

Prospects and Policies for Employment Growth in Australia and Queensland: A Macroeconomic Perspective

By

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1. INTRODUCTION

In September 1994, when the national unemployment rate was 9.5%, I wrote in the Courier-Mail that, if Australia could average about 4% economic growth per year for the rest of the decade (what I considered to be 'a big ask' at the time), about the best unemployment rate which we could nonetheless hope to see registered by the end of the 1990s would be around 6.5%. A number of commentators at the time considered this to be a very pessimistic position. As it turns out, it was unfortunately a little overly optimistic.

Now, after seven years of uninterrupted economic growth, Australia still has unemployment above 7%. Is this socially and economically acceptable? No! Can we do better? Yes! Can we achieve an unemployment rate of 5%? Yes, but only if we really want to! Let me elaborate.

In unemployment debates you often hear the term, 'the structural rate of unemployment'. It is meant to convey the notion that, in a dynamic economy, subject to technological change and innovation, with thousands of companies, in dozens of industries, producing hundreds of thousands of goods and services there will always exist some level of structural and frictional unemployment as inevitable dynamic adjustments occur to underlying demand and supply conditions. However, I would hope that, even in a very dynamic economy, structural and frictional unemployment in the medium to longer term should amount to no more than about 5%. Of course, the speed with which newly unemployed people are absorbed back into employment will depend on the labour market institutions adopted by different communities.

In this regard, it seems fairly clear that countries with very rigid labour market institutions tend to have higher rates of unemployment. A number of European countries - France and Germany in particular - with persistent double digit unemployment rates over many years are examples. Other European countries, like the Netherlands, Denmark, Ireland and Britain, which have recently moved to free up their labour markets, have been much more successful of late in getting their unemployment rates down. And of course the US, which is considered to have about the most flexible labour market in the world, also has a very low unemployment rate.

This suggests that a nation's medium to long term unemployment rate - as opposed to short term cyclical unemployment arising on account of the business cycle - may largely be one of choice. To the extent that this is true, we should choose as a community a set of macroeconomic and microeconomic policies and labour market institutions which can allow unemployment to return reasonably quickly to around the 5% level (or better) during economic expansions. This would seem to be a worthy public policy objective and one which I believe it is possible to achieve.

Another term often used in debates about unemployment - and considered by some to be largely synonymous with the structural rate - is the so-called NAIRU (the 'non-accelerating inflation rate of unemployment'). In the US, only a few years ago, analysts used to speak of the US NAIRU as being somewhere around 6%. However, the US unemployment rate has been around 4% now for quite a while with little sign yet of inflation breaking out! In Australia, only a couple of years ago, researchers estimated our NAIRU at over 8% and yet unemployment here has been below that for

quite a while now with virtually little or no sign of inflation breaking out. Most recently, Australia's NAIRU is now estimated to be 6.5%. Here again, the evidence suggests that a country's NAIRU is not some immutable constant of nature. It can certainly be impacted – favourably and unfavourably – by the policies (labour market and other) a community chooses for itself. Personally, in my view, there is no reason why inflation necessarily needs to become a policy problem at unemployment levels below 6.5%. Again, however, it requires Australian policymakers to choose to employ appropriate policies to bring this about.

In sum, one might say that, as a result of policies we have chosen to adopt, over the final two decades of this century Australia has experienced average unemployment rates in excess of 8%. However, I hope that the policies we may choose to adopt now and into the future will produce a better and much healthier result of 5-6% over the first two decades of the new century.

In what follows I will try to sketch out a set of economic policies (or at least policy approaches) which I believe may assist us in achieving this objective. The outline of the paper is as follows. In section 2 I present and discuss some recent employment and unemployment history. The following section comprises a discussion of other aspects of our economic performance. Section 4 discusses prospects for economic growth and unemployment while the last section presents a suggested policy prescription.

