SHANN MEMORIAL LECTURE
THE CHANGING FOCUS OF GOVERNMENT ECONOMIC POLICIES

by

Ted Evans

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DEPARTMENT OF ECONOMICS
THE UNIVERSITY OF WESTERN AUSTRALIA
35 STIRLING HIGHWAY
CRAWLEY, WA 6009
AUSTRALIA
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It is a pleasure for me to present the 2001 Shann memorial lecture, in honour of Edward Owen Giblin Shann and of his long contribution to the development of economic thought; and, incidentally, of this University.

I don't know whether I am the first in the now long list of distinguished presenters of this annual lecture who had had no prior association with Shann's writings - or simply the first to admit it. Having now corrected that omission in preparation for this event, I can only say that my professional life would have been considerably easier had his essays come to my attention a few decades earlier.

As it is, I have found his general line of thinking very much in accord with that which I have absorbed over a long period - much of which was taught to me by others who, no doubt, reflected Shann's earlier development of the ideas. But nowhere have I seen the thoughts expressed with such clarity, and generally with such force, as in Shann's own material1.

And it is more than a little disarming to find that notions which we thought we were developing, *de novo*, had been the subject of Shann's essays almost a century earlier: not to mention the subject of intense policy and political debate at the same time - the appropriate price of labour being a case in point. It does appear that there is nothing new under the sun.

*Prepared as The Shann Memorial Lecture for 2001 and presented at the University of Western Australia, 25 September 2001.
1A readily available selection from Shann's "An Economic History of Australia" may be found in M.A.B. Siddique "A Decade of Shann Memorial Lectures 1981-90 & the Australian Economy", 1993.
Moreover, the core principles with which he dealt remain as relevant today. Nowhere is this more striking than in his unshakeable belief that market forces will prevail – no matter to what lengths we might go to in search of a different outcome. I no longer have any doubt that this will be the case also in another century’s time; reading Shann’s essays has helped me consolidate that conclusion.

Against that background, I should like to offer some thoughts on the changes I have observed in the focus of economic policy over the past thirty years.

**ECONOMIC PERFORMANCE**

It has been a period of contrasts in Australia’s economic performance – with the decade of the Seventies representing one of the century’s worst and the Nineties one of the best; and lying behind that contrast is the triumph of good policy making.

Just how good was the economic performance of the 1990s?

About as good as it gets: a prolonged period of strong growth and low inflation, with unusually high productivity growth the source of both outcomes; and when one looks beyond the transitory effects on both growth and inflation of the changes to Australia’s tax system, the good performance of the 90s is continuing today. Moreover, this performance has been achieved at a time of considerable underperformance in much of the rest of the world and, at times, particular upheaval in our immediate region.

We have, of course, entered a period of heightened international uncertainty following the recent acts of terrorism in the United States. But as unpredictable – and in this case, horrific – as such events are, they do not affect the fundamentals of government economic policy formulation. They may cause setbacks – losses – that might call for government response in certain respects. For example, insurance of private property and persons against such acts can be properly classified as public good provision: a clear
element of Defence expenditure. But beyond that, such events have no on-going implications for policy formulation.

Returning to Australia’s improved performance through the 90s, I believe it is fair to say that there was no single source: it reflected the combined effects of a long series of policy improvements which came together throughout the decade in a mutually reinforcing fashion: heightened competition in both product and factor markets made macro-policies more effective; and improved macro settings brought greater certainty to market-based decision-making.

It would be wrong to single out any particular policy action as the prime source of the improved performance. But it is certainly the case that several made critical contributions: among those were tariff reform and competition policy more generally; reform of the fiscal policy framework; improvements in the conduct of monetary policy; and, perhaps most importantly, reform of labour market arrangements.

Concluding that success is the result of a multitude of policy improvements may not be very satisfying: it may not appear to provide much guidance to our future or to other countries that might also wish to improve their performance. But satisfying or not, it is the right conclusion; and, as I shall suggest later, it is the very type of advice that others need.

Before turning to others, however, should we be satisfied that we have done enough in terms of policy reform?

The very fact that we live in an ever-changing world is sufficient to answer that in the negative – though there might also be other reasons for doing so.

MACRO

Certainly the macroeconomic policy framework is in better shape than it has been in living memory. Australia’s fiscal position, measured in a balance sheet sense, is one of the world’s strongest; and the fiscal framework, with its concentration on the medium term
rather than on annual budget figures, is an important safeguard against structural slippage. A downturn in the economy could certainly see the budget move into temporary deficit but that, of itself, would not be a worry. It is the essence of the framework, and the improved balance sheet position that has been achieved, that such cyclical shifts can now be accommodated without concern.

