

# Australia's economic 'miracle'\*

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It is a great pleasure for me to be able to address an audience of graduate students in economics from all around Australia, especially at an event run by my alma mater. Coming to economics in the late '90s, your observations of the contemporary Australian economic scene will have been markedly different to graduate students of even a decade ago (let alone those of an old boy from the early 70s!).

For a start, you will have seen Australia's GDP grow by 3½ per cent a year in the 1990s; this was faster than even the USA's lauded performance and a third greater than that achieved by the OECD as a whole. Your predecessors would have become accustomed to a more mediocre record. You will have also observed that Australia's strong growth performance was seemingly unaffected by the financial crisis that gripped our Asian markets in 1997 and, later, the bursting of the dot.com bubble. Again, your forebears had become used to a more susceptible Australian economy (the convention being that when the USA sneezed Australia caught cold).

The strong growth exhibited by our country in the midst of the 1997 Asian crisis led the US economist Paul Krugman to label Australia the 'miracle' economy — the assigned title of my address to you this evening.

As I contemplated this last weekend, the only American dictionary to which I could refer at home was a large *Websters*, circa 1920. Under "miracle"(n.) the first meaning given is "A wonder or wonderful thing; a marvel." I would not wish to disagree with such an assessment, as you will see. However, the second meaning — which has overtaken the first in common parlance in Australia and I assume in America too — is "an event which cannot be accounted for as produced by any of the known forces of nature." If Krugman had intended to be taken literally in this sense (which I doubt) then I must differ.

Australia's improved economic performance, and the productivity surge that underpinned it, *has* been a wonderful thing for Australians but it also has a

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rational explanation. Indeed, as graduate students contemplating a career in economics, and perhaps in economic policy, I hope you will be reassured by my central message this evening — that the main cause of our improved economic performance over the past decade has been (rational) economic reform. I will also try to convince you, however, that both the need and scope for economic reform in Australia have not disappeared, and indeed remain important to our future prospects. In other words, you have chosen your career wisely.

But first, let me attempt briefly to put our recent economic experience in historical perspective. In doing so, I am going to focus largely on the productivity dimension. There is of course more to the economic and social wellbeing of a nation than output growth, but in my defence I shall call on Krugman again, who has boldly observed:

“Productivity isn’t everything, but in the long run it is *almost* everything.”

Indeed, productivity is the mainspring of material living standards. It is a necessary condition, even if not a sufficient one, for a more prosperous society, which I take as the principal object of an economist’s training.

## **From growth laggard to leader**

Australia’s productivity growth in the second half of the 20<sup>th</sup> century can be segmented into three phases: relatively fast growth in the 1950s through to the mid-1970s; a slowdown through to the early 1990s; and, since then, a strong resurgence that has continued more or less unabated.

To interpret these trends, we need to view them in an international setting. During the worldwide productivity boom of the post-war period, Australia’s productivity performance — though stronger than in earlier periods — was poor by the standards of other similarly-developed nations. In contrast, during the 1990s, when the world productivity record was patchy, Australia’s performance stood out. In other words, Australia’s earlier productivity boom was not remarkable by international standards, but its resurgence of the 1990s certainly was.

The early post-war decades (the 1950s and 60s) are generally referred to as a ‘golden age’ for growth internationally — reflecting pent-up demand, reduced constraints on supply and freer international movements of capital, people and technology. In 1950, at the dawn of that era, the USA was the world productivity leader, while Australia ranked fifth, its GDP per hour worked being around 80 per cent of the US level. As the years unfolded, the USA’s performance dropped off somewhat (as might be expected of the productivity leader) while Europe’s and Japan’s growth accelerated in a process of productivity catch-up. Australia, meanwhile, did not even keep pace with the United States and, by 1973, its ranking had slipped to twelfth.

During the subsequent global productivity slowdown, Australia continued to perform poorly even in relative terms and, by 1990, our ranking in per capita GDP and GDP per hour had slumped to 16<sup>th</sup>. (It was in those years that Australians became conscious that they were being overtaken in the income stakes by countries in Asia that many still thought of as ‘developing’. I seem to recall Singapore’s Lee Kuan Yew rubbing this point in at the time.)

