SIR LESLIE MELVILLE LECTURE 2004

THE BOOM OF 1989—AND NOW

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THE BOOM OF 1989—AND NOW[*]

> "The average man who loves a gamble turns a blind eye to any likeness between the sound prosperity on the continuance of which he budgets, and the booms and manias of long ago. Things are different now, he assures you as he shakes off the warning hand on his shoulder. But common prudence bids us turn even the distasteful pages of our history". THE BOOM OF 1890---AND NOW, (Shann, 1927, p1).

MORNING TEA IN THE COOMBS BUILDING

Conversation at morning tea in the 1970s was educative and stimulating for a youngish member of the Economics Department of the Research School of Pacific (now Pacific and Asian) Studies. It seemed a rare privilege then, and looking back now it was a unique privilege, to share Sir Leslie Melville's recollections of the times when Australia and the modern world were grappling with their economies' darkest hours. That the author of Chatham House's authoritative history of the thirties (Arndt, 1946) was always present, and that a leading Australian contributor to the academic discussion of the 1930s and practitioner of Australian policy in the subsequent decades, John Crawford, sometimes joined in, added to the special quality of the education.

Much has been written about the "Australian Settlement" of the early Federation years, which gave us wage regulation and protection, and had its origin in the Depression of the early 1890s (see, for example, Hancock, 1931; Kelly, 1992). A new and more comprehensive "Australian Settlement" emerged from the Great Depression of the 1930s, leaving as a legacy after the Second World War a commitment to full employment and the Welfare State; central banking; comprehensive foreign exchange controls; a conception of an economic policy role in the Treasury functions, focussing on ameliorating the business cycle; a greatly expanded Federal budget; and Horizontal Fiscal Equalisation and the Commonwealth Grants Commission.

When we asked the questions that took us away from contemporary Australian, Philippine, Indonesian, Papua New Guinean or Indian development, and I often did, Sir Leslie would

[*] I am indebted to Selwyn Cornish for access to historical materials related to Sir Leslie Melville, and to Sam Hill of The Australian National University and Alex Erskine of Sequoia Capital Management Limited for assistance with preparation of the charts.

recall Treasurer Theodore's unusually sound (for a politician, Sir Leslie would say) grasp of the inter-relationship between wages, the budget and the exchange rate at the Premier's Conference of 1931. Or he would explain the opportunity that was lost when Prime Minister Lyons' was influenced more by Maynard Keynes' offhand, distant and uninformed authority, than by the Australian economists who had suggested a second devaluation in 1932. Or he would share with us the surprise with which Australians realised that the debt-funded prosperity of the 1920s had been suddenly overwhelmed by the Great Depression.

Or the surprise with which nearly all Australians realised that the prosperity had ended. Sir Leslie, in his obituary in the Economic Record in 1935 for his close colleague, E.O.G. Shann, recalled how the University of Western Australia's Professor of Economics had pointed out a couple of years before the Great Depression that there were many elements of the 1927 prosperity that reminded him of the boom of 1888 to 1890. The debt-funded boom of that earlier expansive time, centred on housing in Melbourne, had followed a couple of decades of soundly based development, and preceded the economic collapse of the early 1890s. Shann's warnings, two years before the Great Depression, had been dismissed—a nay-sayer getting in the road of enjoyment of a well-deserved prosperity.

Sir Leslie's view on these matters in the 1970s had not changed much from his published opinions of the 1930s and 1940s. There was much that you never really knew about the ebb and flow of prosperity. There was no regular and inevitable business cycle. Positive and negative shocks of many kinds would set the economy in a new direction, and the new course would develop momentum. It might be reinforced or offset by new domestic or external shocks—and uniquely in Australia, we were regular recipients of huge shocks from the terms of trade and drought. The task of policy was to minimise vulnerability by doing what you could in the good times to keep productivity high, accumulate budget surpluses and be prudent about debt-funded expansion. Harder times could and would come quickly. Australia was due for a downturn by the late 1920s, because it had funded too much domestic expenditure from debt. This had temporarily supported an unsustainably high cost structure, and had led to weak external current payments. What was by the late 1920s an inevitable downturn, became the Great Depression when external events piled a huge deterioration in the terms of trade on top of domestic imbalances, and the London lenders responded by withdrawing credit to Australians.