Moreover, there is now once again scope for discretionary fiscal policy, should that be required (note that this is recognised in the Charter of Budget Honesty legislation introduced by the current Australian Government). The notion that fiscal policy is impotent derived primarily from experience in many counties where such policy has been attempted in conditions that cast doubt on its sustainability—meaning, primarily, the ability of the governments concerned to meet the ensuing debt without a significant decline in market conditions.

Japan is a prime example among the industrial countries, though there are more extreme versions amongst less developed economies. But the Japanese example is of interest from many perspectives. In particular, it illustrates how adopting the wrong solutions can intensify economic difficulties. Japan has had acute structural problems for well over a decade. The attempt to address the symptoms by expansionary fiscal policy, repeatedly with pressure from her G7 colleagues, has simply prolonged the day of reckoning.

Returning to Australia, it is also notable that the fiscal performances of the State governments are now universally better than they were a decade ago. I believe it is fair to say that we can expect reasonable fiscal performance of any Australian government for the foreseeable future—at least until memories fade.

The monetary policy framework, and policy execution, are also more settled, even if much remains to be done to improve our understanding of monetary transmission mechanisms. But this topic has been well covered by others so I won’t dwell on it, beyond noting the contribution that fiscal consolidation has made in relieving the pressure on monetary policy and reducing the temptation to resort to monetary adjustment for purposes for which it is ill-suited—such as addressing external imbalances.
A prime consequence of this better balance of fiscal and monetary policies is that Australia's exchange rate has been permitted to find its own level rather than being artificially inflated by inappropriate monetary settings; and one consequence of that has been the emergence of better, more sustainable, balance of payments outcomes – though that improvement, I suspect, has still a long way to run.

THE EXCHANGE RATE REGIME

I can't think of a topic that has been more frequently debated over the past thirty years than that of the most appropriate exchange rate regime for particular countries or types of economies. Typically these debates are prefaced with the confident assertion that the choice of exchange rate regime is critical to a country's success.

The facts, however, are otherwise: the choice of exchange regime appears to be irrelevant to success. There are numerous examples of economies functioning well over long periods with fixed exchange rate regimes – though probably more to the contrary. Equally, there are many examples of countries faring poorly with floating rate regimes – though, again, probably more to the contrary.

A recognition of these uncomfortable facts has led many to postulate that it is not the regime, per se, that is critical but how well the regime choice fits with the country's stage of development; most particularly, with the development of its financial markets, institutions and related regulatory systems. There is more to be said for this formulation. But, again, uncomfortable facts intrude: for we find repeated examples of regimes with lengthy successes behind them nevertheless failing when external circumstances alter.

The common element in the failures, on my observation, has not been the exchange rate regime choice, or the stage of economic development, but the view on the part of the authorities that the exchange rate itself should not be the rate that the market for the time being is seeking; and the authorities' attempts to achieve their preferred rate is typically greeted by the markets as an invitation to turn a short-term profit. The ensuing tussle
invariably leads to sharp shifts in the rate — typically referred to, rightly or wrongly, as ‘overshooting’. Effectively, the outcome is an admission of the authorities defeat.

It has to be said that the economics profession, much less financial market participants, does not have an adequate understanding of what determines exchange rates. Certainly the ability to forecast exchange rate movements is close to zero. However that may be, it should by now be recognised that the markets will determine exchange rates regardless of the efforts of authorities to the contrary — a conclusion with which Shann was quite comfortable a century ago.

That is not to say that the quality of domestic economic policies and of economic and financial institutions will not affect exchange rate outcomes. Clearly they will. But they will do so via market assessments and perceptions. So there is a clear role for transparency and for informed debate.

There may also be a role for improved market regulation. It is certainly the view of many that some market participants can have an undue influence on the market — hedge funds and the like. Curiously, this view is most prevalent among those central bankers who simultaneously believe that they should have an unfettered ability to also influence the market and hence the exchange rate. That curiosity aside, there may well be a case for examining ways of changing the apparent ultra short-term focus of exchange market participants — a thought that underlay Tobin’s idea of ‘putting sand in the wheels’. Interestingly, I notice that the IMF in recent weeks, and for the first time in a very long time, has expressed a willingness to re-examine Tobin’s ideas.

