# ACHIEVING AND MAINTAINING FULL EMPLOYMENT

**THE 2007 SIR ROLAND WILSON FOUNDATION LECTURE**

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**KEN HENRY**

**SECRETARY TO THE TREASURY**

# ACHIEVING AND MAINTAINING FULL EMPLOYMENT [1]

Lady Wilson, Professor Chubb and distinguished guests. It is a pleasure to be with you this evening to present the 2007 Sir Roland Wilson Foundation Lecture.

An outstanding Treasury officer and Secretary to the Treasury, Sir Roland Wilson displayed a commitment to intellectual rigour, high ethical standards and an understated passion to improve the wellbeing of the Australian people. Those values continue to resonate strongly throughout the department some 40 years after Sir Roland's departure from it. That's another way of saying that this man left a legacy in the place.

This evening, I want to honour that legacy.

Sir Roland's period as Secretary to the Treasury, from 1951 through to 1966, is often described as a period of sustained 'full employment'. Today, the unemployment rate is once again low; not quite as low as it was in that earlier period, yet there is a larger proportion of the working age population in employment. People of my generation, who studied economics in the late 1970s and the early 1980s, have had to wait a long time to see what a 'full employment' economy might look like. But are we seeing what Sir Roland and his contemporaries saw? And do we worry about the same things? These are among the questions I want to spend some time addressing this evening.

Before that, however, I want to say something about Sir Roland's personal achievements.

Sir Roland was one of the outstanding leaders of his generation; yet he had a modest background. His parents, while providing a comfortable standard of living compared with the standards of the day, had limited formal education.[2] Sir Roland attended a state high school and, after excelling throughout his primary and secondary school education, won a scholarship to undertake a Bachelor of Commerce at the University of Tasmania.

Sir Roland consistently achieved very high grades at university, ultimately winning the 1925 Rhodes Scholarship for Tasmania. He was the first Tasmanian from a state school to win a Rhodes and the first with a commerce degree. His selection was not without controversy, being criticised strongly by some sections of Tasmanian society and academia. Among his alleged failings was the fact that he had not studied Latin and Greek! While initially dismayed by this criticism, with the

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[1] I would like to thank a number of my Treasury colleagues, and especially Dr Steven Kennedy, for their assistance in the preparation of this address.

[2] See Selwyn Cornish's 2002 biographical essay for more information about Sir Roland's early life.

support of friends and mentors such as Giblin, Copland and Brigden, Sir Roland took up the scholarship and went on to achieve considerable success in his post-graduate studies.

Ultimately, he obtained two doctorates: a D.Phil. from Oxford and a Ph.D. from Chicago. In Chicago, he studied under Professor Jacob Viner who, according to Selwyn Cornish, regarded Sir Roland as one of the two or three best students he had ever encountered. Sir Roland published a number of influential pieces of research in the early 1930s, including a very well received book on capital imports and the terms of trade, based on his Ph.D. thesis.

Sir Roland's subsequent professional career was also a great success. In 1936, at the age of 32, he became the Commonwealth Statistician, retaining that position until 1951 when he was appointed Secretary to the Treasury.[3] At age 47, he was the youngest Treasury Secretary until the appointment of Bernie Fraser in 1984. And, of course, following his Treasury career, Sir Roland went on to achieve considerable success in the commercial world, as Margaret Jackson's 2006 lecture reminded us.

Sir Roland's achieving a position of prominence and influence in Australian society is testament to the value of educational opportunity and a demonstration of the fact that that opportunity has existed in Australia for many years. Sir Roland was not alone – from Prime Ministers Menzies to Keating, more than half the departmental secretaries came from state school backgrounds.[4] These personal success stories illustrate an important structural feature of Australian community: a relatively high degree of upward mobility, based largely on merit; a key factor in promoting a socially cohesive, yet dynamic, society.

Even so, as the reaction to Sir Roland's Rhodes demonstrates, as little as 80 years ago, some of the rungs on the ladder of upward mobility were difficult to grasp. His efforts, and those of several of his contemporaries, helped to smooth the way for later talent.

Further evidence of Sir Roland's contribution can be found in his impact on attitudes to the value of tertiary qualifications in the public sector. In the 1920s and 1930s, graduates were excluded from the public service.[5] Sir Roland's appointment, in 1932, to a senior position in the Statistician's

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[3] From 1940 to 1946, Sir Stanley Carver acted as the Commonwealth Statistician while Sir Roland was head of the Department of Labour and National Service.

[4] Weller and Wood (1999).

[5] The public service did not begin graduate recruitment until 1933, limiting recruitment to 10 per cent of overall vacancies (Matheson, 2001). Lateral recruits such as Sir Roland were actively discriminated against to maximise the promotion opportunities of 'insiders'.

Branch of the Treasury – the first economist to be employed in the Commonwealth Public Service – led 'several members of the public service union' to call a strike and his appointment was criticised in Parliament.[6]

With the advent of the Second World War and the need for highly qualified officers to administer a wide range of complex tasks the recruitment of graduates became more common.[7] However, it was not until the 1960s that graduate recruitment in the public service began to increase rapidly.

Today, around 50 per cent of the Australian Public Service holds a university degree. Just 20 years ago the figure was around 30 per cent. The increasing popularity of higher degrees is even more remarkable: 20 years ago, 1½ per cent of public servants had a Masters Degree or Ph.D.; today, the figure exceeds 8 per cent.[8]

## UNEMPLOYMENT AND ECONOMIC POLICY

A defining characteristic of Sir Roland's period as Treasury Secretary was sustained low unemployment. From the end of the Second World War until 1974, the unemployment rate never rose above 3.2 per cent. Many consider this a golden period, not only because of an apparent abundance of job opportunities, but because it was book-ended by periods of high unemployment – and the misery and uncertainty that accompanies macroeconomic failure.

Australia was among the countries most severely affected by the Great Depression and, with the unemployment rate rising to almost 20 per cent, suffered the worst labour market downturn of all western countries with the exception of Germany.[9] The misery thrust upon a young nation shaped economic policy for the next half century; especially in the prominence accorded the pursuit of full employment.[10]

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[6] Cornish (2002).