THE EVOLUTION OF MONETARY POLICY AROUND THE CRASH OF 1990-91

Sir Leslie was strongly supportive of the reforms of the third formative period in Australian economic policy, in the 1980s, in which I was privileged to play a role. He reiterated his positive assessment for these structural changes in a conversation I had with him the day before he died, two years ago. I have appended a contemporary record of that conversation to the written version of this lecture. Sir Leslie was more forgiving than I was or am of the one great mistake in that rich period of economic reform when Bob Hawke was Prime Minister[1]: the mismanagement of monetary policy preceding the recession of 1990-91.

Sir Leslie once said to me about 1990-91, that it is very difficult to judge these things, and sometimes the policy-makers don't get them right because events unfold in unpredictable ways. I remained in the Keynesian world in which I had been raised in one way at least: there was no recession that you had to have.

And yet Sir Leslie had anticipated precisely this risk from relying on tightening monetary policy to bring a boom to heal, in his evidence to the Royal Commission on the Monetary and Banking Systems in Australia (Melville, 1936), and in a paper published in the Economic Record in the war years (Melville, 1942). When business spirits are high, a small increase in interest rates may do little to dampen investment. But if you continue to raise interest rates to control the boom you may bring on depression. For these reasons, he thought that macro-economic management in the boom phase would require the accumulation of budget surpluses that were sufficiently large to make a difference and, no longer fashionable by the nineteen eighties, quantitative controls on credit.

The recession of 1990-91, the worst since the Great Depression in its effects on employment, cast a long shadow forward. Unemployment rose to 11.2 percent, and it took a dozen years of strong growth to take the rate back to the five point something to which it had fallen in 1990. The onset of recession marked the high water mark (but not quite the end) of the golden age of productivity-raising reform in Australia. (John Hyde, leader of the 'dries" in the Liberal Party who supported much of the reform programme from opposition, sees November 1989 as the high point of discussion of structural reform in Australia (Hyde, 2002)).

The high interest rates that precipitated the recession of 1990-91 became a central issue in an Australian Federal campaign, five elections and fifteen years later, in October, 2004. It says something for the political skills of our Prime Ministers now and then, that the Hawke Labor Government was returned in 1990 during that episode of high interest rates, but Labor was defeated in 2004 on the Government's appeal to memories of those high rates.

The silver lining of the recession was the ending of the Australian Great Inflation. The Great Inflation had had its origins during the Gorton and McMahon Prime Ministerships, had run wild in the Whitlam years, had continued above 10 percent through the Fraser Government was falling only slowly down from 10 per cent under Hawke.

Ian Macfarlane, the current Governor of the Reserve Bank, made the best case that could be advanced for the monetary policy that brought on recession in his first speech as Deputy Governor of the Reserve Bank of Australia, in 1992:

> "It was clear by the late eighties that policy, including monetary policy, had to be tightened to bring a substantial slowing of the economy. The economy was growing too fast, we were living beyond our means and there was an unsustainable amount of debt financed asset speculation occurring. The dynamics of a modern capitalist economy are such that it is hard to believe that this excess could be followed by a gentle slowing; it was far more likely that it would be followed by an absolute contraction.
> Some people think that if only the instruments of monetary policy had been adjusted in a more skilful and timely manner, we might have avoided a recession, but I very much doubt it. The business cycle is a fact of life; it can be ameliorated, but not fine-tuned away. …on this occasion we had to run monetary policy somewhat tighter than in earlier recessions, and take the risk that the fall in output would be greater than forecast. To do less than this would be to throw away the once-in-a- decade opportunity for Australia to regain an internationally respectable inflation rate…It is true that we paid a substantial price to reduce inflation, but we had to do it at some stage…We have paid the cost, the task now is to maintain low inflation when we return to growth."
> (Macfarlane, 1992).

The opportunity to sharply reduce inflation was emphasised publicly only after the economy had begun contracting. In November, 1990, with the economy in recession but the published

[1] A note on my own contemporary and subsequent participation in the discussion of macro-economic policy in the late 1980s and early 1990s will be appended to the published version of this paper.

national accounts not yet revealing it, the Governor, Bernie Fraser (1990), was describing two objectives of monetary policy:

> "The monetary authorities have set themselves not one, but two tasks—to avoid (in the current downward phase of the cycle) too severe a contraction in domestic activity and, at the same time, to stay in the fight against inflation….monetary policy aims to get results on inflation, but also to avoid excessive costs in terms of lost output, unemployment and business failures along the way". (Fraser, 1990).