Until such thinking bears fruit, which may not be this century, it would be wise to stick with Shann’s view regarding the role of the market. We may well think that our exchange rate should be higher. And a forecast that it will be may turn out to be correct. But it would be unwise indeed to base policy on either the aspiration or the forecast.

Rather, policy should be focussed on the fundamentals including, importantly, improving the operation of markets.
LABOUR MARKETS

Nowhere is this more evident, and nowhere has structural reform in Australia been more important, than in the operation of labour markets.

The 1990s in Australia witnessed strong growth in output, in productivity and in employment – and hence reductions in unemployment. This highly desirable conjuncture owed much to labour market reform.

There may be some who will want to claim that the employment outcomes were simply the result of strong output growth. That simplistic response, however, begs the question of how that growth occurred without ‘speed limits’ being reached and growth being brought to a halt – as so typically had occurred throughout our post-War history. The answer, of course, is that the improved labour market operation yielded better price and quantity resolutions, avoiding inflation while ensuring jobs growth. In particular, growing experience with enterprise bargaining led to wage and conditions agreements more in keeping with the sustainability of the individual enterprise.

Will these favourable results endure as labour markets continue to tighten? One cannot give an unequivocal answer to that – as it will depend on how determined the parties are to give priority to jobs growth – but, in principle, there is adequate flexibility in current arrangements to achieve continuing good outcomes. Should that not prove the case, the answer will lie in further market deregulation.

Enterprise bargaining could also provide an appropriate response to the vexed issue of workers’ entitlements in cases of enterprise failure. This is not a new issue by any means; but there has long been a tendency – perhaps not unnaturally – for parties to heavily discount the probability of such events: a classic Australian ‘she’ll be right’ attitude.

While entitlements might be safeguarded by legislation, this will come at a cost to the enterprise, most probably through higher capital costs as secured creditors are asked to take second place to workers; and the ultimate cost will be lower employment than otherwise.
Given those potential costs, it is not clear why enterprise bargaining does not offer the most appropriate solution: let workers decide in advance whether they value such entitlements sufficiently to have them enter enterprise bargaining alongside other benefits and conditions.

It would seem a backward step, detrimental to the operation of the labour market and the strength of the Australian economy, to put windup entitlements outside of the scope of enterprise bargaining or individual workplace awards.

More substantial labour market issues are looming.

It is now common knowledge that Australia’s population growth, like that in most of the Western world, is slowing significantly, with labour force growth slowing likewise. Barring significant changes in immigration rates, the demographic forces now in train will see labour force growth approach zero over the next three to four decades.

One early result of these trends might be lower unemployment rates than we have had over the past few decades. But that result is far from assured. It will require, at least, continued freeing-up of labour markets to ensure that the more slowly growing labour supply is directed to the most productive uses. It will require also a reduction in those disincentives to work that are imposed by tax and social security arrangements.

More generally, we will need a change in the mindset that sees a prime role of governments as being to ‘create’ jobs. With labour in less ready supply, governments (and others) will need to revert to the classic economic problem of satisfying competing ends with limited resources.

A welcome casualty of this change will be the process of governments’ ranking projects according to the number of jobs they allegedly ‘produce’ – and, often, of providing government assistance accordingly. While such processes might be excused, if not justified, when labour appears in excess supply, as that supply diminishes, the fundamental weakness of the approach will become apparent.
Increasingly, we will need to give attention to using labour (and capital) more productively – an issue that reaches backwards into the education and training processes that produce labour skills.

OTHER STRUCTURAL ISSUES

This general issue, using resources more productively, has been the essential generic factor underlying the economic reforms of the past two decades – and is likely to be the main policy focus for at least the next few.

One might recall here Shann’s observation, in 1927, regarding public investment:

‘Public works are excellent things, but only so long as the balance is preserved between capital and earning power, between equipment and its use in furthering production.’

No student of economics would take issue with the principles there espoused by Shann. But, today, we would be as likely to think of them as much in relation to private investment as to public works. That reflects the now long history of private investment failure in all economies around the world; and although we accept failure as an expected element of a risk-based economic system, most of us, are nevertheless at least a little unnerved when we see the collapse of an investment the size of, say, Ansett.

I have no knowledge of why Ansett failed beyond that publicly available from the media, which currently stops well short of identifying causes. It may not be particularly helpful to say that it was due to ‘bad management’ though that is certainly the case - indeed it is almost tautological. It is also almost certainly the case that the management failures occurred over a long period; the sheer magnitude of the losses is a pointer to that.

