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## Roundup

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# Contents

# India’s long-term growth potential and the implications for Australia

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After 20 years of economic reform this article discusses India’s long-term growth potential and canvasses some of the challenges that Indian policy makers will need to overcome to realise this potential. Some of the consequences of India’s growth for Australia are also explored.[2]

1 Ben Ralston, Wilson Au-Yeung and Bill Brummitt are from International & G20 Division of Macroeconomic Group within Treasury. This article has benefited as a result of comments and input from Matt Crooke, David Lowe and Nghi Luu. The views expressed are those of the authors and do not necessarily reflect those of The Treasury.

2 This article is based on a speech that was presented by Bill Brummitt to the Australian National University’s India Business and Economic Update on 19 September 2011.

## Introduction

It is 20 years since India embarked on its economic reform and liberalisation journey. These reforms have done much to unlock India's economic potential and the Australia-India bilateral economic relationship continues to blossom. India has also become an important member of fora, including the G20 and the East Asia Summit, and Australia works actively with India in these contexts.

This article assesses India's long-term growth potential, briefly surveys some of the challenges that India needs to overcome to realise its potential and finally discusses some implications for Australia.

## A remarkable transformation

Today India is the fourth largest economy in the world in purchasing power parity terms. But this has not always been the case.

Despite having the world's second largest population, in 1991 the Indian economy was ranked ninth largest in the world.

At that time, the Indian economy was in turmoil, facing a current account crisis. On 24 July 1991, Manmohan Singh, then India's Finance Minister and now Prime Minister, embarked on a series of reforms that helped liberalise the Indian economy. These reforms included the relaxation of import and export restrictions, lessening of current and capital account restrictions, and an expedited removal of what many call the 'Licence Raj'.

These reforms went further than what was needed to overcome the immediate crisis. They were instrumental in catalysing the transformation of the Indian economy that is continuing today.

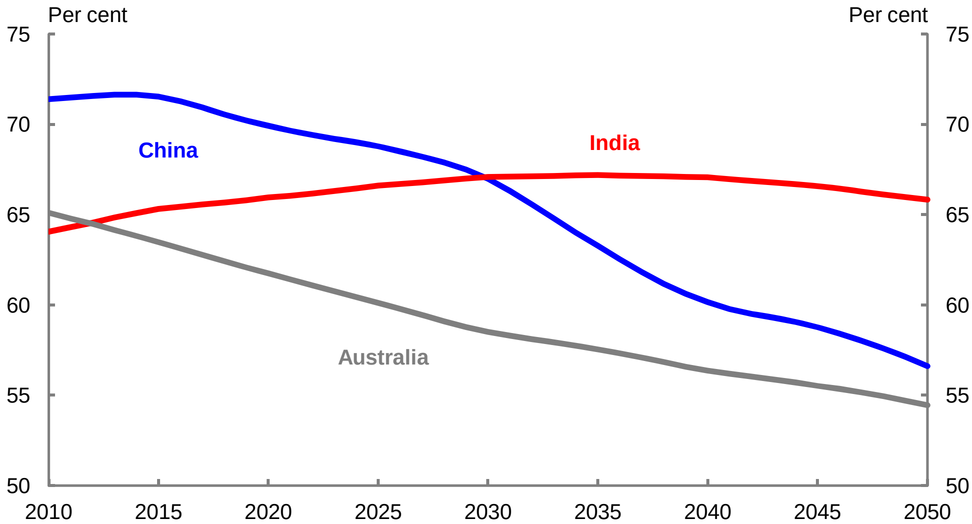
The robustness of the Indian economy was demonstrated recently during the Global Financial Crisis. Economic growth in India slowed to around 6 per cent through the year (tty) in late 2008 and early 2009, then quickly recovered. Since peaking at 9.4 per cent tty in March 2010, economic growth has slowed to 7.7 per cent tty for June 2011. This slowing is in part due to the tightening of monetary policy in response to inflation.

## India's projected long-term output path

Treasury has used the United Nation's long-term population projections and a conditional convergence model to derive the potential long-term economic growth rates for the world's major economies and regions.

One of the key drivers of growth for India is population growth, or more importantly the projected growth of India's working age population. The proportion of people of working age in India is expected to increase steadily until about the middle of the 2040s and reach a peak at around 67 per cent (Chart 1).

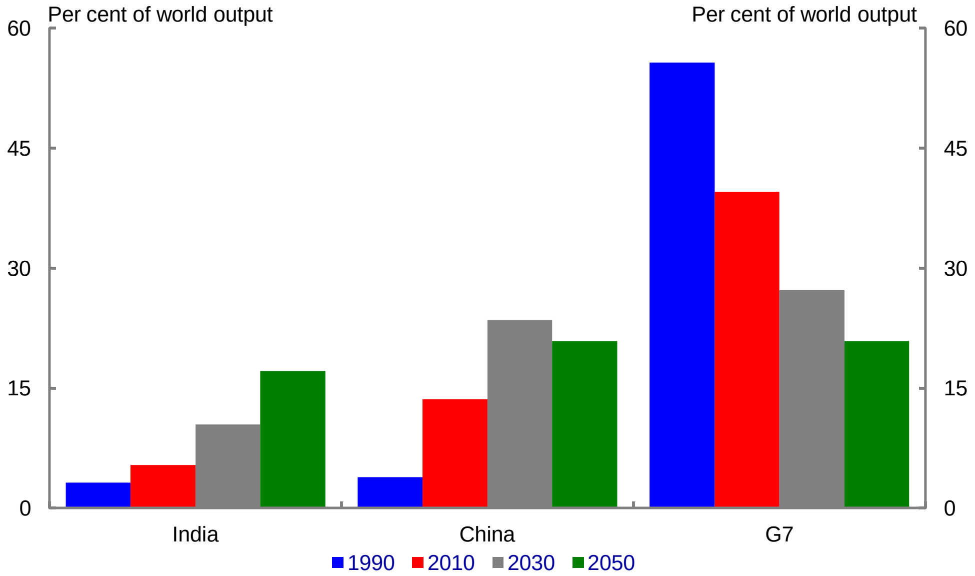
**Chart 1: Working age population as a proportion of population**




Source: UN World Population Prospects 2010 and Treasury.

This contrasts to many other countries, including Australia and most notably China. The change in the composition of India's population has been called the 'demographic dividend'. It drives much of the projected future growth in India (Chart 2).

**Chart 2: Long term projections — India, China and G7**




Source: Treasury, IMF and UN.

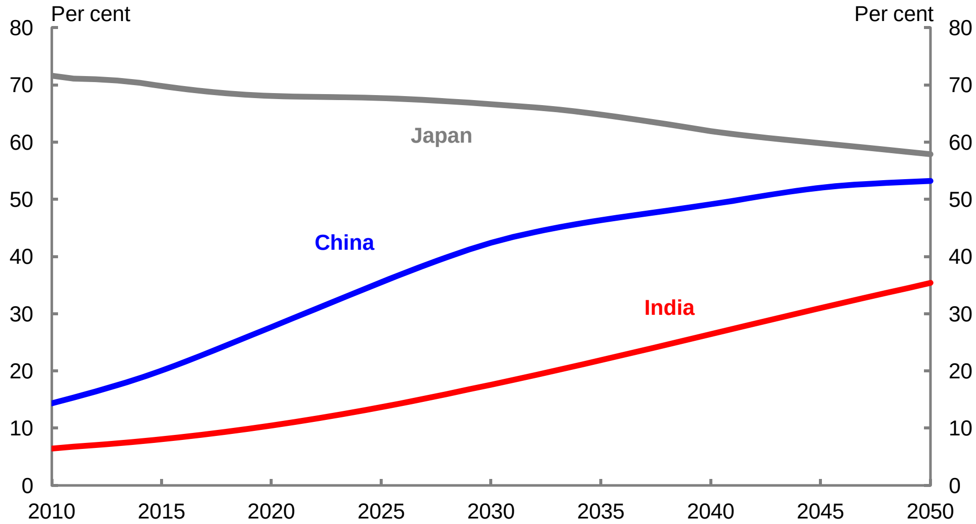
Chart 2 shows projections of the Indian, Chinese and G7 economies as a proportion of world GDP over the next 40 years. By 2050, on these projections, India could account for over 15 per cent of global GDP compared to a little over 20 per cent for China.

Based on its stronger demographic fundamentals and on the strong productivity growth flowing from the convergence process, India's potential growth rate could be faster than China's by the end of the current decade.

In terms of GDP per capita, in 2005, India's was about 5 per cent of the US. In 2050 it is anticipated to be around one-third (Chart 3).

This might not sound like much of a change, but in level terms GDP per capita for India in 2050 is expected to be around where New Zealand or Korea are today.

**Chart 3: GDP per capita as a proportion of the US**




Source: Treasury, IMF and UN.

However, it should be noted that these projections are mechanical in nature and rely on demographic projections and assumptions about convergence in rates of productivity between developed and developing economies.

Caution is needed in applying assumptions about productivity growth convergence. History has shown that simply having the potential to grow at higher rates does not necessarily mean that higher rates will be achieved. The reasons for this generally revolve around technological diffusion, institutional factors, the ability to attract capital, participation in global markets and the like.[3]

The projections are best considered a potential outcome. The extent to which the potential is realised, or exceeded, depends on the policies that India adopts.

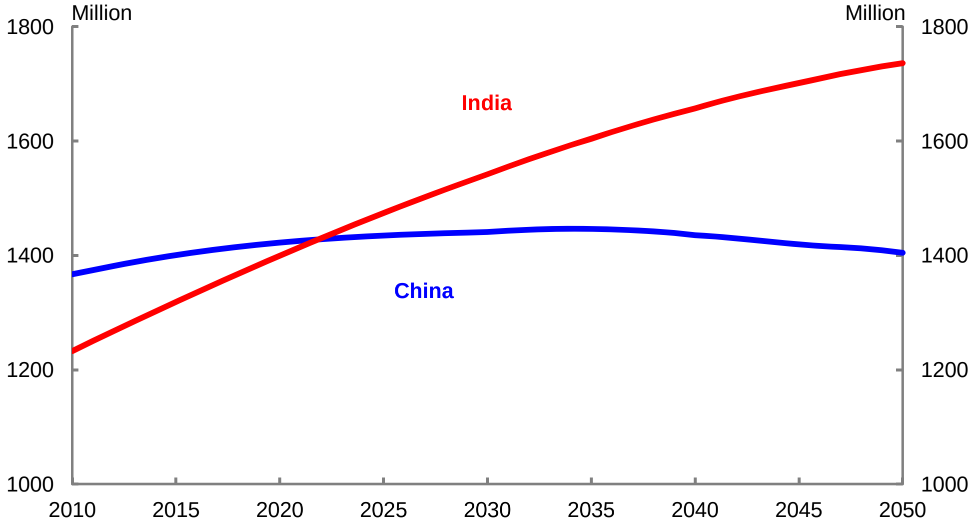
India's broad policy challenges centre around the basic factors of production, namely; population, land, and capital. Beyond the factors of production, productivity is the key determinant to long-run growth prospects, therefore some institutional factors are also briefly discussed.

3 See Acemoglu (2009) or Rodrik (2011).

## Population

Based on UN projections, early next decade India is projected to become the world's most populous country, with 1.4 billion people. By 2050, India is expected to have 1.7 billion people, while China is expected to be the next highest with 1.4 billion people.

**Chart 4: Population of India and China**




Source: UN World Population Prospects 2010 and Treasury.

To put India's growth into perspective, between now and 2050, India's population is expected to grow by around 485 million people. That is more than the present population of the US and Mexico combined.

This raises some very fundamental issues that will need to be addressed, revolving around food security and employment.

Currently, India produces a lot of its own food. Imports of major food items are comparatively low. To ensure that these additional people can be fed, India's domestic agricultural productivity has to improve dramatically or a far greater share of food will need to be imported.

Despite productivity improvements in the Indian agricultural sector over recent decades, driven by the 'Green Revolution', India's agricultural productivity remains very low by world standards.[4]

4 Chakrabarty (2011) and Cagliarini and Rush (2011) provide further discussion on trends in agricultural productivity in India.

For example, estimates of rice yields in India are around 3.2 tonnes per hectare, compared to 7.5 tonnes per hectare in the United States, 6.7 tonnes per hectare in China and an average of 4.3 tonnes per hectare for the world. Similar contrasts in yields have also been observed in the case of wheat, cereals and vegetables. In fact, even the most productive Indian states fall short of world standards. [5]

The opportunities to improve productivity stem from improved practices in land use and rehabilitation, water efficiency and quality, crop and herd management, the mechanisation of agriculture, and upgrading of the logistical supply chain.

To meet India's food needs, the most likely scenario is that there will be some combination of the bolstering of agricultural productivity and rising imports. In meeting these challenges the balance between reform and equity will continue to pose deep political challenges for Indian governments.

There is also the issue of how and where these extra people are going to be employed. While approximately 50 per cent of the working population are employed in the agricultural sector[6], agriculture only generates 15 per cent of GDP.[7] India cannot continue to have 50 per cent of the working population in the agricultural sector. India's vibrant services sector will have to continue to grow and large scale manufacturing will have to expand.

Part of the solution to creating these additional jobs lies in education and labour market reform.

## Education and labour market reform

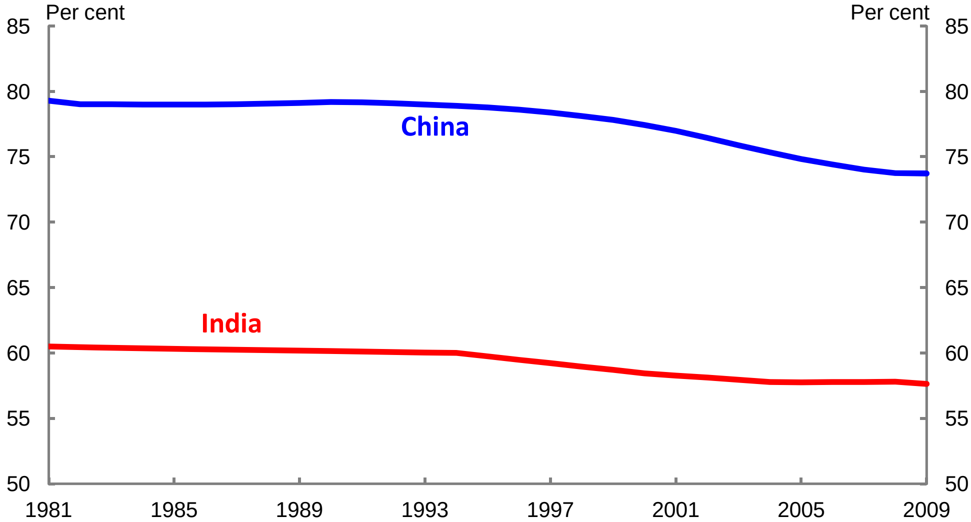
The number of people between the ages of 5 and 14 in India is roughly 250 million.[8] Putting aside higher education, even ensuring that enough people are provided with basic primary school education is a challenge, but it is a challenge India is winning.

According to census data, literacy rates have been improving. In 2001 literacy rates were roughly 65 per cent, while the 2011 census shows that the literacy rate is 74 per cent.

Unfortunately this higher literacy rate is yet to flow through significantly to labour market participation rates, with India's participation rate comparing unfavourably to China (Chart 5).

5 Chakrabarty (2011).
6 Ministry of Labour and Employment (2010).
7 CEIC Asia database.
8 UN World Population Prospects database: The 2010 Revision.

**Chart 5: Participation rates for India and China**




Source: International Labour Organisation.

One reason for the low participation rates and lack of formal job creation is the myriad of labour laws that inhibit market flexibility and act as deterrents to growth in the formal sector.

In 2007 the OECD noted that employment in firms with more than 10 employees accounted for around 3¾ per cent of total employment.[9] This was lower than any OECD country and suggests India is failing to take advantage of its abundance of labour.

A major reason for this is that manufacturing plants with 100 employees or more require government permission to lay off just one worker. There is also the plethora of state and federal laws that combine to make the system quite complex.

In addition, the legal system adds to the difficulty. In one case where an employee was caught sleeping at work and consequently dismissed, it took over 20 years for the courts to make a final decision regarding the legality of the dismissal.[10]

The impact of labour laws on India's economic performance is beginning to be debated. Last year India's Prime Minister questioned whether such laws, designed to protect workers, might actually be doing more harm than good.[11]

9 OECD (2007).
10 Bharat Forge Co. Ltd. v Uttam Manohar Nakate (2005), Indian Supreme Court.
11 Indian Prime Minister Manmohan Singh's address to the 43rd Session of the Indian Labour Conference, 23 November 2010, see http://pmindia.nic.in/lspeech.asp?id=987.

It seems clear that India's outdated labour laws combine with other factors, like uncertainty in property law and other remnant regulations, in holding back growth of the formal sector.

The success of Special Economic Zones, which are relatively less regulated and taxed, and the growth of the IT sector, which is less regulated, are indicators that productivity enhancing reform is possible.

## Land reform

Land reform is often a vexing policy issue for densely populated emerging economies.

Currently in India there is a restriction on the maximum size of land that can be held. This restriction is seeing an increase in the amount of smaller holdings of land as land is subdivided between siblings over successive generations. Between 1960-61 and 2002-03 the share of rural households engaged in agriculture with land holdings of less than one hectare increased from around 58 per cent (30.5 million households) to just under 80 per cent (80.4 million households) (Table 1).[12]

**Table 1: India's rural land distribution (millions)**

| | 1960/61 | 1971/72 | 1981/82 | 1991/92 | 2002/03 |
|---|---|---|---|---|---|
| **Total rural households** | 72.5 | 78.4 | 93.9 | 116.4 | 147.8 |
| **Engaged in agriculture** | 52.9 | 56.9 | 69.4 | 93.4 | 101.8 |
| ***of which land holdings:*** | | | | | |
| **Less than 1 hectare** | 30.5 | 34.3 | 46.6 | 65.5 | 80.4 |
| **1–2 hectares** | 8.6 | 9.3 | 10.1 | 13.3 | 11.4 |
| **2–4 hectares** | 7.3 | 7.3 | 7.4 | 9.1 | 6.3 |
| **4–10 hectares** | 5.0 | 4.6 | 4.4 | 4.6 | 3.0 |
| **Over 10 hectares** | 1.6 | 1.3 | 1.0 | 1.0 | 0.5 |

Source: National Sample Survey Organisation and Reserve Bank of Australia.

These small holdings make it difficult for the land owners to make a living from solely working their land. In addition, with such small holdings capital investment is difficult, which inhibits productivity growth.

Beyond the agricultural sector, land reform is a key issue in the context of industrial and infrastructure development. Land acquisition issues are a factor behind the delays in many projects[13], and pressure for reform is building.

## Capital

As is common in rapidly growing developing economies, the need for enhanced infrastructure in India is overwhelming.

12 Cagliarini and Rush (2011).

13 For example, the delays experienced by steel group Posco in the state of Orissa or Tata's Nano car plant in West Bengal.

The fast growth of the Indian economy and population has meant that increasing stress has been placed on existing infrastructure, such as electricity grids and generation capacity, railways, roads, ports, airports, irrigation, and urban and rural water supply. For example, in 2010-11, 12,200 MW of electricity system capacity was added, up from 9,600 MW the previous year, but well short of the 20,000 MW target.[14]

There is a general consensus that the lack of infrastructure is holding back India's economic development, particularly in the energy and transport sectors. The Indian Government acknowledges this and in its 11th Five-Year Plan (2007-2012) identified increased infrastructure spending as a priority in achieving India's economic growth.

In the upcoming Five-Year Plan, India's Planning Commission anticipates that average investment of around US$200 billion per year will be required, double the average of the current plan, to sustain India's growth. This investment is to be achieved through a combination of public investment and private initiatives, including through Public Private Partnerships (PPP).

However, there are a number of roadblocks in the way of this acceleration of investment. These include financing, public sector capacity, government clearances, land acquisition and limited capacity of contractors.[15]

Despite these obstacles, one area of tremendous progress has been the Indian telecommunications sector. Currently there are in excess of 850 million mobile phone subscribers[16] as well as a thriving call centre industry.

## Institutional factors

India is not only the world's largest democracy, it is extremely diverse, encompassing many different ethnic groups, religions, traditions, and people of vastly different economic standing. As such there exists a multitude of voices that want to be heard and a myriad of interests that all have stakes in India's economic development.

Of course there are well known problems in India with red tape, corruption and a slow legal system. However, ultimately the democratic institutions that India has — the right to vote, an independent judiciary, and a free press — act to assist the establishment of consensus and therefore act as a unifying force. This unifying force and inclusive decision process is an important asset given the dramatic social changes that India has undergone and will need to undergo in the future.

14 Indian Planning Commission.

15 See IMF (2011) Annexe note on Infrastructure Finance Indian Challenges and Country Experiences for a more detailed discussion on the roadblocks identified above, cross-country experiences and lessons for India.

16 Telecom Regulatory Authority of India, Press Release No. 47/2011.

### Tax reform

India's current taxation system is complicated and difficult to administer. For example, the central government has the ability to tax the final consumption of services, but not goods. States have the ability to tax the final consumption of goods, but not services. While the central government has the legal ability to levy taxes on interstate transactions, the home State can collect and retain the tax revenue.[17]

The Indian Government recognises some of the problems in the taxation system and has plans to reform aspects of it with the Direct Tax Code and the introduction of a goods and services tax. However, the Indian experience with tax reform, like Australia's, is not a straightforward one and negotiations are still underway.

### Red tape and bureaucracy

Perhaps a legacy of the old Licence Raj system is India's high level of red tape and bureaucracy.

This has an impact on India's ranking in the World Bank's Ease of Doing Business Index, with India ranking 134 out of 183 economies. As a practical example, this same report notes that it takes around 29 days for a business to be registered in India, while the OECD average is 5.6 days. It should be noted, however, that this is an improvement from 2008 when it took 33 days.

### Corruption and the legal system

The World Bank and others have identified corruption as among the greatest obstacles to economic growth and social development.[18]

Anecdotally and through a number of reports, it is clear that the problem of corruption remains deeply rooted and may even be worsening in India.[19] This poses a significant roadblock to its long-term growth potential.

According to Transparency International's Corruption Perception Index there has been a growing perception of corruption in India.[20] This is supported by a recent public

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17 OECD (2011).

18 Transparency International provides a number of scholarly articles of the impact of corruption on economic growth and development – these can be accessed on their website via http://www.transparency.org.uk/anti-corruption-resources/47-impact-of-corruption-on-economic-growth-and-development.

19 For example the 2G scandal is estimated by the Comptroller and Auditor General of India to have cost USD$39 billion in lost revenue.

20 Corruption Perception Index scores relate to the perception of the degree of corruption as seen by business people, academics and country analysts - scores range between 10 (highly clean) and 0 (highly corrupt). Examining recent trends, India's score has fallen from 3.5 in 2007 to 3.3 in 2010, with recent problems relating to the Government's management of the Commonwealth Games in Delhi.

survey in India that showed that in the past three years, 74 per cent of those surveyed believed the level of corruption had increased.[21] Furthermore, compared to other countries, India's ranking has fallen from 72 in 2007 to 87 in 2010 (against 178 countries).

India is trying to work its way through this sensitive area with the anti-corruption agenda clearly capturing national attention in recent times.

But further work still needs to be done as the World Corruption Perception Index has India behind countries such as China, Thailand and Columbia.

Part of the solution to the corruption challenge is having a quick and efficient court system. A mixture of reform and additional resources are needed.

The problems in the legal system also spill over into the commercial sphere, where issues such as enforceability of contracts and land disputes can act to hinder longer-term investment and consequently development.

Then there is also the law itself. Given the dramatic changes to the Indian economy over the past two decades, there are many areas where the law may not have evolved quickly enough.

## Implications for Australia

India's strong growth has already seen Australia's merchandise trade exports to India rise by nearly 800 per cent from 2000 to 2010. Put differently, this has added around $14.6 billion to Australia's annual merchandise exports and seen India rise from 14th to 4th most important merchandise export destination.[22]

The strengthening trade relationship over the last 10 years has been largely the result of the growth in the Indian economy and its demand for resources. However, as growth in India continues and the middle class expands many more opportunities will open up.[23]

### Resources and energy

India's growing economy is leading to increased demand for energy commodities, such as natural gas and coal, and mineral commodities like gold and copper ore.

21 Transparency International Global Corruption Barometer (2010).

22 ABS cat. no. 5368.0.

23 A broader discussion on Asia's emergence and the implications of an increase in its middle-class will affect Australia is contained in Budget Statement No. 4, 2011-12.

For example, coal exports to India for 2010 were around $6.8 billion, up from $2.6 billion in 2006. India is also expected to be a large customer of the $43 billion Gorgon gas project in Western Australia.

Gold is also a very important export to India. Australia's gold exports to India have risen from $3.6 billion in 2006 to be in excess of $5.3 billion 2010. India's growth has also seen Australia's copper ore and concentrates exports rise to nearly $1.4 billion.[24]

However, the relationship has the potential to extend beyond simply buyer and seller. India itself has large proven deposits of its own. For example India has the fourth largest proven deposits of thermal coal in the world.[25] Bauxite reserves are around 3.3 billion tons, or 7.5 per cent of global reserves, making India a net exporter of bauxite. Iron ore reserves stand at around 13.4 billion tons (fifth largest in the world) with a large percentage of reserves having high ferrous content.[26]

This resource endowment has seen Australian companies undertake exploration activities. Earlier this year Rio Tinto received a social awareness award from the Federation of Indian Mineral Industries for its efforts.

However, there are still many restrictions in place that make such activities difficult. A freeing up of restrictions in the mining sector would be a significant boost for the Indian economy. It would also provide international companies, with the proven expertise and equipment to develop such deposits, a significant opportunity.

But the relationship need not go only one way. Australia itself has substantial resource deposits and Indian investment in our resource and energy sector is growing strongly. For example, there has been heavy investment by Indian companies in Queensland's Galilee Basin coal fields and Adani Group has acquired from the Queensland Government a 99-year lease of the Abbot Point Coal Terminal north of Bowen.

## Agriculture

India's demand for agricultural commodities and processed food items is generally outstripping its domestic productive capacity. Increasingly India is looking to global supply chains to fill the gaps, which will boost trade flows. However, there is also enormous untapped potential onshore.

24 Department of Foreign Affairs and Trade (2010).
25 Indian Ministry of Mines.
26 Austrade-KPMG (2008).

As noted above, India's agricultural productivity is very low by world standards. This has led to talk of the need for a second green revolution.[27]

There are opportunities to improve practices in land use and rehabilitation, water efficiency and quality, crop and herd management, the mechanisation of agriculture, and upgrading the logistical supply chain. These opportunities should be attractive to Australian agribusiness, environmental and logistics firms.

India's agricultural sector will probably remain relatively heavily protected due to the political influence and poor economic and social conditions of agricultural workers.

However, liberalisation has been occurring. The new opportunities can be seasonal and temporary as imports may only be allowed when there is a domestic shortage of production. Such opportunities can be large, however infrequent and unpredictable.

India's rising middle class presents opportunities of a different nature.[28] As incomes rise and the Indian consumer has exposure to international markets, tastes are changing. This translates into growth in demand for protein, imported processed foods, wine and the like.

The liberalisation of FDI in India's multi-brand retail sector could be an important force in helping to transform India's food sector — potentially boosting investment in the cold storage and supply chain, lifting agricultural productivity and incomes, and helping to alleviate food price inflation.

## Infrastructure provision

As noted earlier, India has set itself ambitious targets for infrastructure with the next Five-Year Plan expected to contain total infrastructure spending of US$1 trillion. This is to be implemented with the assistance of the private sector.

There are Australian companies on the infrastructure financing side and on the construction and project management side supporting these efforts. But construction activity, and participation by the private sector, is really only just now ramping up.