2. SOME EMPLOYMENT AND UNEMPLOYMENT HISTORY

The first point I would like to make is the obvious impact of the business cycle on unemployment. As a result of the 1974 recession unemployment ratcheted up from 2% to 4% (See Figure 1). It then ratcheted up again to around 6% as a result of the 1977 recession, staying at that level until the onset of the next recession in 1982. It then rocketed up in less than two years to just over 10% and it subsequently took over six years of economic growth to return it back to the 6% level. The onset of the 1990 recession (the one 'we had to have') again took the unemployment rate back up to just over 11% in the space of about two years, and now even after a full seven years of economic expansion it is still above 7% (nonetheless this does represent a reduction in the unemployment rate of 4 percentage points from June 1992 – June 1999).

A similar pattern is evident for QLD (See Figure 2) although the measured unemployment rate has persistently been above that of Australia for most of the last two decades with the most recent rate estimated at just over 8%. This persistently higher unemployment rate in QLD has been largely the result of a significantly higher workforce participation rate in QLD compared with the rest of Australia over the last 10 years or so.

As I will argue later, this unemployment history provides very stark motivation for trying to get our macroeconomic policies (ie monetary and fiscal policies) right. To ameliorate the obviously extremely serious deleterious impact of the business cycle on unemployment, sound macro policies are clearly absolutely crucial. I mentioned the relatively high workforce participation rate in QLD. This results in a relatively higher measured rate of unemployment in QLD despite very strong growth in employment compared with the rest of Australia. In recent years QLD's participation rate has averaged around 65% whereas in the rest of Australia it has been just under 63%. To illustrate the impact that this higher participation rate has on measured unemployment despite the strong jobs growth in QLD, if we mechanically use the same participation rate as applying in the rest of Australia, the same jobs growth experienced here over recent years would result in a measured unemployment rate of 5% at present!

Of course, not too much should be read into this type of calculation since it assumes that the observed jobs growth is invariant with respect to the participation rate itself. In reality, a quite complex interrelationship exists among a community's demand for goods and services, production, the ensuing demand for labour, desired workforce participation, and the final resulting measured rate of unemployment. Notwithstanding this, and again for illustration purposes only, and certainly with the same strong caveats applying, recent jobs growth nationwide would coincidentally produce a current measured unemployment rate of 2% if one used the 1960s national workforce participation rate (about 60%, compared with recent national participation rates of around 63.4%). Nonetheless, at best I suppose such calculations are mainly of novelty value only, and may simply be yet another example of that old (slightly amended) maxim that there are 'lies, damn lies and unemployment statistics'.

Moving now to employment growth.

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As can be seen from Figure 3, after a slow start, there has been a reasonably large number of jobs created during the current expansion which began in June 1992. Actual employment growth over this time has amounted to 15%. In QLD, jobs growth has been even more impressive and has amounted to 24.5% up to May of this year (See Figure 4). Despite the number of jobs created in QLD over the last seven years, as noted earlier, the high workforce participation rate here means that QLD's unemployment rate remains well above the nation's.

It is of interest to compare the employment and unemployment performance of Australia and QLD with that of the US.

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In the latter part of the 1960s the US experienced unemployment rates around 4% (as opposed to 2% in Australia) and in the last few years of the current expansion it has managed to get unemployment back down to these levels. Again, as can be clearly seen, each US recession had a rapid and substantial impact on unemployment. Of particular interest is the US experience in the last two recessions. In the early 1980s US unemployment peaked at almost 11%. This was actually higher than Australia's unemployment peak at the time of just over 10%. Before the onset of the 1990 recession US unemployment had been reduced to just over 5%. This is quite comparable with Australia's low of around 5.8% just before the onset of our own recession in 1990.