### *The 1990s turnaround*

All that turned around in the 1990s. Productivity growth stepped up again in the USA, while remaining sluggish in most other OECD economies and in Asia. However in this period, as noted, Australia’s productivity growth *surged*, outperforming even that of the USA.

Australia’s strong (labour) productivity performance in conjunction with better, if not ideal, employment outcomes — higher employment and lower unemployment, accompanied by a stable participation rate — translated into strong growth in average incomes. GDP per person (measured in US purchasing power parity dollars) has grown by 2.5 per cent a year since 1990, compared with 1.7 per cent in the 1980s, and an OECD average in the 1990s of 1.7 per cent.

The result has been that Australia’s international ranking in per capita GDP has rebounded from its low point of 16<sup>th</sup> in 1990 to eighth in 2002.

More importantly, that one percentage point boost in our growth rate has translated into a substantial improvement in the average income of Australians. If we had not had the additional productivity growth in the 1990s, Australian households would have been around \$7000 worse off on average by now.

Rises in the average level of GDP per capita are one thing; how the income gains are distributed across the community are another, and arguably just as important for a society’s progress.

- At the aggregate level, labour and capital have shared evenly in the income growth. Moreover, productivity gains were not simply appropriated by enterprises in higher wages and profits. The evidence is that the productivity gains in the best performing industries were predominantly passed on in the form of lower relative prices.
- At the personal and household levels, disparities in market incomes continued to widen in the 1990s. But this was largely offset by redistributions through the tax and transfer system. The distribution of disposable income remained stable or showed a modest increase in disparities — depending on whose figures you use — and the distribution of consumption remained constant. (But, as Melbourne Institute research reveals, these outcomes mask disturbing trends in poverty among jobless households with children, a point to which I return.)

Other considerations, apart from income and its distribution, also matter, such as social and environmental outcomes. Some commentators have recently returned to what at one time was called the ‘growthmanship’ debate, rightly questioning whether additional growth brings us commensurate increases in quality of life or happiness (‘utility’ in the jargon). That raises matters beyond the scope of this talk. I might just observe that at least we are in the relatively comfortable position of being able to debate such an issue. This is not the situation in many poorer countries. Moreover, those countries often have the greatest environmental degradation and social upheaval — and can afford to give very little attention to safety-nets for their citizens.

### **What caused the ‘miracle’?**

If we take as a first approximation, therefore, Krugman’s maxim that productivity “in the long run is almost everything”, it is important that we understand and learn from Australia’s productivity turnaround. At this point I should perhaps make clear that while I have hitherto been talking mainly in terms of *labour* productivity, its rise has been almost wholly accounted for by increased ‘*multifactor* productivity’. Both grew at record rates in the 1990s, but it was the acceleration of MFP growth (from 0.7 per cent to 1.8 per cent annually over the last two productivity cycles) that generated nearly all the action. This is significant, because, multifactor productivity is the more telling indicator of how effectively a nation’s human *and* capital resources are being used.

#### *Not the usual suspects*

Australians have an ingrained sense of (healthy) scepticism, and the economics profession is *trained* to be sceptical. The first reaction by some to a surge in the productivity growth numbers was that the statistics were probably in error or that they were being reported in a misleading way. Successive ABS revisions and methodological improvements have not changed (indeed have strengthened) the underlying story, however, and more detailed examination of individual industry performance has generally confirmed it.

With the aggregate productivity growth numbers beginning to look unassailable, some have sought to find explanations other than policy reform. However, most of those don’t stand up to scrutiny as credible *principal* causes of the turnaround. I can say that with some confidence, because of the work of my colleague Dean Parham and other researchers at the Productivity Commission. It would be nice to cite other sources too, but with one or two notable examples, I have been surprised at how little academic attention has been given to this vital practical topic for economic inquiry. (For any of you who only give credence to what you read in professional journals, I commend

to you Dean's forthcoming review article in *The Economic Record*. Otherwise, simply go to the Commission's various publications, all available on our website.)