Earlier still, during the monetary tightening of the late 1980s, the explanation of monetary policy had been different again. Then the emphasis was entirely on variations of Australia "living beyond its means". The "living beyond its means" was manifest in historically large trade and current account deficits, and in the build-up of net external liabilities to levels that were high by the standards of other developed countries. It was later sometimes said that the Treasury and the Reserve Bank used the current account deficit and foreign debt to make the case for tightening monetary policy, because this was more politically acceptable than the argument that the deceleration of inflation should be intensified. From contemporary discussions, however, I have no doubt that the most senior Treasury and Bank officials with monetary policy responsibilities believed the case that was made publicly for the policy

Surprisingly, in a look through the public record, I was able to find only one explicit reference to the possibility of recession before the contraction had begun – in my own Chairman's Review in the Annual Report of the Bank of Western Australia, for the year ended March, 1989:

> "Business and housing investment were surprisingly resilient as interest rates rose. They must soon be affected severely by the higher rates of recent months. The underlying strength of the Western Australian economy can be expected to sustain growth in excess of that of the Australian economy in future, but Western Australia shares the risk of recession with the rest of Australia through the period of economic adjustment immediately ahead." (Garnaut, 1989).

The extreme tightening of monetary policy to moderate an unsustainable current account deficit and accumulation of net external liabilities generated an important debate. The alternative view was articulated most comprehensively by ANU Professor John Pitchford

(Pitchford, 1989). Pitchford argued that the current account deficit in itself did not matter. It was therefore wrong to tighten monetary policy with the objective of reducing it.

Pitchford won the debate comprehensively. Whereas the current account and external debt dominated the Reserve Bank's and Treasury's discussion of monetary policy in the late 1980s, from the time of the recession they fell out of sight. Today, if it is said that domestic demand has risen unsustainably, and threatens economic stability and continued growth, and some ignorant commentator offers as partial evidence the stagnation of export growth and in all the circumstances an extraordinarily large current account deficit, then he will be advised that the floating Australian dollar will automatically correct any external imbalances that are really unsustainable.

Of course, there are two senses in which the advice is soundly based. The current account deficit is not in itself an important objective of economic policy. And if the financial markets become anxious that the external imbalances have become so large that the country will have difficulties servicing debt, and require a much higher risk premium on lending to Australians, the value of the dollar will fall far and fast enough to reduce the current account deficit to a level that matches the diminished capital inflow. The utter reliability of these processes was demonstrated in Thailand, Indonesia, and Korea during the financial crisis of the late 1990s, once their currencies were set free and depreciated without official intervention. (McLeod and Garnaut, 1998).

But at the same time, we are wise to take heed when the external accounts tell us that the excess of domestic expenditure over production has reached unusual levels. Closer examination of the evidence may reveal that there is no problem of sustainability. Or it may suggest the possibility that a major correction of domestic expenditure or the cost structure relative to the international economy is going to occur, through policy choice or the crude logic of the markets. The avoidance of sudden adjustments through the automatic market processes remains a worthy objective of policy, as it can greatly reduce the costs of adjustment.

The end of concern for external imbalances in monetary policy has allowed the Reserve Bank to focus on one single objective (Macfarlane, 2004). Monetary policy informally since the early 1990s (Macfarlane, 1996), and through formal agreement since 1996, has been directed

to keeping inflation between 2 and 3 per cent per annum over the cycle. The Governor in a recent speech has emphasised the importance of the single inflation objective to the accountability that makes possible the independence of a central bank.

Some questions remain. What is the cycle over which the price level is to be measured? Is it the whole 14 years of the current expansion? If so, could we now run for a considerable period above 4 per cent and still be said to have met the target? And is it inflation as measured by the general price indexes that matters? Or is there to be some adjustment for special shocks, like the direct price effects of a large devaluation? If the latter, should not we also be adjusting for the direct price effects of a large currency appreciation—in which case, is inflation already above the target range?

