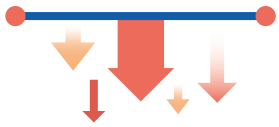
01

Making a miracle: through crisis, reform and recovery

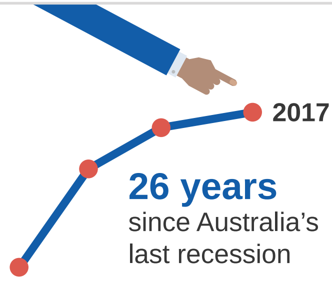
Stability



5 recessions
between 1971 and 1983

Average rate of inflation in the 1970s was **9.8%**

Average rate since introduction of inflation targeting is **2.5%**



26 years
since Australia's last recession

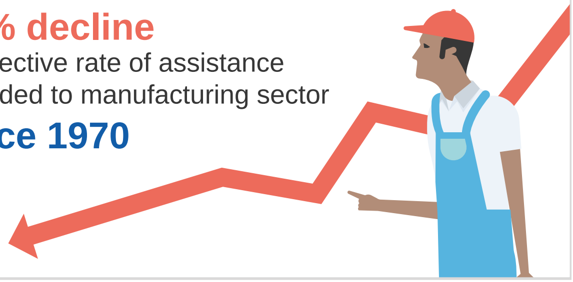
Trade

Combined value of imports and exports as a share of gross domestic product

15% in 1970

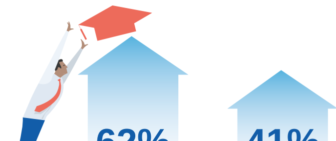
42% in 2017

89% decline
in effective rate of assistance provided to manufacturing sector
since 1970



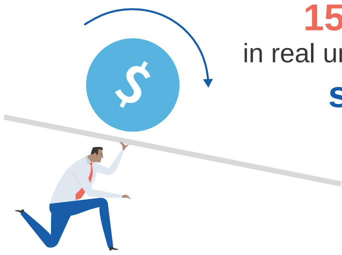
Labour force

Share of labour force with post-school qualification



62% in 2017

41% in 1991



15% decline
in real unit labour costs
since 1986

Proportion of labour force born overseas

1 in **4** in 1991

1 in **3** in 2017

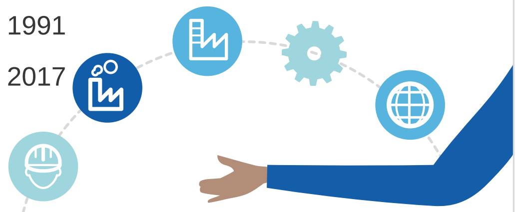
Growth and decline

The size of the Australian economy has increased by **130%** since 1991

Manufacturing as a share of gross domestic product

11% in 1991

5.7% in 2017



Last year, Australia recorded its 26th year without a recession, the longest in its history and indeed, the longest of any developed nation in modern times. Since 1991, Australians have enjoyed one of the fastest income rises of any developed country and they are now amongst the richest in the world. Critical to this performance has been a series of economic reforms through the 1980s and 1990s.

This chapter describes how the highly regulated and rigid economy that emerged from the War was ill equipped to deal with the global economic turbulence of the 1970s when Australia was buffeted by severe recessions, unemployment levels not seen since the Great Depression and persistently high levels of inflation that sapped economic growth. Starting in the late 1970s, a series of major economic reforms were introduced. These reforms were not part of a grand plan per se; and Australia was not a pioneer in the reform process. But nevertheless, they laid the foundations of the modern Australian economy.

While much has been written about the productivity enhancing benefits of the reforms, the more enduring benefit of the totality of the reforms was to make the economy much more flexible and resilient (increasing its dynamic efficiency). The chapter concludes with some observations on the reforms necessary to better integrate Australia into a globalising economy.

The 'Golden Years'?

In the decades after the Second World War, Australia was still haunted by the Great Depression, as were most countries. Macroeconomic policy was profoundly influenced by Keynesianism and focused on demand side controls with the central goal of maintaining full employment. At first, this was mainly through regulating money supply but during the 1960s, the emphasis shifted to broader demand control instruments.

Incomes were controlled through centralised wage fixing. This affected almost all the workforce and salary received was determined by the hundreds of job classifications in the award systems. Governments regulated what interest banks paid on their deposits, interest charged on their loans and provided guidance on who they should lend to. Prices on a wide range of goods and services were also centrally controlled. Much of the tradeable goods sector was regulated by boards that oversaw the 'orderly marketing' of everything from eggs to bulldozers. In addition, differential taxes and excises were levied on many goods. Much of the services sector, particularly professional services, was regulated by professional guilds and codes.

Schedules of what goods could be carried by which mode of transport went into minute detail in their attempt to cover every imaginable freight item. Government owned enterprises also exerted additional control over the transport sector.[1] What could be mined for export was also heavily regulated — exporting iron ore, for example, was banned until the 1960s.[2]

Australia's trade policy was particularly insular. While developed countries (led by the United States and United Kingdom) sought to unravel the pre-War barriers to world trade, Australia argued for an exemption on the grounds that it was a commodities exporter and needed to protect its infant (manufacturing) industries.[3] As other comparable countries

1 The extent of government control over the economy until 1971 is at Butlin, N. Bernard, A. and Pincus, J. 1982 Government and capitalism: Public and private choice in twentieth century Australia Sydney: Allen and Unwin

2 Lee, D 2013, Reluctant relaxation: the end of the iron ore embargo and the origins of Australia's mining boom, 1960–1966. History Australia 10(3):149–170

3 Corden, W.M. 1995 Protection and liberalism in Australia and abroad, in K.Anderson (ed) Australia's economy in its international context, Adelaide, Adelaide University Press

began removing their tariffs, Australia increased both tariff and non-tariff trade barriers and by 1971 they were amongst the highest in the developed world.[4]

For the decades between 1951 and 1971 the centralised control of Australia's economic system appeared to serve the nation well and the period is often regarded as the golden years.[5] Unemployment averaged just 1.8 per cent. Inflation was also subdued, averaging 4.5 per cent a year over the same period, despite increasing sharply during the Korean War. Output grew strongly, increasing 4.6 per cent a year in real terms, slightly above the OECD average[6] of 4.3 per cent a year.[7] Economic inequality was probably the lowest Australia had ever experienced or has since.[8]

The apparent strong growth in output however, largely reflected population increases associated with the major immigration programs implemented following the Second World War. If the effects of faster population growth are removed, Australia underperformed relative to other developed economies. In the 1950s, growth in real Gross Domestic Product (GDP) per capita in Australia averaged just 1.7 per cent, well below the average of 3.1 per cent a year for OECD countries. Growth in real output per capita improved in the 1960s, reaching 3.1 per cent a year but still fell short of the OECD average of 3.9 per cent a year. So while the 1950s and 1960s were indeed golden years for Australia, they were considerably less golden than those of comparable countries.