The major difference between the two countries in fact is that the 1990s recession was extremely severe in Australia compared with the US. Whereas our unemployment rate was pushed up to 11.2%, the US rate only went up to a maximum of 7.8% in June 1992. Since then the US has reduced its unemployment rate by 3.5 percentage points whereas Australia has actually reduced its unemployment rate by a full 4 percentage points. The US employment picture during the current expansion is also interesting in comparison to Australia's. Since June 1992 the US has experienced 12.7% employment growth. You will recall that, over the same period, Australia actually experienced 15% employment growth – a significantly higher outcome.

Thus, while the US is widely considered around the world to have performed remarkably during the 1990s, Australia's performance in terms of economic growth, labour productivity growth, inflation, employment growth and unemployment reduction I would say is actually superior. This, plus Australia's success in withstanding the firestorm of the Asian economic and financial crises, is no doubt why the eminent international economist, Paul Krugman, referred to Australia as a 'miracle economy'. The US employment performance is all the more interesting as the flexibility in the US labour market institutions is often mentioned as the prime reason for its lower unemployment rate than that of Australia's. This conclusion would seem to be somewhat moot.

3. OTHER ASPECTS OF AUSTRALIA'S RECENT ECONOMIC PERFORMANCE

Figure 7 shows four decades of per capita economic growth for Australia and the OECD. As can be seen, despite the view that the 1960s has often been considered the high point of Australia's economic performance, it has only been in the 1990s that Australia has actually out-performed the rest of the OECD.

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Figure 8 presents a different aspect of this story. Three measures of productivity are presented – labour, capital, and multifactor productivity – from the mid-1960s to last year. Three things are striking. First, over the last four years labour productivity growth has been running at a higher rate than at any time over the last four decades. Second, capital productivity growth has actually been negative over this four decade period except until the second half of the 1990s! Third, multifactor productivity growth is now also running at the highest rate seen over the entire period. Indeed, it is currently about 65% higher now than the next highest performance in the early 1970s.

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Figure 9 demonstrates Australia's recent remarkable performance on the inflation front. From the regular double digit inflation of the 1970s, to inflation averaging around 8% per year in the 1980s, the average inflation rate for the 1990s will certainly be just over 2%. Importantly, inflationary expectations have now also come down considerably although they still remain quite a lot above actual inflation.

Figure 10 depicts the dramatic reduction in Australia's interest rates, both in terms of their level and in comparison with the US. During the second half of the 1980s the US-Australia differential averaged over 400 basis points whereas over the last few years it has been mostly less than 50 points, and sometimes very near parity.

Figure 11 is a final vivid indication of Australia's achievement in withstanding the 1997-98 Asian economic and financial crises. Despite almost two thirds of our trading partners going into recession during this time our economy continued (and is continuing) to perform exceptionally well.

I would argue strongly that this very good economic performance was no accident. It was very much the result of very sound monetary and fiscal policies employed over the last few years as well as the accumulated impact of the past 15 years of microeconomic reform. If not for these policies I am almost certain that Australia would also have gone into recession sometime during the last two years along with many of the other countries in our region.

Some of the major policy reforms over the past 15 years have been:

- Floating of A\$, removal of foreign capital controls, deregulation of Australia's domestic financial system, entry of foreign banks into Australia
- Much reduced levels of import tariff protection
- National competition policy agenda
- Labour market reforms
- And now major taxation reform.

There is no room in this paper to go into a detailed discussion of the policy imperatives behind these reforms except to say their overall objective was to make the Australian economy more flexible, open, competitive and efficient. However, the real benefits took quite a few years to flow through and it was really only in the mid-1990s that the fruits started to be richly in evidence. The overall result is that Australia in the late 1990s is a much more flexible, competitive, and outwardly focussed economy compared with the late 1970s. This has probably also occurred just in time given the sort of world we are likely to be living in as we enter the next century.