Whatever the current paradigm, the floating dollar has not repealed the economic constraints on Australian expenditure and development. It has changed the nature of the corrective processes in ways that can assist in avoiding unsustainable imbalances, as well as in correcting them once they have revealed themselves. But the floating dollar removes neither the necessity for nor the pain of adjustment to excessive imbalances once they have been allowed to emerge.

THE BOOM OF 1989—AND NOW

I would now like to take you through a number of charts that compare economic developments in the 23 quarters up to September, 2004, with the corresponding period in the lead-up to the recession of 1990-91. The shaded region in the first two charts covers the period from the first to the last of the several quarters in which Australian production fell. I invite you to notice the similarities between the growth paths of the economy in the two periods. The comparisons suggest that all of the main variables that were worrying the macro-economic policy practitioners in the late 1980s, and which were said at the time to have led to the extreme tightening of monetary policy, reveal similar or larger imbalances at present.

Chart 1 illustrates a strikingly similar trajectory and level of output growth in the years leading up to the present, and those leading up to the recession of 1990-91. In both periods, the average rate of growth was high by the standards of other developed

countries─departures from the general tendency for Australia to lag the high-income economies in the first eight decades of the twentieth century.

The sectoral composition of growth was also similar in the two periods. Both domestic final demand (Chart 2) and net exports (Chart 3) contributed in the early phase of strong expansion, but domestic demand dominated in the couple of years leading up to the present and to the recession. In the early 1990s, recession quickly increased the contribution of net exports, and the extent and speed of this response prevented the contraction from being even more severe that it was.

Within the expansion of domestic final demand, the growth of real household consumption was high in both periods, and if anything higher in the recent episode (Chart 4). Real private investment grew strongly at the height of the boom on both occasions (Chart 5).

What is already a distinctive feature of the recent boom, is the length of the period in which net exports have detracted from growth in output. Real export growth has now been negligible for almost four years─the exceptions in the year to June 2004, and to a lesser extent in the year to September, are to a considerable extent the statistical effect of comparison with the extremely low rates of exports in mid-2003, due to SARS and the lagged effects of drought (Chart 6). On the other hand, the negative contribution of import growth was greater late in 1980s than the early 2000s, (Chart 7), partly under the influence of reductions in protection through the early period.

The exceptional weakness in export growth in recent years covers manufactures (Chart 8), resources (Chart 9) and services (Chart 10). Growth in the volume of rural exports fluctuated widely around a low average in both periods, with variations in seasonal conditions dominating outcomes (Chart 11).

It has become a distinctive feature of the early twentieth century, that the official advisers to the Government have been consistently anticipating a recovery of export growth that so far has shown no sign of coming. At the time of the Australian budget for 2004-05, in May this year, I pointed out that in the May 2001 budget papers, Treasury forecast export volume growth of 5 per cent. The next year's budget reported the outcome at minus 2 per cent. The same forecast for 2002-03 was 6 per cent. The reported outcome was zero. The forecast

outcome for 2003-04 was again 6 per cent. The outcome was reported the next year as 2 per cent. The May 2004 budget anticipated growth in export volumes at 8 per cent for the current financial year. I noted at the time that there were reasons to expect disappointments for this year as well. After the large fall in the volume of exports for the September quarter, revealed in Wednesday's national accounts, my expectations of disappointment for this year are unlikely to be challenged.

The combination of weak export and strong import growth generated large trade deficits─much larger and more persistent in the contemporary period (Chart 12).

The large, negative contributions of net exports were the main contributor to the increase in the current account deficit as a share of GDP, to close to the highest levels on record in both episodes (Chart 13). This is a startling comparison, since the need to reduce this deficit was the main reason put forward for the extreme monetary tightening that precipitated the recession of 1990-91, and today's deficit brings forth neither policy response nor substantial comment from the authorities.