For many years, Australia's comparatively weak economic growth was masked by strong nominal output from agricultural and mining industries which, at the time, were benefiting from terms of trade that favoured Australia's primary commodities.

Things began to unravel quickly and irrevocably in 1971 when a period of high macroeconomic instability set in as policy makers struggled to manage a number of large external and internal shocks. The economy slid into recession on five occasions: in 1971, 1975, 1977, 1981 and most notably in 1982 which remains the most severe economic downturn in Australia since the Great Depression.[9] Average economic growth deteriorated in line with higher volatility, falling to 2.5 per cent a year in the twelve years to 1983. Inflation accelerated, reaching as high as 18 per cent in the March quarter 1975, while the unemployment rate grew from 1.7 per cent in 1971 to 10 per cent in 1983.

The combination of falling terms of trade, slower productivity growth and lack of flexibility in the economy ultimately led to a relative decline in living standards. In 1950, Australia ranked fifth in the world in terms of GDP per capita but by 1983 it had slipped to 15th.[10]

4 Anderson, K. and Garnault, R.1987 Australian protectionism: extent, causes and effect, Sydney: Allen and Unwin

5 Macfarlane, I. 2002 The Australian Economy: past, present and future, http://www.rba.gov.au/speeches/2002/sp-gov-040402.html

6 Founding OECD members less Iceland and Luxembourg

7 Maddison, A. 2010, *Historical Statistics of the World Economy: 1-2008 AD,* http://www.ggdc.net/maddison/maddison-project/home.htm accessed 19 December, 2017

8 Leigh, A. 2005, Deriving long-run inequality series from tax data, The Economic Record, 81(255):58–70

9 Department of Foreign Affairs and Trade, 2018, Australia's trade and economic indicators, http://dfat.gov.au/trade/resources/trade-statistics/Pages/trade-time-series-data.aspx

10 Maddison, A. 2010, *Historical Statistics of the World Economy:1-2008 AD,* http://www.ggdc.net/maddison/maddison-project/home.htm accessed 19 December, 2017

The reform era

In response to the decline in economic performance, Australian governments embarked on a series of reforms that laid the foundations for a period of sustained economic growth. The reforms were wide-ranging and included changes to both macro and microeconomic policies. It should be noted that Australia was not a pioneer in the reform agenda. Other developed countries also introduced similar reforms, often many years before Australia.

One of the reasons why reform was difficult in Australia was the interlocking structure of the regulated economy where each component was dependent on another. Centralised wage fixing, for example, was reliant on both the tariff system and immigration controls which was in turn reliant on exchange rates controls which relied on foreign exchange regulation. Policy makers were rightly concerned that removal of a major piece of economic regulation too quickly would result in a rapid and uncontrolled unravelling of the other pieces.

The major areas of reform were:

- Banking
- Foreign exchange
- National Competition Policy
- Labour market
- Tariffs
- Tax.

Each of these will be discussed in turn below.

Banking reform

In the tightly regulated economy until 1971, no sector was more closely supervised than the finance sector. In 1951, banks controlled nearly 90 per cent of the assets of financial intermediaries and government largely controlled the banks. Except for two small institutions, foreign banks were either banned or had their operations severely circumscribed.[11]

Non-Bank Financial Institutions (NBFIs) such as Building Societies and finance companies sprang up during the 1960s as an alternative to banks while life offices and superannuation companies became more active in the lending market.

As NBFIs expanded, banks' market share of institutional financial capital fell steadily, reaching a low of 57 per cent in 1982–83[12] and consequently the government's control of the finance sector became less effective. The government responded by starting the process of deregulating the financial sector beginning with a gradual relaxation of credit and foreign exchange controls throughout the 1970s. Further deregulation followed in 1981 with the removal of restrictions on foreign bank operations in Australia.[13]

In common with most countries, financial deregulation in Australia was not accompanied by increased prudential supervision. A rapid increase in credit growth from inexperienced lenders led to an asset bubble in the economy. Official interest rates were increased to 17 per cent (many businesses were paying 22 per cent) in an attempt to cool the market. This collapsed asset values and triggered the severe 1990 recession.

11 Beggs, M 2015 The evolution of Australian monetary policy in the 1950s. Australian economic history review 57(1): 22–44

12 Edey, M. Gray. B, 1996, *The Evolving Structure of the Australian Financial System*

13 Australian Financial System Inquiry 1981, *Australian Financial System: Final Report of the Committee of Inquiry into the Australian Financial System*

Increased prudential supervision of Australia's financial system was introduced during the 1990s. At the core of the system are two regulators, the Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA). Broadly speaking, ASIC's main role is in consumer protection, while APRA's main role is prudential supervisor of Australian financial institutions. The balance between flexibility and prudential control was tested during the Global Financial Crisis. Australian banks stood almost alone amongst the world's banks by not suffering even a single quarter of losses.

Foreign exchange and floating the dollar

The exchange rate, which had been tightly regulated since the War, was deregulated in 1983. However, this was achieved only after all other plausible options had been exhausted, including:

- Pegging the dollar to the US dollar between 1971 and 1974
- Pegging to a Trade Weighted Index (TWI) between 1974 and 1976
- The crawling peg between 1976 and 1983.[14]

These all proved unsuccessful. The collision between a fixed exchange rate and deregulated foreign exchange flow meant that domestic interest rates became the de facto adjustment mechanism and they swung through a wide arc. Current account crises were also a persistent feature of the Australian economic landscape. The situation came to a head in 1983. In the latter half of the year, inflows of foreign capital triggered by speculation of an appreciation of the Australian dollar caused a major current account crisis.[15] In December, all foreign exchange transactions were suspended for three days while authorities debated the options. In the end, on the 12 December, Australia joined other developed countries and floated its currency.[16]

