policy outcomes has been our chronic current account deficit and the consequent build up of external debt. Over the last 15 years the current account deficit has averaged 4 1/2% of GDP. In no year - not even in years when commodity prices have been so high as to cause concern about overheating or in years of recession - has the deficit been lower than 3% of GDP.

As I said earlier, in our first conversation Paul Keating and I agreed that the exchange rate had been kept too high under the managed system. We thought this disadvantaged the traded goods sector and contributed to the tendency for current account problems to emerge whenever growth became robust.

As 1983 progressed the Government and its official advisers became increasingly concerned that the managed exchange rate system was adding to speculative capital inflows which were causing problems for monetary management. There was concern that within this environment the accord would be severely tested.

Keating saw that the two major threats to his objective of sustaining around 4% annual growth for a run of years were a current account crisis or a wages blowout. The existing exchange rate system was exacerbating both threats. The float was also favoured because the discipline market signals would provide would assist with economic management.

It is history now that the float occurred and that it didn't do much to improve our external balance. Much of the sharp nominal depreciation which followed with a lag was needed to unwind previous real appreciations. Subsequent nominal appreciations and higher inflation than in our trading partners soon removed almost all the improvement in competitiveness. Bouts of clearly excessive domestic demand growth did not help. With inflation under control we seem to have achieved a real depreciation over the past year or so. We will have to wait to see whether that is sustained and whether it helps with the current account. It will only do so if we can continue to avoid a burst of over rapid demand growth.

Paul Keating's "banana republic" interview with John Laws in May 1986 is also history. It was provoked by a blow-out in the current account deficit partly arising from a collapse in commodity prices. The interview was followed by a sharp tightening of fiscal policy.

According to the twin deficits theory the large cut in the budget deficit should have produced a similar improvement in the current account position. This approach to the current account deficit was maintained for some time with the budget moving into substantial surplus.

It is difficult to assess the impact fiscal tightening had on the current account. The deficit did contract but this seems largely to have reflected the sharp reversal of the earlier commodity price fall. The turnaround in commodity prices also had an impact on the level of economic activity which included a boost in imports.

At the same time, the Reserve Bank took the opportunity of tighter fiscal policy to ease interest rates. That policy trade-off also strengthened private sector demand particularly for investment goods which have a high import content. In retrospect this easing of monetary policy looks to be a prime example of an inappropriate monetary stance.

The Government's third attempt to deal with the chronic current account problem is its attempt to increase private saving through compulsory superannuation.

This policy is being pursued at the same time as the Government is resuming its efforts to increase public saving and when the real exchange rate does seem to be providing the best position for the traded goods sector in a very long time. It is also important that activity appears to be running at sustainable levels. Theory suggests a current account improvement should occur. In the medium term, however, population ageing will pose new problems for saving and the current account balance.

I want to turn now to microeconomic issues. It is this area of the dismal science that both Bert Kelly and his father concentrated on. It is at the same time the area where David Henderson found the worst do-it-yourself stupidities but which Bert found he could make easy.

John Howe wrote a paper for EPAC in 1993 which examined Australia's recent growth performance and its potential in the 1990s. He argued that the "root causes" of Australia's poor performance "lie on the supply side, with lack of exposure of domestic procedures to international competition, insufficient domestic competition, inadequate attention to improving our stock of human capital, a poor record on innovation and research and development and only modest improvements in the efficiency with which capital is used all being important". Howe acknowledges that there have been numerous initiatives to address these problems but says there is still a way to go.

The World Bank prescription for growth also addresses these issues. The Bank sees investment in human and physical capital (which brings with it innovative technology), as important ingredients of growth but stresses that the really successful countries are also able to allocate these resources to high yielding investments. A stable macroeconomic environment and a reliable legal framework to promote domestic and international competition can help in this.

Australia is making a concerted attempt to improve our stock of human capital. Retention rates in high schools have about doubled since the early 1980s and participation in post secondary education has increased sharply. Government has pressed the private sector to increase its training efforts and more recently has expanded its own efforts to retrain the long term unemployed.

We have also made efforts to increase and better focus research and development spending through the 150% tax deductibility for R & D spending and changes to CSIRO and university research arrangements. These changes give industry a role in deciding research priorities and force researchers to consider the economic context of their work.

Without doubt, however, the two most significant microeconomic reforms undertaken by Hawke and Keating have been the abolition of exchange controls and the phasing down of border protection. In combination they are extremely powerful reforms which have acted as catalysts for further reform. The moves to freer trade and freer international capital flows have forced Australians governments (State and Federal), managers and workers to face up to the need for change and greater productivity of capital and labour.