The comparison of current account deficits between the two cycles is flattering to the present, for reasons that are clear from Charts 14, 15 and 16. The terms of trade were rising and in the end high in both periods, and this was one of the generators of boom conditions (Chart 14). In the 1980s they corrected downwards from 1989: disruption after the Beijing political upheavals of what had been strong economic growth in China, and the decline in economic activity in Eastern Europe and the former Soviet Union as the communist systems moved towards their final date with history, led to large falls in global demand for a number of commodities that were important in Australian exports, first of all wool. In contrast, the terms of trade have continued to rise strongly over the past two years, to the highest levels for several decades. The increase in export prices over the past two years has added over 2 percentage points of GDP to the credit side of the current account of the balance of payments.

The comparison is also flattering to the recent period because substantially higher net external liabilities as a share of GDP (Chart 15) have been associated with substantially lower costs of servicing external net income payments (Chart 16). This difference is mainly the consequence of global interest rates having been unprecedentedly low─an enormously important reality for a country that now has close to the highest ratio of net external debt to

GDP for a all developed economy. The advantage will be challenged by the normalisation of global interest rates that commenced in mid-2004, and the beginnings of which were reflected in the September quarter of this year.

The strong domestic demand and high terms of trade contributed to strong upward pressure on the real exchange rate in both expansionary periods (Chart 17). High interest rates raised the real exchange rate earlier in the late 1980s. In both periods, the high real exchange rate was a major cause of the lower export and higher import growth.

The relationship between the real exchange rate and the terms of trade was the only short-term macro-economic stabilisation issue upon which I offered advice in my Report to Government on structural reform in October 1989. I noted in *Australia and the Northeast Asian Ascendancy* that, under free trade, Australian exports would be more diverse, both sectorally and geographically. This would reduce to some extent Australia's exceptional vulnerability to fluctuations in the terms of trade. However, wide fluctuations would continue to be important. Unless domestic expenditure was insulated from them, this would generate fluctuations in the real exchange rate – which, amongst other things, was a significant deterrent to internationalisation of production and the emergence of an export culture. I noted that during 1988 and 1989 there had been some sterilisation of the effects of high export prices, through a high budget surplus. I suggested that Australia go further than that, and seek to absorb through fiscal policy as much as possible of the domestic income effects from terms of trade fluctuations, with the aim of holding real expenditure and the real exchange rate as closely as possible to a steady trend (Garnaut, 1989a, pp. 218-19). This suggestion was taken up by staff of the Business Council of Australia in the early 1990s, which led to a proposal by Nick Gruen for independent fiscal stabilisation, through institutional arrangements analogous to those that had secured independence for monetary policy. Regrettably, these proposals have not yet been influential in policy.

Certainly the counter-cyclical fiscal response to boom conditions was stronger in the late 1980s than in the early twenty first century. There were budget surpluses through the height of both expansions, and for the critical years a percentage point of GDP higher in the late 1980s than the 2000s (Chart 18). In retrospective, it would have been better if the surplus had been even larger at the height o the 1980s boom, to perform its counter-cyclical task. If true for the late 1980s, this view would hold more strongly for fiscal policy over recent years.

Monetary policy was hugely more expansionary in the early twenty first century (see Charts 19 and 20).

One big difference between the two periods was the entrenched inflation of the 1980s, compared with low inflation in the 2000s (Chart 21).

Labour productivity growth was reasonably strong and therefore a similarly influential counter to inflation at the height of both boom periods—until it was dragged down in recession in 1990 (Chart 22). Real wages growth has been significantly more rapid in the early twenty first century (Chart 23).

Employment expansion was substantially more rapid in the 1980s (Charts 24 and 25), with wage restraint delivered through the Government's Accord with the trade union movement. Perhaps there was reason for concern that the tightening labour market would block the effective downward pressure on inflation of a more moderate tightening of monetary policy. But is the moderate policy of the recent period putting at risk the inflation gains of 1990-91, with prices of non-traded goods and services rising at a rate well above the target inflation range now for several years (Chart 26). The total CPI inflation has been kept within the range over by falling prices for tradeable goods and services, themselves resulting from appreciation of the real exchange rate. This anti-inflationary benefit is compounding the external imbalances, and in any case may not be supported indefinitely by the financial markets.

EXTERNAL UNCERTAINTIES

How will the recent period of exceptional demand expansion end—with stronger consumption growth, a more virulent speculative boom in the housing sector, weaker exports, and a proportionately larger trade deficit and foreign debt than in the boom that preceded the wreck of 1990-91?