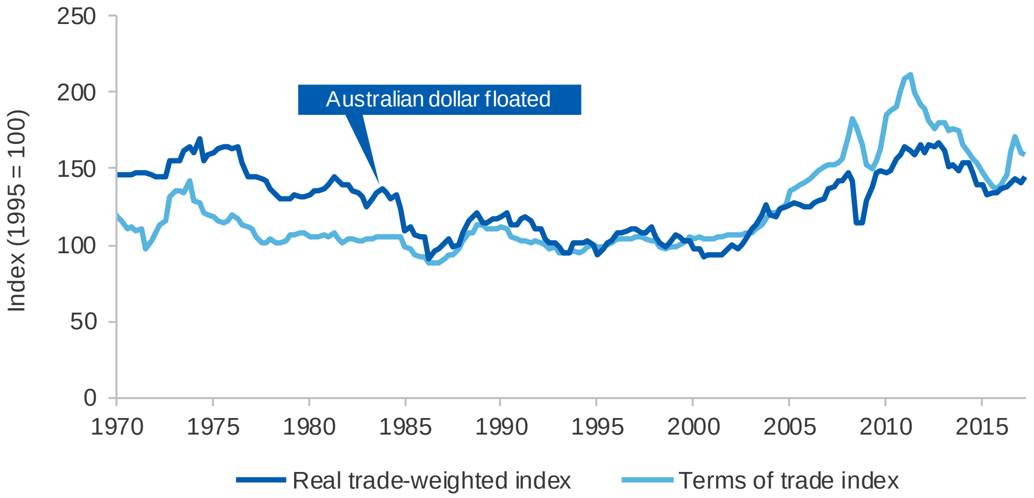
The float of the dollar had two main effects. The first was a major devaluation of the dollar which fell by a third within 18 months of the float measured both against the US dollar and the TWI (Figure 1.1).

14 Under this system, representatives from the Reserve Bank of Australia, Treasury and the Department of Prime Minister and Cabinet would meet every morning to determine the day's exchange rate with a maximum daily movement allowance of 0.2 per cent.

15 Stevens, G. 2013, *The Australian Dollar: Thirty Years of Floating*, Reserve Bank of Australia

16 Most developed countries floated their currency in 1971 when the Bretton Woods agreement collapsed. At the time, Australian policy makers feared, probably correctly, that the highly protected banking system was in no position to cope with floating the currency.

Figure 1.1: Real exchange rate and terms of trade, 1972 to 2017

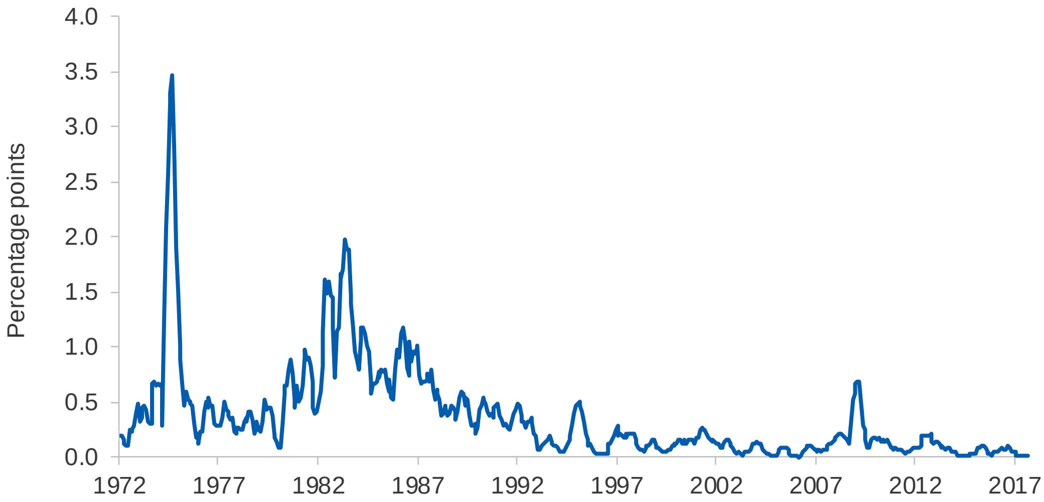


Notes: The ‘Real trade-weighted index’ is the average value of the Australian dollar in relation to currencies of Australia’s trading partners adjusted for relative price levels using core consumer price indices, where available, from these countries. Where core consumer price indices are not available, headline measures are used; March 1995 = 100.

Source: RBA statistics 2018, Real Exchange Measures and Terms of Trade

The second effect of the float was that it left monetary policy free to pursue other macroeconomic objectives, particularly inflation. The Reserve Bank of Australia (RBA) began to take a larger role in using monetary policy to control inflation in the late 1980s and 1990s. In 1993, the RBA introduced an inflation target for consumer price inflation of between two and three per cent. In 1996, the Statement on the Conduct of Monetary Policy was released which formally established the independence of the RBA. Since the introduction of inflation targeting, volatility in interest rates, which can inhibit investment required for future growth, has declined considerably (Figure 1.2).

Figure 1.2: Interest rate volatility, 1972 to 2017



Notes: Absolute monthly change in 90-day bank bill rates, six month rolling average.

Source: Reserve Bank of Australia, 2017, Statistical Tables, Table F1.1 Interest rates and yields — Money Market

Of perhaps equal importance to the floating of the dollar, a tender system was introduced for the sale of Treasury bonds in 1982.[17] This greatly increased the ability of the RBA to control money supply.

National Competition Policy

As the reform agenda progressed in the early 1990s, it became apparent that parts of the broader competition policy framework were inhibiting necessary adjustments in the economy. In response, Australian and state and territory governments agreed in 1993 to implement a comprehensive National Competition Policy (NCP).

Among other things, the NCP:

- Extended the anti-competitive provisions of the Trade Practices Act 1974 to unincorporated enterprises and government businesses
- Introduced governance and structural reforms to government businesses to compel them to become more commercially focused and expose them to competitive market pressures
- Created independent authorities to set, administer, or oversee prices for monopoly service providers
- Established a third-party access regime for infrastructure services with natural monopoly characteristics
- Introduced a legislative review program to assess whether regulatory restrictions on competition are in the public interest.[18]

The program of reforms under the NCP were based on the principle that competitive markets generally serve the interests of consumers by providing strong incentives for firms to operate efficiently, innovate, and lower prices.