India is actively seeking to modernise its PPP frameworks and attract foreign capital and know-how. Again the opportunities and possible collaboration are significant, if the domestic policy settings and investment climate can be made more conducive.

27 Indian Prime Minister Manmohan Singh's address to the 83rd foundation day of the Indian Council of Agricultural Research, 16 July 2011.

28 See Kharas (2010) for further estimates of Asia's middle class.

## Education

Currently around 11 million Indian students are pursuing higher education — but this represents just 11 per cent of the nation's 17-23 year olds. The level of unmet demand for university places runs at around 4.7 million places each year.

Government policy is directed towards increasing the Gross Enrolment Ratio — the ratio of actual students to potential students — to 25 per cent by 2022. [29]

To supply the necessary places, India intends to set up around 1,500 new higher education institutions, at least one central university in each state, and 14 new innovation universities.[30]

The opportunities for Australian universities, whether in terms of partnering with Indian institutions during this growth phase or attracting more Indian international students to Australia are clear.

In terms of vocational education and training, the scope of opportunity is also impressive. The Australian Government has identified opportunities to increase the delivery of Australian vocational education and training (VET) qualifications in India.

At present only 2-2.5 per cent of India's population undertakes formal VET training. However, it is estimated that some 500 million people will require training by 2022 — over 21 times Australia's population. The current capacity of the Indian VET system is around 4.3 million training places. [31]

The challenge for India is enormous and India recognises that it cannot achieve these goals alone.

The scale of needs in India has seen our exports of education services to India experience roughly a 28 fold increase in dollars spent over the 15 years to 2010.[32] These exports remain at very high levels and the whole trade is now on a much more sustainable path after the Government's series of visa reforms.[33]

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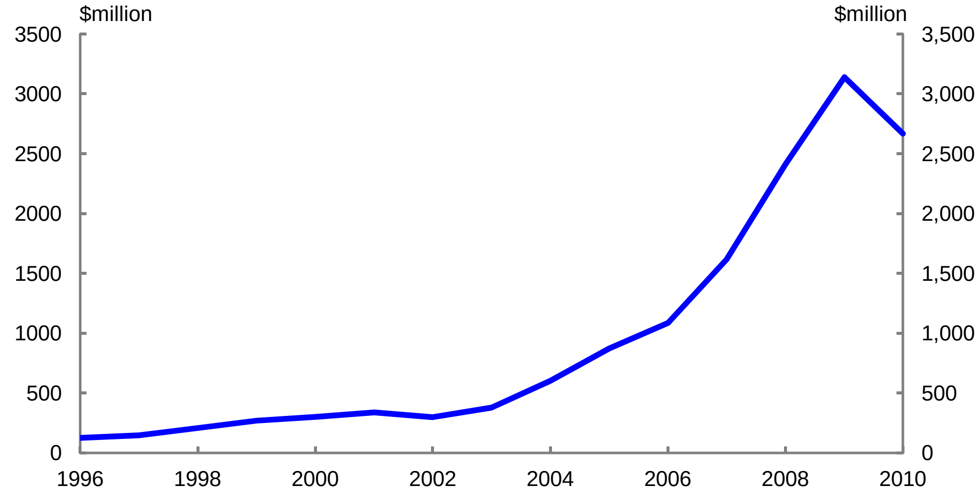
29 Indian Planning Commission.
30 Indian Planning Commission.
31 Indian Planning Commission.
32 ABS cat. no. 5368.0.
33 See press releases from the Minister for Immigration and Citizenship 'Migration reforms to deliver Australia's skills needs', 8 February 2010, and 'Boost to International Education sector in response to Knight review', 22 September 2011.

**Chart 6: Australia's exports of education services to India**




Source: ABS cat. no. 5368.0 and Treasury.

## Tourism

India was the eleventh largest source of tourist arrivals in 2009, while China was fourth largest. As Indian incomes continue to rise there is much future growth potential. In addition, there is also scope for a change in the focus of visits from 'visiting friends and relatives' to 'holidays', which would increase the economic value from Indian tourism.

This growth in outbound Indian tourism will occur against a backdrop of increased competition among potential tourist destinations. How well Australia does in capturing this market will depend greatly on the skill and creativity of Australian tourism providers.

# Summary

The long term prospects for the Indian economy are very strong.

But India's policy makers must continue the reform process if India is to harness all of its growth drivers and achieve its enormous potential.

The rise of the middle-class in India will open up many new opportunities for Australia, but our success is not pre-ordained. Continued reforms to drive our competitiveness and a determined effort to better understand the Indian market will be essential.

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# The second international food and fuel price shock and Forum island economies

Martin Gould, Giles Dickenson-Jones and Richard Wood[1]

A version of this paper was tabled as an Australian Government out-of-session Information Note at the Pacific Islands Forum Economic Ministers Meeting held on 19-21 July 2011 in Apia, Samoa.

1 The authors are from International Finance and Development Division, the Australian Treasury. This article has benefited from comments and suggestions provided by Patrick Colmer, Kelly Trudgen, Sigi Gartmann and Sharon Traucki. The views in this article are those of the author and not necessarily those of the Australian Treasury

## Introduction

This note analyses the recent strong surge in international food and fuel prices and discusses the implications for Forum island countries (FICs). It identifies likely economic impacts and reviews policy options.

The note begins by separately analysing food prices in Part I and fuel prices in Part II. In each case, the note identifies the main reasons for the most recent surge in international prices; reviews indicators of the vulnerability of different Forum island economies to these price developments; and assesses the implications of the different exchange rate systems operating across the Pacific for local prices. Part III summarises the main findings of Parts I and II. Part IV outlines the main macroeconomic effects of recent international food and fuel price increases on FICs. Part V reviews possible policy responses and Attachment A reports on work underway by the G20 on commodity price volatility.

The note makes clear that the confluence of the relatively high dependency on imported food and fuel and rising international food and fuel prices causes significant current and potential macroeconomic, food security and energy risks for FICs.

Rising food and fuel prices can adversely affect output and inflation, the fiscal balance and the balance of payments, and can contribute to increased poverty although informal safety nets are relatively strong across the Pacific. A number of FICs (PNG, Solomon Islands and Vanuatu being the main exceptions) have not yet recovered significantly from the first food and fuel price shock and the subsequent global economic recession. Because output, demand and living standards are still weak in some FICs, the effects of recent food and fuel price increases on inflation and external balance may be less apparent than in 2008 and 2009. Where rising food and fuel prices impact adversely on economic activity and living standards, government revenues also decline but pressures can increase to expand expenditure on safety nets, health and poverty alleviation, which might threaten the fiscal balance.

The outlook for international food and fuel prices remains uncertain. Past experiences suggests that a sharp collapse in international prices is possible, particularly if global recession returns, but most forecasters currently expect continuing upward pressure on international commodity prices for some time as a result of underlying structural changes in global supply and demand.

In the face of this second food and fuel price shock, it is important for macroeconomic policies to address any inflation break-out and maintain fiscal sustainability and external balance.

In responding to rising international food and fuel prices, policy makers need to generally avoid short-term measures (for example, subsidies, tax reductions and price controls) that distort price signals or impede the incentive or ability of domestic producers to undertake investments and activity aimed at increasing local production, productivity, and efficiency.

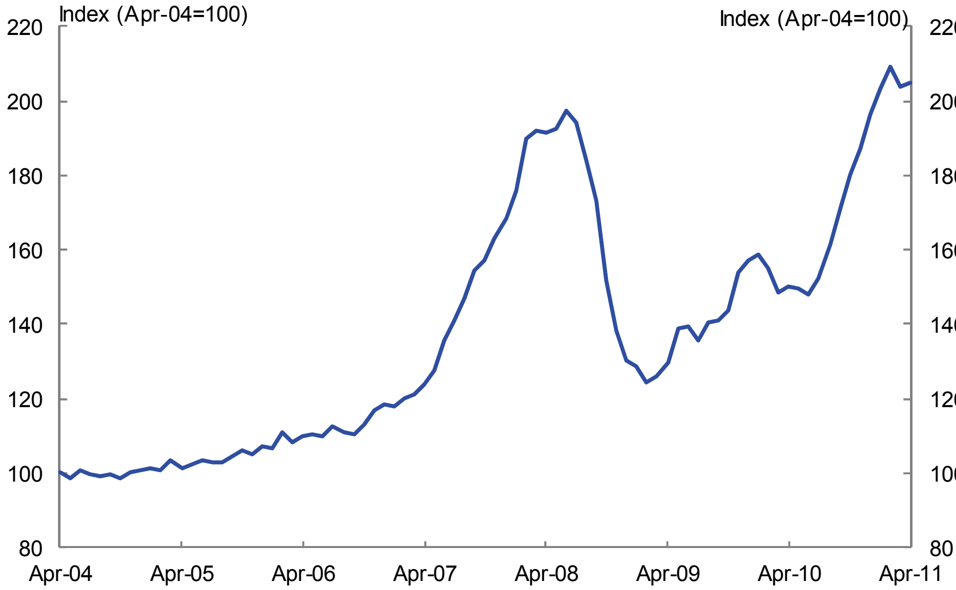
The resurgence of food and fuel prices signals the need for a renewed commitment by FIC Economic Ministers to re-double efforts to minimise risks to their economies into the future. A range of possible policy responses are identified for discussion. Where high and rising international food and fuel price rises are judged to threaten longer-term growth and economic welfare in the FICs, governments might consider — where factor and resource endowments (land, labour, capital and technology), climatic conditions and technical capabilities permit — whether some broadening of their domestic economic base over time could be advantageous. This form of longer-term base broadening could potentially involve non-distortionary resource allocation responses aimed at increasing efficiency, remaining competitive and moderating reliance on imported food and imported fuel by increasing or diversifying domestic food production where economically viable, and considering alternative sources of energy where feasible.

# I. Food Prices

## a) The global situation

Figure 1 shows movements in the Food and Agriculture Organisation (FAO) Food Price Index (based on nominal US dollar prices). The index increased by 68 per cent between February 2009 and April 2011, rising above its 2008 peak in January 2011. The resurgent rise in international food prices has sparked concerns about rising inflation, increasing poverty, and a longer-term 'food crisis'.

**Figure 1: FAO international food price index (US dollar-based)**

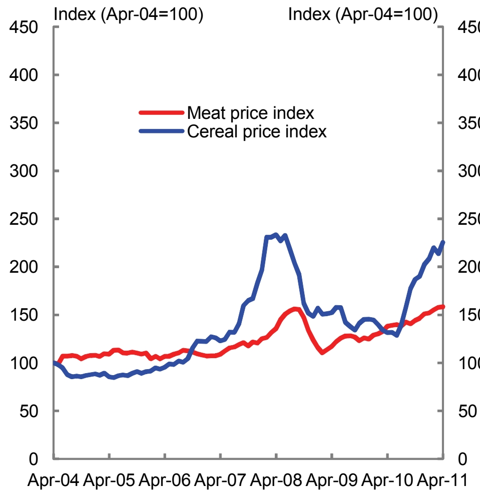



Source: FAO.

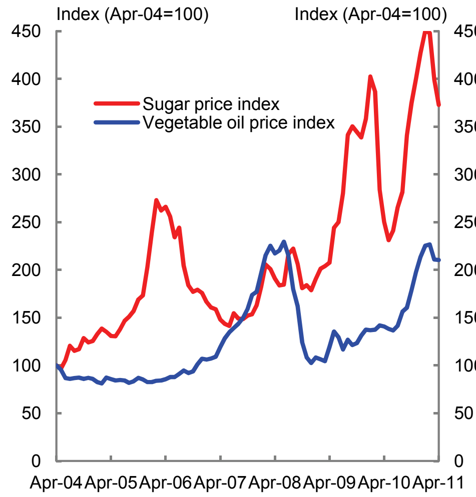
The main reasons for the latest surge in international food prices include: changes in market fundamentals such as weather-induced supply shortfalls, declining productivity, strong general food demand growth in emerging market economies and higher demand for meat and biofuels; tight stock levels; higher fuel, transport and agriculture feedstock prices; and loose monetary policies in some countries. Movements in the FAO food price index and the US dollar are correlated and this might be interpreted as suggesting that the rise in food prices is due to the depreciation of the US dollar exchange rate. However, the depreciation of the US dollar since March 2009, while influential directly and indirectly, has not been the dominant driving force behind the recent strong rise in the food price index.

Key components of the overall FAO food price index are reported in Figures 2 and 3. While price increases have been recorded for all major commodities in the FAO food price index, sugar prices have risen particularly strongly over the past year (Figure 3) but have fallen in recent months. Sugar has a relatively low weight in the FAO food price index and in Forum island food energy patterns. Vegetable oil and cereals prices have increased while meat price increases have been more subdued (Figures 2 and 3). Cereals, and rice in particular, are important commodities in Pacific island consumption and import patterns, as are meat and dairy.

**Figures 2 and 3: International vegetable oil, sugar, meat and cereal prices (US dollar-based)**




Source: FAO.




Source: FAO.

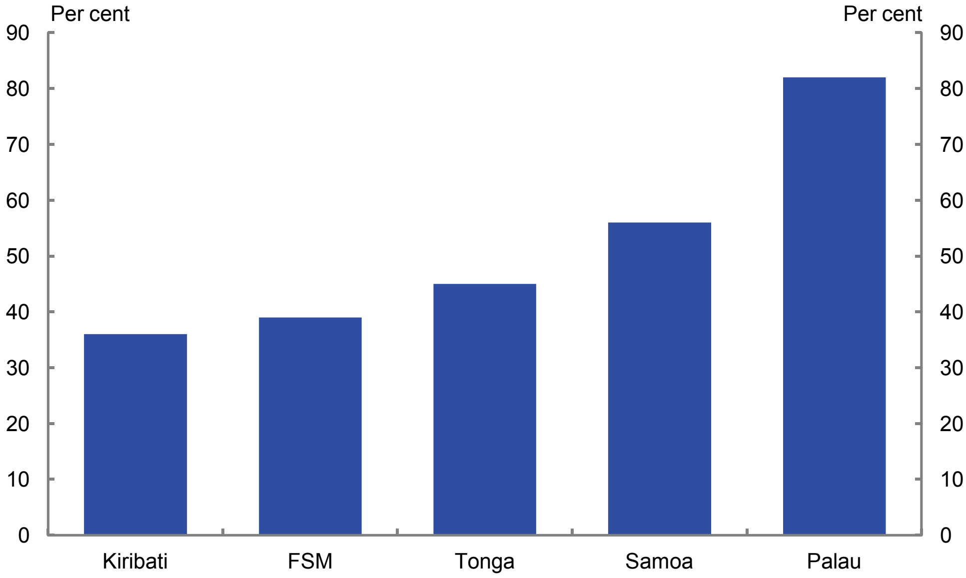
## b) FICs' vulnerability to rising international food prices

The magnitude of the effects of the rising international food prices in any FIC principally depends on the level of the country's reliance on imported food. The effects of rising international food prices in the Pacific are compounded by already high transport costs and rising international fuel prices. Rising international food prices result in higher inflation, a deterioration in the external balance, increased poverty and health complications.

While resource endowments mean that many FICs will necessarily retain a high degree of import dependency, there is significant heterogeneity across FICs when it comes to the reliance on imported food. In PNG and Solomon Islands the vast majority (around 75 to 85 per cent) of calories consumed come from domestically produced food, mostly through subsistence agriculture. Fiji and the Federated States of Micronesia (FSM), on the other hand, rely on imported food for around 60 to 70 per cent of protein consumed.[2] Import reliance can also be assessed by measuring the percentage of total food expenditure that is spent on imported food; shown for selected FICs in Figure 4. Using this measure Palau and Samoa have the greatest reliance on imported food of the countries shown.

2 See 'Pacific Island Food Security, Situation, Challenges and Opportunities', Andrew McGregor, R. Michael Bourke, Marita Manley, Sakiusa Tubuna and Rajhnael Deo, September 2008.

**Figure 4: Proportion of food expenditure accounted for by imported food**




Source: McGregor et al., 2008.

However, when assessing a country's vulnerability to increasing international food prices, it is also important to consider its ability to pay for the food it imports and account for the fact that higher international food prices could potentially benefit FIC exporters of food. A 2005 FAO paper examines this issue using the ratio of food imports to total exports plus remittances (Figure 5).

**Figure 5: Food insecurity using 'food import capability' indicators**

| Low | Moderate | High |
|---|---|---|
| PNG, Solomon Islands, Fiji | Vanuatu, Samoa, Tonga | Cook Islands, Kiribati, Niue, Tuvalu |

Source: FAO.

More recently the United Nations International Children's Emergency Fund (UNICEF)[3] developed an assessment of the vulnerability of Pacific island children and women to food price increases. This assessment considered, inter alia, the incidence of natural disasters, family size and level of social protection. The UNICEF results suggest that Tuvalu, Marshall Islands, Kiribati and Tonga have 'extremely high' levels of measured vulnerability (based on this measure).

Considering all of the above indicators, the most vulnerable FICs to international food price rises appear to be those countries with relatively small populations (Cook Islands, Kiribati, Marshall Islands, Niue, Palau and Tuvalu) that import a

3 'Situation Monitoring: Food Price Increases in the Pacific Islands', UNICEF, March 2011.

substantial portion of locally-consumed food and have a low export base that is unable to expand rapidly to take advantage of high global agricultural prices.

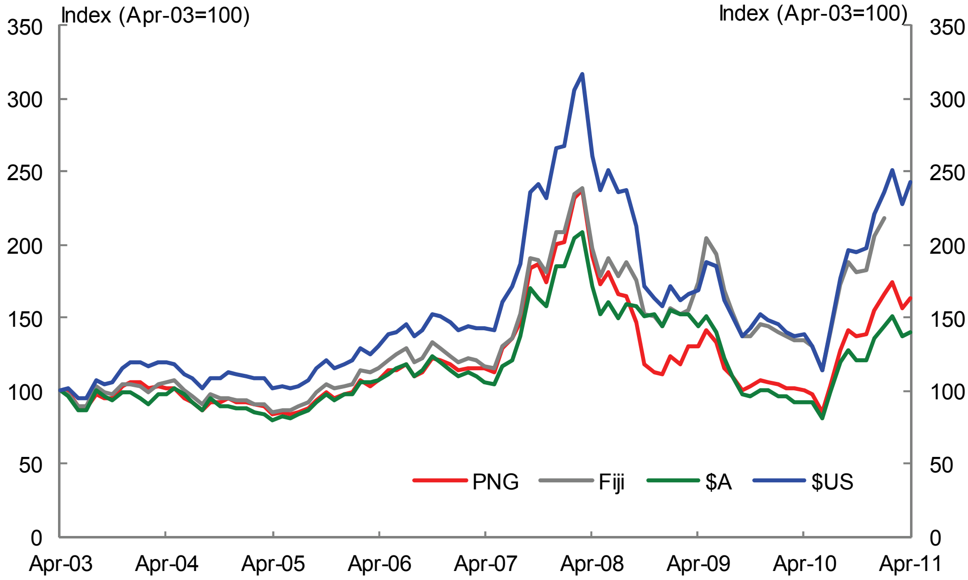
### c) Wheat, beef, chicken and rice prices in local currencies[4]

As of April 2011, international wheat prices (measured in US dollars) are 113 per cent higher than in the trough of June 2010, but have not reached the heights seen in 2008 (Figure 6). Global wheat prices, when converted to the currencies of PNG (Kina), Fiji (Fiji dollar) and Kiribati, Nauru and Tuvalu (which use the Australian dollar as their currency), have risen by smaller degrees over the same period than US-dollar based prices. For instance, the recent rise in international wheat prices measured in Australian dollar terms — around 70 per cent over the period since June 2010 — has been around 60 per cent less than the US dollar valued price rise[5], to the relative advantage of Kiribati, Nauru and Tuvalu on the assumption that they largely purchase wheat supplies from Australia.

4 There are a wide variety of currency arrangements across Forum island countries. Kiribati, Nauru and Tuvalu have adopted the Australian currency as their own; Cook Islands, and Niue adopted the New Zealand dollar; Marshall Islands, Micronesia and Palau adopted the United States dollar; Solomon Islands is closely tied (de facto peg) to the United States dollar; Tonga, Samoa, Vanuatu and Fiji have their own basket-based fixed exchange rates; and PNG has a managed floating currency.

5 This analysis assumes that the only difference between food prices in different countries is the exchange rate. It assumes the international price is prevalent in all countries. As such the analysis does not address transport cost differences, refining distribution and marketing costs, taxes, price controls, other regulatory arrangements and the effects of local events (for example, weather) on prices quoted on markets in different countries.

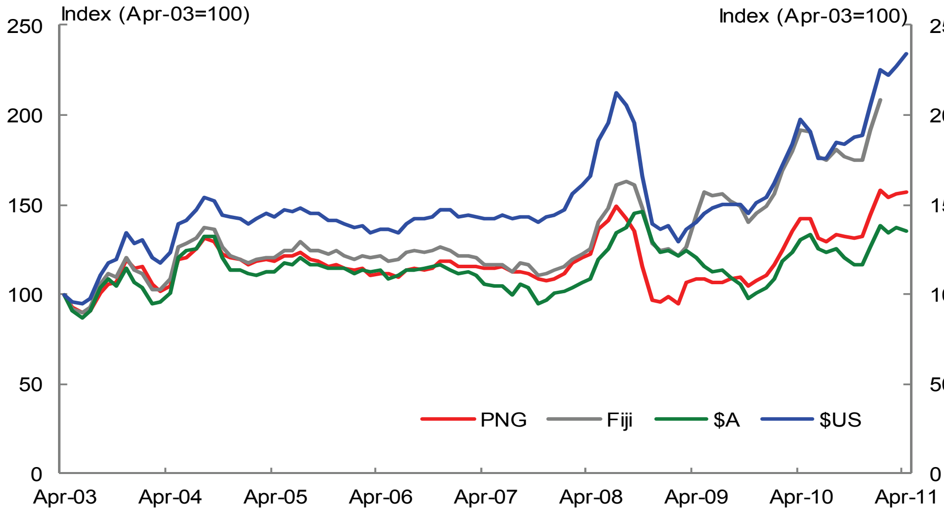
**Figure 6: Wheat price in the local currencies of PNG and Fiji; in $A terms for Kiribati, Nauru and Tuvalu; and in $US terms for Marshall Islands, Micronesia and Palau**




Source: Prices (World Bank), Exchange rates (IMF).

Meat, including beef, chicken and lamb, is a popular import in the Pacific island region. As with wheat, and all imported commodities, the different exchange rate regimes in place have influenced the local prices paid across the FICs. By way of illustration, the price of beef has risen significantly over the period since February 2009 when measured in $US dollar terms (up 80 per cent), while staying relatively unchanged when measured in Australian dollar terms (Figure 7). This benefits countries that are tied to the Australian dollar or that purchase beef using Australian dollars (abstracting from the influence of transport charges). As the Australian and New Zealand dollars have moved closely together over recent years, the same beneficial exchange rate impact is also true for Cook Islands and Niue assuming they purchase their beef using New Zealand dollars. Prices measured in Fiji dollars and Kina have risen faster than the Australian dollar and prices.

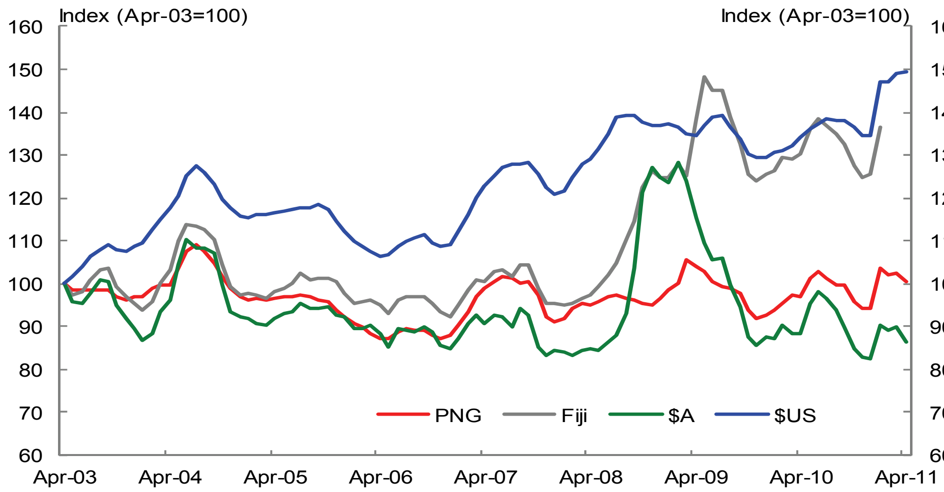
**Figure 7: Beef price in the local currencies of PNG and Fiji; in $A terms for Kiribati, Nauru and Tuvalu; and in $US terms for Marshall Islands, Micronesia and Palau**




Source: Prices (World Bank), Exchange rates (IMF).

The price of chicken has been relatively stable over recent years (Figure 8), and the World Bank forecasts little change going forward.

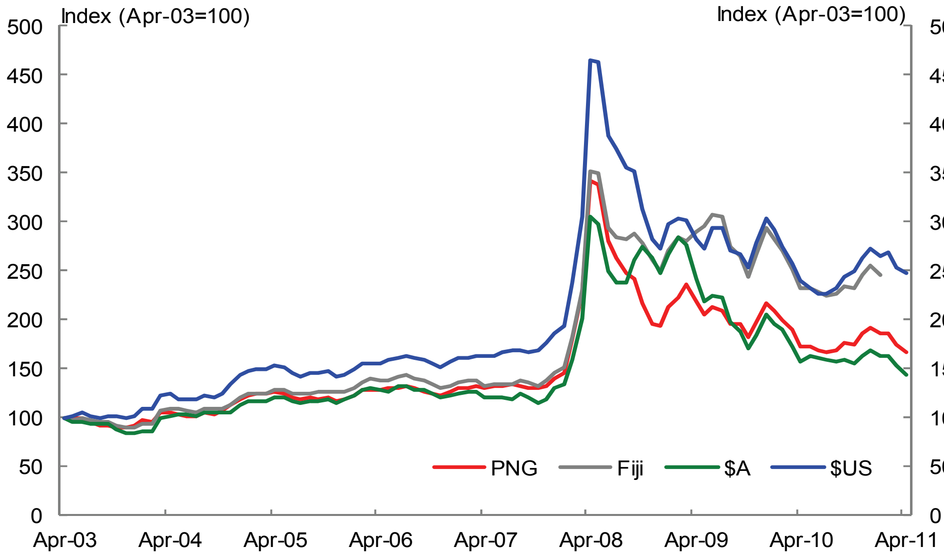
**Figure 8: Chicken price in the local currencies of PNG and Fiji; in $A terms for Kiribati, Nauru and Tuvalu; and in $US terms for Marshall Islands, Micronesia and Palau**




Source: Prices (World Bank), Exchange rates (IMF).

Rice prices spiked sharply in 2008 and have since fallen by about 50 per cent when measured in US dollar terms (Figure 9). The World Bank forecasts that the price of rice is likely to plateau over the next two years.

**Figure 9: Rice in the local currencies of PNG and Fiji; in $A terms for Kiribati, Nauru and Tuvalu; and in $US terms for Marshall Islands, Micronesia and Palau**




Source: Prices (World Bank), Exchange rates (IMF).

## d) Conclusion on food prices

The countries that are most vulnerable to international food price increases are mainly small, remote, soil-deficient, high-import-dependent states. Some of these states, for example Nauru, Kiribati, Cook Islands, Niue, Tuvalu, and possibly others, import substantial food supplies from Australia and New Zealand. These countries have been shielded to a degree from higher international food prices assuming they use either the $A or $NZ to purchase their food imports, both of which have risen recently against the $US. As a consequence the rise in local food prices could be lower than might otherwise be the case.

Fiji obtains 75 per cent of its total food and live animals imports from Australia and New Zealand. Because the Fiji dollar depreciated against the Australian and New Zealand dollars during 2009, Fiji would have incurred higher food costs.