On the monetary policy front, in 1993 the RBA adopted an informal inflation target of "2-3% for underlying inflation over the business cycle". This was made a formal official monetary policy objective in 1996 when the "Statement On the Conduct of Monetary Policy" was signed by the Treasurer and RBA Governor. The RBA is now viewed internationally as having considerable policy independence and credibility as far as maintaining a low inflation environment in Australia. This has had tremendous benefits to the Australian economy in terms of low inflation, low interest rates, a stable business decision making environment, moderate wage growth, and the more productive use of available capital.

Recently an explicit medium term objective for fiscal policy has also been articulated by the authorities, viz. "to maintain fiscal balance, on average, over the course of the business cycle." This should allow fiscal policy to be appropriately expansionary in downturns but to be tightened again once recovery is underway. In the past, it has been allowed sometimes to contribute to excess demand pressures in the economy which has led to inflation, interest rate, and current account deficit (CAD) concerns. These concerns in turn have often precipitated the subsequent recession.

4. PROSPECTS FOR ECONOMIC GROWTH AND REDUCED UNEMPLOYMENT

Sound fiscal and monetary policy frameworks have allowed Australia to maintain much lower levels of inflation and interest rates as compared with earlier periods and this was a major factor in Australian domestic demand remaining remarkably buoyant over the last two years. Unfortunately, as we all acknowledge, we still have the

challenge of too high a level of unemployment in Australia. Sound macroeconomic policies can certainly help ameliorate the evident deleterious effects on unemployment of earlier boom/bust cycles.

What about economic growth prospects for the next couple of years – internationally and domestically? I think the international economy will fare better in 99/00 than the 2 – 2 ¼% recently predicted by Federal Treasury. Given developments in Japan, the rest of East Asia, the continuing performance of the US, and likely improvements in the EU, I think this will prove to be a significant underestimate. Domestically, again I think the impact of apparently very subdued investment intentions is overdone. The most likely outcome for Australia's growth in 99/00 I think is to comfortably exceed the 3% forecast by Treasury. For the year after, at this stage, I see no reason to doubt that Treasury's projection of 3 ½% will be achieved.

There are a couple of risks to this scenario, especially on the international front. First, some commentators are concerned about the possibility of a major correction in the US stockmarket and the impact that may have on that country's real economy and, thereby, on the rest of the world. A second risk, again relating to the US, is an apparent increase in protectionist attitudes. Hopefully, such protectionist inclinations will in the main be resisted by policymakers. An international switch to protectionism would be very negative for Australia.

Will another few years of reasonable economic growth be enough to get unemployment back down to 5%? Some commentators think so, and perhaps the microeconomic reform of the past 15 years, along with the impact which technology has had on production processes, has lowered the NAIRU to such an extent that inflation will remain benign as further growth continues to have favourable impacts on unemployment. However, in order to get to the 5% mark by the end of 2001, annual economic growth would have to be enough to allow employment to grow at twice the rate of growth in the workforce. With labour productivity growth of say a conservative 2% per annum, and the workforce growing conservatively at, say, 1% per annum, this would require the economy to continue to grow at 4% per annum for the next two and a half years until the end of 2001. While not impossible, this is a big ask given our post-WWII economic experience.

In the case of QLD, if we reasonably assume a higher workforce growth of, say 1.5%, and because we are starting from a higher unemployment rate now, the same labour productivity growth would require annual economic growth of 4.5% for 3 ½ years through until the end of 2002 to get down to the 5% mark. Again, this is not impossible but I think most would probably agree that it is not highly likely either.

At best, hoping for such strong economic growth alone for these sorts of periods – with no additional policy initiatives - is a risky strategy to achieve the 5% target nationally and in QLD.

5. A SUGGESTED POLICY PRESCRIPTION

Therefore, to get unemployment down to 5% or below, I believe we will not only need reasonable international and local economic growth for the next couple of years but

we will also need to continue the economic reform process; in particular, labour market, social welfare and taxation reforms.

In particular, the policy approach I would recommend for consideration would be as follows.