What are the chances this time, with the instruments of monetary policy being adjusted in a more skilful and timely manner, of avoiding an unhappy ending?

That depends partly on events beyond Australians' control. It depends on whether the current high terms of trade continue. For the current high average export prices to be maintained, there would need to be unbroken global economic growth at the China-led rates of 2003 and 2004. There would also need to be some inhibition of international supply response to high prices for our resource exports─some delayed confirmation that the Club of Rome was right in the early 1970s about an emerging scarcity of natural resources.

The international supply response will vary across the circumstances of different commodities. Already high global prices for vegetable oils and feed grains in 2003, induced by exceptional growth in Chinese import demand, have been removed by large expansion of production in Brazil, the US and Argentina. There is now an awful lot of soybean in Brazil. Expansions of natural gas capacity to supply China from Indonesia, the Middle East, Russia and the contiguous States of Central Asia, as well as Australia, are being announced at regular intervals. There is even more excitement about expansion of iron ore capacity in Brazil, West Africa and India than in Australia, and Australia has lost much of its previously high share of the Chinese market. For many commodities whose prices have contributed to the high Australian terms of trade—gold, copper and the base metals for example—there is limited opportunity for expanding capacity in Australia, and much more, proportionately, in the rest of the world.

More probable than the conditions that would sustain current high average export prices indefinitely, would be the continuation of strong, China-led growth in export demand, but with a normal, global resource supply response. In this case, the average real price of our exports could be expected after a while to retreat a long way from their current giddy heights, but remain above the average of the past quarter century. Prices would remain high enough to induce into production a steady stream of new capacity, but without the rents of short-term scarcity that are now an element in price. This is what happened when sustained Japanese industrial growth kept global demand growing steadily in the 1960s. Average future real prices for commodity exports closer to the 1960s than the 1980s and 1990s would be a large and welcome improvement for Australia─but a considerable step down from the prices of the September quarter of 2004.

None of this is to deny the entirely favourable effects on Australia's terms of trade of sustained economic growth in China in particular, and other large, resource-poor developing

economies (Macfarlane, 2003; Gruen, 2001). These are the developments that hold out the prospect of Australia's terms of trade in the next one or two decades being substantially more favourable than they were in the last quarter of the twentieth century. It is just that the current terms of trade are already higher than the more favourable averages which we might expect to be sustained.

The Australian outlook will be affected as well by global interest rates. Sustained global growth—and that is what is necessary to hold the terms of trade above the average of recent decades─will take international interest rates that are currently historically low, perhaps back to levels that we once considered normal. Without any lift in Australian rates, this would put immense downward pressure on the Australian dollar whatever the terms of trade. And at current levels of external debt (and those levels are rising quarter by quarter at an awesome pace), and with no Australian dollar depreciation to exaggerate the impact, it would add considerably to the current account deficit as a share of national production.

I need not spend time spelling out the combined effects of retreat of export prices from their current heights, and normalisation of global interest rates.

Worse scenarios are possible. There is some chance that at some time before long, there will be a break in the current highly favourable trajectory of global economic growth. One can be an optimist about the long-term prospects for Chinese economic growth, without denying that a temporary dip in the Chinese growth rate might occur from time to time. A large deceleration in 1989 and 1990 did not knock long-term Chinese growth from its high trajectory. But it nevertheless played an important role in the Australian crash of 1990-91, at a time when China was proportionately less important to Australian than it is today. There will be other bumps from time to time in the Chinese path to a modern economy. Neither would one need to be a pessimist, to acknowledge that the unprecedentedly large budget and current account deficits in the US might cut down prematurely the contemporary US expansion. Either of these eventualities would for a while force the terms of trade below the high average of the years of Japanese industrialisation, closer to the levels of the early 1990s. Australia is unprepared for a setback of this magnitude─shocks of the kind with which every earlier Australian generation has had to contend.

The weaknesses in export volume growth and in the external accounts is to a considerable extent the result of a decline in Australian competitiveness over recent years. Australian domestic prices have inflated faster than in such important trading partners as Japan, the US, China, Hong Kong, Taiwan and Korea. There has been loss of momentum in productivity-raising reform. These developments have been compounded recently by appreciation of Australia's currency against an average of its trading partners.