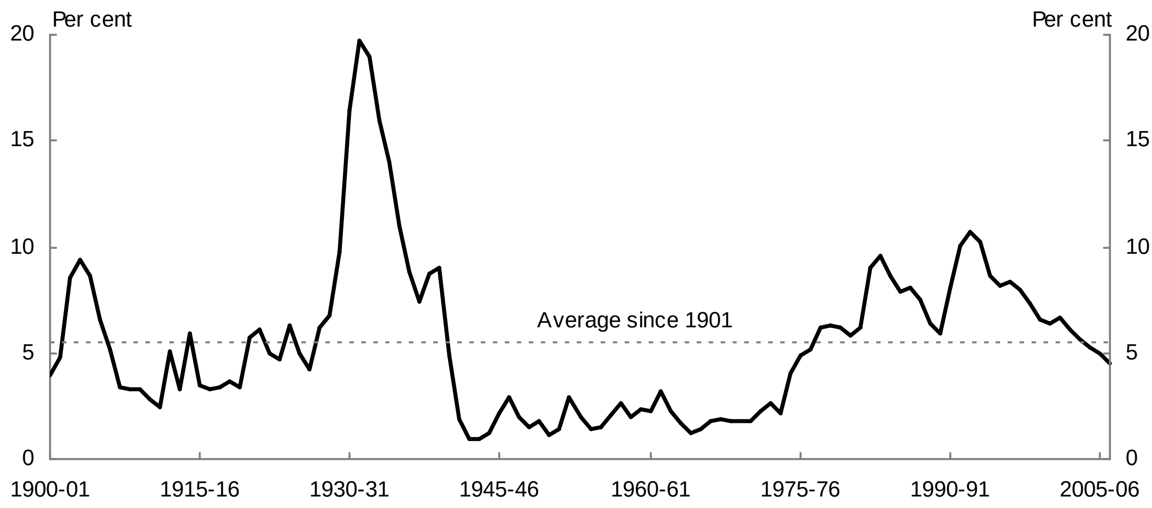
[7] Matheson (2001).

[8] Data supplied by the Australian Public Service Commission.

[9] Schedvin (1988) pg 46.

[10] There is little doubt that the Great Depression also increased the focus on many other aspects of economic policy, including trade, government finances and regulation. Sir Roland was typical of policy makers of the period, displaying a strong interest in the labour market; see, for example, Wilson (1932).

**Chart 1: Unemployment rate**




Source: ABS Catalogue Number 6204.0.55.001, 6202.0 and Reserve Bank of Australia,

It is not surprising that "the maintenance of full employment in Australia" was enshrined in the Reserve Bank Act of 1959. Reflecting the focus on employment, Australia played a central role throughout the post-war period in having the objective of full employment incorporated into international agreements. According to Coleman, Cornish and Haggar, all Australian delegates to international conferences from 1943 onwards sought to have commitments to full employment inserted into international agreements.[11]

Significantly, Sir Roland was instrumental in Australia's success in having a pledge to achieve full employment included in the United Nations Charter (Articles 55 and 56) despite protestations from United States negotiators.[12]

Full employment, despite the emphasis accorded to it, is probably best thought of as an instrumental objective – instrumental, that is, in securing higher living standards, or higher levels of wellbeing. The economic history of Australia also reveals a preoccupation with real wages growth as a source of higher living standards for the country's workers. The tension between these two instrumental objectives – full employment and higher real wages – dominated economic policy debate in this country until, perhaps, as recently as a decade ago. It was the dominant theme not only in

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11 Coleman et. al. (2006) pg 200.

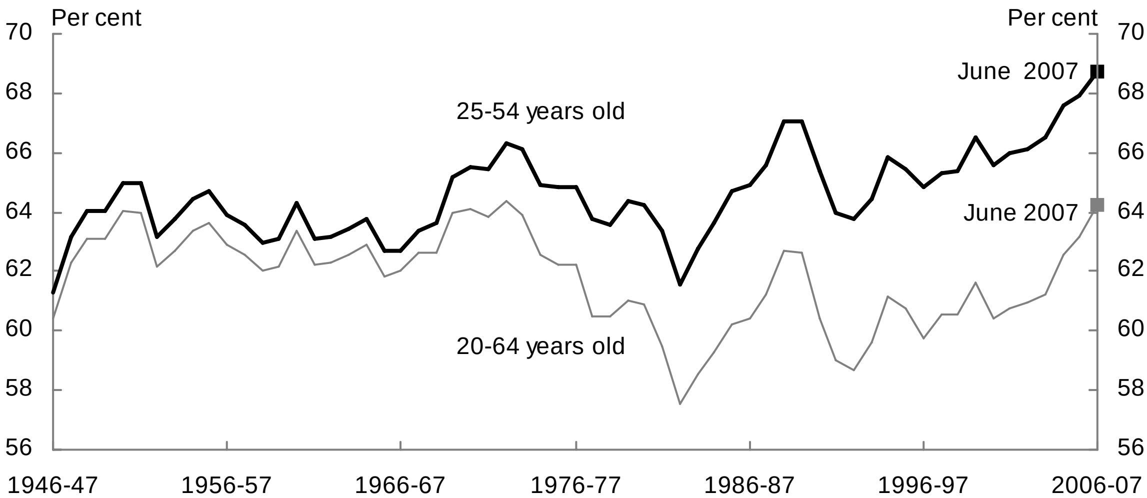
12 Ibid. pg 205.

macroeconomic policy discourse, but also in debates on trade policy, industrial relations and industry policy.

Today the Australian economy is as close to full employment as it has been for more than 30 years. At 4.3 per cent, the unemployment rate is at a level that many would have thought was not achievable without unsustainable wage and price pressures. This might lead one to ask whether the low unemployment rate experience of the 1950s and 60s can be repeated.

Well, as I noted earlier, there are actually more people in employment today as a proportion of the working age population than there were in Sir Roland's time at the Treasury helm. After adjusting for the significant proportion of these who are in part-time employment and the increasing numbers of people in education under the age of 20 years, labour utilisation measures are around the levels of the early 1960s. Thus, according to these measures, the Australian economy is as fully employed today as it was in the 1950s and 60s.