It is interesting to reflect on 1983. The currency float and abolition of exchange control were always spoken of in tandem but the debate was entirely about the float. Exchange control was abolished without much analysis or consideration. I recall John Phillips (then Deputy Governor of the Reserve Bank) saying it was more important than the float but if anyone else heard they didn't let on.

With the end of exchange control Australian investors could for the first time freely decide whether to invest in Australia or elsewhere. Companies could build their factories in Thailand or Singapore if that looked more profitable than building them here.

Phasing down tariffs also phased out an artificial incentive for firms to invest in Australia rather than somewhere else.

The border protection arrangements for passenger motor vehicles for example had been designed to reserve 80% of the Australian market for cars which were locally produced and had 80% local content. The only way to have real access to the market was to set up production inside the protective net.

Protection had a range of adverse consequences. We ended up with 5 car manufacturers in a market that was roughly large enough for one optimal scale plant. The situation in Venezuela was even more absurd. They ended up with 15 manufacturers.

Overcapitalised outfits such as these clearly require long pay-back periods. They cannot introduce new features or processes if that will make old equipment obsolete. They have little incentive to undertake research spending since that would only hasten obsolescence of plant and the need for further investment.

Under the regime our cars fell back from world standard. Exports dwindled because of the relative quality decline and because industry assistance was focussed on import substitution and was not extended to export activity.

Protection not only protected uncompetitive industries it also made them even less competitive by promoting overcapitalisation, slowing obsolescence and the introduction of new plant, new techniques and new features, and removing the goad of external competition.

In every industry sector except rural and mining, capital productivity in Australia is very substantially lower than in other OECD countries. In most sectors our labour productivity is also lower.

Of course these are average outcomes and the average is held down by the bad performers, the industries and firms which grew through protection and the poor performing government monopolies.

With no or low tariffs and with no exchange control we are going to have to lift our game across the board if we want to retain local and attract foreign investment so as to get the jobs, the growth and the living standards it provides.

Of course the investment playing field is still no where near level. Australia still shuts out foreign investors in some sectors and our dividend imputation system still provides a tax incentive to invest locally. There is also a degree of subtle pressure on superannuation and other fund managers to maintain their local investments. It is not clear that the benefits of any of these provisions outweigh their costs.

For example, is the current concentration of media ownership preferable to a more diverse but partly foreign ownership?

I have said that tariff and exchange control reforms have been the most important microeconomic policy initiatives. I think that next in my list comes the international trade in services reference to the IAC. The Commissionís report highlighted the costs our massively inefficient State and Commonwealth business enterprises were imposing on our exporting and import competing industries. That report built the case for dismantling statutory monopolies, for privatisation and ultimately for the Hilmer reforms.

I share Paul Kellyís view that the 1980s saw a fundamental change in Australia. Of course this change has come with pain and the new path has not been smooth. Things have not turned out exactly as we expected. They never do.

Bert Kelly and Alf Rattigan and Alan Wood who led the fight against protection should be proud of the progress.

The issues are no longer party political. Internationalist rationalists are to the fore in both major parties. Their priorities and emphasis vary but neither would abandon the reform process or seek to unwind it.

The irrationalists have done well in the emotional and rhetorical stakes. It astounds me that they have managed to make "rationalist" a term of abuse and that in the land of the fair go a level playing field can be portrayed as un-Australian.

But they have not won many of the big battles - the dollar has been floated, foreign banks are trading in a deregulated financial market, Telecom has competitors, tariffs are declining. While the sentimental traditionalists may have slowed the pace of change they have not stopped it and they have not reversed it. Where reforms have frayed, such as the decision not to proceed with a single ANZ aviation market, other factors seem to have caused the fraying.

I know it is fashionable for dry or rational economists to lament the slow pace of change and I agree we still have some pretty deep problems to reform our way out of.

To date change has been driven by a series of crises and the conviction they brought that the old way was not sustainable.

People tire of crises. The sentimental traditionalists appeal to memories of the good old days and ascribe the crises to the reforms themselves. The float and the market cowboys it created are blamed for the fragility of our dollar. Tariffs cuts are said to have wiped out businesses, and jobs, made a flood of imports inevitable and caused the current account deficit.

We need to explain that the good old days are mythical. That Australia was going nowhere but backwards. We really were on the road to becoming the poor white trash of Asia.

Of course we must highlight the challenges we face. But we also need to show how the reforms to date are producing benefits and will help meet those challenges.

We need to tell Australians about the experience of other countries - not just New Zealand but the dozens of other countries such as Hong Kong and India and China and Chile whose experience shows the benefits we can expect from further reform.

In short we need to combat the fear and emotion exploited by the sentimental traditionalists by creating hope and confidence. Australians should be impatient for change and embrace its benefits rather than be afraid.

The rhetoric of crisis and ruin cannot drive a long term program of reform. We should all be joining CEDA and the BCA with a sustained message of vision and hope.