Estimates released by the Productivity Commission (PC) in 2005 suggested that productivity improvements and price changes linked to infrastructure reforms alone delivered a permanent 2.5 per cent increase in GDP.[19]

17 Macfarlane, I. 2006, *The Search for Stability*, Boyer Lecture 2006, Australian Broadcasting Corporation
18 Productivity Commission, 2005, *Review of National Competition Policy Reforms*, p. xv
19 Productivity Commission, 2005, *Review of National Competition Policy Reforms*, p. 51

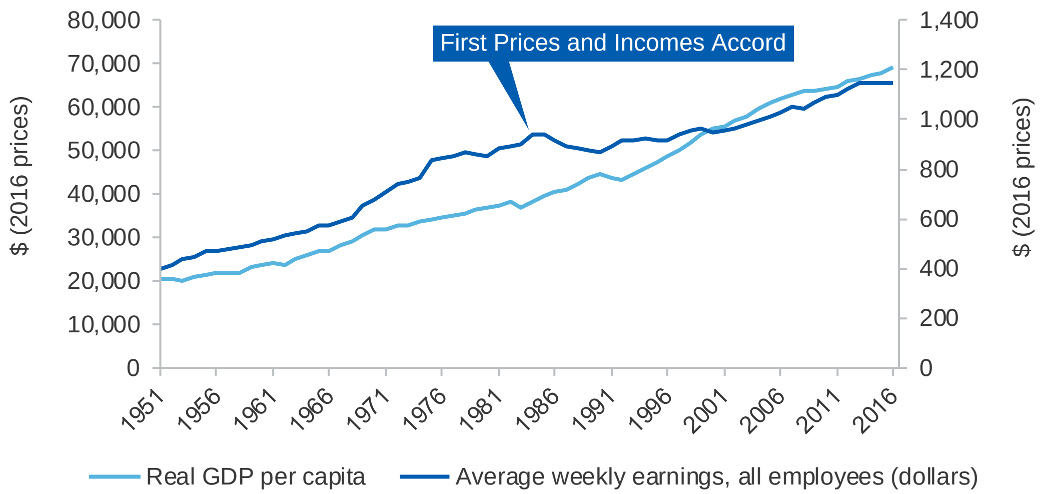
A more flexible labour force

Australia had maintained a centralised wage system since 1907. By inhibiting the ability of wages to adjust in relative terms, centralised wage determination impeded the efficient allocation of labour among industries and firms facing different economic conditions and pattern bargaining[20] drove up inflation.[21]

The Prices and Incomes Accords were a series of agreements between the Australian Council of Trade Unions and the Commonwealth Government between 1983 and 1991 designed to combat inflation. Under these agreements, real wages were reduced in return for an increase in the social wage (reforms in health, social welfare, superannuation, minimum wages and taxation).

Later reforms eventually led to a fully decentralised wage setting process, with the introduction of enterprise bargaining in 1993. As market based approaches became more widespread, wages growth aligned more closely with growth in changes in GDP per capita (Figure 1.3).

Figure 1.3 Real wages and real GDP per capita, 1951 to 2016



Notes: Australian wage growth ran ahead of GDP per capita growth throughout the 1950s and 1960s which was a major source of underlying inflation. The gap opened wider in the 1970s and 1980s. This further drove up domestic inflation. 'Imported inflation' from global trading partners increased inflation yet more. During the operation of the Prices and Incomes Accord, real wages and GDP per capita were gradually brought into alignment and alleviated inflationary pressures in the economy.

Source: Hutchinson D and Ploeckl F, 2017 MeasuringWorth, Constructing a time series of average weekly wages in Australia is difficult before the 1970s. Caveats are at, http://www.measuringworth.com/australiadata/

20 Pattern bargaining is a process where one wage settlement is used as the basis for negotiating the next one even if it is a different industry. For example, a pay rise in the metal trades industry could be used as a basis for negotiations in the transport sector.

21 Hatton, T. and Withers, G. 2014, *The labour market, in Cambridge Economic History of Australia*

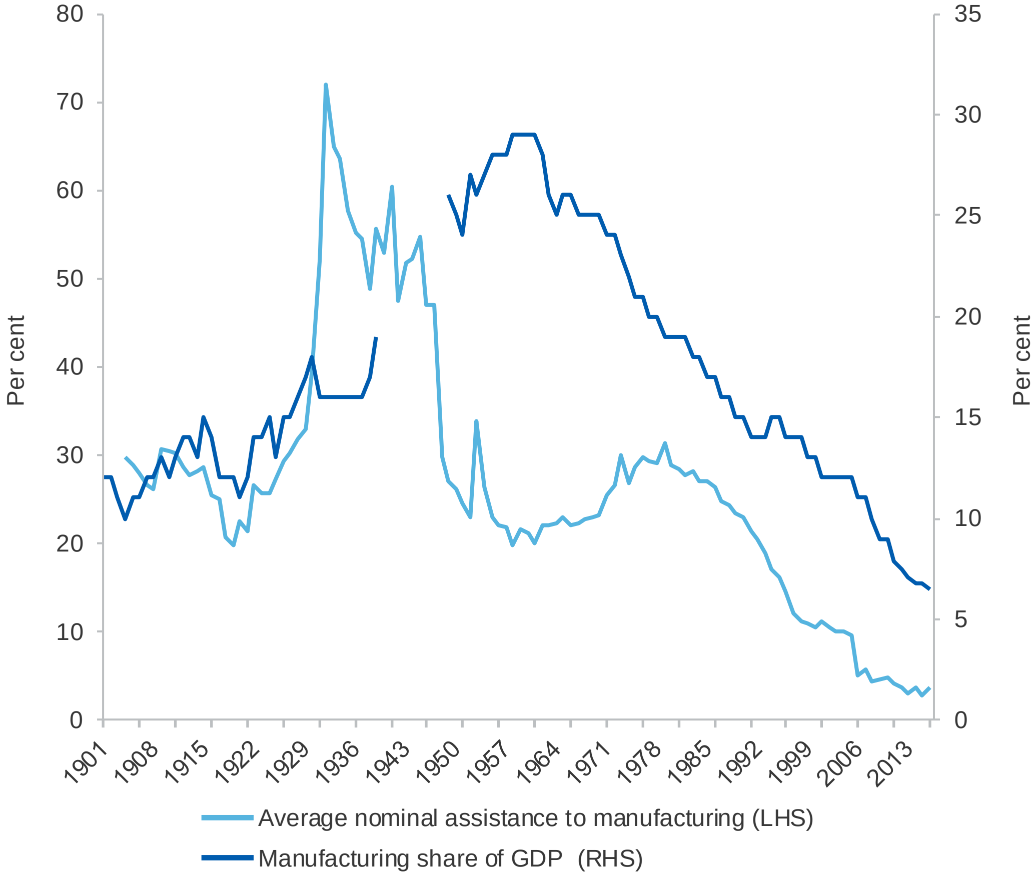
The beginning of the end of protectionism

The microeconomic reform agenda also included significant changes to trade policy. These complemented changes to macroeconomic policies designed to open the Australian economy to international markets.

After stalling following a 25 per cent across-the-board tariff cut in 1973, efforts to reduce protectionist trade measures gathered pace in the late 1980s with the abolition of quantitative import controls and further tariff cuts. Remaining tariffs were progressively lowered over the following decade, exposing domestic firms to increasing levels of foreign competition.