Palau, Solomon Islands, Marshall Islands and the Federated States of Micronesia are likely to have been relatively adversely impacted by the recent rises in international food prices to the extent they source food supplies from the United States and transact in US dollars.

FICs with their own currencies, such as Tonga and Samoa, may have fared less adversely than the Compact States (Federated States of Micronesia, the Republic of the Marshall Islands and the Republic of Palau) to the extent their currencies have appreciated against the US dollar.

The international food price outlook is uncertain. Ongoing weather problems in the USA and Europe could reduce production in the world's two largest grain exporters next season and this could contribute to continuing high prices during 2012. The IMF expects international non-fuel commodity prices to rise by 35 per cent in 2011 in year average terms, before stabilising in 2012. The Asian Development Bank (ADB) the World Bank and the FAO consider that the underlying upward pressures on food prices are unlikely to moderate in the near future. Oxfam predicts that real international prices of staples will rise by between 120 per cent and 180 per cent by 2030[6].

# II. Fuel prices

## a) The global situation

Just as international food prices have been surging upward over recent years, so too has the international price of fuel when measured in nominal US dollars. Over the past two years, the US dollar price of oil has risen by 195 per cent (Figure 10). Recent international oil price increases have chiefly been the result of strong demand, particularly from newly emerging economies engaged in rapid industrialisation; under-investment in exploration, production and refining; OPEC supply policies; higher exploration and production costs; and uncertainty fuelled by tensions in the Middle East. The US dollar depreciation will also have influenced the US dollar-based price index.

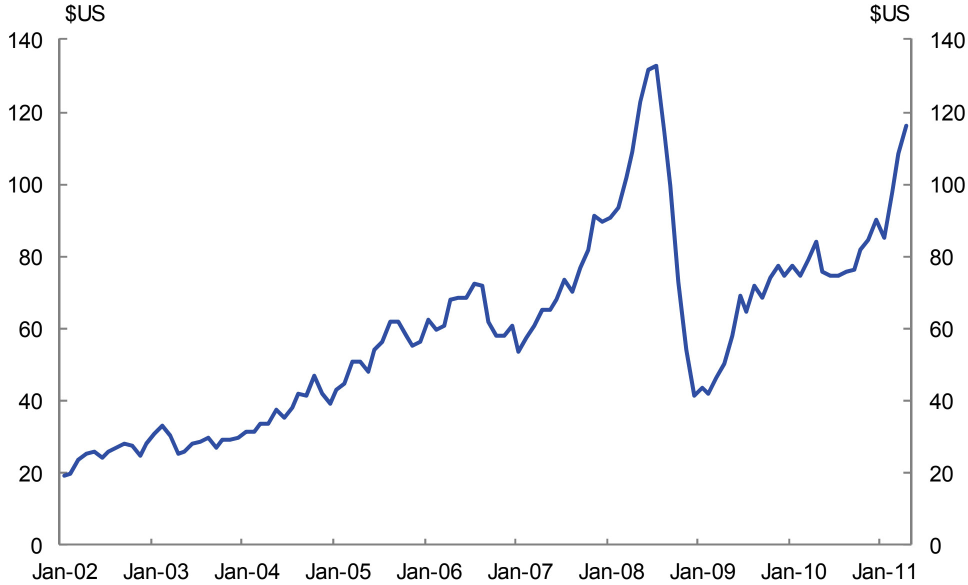
The sharply rising international oil price over the past two years represents a major supply-side shock to FICs, resulting in rising transportation, electricity and production costs and a higher cost of living.

Much of the fuel imported into the Pacific region, except for that destined for Australia, New Zealand and PNG, is shipped from Singapore through entrepots in Fiji and Guam[7]. These shipments are predominantly transacted in US dollars. However petroleum products do arrive in FICs from countries other than Singapore, including from Australia and New Zealand. Nauru currently sources oil supplies from PNG.

6 See 'Growing a Better Future: Food Justice in a Resource-Constrained World', Oxfam, 1 June 2011.

7 See 'Taking Control of Oil: Managing Dependence on Petroleum Fuels in the Pacific', Asian Development Bank, Pacific Studies Series, 2009.

**Figure 10: International crude oil price in US dollars**

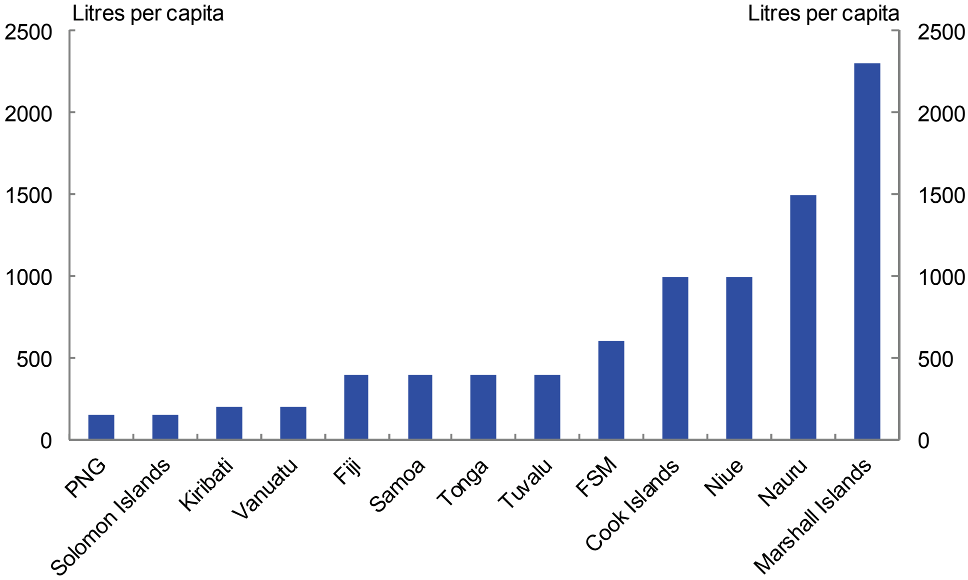



Source: World Bank.

## b) FICs; vulnerability to rising international fuel prices

FICs are heavily dependent on oil — particularly diesel, kerosene and gasoline — as a source of energy, especially for power generation (25 per cent of oil use) and transportation (75 per cent of oil use). Petroleum is responsible for more than 80 per cent of energy generation in the Pacific, with countries such as Cook Islands, Kiribati, Nauru, Solomon Islands, and Tonga relying almost exclusively on oil for their commercial energy requirements. Per capita fuel use varies across the region (Figure 11), with the smaller FICs using more oil per citizen and hence being more vulnerable to international fuel price movements.

**Figure 11: Per capita fuel use in the Pacific (2003)**




Source: Asian Development Bank.

PNG is a net exporter of petroleum and so PNG's balance of payments will benefit from the recent rises in international crude oil prices. However higher world and local prices mean that the poorer sections of the population in PNG still remain vulnerable to rising fuel prices.

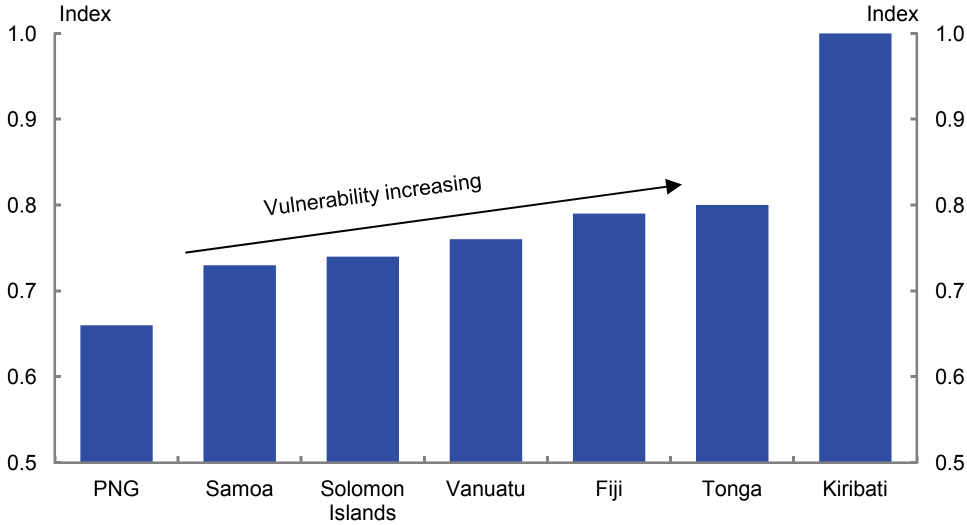
For FICs other than PNG most oil, and therefore energy generation, is imported. Fuel imports as a proportion of GDP were trending upward across a number of FICs (for example, Tonga, Solomon Islands and Samoa) prior to the oil price crisis in 2008. Fuel imports are, on average, equivalent to around 10 per cent of GDP[8] in the region.

In 2009 the ADB compiled an Oil Price Vulnerability Index (which combines measures like economic growth, oil intensity and budget balance[9]) for those FICs with sufficient data (Figure 12).

8 'Pacific Island Countries: Vulnerabilities to Commodity Price Shocks', *Regional Economic Outlook, Asia and Pacific, Managing the Next Phase of Growth*, IMF, April 2011.

9 The eight measures used are: balance of payments: current account; budget balance; import cover; oil import dependence; GDP per capita; oil intensity of GDP; real GDP growth rate; share of oil in primary energy consumption.

**Figure 12: Oil Price Vulnerability Index (2008)**




Source: Asian Development Bank.

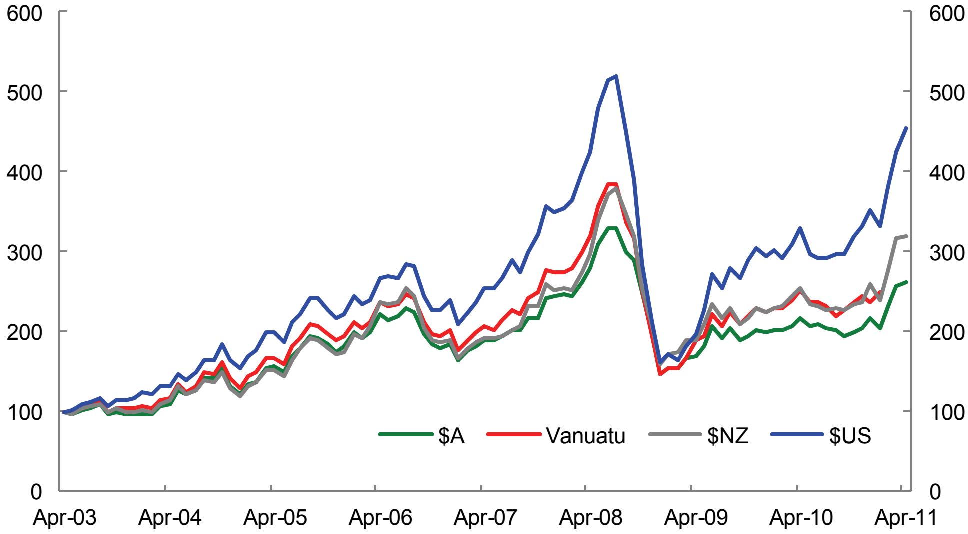
The FICs most vulnerable to rising international oil prices are those which rely on oil for energy generation, have a low export base and no domestic oil production. Kiribati and Tonga are the most vulnerable among the seven FICs analysed by the ADB. However, the ADB notes that 'overall, when compared to 39 other developing countries, all seven Pacific nations were among the 10 most vulnerable to international oil price rises.'

## c) Imported oil prices in local currencies

Petroleum products are generally traded and paid for in US dollars. These products are then on-sold to the local market in exchange for local currency.

As Figure 13 illustrates, the international oil price measured in Australian dollar terms (the currency used by Kiribati, Nauru and Tuvalu) has risen by only 70 per cent from January 2009 to April 2011. If measured in New Zealand dollars (the currency used by Cook Islands and Niue) the rise is 86 per cent. International oil price rises measured in these currencies are much less than the 165 per cent increase recorded in US dollar terms.

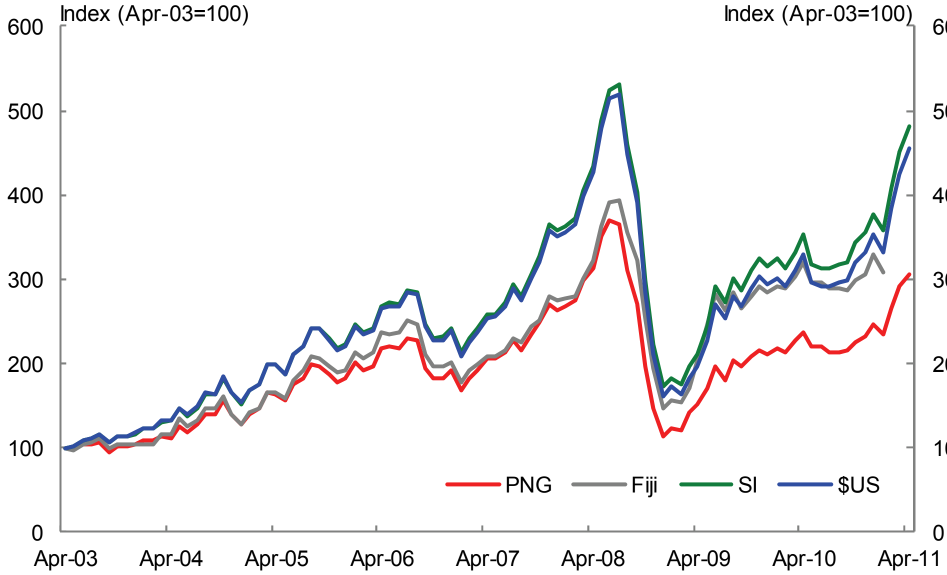
**Figure 13: Oil price in $US terms for Marshall Islands, Micronesia and Palau; in the local currencies of Vanuatu; in $A terms for Kiribati, Nauru, Tuvalu; and in $NZ terms for Cook Islands, and Niue**




Source: Prices (World Bank), Exchange rates (IMF).

The international price of oil measured in Fiji dollars and PNG Kina has risen by a smaller degree than the international price of oil measured in Solomon Island dollars over the longer term (since April 2003), but by a greater degree than the international price of oil measured in Australian dollars and vatu terms (see Figures 13 and 14).

**Figure 14: Oil price in US dollar terms for Marshall Islands, Micronesia and Palau; and in the local currencies of PNG, Fiji and Solomon Islands**




Source: Prices (World Bank), Exchange rates (IMF).

## d) Conclusion on oil prices

International crude oil price increases over the past year have risen toward the levels experienced during the last oil price shock in 2008. The region's strong reliance on oil for energy generation means that any international oil price increases are felt widely throughout the FIC region. Generally, exchange rate considerations aside, the most vulnerable FICs to rising fuel prices include the Marshall Islands, Nauru, Kiribati and Tonga.

Countries that purchase oil supplies in US dollars, are likely to have been relatively substantially impacted. FICs that have their own sovereign currency and have seen their local currencies appreciate against the US dollar will have benefited in relative terms (e.g. Samoa, Tonga and, most recently, Solomon Islands[10]). To the extent that other FICs were able to pay for their imported oil supplies in Australian or New Zealand dollars, the adverse effects of rising international oil prices could have been ameliorated over the past two years.

The outlook for international crude oil prices is uncertain. The IMF expects international crude oil prices to rise by 25 per cent in 2011 in year average terms, declining slightly in 2012. Any substantial unexpected slowing in global economic

10 Solomon Islands government announced a 5 per cent appreciation of the Solomon Islands dollar on 14 June 2011.

activity could take prices sharply lower. The International Energy Agency (IEA) expects average IEA crude oil prices to rise from just under $US60 per barrel in 2009 to $US113 per barrel (in 2009 dollars) by 2035[11].

## III. Summary of food and fuel price vulnerability

The main findings from the above analysis are that, exchange rate considerations aside, the most vulnerable FICs to international food price rises include Cook Islands, Kiribati, Marshall Islands, Niue, Palau, Tuvalu, and likely Nauru. This mainly reflects their small populations, import dependency and low export bases.

As well, exchange rate considerations aside, the most vulnerable FICs to international crude oil price rises appear to be Kiribati, Marshall Islands, Nauru and Tonga. This mainly reflects their high import dependency and fuel use per capita.

Marshall Islands, Kiribati, and most likely Nauru are highly vulnerable to both food and fuel price rises.

Exchange rate arrangements, local exchange rate developments and the currency used to pay for purchases of imported oil and food can be important determinants of the severity of international price rises on local FIC economies. Generally those countries with appreciating currencies have suffered less than those with depreciating currencies.

## IV. Macroeconomic effects

Where countries are vulnerable to international food and fuel price rises, they generally experience higher inflation, a deterioration in the balance of payments and lower real incomes.

### Inflation effects

Across the Forum island region, food prices account for around 45 per cent of their consumer price index baskets on average.

In 2008 surging food and fuel prices contributed to a rise in inflation across the Forum island region, lifting inflation (on average) from 2.5 to 12 per cent per annum.

The pass-through of international crude oil price rises into domestic inflation was almost complete but the pass-through of food price increases was smaller as some FICs reduced tariffs on food or introduced price controls[12].

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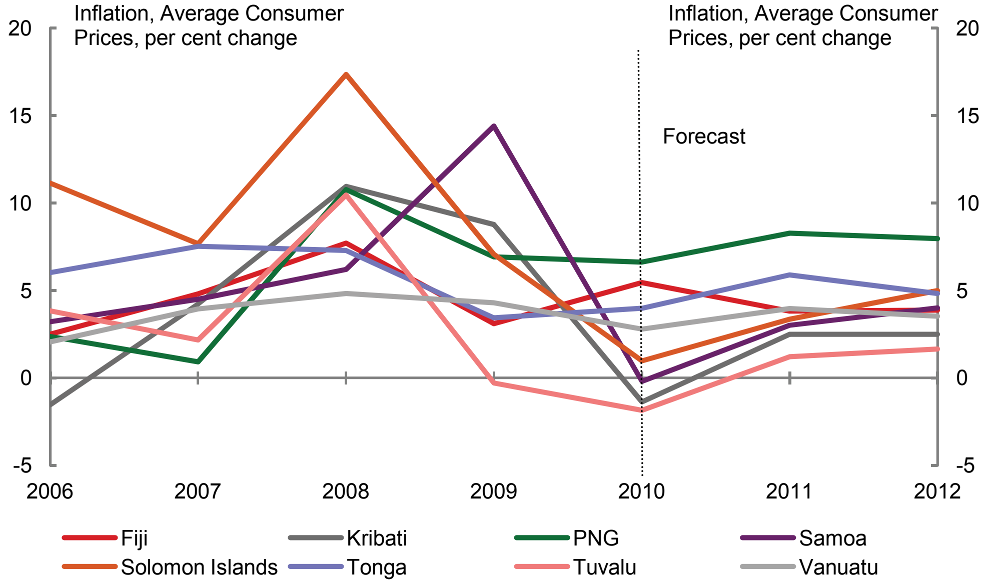
11 See IEA, Press Release, 10(15), November 2010.

Higher food and fuel prices, in combination with other forces, contributed to rising inflation in FICs during 2010 and into 2011, but inflation is expected to be relatively subdued across the Pacific later in 2011 and in 2012 (see Figure 15).

Based on IMF forecasts, inflation is expected to pick up by around two or three percentage points in Solomon Islands, Tuvalu, Kiribati, PNG, Tonga and Nauru in 2011. The ADB expects a broadly similar-sized rise in inflation in the Marshall Islands. The expected rise in inflation in these countries is partly or largely due to higher international commodity prices (the effects of which, in some FICs, has been contained somewhat by currency appreciation).

FICs have relatively high levels of liquidity (which influences inflation) in their banking systems at the present time, but inflationary price pressures have been subdued by flat GDP (in a number of FICs) and weak demand for loans by the private sector. With liquidity high, and food and fuel prices strong, there may, nevertheless, be upside risks to the inflation forecasts. Over the year to May 2011, inflation was running at higher than forecast in Fiji. Inflation is also above forecast in Solomon Islands and Tonga, over the year to April 2011.

**Figure 15: Recent inflation experience and forecasts**




Source: IMF.

12 'Pacific Island Countries: Vulnerabilities to Commodity Price Shocks', *Regional Economic Outlook, Asia and Pacific, Managing the Next Phase of Growth*, IMF, April 2011

### Balance of payments effects

Generally, while rising international food and fuel prices will be working to weaken FICs' balance of payments positions, large adverse balance of payments movements are not expected in the period ahead, partly due to subdued domestic demand. Higher levels of foreign currency reserves may provide a buffer in some FICs.

During 2010 and into 2011, the balance of payments in PNG has benefited from higher commodity export prices for mining products, crude oil, agriculture and logs. Nauru has benefitted from higher phosphate prices, and rising international log prices assisted the balance of payments of Solomon Islands.

FICs with their own currencies have scope to adjust their exchange rates in response to external price shocks. FICs that have adopted another currency as their own do not have this capacity.

### Lower real incomes, poverty and budget effects

Rising food and fuel prices have their greatest adverse effects on the poorest urban households, those in rural areas without access to land, those families that are net consumers of food, and those outer-island dwellers vulnerable to higher fuel and transport costs. As prices rise, and if cash incomes are unchanged, then living standards fall, although the effects of rising import prices may be mitigated if individuals can substitute the more expensive imported products with cheaper locally produced products (including, for example, fish). In some cases, however, family stress and poverty increases, nutrition can suffer, malnutrition may spread and health costs could be raised. Policy responses to such developments generally involve increased budget expenditures.

## V. Policy Principles

Governments need to review possible policy responses to mitigate, where necessary, the adverse economic effects of rising international food and fuel prices.

### a) Examples of policy responses to the 2008 food and fuel price spike in FICs

A range of different policies were employed across the Pacific in the wake of the surge in food and fuel price increases in 2008. These policies included:

- Reduced tariffs on food, fuel and poultry feed, fishing equipment and other agricultural inputs; lower taxes on food and fuel; price controls; increased subsidies on food, fuel and electricity; delays in raising electricity prices and other state enterprise prices.

- Encouragement to buy locally-produced goods and cultivate garden crops; training programs to transform breadfruit into flour; promotion of root crops, coconut replanting, organic farming and virgin oil production; fuel rationing.

- Increased income tax thresholds, removal of excise duties on sea and air transport operations.

- Increased foreign aid aimed at food and fuel provision, declaration of a state of emergency.

- Loans to increase fuel storage capacity.

## b) Examples of policy responses to recent 2010-2011 escalation in oil and food prices

A recent UNICEF publication[13] identifies recent policy measures introduced by a number of FICs, viz:

- Vanuatu has a preferential tax rate on preferred food items, the duty rate on essential food items has been reduced and copra price subsidies have been increased.

- Tonga is controlling the cost of flour and fuel.

- Kiribati has introduced price controls for basic food items, ensures cargo shipments to address food shortages in outer islands and has been supporting garden production of nutritious foods.

- Fiji is now setting prices for a range of essential items. However VAT was increased by 2.5 per cent in February 2011 and canned fish (widely consumed) is now also subject to a fiscal duty of 15 per cent.

Solomon Islands recently appreciated its currency in part to counter rising international food and fuel prices.

The World Bank is providing 62,000 residents of the outer islands of Kiribati with emergency food supplies.

The IEA is releasing 60 million barrels of crude oil from emergency stocks.

The World Bank is supporting the development of an Agricultural Price Risk Management product for potential application in developing countries, focussing initially on Latin America and Southeast Asia.

13 *Situation Monitoring: Food Price Increases in the Pacific Islands*, UNICEF, March 2011

The G20 has advanced a series of work streams on commodity price volatility: see details at Attachment A. G20 Agriculture Ministers have agreed to an 'Action Plan on food price volatility and agriculture' which will be submitted to Leaders at their Summit in November 2011. As well, G20 Agriculture Ministers have requested that relevant international institutions develop a proposal for a pilot program for regional emergency humanitarian food reserves. The pilot program would cover a limited group of countries, selected from Low Income Food Deficit Countries as determined by FAO and Least Developed Countries as defined by the United Nations General Assembly in a particular region. Some FICs are in these country groupings.

Australia contributes to Pacific food security through investment in the Pacific Horticulture and Agricultural Market Access Program, the Pacific Agricultural Research Development Initiative and support for various fisheries initiatives through the Secretariat of the Pacific Community and Forum Fisheries Agency.

## c) General policy principles

The international experience has led various institutions such as the IMF, ADB, World Bank and UNICEF to suggest a range of principles to guide decision-making to address rising food and fuel prices[14]. These include the following types of approaches:

### Resource allocation policy

At the broadest level, when faced with multiple food and fuel price shocks and higher price levels (both relative and absolute), a well functioning, undistorted price system is desirable.

It would also be beneficial to remove supply bottlenecks and encourage greater domestic production (where possible) by: investing in transport infrastructure; improving efficiency in the transport sector; facilitating land reform; improving agricultural productivity and further developing irrigation and reticulation where appropriate, in conformity with sound cost/benefit principles.

Some FICs could benefit from: the development of clearer, comprehensive energy policies with the objectives of achieving greater fuel efficiency (including in the transport sector and through bio-fuels); the development of non-petroleum-based and renewable energy production, including hydro-power, wind-power and solar energy; and establishing the feasibility of erecting oil storage facilities.

These various resource allocation policies could potentially broaden the economic base and reduce excessive oil and import dependency. While FICs should not invest in

14 See, as well, the Communique of the Inaugural Regional Meeting of Ministers of Energy, Information and Communication Technology (ICT) and Transport, Secretariat of the Pacific Community, Noumea, New Caledonia, 4-8 April 2011.

inefficient or uneconomic industries, such reforms could increase the efficiency of existing industries and open-up new areas of competitive advantage.

### Policies to address inflationary effects

General inflationary pressures resulting from rising food and fuel prices need to be carefully monitored. Reducing excess liquidity and tightening monetary policies may be necessary to avoid and counter second-round food and fuel price impacts on inflation and inflationary expectations.

It may be advantageous to review and rationalise existing oil procurement arrangements and oil pricing policies, including development of options for competitive tendering and obtaining fuel at lower prices than in existing contractual agreements.

Encouraging competition and reducing barriers to entry in key production, transport and marketing sectors may help minimise the impacts of high food and fuel prices on consumers.

Where feasible, greater use of hedging mechanisms may enable traders and users of commodities to minimise the effects of price volatility. However, some hedging instruments, for example, foreign exchange futures, are not widely available in the Pacific island region.

Market uncertainty about food stocks may work to maintain high prices. Greater market and related data transparency may be of general benefit.

Price controls on food and fuel prices and ceilings aimed at controlling inflation are distorting and limit domestic responses to higher import prices by reducing the attractiveness of local products and limiting investment in domestic production.

### Exchange rates, trade and the balance of payments

In the face of external price shocks adequate exchange rate flexibility may help avoid real exchange rate overvaluation or undervaluation and minimise adverse competitiveness or inflation impacts respectively.

Generally, all else remaining equal, appreciating exchange rates reduce the domestic inflation effects of international food and fuel price increases but weaken general trade competitiveness. Depreciating currencies increase adverse domestic inflation effects but improve general trade competitiveness. Clearly for FICs with their own currencies there is a trade-off to be made between trade and inflation objectives in response to external price shocks.

As noted in the outcome of the Pacific Islands Forum Energy Ministers' Meeting (2011), FICs may want to consider exploring alternative cost-effective and reliable oil supply sources while at the same time reviewing current oil pricing practices and policies.

An open global trading system is desirable. Reducing tariffs on food and fuel and agricultural inputs may be beneficial in ameliorating increases in prices and costs, but there would be an associated adverse impact on the budget balance, and an incentive for continued import dependency.

The use of export restrictions to lower or contain domestic prices will lower the incentive to invest domestically to boost supply, reduce global food supplies and threaten world food security.