Given all this work, I can afford to be brief:

- First, as already noted, unlike the experience of the 1950s and 60s, Australia could not be said to have been carried along by any international productivity boom in the 1990s.
- Second, the surge in productivity cannot be dismissed as the normal result of recovery from the early 1990s recession. The improved performance has been both longer and stronger than in previous recoveries. Besides, the relevant ABS measures abstract from cyclical influences.
- Third, higher skill levels in the workforce could have pushed up productivity. But there appears to have been no significant acceleration in workforce skills in the 1990s. In fact, the evidence shows a faster increase in skills in the 1980s.
- Fourth, there have been claims that the productivity surge has been produced on the backs of workers through increased 'work intensity': increased hours of and pace of work. Again, some compelling counter arguments have been made (for example, that productivity measures already take into account additional labour input). But let me just focus on the key prediction that higher work intensity by the mid-1990s would mean that the measured improvement in productivity could not be sustained. Well, the level of productivity has not slipped back. In fact, we have had 7 or 8 years of almost continuous *further* improvements in productivity since then.

(As an aside, I should clarify that the 'work intensity' issues raised in this context relate to whether productivity estimates are mismeasured or unsustainable. They should not be confused with other live issues in community debate about job security and the ability for people to make appropriate work/life choices. All I might say on those important issues is that increased productivity — through working 'smarter' — is the friend, not the enemy, of the work/life tradeoff.)

- Finally, it cannot be said that Australia has been favoured by any special technological leap forward. Indeed, on a number of indicators such as business R&D spending, Australia is below the OECD average. Other countries, including the USA, derived some benefit from rapid advances in the *production* of information and communications technologies (ICTs) in the 1990s. Australia produces little in the way of ICTs and so we have not accessed that source of productivity gain. But what about productivity gains from *use* of ICTs? This seems relevant given that Australia moved toward the top of the ladder on the uptake of ICTs in the 1990s (second or third in the OECD on major indicators). Our research suggests that *use* of ICTs did indeed contribute to Australia's productivity pick up, but not by much at the aggregate level — around 2 tenths of a percentage point. And even then we

are left to ask, ‘Why was it that Australia moved from being slow on the technology uptake in earlier decades to a frontrunner in the 1990s?’

### *Microeconomic reform has made the difference*

The answer is in large part the same as the answer to a wider question: what were the ‘home grown’ factors that saw us part company with international trends — factors that had held us back in earlier decades?

Adam Smith observed (I think) that ‘there is much ruin in a nation’, meaning that an economy is potentially quite resilient to shocks and mismanagement. However Australian government policy throughout much of the 20<sup>th</sup> century had almost systematically, if unwittingly, undermined the economy’s productive potential, by distorting price signals and protecting producers from competition. It is not surprising that those policies took their toll. Equally, it should not be surprising that their reversal has yielded the benefits that economic theory would anticipate.

As you know, the reforms really began with the lowering of barriers to foreign competition in goods and financial markets in the 1980s. As tariff reform and takeover pressure began to bite, managers began to devote more attention to improving the performance of their business. They needed to reduce their costs and improve their flexibility to respond to mounting competitive pressures. Two major impediments to those objectives were the high costs of energy, transport and other services provided by inefficient public utility monopolies (engaged in cross subsidising households), and a centralised system for ‘fixing’ wages and conditions, irrespective of the diverse circumstances of individual enterprises.

Reforms in these areas followed. A presumption of competition being in the public interest found ultimate expression in the National Competition Policy — the systematic program agreed to by all Australian governments in 1995 to extend competition throughout the economy.

I should not give the impression that any of this was easily or quickly achieved. Reforming anti-competitive policy is generally a lot harder than implementing it. For one thing, producer interests (including employees) become rather attached to it and they fight hard to retain what they perceive as their entitlements. The story of economic liberalisation in Australia thus has as much to do with politics and institutions as with economics. That said, the economics profession in Australia has played an important role both in identifying necessary reforms and demonstrating the likely payoffs, and in selling reform to governments and the wider community.