By 2006, the average nominal rate of assistance provided to the manufacturing (Figure 1.4) sector had fallen below five per cent, down from 31 per cent in 1979.[22] The effective rate of assistance provided to the agricultural sector also declined, from 28 per cent in 1971, to three per cent in 2001.

Figure 1.4: Average nominal assistance to manufacturing and manufacturing's share of GDP, 1904 to 2016[23]



Notes: Assistance data unavailable for the years 1901–1904. Manufacturing's share of GDP data unavailable for the years 1939–1948.

Source: Butlin, M., Dixon, R. and Lloyd, P. A statistical narrative: Australia, 1800–2010 in Ville, S. and Withers, G., The Cambridge Economic History of Australia, Cambridge University Press, ABS National Accounts and Productivity Commission, 2017, Trade & Assistance Review 2015–16

22 Assistance varied widely between industries. The rise in assistance in the 1970s and 1980s was directed mainly at the automotive industry and the textile, clothing and footwear industries.

23 Manufacturing Gross Value Added (the output of manufacturing) likewise seemed insensitive to assistance levels growing by 65 per cent between 1975 and 2009 (the GFC) before declining by around 15 per cent.

Taxation reform

There are a number of features that make the Australian tax and transfer system distinctive among developed countries.

- First, it is highly progressive when compared to most OECD countries.
- Second, transfer payments are also extremely low as a proportion of GDP[24] but the transfer to the bottom 25 per cent is amongst the highest.[25] This is augmented by the highest minimum wage in the developed world.[26]
- Third, consumption taxes have historically been relatively low in Australia. Pre-1971, they were widely used as part of demand management and varied widely depending on the policy objective at a particular time.

In order to simplify consumption taxes and balance the taxation system, the Goods and Services Tax (GST) was introduced in 2000 at a comparatively low rate and with wide exemptions. Consequently, consumption taxes in Australia are still low by OECD standards but nevertheless the tax base was widened and its resilience improved.[27]

Improving Australia's competitiveness

This section will look at the overall effect of the reforms on the Australian economy from three perspectives: changes in output, productivity and flexibility.

Increased output and economic restructuring

The period of reform that began in the 1980s shaped a new, more productive, and more flexible economy. By increasing dynamic efficiency, the reforms allowed Australian firms and workers to realise opportunities that improved productivity and competitiveness, without generating the macroeconomic instability that had plagued the economy in the 1970s.

This is most notable when comparing Australia's GDP growth to the OECD average (Figure 1.5). GDP growth in Australia during the 1960s was below the OECD average but as the reforms began to take effect, Australia began to grow more strongly than the OECD average.

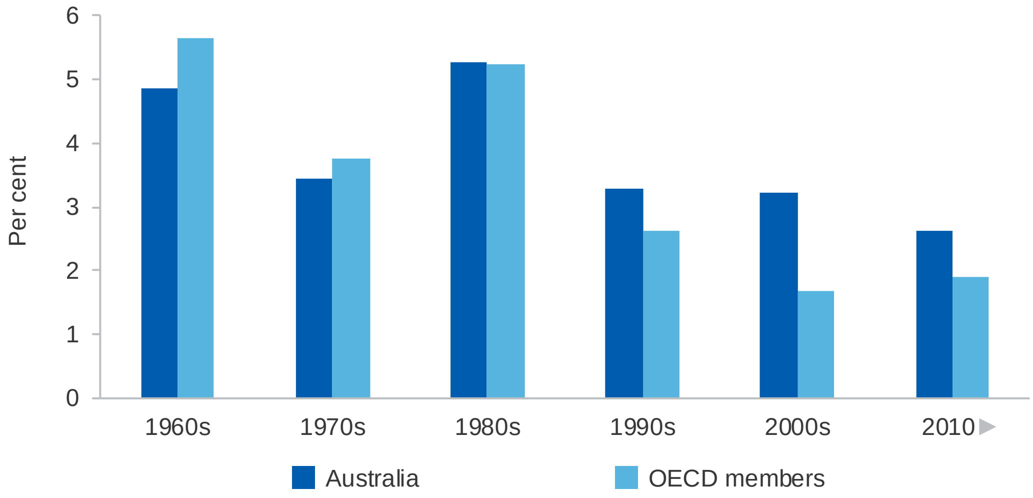
24 OECD Statistics 2017 Social Expenditure — Aggregated Data http://stats.oecd.org/Index.aspx?datasetcode=SOCX_AGG

25 Treasury, 2010, *Australia's Future Tax System, Chapter 9*

26 OECD Statistics, 2017, Real Minimum Wages. Australia has a long standing policy of relatively parsimonious unemployment benefits and a high minimum wage to encourage people into work. Minimum wages as a ratio to median wages have been slowly declining over a number of years.

27 OECD, 2017, Revenue Statistics:1965–2016

Figure 1.5: Australia's GDP growth compared to the OECD average, 1960 to 2016



Notes: Original members.

Source: World Bank, 2017, GDP growth annual, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

Increased international competition in the traded goods sector created strong pressure to reduce input costs, including labour and services provided by the non-traded utilities sector. In the past, firms had been able to pass on excessive input costs to customers because they were protected from international competition by a tariff wall. With falling levels of protection, local firms and workers were forced to improve productivity to remain competitive.[28] Lower barriers to trade also provided access to imported goods for consumption and investment at reduced cost, allowing households and firms to benefit from the comparative advantages of Australia's trading partners.

The structural adjustments that followed the reform agenda changed the Australian economy in a number of important ways.

- Changes facilitated by the reforms altered the structure of economic activity within Australia. At its peak in 1963, manufacturing accounted for 28 per cent of GDP.[29] By 2017, this share had fallen to just 5.7 per cent. In contrast, the service sector's contribution to the economy grew from 51 per cent in 1963 to around 79 per cent in 2017.
- A similar impact can be seen in the labour market. During the 1960s more than a quarter of the workforce was employed in manufacturing.[30] By 2017, this share had declined to 7.4 per cent. Services grew from around two-thirds of the workforce in the 1960s, to nearly 80 per cent today.
- Skill levels have increased in line with technological advances. Despite the reforms to the university sector in the 1970s, only six per cent of the population had a Bachelors degree or above in 1982. By 2017, this share had increased to 31 per cent.[31]
- Immigration and greater openness to foreign markets have also created a more diverse workforce. In 1991, around one in four workers in Australia had been born overseas; by 2017, this proportion stood closer to one in three.