**Chart 2: Labour utilisation (Full-time equivalent employment)**



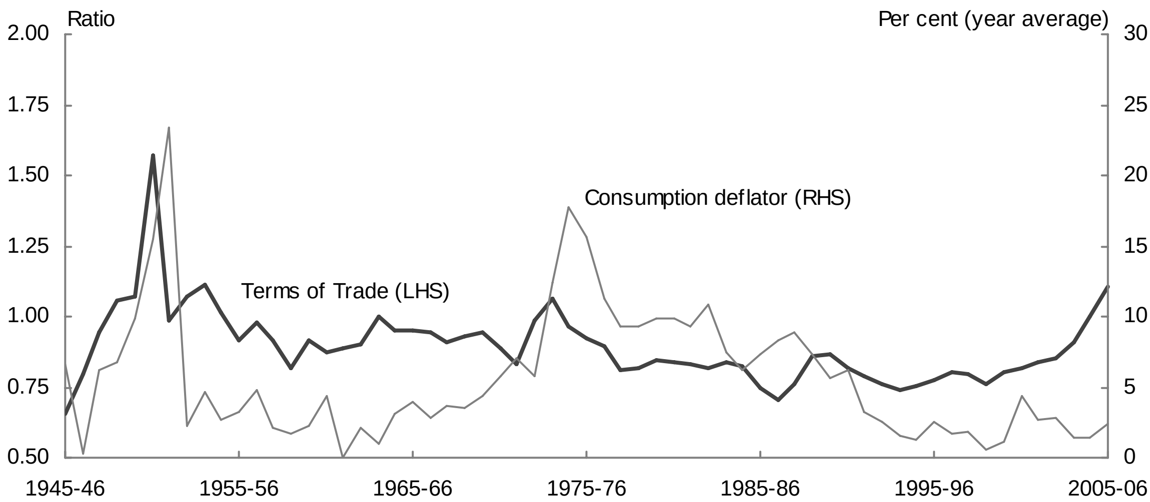

Source: ABS Catalogue Numbers 6202.0, 6204.0, 3105.0.65.001 and Reserve Bank of Australia.

But the composition of employment is different. Obviously, given comparable rates of labour utilisation, there is as much demand for labour today as there was in the 1950s and 1960s. But since the unemployment rate is larger, the supply of labour – measured as a proportion of the population of working age – is actually higher than in Sir Roland's day. And, more generally, the structure and functioning of the labour market is very different from that of the 1950s and 1960s.

## LOOKING BACK OVER THE AUSTRALIAN ECONOMY OF THE 1950S AND 1960S

As Secretary to the Treasury, Sir Roland confronted unique challenges. Shortly after being sworn in, the terms of trade (the prices of Australia's exports relative to the prices of imports) rose to their highest level on record. This massive rise in the terms of trade reflected a surge in demand for wool associated with the need to provide soldiers with uniforms for the Korean War. The exchange rate was fixed and was not helping to cushion the stimulus arising from the increase in the terms of trade. In fact, an earlier depreciation of the Australian pound against the US dollar, in line with a decision of all Commonwealth (or Sterling) countries, exaggerated the effects of the spike in the terms of trade, leading to a surge in demand and contributing to very substantial price pressures.

**Chart 3: Terms of trade and inflation**




Source: ABS Catalogue Number 5204.0 and Reserve Bank of Australia.

Inflation rose to around 20 per cent and the institutional arrangements, which linked wages to consumer prices, saw wages follow. Sir Roland advised the government to increase taxes and cut public spending. This must have been a difficult time for an economic policy adviser. There was much criticism of the Government and of the Treasury. To give you a flavour of the criticism, the editor of the *Sydney Morning Herald* offered the following opinion in September of 1951: 'The Budget is the offspring of an unholy alliance between an improvident Government and a set of self-opinionated bureaucratic planners, and the result is not only thoroughly unsound economics, but an immense political blunder'. Needless to say, today's press is far more generous in its opinions of bureaucrats, rarely resorting to this sort of hyperbole to sell copy.

Happily, inflation was brought under control and remained low for the next 15 years, although it's worth observing that the inflation rate was more volatile than our experience of the past 15 years. In Sir Roland's time as Treasury Secretary, the unemployment rate never rose above 3.2 per cent, a truly remarkable achievement.

While, within a couple of years, the terms of trade retraced most of their 1951 increase, they had already increased significantly prior to 1951 and they remained relatively high for a number of years. In fact, they remained above or around the level of today's terms of trade for six years, reflecting ongoing strong demand for rural commodities and other commodities associated with Japan's reconstruction. Throughout this period, the share of Australia's exports going to the United Kingdom consistently fell while for Japan it rose.

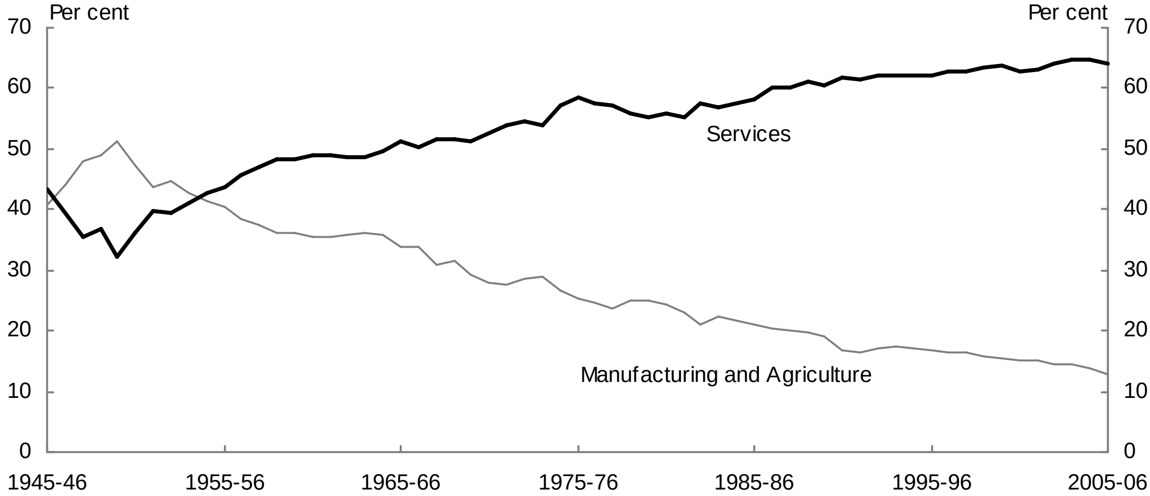
Some of the features of the economy in the 1950s and 60s might seem familiar to you. The terms of trade, for example, are currently at their highest level since 1951, and there is some prospect that they will remain high for some years. And, as noted earlier, the economy is also as close to fully employed as it was in that earlier period.