## Evidence of reform's effects

The liberalisation of the Australian economy has coincided with important structural and behavioural changes which are consistent with the observed step-up in productivity performance. These include:

- a sharp increase in trade intensity, with the ratio of exports and imports to GDP rising from 27 to 44 per cent since the mid-1980s;
- the decline of high cost manufacturing activities and the rise of ETMs (for example, while TCF production has fallen in real terms by about 40 per cent since 1985, manufacturing production as a whole has risen by 40 per cent);
- the growth in enterprise agreements, involving substantial variations in previously prescribed employment conditions and work practices; and
- a rise in BERD and other indicators of innovation (in production, distribution and marketing) including, as noted previously, increased uptake of ICT.

If we trace the productivity performance of individual industries over time, we can also observe some strong linkages with earlier microeconomic reforms. These are most apparent for those industries previously dominated by public sector monopolies, following wide-ranging reforms. For example, MFP growth in electricity, gas and water jumped by 60 per cent in the 1980s, while in the 1990s MFP growth rates in transport/storage and communications doubled.

The performance of the 'traditional' sectoral contributors to aggregate productivity growth was mixed, with agriculture surging in the 1990s, whereas mining had its burst in the second half of the 1980s and slowed thereafter, and manufacturing slumped in the mid-90s when the market aggregate was rising most strongly.

Given the focus of trade liberalisation and other reforms on manufacturing, one might have expected to see its productivity growth do better. There are a few points to note. One is that there has been much stronger *labour* productivity growth in manufacturing in the 1990s, reflecting (hi-tech) capital deepening. Second, the MFP performance generally appears to have been much greater in particular industries (whitegoods in the 80s, automotive from the late 90s) where trade pressure increased most. Third, we are now also seeing aggregate MFP growth rates for manufacturing accelerate; in 2000-01 and 2001-02 they recorded their highest rates for 17 years.

However, the stand-out contributors to the productivity surge of the 1990s were the wholesale trade and finance and insurance industries. At first blush this might not seem in tune with a microeconomic reform theme. We wondered about it ourselves. What we found from more detailed follow-up research was that both industries achieved a significant uplift in productivity primarily through the innovative use of ICT. For example, developments like scanning and bar coding and IT-based inventory systems helped transform wholesaling from a storage-based activity to fast flow-through logistics systems. But it was

the *reorganisation* of the businesses that generated the productivity gains — from reduced warehousing and handling — rather than the mere acquisition of ICT. These organisational changes were, on the one hand, prompted by competitive pressures downstream (for example, as the hard-pressed auto industry sought cost reductions all along the value chain) while, on the other hand, being facilitated by work practice changes that could not have happened under the prescriptive and inflexible arrangements of the old IR regime.

This is supported by recent OECD research for their ‘Growth Project’. OECD researchers found that product market regulations and employment protection legislation had a negative impact on MFP growth across countries in the 1990s. They found that countries with decentralised bargaining systems and less stringent employment protection were better placed to innovate in industries characterised by multiple and rapidly-evolving technologies.

### **Sustaining the ‘miracle’**

In sum, much of the so-called ‘miracle’ of Australia’s transformation from economic laggard can be attributed to us simply removing the lead from our saddlebags. Mancur Olsen likened the potential gains from such reform to finding \$100 bills on the sidewalk. Easy pickings for economists, if not for those who must implement the necessary reforms.

Indeed it could be said that the most miraculous thing about Australia’s economic turnaround was that the necessary policy reforms took place at all! As a much earlier economist Vilfredo Pareto first demonstrated, the natural forces of political economy are not conducive to reforms that potentially provide diffuse benefits to the many at the concentrated cost of the few. Even from this perspective, however, it is apparent that considerable groundwork was laid over many years across different governments to create a climate of receptiveness to the need for change. Australia’s proclivity for systematic inquiry and public debate in policy development has been part of this. The OECD alluded to this feature in its most recent report card on Australia’s economy:

“The Government’s commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is ... something that other countries could learn from.”