### Fiscal policy

Food and fuel subsidies may be problematic as they can be poorly targeted, dampen price signals, and may not be based on need and represent an additional call on scarce budget resources.

Any reductions in consumption taxes on food and fuel need to be carefully considered against the cost to government revenue, administrative complexity and price distortions.

As direct taxes in FICs are likely to be paid mainly by the relatively well off members of their societies, direct tax reductions may be inequitable, mainly benefiting the rich.

Any budget measures must be carefully judged and take into account the overriding need to maintain fiscal sustainability.

FICs may need to review incentive structures and regulations that distort food and oil consumption and production.

### Poverty alleviation policies

Where FICs have adequate systems in place, governments may consider expanding or strengthening monitoring programs, safety nets, targeted cash transfers and nutritional programs.

Given the importance of strong family ties, informal safety nets and the informal economy in offsetting shocks in FICs, governments should carefully assess needs and the impact of different policy options.

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# Attachment A: G20 work on commodity price volatility

Addressing commodity price volatility and food security are key G20 priorities. Work on commodity price volatility is progressing in various G20 work streams (see below). Recommendations will be presented to G20 Leaders for consideration at the Cannes Summit on 3-4 November 2011.

## G20 Study Group on Commodities

This Study Group is considering the drivers of commodity prices (physical and financial), macroeconomic and other impacts of commodity price volatility, and the linkages between the physical and financial markets for commodities. The Study Group will lay the groundwork for subsequent policy discussions by finance ministers.

## Development Working Group (DWG)

The DWG was tasked with mitigating risk in price volatility and enhance protection for the most vulnerable. The international organisations (the Food and Agriculture Organisation, International Fund for Agricultural Development, the International Monetary Fund, the Organisation of Economic Cooperation and Development, the United Nations Conference on Trade and Development, the World Food Program, the World Bank, the World Trade Organisation, the International Food Policy Research Institute and the United Nations High Level Task Force on the Global Food Security Crisis) were tasked to 'develop options for G20 consideration on how to better mitigate and manage the risks associated with the price volatility of food and agricultural commodities without distorting market behaviour, ultimately to protect the most vulnerable.' Recommendations from this paper have shaped aspects of the proposed agriculture action plan to be issued by G20 Agriculture Ministers in June.

## G20 Agriculture Ministers meeting

A one-off Agriculture Ministers' meeting will consider price volatility in agricultural commodity markets. Agriculture Ministers will issue a communiqué and put forward an action plan for endorsement at the G20 Leaders' meeting in November. A key focus will be on improving the transparency of physical agricultural commodity markets, and increasing long-run agricultural productivity.

## Supervision and regulation of commodity derivatives markets

Further work is underway on the supervision and regulation of commodity derivatives markets and ways to improve market integrity and efficiency. G20 Finance Ministers and Central Bank Governors tasked the International Organisation of Securities Commissions (IOSCO) to undertake work to strengthen transparency and address market abuses. IOSCO intends to revise and improve its best practice guidelines for the regulation and supervision of commodity derivatives markets. IOSCO also continues to work on the development of a trade repository for financial oil contracts.

## Financial Stability Board (FSB) Over-the-Counter (OTC) Derivatives Market Reforms

The G20 has called for 'all standardised OTC derivative contracts to be centrally cleared, and to be traded on exchanges or electronic trading platforms where appropriate.' The FSB has proposed recommendations for practical implementation to improve transparency, mitigate systemic risk, and protect against market abuse in commodity derivatives markets.

## G20 Fossil Fuel Price Volatility Working Group

This Working Group is focused on physical markets and linkages with financial markets. The Working Group is considering ways to improve reporting on oil data. The Working Group will consider a report from international organisations on price drivers in coal and gas markets. The Working Group will also assess a report on how oil spot market prices are assessed by oil price reporting agencies.

# Compulsory superannuation and national saving

Dr David Gruen and Leigh Soding[1]

This paper was presented by David Gruen at the 2011 Economic and Social Outlook Conference on 1 July 2011.

1 The authors are from Macroeconomic Group, the Australian Treasury. The authors are extremely grateful to Phil Gallagher and George Rothman for much help with the empirical estimates presented in the paper, and to Nicholas Gruen, James Kelly, Tony MacDonald, Steve Morling and Martin Parkinson for helpful comments.

## Introduction

Thank you for the opportunity to speak to you.

The question of whether, as a nation, Australia saves enough has been a recurring one — especially in the years since the mid 1980s as it became increasingly clear that sizeable current account deficits were becoming a prominent feature of the Australian economic landscape. [2]

Most recently, this question has again been brought to the fore by the mining boom, with its huge boost to Australian national income. In its most recent incarnation, many have argued that Australia needs a sovereign wealth fund to save more of the bounty from the mining boom for the benefit of future generations.

In my remarks today, I want to make a modest contribution to this debate. In particular, I want to discuss the role that compulsory superannuation has played, and will continue to play, in contributing to Australia's national saving.

## Australian national saving and investment

Before delving into the details of compulsory super, it is of interest to recall how Australia fares, relative to peer countries, in terms of gross national saving and investment. Table 1 shows the results for Australia, New Zealand, and the G7 countries, for the decade to 2010, with outcomes shown separately for the first and second halves of the decade.

2 The Australian current account deficit rose from 1.1 per cent of GDP in the 1970s, to 4.1 per cent in the 1980s, 3.9 per cent in the 1990s and 4.6 per cent in the 2000s.

**Table 1: Gross national saving and investment**

Per cent of GDP

| | Gross National Saving | | Investment | |
|---|---|---|---|---|
| | (2001-2005) | (2006-2010) | (2001-2005) | (2006-2010) |
| Australia | **21** | **24** | **26** | **28** |
| NZ | 19 | 16 | 23 | 22 |
| US | 15 | 13 | 19 | 18 |
| Japan | 27 | 26 | 23 | 22 |
| Germany | 20 | 24 | 18 | 18 |
| UK | 15 | 14 | 17 | 16 |
| France | 20 | 19 | 20 | 21 |
| Italy | 20 | 18 | 21 | 21 |
| Canada | 22 | 22 | 20 | 22 |
| **OECD average** | **22** | **21** | **22** | **22** |
| **G7 average** | **20** | **19** | **20** | **20** |

Notes: Average over the specified period. Australian data are on the new System of National Accounts (SNA) 2008 basis, while other data uses the SNA93 and therefore may not be fully comparable due to changes in savings and investment measurement methodologies, although the differences appear small. New Zealand data are only to 2009.
Source: IMF World Economic Outlook, April 2011.

In the first half of the decade, Australia's gross national saving rate was close to the average for both the G7 and the OECD while, in the second half of the decade, Australia's saving rate was clearly above the average rates for the G7 and the OECD.

Of course, this second period is punctuated by the global financial crisis, and therefore might not be a good guide to longer term trends. Nevertheless, Australia's gross national saving rate in the 2000s is clearly similar to or, in many cases, higher than the saving rates of comparable countries.

Of particular note is the comparison with the other Anglophone countries (Canada, New Zealand, United States and United Kingdom) which have similar deregulated financial systems, which facilitate peoples' capacity to borrow against assets and future income, and thereby tend to reduce national saving rates.[3] Compared to these other Anglophone countries, Australia's national saving rate stands out as being high.

As Table 1 also makes clear, Australia's persistently high current account deficits are a consequence of very high national investment, rather than low saving. Over the decade to 2010, Australia's national investment rate has been well above those of all the other countries in Table 1, averaging a full 5 percentage points of GDP above the OECD average over that time.

3 For more on the relevance of deregulated financial systems for national saving, see Gruen (2005).

One important contributor to Australia's relatively high national saving rate is the long history of prudent fiscal policy in Australia that has kept net government debt at low levels and thereby contributed to national saving.[4]

Another important contributor to Australia's high national saving has been the establishment and gradual growth in compulsory superannuation.

It is to this that I now turn.

## The history of compulsory super

The compulsory superannuation system began with industrial award-based superannuation, agreed by the Government of the day and the Australian Council of Trade Unions as part of the 1985 Prices and Incomes Accord. A 3 per cent superannuation contribution was paid by employers into employees' individual accounts in nominated superannuation funds, rather than being paid as a wage rise.[5]

The coverage of award superannuation was expanded significantly in 1992, with the introduction of the Superannuation Guarantee Levy, which required employers to make superannuation contributions on behalf of their employees, and enshrined superannuation contributions in federal legislation rather than relying on the award system.

The then Government announced plans to gradually increase the minimum contribution rate to 9 per cent by 2000-01 (amended by the subsequent Government to 2002-03). In 2010, the current Government announced plans to raise the contribution rate gradually from 9 per cent to reach 12 per cent by 2019-20.

The expansion of the superannuation system saw employee coverage rise sharply, from around 40 per cent of total public and private sector employees in the mid 1980s, to more than 90 per cent a decade later, where it has broadly stabilised. This growth in coverage of superannuation and the gradual rise in contribution rates have seen a strong rise in superannuation assets, so that they now constitute the second largest component of household wealth after property assets (owner-occupied housing and other property assets).[6]

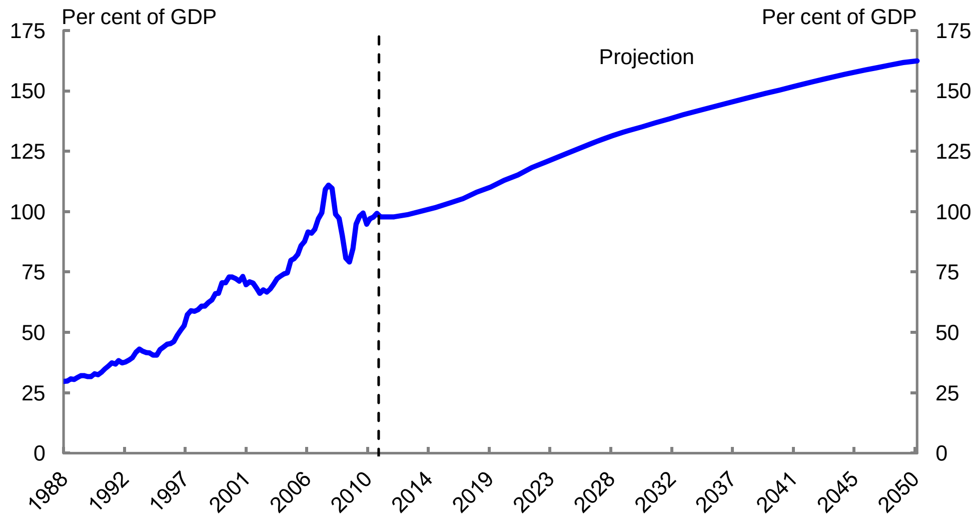
4 This conclusion assumes only partial 'Ricardian' offset by the private sector to changes in government debt; an assumption supported by most empirical evidence (see De Mello et al. (2004) and Gale and Orszag (2004) for example).

5 The decision was formally endorsed by the Conciliation and Arbitration Commission (the predecessor to the Australian Industrial Relations Commission and now Fair Work Australia) in 1986, and superannuation contributions began to be incorporated in awards.

6 Based on the latest survey of household wealth by the ABS in 2005-06.

At the end of 2010, total superannuation assets, arising from both compulsory and voluntary super contributions, were around $1.3 trillion, or about 100 per cent of annual GDP (Figure 1). With the proposed increase in the Superannuation Guarantee to 12 per cent, total superannuation assets are projected to grow to over 160 per cent of GDP by mid-century, assuming a 4 per cent real pre-tax after-fee rate of return on assets, which is the average over the past 30 years.

**Figure 1: Superannuation assets**




Source: ABS Cat. No. 5206.0 and 5232.0, APRA and Treasury.

As I will discuss in more detail shortly, the stock of assets in the Australian superannuation system is not that much smaller, relative to the size of the economy, than the stock of assets in the Norwegian Government Pension Fund Global, which is often held up as an exemplar of advanced economy sovereign wealth funds.

I turn now to the question of how much compulsory superannuation has contributed to Australian national saving.

## The contribution of compulsory super to national saving

The extent to which a compulsory saving scheme adds to national saving depends on the extent to which money saved in the scheme is offset by reductions in other forms of saving.

For those on lower incomes, credit constraints imply a limited capacity to reduce other forms of saving in response to a rise in compulsory saving – which suggests that the offset is likely to be small for these people.

For those on higher incomes, credit constraints are less binding and significant reductions in other forms of saving seem a plausible response to a rise in compulsory saving, at least for some of these people.

However, there is by now significant evidence of the importance of behavioural insights for the decision about how much to save for retirement, with commitment devices and default options having a significant impact on aggregate levels of retirement saving. These insights remain relevant even for those on high incomes who could in principle offset any effects of compulsion on their aggregate level of saving.[7]

There have been a few attempts to estimate the extent to which other forms of private saving are reduced in response to compulsory superannuation. Perhaps the most compelling of these estimates, based on an analysis of microeconomic survey data from the Household Income and Labour Dynamics in Australia (HILDA) survey, is by Ellis Connolly of the Reserve Bank who estimated a private saving offset of 30 per cent or less (Connolly, 2007; see also Connolly and Kohler, 2004).

The results presented here assume an offset of 30 per cent and use the methodology outlined by Gallagher (1997) to estimate the boost to private saving through time from the introduction and gradual growth of compulsory superannuation.[8]

Part of the boost to private saving comes from the public sector, because of the tax-preferred status of superannuation. The public sector forgoes tax revenue that otherwise would have been collected had compulsory super contributions been paid instead as wages to employees.

This forgone tax revenue interacts with the Federal government's fiscal strategy in an important way. Recall that the fiscal strategy commits the Federal government to achieve budget surpluses on average over the medium term. It follows that any budget shortfall arising from the tax-preferred status of compulsory superannuation must be offset elsewhere in the budget, on average over the medium term.

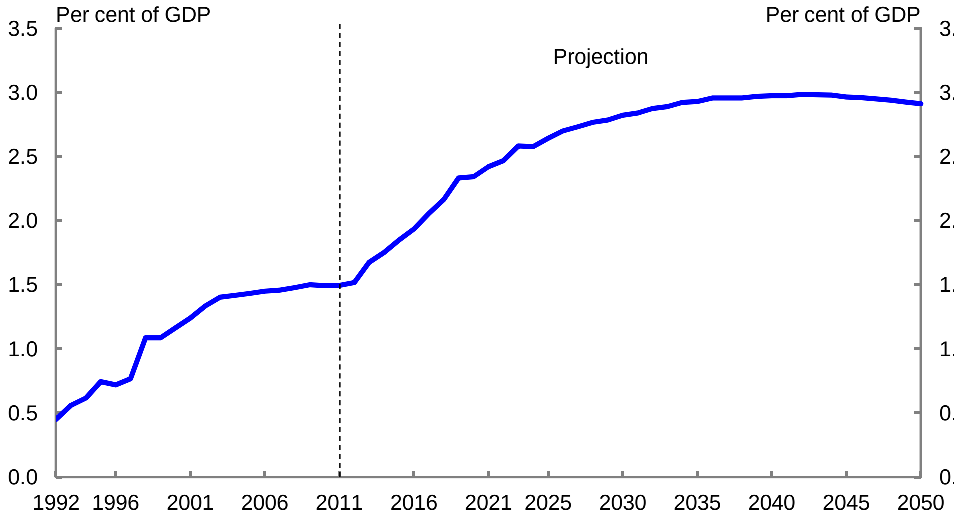
7 See 'Regulation of Retirement Saving', Squam Lake Working Group on Financial Regulation (2009) and Gruen and Wong (2010) for further discussion and evidence.

8 The methodology involves detailed modelling of financial flows for a large number of cohorts which make up the household sector. For each cohort, the calculations accumulate super and non-super savings through time with assumed rates of return, and take account of tax payments and expenditures, and other interactions with the tax/transfer system. The contributions of compulsory super to saving, from both the private and public sectors, are calculated relative to a counterfactual in which the compulsory super contributions were instead paid as wages, and assume a 30 per cent private saving offset to all changes to compulsory super contributions.

Subject to some caveats, the boost to private saving therefore translates (on average over time) to the same boost to national saving because the public sector makes good any shortfall in tax revenues elsewhere in the budget.[9]

Figure 2 presents the results. The current estimated boost to private (national) saving is about 1.5 per cent of GDP, rising significantly over the next decade, as the Superannuation Guarantee rises gradually from 9 to 12 per cent.

**Figure 2: Estimated contribution of compulsory super to private saving**



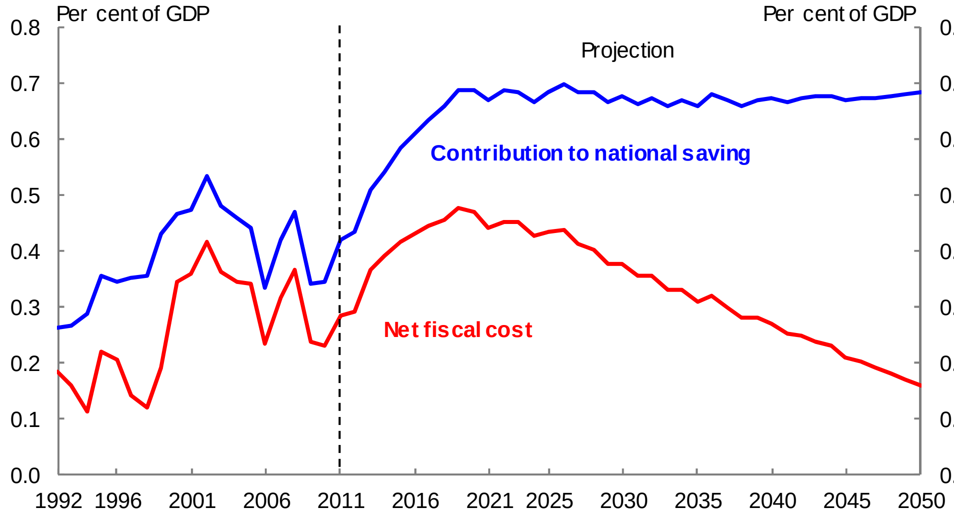

Note: Estimated contribution in history has been smoothed. Subject to some caveats, the contribution to national saving should be the same, on average over time, as the contribution to private saving (see text).
Source: Treasury.

The public sector's contribution to private (and therefore national) saving as a consequence of the compulsory superannuation system is shown by the blue line in Figure 3. As previously mentioned, this public sector contribution arises from the tax-preferred status of compulsory super. The public sector's contribution is estimated to be about 0.4 per cent of GDP currently, rising gradually to nearly 0.7 per cent of GDP

9 The caveats are as follows. Since the budget balance is public saving minus public investment, returning the budget to surplus can be achieved in principle by some combination of higher public saving and lower public investment. For the boost to private saving to translate to the *same* boost to national saving requires that the shortfall to tax revenue from compulsory super be offset by raising public saving rather than cutting public investment. It also requires that making up the shortfall elsewhere in the budget does not lead to lower non-super private saving. Note further that, for the purposes of the argument in the text, it does not matter whether the fiscal strategy is surpluses on average over the medium term (the current Government's strategy), or budget balance on average over the medium term (the previous Coalition Government's strategy). What matters is that the government makes good any shortfall in tax revenues elsewhere in the budget, on average over the medium term.

by the end of the decade, and then staying around that level to the middle of the century.

**Figure 3: Public sector contribution to national saving and the net fiscal cost**




Source: Treasury.

The estimated net fiscal cost to the budget, shown in the red line in Figure 3, is smaller than the public sector's contribution to private saving, because budget savings arising from the compulsory super system reduce the net fiscal cost of compulsory super.[10]

## Compulsory super and sovereign wealth funds

As mentioned at the beginning of the talk, over the past few years there have been many suggestions that Australia needs a sovereign wealth fund to save more of the bounty from the mining boom for the benefit of future generations.

In light of these suggestions, it is worth spending some time discussing the nature of sovereign wealth funds and where Australia's compulsory super system fits in.

Sovereign wealth funds, of whatever type, must be complemented by fiscal rules which determine when, or under what economic conditions, funds are to be transferred from the government's budget into the sovereign wealth fund and when they are withdrawn, which makes them available to be spent.

10 These budget savings are primarily lower age and disability support pension payments. These lower pension payments arise primarily because wages are lower with compulsory super than they would otherwise be and pension payments, which are indexed to wages, are therefore also lower.

By 'fiscal rules' I mean to include the culture and institutions which ensure that these rules are followed in letter and spirit. For there are plenty of examples of governments around the world that are notionally bound by rules such as a balanced budget constraint, but which nevertheless find ways to evade their spirit if not their letter.

Broadly speaking, there are two types of sovereign wealth funds. One type, exemplified by Norway's Government Pension Fund Global, involves building up a stock of financial assets over an extended period of time, and then using the earnings from these financial assets to supplement the annual budget, while preserving the principal value of the fund for the long term. In building up its fund, Norway has converted some of the revenue from the sale of its oil into a stock of financial assets. By the end of 2010, the assets in Norway's sovereign wealth fund were valued at $US525 billion, or nearly 125 per cent of Norway's annual GDP.

Australia's compulsory super system has some important elements in common with this type of sovereign wealth fund. In Australia, the stock of financial assets that has been gradually been built up (as a consequence of both compulsory and voluntary contributions) amounted to $A1.3 trillion or about 100 per cent of Australia's annual GDP by the end of 2010.

In Norway, public sector contributions into the sovereign wealth fund come from the government's share of oil revenues which are volatile through time and sometimes amount to a large share of annual GDP.

In Australia, the public sector contribution to the long term saving vehicle is less volatile, and smaller, but still significant. In Australia's case, the public sector contribution is projected to rise significantly over the next decade and then remain high, primarily as a result of the gradual rise in the Superannuation Guarantee from 9 to 12 per cent.

A key difference between the schemes, of course, is that financial assets sit in individual retirement accounts in the Australian scheme, rather than in a centralised single fund managed (at arm's length) by the central bank, as in Norway. Another difference is that savings cannot be accessed until individuals reach their preservation age in the Australian scheme, while the real earnings from the Norwegian fund are available to be spent each year by the government.

The second type of sovereign wealth fund, exemplified by Chile, is a stabilisation fund designed to enhance the government's capacity to implement countercyclical fiscal policy.

Chile introduced its stabilisation sovereign wealth fund, and reformed its fiscal rules, to mark a decisive break from a long history of Latin American commodity exporting countries suffering from repeated bouts of pro-cyclical fiscal policy (Frankel, 2011). This long history involved governments of Latin American commodity exporting countries spending too much in booms, and then being forced to cut back in downturns often because the government lost access to international capital markets in a 'sudden stop' when the economic downturn came.

By contrast with this history, fiscal policy in Chile since 2000 has been governed by a structural budget rule, derived using official estimates of trend real GDP growth and the 10-year price of copper (the commodity of most importance to Chile). As planned, adherence to this structural budget rule has enabled Chile to make a successful break from the earlier disastrous Latin American fiscal experience, and to implement countercyclical fiscal policy, as it did both in the years leading up to, and during, the global financial crisis.

When thinking about the domestic relevance of the Chilean model, it is important to note that in contrast to the Latin American experience, Australia has well designed fiscal and monetary institutions, and a long history of low government net debt.

The possibility of a Latin-American style capital market 'sudden stop' is not relevant to Australia's circumstances. Australia has long been able to conduct countercyclical fiscal policy. Indeed, along with Chile, Australia implemented a rapid discretionary countercyclical fiscal response to considerable effect in the global financial crisis.

## Conclusion

To sum up then, Australia has a relatively high gross national saving rate, particularly when compared to other Anglophone countries with similarly deregulated financial systems. There are two noteworthy contributors to this relatively high national saving rate: a long history of prudent fiscal policy, and the compulsory superannuation system.

A large stock of financial assets has been built up gradually in the Australian super system, a consequence of both compulsory and voluntary contributions into the system. The compulsory system appears to have made a significant contribution to national saving — estimated currently at about 1.5 per cent of GDP, and rising to close to 3 per cent over the next few decades.

Because of the tax-preferred status of superannuation and the nature of the fiscal strategy, the public sector makes a significant contribution to the rise in national saving generated by the compulsory system. The public sector's contribution to national saving, via the compulsory super system, is estimated to be currently about 0.4 per cent of GDP, rising gradually to nearly 0.7 per cent of GDP by the end of the decade.

The Australian compulsory super system has some important elements in common with a Norwegian-style sovereign wealth fund. In both cases, a large stock of financial assets is being accumulated in a long-term compulsory saving vehicle, and in both cases the public sector makes a significant contribution to the boost in national saving that arises as a consequence.

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# Sustainable wellbeing — an economic future for Australia

Dr Martin Parkinson, PSM[1]
Secretary, Australian Treasury

This speech was delivered on 23 August 2011 as part of the Shann Memorial Lecture series.

1 I would like to acknowledge the contribution of my Treasury colleague Shane Johnson in the preparation of this address.

## Introduction

I would like to thank the University of Western Australia Business School and the Economic Society of Australia for inviting me to give this lecture, which commemorates the foundation Professor of History and Economics at this University, Edward Owen Giblin Shann.

Edward Shann made a tremendous contribution to the economics profession during a time when there were a number of similarities with today. In reading up on Shann, I was struck by the irony that one of his most famous pieces of work concerned the reliance on foreign capital at a time of uncertain export prices. He saw periods of high population growth, terms of trade volatility, financial market meltdown and fragility — though in an economy with less flexibility than we now have. While he didn't use this language, he understood that being able to adapt was crucial to improving wellbeing.

This lecture series honours Shann's own distinctive contribution to Australian economics. But when one looks at the topics past speakers have addressed, it provides a window into the issues of the day and the frameworks and tools that have been so important in navigating these challenges over five decades.

Once again we face a period of great complexity, requiring decisions which will fundamentally shape the future wellbeing of Australians — what we in the Treasury think of primarily as a person's substantive freedom to lead a life they have reason to value, a concept found throughout Shann's writings.

As has been noted in the recent Budget papers and elsewhere (Parkinson, 2011a and Parkinson, 2011b), while the medium term outlook for the Australian economy remains positive there are significant short-term risks relating to the global economic outlook.

In particular, despite the recent financial assistance package for Greece and agreement to lift the debt ceiling in the United States, sovereign debt concerns persist around key European economies and, to a lesser extent, the United States.

It is not well appreciated in Australia that our economic position is markedly different to that of the rest of the developed world. While a number of factors were at play, it should be obvious that if it were not for our flexibility — itself a consequence of sustained structural reforms and sound monetary and fiscal frameworks — Australia would not have avoided the worst of the impacts of the Global Financial Crisis (GFC).

However, it should give us pause that the United States (US) economy shrunk by 5 per cent during its most recent recession and today has still not made up this loss.

Indeed, real Gross Domestic Profit (GDP) per person in the US is still over 3 per cent lower and the proportion of adult Americans in employment is around its lowest level in a quarter of a century.

When we look at Europe or Japan, the situation is even more grim — Japan's real level of GDP is 6 per cent lower than its pre-crisis peak, while the Irish and Greek economies are 12 and 10 per cent smaller than before the crisis.

Many of these economies also face persistently high unemployment rates, with the unemployment rate in the euro area around 10 per cent, the US at around 9 per cent and the United Kingdom (UK) at around 8 per cent.

The lack of credible medium term fiscal and structural policy strategies to address the underlying competitiveness and debt issues on both sides of the North Atlantic, along with evidence that the US recovery has been much weaker than previously thought, is generating considerable uncertainty and volatility in global financial markets.

Unfortunately, recurrent episodes of volatility are likely to be a feature of global financial markets over the next few years. Such is the sense of concern over the lack of credible policy responses, repeat episodes may be triggered by apparently innocuous events or pieces of information.

This risks adding a dimension of macroeconomic instability into the Australian economy of a sort that we have not experienced for many years. As we know from our past history, and from experience in other countries, such instability makes economic management considerably more difficult and results in more volatile growth and fiscal outcomes.