The effects on export growth of declining competitiveness are likely to be compounded in the period ahead by developments in the international trading framework. The comprehensive breakdown of the Asia Pacific trading system into bilateral and small-group preferential trading arrangements that is now in train, and which enters a new stage with the coming into effect of the Australia-US FTA on January 1, is likely to have noticeably damaging effects on the growth of Australian agricultural and manufactured exports (Garnaut, 2004).

Sir Leslie Melville would have been quick to draw the analogy with the 1930s. Melville and Shann were advisers to Australian Prime Minister Lyons at the Ottawa conference in 1932, which set up the British Empire preferential tariff. Sir Leslie thought the British Empire FTA (as it would be called today) a setback for good economic policy. Preferential trade promoted protectionist trade diversion rather than liberalising trade creation. Recalling in his obituary to Shann the voyage the two colleagues shared on the *Aorangi* to the Ottawa conference, Melville commented that "a hot favourite at a ship-board race meeting was a horse called "Recovery" by "Quotas" out of "Quantitative Restrictions"" (Melville, 1935).

Incidentally, and I hope without relevance to contemporary developments, Sir Leslie thought that discrimination against Japan in the Empire FTA was a cause of Japanese expansionism and the Second World War in the Pacific.

THE PATH AHEAD

The Australian economy has now experienced more than thirteen years of remarkably strong sustained growth, on the foundation of economic reform over the preceding decade, the disinflation of the early 1990s, prudent fiscal policy for the first several years of the Howard Government, steady and mostly well-judged independent monetary policy. It has now entered a period of vulnerability.

The large expansion of domestic consumption and housing investment over the past several years, and the immediate expenditure of windfall increases in the public revenues from exceptional export prices, have raised domestic expenditures and relative costs to levels that will turn out to be sustainable only in the most favourable circumstances.

In the early 2000s, as in the late 1980s, but more so, a less expansive fiscal policy would have left open a more palatable set of policy choices, and economic outcomes. Alternatively, and with less unambiguously favourable effects, earlier judicious tightening of monetary policy would have left us less vulnerable now. I hope that lessons from this experience will be influential if events unfold unhappily in the period ahead. Just as the monetary misjudgements of the late 1980s paved the way for independent monetary policy, contemplation of the role of excessive fiscal expansion in the emergence of the current vulnerability may pave the way for fundamental reform of mechanisms for counter-cyclical fiscal management.

But for the immediate future, we must manage within the realities of high inflation for non-tradeables prices, a high real exchange rate, and negligible growth in export volumes. We have to manage within the reality that trade and current account deficits near record levels have emerged, despite conditions in external markets that are so favourable that they cannot be expected to continue indefinitely. We have to manage within the reality that a debt-ridden household sector is abnormally vulnerable to a range of shocks, including higher interest rates.

There is a possibility of a happy ending. This is the scenario favoured by the Government's official advisers, and reflected, for example in Budget Statement No.2 in each of the last several years. In the story with the happy ending, export volumes now begin to grow strongly. Until recently, the authorities expected resumption of the broadly based export growth that characterised most of the period from the mid-1980s until 2000. The Treasurer this week, in response to the current account and production data for September, narrowed official optimism for export volumes to the resources sector.

In the official scenario, the resumption of growth in export volumes is accompanied by commensurate easing in private consumption and housing investment. Overall growth eases to a bit below the level of recent years. This latter development reduces the inflation of

prices for non-tradeable goods and services. This in turn, keeps overall inflation within the Reserve Bank's target range without further appreciation of the Australian dollar. Australia's terms of trade—supported on both the export and import side by developments in China and elsewhere in developing Asia—remain at or perhaps above current levels, and this supports high rates of investment and export expansion in the resource sector. Strong export growth and easing domestic demand reduce the trade and current account deficits.

I acknowledge that this is a possible way forward from the current situation. But it depends on a number of favourable developments, none of which is certain.

It depends on there being no early downward adjustment in the terms of trade—which, in turn, depends on the maintenance of strong economic growth in China and globally. It depends on global interest rates remaining significantly below historically normal levels. It depends on the recent easing of private consumption and housing investment continuing, but not going too far. It depends on the established non-tradeables inflation falling significantly. It depends on the foreign exchange markets continuing to support a strong Australian dollar, despite historically high trade and current account deficits. And it depends on the four-year stagnation of Australiana exports giving way quickly to strong export growth, while the real exchange rate remains much higher than during most of the period of export stagnation.