One aspect of interest from a public policy perspective is why failures occurring over a long period did not come to light earlier; it is not drawing too long a bow to detect
similarities between the collapse of Ansett and that of the USSR: both substantial management failures, with the results hidden from stakeholders over very many years.

Obviously, there is a failure of disclosure requirements and a need for improved transparency. But more fundamentally, there is a failure of corporate governance – a failure of Boards to keep themselves, let alone others, properly informed. This, incidentally, has nothing to do with foreign ownership; and the problems will not be fixed by Australian ownership. Rather they go to the quality of Boards and the role that they play, or should be expected to play, in the fortunes of a company – to repeat Shann’s words, in ensuring that ‘balance is preserved between capital and earning power’.

Improving the quality of corporate governance will require more than the application of economic principles, though they must play a role as, increasingly, they must in diverse fields.

To note one such example, we can expect to see a greatly increased role for economic principles in dealing with environmental issues.

Not all will agree that economic growth is good for the environment – for the good reason that such a statement is often at odds with the facts. And the response that growth provides the means of addressing environmental issues is far from convincing. What is more certain is that we are unlikely to find adequate solutions to environmental problems without the application of economic principles, particularly in respect of pricing.

Is it really any wonder that resources such as land, air and water are misused when they carry a zero price tag? The fact that that is the price set by the market should not long detain us, for we are dealing here with resources whose use creates externalities and which therefore require an element of public good pricing. That does not preclude the possibility that markets might still provide the best pricing mechanism but it does require that there must be public involvement – ie government involvement - in setting the market rules.

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Does this represent a departure from Shann's principles? I don't think so. It simply reflects the requirements of having a properly informed market. In this case one that accounts for externalities and the long-term effects of resource use.

INTERNATIONAL ISSUES

Though I have been speaking here primarily about Australia, most of the thoughts are as relevant elsewhere; indeed many are based on observation of other countries’ experience.

But answers to questions of why countries unexpectedly get into difficulties, and of how best to address those difficulties, remain elusive.

In the wake of the Asian financial crisis of the late 1990s and the less than satisfactory international response to those events, the issue of appropriate responses has been hotly debated in international forums. One element of that debate has been whether the policy response should concentrate on macro policies or structural reforms. In part, this attempted dichotomy is driven by the observation that implementing structural reform in a crisis situation is extremely demanding, with the probability of success being fairly low.

To my mind, this debate has been futile from the outset. If the problems are structural, they simply will not be addressed by a macro policy response – the more so if this is not the first attempt to do so: recall Japan. Hence structural responses will typically be required, regardless of how difficult their implementation might be.

The policy advising skill lies in determining which structural reforms are necessary, what the priority and timetable for their implementation should best be, and what the political capability of the authorities is. Answering all of those difficult questions in a crisis situation, starting from scratch, is most unlikely to prove successful. That, indeed, has been the essence of the IMF’s limited success.
Of course, the IMF does not start from scratch. For three decades, and partly reflecting prior experience, it has conducted surveillance of its members' economies and policies on at least an annual basis. But the quality of that examination has often left a lot to be desired, an observation supported by the Fund's lack of preparedness when crises have occurred.

This is not a comment to be made lightly. In my experience, it is extremely difficult for 'outsiders' to get a full and proper understanding of a country or economy; particularly when that extends to an understanding of the political capacity of the country's leaders to undertake what will invariably be politically demanding action – action that those leaders have probably been knowingly avoiding for that very reason. Such assessments do not come readily, and certainly not without a long period of preparation, preferably with the country's cooperation.

But, as simple or unnoteworthy as such a conclusion might be, it is the right conclusion – the simple importance, to use the Australian vernacular, of doing the hard yards.

CONCLUDING REMARKS

Let me conclude by simply drawing a few threads together.

The 'shifting focus' of government economic policies refers simply to the predominance these days, of microeconomic issues.

- Fiscal policy is now in safe custody; and monetary policy has been largely relegated to the bureaucrats.

- Microeconomic issues, however – the question of the most productive use of resources – are at the core of most government policy, regardless of the level of government.

- And market resolution of the issues is increasingly the preferred route.
The prime role of government lies in ensuring that markets are properly informed and otherwise determining the rules of market operation.

Edward Shann may have baulked a little at the currently perceived need for market regulation but otherwise, I believe, would see little in today's economy to either surprise or greatly concern him.
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