28 Banks, G. 2005, *Structural reform Australian-style: lessons for others?* Productivity Commission, p. 5

29 Productivity Commission 2003, Trends in Australian Manufacturing http://www.pc.gov.au/research/completed/manufacturing/tiam.pdf

30 Withers G, Endres T and Perry L 1985 *Australian historical statistics: Labour statistics*, Source Papers in Economic History, Source Paper No. 7; ABS (2017) *Labour force, Australia, detailed*, Quarterly, May 2017, Cat. 6291.0.55.003

31 Australian Bureau of Statistics, 2017, Education and work, Australia, May 2017, Cat.no. 6227.0

Increased productivity

Australia's productivity growth improved considerably in the mid-1990s. Growth rates for both labour and multifactor productivity (a measure of how efficiently labour and capital are used to produce economic output) increased to 40 year highs between 1993 and 1999.

Results from a study released by the International Monetary Fund (IMF) in 2000, suggested the combination of trade liberalisation, industrial relations reform and increased competition improved trend total factor productivity growth in Australia by as much as 0.9 percentage points.[32] A later report released by the IMF in 2008 supported this conclusion, suggesting reforms in the product and labour markets contributed to higher levels of productivity by improving the diffusion of information and communications technologies within the economy.[33]

In addition to placing downward pressure on prices, greater levels of competition also generated other benefits by improving the quality of goods and services, and expanding the range of products available to consumers.

Contestability in retail energy increased consumer choice and placed pressure on suppliers to innovate and introduce new services to attract and retain customers. Greater competition in the telecommunications market accelerated the introduction of new technologies and led to the availability of a much wider range of products and services. Households also benefited from the deregulation of retail trading hours, which allowed consumers greater choice in deciding when to shop.[34]

Improved dynamic efficiency

Deregulation also improved the ability of the economy to adjust to future shocks by allowing key price mechanisms to operate more efficiently. Deregulation transferred the burdens of processing information and decision making from the government to the multitude of market participants. As a result, prices provided more timely, accurate, and transparent signals about the relative returns available to resources in the economy.

An example of the improvement in dynamic efficiency and macroeconomic stability can be seen in the adjustment to the recent mining boom. Global demand for commodities used in steel and energy production increased considerably in the mid-2000s. With the response from global supply constrained by the long lead times associated with new capacity, prices increased sharply, leading to a large rise in Australia's terms of trade. In the period between 2003 and 2012, Australia's terms of trade increased 82 per cent, reaching their highest level on record in September 2011.[35]

Despite the scale of the shock, the process of structural adjustment that followed was relatively smooth: inflation largely stayed within the target range; unemployment remained relatively low; and output grew at a rate close to trend.

32 Salgado et al. 2000, *Australia: Selected Issues and Statistical Appendix*, IMF Staff Country Report No. 00/24, p. 11

33 Tressel, T. 2008, *Does Technical Diffusion Explain Australia's Productivity Performance?* IMF Working Paper 08/4, p. 23

34 Productivity Commission, 2005, *Review of National Competition Policy Reforms*, p. xxi

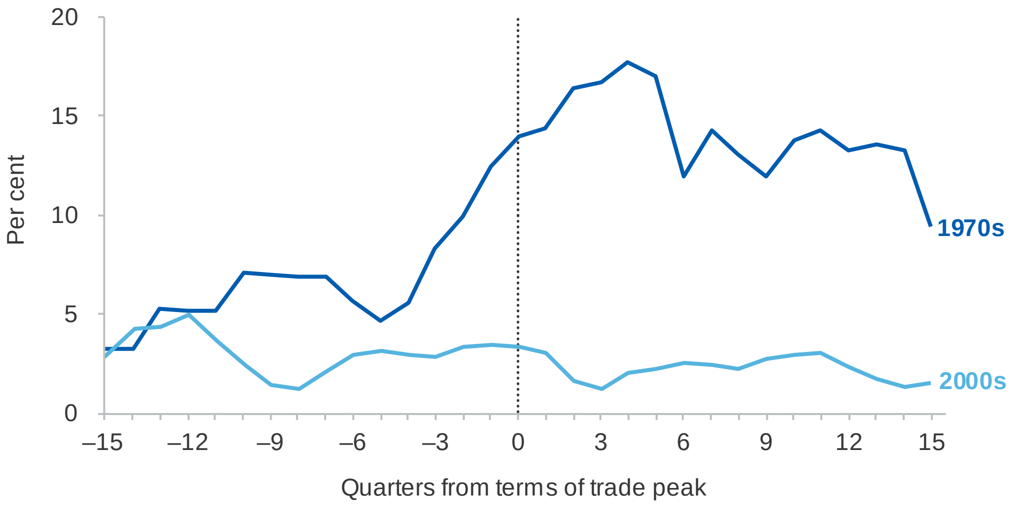
35 Atkin et al, 2014, Australia after the Terms of Trade Boom, RBA Bulletin, March quarter, p. 55

The smooth adjustment stands in stark contrast to previous terms of trade shocks, which often led to rapid inflation and high unemployment. In the early 1970s for example, the terms of trade increased sharply as prices for Australia's agricultural exports spiked. In 1973, the price of wool increased 61 per cent; cereals and meat by around 40 per cent; and dried and canned fruits by 35 per cent.[36]

Wages growth accelerated sharply in the period that followed. Adult male earnings increased 31 per cent during 1974 alone.[37] Inflation also increased rapidly, albeit at a somewhat lower rate. By 1977, the unemployment rate had risen above 5.5 per cent, and with the exception of June 1981, did not fall back below that level until October 2004.

To a large extent, the relatively smooth adjustment to the latest terms of trade shock is a direct consequence of the economic reforms introduced in the 1980s and 1990s. The floating exchange rate acted to contain inflation and facilitate the reallocation of labour and capital across industries (Figure 1.6). By allowing the dollar to appreciate in nominal terms, the floating exchange rate restrained activity and income in trade exposed industries outside the mining sector.[38]

Figure 1.6: Inflation associated with two terms of trade shocks



Notes: Year-ended consumer price inflation.