However, there are some dramatic differences. Obviously, macro policy frameworks are very different. But so too, the structure of the economy, trade policy, and the labour market are all very different from what existed in the 1950s and 60s.

***Industrial Structure***

In the 1950s and 60s, manufacturing and agriculture represented a much larger proportion of the economy than today. At their post World War 2 zenith in the early 1950s, together they made up over 50 per cent of output. By 2005-06, this contribution had fallen to around 13 per cent. While it is well recognised that in most developed countries services have steadily increased in their importance over the past 50 years, services already comprised a large portion – 30 per cent – of activity in the 1950s. Today services make up around 65 per cent of total output.

**Chart 4: Industry shares of GDP**

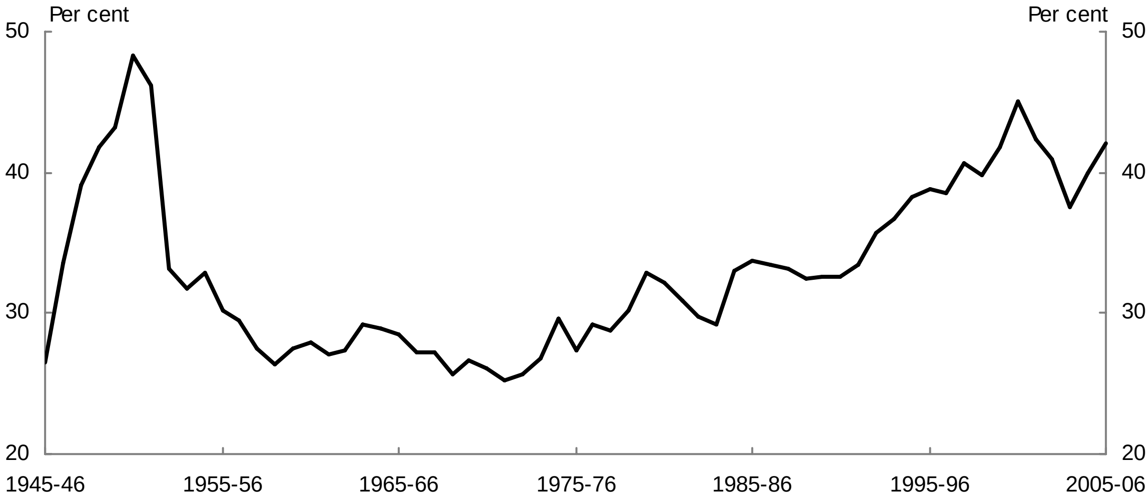



Source: ABS Catalogue Number 5204.0, Reserve Bank of Australia and Australians: Historical Statistics.

With respect to the composition of trade, the story is somewhat different. In the 1950s, commodities were over 85 per cent of our exports. In 2005-06, they accounted for around 60 per cent of exports, although non-rural commodities had become a significantly larger proportion of the total. Even this change hides some important features of the earlier period. Wool was particularly important as an export earner in the 1950s, making up nearly 50 per cent of exports. Australia was a major international wool supplier; between 1949 and 1953, Australian wool production was a little over 28 per cent of world wool supply.

Through the 1950s and 60s, Australia steadily became less trade exposed. That is, the value of exports and imports as a proportion of national income declined. This trend began to turn around in the 1970s, after which it the rose steadily until quite recently. The decline in trade exposure also reflected protectionist trade policies. In part, these policies were implemented in response to the disruptions of earlier periods, when large swings in the external balance had prompted policy makers to institute stabilising features.

**Chart 5: Trade intensity (nominal exports and imports as a share of GDP)**




Source: ABS Catalogue Number 5204.0 and Reserve Bank of Australia.

But there was an even more significant policy aim of Australia's trade policy in the earlier period, and that was to promote higher growth in real wages. The connection between living standards, real wages and tariff policy had been asserted for some time. The Excise Tariff Act of 1906 gave employers tariff protection provided that a fair and reasonable wage was paid to their workers. This appears to have been a clumsy attempt to ensure that the 'rents' of protection were shared equitably as between capital and labour – a recurring theme in Australian industrial relations until quite recent times. The first time a fair and reasonable wage was defined was by the Commonwealth Court of Conciliation and Arbitration in the Harvester judgement of 1907. As the 20$^{th}$ century wore on, however, protectionist policy became more heavily influenced by the 1929 Brigden enquiry.

### *The influence of the Brigden enquiry*

There were two key features of Australian protectionism. One was a naïve desire to promote exports, depress imports and shield economies from external fluctuations. This was an argument primarily mercantilist in nature: a protective wall comprised of tariffs, import controls and other regulatory features was considered necessary in order to grow an Australian manufacturing industry and protect the economy from swings in commodity markets.[13]

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13 Volatility in global capital markets was also a concern of economists and the broader public.

For a time, the proponents of this argument could point to the increase in manufacturing's share of total output as evidence of the policy working. Of course, it was also evidence of the policy not working. And it sowed the seeds of the crisis that we eventually faced in the 1970s and 1980s.

Unfortunately, despite Adam Smith's full-frontal assault on mercantilism 230 years ago, and despite close to 200 years having elapsed since Ricardo's exposition of the principle of comparative advantage, mercantilist sentiment still persists today. It is a worrying element of the friction in Chinese and US relations, and continues to dog industry policy debate in Australia.[14]

The second feature of Australian protectionism arose from a far more considered exposition of trade theory. The Brigden enquiry, 'The Australian Tariff: An Economic Enquiry', was prepared by Brigden, Copland, Dyason, Giblin and Wickens at the request of Prime Minister Bruce. It reported its findings in 1929. The report alluded to many of the insights of trade theory that were popularised subsequently by the Hecksher-Ohlin-Samuelson trade model and, in particular, it foreshadowed the key results of the celebrated Stolper-Samuelson theorem.