And, as I have discussed elsewhere, our closer economic integration with the world's major emerging economies means we are more exposed to volatility arising from policy mis-steps in key trading partners such as China, which are trying to manage challenges arising from greater liberalisation of their economies.

These current risks need to be set against a backdrop of longer-term trends influencing the Australian economy, trends that offer huge opportunities for Australia and which will influence the sustainability of the wellbeing for future generations.

Indeed, I believe the theme of sustainability will need to shape the approach to policy development of this generation.

While there is a growing awareness of sustainability issues, these are often cast in terms of the environment and, more specifically climate change.

But issues of sustainability are much broader than this.

So what do we mean by sustainability?

Sustainable wellbeing requires that at least the current level of wellbeing be maintained for future generations.

In this regard, we can consider sustainability as requiring, relative to their populations, that each generation bequeath a stock of capital — the productive base for wellbeing — that is at least as large as the stock it inherited (Arrow et. al., 2004 and Dasgupta, 2007).

As wellbeing is a multidimensional concept, going beyond material living standards — and even the environment — we can see that the stock of capital, or the productive base for wellbeing, should include all forms of capital:

- physical and financial capital — the value of fixed assets such as plant and equipment and financial assets and liabilities;
- human capital — the productive wealth embodied in our labour, skills and knowledge and in an individual's health;
- environmental capital — our natural resources and the eco-systems which include water, productive soil, forest cover, the atmosphere, minerals, ores and fossil fuels. In other words, all the natural resources that support life and other services to society; and
- social capital — which includes factors such as openness and competitiveness of the economy, institutional arrangements, secure property rights, honesty, interpersonal networks and sense of community, as well as individual rights and freedoms.

These stocks create flows of goods and services which contribute to the wellbeing of all Australians.

Running down the stock of capital in aggregate diminishes the opportunities for future generations. In one way or another, eroding the productive base will lead to lower future wellbeing.

Note, though, that drawing down any one part of the capital base may be reasonable as long as the economy's aggregate productive base is not eroded. For example, reducing our natural resource base and using the proceeds to build human capital or infrastructure may offer prospects of higher future wellbeing. A necessary, but not sufficient, condition for this to be the case is that those resources are priced appropriately and that the returns are invested sensibly.

When one thinks about wellbeing, rather than GDP, it becomes quickly apparent that society does not get an adequate return on many environmental goods. For example, water and carbon are not yet priced appropriately. In the case of minerals and energy, arguably society is not sharing sufficiently in the returns from their exploitation, with the vast bulk of the benefits accruing to the shareholders of the firms doing the mining. As such, society is not getting the resources it would need to build up other parts of its capital stock.

Unsustainable growth cannot continue indefinitely — if we reduce the aggregate capital stock in the long run future generations will be made worse off. The problem is that we can be on an unsustainable path for a long period — and by the time we recognise and change, it could be too late.

## Long-Term Trends

There are four long term trends facing the Australian economy that will have a significant effect on its future shape. These are:

- continued globalisation and the development of emerging market economies — particularly the rise of China and India as global economic superpowers;
- continuing rapid technological innovation;
- demographic change — the ageing of the population; and
- environmental pressures — including climate change and water.

This complex mix of long-term trends will have significant impacts, both positive and negative, on Australia's productive base and, therefore, the wellbeing of future generations.

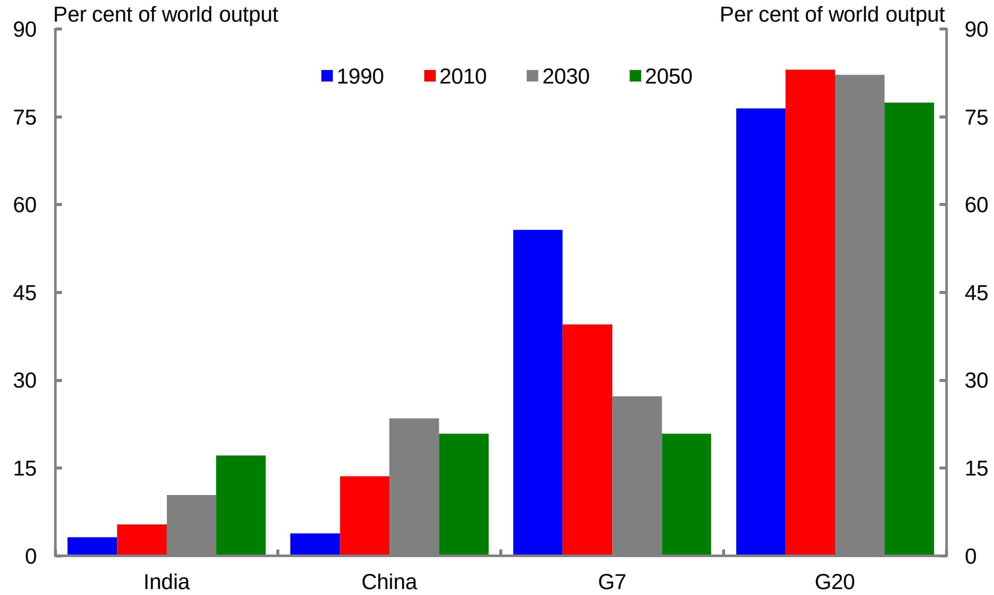
### Globalisation and the rise of Asia

The first of these four long term trends is continued globalisation. The global economy is in the midst of a radical transformation, unprecedented in the last 100 years.

The speed of globalisation has accelerated through the advancement of new technologies, falling transport costs, and as tariffs and other barriers to trade have been removed (Chart 1).

More countries are opening up their economies and seizing the opportunities that arise from being integrated within the global economy.

**Chart 1: Shares of world domestic product over time**




Source: IMF and Treasury.

Continued globalisation has also led to significant growth in developing economies. As highlighted by Nobel laureate Michael Spence, who recently visited Australia, 13 countries[2] (including China) have grown by more than 7 per cent per year on average for 25 years or more, and this list of countries will only grow — it will not be too long before India may also join this club.

The growth of developing countries is also reshuffling the deck in terms of countries' relative economic importance.

For example, China is now the second largest economy in the world, and is expected to surpass the US in size by 2020 while India is on track to surpass the US by mid century. This is not just of economic interest for Australia — economic success is the foundation for global influence and for seats at the table in key global fora.

These trends are therefore shifting both geo-strategic and geo-economic weight from the western advanced economies towards the emerging market economies. The pace of this transformation has been much faster than anticipated even a decade ago. The

2 Spence (2011a) lists the 13 countries as Botswana (1960-2005), Brazil (1950-1980), China (1961-2005), Hong Kong (1960-1997), Indonesia (1966-1997), Japan (1950-1983), Republic of Korea (1960-2001), Malaysia (1967-1997), Malta (1963-1994), Oman (1960-1999), Singapore (1967-2002), Taiwan (1965-2002), Thailand (1960-1997).

failure to tackle the structural and debt problems of the developed world will only accelerate this transformation.[3]

A natural part of this development will be shifts in comparative advantage.

Emerging market economies face increasing pressure to upgrade their industrial base to compete in higher value-added manufacturing — towards areas that have traditionally been the domain of advanced economies. We saw this during the emergence of Japan and the Newly Industrialising Economies[4] and we are seeing it now with China.

So as emerging market economies grow, new areas of comparative advantage for Australia will open while some existing areas will face increasing pressure.

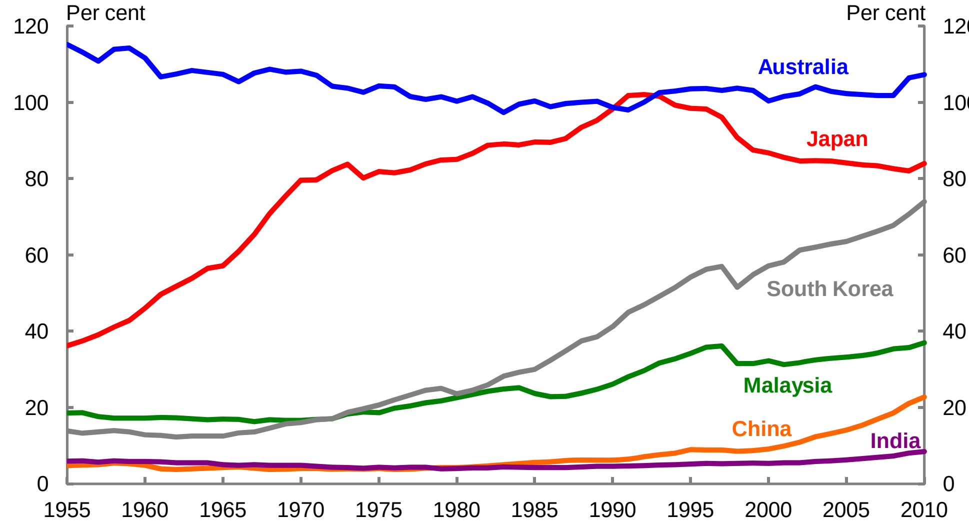
These developments will have implications for the structure of the Australian economy.

Already, the resource intensive nature of China and India's growth, reflecting their industrialisation and urbanisation, represents one of the most significant shocks to hit the Australian economy. As Chart 2 — which shows China and India's catch-up in per capita incomes — suggests, this transformation underway in both countries has the potential to go on for decades.

3 For example, Spence (2011b) highlights potential escalation of structural pressures on the United States economy in response to changes in the comparative advantage of emerging market economies.

4 Newly Industrialised Economies are Singapore, Taiwan, South Korea and Hong Kong.

**Chart 2: GDP per capita (Per cent of OECD-15 average)**




Note: OECD-15: Australia, Austria, Belgium, Denmark, Finland, France, Iceland, Ireland, Netherlands, Norway, Sweden, Switzerland, UK, US and Canada.
Source: The Conference Board Total Economy Database and Treasury.

The continuing transformation of the economies and societies of China and India has far-reaching implications. For example, by 2020, the Asia Pacific region could have more people in their middle class than the rest of the world combined. China could have a middle class market that surpasses the US in dollar terms. The continued rise of the Asian middle class presents Australia with huge opportunities — a potentially very large market for our goods and services. But it is not pre-ordained that this will benefit us — we need to take the decisions that will allow us to succeed in this new world, one where there will be a premium on a flexible, adaptable and innovative Australian business culture.

For now, the mining boom is the most obvious early manifestation for Australia of the shift in the world's economic geography from west to east.

With the rise of China and India, the global demand for resources and energy has out-stripped the rise in global supply, resulting in a sharp rise in global resource and energy prices.

In addition, growth in the manufacturing sectors of China has led to increased global supply of low cost manufactures.

Together, this has resulted in Australia's terms of trade reaching their highest sustained level in 140 years.

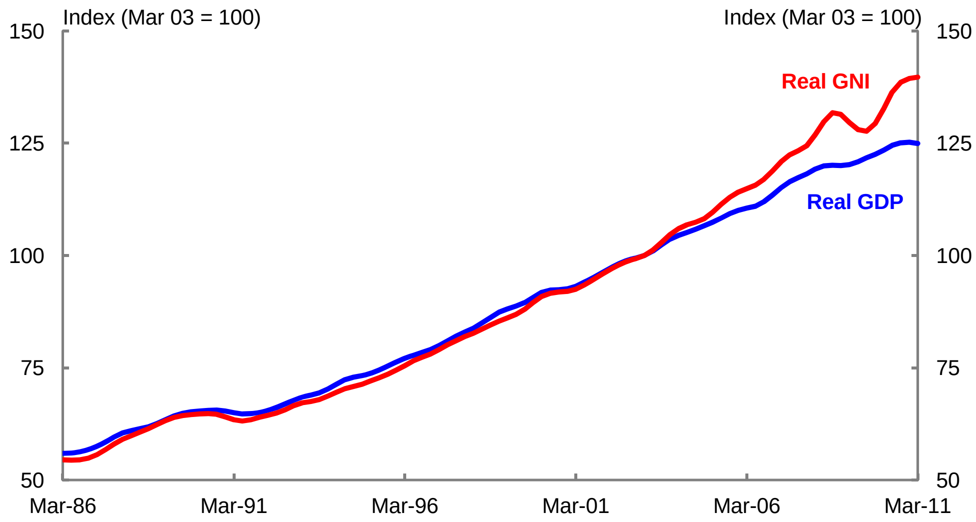
Improved terms of trade increase real national income — the rise in global commodity prices increases the value of Australia's mineral and energy endowment. In short, it's as if we woke up one morning and found the world had made us richer as a nation. We can now purchase more imports for each unit of exports; or, put another way, we can afford to purchase more without doing anything else different.

We can see the extent of the improvement in real incomes arising from the improvement in the terms of trade by comparing real GDP and real gross national income (GNI) — with the difference between the two representing changes in the terms of trade and net overseas transfers. (Chart 3).

Since March 2003, real GNI has grown significantly faster than real GDP, by around 14 per cent.

The improvement in the terms of trade has in fact accounted for around 40 per cent of total real national income growth since early 2003.

**Chart 3: Real GDP vs Real GNI (Trend)**




Source: ABS Cat. No. 5206.0.

Is this sustainable?

Eventually no, but when this is likely to be the case remains unknown.

At some point, growth in the global supply of commodities will start to outweigh the continued strong growth in demand, which will first stop the rise in prices and, eventually see them fall.

The Budget outlines a central case where the terms of trade come off slowly, declining by around 20 per cent over the next 15 years.

As an aside, some have claimed that the Budget is hopelessly optimistic, with the terms of trade assumption apparently interpreted as meaning we believe in perpetual unfettered growth in China.

This is not the case.

Even if the 21st century is the Asian century, it would be naive to believe there will not still be economic cycles — recall that even though we now refer to the 20th century as 'the American century', the US experienced numerous economic slowdowns and recessions (to say nothing of the Great Depression). But absent geostrategic or social crises, viewed through the prism of history, cycles over the next few decades are likely to be around a sustained trend increase in emerging Asian GDP and living standards.

While the current level of the terms of trade will not be sustained forever, they are expected to remain high for a very long time. As such, it is worth looking at some of the implications of this.

First, despite the significant improvement in the terms of trade, and consequent increase in national income, many Australians don't feel better off. Why is this?

We are currently seeing the higher terms of trade resulting in a shift in economic activity towards mining and related sectors, with scarce labour and other factors of production being drawn away from other sectors involved in international trade.

This structural adjustment has distributional consequences — many at a geographical or sectoral scale.

For example, at the time of preparing the 2011-12 Budget, the domestic economy was forecast to grow at around 4 per cent in 2011-12. But this aggregate forecast masked considerable divergence at a sectoral level.

The mining and related metals manufacturing sectors were expected to grow at around 10 per cent, boosted by the surge in mining investment. But the mining and related metals manufacturing sectors only comprise around 12 per cent of the economy (in 2009-10).

In addition to generating strong growth in the mining industry, the resources boom is supporting strong growth in the mining-related construction, services, manufacturing and transport sectors. Mining-related production, which represents a further 8-10 per cent of the economy, was expected to grow around 30 per cent in 2011-12 and 20 per cent in 2012-13.

But this leaves around three quarters of the economy's output not being boosted directly from the mining boom. Abstracting from the agricultural sector, it is estimated that the remaining non-mining economy will only grow at around 1 per cent annually in 2011-12 and 2012-13. In other words, a structural decomposition of the budget GDP growth forecasts implies that a large proportion of the economy will record weak growth for at least the next two years — a direct consequence of the impact of the terms of trade on the exchange rate and competitiveness, the lingering effects of the global financial crisis including the cautious consumer, and Australia's decade-long productivity performance.

But even this 1 per cent growth rate masks significant divergence, with some service sectors growing and generating significant increases in employment (for example in 2010-11, the number of people employed in health care and social assistance grew by 6.2 per cent) with other sectors (for example retail and wholesale trade, and manufacturing) under considerable pressure.

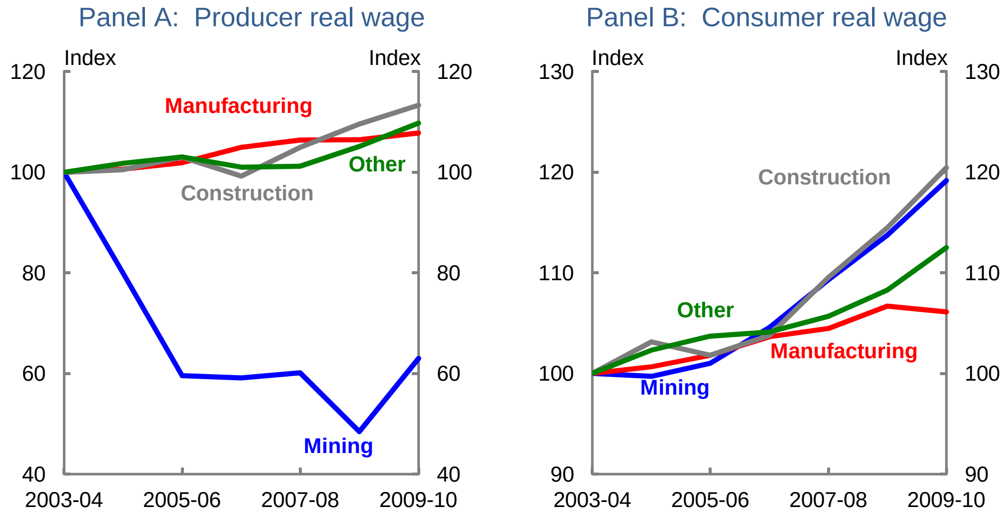
We can also see the pressure of structural adjustment by examining the real producer wage — that is, labour costs relative to producer prices.

The real producer wage in the mining sector has fallen significantly since the beginning of the mining boom, as output price growth in the sector has outpaced very rapid nominal wage growth. This is, in effect, a price signal to mining firms to hire more labour, even at much higher nominal wage rates, and has been driving strong employment growth in the mining sector (although in absolute terms the sector is only a very small employer).

In contrast, the relative wage costs for firms in other industries like manufacturing have increased, in part because the higher exchange rate is restricting their capacity to maintain prices.

But for workers, the incentives they face and their standard of living depends not on real producer wages but how their earnings have fared relative to consumer prices (Chart 4).

**Chart 4: Real wages (by sector)**




Source: ABS Cat. No. 6302.0, 6401.0 and 5204.0.

In this regard, real consumer wages (that is wages deflated by the Consumer Price Index (CPI)) in the mining and construction sectors have grown strongly, increasing by around 20 per cent since the beginning of the boom. On the other hand, real wages in the manufacturing sector have grown much slower since the beginning of the boom, and actually fell over the past year.

That the relatively strong growth in earnings in the booming mining and related sectors of the economy has not spilled over to the rest of the economy is a sign of the economy's flexibility. This reflects positively on labour market reforms of past decades. Together with other structural reforms to improve the economy's flexibility, this has helped moderate across the board wage inflation pressures and facilitated necessary resource reallocation — the result is higher employment than we would have seen if the reforms of the 1980s and 1990s had not been implemented.

But we also need to recognise that nominal wage growth in some parts of the economy has also been slowed by the competitive pressures on the non-mining traded goods sector from a higher exchange rate. This has put pressure on many businesses, creating uncertainty over future profitability and employment prospects, and dampening wage growth. This is compounded by uncertainty over the global economic outlook.

A higher exchange rate has, however, provided consumer benefits by reducing the cost of imported goods — one way the benefits of the boom are spread across the economy.

A further reason households may not feel wealthier in the face of the mining boom is that despite the increase in the terms of trade, real incomes have continued to grow at around the same rate as they did in the 10 years prior to the boom.

The reason real incomes have continued to grow at around the same rate, despite the improvement in the terms of trade, is because labour productivity has not kept pace with the high growth achieved during the 1990s. I have discussed the consequences of this for Australia's future income growth elsewhere (Parkinson, 2011b), but it also feeds back directly into the pressures confronting some Australian firms as a consequence of the exchange rate.

So while households have higher real purchasing power as a consequence of the boom and its impact on the exchange rate, real income growth is occurring only at a rate with which people are already familiar. This, combined with the employment effects of restructuring, appears to be resulting in a sense that people are not sharing in a once in a century increase in Australian wealth.

Given the implications for the economy as a result of globalisation, and the rise of China and India in particular, it will be important that we adapt in a sustainable way. Whether we do this however, will depend on whether policy makers and businesses make the right decisions for the long-term.

A flexible, responsive economy will be crucial.

It will be important that we facilitate structural adjustment, not oppose it.

It will be important to build new comparative advantages through investments in infrastructure, education, skills and innovation and that we take advantage of the opportunities presented by the continued development of the emerging market economies.

## Rapid technological advancement

The second long term trend is continued technological advancement.

Rapid technological advancement will have significant implications for sustainability — improvements in information and communication technology (ICT) in particular, have the prospect of improving productivity, service delivery and networking. Technological advances have already transformed businesses and trade and played an important role in reducing the 'tyranny of distance'.

In short, ICT is an enabler of change, for both business and the public sector.

It enables new innovative tools to be developed, allows new business models to arise, facilitates the emergence of new products, industries and production processes as well as increasing competition and greater specialisation. This will have a profound impact on the Australian economy.

The ICT revolution will also have implications for the way in which government services are provided to a growing and ageing population and, more generally, for the way in which citizens of all ages interact with their governments. This will be especially valuable for rural and regional Australia.

Already we are seeing how ICT is changing the contact points between governments and its citizens. In particular, continued ICT advancement will improve the delivery of education and health services, improving human capital.

ICT will continue to change the way we do business and provide Australia with an avenue to capitalise on the opportunities we have over the decades ahead.

## Demographic change — ageing and population growth

I would now like to turn to the third long term trend — demographic change.

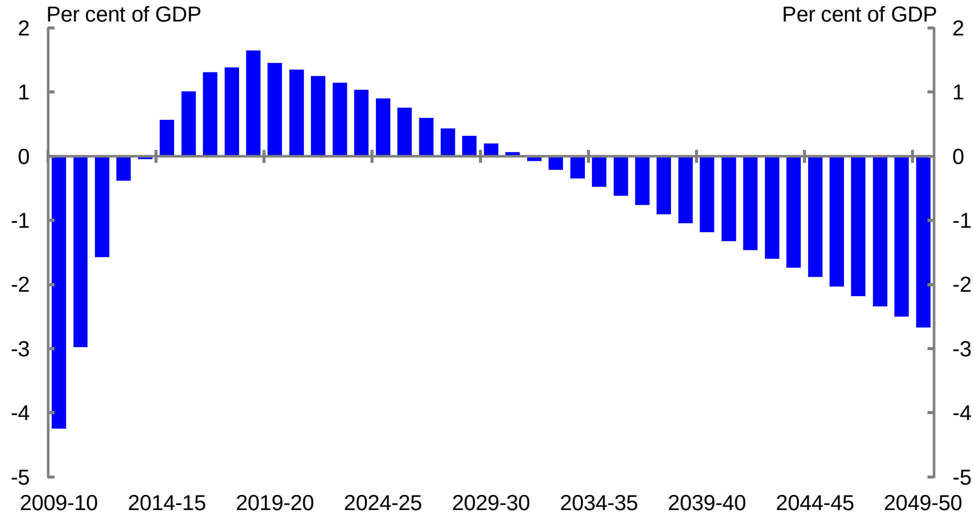
As with all other advanced economies — and many emerging economies — Australia has an ageing population, reflecting the combined effects of the decline in fertility since the 1960s, the shift of the baby boomer population bulge into ever older age cohorts and a general increase in life expectancy.

The proportion of the population aged 65 and over has increased from just over 8 per cent in 1969 to around 13 per cent today. The 2010 Intergenerational Report (IGR) projected that by 2050 the proportion of the population aged 65 and over would rise to around 23 per cent.

Furthermore, it projected that by 2050, around 5 per cent of the population — that is one in twenty — will be aged 85 and over — this compares to around 1.8 per cent today.

The ageing of the population will create substantial pressures around fiscal sustainability. (Chart 5).

**Chart 5: Projected fiscal gap**




Source: Treasury.

Rising dependency ratios and slower economic growth will reduce the capacity of Australia to fund its spending commitments. At the same time increased demand for age-related payments and services, including through technological advancements in health and demand for higher quality health services will drive up expenditure.

The 2010 IGR projected that increased ageing and health pressures would result in an increase in total government spending from around 22.4 per cent of GDP in 2015-16 to over 27 per cent of GDP by 2049-50.

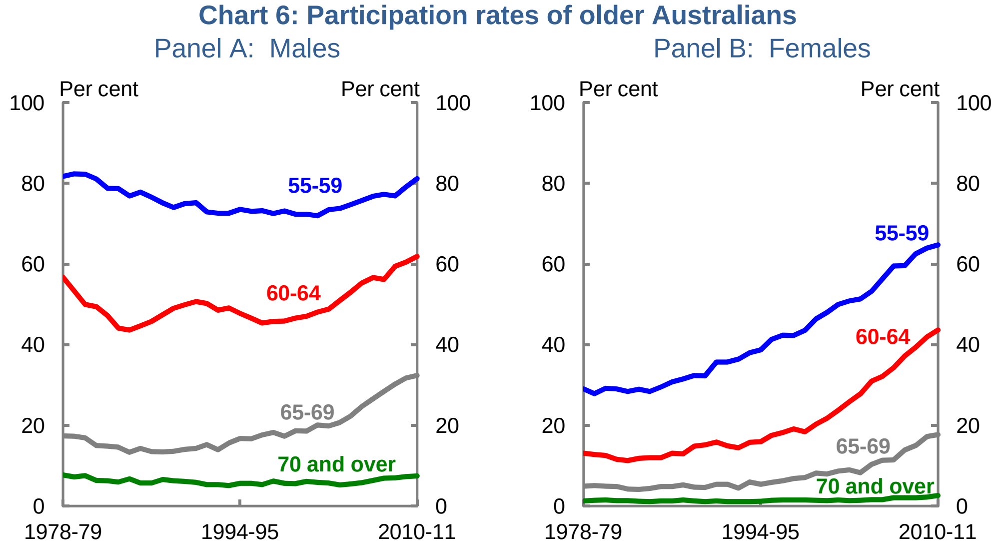
As a consequence, spending was projected to exceed revenue by 2¾ per cent of GDP in 40 years time.

While we always need to keep in mind the limitations of exercises like the IGR, there is a consistent message about the importance of a long-term approach to policy and fiscal sustainability.

In that regard, it is important to recognise that even small variations in productivity growth and participation rates can have significant consequences.

We are already seeing differences in the participation rates for older Australians, although we do not know whether these will be sustained (Chart 6).

**Chart 6: Participation rates of older Australians**




Source: ABS Cat. No. 6291.0.55.001.

The 2010 IGR illustrated that while the rate of ageing has reduced somewhat compared with previous IGRs, the proportion of traditional working age people is still projected to fall markedly, reducing the average rate of labour force participation.

Arguably, the main conclusion of the IGR is that ageing will slow annual growth in GDP per capita by about 0.3 per cent per year over the period to 2050. That is, the impact of ageing will be around three times that of responding to climate change!

If our participation rate in 2049-50 turns out to be 57.0 per cent rather than the 60.6 per cent we are currently projecting, real average annual GDP growth will fall by a further 0.11 percentage points. This small change in the participation rate will also lead to increased spending in the order of 0.9 per cent of GDP in 2049-50 (or around $33 billion in 2010-11 terms) on health care, aged care, pensions and education, putting further pressure on the budget.

For this reason, participation and productivity enhancing policies are key to ameliorating the economic impacts of an ageing population.

## Environmental sustainability

The fourth long term trend is environmental sustainability.

Environmental issues, particularly climate change, are probably those most commonly associated with the term 'sustainability'.

With the expected rapid growth of the global economy over coming decades, significant pressures will be placed on global resources — particularly the natural environment.

This presents a serious challenge, not only for Australia but for the world.

The Australian economy will need to become more energy, resource and environmentally efficient.