As I noted earlier, economists in various capacities — academics, consultants, public servants and political advisers — have been at the centre of this process and should be proud of their contributions.

But I began this presentation on a hopeful note for your futures in economics and you may be wondering at this point whether there are any challenges left.

## *Reasons for seeking further improvement*

Returning to the productivity window on our overall performance, it is clear that while we have been in catch-up mode internationally, there is still some catching up to do. For example, in terms of GDP per hour worked, in 2002 we were at 83 per cent of the US level, which was only slightly above where we were in 1950. Our manufacturing productivity in particular remains well below US levels.

Whether or not aspiring to US levels of productivity is realistic, the need for us to realise our productivity *potential* has not diminished. Taking Australian society and its regions as a whole, it would be difficult to argue that standards of living should not be any higher. And it seems clear that that cannot be achieved in any sustainable way without productivity growth. As the ANU's Ross Garnaut has put it when addressing the *Opportunity and Prosperity Conference* last year:

“Effective measures to promote distributional equity make large demands on a country's fiscal resources. Economic growth is therefore a necessary underpinning of progress towards distributional equity. For these reasons, it remains likely that Australia will have all of productivity-raising economic reform, progress towards greater distributional equity and stronger economic growth, or none of them.”

Moreover there are both external and domestic challenges to our living standards which would make it unwise to rest on our laurels.

For one thing, the ongoing external pressures of globalisation and the reforms which have unleashed the competitive strength of other countries, like China, mean that we have to continuously improve our performance.

Compounding these (positive) external challenges, is the gathering international retreat from multilateralism in trade policy and the rise of discriminatory liberalisation. To the extent that Australia is excluded from such preferential deals, we are exposed to terms of trade and income losses. However in engaging in such deals ourselves, we may be exposed to other negatives through trade diversion and increased transaction costs. In other words, in terms of our external trade policy, we potentially face a no-win situation: this sharpens our need to take any measures that can enhance unilaterally our economic performance and competitiveness.

On the domestic front, we face two looming challenges that add to the productivity imperative. One is environmental sustainability. Dealing with the legacy of (unwitting) environmental mismanagement will demand additional resources in rectification, and policy reforms which will involve adjustment costs, much of which may be concentrated in regions that are already ‘doing it tough’.

Secondly, while Australia has benefited from a relatively high engagement of its population in work, the demographics of our ageing society — with a doubling of the proportion of people over 65 years of age by 2040, as people

live longer and procreate less — will reduce per capita income growth for given productivity growth, while potentially raising the costs of health and other services.

So plenty of challenges lie ahead for a new generation of economists to tackle. In some areas, past reforms will provide useful guidance, and indeed there remain parts of the existing reform program that need to be completed. These include remaining industry protection (including some contentious non-tariff issues raised in the current AUSFTA negotiations), the National Competition Policy (water reform being particularly important) and industrial relations reform.

However, there are a number of critical areas for the future which present new complexities for reformers and few ‘off-the-shelf’ or ‘tried-and-true’ solutions. These include:

- getting the best out of Australia’s ‘social infrastructure’— health, aged care and other community services — which account for a sizeable and growing share of GDP and are key to future living standards;
- raising the performance and accessibility of our education and training systems — primary, secondary and tertiary — particularly given their importance in deepening Australia’s human capital, on which innovation and economic growth will increasingly depend;
- raising the participation in employment of the Australian working-age population, including by reducing long term unemployment (the major contributor to poverty) and premature ‘retirement’ from the workforce;
- related to this, devising better mechanisms to ease social hardship, including from job losses associated with policy change, without detracting from economic performance; and
- devising better mechanisms for redressing and avoiding adverse environmental side-effects of economic activity.

Such areas are difficult to deal with because of the blend of social and economic objectives that arise, but they are problems for which an economist’s training — in systematically analysing the role of incentives on human behaviour and the necessary tradeoffs in all policy choices — is apposite.

I therefore wish you well with your studies and look forward to your future contribution to sustaining the Australian ‘miracle’.