It is possible that these conditions will be met. But it is not certain.

I should add as well that this favourable scenario, avoiding both re-ignition of inflation and damaging contraction of activity, would place huge adjustment pressures on the regional and inter-state distribution of employment and incomes in Australia. These would in themselves be the source of major stress. The easing of private consumption and housing investment would be concentrated disproportionately in Sydney and Melbourne. The expansion of business investment and exports would be concentrated overwhelmingly in northern and western Australia. And yet the Australian system of Horizontal Fiscal Equalisation—entrenched in 1999 in the Federal settlement in preparation for the introduction of the GST—is geared to redistribution of public revenues from New South Wales and Victoria to the other States. Horizontal Fiscal Equalisation contains mechanisms for adjustment over time, but too slowly to avoid exceptional economic pressure on our two largest cities and most populous states.

The other possibilities are less favourable for Australia as a whole.

One possibility is that domestic demand continues to expand strongly enough to keep inflation of non-tradeables prices near the rates of recent years. This cannot be ruled out, as longstanding inflations are not easily removed. The holding of overall inflation within the target range would then be disrupted if there were at any time a large fall in the foreign exchange value of the Australian dollar. Such an exchange rate adjustment is possible at any time in the current state of the external accounts, and could easily be precipitated by steps towards normalisation of global commodity prices and interest rates.

It may be that the greater flexibility of Australian labour markets in the early 2000s will allow some deceleration of inflation with relatively small reductions in growth in domestic demand. But the experience with flexible labour markets in other countries and at other times warns us not to hope for too much.

It is optimistic to expect an early resumption of growth in export volumes, that is strong enough to underwrite the story with the happy ending. The real exchange rate is significantly higher now than in the September quarter. Strong growth in export volumes in the resource industries must await gestation periods of considerable length, and in any case will be concentrated in a narrow range of commodities, representing perhaps one fifth to one quarter of the total value of current exports. Growth in exports from those industries would need to be extraordinarily strong, to support growth in total Australian export volumes at anything like the rates that have been written into forecasts upon which each of the past four budgets have been based.

So there is a considerable chance that the current vulnerability to large external or domestic shocks will continue, and some chance that it will continue to increase, for some time to come.

We would be wise to do everything we can to reduce vulnerability in the period ahead.

The Governor of the Reserve Bank's recent waring about credit standards is important in this context, as the strength of the financial sector is an important determinant of the severity of

any downturn (Macfarlane, 2004). Generally, the Australian banks are in a better position now to absorb a shock than they were in the late 1980s, still in the learning years after financial deregulation.

It would help if fiscal policy were now tightened considerably. It would have been better done much earlier, but now is better than later. This would take pressure from domestic demand without raising the exchange rate─as tightening monetary policy would do. But if fiscal adjustment were small or long delayed, and domestic demand growth and non-tradeables inflation continued near recent levels, for all its risks to a debt-ridden household economy, monetary tightening would still be necessary to contain vulnerability to extreme international market responses.

It would have helped if the price index that is the object of the inflation targets had been an index of non-tradeables prices, excluding the deflationary effects of exchange rate appreciation in recent years, and the inflationary effects of any large depreciation in the period ahead.

The benefits of productivity-raising reform are received gradually and slowly. But early resumption of focus on the reform agenda will be helpful to macro-economic adjustment if it turns out that market responses to current imbalances give us some time.

The imbalances that have emerged from the boom of the early twenty first century have much in common with those of the late 1980s. This should at least give us cause for reflection. The boom of 1989 was mismanaged badly─at first through the decisions that allowed it to develop; and more through the monetary policy response to it.

In the early 2000s, we have repeated the first of the errors. It is important for policy to respond to them, with greater skill than in the late 1980s, and applying the lessons of that period. Not to respond at all would be to substitute the error of inaction for the error of excessive and wrong reaction.

For policy not to respond at all would not avoid adjustment It would leave adjustment to the unmediated international market place. This would invite dislocation more sudden and less predictable in its severity and incidence than the bungled monetary policy of 1989.