In fact, going forward, energy, resource and environmental efficiency will be key drivers of productivity.

The Australian economy faces a number of pressures on environmental sustainability, including: climate change, salinity, resource depletion, in addition to water availability and pressures around biodiversity.

Today I will only briefly touch on climate change.

### Climate Change Policy

Climate change policy — both in relation to adaptation and mitigation — is not just an environmental issue; it is more fundamentally an economic and social challenge.

The impact of decisions today will be felt in decades to come, and the progression of climate change impacts is unlikely to be linear.

There are significant risks and uncertainties arising from our imperfect knowledge of the climate system. It is possible that climate impacts could suddenly accelerate. In fact, certain impacts to the climate system may lead to a tipping point where sudden irreversible changes arise.

These sudden changes may not be seen for some time, but they could arise from our actions, or inaction, today. To an economist, climate change is fundamentally a risk management issue. Even if you do not accept all elements of the science, prudence suggests taking out some form of insurance.

We also need to remind ourselves, and others, that if no-one acts first we all lose. But more so — unless we all act, we all lose in the end.

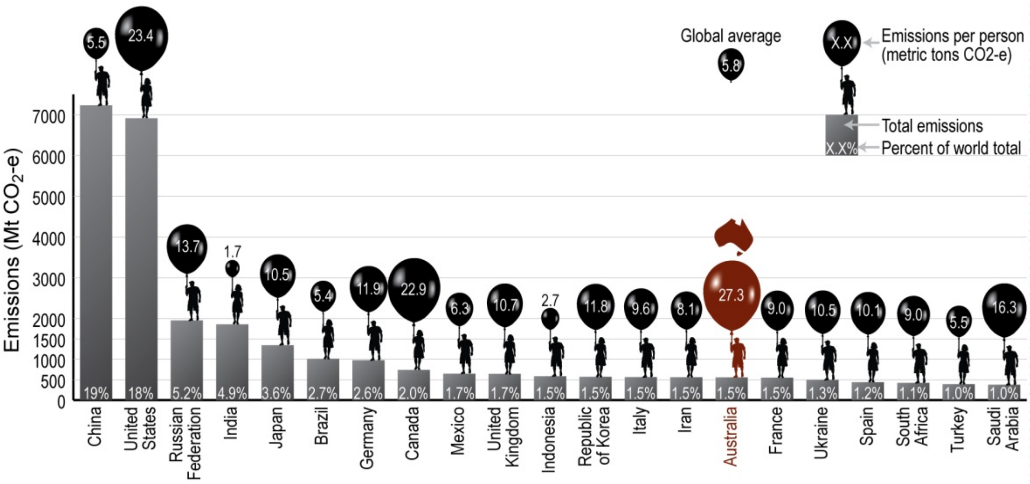
That said, the world is moving (Chart 7) — Australia is not a first mover, but more accurately described as in the middle of the pack.

### Chart 7: World climate change action


Source: Treasury.

Moreover, to suggest Australia should do nothing because we are only 1.5 per cent of emissions suggests that most countries should do nothing (Chart 8) — not Indonesia, not the UK or France.

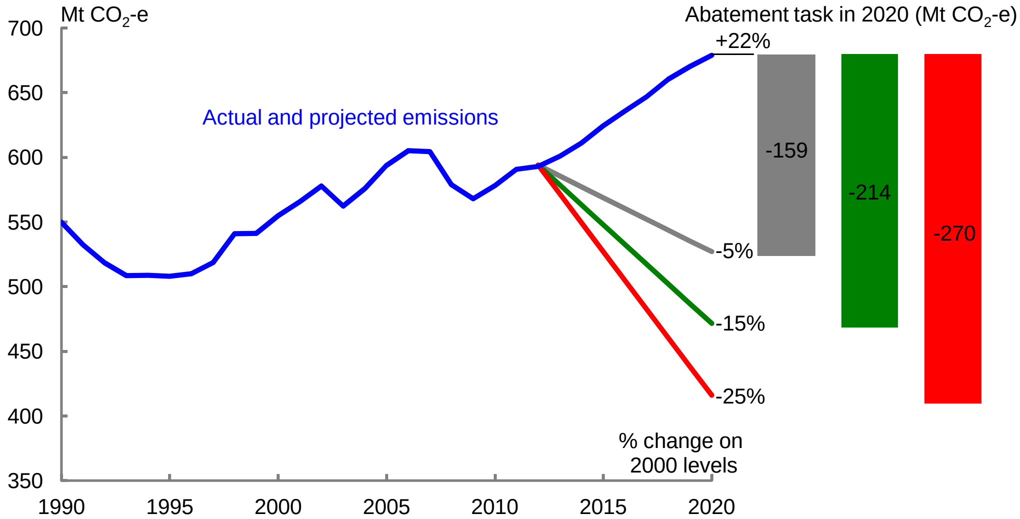
### Chart 8: Global comparison — overall and per person emissions in 2005




Note: Land use change is excluded.
Source: Climate Analysis Indicators Tool, Version 8.0 (World Resources Institute, 2010).

Rather, we should leave all the heavy lifting to the US and China. This conveniently overlooks the fact that Australia's per capita emissions are five times larger than those of China (and almost three times that of France and the UK, 10 times that of Indonesia and greater even than in the US).

**Chart 9: Climate change policy (climate change baseline projections)**




Note: Emissions include abatement from Carbon Farming Initiative of 7Mt CO2-e.
Source: Treasury.

In the absence of further policy action, strong growth in Australia's emissions is projected between now and 2020 — emissions are projected to reach 679Mt CO2-e in 2020, or 22 per cent above 2000 levels (555Mt CO2-e). (Chart 9).

The level of projected emissions in 2020 represents the starting point for Australia's abatement challenge — the amount of abatement required from additional policies to achieve national emissions targets in 2020.

Based on these projections, Australia requires additional abatement of between 159Mt CO2-e and 270Mt CO2-e in 2020, depending on the target, after accounting for the abatement from the Carbon Farming Initiative.

A 5 per cent target sounds small.

15 per cent and 25 per cent sound much bigger.

But Australia's bipartisan 5 per cent target — a reduction of 159Mt CO2-e — is actually equivalent to a 23 per cent cut compared to the expected 'business as usual' level of emissions in 2020.

By way of comparison, 159Mt CO2-e is roughly 80 per cent of Australia's total current emissions from the generation of electricity, or roughly twice our road transport emissions.

All of this highlights just how important it is to achieve greenhouse gas emission reductions in the most efficient manner possible.

It is clear that poor policy choices will mean that the economic costs of meeting Australia's emissions targets would be substantially larger than it needed to be, with negative impacts on productivity, living standards and overall wellbeing.

So when is the right time to reduce emissions?

The key message from the Strong growth, low pollution modelling was that the economy will continue to prosper while emissions are reduced.

Further, the economic costs of adjustment are modest if action starts sooner rather than later — delaying action will only raise the eventual economic costs.

## The resulting structural adjustments will generate concerns

A common thread across all these longer term trends is that they all involve structural adjustment.

This structural adjustment can be managed, or it can be opposed — the critical point is that it cannot be avoided. Moreover, history shows that opposing adjustment rarely succeeds, and the negative consequences are significant. The challenge for policy makers is to facilitate as smooth an adjustment as possible for all affected.

The most effective and credible policy responses will be those that encourage structural adjustment while at the same time protecting those individuals most vulnerable.

### Treasury's wellbeing framework

As a central policy agency, the Treasury is expected to anticipate and analyse these longer-term trends from a whole-of-economy perspective.

In order to do this we need an understanding of wellbeing that recognises that wellbeing is broader than just GDP, that sustainability is more than an environmental issue.

It may come as a surpise to some, but Treasury recognised this a long time ago.

Two early papers addressing these issues are the 1964 Supplement to the Treasury Information Bulletin, entitled *The Meaning and Measurement of Economic Growth* and the 1973 Treasury Economic Paper *Economic Growth: Is it worth having?*

Both papers explored the nature of economic growth and its connection to wellbeing, and the latter was written partly in response to the apocalyptic claims of the Limits to Growth study sponsored by the Club of Rome.

A focus on wellbeing and sustainability continue to be important parts of Treasury's culture and identity: they assist in providing context and high level direction for our policy advice; and they facilitate internal and external engagement and communication.

Almost a decade ago we attempted to put more structure around the issue by writing down a wellbeing framework to provide greater guidance to staff on our mission (Treasury, 2004)

The framework identifies elements of wellbeing which are particularly relevant to our work and which should be considered in providing thorough analysis.

The framework is descriptive, providing a context for public policy analysis and advice that encourages a broad assessment of the costs and benefits of policy proposals.

It acknowledges that in addition to income and (material) consumption, a policy relevant assessment of wellbeing, both at the individual and social level, depends on health, education, social relationships, and a myriad of other aspects of life that people have reason to value.

We have just completed a review of the framework, and updated the framework to address more recent developments in the Department's work (Chart 10).

**Chart 10: Elements of the Wellbeing Framework**


Source: Treasury

The framework is based on five dimensions that directly or indirectly have important implications for wellbeing and are particularly relevant to Treasury. The dimensions are:

- The set of opportunities available to people. This includes not only the level of goods and services that can be consumed, but good health and environmental amenity, leisure and intangibles such as personal and social activities, community participation and political rights and freedoms.

- The distribution of those opportunities across the Australian people. In particular, that all Australians have the opportunity to lead a fulfilling life and participate meaningfully in society.

- The sustainability of those opportunities available over time. In particular, consideration of whether the productive base needed to generate opportunities (the total stock of capital, including human, physical, social and natural assets) is maintained or enhanced for current and future generations.

- The overall level and allocation of risk borne by individuals and the community. This includes a concern for the ability, and inability, of individuals to manage the level and nature of the risks they face.

- The complexity of the choices facing individuals and the community. Our concerns include the costs of dealing with unwanted complexity, the transparency of government and the ability of individuals and the community to make choices and trade-offs that better match their preferences.

The wellbeing framework provides guidance on the key issues Treasury officers should be thinking about in framing policy advice to government. It also serves as an important unifying function for Treasury's policy analysis and advice.

The dimensions do not provide a simple checklist: rather, their consideration provides the broad context for the use of the best available economic and other analytical frameworks, evidence and measures.

Further, the dimensions reinforce our conviction that trade-offs matter deeply — tradeoffs both between and within dimensions. Most reforms will involve trade-offs within or between dimensions of wellbeing. These trade-offs are often complex and multidimensional — but they must be made, and decisions will be better if we're more explicit about what's involved.

## Conclusion

In conclusion, Australia is embracing the fact that the global economy is becoming more integrated, with cross border trade between countries increasing, capital markets becoming more interlinked, and greater technological transfers and global competition.

We face long term trends that will lead to even more change and opportunities. But we must also consider whether the path we take is sustainable — not just in terms of government fiscal positions and environmental outcomes but in all we do.

In many respects, sustainability can come from the development and maintenance of reliable markets. The ability to properly price the use of resources and other goods and services over the longer term is vital.

If we get these settings right we will be able to bequeath a stock of capital — the productive base for wellbeing — that is at least as large as the stock we inherited. By doing so, future generations of Australians should enjoy enduring improvements in wellbeing, an outcome which Shann would have endorsed whole-heartedly.

Thank you.

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# Wellbeing, living standards and their distribution

Dr David Gruen, James Kelly, Stephanie Gorecki and Tim Wong[1]

This speech was delivered by David Gruen on 9 September 2011 to the New Zealand Treasury Academic Guest Lecture series.

1 The authors are grateful to Thomas Abhayaratna, Gerry Antioch, Robert Gardner and Anthony King for helpful comments.

## Introduction

It is my great pleasure to be here today in Wellington to talk to you about wellbeing and living standards.

I will start with a brief overview of the Australian Treasury's wellbeing framework and then make some comments on the recently released living standards framework of the New Zealand Treasury, including highlighting some of the differences.

I would then like to focus on a point of commonality — an expressed concern for distributional outcomes — for which such frameworks have the benefit of encouraging us to come out of our comfort zones.

## Some observations on the Australian and New Zealand frameworks

The Australian Treasury developed a wellbeing framework about a decade ago to provide some guidance about its mission, which is to improve the wellbeing — rather than living standards — of the Australian people.[2] It also identified elements that need to be considered in providing thorough analysis, and are particularly relevant to our work.

From an institutional perspective, the process of developing the framework was important in itself, as it required Treasury to think carefully about what people value, and how this relates to policy analysis and advice. Since late last year we've been talking to staff within the Australian Treasury on their experiences with the framework and considering what updating if any is required. Following the consultations, we made some changes to the framework, to address specific issues raised by staff and reflect more recent developments in the Department's work.

Our framework continues to reflect our view that in addition to income and (material) consumption, a policy relevant assessment of wellbeing also depends on persons' health status, how well-educated they are, the quality of social relationships, and a myriad of other aspects of life that people have reason to value.

Without going into too much detail, the five dimensions given prominence in the Australian Treasury's framework are:

- The set of opportunities available to people.

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2 Treasury's mission is to improve the wellbeing of the Australian people by providing sound and timely advice to the Government, based on objective and thorough analysis of options, and by assisting Treasury Ministers in the administration of their responsibilities and the implementation of Government decisions.

- The distribution of opportunities across the Australian people.
- The sustainability of opportunities available over time.
- The overall level and allocation of risk borne by individuals and, in aggregate, the community.
- The complexity of the choices facing people and the community.

Some of these will be familiar to you, as they also appear in your living standards framework in one form or another. One change we have just made, that reinforces this commonality, is to explicitly include sustainability and describe that from a stock perspective. Unsurprisingly, though, there are also some clear differences between the two frameworks.

One obvious difference is the greater explicit emphasis the wellbeing framework gives to risk and complexity. One reason why we include these criteria is they directly relate to important aspects of our responsibilities. I am personally concerned with macroeconomic risks. And those parts of the Australian Treasury dealing with taxation and market regulation need to take account of the complexity they are directly responsible for, and they also play a role in our management of risk or otherwise influence choices about risk.

But as importantly, we are concerned about individuals' capacity to make good choices from the set of opportunities available to them — and for this both well-functioning markets and well-developed personal capacities are required.

Perhaps a more intriguing difference between the two frameworks concerns the approach to measurement of wellbeing. Conceptualising and measuring wellbeing are distinct endeavours, and, in this regard, the Australian Treasury's goal in its framework has been modest: merely to bring out our understanding of wellbeing and to identify things that are important in the formulation of public policy advice.

This is because since its development, the framework's intended role has been to provide a broad context and high level direction for policy advice, and not to provide a checklist to be applied in every circumstance, which might result if a list of measures is prescribed. As part of our review of our wellbeing framework, we found however that the intended purpose and usage of the framework has not been clear to many staff, and that some wanted a tool that would deliver concrete answers to the policy questions they encountered.

The New Zealand framework similarly states that it is intended to be used as an input to the policy process, rather than an analytical tool. But from the living standards paper, it is evident that your framework is more ambitious by more directly addressing measurement related issues. For example, in its direct recognition of subjective wellbeing measures, and the extended coverage of measures. Related to this, the detailed discussion of the different stocks can give a reader a strong sense of policy directions.

So it will be interesting for me to see how you find staff use, or want to use, your living standards framework. Based on our experience, being clear about how you expect it to be used and getting a sense at some point on how staff are travelling may be worthwhile. It would then be interesting to compare notes.

## A shared concern for distributional issues

If we look at the wellbeing and living standards frameworks together, it is striking that many of the dimensions identified concern the distribution of material and non-material things, to use the language of the living standards paper (New Zealand Treasury, 2011).

In particular, we can be concerned with distribution:

- within a generation (and over that generation's lifetime);
- between generations,  which we both label 'sustainability'; and
- between uncertain or contingent states, which in the Australian framework alone is separately identified as 'risk'.[3]

For the rest of my presentation I'd like to focus my attention on the more conventional, intra-generational, distributional issues. My reason for doing so is that despite the formal emphasis we place on distribution in thinking about wellbeing, or living standards, it is all to easy to be reticent about explicitly discussing or advising on distributional issues.

We have found that one benefit of having a wellbeing framework has been to emphasise concern over distributional issues, and encourage internal debate about

3 Identifying 'risk' as concerning distribution may seem odd to some. We can think of risk in a number of ways, but consider, for example, that a person's decision as to whether to take out health insurance is a decision as to whether to distribute resources (premiums) from their healthy state to their unhealthy state (payouts).  Alternatively, consider the Rawlsian original position, in which a veil of ignorance generates uncertainty as to status and resources that will be available to people.

them.[4] So I was struck by page 27 of the living standards paper (New Zealand Treasury, 2011), which states:

'Where normative approaches ask what the distribution of living standards should be, positive approaches ask what the distribution is. ...

Treasury takes a positive approach to distribution as opposed to a normative, value-based one. ...'

Here, it seems to me, is reticence proclaimed a virtue. As the living standards paper notes, there are many different theories of distributive equity. So there is good reason for being cautious about being lost in the normative jungle.

But there is no avoiding that jungle. Among other things, some normative theories are built into much of the economic literature on which we rely as policy advisers. The optimal tax literature is one obvious example, built on welfarist, predominantly utilitarian foundations. I will give an example of this later on.

And, as with other choices that communities, governments and parliaments ultimately make, policy advisers can seek to improve the quality of the public debate and decision making.

## Making sense of distributional measures

It also does not seem possible to me to simply communicate 'what the distribution is' without engaging with normative issues.

Implicit in the distributional measures that we see are normative judgements about among whom it is that we're concerned, such as households within a country. There are also judgements about what it is that is of distributional concern. Typically, the focus is on cash income or wealth. Intimately related to the latter are judgements as to the appropriate distributive rule or concern. This can be a concern over inequality or over absolute or relative poverty.

Many of the distributional measures have been around some time, and are reported on frequently. For example, charts showing income decile comparisons, gini coefficients, and relative poverty are in the Annex to the living standards paper. Taken as a whole though, those that focus on equality or inequality seem to have had little direct impact on policy advice and government decisions — at least in Australia. Measures of adequacy seem to have had greater impact — and as should become clear, I think there are good reasons for this.

4 For a public example of this debate, see Henry, 2007 and Henry, 2009.

But without pretending to know why in practice equality focussed distributional measures have had less impact, it could in part be a function of three related things:

- the 'what' that is of concern is measured too narrowly;
- there can be a disconnect between these measures and the reasons why we may be concerned about distribution; and
- there can be a disconnect between these measures and some common ideas of fairness.

## Growing Unequal?

The Organisation for Economic Co-operation and Development's (OECD) *Growing Unequal?* report of 2008 illustrates these points, notwithstanding that it is an impressive piece of work (OECD, 2008). The report looked at income inequality and poverty in OECD countries. It focussed primarily on measures of inequality of disposable cash income and relative poverty for households. It also looked at the effects of taking account of consumption taxes and in-kind benefits provided by government and some wealth measures.

Cash income as a measure of 'what' it is that is of distributional concern is quite narrow. For example, it does not account for either home production or the value of leisure. It focuses on annual income in preference to consumption (which deviates less over lifetimes) or a lifetime measure. Nor does it reflect the consequences for those unemployed of not having a job beyond the loss of disposable income.

The distribution of health outcomes is also not factored in: good health and long life would likely merit large weights in any assessment of living standards and quality of life. Further, the distribution of rights or liberties is not reflected. These have probably become more equal in recent decades, and, as the living standards paper suggests, are also likely to be important of themselves for wellbeing.

The distribution of self-reported subjective wellbeing is also not considered, whether mood happiness, life satisfaction, or other subjective states. Some would advocate doing so because they see positive subjective states as an appropriate objective of policy. Whether you accept that or not, it would be worth examining the distribution of subjective wellbeing for the reason suggested in the living standards paper — as a useful cross check against the narrow measures of resources used in the distributional statistics presented.

## Why are we concerned with inequality?

Whether disposable cash income — either extended to include in-kind benefits or not — is too narrow a measure depends of course on what your objective or concern is. So why are we concerned about inequality?

The OECD gives a few reasons separate from just fairness. These included concerns over the sustainability of the polity, potential benefits from reducing resistance to reforms that are fuelled by concerns over inequality, and that inequality can directly generate unhappiness.[5]

### Maximising a social welfare function

You probably won't be surprised to hear that a desire to maximise a social welfare function doesn't rate a mention in *Growing Unequal?*. Such an objective doesn't resonate with most people. But if you are not surprised, I would suggest you should be a little disturbed that it's not even mentioned in passing. It underlies much of economics, including that concerning optimal tax-transfer systems for achieving distributional outcomes. And its central tenets have some persuasive proponents.[6]

Social welfare functions add up, or count in some way or other, a measure of the welfare of each individual in a designated group. Of course, many types of social welfare functions have been put forward, and there are widely differing views as to whether they are appropriate, what they mean, how they should be interpreted, and even whether they are meaningful.

If your welfare function is Rawlsian in form, so that you are concerned with maximising the utility or the resources of those with the least, equality per se is not relevant. Only the conditions of the people at the bottom are relevant, and the rest of the distribution ignored. Inequality or relative poverty measures will tell you little of what you need to know.

5 A separate argument is that income inequality has a negative effect on health, most recently popularised by Wilkinson and Pickett, 2009. But it remains unclear whether this claim is supported by the evidence, for example see Deaton, 2003.

6 For example, see Kaplow 2008.

On the other hand, if you are a Benthamite utilitarian, then you want to maximise aggregate utility[7], the sum of individual utilities, and you consider utility to be 'happiness' simply understood.[8] If we assume that there is diminishing marginal utility of consumption, then a more equal distribution of income (including leisure) will help equalise the marginal utility of income and hence — subject to efficiency costs — maximise aggregate utility.

Note that the utilitarian's concern is to equalise marginal utility, not levels of utility between persons. But if people are alike and have equal capacity to convert resources or income into things or functions that they value, and then to convert things that they value into happiness, then equalising income after tax and transfers will help equalise individual utilities as well as marginal utility. Again, this is subject to any trade-off with efficiency.

One-well known critique of this line of reasoning has been provided by Amartya Sen.

People don't have equal capacity to convert income into things or functions that they value. A blind person for example may require more income to do or achieve certain things. Others may not have the education or skills to make the best use of the income they have. If you're concerned with maximising aggregate utility you may want to give such a person less income than others, as they may be an inefficient utility generator. But if you are concerned with equalising individual utilities you may want to give them more than an equal share of income or resources.

So Sen suggested that we look at people's capabilities: the outcomes or functionings they can achieve —such as good health and their ability to participate in society as well as consumption of goods and services. If you conceptualise income in a very broad way as both Treasuries do, then the distinction between income and resources on the one hand, and capabilities on the other, begins to disappear. Differences in people's ability to convert resources or income into something they value would be reflected in your measure of resources or income.

Sen is less keen on going the next step to focus on happiness or subjective well-being. But there can also be blurring on that side as well. If what people value ultimately is happiness or some other subjective state, then some may be less efficient than others in

7 More typically today, utility is seen as reflecting the fulfilment of desires or preferences. But if so interpreted it is unclear how individual utilities can be added up or what average utility is — see Sen, 1999.

8 One conclusion you can draw from the subjective wellbeing literature is that happiness cannot be simply understood — for example, is it mood happiness as it is experienced, or as you look back, or is it life satisfaction? (Fleurbaey, 2009). And what of other subjective states such as a sense of purpose that also appear to matter to people in their own right (Benjamin, Heffetz, Kimball, & Rees-Jones, 2010).

converting resources, or capabilities, into happiness. It would seem strange, for example, to care about a person's mental illness if it negatively affects the tangible outcomes they can achieve, but not care if it leaves their capabilities unchanged but affects their mood happiness or sense of self.

As a general rule then, and as researchers in the field have long understood, broader measures of resources and income are called for than disposable cash income. While noting that it is a formidable task, the 2009 Stiglitz-Sen-Fitoussi report on the Measurement of Economic Performance and Social Progress argued that measures of the distribution of what it called 'full income' should be part of the research agenda.[9]

In essence, such a measure could be expected to reflect the underlying broad productive capacity of individuals or households, akin to the stock concept emphasised in the living standards paper. It is also akin to the optimal tax literature's concern with taxing an individual's productive capacity (and so avoiding disincentives to paid work), through finding proxies for that otherwise unobservable capacity.

## Should we care about inequality because it is unfair?

Reasons for caring about equality can also be derived from overarching theories of justice. Rawls is well known for constructing a thought experiment to argue that fairness, or justice, requires the equality of rights and liberties and that we choose those institutions that maximise the resources available to those with the least.

So perhaps we should care about inequality of incomes because it is simply unfair or unjust.

This is a natural line of thought, and in explaining why we should care about inequality of cash income, *Growing Unequal?* places emphasis on social concerns (OECD, 2008, page 283). But other common views around 'fairness' are largely ignored in *Growing Unequal?*, or even viewed as adding to the negative consequences of inequality (page 131).

In 2003, the economist James Konow provided a survey of the empirical evidence — essentially surveys, vignettes and social laboratory experiments — on fairness (Konow, 2003). One of his goals was a positive analysis of normative theories of justice. That is, how the normative theories of say Rawls or of utilitarians, and also Pareto principles, stack up with the views of people in general.

To illustrate, consider the following stylised question that Konow records as being asked of 211, presumably American, respondents:

9 The report suggests full income would include leisure, household production and imputed rent as well as financial income and in-kind benefits (Stiglitz, Sen and Fitoussi, 2009).

Question: Jane has baked 6 pies to give to her two friends, Ann and Betty, who do not know each other. Betty enjoys pie twice as much as Ann. In distributing the pies, what is fairer:

A. 2 pies to Ann and 4 to Betty, or
B. 4 pies to Ann and 2 To Betty, or
C. 3 pies each?

A, with more given to the person whose enjoyment will be greatest, is consistent with a utilitarian perspective: choice A will generate more aggregate enjoyment, or average enjoyment, than B and C. It received support from 40 per cent of those asked.

B, with more pies given to the person who enjoys them the least, corresponds with equalising enjoyment (or utility) between individuals. It reflects what is often called Sen's weak equity axiom. It received a positive response from only 4 per cent.[10]

So it was 'C', a simple two way split of the pies, that received majority support of 56 per cent.

Based on considering a wide range of other such examples structured to cast light on different perspectives on fairness, Konow set out what he saw as the three principles underlying what people consider a fair distribution. These were:

- *Need*, concerning the satisfaction of basic needs.
- *Equity* (or just deserts), concerning proportionality (for example, of income to work effort or risks deliberately taken) and individual responsibility.
- *Efficiency*, concerning maximising aggregate income, consumption or even subjective outcomes like enjoyment.

Reflecting the behavioural economics literature, he noted that context also matters, and sets the stage for the playing out of these competing principles. He also noted that people appear to trade off the three principles rather than giving precedence to one over the others. That is, people are generally pluralists, not monists or absolutists like some utilitarians I happen to know.

Strikingly, Konow argues that equality or egalitarianism is itself not an underlying principle. Rather he describes it as the default rule that people apply when they lack information on need, equity or efficiency. Perhaps it would be better thought of as a

10 Konow (2003) notes that other evidence supports Sen's weak equity axiom. In particular, he gives example where respondents support the unequal distribution of food to achieve equal health outcomes.

default principle, that is applied in the common situation in which information is often either incomplete, ambiguous or plainly not available this default rule becomes prominent.

Of the principles that Konow identified, thinking of equity in the sense of desert or proportionality, and as reflected in Robert Nozick's concerns for procedural fairness, is probably what economists — and the authors of *Growing Unequal?* — find most uncomfortable. We do of course see rewarding effort and risk as important from an efficiency perspective, but for that reason only.

Desert though features heavily in public discourse. Mankiw (2010) sees differences in the weights that people place on equality and just deserts as explaining major political fault lines in the United States. It also underlies arguments for equality of opportunity rather than equality of outcomes.