The report had three key conclusions: tariffs have costs that can outweigh the benefits; real wages are not necessarily higher under free trade; and the available evidence doesn't allow a more precise statement on either of these two effects.

Today we understand that the imposition of a tariff can increase the real wage if the import-competing sector of the economy is relatively labour-intensive. This is the standard Stolper-Samuelson result established in 1941. One can imagine the power of the theorem in the early 1950s with movements in the terms of trade advantaging capital-intensive exports, and a concern that slower real wages growth would undermine the pursuit of rising living standards.

In a speech to the Australian Business Economists in 2006[15], I observed that the recent rise in our terms of trade, which has favoured the capital-intensive mining sector and, for that reason, disadvantaged the relatively labour-intensive manufacturing sector, is likely to mean, over time, a higher profits share, slower real wages growth, and slower rates of labour productivity growth, than what might have been observed had the terms of trade remained at lower levels.

Now, I doubt that Australians are any less interested today in distributional matters. Why, then, are we not feeling the same protectionist pressure from the rise in the terms of trade? I would propose

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14 David Ricardo (1817) *The Principles of Political Economy and Taxation*.

15 See Henry (2006).

five reasons.  First, the gains from sustained economic growth, and in particular the additional employment stimulated by the increase in the terms of trade, has softened the redistributive impacts, at least to date.  Second, broad based tax cuts, funded by the extra revenue associated with the increase in the terms of trade, have redistributed income from capital to labour.  Third, while producer real wages (nominal wages deflated by producer prices) have been constrained, consistent with the Stolper-Samuelson effect, consumer real wages (nominal wages deflated by consumer prices) have held up well, even in the most labour-intensive industries.[16]  Fourth, the increased exposure of households to the mining sector, directly through the stock market and indirectly through superannuation, means that some of the higher returns to capital are flowing to people who, at other times in our history, would have relied exclusively on labour income.  Especially because of the rampant spread of superannuation across the Australian workforce, the traditional distinctions between the interests of capital and labour have become quite fuzzy.  And fifth, protectionism comes in many guises.  The case for the removal of tariff protection has been broadly accepted for more than 15 years now.  Whatever its impact on the functional distribution of income, arguments pointing to the adverse impact of tariff protection on the efficiency of resource allocation have proved persuasive.  But there is no end to the number and variety of even less optimal policy interventions that might be proposed in order to compensate those affected adversely by the structural adjustments occasioned by the increase in the terms of trade.  Their proponents would not describe such interventions as protectionist, of course, but their economic consequences would be even more costly.

The first four of these developments are overwhelmingly positive.  Only the fifth poses a risk of policy failure.  That risk should be small.  After all, the slowdown in growth and allocative inefficiencies that became apparent over the 1970s, demonstrated that market interventions are not likely to provide a long-term solution to distributional challenges.   Most economists didn't need the demonstration.  Sir Roland, for example, was one of many who was never comfortable with the high degree of trade protection in Australia.[17]  I will return to the management of this risk in my closing remarks.

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[16] Between 2003-04 and 2005-06, the GDP deflator increased by 8.9 per cent, while the CPI increased by only 5.7 per cent.

[17] Cornish (2002) pg 34.

### *Fixed exchange rates, capital flows and external balance*

Another defining characteristic of the 1950s and 1960s was fixed nominal exchange rates. Australia had a fixed or pegged nominal exchange rate until December 1983. Today, the floating exchange rate exerts a stabilising influence in response to external shocks.

Of course, the real exchange will move in response to external pressures regardless of whether the nominal exchange rate is fixed or not. When nominal exchange rates are fixed, movements in the real exchange rate will come through movements in relative country prices. This is an aspect of our understanding of external balance to which Sir Roland made an important contribution through his book, *Capital Imports and the Terms of Trade: Examined in the Light of 60 years of Australian Borrowing*.[18]

Sir Roland challenged the conventional wisdom that an increase in capital imports[19] would necessarily increase the terms of trade. He argued that movements in the terms of trade were determined by world markets (demand and supply), and that capital imports may or may not be associated with shifts in the terms of trade. Moreover, capital imports that were associated with an increase in the terms of trade could increase domestic prices relative to the capital exporting country. This proposition is a precursor to the well-known Gregory thesis, which holds that an increase in the terms of trade arising from an increase in minerals prices leads to a real exchange rate appreciation, crowding out activity in other sectors. As to that, it is worth noting that our real exchange rate is currently around its highest level in the post-float period.

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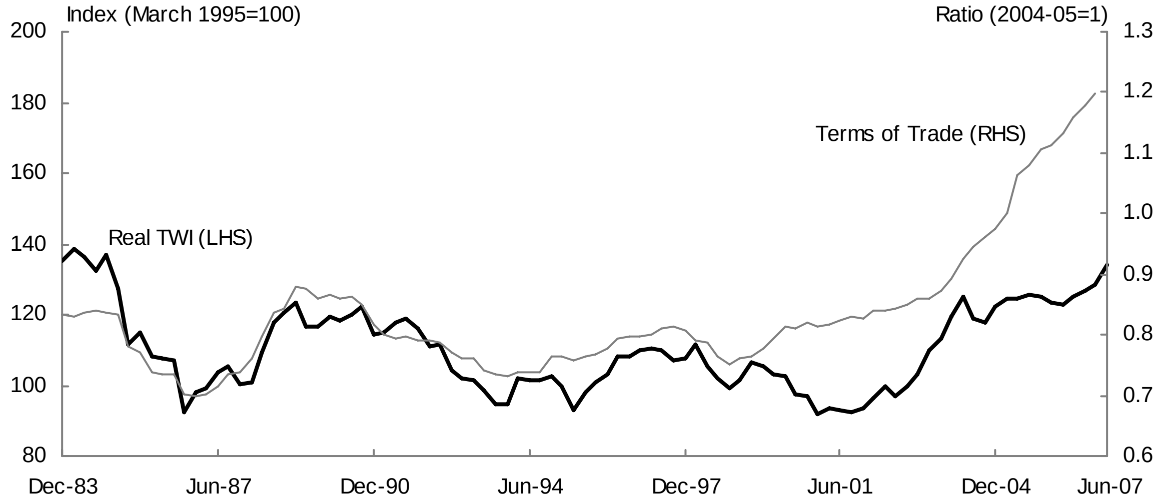
[18] For an excellent summary of Sir Roland's book, see Harrod's favourable review published in *The Economic Journal* in 1932.

