Stimulating the Australian economy,
Comments to the Senate Standing Committee on Finance and Public Administration

by

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Australia faces a potentially serious economic downturn in 2009-10 and 2010-11 and possibly beyond. There are three negative forces impacting the economy:

(1) a reduction in consumer confidence which is likely to lead to a cut in consumer demand;

(2) a reduction in world demand for Australia's products which will lead to a contraction in export prices and quantities; and

(3) an increase in required rates of return on capital reflecting a loss in investor confidence.

This third force is probably the most important. What it means is that whereas in recent years a project promising a rate of return of X per cent would be undertaken by businesses, in the next couple of years only projects promising a rate of return of say 2X per cent will be undertaken. With this higher hurdle rate, there is likely to be a severe contraction of investment: many less projects will meet the required rate of return.

So to summarize, we have a loss of consumer confidence, a reduction in demand for our exports, and a loss of investor confidence.

My specialty is economic modelling. After receiving the invitation to talk with you, I have been doing a few calculations with an economy-wide model. It is not difficult to specify scenarios for these three negative forces, consistent with views of respected commentators, that imply a loss of 500,000 Australian jobs in 2009-10. In such scenarios, Australian employment would take until 2012-13 to recover to its business-as-usual path.

Naturally in these circumstances the government recognizes a need for strong action. The strategy that it has proposed and that you are currently considering has two parts. The first is an almost immediate grant to households of about $13 billion. This is a 2 per cent addition to household disposable income. The second part consists mainly of government spending on a variety of construction projects, about $14 billion in each of 2009-10 and 2010-11. $14 billion is about 10 per cent of the current year's economy-wide construction expenditure.

So to summarize again, the government proposes a 2 per cent increase in household disposable income that would be spent mainly in 2009-10 and a 10 per cent stimulus to the construction industry in 2009-10 and 2010-11.

I am not concerned with the details of the 2 per cent increase in household disposable income: I don't have strong views on whether it should be a grant or a tax cut. Nor am I concerned with the details of the proposed construction stimulus. I imagine you will receive submissions suggesting that it should be focused on A rather than B or C rather than D. The nature of the construction expenditures is clearly an important microeconomic issue that should be carefully considered, but my concern here is with macroeconomics.

Is it likely that the Government's package will save Australia from a disastrous loss of jobs? In a model simulation in which the three negative forces cause a loss of 500,000 jobs in 2009-10, the Government's package reduces this loss to about 350,000 jobs. That is, it saves 150,000 jobs. This is certainly a valuable contribution. However, it might seem a little disappointing. After all, the Government is planning to boost demand in 2009-10 by about $27 billion ($13 billion for consumption and $14 billion for infrastructure). With the average wage rate being about $60,000, why doesn't $27 billion buy about 450,000 jobs? This is $27 billion divided by 60,000.

The package delivers only about 150,000 jobs rather than 450,000 jobs mainly because of leakage through the trade accounts. Extra spending either by households or the government significantly reduces exports and increases imports. This may be a hard point to understand, especially if the extra spending is concentrated mainly on construction services that are barely imported or exported. So why is there such a big leakage to trade? The answer is that extra spending reduces Australia's competitiveness. It makes real wage rates in Australia higher than they otherwise would have been, thereby increasing costs for both exporting industries and import-competing industries. This reduces our ability to export and to compete with imports. This effect happens even if the additional expenditures are concentrated on non-traded services such as construction.

So, if large amounts of extra spending are not going to fix our problem, what will?

Going back to the start of my remarks, remember that there are three forces threatening the Australian economy. The Government's package is squarely focused on counteracting force (1), loss of consumer demand, and on mitigating the effects for the construction industry of force (3), the loss of investor confidence. However, if Australia is to successfully weather a major economic storm, we must recognise that forces (2) and (3) have implications for wage rates.

A reduction in the prices of Australian exports, force (2), and an increase in required rates of return on capital, force (3), both mean that any given level of employment growth can be maintained in Australia only if the real costs of employing labour are reduced. When the prices of Australia's exports fall, there is a fall in the value of what Australian workers can produce. If they are to continue in employment, there must be a corresponding fall in the cost of employing them. When required rates of return rise, real wage rates must fall for capital expansion in the business sector to be sufficiently profitable to meet the new hurdle rate. Expansion of capital in Australian industries is critical for the maintenance of employment growth.

So my conclusions are as follows.

(a) The Government's demand-stimulation package will make a useful contribution to employment in Australia. I do not object to the first part of the package aimed at immediately stimulating consumer demand. However, I think that the second part of the package is less urgent and more time could be usefully spent on thinking it through.

(b) If Australia is hit with major negative forces of the type that I have described, then no demand-stimulation package is likely to adequately insulate employment. A major part of Australia's economic strategy should be directed at wage policy. Ideas that were successfully implemented in the low-employment era of the 1980s should be revisited. In particular the Government should be looking for opportunities to convince the public that wage increases should be foregone. Rather than wage increases, the Government can offer tax cuts or improved social capital. That is, rather than (as in the present package) simply giving the public extra money or extra social capital, the Government should be looking for a return in the form of wage moderation. Bargains of this sort will help restrain the costs of employing labour, critical if we are to counteract forces (2) and (3), while at the same time they will add to demand and thereby help to counteract the demand-side implications of forces (1) and (3).

An issue on which I have not had time to comment is debt. Let me just say that I don't think the Government's package will cause an unacceptable increase in either the public sector debt or Australia's foreign liabilities.

Thankyou.