But as for equality where we always need to ask about 'equality of what', so we should ask 'fairness of what'. One way to interpret Konow's findings is that proportionality reflects a concern for inequality in respect of a broad measure of income, by taking account of leisure and risks taken — rather than just cash received or goods and services consumed.

So the point for me is much the same as before. Whether we're concerned about equality or community ideas of fairness, we have to continue to try to move beyond narrow measures of income such as cash income.

## The Australian Treasury's perspective

So what is the Australian Treasury perspective on the distribution concern identified in its wellbeing framework? Related to that, and the issue I raised previously of how should you use such a framework, how do we go about operationalising it in our advice?

Needless to say, in a large organisation that has evolved over time there is no single answer to either of these questions. But there are distinctive features to how we have approached these issues that I suspect are shared by New Zealand Treasury.

### The Australian Treasury's underlying concern

Our revised framework points to the Australian Treasury's underlying concern as relating to need in the sense of all in the community being able to lead a fulfilling life and participate fully in the community. Such a perspective would I expect have general community acceptance, and while it does not advocate more egalitarian or redistributionist policies that a government may be minded to implement, it does not preclude them either.

Such a perspective or objective is of course concerned with more than just the distribution of cash income over a defined period.[11] And it does not neatly fit in either the absolute or relative poverty camps: it treats both senses of poverty as relevant.

This view informed, for example, the recent review of the Australian tax and transfer system by a panel chaired by Dr Ken Henry and supported by a Treasury secretariat. In considering the appropriate level of assistance to demographic groups with little capacity to work or expectation that they should work, it suggested transfers be 'sufficient to provide an adequate standard of living, based on an accepted community standard.' (Commonwealth of Australia, 2010a). Adequacy or need, rather than reducing inequality per se, was the concern.

In the living standards paper I find some resonance with this view in the statement that (page 28):

> [New Zealand] Treasury's advice on distribution has tended to emphasise the inefficiencies that result from having living standards distributed in ways that prevent some people from fully participating in the economy and society.

It also finds some resonance in the *Growing Unequal?* report's indicators of material deprivation, identified as 'one area where consumption data hold special promise' (page 298). To quote the report:

> … today, most authors define material deprivation as 'exclusion from the minimum acceptable way of life in one's own society because of inadequate resources' (page 179).

By looking at whether people are able to achieve a given set of outcomes or functionings, and also avoid negative outcomes such as financial stress or poor environmental conditions, material deprivation takes a broader range of resources into account than cash income or wealth alone, including some factors affecting the conversion of resources into outcomes. These other factors can be personal, such as a lack of self control, or external, such as the climate.

Looking at material deprivation generates some different results from relative income poverty measures that we often default to. For example, using individual level data to test for a common set of seven deprivation items such as inadequate heating, poor environmental conditions and an inability to make ends meet, the OECD found that many of those who are cash income poor based on a relative poverty measure are not materially deprived.

11 This is not to say such concerns should be irrelevant to public policy. Transfer systems will always have a concern for people who are very cash poor over even short periods of time, such as a fortnight, and face liquidity or borrowing constraints.

Related to this, the age profile of material deprivation is different from that associated with relative poverty. Whereas relative income poverty has a U-shaped relationship — declining in middle age and increasing in old age — material deprivation, when measured as the share of an age group experiencing two or more deprivation items, generally declines with age.

As for the other measures of distribution, more work remains to be done. But such measures would seem to provide important information that measures based on income or wealth alone lack.[12]

## Distributional concerns and policy advice

To be concerned with distributional issues is not to say that we should factor such concerns into our advice on all issues.

In economics there is a long tradition of trying to separate consideration of efficiency issues from those of equity or distribution. For example, the Kaldor-Hicks criterion that only requires that the losers from a change could potentially be compensated.

For policy makers, it seems generally sensible to adopt such an approach and focus on efficiency concerns except where affecting distribution is the primary goal. So, for example, the recent review of the Australian tax system argued that:

> 'The transfer system, together with progressive personal taxation, is better suited to this task, and should be the primary means through which the government influences the distribution of income in the economy ...' (Commonwealth of Australia, 2010b).

## Separating efficiency from equity considerations

This was in the section of the report dealing with the taxation of consumption. But experiences with consumption taxes illustrate the difficulty, both political but also analytically, you can have in trying to separate efficiency and distributional issues. For example, when the introduction of a GST in Australia was being debated in the late 1990s, the question of whether to include basic food in the GST base was one of the major points of contention.

12 The Australian Bureau of Statistics is currently undertaking a Low Consumption Possibilities research project (see http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/1504.0Main+Features5Jun+2009), that combines data on the income and wealth of households, rather than looking at income or wealth alone. While not a measure of material deprivation per se, it is likely to indirectly capture some of the same outcomes, for example, in respect of the position of the aged. In a similar vein, distributional analysis based on consumption or expenditure rather than income also appears to better reflect observed deprivation (Meyer and Sullivan, 2011).

Anthony Atkinson and Joseph Stiglitz, in their seminal 1976 paper, found that where there is an optimal direct (labour) income tax in place, any given distributional goal can be achieved more efficiently using the tax-transfer system alone (Atkinson and Stiglitz, 1976). This finding, and similar results from related branches of the optimal tax literature, have been highly influential, and have been adapted to analyse other important policy questions.

As there are many excellent discussions of the Atkinson-Stiglitz and related theorems and their policy relevance in the literature, I will only touch on some aspects particularly relevant to us today.

First, the theorem can take into account the presence of subsistence levels of consumption, such as basic non-discretionary items like parts of household expenditure on food, water and shelter. However, what is seen as a non-discretionary item is likely to change over time and vary across the population. For the theorem to hold, governments must be able to observe and act on these basic needs through lump sum transfers. But what government can do in practice is likely to be more constrained.

This leads to a second (more general) point regarding assumptions about the behaviour of governing authorities. While there is a growing body of work that takes into account the effect of political economy constraints, arguments like Atkinson and Stiglitz typically assume that governments' act consistently to maximise social welfare. In the Australian GST debate, critics questioned whether governments could be trusted to compensate properly and then not unwind compensation over time.

Finally, the theorem also relies on making normative judgements rather than just arguments relating to efficiency. Underlying the theorem is an objective of maximising a social welfare function which is essentially utilitarian. You may think the set of social welfare functions consistent with achieving the Atkinson-Stiglitz result to be acceptable, but this is a normative position. Much of the debate in Australia involved normative claims inconsistent with this viewpoint.

These three observations also relate more broadly to the subsequent economic analysis of optimal taxes. To undertake economic analysis involving both efficiency and equity objectives, we need to have a sound grasp of both the positive and the normative underpinnings. The optimal tax literature, by beginning to formalise and empirically test these underpinnings, has given policymakers some valuable insights into how these underpinnings trade-off against each other. But that literature cannot provide definitive answers.

## Achieving distributional outcomes outside of the tax-transfer system — work and education

Government action to achieve distributional outcomes is of course not limited to using the tax-transfer system, regardless of its optimal configuration.

And it is important that it not be limited to the distribution of cash. Governments and their advisers are more aware these days of the potential negative consequences of transfer payments in entrenching disadvantage, and the benefits for some groups of attaching labour force participation requirements to transfers made to them, supplemented where appropriate by active labour market programs.

This is not only because of the potential improvements in the distribution of disposable income in the medium- to long-run through earlier attachment to the labour force. It is also because, in general, we see work having benefits in its own right beyond the income provided. The living standards paper points to some evidence that supports this view.

If we look at the related issue of labour market deregulation, one view is that while the movement in recent decades to more deregulated labour markets in countries reduced income inequality by improving employment outcomes, it widened wage inequalities at the same time. As a consequence the net effect on income inequality has been ambiguous.

Yet if work has benefits separate from income, the calculus is much more likely to be net positive.

We are also now more aware of the importance of human capital, of education and good physical and mental health for the outcomes people achieve. Better education is associated with improved participation in the labour market, higher lifetime incomes and longer lives. Assistance provided through better education outcomes therefore avoids some of the incentive constraints of cash transfers.

Also of importance for us, however, are the non-income benefits associated with education — that it gives people greater capacity to convert other resources or income into positive outcomes, and more sensibly choose between them. Better education is associated with improved health, lower rates of incarceration and increased engagement in civic life.

Improving educational outcomes for those otherwise disadvantaged is likely then to improve distributional outcomes, regardless of the distributional rule you favour. It is also likely to sit well with general community notions of fairness.

## Conclusion

The Australian Treasury has found having a wellbeing framework a positive experience. Not because it tells us to forget our economic frameworks, but because it reminds us that they are richer and broader than is often assumed.

We have also found that having a framework is not the end of the matter. How you make use of your framework is also important. Critical here will be the example of the senior leadership of the New Zealand Treasury.

Today I have focussed on distributional issues. I expect one advantage you'll find of your living standards framework is that it encourages you to debate these and some other issues more than you have in the past.

I hope I have contributed to that debate.

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# Key themes from Treasury’s Business Liaison Program

## Overview

As part of its quarterly Business Liaison Program, Treasury met with 27 businesses and organisations in August. The meetings took place in four capital cities as well as in regional areas and via teleconference. Treasury greatly appreciates the commitment of time and effort made by the businesses and industry associations that participate in this program.

Since the last round, the divergent outlook for the mining and non mining parts of the economy has become more pronounced, driven by increasing weakness in the 'goods' sectors, notably manufacturing and retail.

Contacts report that prospects for the mining and related sectors remain strong, and that the recent global turbulence is not expected to affect investment plans. By contrast, the 'goods' part of the economy is struggling under the weight of soft demand, partly due to the impact of the high exchange rate, and is increasingly vulnerable to the impact of the uncertain global outlook on business and consumer confidence. Soft demand also continues to dampen activity in the residential and non residential construction sectors.

Consistent with the patchiness across the economy, a more mixed outlook for employment emerged this round. Competition for skilled labour is driving more flexible conditions in the mining and related sectors, along with strong wages growth. However, softer employment growth is now evident in the retail and manufacturing sectors.

### Activity

Liaison discussions confirm that activity in the resources sector remains robust, with strong demand for Australia's key non rural bulk commodities. Production rates for iron ore and thermal coal in New South Wales have fully recovered after the adverse weather events earlier in 2011. However, some Queensland coal mines are still struggling with high water levels. General indications are that coal operations in Queensland will continue to be affected throughout the rest of 2011, although this is not expected to affect the broader recovery in the sector.

In the retail sector, the general sentiment is pessimistic, with already weak sales and confidence dipping in response to the recent global volatility. Contacts report that store closures have increased and, that a few high profile retailers are downsizing their operations and closing less profitable outlets.

Contacts report varying conditions in the manufacturing sector, with firms servicing the mining sector, and those less exposed to the high exchange rate and faltering global conditions, better placed than others. However other, non mining trade exposed firms, are increasingly uncertain about their prospects.

Contacts report that conditions in the broader construction sector are weak, with growth slowing in the residential and non residential construction sectors. The outlook for private non residential construction remains weak with the slowdown in employment growth leading to less demand for new office space, although public construction continues to support the services related areas of the sector. Hospital construction is supporting activity in regional Australia, as is education construction, notwithstanding the wind down of the Building the Education Revolution spending. Contacts also note that public funding for construction has reversed the negative outcomes induced by the natural disasters earlier in the year.

Despite some positive pockets of activity in the residential sector in Victoria, the outlook for residential construction activity is broadly flat.

## Employment and wages

Overall, the outlook for employment is mixed. While mining employment remains strong, contacts in the manufacturing, retail and finance sectors report a reduction in their hiring intentions.

The labour market in the mining and related sectors remains tight. Some contacts report acute labour shortages, and the need to look overseas for skilled labour. Some firms also report the need to compete in ways that do not involve wages, such as a shift towards more flexible rosters.

Some contacts in the manufacturing and retail sectors report that they have already reduced staffing levels, and that this is expected to continue in light of the global uncertainty and overall softer outlook. While the exchange rate appreciation has helped dampen some input costs, contacts are concerned about the prospect of increased labour costs in coming years.

With regard to wages, overall skills shortages in the resource and construction sectors are expected to drive wage pressures, with wage agreements above 4 per cent and, for more experienced employees, above 6 per cent. Elsewhere, firms are generally providing increases of around 3 to 4 per cent.

In the retail sector, some contacts are seeking to reduce costs through wage freezes for senior staff.

## Costs and prices

Contacts indicate that demand for Australia's key non rural bulk commodities is expected to remain strong for the foreseeable future, helping to support continued high prices. There is also expected to be continued short term support for metallurgical coal prices, with tight supply as dewatering drags on for longer than originally expected.

## Financing and investment

Contacts report that the boom in mining investment continues on the back of continued strength in commodity prices, notwithstanding some investment delays and cost overruns arising from regulatory requirements. Further, investment intentions appear resilient to the recent global uncertainty with the large players driving the strength in investment. For junior and mid tier miners, financing and post GFC caution are holding back final investment decisions for some projects, although there is an abundance of feasibility studies.

Contractors supporting mining and oil and gas operations are optimistic about the strong pipeline of work which is expected to come their way over coming years with some indicating that the full benefits are yet to be felt.

The general pessimism in the retail sector is impacting investment, with cuts in capital expenditure reported by some in the retail sector, including delays to planned expansions. High volume, low cost outlets appear to be defying the general trend, with planned expansions on track.

Contacts in the non residential construction sector cite increasing retail vacancies as delaying plans for retail construction while anticipated reductions in white collar employment across industries could translate into additional spare capacity and a weaker outlook for office construction.

# Ben Chifley: the true believer[1]

John Hawkins[2]

Chifley was a 'true believer' in the Labor Party and in the role that government could play in stabilising the economy and keeping unemployment low. He was an active treasurer, initially working well with Prime Minister Curtin and then serving as both Prime Minister and Treasurer himself. He managed the war economy competently and achieved a smooth transition to a peacetime economy, although he allowed inflationary pressures to build up in the post-war years. Among his economic reforms were increased welfare payments, uniform income taxation and developing central banking powers (through direct controls rather than market mechanisms) for the Commonwealth Bank.


Source: National Library of Australia.[3]

1 Arthur Fadden served almost a year as treasurer before Chifley, but as Chifley was Treasurer for most of the 1940s and Fadden for most of the 1950s, the essay on Chifley is being presented first in this series.

2 The author formerly worked in the Domestic Economy Division, the Australian Treasury. This article has benefited from comments provided by Selwyn Cornish, Robin McLachlan, Sam Malloy and Richard Grant. Thanks are also extended to the staff of the Chifley Home in Bathurst. The views in this article are those of the author and not necessarily those of the Australian Treasury.

## Introduction

The Right Honorable Joseph Benedict Chifley was a 'true believer' in the Labor cause.[4] While an idealist, remembered for coining the term 'light on the hill' to capture Labor's aspirations for a better world, he was pragmatic enough to have also coined the expression 'hip pocket nerve' to denote what motivates many voters.[5] He had both a 'deep-rooted passion to improve the lives of his fellow Australians' and 'a practical appreciation of the political compromises and ruses that were sometimes necessary for success'.[6]

One time colleague and later opponent, and fellow Treasurer, Joe Lyons described him 'as one of the finest fellows I have ever met', while Lyons' wife Enid remembered Chifley's 'rugged good looks, immense personal dignity and his friendly but always slightly reserved bearing'.[7] Other colleagues recalled how Chifley 'was gracious with everyone, lived simply, and continually went out of his way to help people. He was wholly devoid of arrogance and never indulged in wounding political repartee'.[8] At the time it was noted that Chifley 'regards himself as a pretty average bloke'.[9]

He was respected as well as liked, being recalled as 'a prodigious worker'[10]; 'an administrator of rare quality'[11] and 'one of the soundest members of the new House'.[12] Never a great orator, his voice became increasingly raspy over the years as addressing many outdoor public meetings in poor weather took its toll.

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3 'Portrait of Prime Minister Ben Chifley, 18 May 1948', by William Henry Bale, Bib ID: 4586730.

4 The expression 'true believer' was popularised by Bob Ellis' eponymous television series about the Curtin-Chifley era. In discussion with the author, Ellis conceded the term was not used in Labor circles at the time.

5 Day (2007, p 94).

6 Day (2001, p 530).

7 Enid Lyons (1972, p 97).

8 Beazley (2000, p 16). Similarly Calwell (1972, p 60) remembered him as 'a warm friendly man'. While Treasurer Chifley's lunch consisted of a cup of tea and a pie and between sessions he lived simply at his modest Bathurst home; Holt (1969, p 52). Senior public servant Breen (1974, p 226) said 'he was the embodiment of the spirit of the average Australian.' Makin (1961, p 122) recalls Chifley 'always brought men closer to one another'. Nugget Coombs (1981, p 90) appreciated Chifley's 'gentleness, his simple faith in mankind and his warm gift for friendship'. One biographer refers to the challenge that 'it is almost impossible to find anybody with a bad word to say' about him; Thompson (1964, p 55).

9 *Australian Women's Weekly*, 28 July 1945.

10 A public servant cited by Day (2001, p 389). Evatt said 'I do not suppose there has been a man in public life who has worked harder'; *Hansard*, 20 June 1951, p 68. There is an example of an 83-hour working week in *Sunday Telegraph*, 8 April 1945.

11 Bennett (1973, p 13).

12 A comment by the Liberal intellectual Frederic Eggleston; Osmond (1985, p 202).

Chifley was 'endowed with a clear, hard, practical mind with an unusual capacity for simplifying the intricacies of finance and economics and taking swift and firm political decisions with a keen insight into their practical effects'.[13] He was assisted by his 'remarkable ability and memory for figures'.[14] A contemporary recalled 'Mr Chifley had the most powerful mind in the politics of his day and he was able to learn more quickly than most parliamentarians … '[15] While known as a reader of crime novels for relaxation, he was also a keen attendee at meetings of the Commonwealth Literary Fund where he surprised those present with his knowledge of Australian writers.[16]

Chifley was 'deeply interested in economic matters'.[17] Indeed his wife recalled that it was a frequent topic of conversation when they were courting.[18] A contemporary journalist said 'Chifley's interests were economic and financial. They were almost exclusively economic and financial.'[19] Menzies recalled Chifley 'mastered the techniques of public finance'.[20] Nugget Coombs, who worked closely with him, refers to Chifley's 'considerable mental aptitude for financial and economic matters'.[21] More recent writers also refer to Chifley's 'quite remarkable grasp of finance'.[22]

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13 Hasluck (1952, p 262). Crisp (1960, p 147) refers to his 'remarkably keen, if largely self-tutored, intellect'.

14 Day (2001, p 530). Bennett (1973, p 13) claims 'his memory was so good that he never had to use a telephone directory'.

15 Eggleston (1953, p 82). Hawke (1985, p 2) had a similar view.

16 Waterson (1993).

17 Day (2001, p 235). Eggleston regarded Chifley as one of the few 'able to command their respect and to appreciate what the economist could do for them … '. Edwards (2005, p 81) believes, however, that Curtin was more widely read in economics than was Chifley.

18 Crisp (1960, p 8). In Ellis and McLachlan's (2005, p 21) play about Chifley, he says of his wife 'what I liked about her … was how you could talk to her about economics … '.

19 Holt (1969, p 51). Ryan (2004, pp 84-85) refers to Chifley's extensive reading, especially of Keynes. At the time of his death he still kept in his study a copy of Shann and Copland's (1931) compendium of key economic documents related to the Depression.

20 Undated typescript, *Menzies Papers*, National Library of Australia, MS 4936, box 354. On the ABC TV programme 'Mr Prime Minister' (broadcast 25 May 1966), Menzies recalled that Chifley 'had the most acute mind — he got on top of Treasury and economic problems in the most remarkable way'. See also Beale (1977, p 32).

21 *Melbourne Herald*, 11 August 1976. 'Chifley had a grasp of finance and the respect of his Treasury officers as no other prime minister had before or since'; Haylen (1969, p 43).

22 Golding (1996, p 126). Senior public servant Breen (1974, p 228) characterised him as 'a thinker well above the average in finance'.

Some regard Ben Chifley as Australia's greatest Treasurer.[23] Chifley once said that he would be remembered as Treasurer and not as Prime Minister.[24]

## Chifley's life before politics

Chifley was born in Bathurst on 22 September 1885, the son of a blacksmith. He was largely raised on his grandfather's farm at Limekilns 18 kilometres away, where he lived from the age of five to fourteen.[25] He received only rudimentary schooling two to three days a week.[26] There are two ways this period in his life may have influenced Chifley as a Treasurer. Firstly it instilled in him a love of reading[27] and, secondly, observing the effect on his grandfather and their neighbours of the bank collapses of the 1890s meant banking reform was always a priority for Chifley.[28]

Returning to Bathurst, he had some full-time schooling and then started work in a retail store but soon moved to the railway workshop and over a decade quickly rose to driving locomotives (although he was demoted for a time due to his role in a 1917 strike). He attended evening classes four times a week for fifteeen years and read voraciously, as well as playing rugby[29] and cricket. He taught at the Railway Institute on Sunday mornings.

A Catholic, he married Elizabeth McKenzie, the daughter of another driver, and a Presbyterian, in 1914, thereby placing himself outside the mainstream of his church.[30]

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23 McMullin (2000, p 254). Professor Keith Hancock cites his role in funding Australia's World War II effort, making the adjustment to bigger government and managing the post-war period; *The Age*, 9 May 2005. Waterson (1993), p 4, shares this view. Golding (1996, p 126) remarks 'there are many who would argue that Chifley was in fact one of Austraila's very great treasurers'. A senior Treasury official asked at the end of World War II whether Chifley was the best treasurer said 'well we had Theodore, I'd vote Chifley next and in some ways I'd say he was even better'; cited in Crisp (1960, p 165). His press secretary, Don Rodgers, thought even contemporary business leaders would have shared his view that Chifley was the greatest treasurer; NLA oral history.

24 Beazley (2000, p 16).

25 As Chifley put it, 'I went for a holiday and I came back nine years later'; Crisp (1960, p 3).

26 Many years later Chifley was to say to his nephew that 'I'd rather have had Mr Menzies' education than a million pounds'; Crisp (1960, p 6).

27 School friends recalled Chifley 'sitting in the school playground, waiting his turn to bat, with his head stuck in a book'; Thompson (1964, p 58).

28 Over half a century later, Chifley recalled 'I can remember the depression of the 'nineties, and the farmers near where I lived who were desolated and grief-stricken at the closing of the banks'; *Hansard*, 11 November 1947, p 1927.

29 Well enough to represent NSW Country and be in contention for the Australian team.

30 This extended beyond the grave: Ben and Elizabeth Chifley are buried in different sections of the Bathurst Cemetery; Wright (1988).

They shared the Bathurst cottage provided by her parents for the rest of their lives. Elizabeth miscarried in 1915 and was thereafter in poor health. They had no children.

Chifley worked his way up in the trade union movement and the Labor Party. In 1922 and 1924 he unsuccessfully contested ALP preselection for the NSW parliament.

## His early years in parliament

Chifley was elected for the then Bathurst-centred seat of Macquarie, at his second attempt, in 1928, and sat next to fellow newcomer and future Prime Minister John Curtin, to whom he became very close. In one of his first parliamentary speeches Chifley (like Curtin) opposed Bruce's plan for an Economic Research Bureau as duplicating work done by other organisations and questioned whether economists with 'academic ideas gathered in the rarified atmosphere of some university' offered better advice than 'someone with a wider and more practical experience'.[31] Chifley served on the busy Joint Committee of Public Accounts and in the course of its inquiries seemed to have formed a more favourable view of economists.[32]

In March 1931 he became minister for defence in Scullin's government and assisted Theodore on some economic matters, such as being delegated responsibility for implementing some spending cuts required under the Premiers' Plan.[33] Some accounts suggest Chifley had some misgivings about Theodore's approach, but others say he was a 'strong supporter of the Theodore plan'.[34] On a personal level he got on well with Theodore. They had long conversations walking the gardens of Parliament House and they fished together.

The Scullin Government fell, however, within a year of Chifley's appointment when Lyons defected and rebels backing NSW premier Jack Lang turned on it too. In the ensuing election, Chifley lost his seat and was out of parliament for nearly a decade.

31 *Hansard*, 19 March 1929, p 1470.

32 Crisp (1960, p 52). One of its reports recommending establishing a body like the Commonwealth Grants Commission.

33 Day (2001, p 258), Bennett (1973, p 8). Crisp and Bridge (2004, p 417) call him 'minister assisting the treasurer' but he does not seem to have been officially recognised as such.

34 Waterson (1993), Robinson (1986, pp 129-30). Day (2001, p 254) says Chifley was concerned about how London bondholders would view Theodore's policies. Chifley strongly supported Theodore's Fiduciary Notes Bill; *Hansard*, 25 March 1931, pp 602-6. By the time he was treasurer himself, Chifley regarded Theodore's policies as right; Reid (1980, p 40).

## The wilderness years

Joseph Lyons had offered Chifley the Treasurership if he also left Labor but Chifley declined.[35] His biographer says 'he rebuffed it immediately' but according to Lyons' wife, Chifley 'had been briefly tempted to go with Joe'.[36]

While out of parliament Chifley fought the Lang forces, being elected as NSW president of the federal version of the Labor Party in 1934. He was elected to Abercrombie Shire Council in 1933 and stayed on it until 1947 (even while Prime Minister and Treasurer), serving as shire president for a few years. Chifley's involvement with many community organisations in Bathurst was not enough for him to win back Macquarie when he contested it again in 1934. In 1935 he stood unsuccessfully against Lang in the state seat of Auburn. By one account he made a trip to Indonesia.[37]

Chifley continued his study of finance and economics and continued to meet with Theodore.[38]

### Royal Commission on Banking

In 1935 Lyons and Casey appointed Chifley to the Royal Commission on the Monetary and Banking Systems. 'Both his knowledge of finance and the analytical habit of his mind fitted him admirably for such a task'.[39] Over nine months the Commission took evidence in every capital. A biographer comments that Chifley 'added to his knowledge of economics and finance by his searching interrogations of the leading economists who came before the commission, as well as by the many months of discussion, both formal and informal, with his fellow commission members … '.[40]

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35 Lyons was now leading the United Australia Party. Given the UAP candidate won Macquarie at the 1931 election and held it until Chifley won it back in 1940, taking up Lyons' offer would almost certainly have allowed Chifley to stay in parliament throughout the 1930s. He may well have succeeded an ailing Lyons as prime minister in the 1930s; Ellis and McLachlan (2005, p 41).

36 Crisp (1960, p 65), E Lyons (1972, p 97).

37 Ryan (2004, p 87).

38 Crisp (1960, p 86).

39 E Lyons (1972, pp 97-80). Anstey had lobbied for the position but Curtin pushed Chifley and it is likely that Chifley's case was helped by the good opinions held of him by Lyons and Scullin; Crisp (1960, p 167); Day (2001, p 321); Sutherlin (1980, p 39). Much later Casey uncharitably recalled 'I bought him off the street, not for the reason that he had any prior knowledge of banking, because I think at that stage the right honourable gentleman did not know a bank from a public convenience'; *Hansard*, 20 April 1950, p 1707.