[19] Capital imports would rise when, for example, the home country increases its borrowings from abroad.

**Chart 6: Terms of trade and real exchange rate**




Note: The Jun-07 observation for the Real TWI is an estimate based on the nominal TWI for the quarter and assumed constant year-ended inflation.

Source: ABS Catalogue Number 5302.0 and Reserve Bank of Australia.

If Sir Roland were writing his book today, he would need to amend the title to refer to '136 years of Australian borrowings'. We have been borrowing from the rest of the world for that long. The extent to which Australia's ongoing current account deficit has receded from public debate is remarkable. For most of the previous century, there were concerns as to both the size of the current account deficit and its implications for the net stock of foreign liabilities. This is not surprising given the difficulties of managing internal and external balance in the fixed exchange rate regime era. It is also not surprising given the size of net foreign liabilities in the earlier part of the past century. Once the exchange rate was floated, concerns shifted toward the degree to which government debt contributed to Australia's net liability position, the currency denomination and duration of those liabilities, and the vulnerability of the economy to external shocks.[20]

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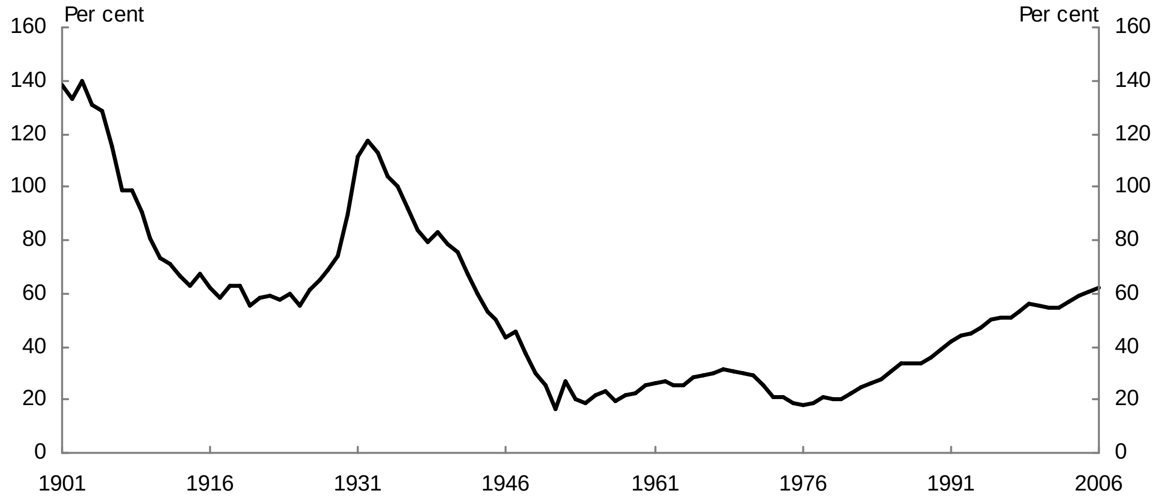
[20] See Belkar, Cockerell and Kent (2007) for discussion of policy debates around Australian current account deficits.

**Chart 7: Cumulative current account deficits (as a proportion of GDP)**




Source: Reserve Bank of Australia.

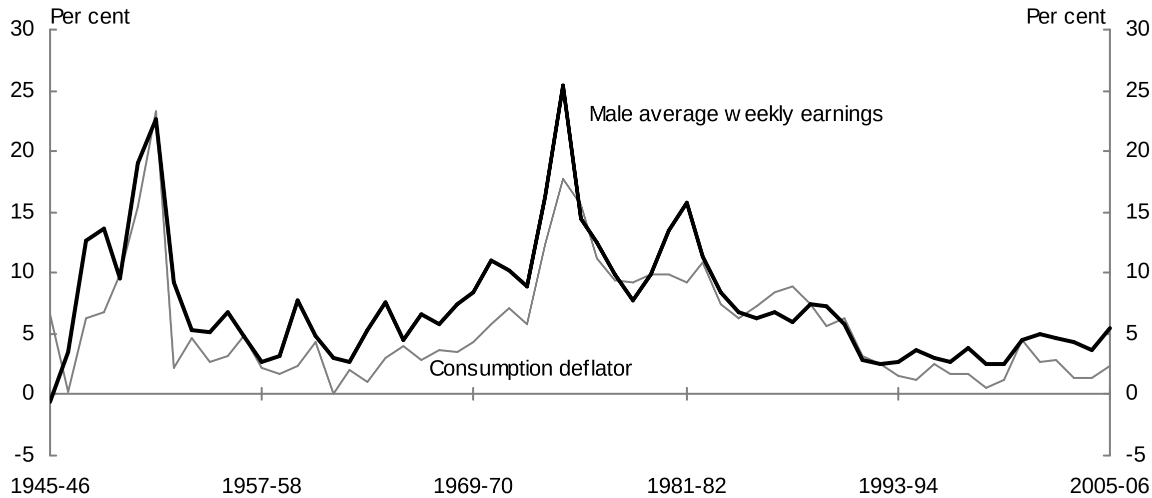
Today, the so-called 'consenting adults' view' of our external position prevails. It's a view with which I am broadly comfortable; but not uncritically so. I don't, for example, subscribe to the view that financial market arbitrage is always stabilising; financial markets can, and do, overshoot. And sometimes, the consequences can be very damaging to real economy performance. While the global deepening in financial markets, including derivatives markets, has generally been an important contributor to a more stable external capital account environment for developed country capital importers such as Australia and the United States, the increasing opacity of the global distribution of risk is something that is, appropriately, attracting increasing attention, including from regulators.