Source: ABS cat. no. 6401.0

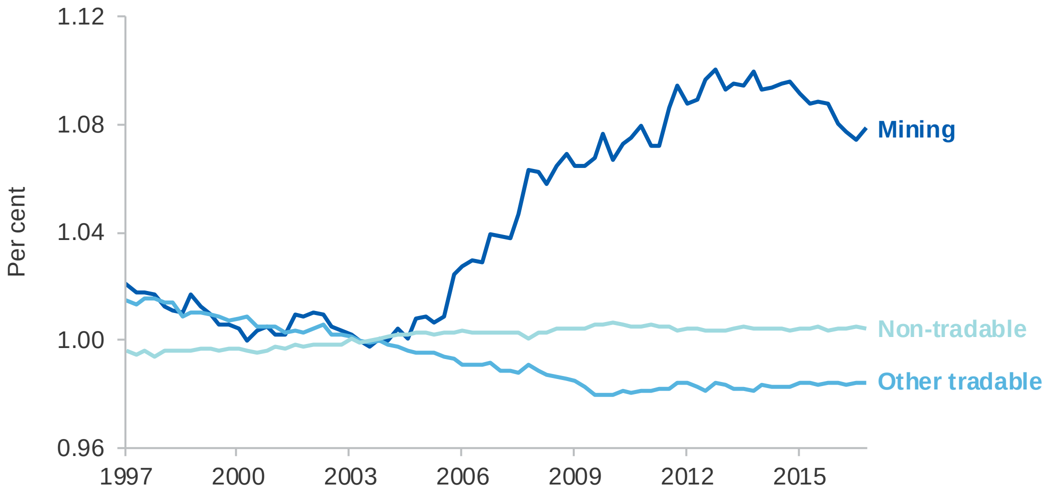
Reforms to the wage-setting process also facilitated the process of adjustment by restraining inflation and supporting the reallocation of labour within the economy. In the absence of centralised determination, wages were free to adjust in relative terms to reflect the different conditions facing each sector of the economy. Wages in the mining sector increased rapidly in response to the higher price for commodities. In contrast, there was little movement in wages in the non-traded sector, and a fall in trade exposed sectors outside the mining sector (see Figure 1.7).

36 Organisation for Economic Cooperation and Development, 1974, *Economic Surveys: Australia*, p. 11

37 Hughes, B. 1980, *Exit Full Employment*, Angus and Robertson, p. 69

38 Reserve Bank of Australia, 2005, *Commodity Prices and the Terms of Trade*, Reserve Bank Bulletin, April Quarter, p. 4

Figure 1.7: Relative wage levels, 1997 to 2016



Notes: Sector wage price index as a ratio of aggregate wage price index, 2003–04 = 1; Other tradable sector excludes agriculture. This is because aggregating industry Divisions requires statistical weights and these are not available for agriculture. Agriculture is an inherently volatile industry and its exclusion lessens the variability of the index.

Source: ABS cat. no. 6345.0 and 63450

The adjustment in relative wages and modest increase in overall wage growth also benefited from the introduction of inflation targeting, which provided a credible anchor for inflation expectations and wages growth.[39]

Prospects for the next 25 years

The weaknesses in the current Australian economy and the areas that need reform into the future have been well canvassed by the Productivity Commission (PC) and need not be recounted here.[40] What is less well covered is the necessity of reform for Australia to improve its international competitiveness. This is the subject of the closing section of this chapter.

Australia is often described as a small, trading nation. However, the nation's economy is currently ranked 14th largest in the world, of a similar size to the much more populous countries of Spain, Russia and Mexico.[41] In other words, Australia is a medium sized economy.

Australia's international trade profile is unique amongst medium sized economies. This is partly due to geography but mainly due to policy. Decades of high exchange rates, high tariffs, high trade costs, restrictive trade practices and reluctance to participate in multi-lateral trade negotiations described above have taken their toll. As shown in Figure 1.8, Australia's integration into the global economy has been weak. Measured by the proportion of merchandise trade of its GDP, Australia is in the bottom ten per cent of countries alongside nations with large internal economies such as the US and least developed countries such as Ethiopia.[42]

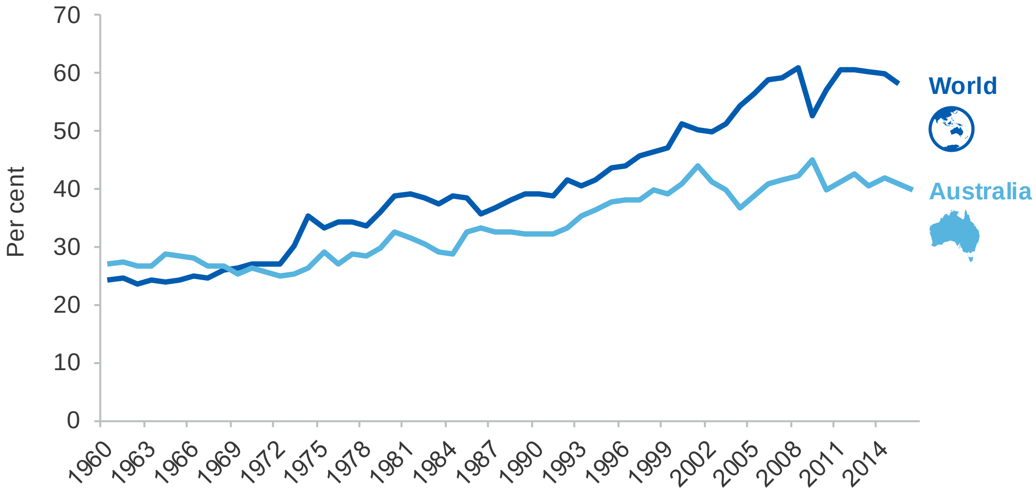
39 Bishop et al. 2013, *The Resources Boom and the Australian Economy: A Sectoral Analysis*, Reserve Bank Bulletin, March Quarter, p. 48

40 Productivity Commission, 2017, *Shifting the Dial: 5 year productivity review*

41 World Bank 2016, Gross domestic product ranking table, https://data.worldbank.org/data-catalog/GDP-ranking-table

42 New Zealand's economy, for example, is much more integrated into the global economy than Australia.

Figure 1.8: International trade in merchandise goods as a percentage of GDP, Australia and World average, 1960 to 2016



Notes: The ratio of a nation's international trade to its GDP is described by the unfortunate term of 'openness.'

Source: Source: World Trade Organisation, 2017, Merchandise trade (%GDP) https://data.worldbank.org/indicator/TG.VAL.TOTL.GD.ZS

The second part of this report (forthcoming) will show that Australia's integration into the global economy has also been comparatively shallow. Its participation in Global Value Chains is the lowest of any developed nation and it is progressively moving upstream in the global production process driven by its reliance of resources exports.