40 Day (2001, p 322).

Chifley questioned the Commonwealth Bank about their reluctance to compete with the private banks[41], in part due to a perceived incompatibility with the Bank's role as a central bank,[42] and their lack of control over the exchange rate.[43] He asked the private banks about funds they placed with the Bank and referred to the compulsory deposits banks were required to place with the central banks in New Zealand, America and Africa.[44] He referred to evidence from Professor Gregory to the Canadian banking inquiry about the need for such required reserves to supplement open market operations and similar suggestions by the Macmillan Committee.[45] He also asked about controls on interest rates and about open market operations.[46] Chifley asked whether the Treasurer rather than the treasury secretary should be on the board given confidentiality would inhibit the secretary reporting back to the Treasurer.[47] Chifley was concerned that bank mergers were reducing competition and that this was further impeded by gentlemen's agreements between the banks.[48] He repeatedly questioned the banks about their ability to check booms or recessions or to affect the demand for imports.[49] He was also concerned about the lack of finance, particularly longer-term finance, for small business.[50]

The Commission's economist recalled Chifley was 'vitally important in the drafting process' and the 'Commission's major impact was the education of Ben Chifley'.[51]

The Commission concluded that 'no action by the monetary and banking system of Australia could have avoided some depression, although the system together with the governments, and, indeed, the community as a whole, must share some responsibility for the extent of the depression … the proper policy for the Commonwealth Bank, as the depression developed, was one of expansion … '.[52] They recommended some, relatively mild, strengthening of the central banking powers of the Commonwealth Bank, such as requiring trading banks to place a deposit representing a set proportion of their liabilities with the Bank. But in his dissenting comments, Chifley argued the

41 Royal Commission, *Transcript of Evidence*, pp 13, 53-54 and 68-69. He also put this question to the private banks, p 464.
42 Royal Commission, *Transcript of Evidence*, pp 17, 54.
43 Royal Commission, *Transcript of Evidence*, p 28.
44 Royal Commission, *Transcript of Evidence*, pp 161, 313, 351 and 482-3. He also questioned economists about this, Melville (1993).
45 Royal Commission, *Transcript of Evidence*, pp 67, 276 and 481-2.
46 Royal Commission, *Transcript of Evidence*, pp 1174, 1175 and 1279.
47 Royal Commission, *Transcript of Evidence*, pp 57, 1395.
48 Royal Commission, *Transcript of Evidence*, pp 183-4, 208, 222-3, 257, 315 and 363. At times these exchanges became testy with one banker accusing Chifley of attempting to 'put words in my mouth'; p 97.
49 Royal Commission, *Transcript of Evidence*, pp 101, 134, 257.
50 Royal Commission, *Transcript of Evidence*, pp 50, 258, 400 and 1112.
51 Sir John Phillips, interviewed by Sutherlin (1980, pp 48 and 278).
52 Royal Commission Monetary and Banking Systems (1936, pp 209-10).

report did not go far enough and that desirable economic outcomes were incompatible with privately-owned, profit-oriented banks.[53] It may be that Chifley felt obliged to put forward nationalisation as Labor policy, even if his personal preference was for central bank control over private banks.[54] The Commission also thought the Government should explore establishing a market for treasury bills and should introduce decimal currency.

### Other work

The Menzies Government appointed Chifley to the Capital Issues Advisory Board soon after the outbreak of the war.[55] He was also briefly Director of Labour at the Department of Munitions, before resigning and winning back the seat of Macquarie at the 1940 election. Chifley was immediately restored to the frontbench and in 1941 served on the Board of Inquiry into Hire Purchase and Cash Order Systems.

## Curtin's Treasurer

Chifley was unexpectedly appointed Treasurer[56] in October 1941 when the two independents holding the balance of power withdrew their support from the conservative coalition led by Fadden and backed John Curtin's Labor Party. He ranked behind only Curtin and deputy leader Forde in cabinet precedence.

As well as his advisers within Treasury, during his first fortnight in the portfolio Chifley solicited briefings from leading economists such as 'Nugget' Coombs, Copland, Giblin and Melville. While Chifley was generally popular with colleagues, he felt the usual pressures of the job: 'As Treasurer I have to do a lot of hard things. Nobody likes being unpopular. Treasurers are notoriously unpopular. They are loved by nobody,

53 Royal Commission Monetary and Banking Systems (1936, pp 262-8). Chifley commented 'in times of unhealthy boom conditions the trading banks are unable individually to check these conditions, and collectively they have never attempted to do so … during a depression or feared slump, the banks, in their own interest, and to protect their depositors, on whose confidence the banks' prestige and solvency depend, adopt a policy of contraction which intensifies the evil.' Butlin (1937, p 50) opines that 'Mr Chifley made out, even in his three pages, a better case for nationalisation than the Majority did for private ownership'. Sir Leslie Melville (1993, p 444), however, recalled that Chifley's minority report 'did not leave much impression'.

54 Sir John Phillips, interviewed by Sutherlin (1980, p 123).

55 Butlin (1955, pp 202-3).

56 With Scullin too ill, Chifley was the best qualified for the job in terms of experience (and was recommended by Scullin) but Forde aspired to it and as deputy leader was expected to be given it; Crisp (1960, pp 140-142), Whitington (1972, pp 110-1), McMullin (1991, pp 212).

not even their own colleagues. The hand of every man is against them. Nobody wants to give them anything, but everybody wants to get something from them'.[57]

As well as Treasurer, from December 1942 to February 1945 Chifley was Minister for Post-war Reconstruction, a new department headed by Coombs and including a number of progressives.[58]

## Budgets and taxation

Fadden had just presented a budget when Chifley became Treasurer and in the time available Chifley could make only relatively minor changes to it, increasing pensions and raising pay for the armed forces. He removed the provisions for compulsory loans and raised company taxes and shifted the impact of higher income tax from middle to high income earners.

Soon after Chifley assumed the Treasurer's job, the Japanese attack on Pearl Harbor in December 1941 and the bombing of Darwin in February 1942 brought the war much closer to Australia and greatly increased public support for a 'total war economy'. War expenditure almost doubled between 1940-41 and 1941-42 and the 1942-43 budget expanded it further, necessitating further increases in personal income, company and sales taxes.

Curtin established a Production Executive, a cabinet committee similar to Menzies' Economic Cabinet, to which he appointed Chifley.[59]

The Government very quickly adopted responsibility for income taxation. In February 1942 an advisory committee[60] was established to examine whether the federal government should take over as the sole imposer of income tax. Following its report in March, the Government moved to take over the powers in May. The High Court rejected a challenge by four states in July 1942. The income tax system was also placed on a 'pay-as-you-earn' basis.

In his 1943 Budget speech Chifley said 'a well-balanced system of taxation is the most efficient and equitable method of meeting the cost of the war. It makes a direct reduction of the volume of civilian spending'.[61] He foreshadowed that taxes would

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57 Ben Chifley, quoted by Crisp (1960, p 153).

58 'Long-haired men and short-skirted women', as Chifley joked; Crisp (1960, p 187).

59 The Production Executive is described in Hasluck (1952, pp 430-3).

60 It included Scullin, Professor Mills (with whom Chifley had served on the Banking Commission) and UAP MP Eric Spooner (who after later losing his seat stood unsuccessfully against Chifley in Macquarie in 1946).

61 *Hansard*, 29 September 1943, p 157. Chifley was drawing on advice from Australia's leading economists on the 'F&E committee'; Maddock and Penny (1983, p 32).

need to be maintained: 'after the war, to save ourselves from inflated costs and prices, and to distribute equitably the additional wealth which full employment brings, we must expect fairly heavy tax rates ... higher than before the war.'[62] By 1944, however, he was warning 'taxation is so high that it is impracticable to obtain any further contribution from this source'.[63]

## Banking and monetary policy

Curtin was keen to avoid the problems faced by Scullin and so supported Chifley in taking control of the Commonwealth Bank.[64] By early 1942, much of the recommendations of the 1937 report of the Royal Commission on Banking had been implemented under wartime National Security Regulations, such as supplementing the Bank's ability to conduct market operations by the private banks being obliged to lodge funds in special accounts with the Commonwealth Bank and comply with its policy on advances. The Commonwealth Bank was also empowered to set maximum interest rates on bank deposits and advances.

A mortgage bank was established in 1942 as a department within the Commonwealth Bank, implementing another recommendation of the Royal Commission. While its operations were restricted at the time, Chifley saw it as 'a powerful instrument in post-war reconstruction'.[65] An Industrial Finance Department was established later for long-term lending.

In March 1945 Chifley introduced legislation to continue the wartime controls on the private banks, consolidate the Commonwealth Bank's role as a central bank and replace the Bank's board with a single governor and an advisory board of officials. The *Banking Act 1945* and the *Commonwealth Bank Act 1945* have been described as 'substantially the work of JB Chifley'.[66] As Chifley explained, the legislation was 'based on the conviction that the Government must accept responsibility for the economic condition of the nation ... the Government has decided to assume the powers which are necessary over banking policy to assist it in maintaining national economic health and prosperity.[67]

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62 Chifley (1943, p 2).
63 *Hansard*, 7 September 1944, p 574.
64 Curtin had curbed some of his radical views by the time he was prime minister. Reminded of a speech he gave years before advocating nationalisation, Curtin replies 'yes, I remember that speech and I also remember that that year I lost my seat'; Beazley (undated, p 17).
65 *Hansard*, 25 September 1942, p 973.
66 Polden (1977, p 2). Sir John Phillips is less sure; ' … although Chifley was a very strong force behind the legislation, much of it would have happened anyway'; Sutherlin (1980, pp 278-9).
67 *Hansard*, 9 March 1945, p 547.

This required the Commonwealth Bank to act as a central bank and 'to control the issue of bank credit by all the banks in such a manner as to avoid expansion of credit in times of boom and contraction of credit in times of depression'.[68]

The Act introduced the three goals of the Bank which are still in place as the goals of the Reserve Bank today and remain inscribed in gold letters on the Bank's headquarters:

- The stability of the currency of Australia.
- The maintenance of full employment.
- The economic prosperity and welfare of the people.

## Welfare

Despite the pressure of war, Chifley increased old age and invalid pensions and introduced widows' pensions, additional maternity allowances, funeral benefits, unemployment and sickness benefits. He foreshadowed further measures once the war was over.[69] This was sometimes portrayed as a trade-off for extending income tax onto lower income earners.[70] This was implemented through a National Welfare Fund into which was paid the lower of £30 million or one-quarter of personal income tax collections. This had the additional advantage of being an economic stabiliser.[71] Chifley rejected viewing welfare as a form of insurance, believing it was more equitable for it to be paid out of progressive taxation.[72]

## Rise of Keynesianism and the 1945 White Paper

The Government was concerned that 'employment and aggregate incomes are constantly increasing whilst the goods and services available for civilian spending are

68 *Hansard*, 9 March 1948, p 548.
69 *Hansard*, 11 February 1943, pp 548-550. In Chifley (1945, pp 1-2) he compared social security to a trapeze artist's safety net, providing 'a national minimum of cash income which is available to all in their emergencies and below which none must be allowed to fall'.
70 Butlin and Schedvin (1977, p 337) called it 'the sugar coating on the pill'. See also De Maria (1991).
71 Chifley (1943, p 10) and (1945, p 12).
72 Chifley (1945).

continually becoming less' and 'it may force a strong and continuous rise in prices'.[73] Taxation increases were used to soak up much of this spending power.

In addition price controls were introduced 'to prevent profiteering and minimise the rise in prices' and rationing by coupons (initially of clothing, tea and sugar, later extended to meat, butter and drapery) were imposed under wartime powers. Subsidies were paid to stabilise the prices of tea, potatoes and milk. Measures were also taken for the control of rents and land sales. Under the National Economic Plan announced in February 1942 real wages were to be frozen. Rents were also frozen from end-1941 to mid-1945.

In resorting to rationing and price controls Chifley rejected advice from his most Keynesian advisors that macroeconomic measures alone could prevent inflation.[74] As the end of World War II came into view Chifley was pondering the risk that with deferred spending unleashed 'and a short supply of goods, inflation can very easily be caused'.[75] He viewed this as grounds for retention of controls, especially as the inflationary boom could be followed by a slump, as occurred after World War I.[76]

Chifley's first biographer may have been gilding the lily calling him a 'Keynesian-of-the-first-hour'.[77] Treasury itself became more Keynesian as economists joined the department. The most talented of these could rise quickly as a large proportion of the staff were World War I veterans reaching retirement.[78]

Curtin was inspired by the UK Government's May 1944 *White Paper on Employment Policy* and on his return from there in July initiated production of an Australian equivalent.[79] Coombs was in charge of drafting it and Chifley was the only minister to be given an early draft. Apparently initially very supportive of Coomb's draft, Chifley was later influenced by Treasury to be more restrained. Cabinet referred a revised draft to a subcommittee of Chifley, Dedman, Holloway and Calwell. There had been a tension throughout the drafting about whether the paper was an 'economic' or

73 *Hansard*, 11 February 1943, p 553. Whitwell (1994, p 216) says '... at the end of World War II it was widely assumed in Australia that there would soon be a slump after an intense but short-lived boom'.
74 Cornish (1993, p 48).
75 *Hansard*, 13 October 1943, p 484.
76 Stephens (1976). As John Stone recalled 'everyone feared that the war-time boom would be succeeded, perhaps after a few years "false prosperity" during the readjustment period, by the kind of post-war slump by which, throughout all history, wars had been succeeded'; cited by Whitwell (1986, p 83). Waters (1970, p 51) demonstrates how widespread was the concern about a post-war slump.
77 Crisp (1960, p 169).
78 Crisp (1960, p 322).
79 Nugget Coombs had been thinking along similar lines as far back as 1938 and expounded his thoughts publicly in Coombs (1944).

'political' document, and by the end it was a far more cautious political document than it had started out.[80]

Australia's representatives were strong advocates at international fora of other countries also adopting the full employment objective and Keynesian policies.[81] Indeed, it has been suggested that 'Keynes found the Australians more Keynesian than he was himself'.[82]

## Chifley and Curtin

'Curtin was very loyal to Chifley and Chifley was very loyal to Curtin. Curtin told Chifley that if he would not become Treasurer … Curtin himself would not become Prime Minister'.[83] It was said that Curtin discussed all important decisions with him.[84]

Hasluck comments '… when one turns to economic policy … it would seem that Chifley was a more significant wartime figure than the Prime Minister'.[85] Curtin's first biographer suggested 'Curtin accepted unhesitatingly Chifley's views on financial issues'.[86] A latter biographer challenges this, arguing that Curtin was 'the ultimate

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80 Cornish (1981) describes the drafting process in detail. Sections containing statistical projections in early drafts were first relegated to an appendix then dropped altogether. Butlin and Schedvin (1977, p 679) describe the final result as 'an amalgam of ministerial statement and specialist report which served neither purpose adequately'.

81 Chifley (1943, pp 4-7); Cornish (1981, p 10); Grant (1996, chapter two); Maddock and Penny (1983, pp 43-44).

82 Edwards (2005, p 153), drawing on Markwell's (1985, p 59) interpretation of letters reproduced in Keynes (1980, pp 383-5).

83 Calwell (1972, p 60). It has been asked 'whether Curtin, frail and sensitive, could have attained his greatness without the robust, tough and experienced' Chifley supporting him'; Ryan (2004, p 84). Senior public servant Breen (1974, p 227) said that Curtin 'drew strength from the rock-like Chifley'. Ross (1977, p 224) claimed 'Chifley was his guide and philosopher and confessor'.

84 Day (2007, p 94), Bennett (1973, p 12). Chifley's private secretary recalled ' … Curtin never made a decision of any importance that he didn't consult Chifley about … normally it was Mr Chifley's view that prevailed'; Murray Tyrell, cited in Thompson (1964, p 73). McMullin (1991, p 234) states that Chifley 'took responsibility for the economy … allowing Curtin to concentrate on defence and war strategy'. Curtin found in Chifley 'with his complete self-mastery, steady consistency of temperament and dogged loyalty, the sort of emotional sheet-anchor he required and he could rely on absolutely … Curtin chose him to be the confidant, the companion, the shock absorber of a highly strung prime minister of a nation at war for its life'; Crisp (1960, pp 143-4).

85 Hasluck (1995, p 119).

86 Ross (1977, p 387).

source of authority in economic affairs' even if he delegated details of finance to Chifley.[87]

As Curtin's health deteriorated, with Forde overseas, Chifley became acting Prime Minister in April 1945.

## Prime Minister and Treasurer

After Curtin's death in July 1945, Chifley reluctantly became the new Prime Minister; he would have preferred to have stayed a powerful Treasurer.[88] Chifley remained Treasurer while Prime Minister, a workload no future leader shouldered for more than a few days.[89] Chifley groomed John Dedman as a future Treasurer, but lost office before this transition could be made.[90]

Chifley was 'highly thought of in the Treasury in the years he presided over that conservative department'.[91] He worked well with Treasury secretaries ('Misery Mac') McFarlane and Watt and also dealt with more junior officers. In 1950 he referred to having assembled 'a group of outstandingly able officers'.[92]

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87 Edwards (2005, pp 124-132). One contemporary journalist wrote: 'Mr Curtin, however, holds more than a watching brief whenever Labor comes to discuss finance. He is himself a crisp financial thinker', although the writer also says of Chifley 'on finance, none more authoritative'; *Sydney Morning Herald*, 29 October 1941, p 10. Beazley (1972, p 5) opines that 'it was Curtin, however, who accurately defined in practice the acceptable limits of a radical financial policy'.

88 A dying Curtin entrusted to Scullin persuading Chifley to stand despite Mrs Chifley's objections: Reid (1980, p 38), Crisp (1960, pp 221-2); Langmore (1992, p 519). Treasury Secretary Watt recalled Chifley telling him that he felt, despite medical advice that he should not take on extra responsibilities, a duty to the party to take the leadership given misgivings about alternative leaders; cited in Thompson (1964, p 72) and Breen (1974). Chifley's nephew John (1992, p 24) said his uncle did not want the publicity and limelight of being prime minister; he 'worked to be the planner — the treasurer'. Journalist Alan Reid (1980, p 38) has similar recollections. Daly (1977, p 32) recalled Chifley termed standing for leader 'joining the suicide squad'.

89 Among his Labor predecessors as prime minister, Watson and Fisher had simultaneously been Treasurer, Curtin had simultaneously been Defence minister during World War II, Hughes had been Attorney-General and Scullin Minister for External Affairs and Industry (and for a while Treasurer). On the other side of politics, Barton, Deakin, Reid and Bruce had simultaneously been External Affairs Minister and Prime Minister and Menzies and Fadden (and for a while Lyons) both Prime Minister and Treasurer. With Scullin in poor health, there was no obvious candidate for Treasurer. Nonetheless, C. Hughes (1976, p 145) argued that it was a serious mistake for Chifley to take on both positions.

90 Makin (1961, p 130). Similarly, Nelson Lemmon was reportedly Chifley's preferred successor as leader but he was also defeated at the 1949 election.

91 Holt (1969, p 52).

92 Crisp (1960, p 257).

While Chifley's frugality may have commended him to Treasury, it sometimes frustrated his ministers. Evatt is claimed to have said exasperatedly 'It's almost impossible to get money out of Ben. You'd think it was his own'.[93]

Chifley supported a mixed economy. As he put it, 'nationalisation of hamburger stands or ice-cream shops or permanent wave establishments is not our business'.[94]

## Macroeconomic policy and the expansion of Keynesianism

Chifley continued to seek economic advice as Prime Minister. He chaired the Investment and Employment Committee from its establishment in late 1946 to its last meeting in November 1949. It brought together leading economic advisers from a number of economic departments and agencies. While it provided useful analysis it was not influential.[95] Chifley planned to include an Economic Policy Division in the Prime Minister's Department.[96] His industrial relations legislation provided for an economic bureau to assist the arbitration commissioners.[97]

Chifley faced internal party opposition to Australia joining the World Bank and the IMF but patiently and adroitly gained approval from cabinet, federal executive and caucus.[98]

With the war finally over, Chifley was concerned in his 1945 Budget that the 'existence of excess spending power will be a dominant feature of the whole transition period'.[99] In the 1946 Budget, while pleased 'the first stage of the post-war transition has been completed successfully', Chifley warned 'the danger of inflation is still present ... [reflecting] the increased demand which has arisen from higher employment'.[100] He warned 'I do not know of a greater menace than inflation and I know who suffers the most … and those are the people that I represent in Parliament'.[101]

Chifley was successful in maintaining low unemployment, even during the period of demobilising the large defence forces. He established the Commonwealth Employment

93 Reported in Holt (1969, p 52).
94 Speech in September 1948, reprinted in Chifley (1952, p 35).
95 Cornish (1993, pp 56-57).
96 Lee (1995, p 127).
97 Eggleston (1953, p 160).
98 Weller (2007, pp 80-82) describes the process.
99 Chifley recalled the 29 per cent increase in consumer prices in the two years following World War I; *Hansard* 9 March 1945, p 548.
100 *Hansard*, 14 November 1946, pp 241-242. Chifley had made similar warnings to the ALP NSW conference in June; reprinted in Chifley (1952, p 20). This was a widely held fear. Back in 1940 Menzies warned 'unless we learned from past experience this war will be succeeded by boom just like the last one'; Cornish (1981, p 12).
101 Speech in June 1948, reprinted in Chifley (1952, p 30).

Service to help the unemployed find work. By 1948 he said 'for the first time in my life, the country has almost achieved full employment'.[102] He also succeeded in stabilising prices in the immediate post-war period. But to do this he retained some wartime rationing, which became increasingly unpopular. Also highly controversial was Chifley's deployment of troops to mine coal during a strike by miners.

In September 1949 Australia followed the rest of the sterling area by depreciating the Australian pound by 30 per cent against the US dollar.[103] With fiscal policy also still expansionary, this added inflationary pressures to the economy.[104] By this time inflation was up to 9 per cent, a 'serious concern', and was likely to rise further as the inflationary pressures that had been supressed by controls manifested.[105] Chifley rejected advice to tighten policy, due to the impending election and possibly some concern about the risk of recession.[106]

Chifley cut taxes in his post-war budgets, but also repaid debt. He explained, however, that 'war costs do not end when fighting ceases. Some of these items, such as debt charges and war pensions, will continue for many years'.[107] Yet by 1949 Chifley was able to say that 'the majority of taxpayers now pay considerably less than half the tax which would have been payable at war-time rates'.[108]

## Nation-building

The air of 'tremendous optimism' was manifest in nation-building projects such as the Snowy Mountains scheme.[109] Menzies later generously described the Snowy Mountains Scheme as a 'living memorial to the courage, enterprise and drive of Mr

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102 Speech in June 1947, reprinted in Chifley (1952, p 24); and *Hansard*, 29 September 1948, p 968.

103 Chifley emphasised that Britain (and other countries with currencies linked to the pound) was Australia's most important export market; *Hansard*, 20 September 1949, p 339.

104 Trevor Swan (1949) warned of inflation and also the danger that it could be reversed in the early 1950s setting off a recession, calling for more restrictive policies immediately but the preparation of expansionary policies.

105 *Hansard*, 8 September 1948, p 234. Chifley took some comfort, however, from the comparison that 'price increases have been less in Australia than in any other country'; *Hansard*, 1949, p 499.

106 Chifley in 1949 was still worried that 'following upon the very great boom conditions that have obtained throughout the world since the end of the war, some measure of recession could be expected'; *Hansard*, 31 May 1949, p 296. The United States had entered a recession in 1949, which was feared to be the start of such a pattern recurring; Whitwell (1986, p 86).

107 *Hansard*, 14 November 1946, p 244.

108 *Hansard*, 7 September 1949, p 27, repeated in his 1949 election policy speech; reprinted in Chifley (1952, p 78).

109 Beazley (undated, p 16). Chifley had an interest in water supply schemes and as the local member had been involved in the establishment of the Fish River Water Supply Scheme during the War.

Chifley'.[110] Chifley founded the Australian National University[111] in 1946, introduced direct grants to other universities, and a university scholarship scheme. The Chifley Government initiated the post-war immigration programme and established a large scale Australian car industry in 1948 by encouraging General Motors in the production of the Holden.

## Referenda

Chifley attempted to increase federal powers through referenda, but with limited success. In August 1944 a referendum proposing to grant 14 additional federal powers (including over employment and for the curbing of monopolies) for five years after the end of the war was rejected.[112] Three separate questions were put concurrently with the 1946 election, proposing federal power over social services, marketing of primary produce and conditions of employment. Despite Labor being comfortably returned at the election, and a national majority for all three questions, only the first proposition was approved.[113] In May 1948 a referendum to give the federal government power over prices and rents was rejected overwhelmingly.

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110 Cited by Starr (2001, p 185).

111 Literally laying the foundation stones for two buildings there.

112 The additional powers were already held by the national governments of Canada, New Zealand and the United Kingdom; McMullin (1991, p 232).

113 Queensland, South Australia and Tasmania voted against the second and third propositions so they failed to meet the approval by a majority of states criterion.

## Bank nationalisation

On 16 August 1947 Chifley announced his plan to nationalise the banks.[114] The direct trigger was the High Court ruling three days earlier that Section 48 of the *Banking Act*, which allowed the government to direct local governments to conduct their banking with the Commonwealth Bank, was invalid.[115] Chifley believed the banks would next challenge the special accounts provisions and so remove the ability to use monetary policy to guide the economy.[116]

Chifley informally approached the banks and said he would not resist the Court's decision if the banks assured him that they would not go on to challenge the special accounts provisions but the banks would give no such assurance.[117]

A bill was brought before the House in October 1947. Chifley argued that 'since private banks are conducted primarily for profit and therefore follow policies which in important respects run counter to the public interest, their business should be transferred to public ownership'.[118] The legislation did not take effect, however, as the High Court, and on appeal the Privy Council[119], ruled that nationalisation was unconstitutional.

## Welfare

Chifley introduced the *National Welfare Act 1945* to place the Welfare Fund (see above) on a permanent basis and finance it from payroll tax and a specified component of personal income tax. Recalling the difficulties he had seen poor families face when a child was born or a father fell sick, Chifley explained 'we aim to compel those who can

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114 Whereas the 1945 banking bills were considered by cabinet clause-by-clause over five days, cabinet and then caucus both agreed unanimously to bank nationalisation without notice at single meetings a day apart: Weller (1975, p 427); Weller (2007, p 89); Crisp (1962, pp 323-8). Cabinet ministers overseas at the time was incredulous when told of the decision; Coombs (1981, p 116) and Daly (1977, p 58).

115 One contemporary journalist reports rumours that Chifley's 'heart condition was having its effect on his temper and his moods' making him 'indifferent to public opinion'; E Holt (1969, p 58).

116 Haylen (1969, pp 43-51); Melville (1993, p 450); *Hansard* 15 October 1947, pp 802-803; speech in September 1947, reprinted in Chifley (1952, p 95). Stephens (1976, p 268) argues that had Chifley being ideologically committed to nationalisation, he would have moved immediately after the 1946 election win. When the 1945 legislation was brought before caucus there was a move to have the banks nationalised instead but Chifley did not support it and the motion was defeated. Calwell and Dedman, however, suggested Chifley may have been deferring to Curtin; cited in Stephens (1974, p 85).

117 Coombs (1981, pp 115-116).

118 *Hansard*, 15 October 1947, p 798.

119 The hearing there was a marathon; Attorney-General 'Doc' Evatt's opening address lasted for 14 days and two judges died during the hearing.

well afford to do so to surrender some of their income to those who do the hard and tedious work ... '.[120] He also introduced the Pharmaceutical Benefits Scheme.

## Opposition leader

Labor lost the 1949 elections, with petrol rationing[121], bank nationalisation and inflation among the main reasons. Labor retained control of the Senate and Chifley served as opposition leader.[122] He was given the freedom of the City of Bathurst.[123]

Chifley attempted to make rising inflation the subject of the 1951 double dissolution election but it became dominated by communism, an issue that divided the Labor Party and their trade union supporters. Menzies won majorities in both houses.

Chifley was still opposition leader on 13 June 1951, when Menzies halted the ball commemorating fifty years of federal parliament to announce the passing of his great rival, who had suffered a heart attack in his modest room at the Hotel Kurrajong.

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120 *Hansard*, 29 September 1948, p 970.

121 Chifley maintained rationing in part to support the UK which was short of dollars to buy fuel; Crisp (1960, pp 309-314.). Chifley was very supportive of the English, notwithstanding his Irish ancestry.

122 By this time his health was suffering. He told a senior public servant, 'I know how hard it is to do a good job when you feel unwell'; Breen (1974, p 240).

123 According to his nephew John Chifley (1992, p 2), 'of all the honours he received this was the one which moved him most'.

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