***Labour Market***

Earlier, in observing that labour utilisation is currently back at levels comparable with the 1950s and 1960s, I noted that there were, nevertheless, stark differences in the structure and operation of the labour market. For most of the period from the early 1900s until 1993, around 90 per cent of Australian workers were on awards, and for most of this period, changes in these awards were largely linked to movements in prices. Today, Commonwealth and State awards cover less than 20 per cent of employees.

There were periods when the linking of wages and prices was broken. For example, in the mid-1970s wages increased dramatically ahead of prices. This put an end to the period of sustained low unemployment. In the 1980s, through the prices and incomes accord, the centralised wage system acted to reduce producer real wages, playing an important role in stabilising the economy and facilitating the first steps to the more sustainable and flexible labour market arrangements we have in place today.

**Chart 8: Prices and wages (year average)**

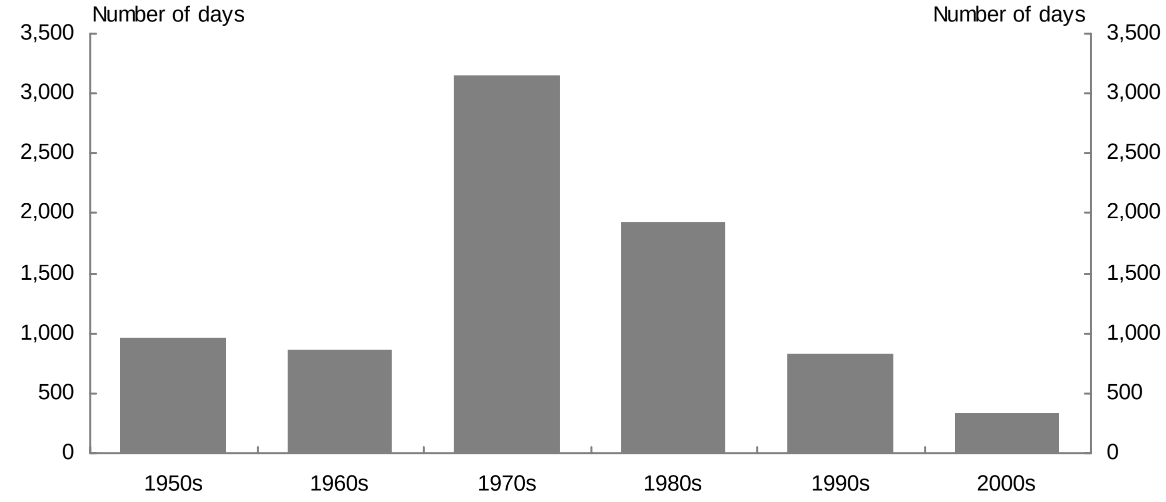



Source: ABS Catalogue Number 5204.0, 6302.0 and Reserve Bank of Australia.

One indicator of the degree to which employment arrangements are efficient is the extent of industrial disputation. It is perhaps not surprising that in a time of great economic uncertainty, such as in the mid 1970s, industrial disputation would rise. However, industrial disputation today is even lower than during the earlier long period of low unemployment, perhaps reflecting the extent to which today's flexible arrangements better match the preferences of employers and employees.[21]

[21] Per employee, the reduction in days lost to industrial disputes is even more striking.

**Chart 9: Working days lost to industrial disputes (annual average)**




Source: ABS Catalogue Number 6321.0.55.001 and Reserve Bank of Australia.

While improved institutional arrangements have promoted the efficiency of the Australian labour market, so too have education and training. Increasing the skills and capabilities of the workforce contributes directly to productivity; but it also increases the flexibility of the labour market: workers who are better educated and skilled can more easily transfer their abilities and change occupations in response to structural change.

## MACRO AND MICROECONOMIC POLICY SETTINGS

The combination of highly regulated labour and product markets and a fixed exchange rate meant that in Sir Roland's time, fiscal policy was the principal instrument of short term macroeconomic management.[22] And, given the institutional arrangements of the 1950s and 60s, fiscal policy was remarkably powerful.

It is a great credit to Sir Roland that policy was so effective in promoting relative stability during his time as Secretary. It was brave advice that led to the short recession in 1952 which was designed to wring out of the economy the surge in inflation sparked by the rise in the terms of trade to which I referred earlier. The imposition of measures to restrain credit growth in the early 1960s also reflected brave Treasury advice specifically designed to bring inflation back under control.

[22] Sir Roland was not only concerned with demand management, he was also very concerned about instituting supply side policies (Cornish, 2002).

And that is the true essence of Sir Roland's legacy: the bravery, the courage, to call it as it is, no matter the political sensitivity of the advice.

Not only was Sir Roland's advice brave, it demanded fine judgement. The difficulties in predicting movements in the economy, coupled with the implementation and transmission lags that typically accompany fiscal policy adjustments and administrative interventions, complicated the operation of stabilising macro policy.

Today, we have medium-term frameworks for fiscal and monetary policy, a flexible exchange rate, low rates of industrial protection and strong product market competition policy and institutions; and wages are largely market-determined. And growth has been relatively stable for many years now. But it would be a mistake to conclude that the operation of macro policy is free of the difficulties of earlier periods. The difficulties in predicting turning points in the economy, and of judging the appropriate response, are enduring themes of macro policy.

While Sir Roland's period can fairly be characterised as one of relative macro policy success, that description could not be applied to the period that followed.

Through the mid and late 1970s, the Australian economy came undone. Despite Sir Roland's earlier demonstration of the need to tighten fiscal policy when the terms of trade rose in order to control the inflationary surge, fiscal policy was loosened dramatically. But that wasn't the only policy error. Any careful reader of the Brigden enquiry, and certainly anybody familiar with the Stolper-Samuelson Theorem, would have expected to see the terms of trade surge of the 1970s put downward pressure on producer real wages; this being a necessary adjustment to preserve full employment. Instead, through the operations of administered intervention and the centralised wage fixing system, producer real wages were lifted substantially, rising by 15.2 per cent between 1972-73 and 1976-77. Thus, just as Sir Roland had had to contend with an untimely currency depreciation just before the 1950s terms of trade increase, Sir Frederick Wheeler had to contend with an equally untimely administered increase in real wages just as the terms of trade took-off again in the 1970s.