Four areas of reform that could help Australia is to improve its integration into the world economy are as follows:

- Service sector regulation reform — The PC has pointed to a number of service industry sectors that remain shielded from competitive pressures.[43] This is partly due to a remnant of the pre-1971 economy that was not reformed and also lack of exposure to global competitors because international trade penetration into the Australian economy is relatively low. As these sectors grow in importance as a proportion of the rest of the economy and in particular for international trade (a major theme of the second part of this report), the case for reform is becoming more urgent.
- Trade cost reduction — Trade costs are the cost of getting goods into and out of Australia. These include border costs such as Customs and other inspections, port costs and time in bond. These remain much higher in Australia than the rest of the developed world.[44] Indeed the World Bank *Doing Business* survey ranked Australia as 91 out of 190 countries and well below any other developed country. High trade costs inhibit trade in much the same way as tariffs do and are of particular significance for Australia. Because of its isolated geographic position, transport and trade costs make up a comparatively higher proportion of base costs.
- Transport costs — Australia's settlement pattern of large cities separated by long distances and remoteness from international markets means that the efficient movement of people and goods is a critical factor for the Australian economy. Real domestic freight transport costs have not fallen for 25 years for any mode of transport, despite record amounts being spent on infrastructure as a proportion of GDP.[45]

43 Productivity Commission, 2017, *Shifting the Dial: 5 year productivity review.*

44 Thirlwell, M. 2016, *Time and Cost to trade: How does Australia compare?*

45 BITRE 2017, Freight Rates in Australia, Information Sheet 90, Canberra: BITRE

- Connectivity — In a digitally connected world, communications infrastructure is critical. While this is being addressed by the National Broadband Network (NBN), internet speeds in Australia are amongst the lowest of any developed country.[46]

The Australian economy since 1991 has been described as the 'miracle economy'. As this chapter has shown, it has been Australia's businesses, workers and investors who have performed the 'miracle'. It is true that the reform process was often messy and often later than it needed to have been. Nevertheless, transforming the rigid pre-1971 economy into the modern economy that has delivered so much to so many is a magnificent achievement.

Ultimately, our long run prosperity depends on our ability to innovate[47] and increase productivity.[48] While the areas for change may seem formidable, the lesson from this chapter is that Australia has the capacity to make far reaching reforms to its economy.

46 Akamai 2017, State of the Internet Report www.akamai.com/Connectivity

47 OECD 2015, The OECD Innovation Strategy 2015 http://www.oecd.org/site/innovationstrategy/

48 Productivity Commission, 2017, *Shifting the Dial: 5 year productivity review,* p. 3

Changing jobs: Supporting workers in dynamic labour markets

Andrew Charlton

Director, AlphaBeta

Australia has experienced an extraordinary period of economic growth, but beneath the seemingly placid surface of our economy, there is tremendous change. Career changes have become more frequent and job changes are increasingly commonplace. In the future, how we support workers through job transitions will be equally, if not more, important as preparing them for their first job.

Over the past 25 years, Australia's labour market has been in constant flux. We have lost around 100,000 machinery operator jobs, nearly 400,000 labourers, nearly 500,000 secretaries and clerks and nearly 250,000 jobs from the technicians and trades.[49] Offsetting these losses, there has been an explosion of more than 400,000 new jobs in community and personal services and 700,000 new jobs across the professional and business services.

At the macroeconomic level, much of this change has been positive. The economy has created new jobs that are, on average, better paid, more satisfying and safer than the jobs that were lost.[50] But the impact on the individuals who must transition between jobs is significant.

What do we know about workforce transitions in Australia? Each year 190,000 Australians either lose their job due to being laid off, made redundant or their employer going out of business.[51] That's about 25 per cent more such transitions than occurred 15 years ago.

49 AlphaBeta and FYA 2015, *The New Work Order.*

50 AlphaBeta 2017, *The Automation Advantage.*

51 AlphaBeta 2017, Australian Workforce Transitions, mimeo.

The average time these people will spend out of work during their transition is two months, and one third of them will drop out of the labour force entirely for a period (i.e. they will stop looking for work). Nearly one in five will receive some form of welfare or public assistance during their transition, 9 per cent will undertake some retraining or other education and 18 per cent will ultimately move occupations to find a new job.[52]

In an increasingly dynamic economy, these workforce transitions are not only a common feature of careers, they are an increasingly important economic issue. Adding up the cost of lost wages, retraining, welfare and the depreciation of unused qualifications, the total cost of workforce transitions to the Australian economy is more than $6 billion each year.[53]

But not all transitions are negative. About half of all workers actually come through transitions better off, with higher wages and reporting higher workplace satisfaction. So, if we accept that career transitions will become common, how can we help ensure they are positive for more people?

The answer starts with equipping students with skills of durable value through their careers. Our current education system is not responsive enough to the changing labour market. AlphaBeta research in partnership with the Foundation for Young Australians (FYA), shows that almost 60 per cent of Australian students are currently getting educated for jobs that will be radically affected by automation and digitisation over the next 10 to 15 years.[54] An entire generation of young Australians is at risk of learning skills that will be of decreasing value in the future world of work.

We also need to equip workers with portable skills that they can take with them as they build careers from multiple jobs and top up through further education as they go. Changes in the labour market are increasing the premium on general rather than specific skills. By 2030 workers will spend on average 30 per cent more time per week learning on the job, spend double the time solving problems, spend 41 per cent more time on critical thinking and judgment, and 77 per cent more time using science and maths.[55] They will also likely use verbal communication and interpersonal skills 17 per cent more often per week and develop a stronger entrepreneurial mindset. Responding to these trends, employers are increasingly looking for workers with general skills such as team work, presentation skills, problem solving and creativity.

Finally, there is also significant room to improve the matching of workers to jobs. Australia doesn't have a good record of finding new work for people displaced from the labour market. Over the past 25 years, nearly one in ten unskilled men lost their jobs and did not return to the labour force. Today, more than one in four unskilled men don't participate. This need not be the case. In an environment of near full employment we should be able to quickly match workers in declining industries to jobs that require similar skills and prevent people from falling out of the labour market. The availability of big-data analysis on employment opportunities should significantly help policymakers, education providers and employers to target training and re-training opportunities.[56]

Increasingly, periods of transition are becoming a common part of career trajectories. Creating a resilient workforce that can manage — even benefit from — career transitions will be one of the most important labour market objectives over the coming decades.

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52 AlphaBeta 2017, Australian Workforce Transitions, mimeo.

53 AlphaBeta 2017, Australian Workforce Transitions, mimeo.

54 FYA 2015, *The New Work Order.*

55 AlphaBeta and FYA 2017, *The New Work Smarts*, https://www.fya.org.au/wp-content/uploads/2017/07/FYA_TheNewWorkSmarts_July2017.pdf

56 AlphaBeta and FYA 2015, *The New Work Order.*