1. At the macroeconomic level, monetary policy must be forward looking and must continue to target an inflation rate of 2 – 3%. However, provided forward and current indicators of inflation are benign, robust economic growth alone should not be a reason for applying monetary brakes, nor should reductions in unemployment down to or below 6.5%, and nor should a current account deficit in excess of 6% be grounds for tightening monetary policy.
2. Fiscal policy should continue to be set so as to achieve fiscal surpluses to contribute to Australia's national saving, to retire government debt, and to allow interest rates to remain as low as possible.
3. GOEs should continue to be reformed where appropriate to improve their efficiency.
4. Competition Policy reform should be continued.
5. Protectionist tendencies should be resisted and tariff and other import barriers should continue to be reduced.
6. Taxation reform including: measures to assist access to venture capital; CGT reform; reduction in the corporate tax rate; reduction or removal of payroll tax.
7. Industry policy: resist industry-specific measures; if assistance is deemed necessary to overcome market imperfections, then provide it across-the-board; re-introduce the 150% R&D tax incentive; provide more government funding for training and education; government should invest more in basic research by universities; government investment in physical infrastructure and the provision of appropriate legal infrastructure.

Specific Labour Market Initiatives

The cost of labour matters. This was demonstrated, among other ways, by the 1980s Accord and its impact on the 1970s real wages overhang. Therefore, we should seriously consider proposals such as some form of wage/tax trade-offs, training or youth wages, and the possibility of wage subsidies for the LT unemployment.

We should also do what we can to create incentives to encourage the unemployment to re-enter employment as quickly as possible by, for example: looking at the tax/welfare interface to reduce/remove so-called poverty traps; considering re-employment bonuses for the LT unemployment re-entering the workforce; continuing the work-for-the-dole scheme and the other aspects of the principle of mutual obligation which aim to improve the work-readiness of the unemployment including compulsory training, education or intensive job search.

Of course, the other side of the equation is that jobs have to be on offer. The demand for labour is obviously a function of production levels, labour productivity, and the relative cost of labour in comparison to capital. We need to look continually to see if there are any ways we can induce even greater flexibility into our labour markets. The move towards enterprise - or even individual workplace - agreements has already produced significant dividends. This needs to continue and for the system in total to allow even greater varieties of creative individual workplace agreements. Recognising that a very large percentage of employment in Australia, and particularly in QLD, is generated by SMEs we need to be careful to ensure as few as possible legislative barriers to hiring are erected. Unfair dismissal laws are a case in point. Whilst grounded on the best of intentions, in practical terms, such laws can work to provide a very significant deterrent to small businesses taking on new staff.

6. CONCLUSION

Reducing unemployment down to 5% is a very worthy community and public policy goal and I believe it can certainly be achieved. However, it will require us, as a community, to commit to a set of policies which can bring it about. In this paper I have argued the case for what I believe is the best way forward.

Firstly, and very importantly, fiscal and monetary policies must be set so as to ensure Australia maintains a low inflation, low interest rate economy. Secondly, it is important for the community to recognise the great benefits which have flowed from the microeconomic reform process which has occurred over the last 15 years and for the community and policymakers now to stay the course. In particular, Australia should continue to open its economy to international competition to ensure its scarce resources are used in the most productive way and its firms and industries operate as efficiently as possible. Thirdly, government industry policy initiatives which operate across the board rather than ones which aim to assist particular industries are to be preferred. Examples would include R&D incentives, broad education and training initiatives, and the provision of the appropriate physical, regulatory, and other legal infrastructure to enable business to get on with the job of creating value and jobs. Fourthly, we should do all we can to allow Australian workplaces to be as flexible and efficient as possible to enable the quick adjustments needed in the global, dynamic, highly competitive and fluid international economy of the next century.

With the right policies and sufficient resolve I think it is reasonable to aspire to be in a position where, at the end of the first decade of the next century, and in the absence of a major international recession, we will be able to look back on a decade of Un which averaged 5-6%.