It is virtually axiomatic that if real wages are increased and, at the same time, output of the relatively capital-intensive sector is to expand, then labour will become unemployed. And, indeed, employment outcomes deteriorated markedly. In the blink of a somewhat distracted eye, we had achieved the remarkable coincidence of high inflation and high unemployment. It took the best part of a generation for these problems to be overcome.

As my colleague, David Gruen, noted in a recent speech, the response of the economy to today's terms of trade increase stands in stark contrast to the experience of the 1970s.[23] It is difficult to avoid the conclusion that this much better performance is due overwhelmingly to the numerous economic reforms that were implemented progressively in response to the failures of the 1970s.

Sir Roland may well have considered it ironic that when the reform programme eventually got under-way, it started with the capital account.

**SUSTAINING FULL EMPLOYMENT**

The Australian economy is adjusting well to the most recent run-up in the terms of trade, with little sign of the rapidly accelerating prices observed in the early 1950s and 1970s. Labour and capital are moving to the sectors of the economy where demand is growing strongly and the flexible exchange rate is assisting enormously in maintaining macroeconomic stability.

While a more stable set of macroeconomic policies, instituted through medium-term fiscal and monetary policy frameworks in conjunction with the flexible exchange rate, have made important contributions to the good outcomes to date, flexible product, financial and labour markets are also playing a significant role.

We have, today, a far more effective policy environment than that which Sir Roland had to work with. For example, monetary policy put into effect through an operationally independent central bank has proved far more effective in trimming the sails of economic growth than short-term counter-cyclical fiscal policy.

The flexible labour market is also important. We can see evidence of flexibility in both differences in wages growth across industries and in the speed with which employment is growing where demand is strongest. For example, mining and construction wages have been growing by around 5 per cent, well ahead of wages in other sectors of the economy. And the share of total employment attributable to mining and construction has increased by 2 percentage points over the past 5 years; its combined share now exceeding that of manufacturing.

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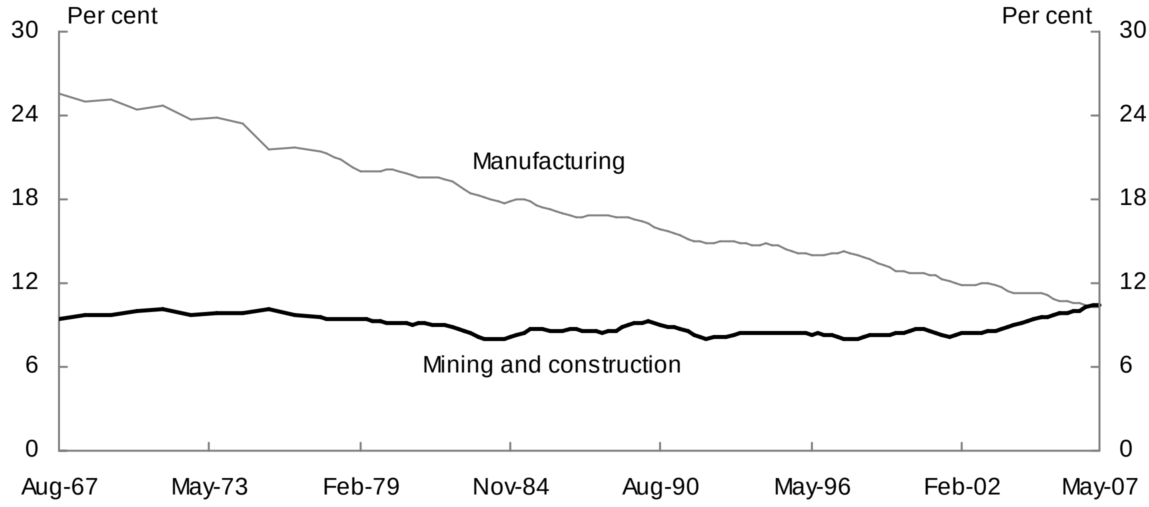
[23] See Gruen 2006.

**Chart 10: Employment shares by industry (4 quarter moving average, original)**




Note: Data prior to 1977 is annual (August data). 4 quarter moving average post 1977.

Source: ABS Catalogue Numbers 6204.0.55.001 and 6291.0.55.003.

Looking back over the past 50 years one gets a strong sense of policy achievement. There can be little doubt that reforms have improved prospects for economic growth and wellbeing more broadly. We saw evidence of these improvements in the Australian economy’s ability to withstand the Asian Financial Crisis of the late 1990s and the US tech bubble bursting in the early years of this decade. More recently, further evidence is emerging from our relatively orderly adjustment to the sort of terms of trade shock that, in earlier times, would have provoked a policy crisis. It is too early to declare victory, but the signs are very promising indeed.

Sir Roland’s legacy rings strongly through these policy improvements. His focus on reforming the supply side of the economy, his distrust of trade protection and his wariness of rent-seeking behaviour remain enduring features of Treasury advice.

The policy mistakes of the past often arose from a desire to protect real wages or particular industries. Ultimately, the interests of the protected industry dominated the interests of the wider economy, leaving us more vulnerable to subsequent shocks. And in addressing distributional issues through labour market interventions, we usually succeeded only in forcing the bulk of adjustment upon the unemployed.

This is a good time to remind ourselves of past failures. The fact that our reformed policy and institutional frameworks are achieving macroeconomic stability does not mean that they are avoiding change at the microeconomic level; quite the opposite: macroeconomic stability is being achieved because those policies and frameworks are helping to facilitate very substantial structural change.  Those microeconomic adjustments will prompt some to argue the need for a return to old thinking.  It is imperative that those arguments be resisted.

We are currently passing through one of the most prosperous periods in Australia's history.  Most Australians are benefiting from this prosperity.  But there are some notable exceptions.  There will always be a temptation, especially in times of rapid structural adjustment, to focus on the <u>acute</u> cases of loss.  But there is a stronger case to be focussing, in these times of plenty, on the <u>chronic</u> cases of disadvantage that have tarnished the record of Australian development not for months, or even years, but for centuries.  I am, of course, referring, among other things, to chronic indigenous disadvantage.  If we are able to muster the courage – if we prove brave enough – to resist the pressure to impede structural change, and instead use this historic opportunity to tackle problems as challenging as indigenous disadvantage, then we will truly have honoured Sir Roland's legacy.

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