PRIME MINISTER

CHECK AGAINST DELIVERY EMBARGOED UNTIL DELIVERY

SPEECH BY THE PRIME MINISTER
N.S.W. BRANCH OF THE ECONOMIC SOCIETY
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Ladies and Gentlemen,

I understand that today you have been hearing various forecasts of major interest rates and the exchange rate. This is undoubtedly a fascinating pastime; and one which has both made and lost the reputation of many distinguished economists - and none too few public servants. So I trust that you will understand if I do not do the same.

Let me instead begin with a brief advertisement for two of our major trading banks - I know there are four but I have now an established track record that I only do ads for half of any product.

Over the last month or so these two banks have treated Australians to rather a rare event in this country. Despite very rapid growth in their lending to business and higher borrowing costs, these banks have offered temporarily lower interest rates on new loans taken up during July.

This may seem a trifling event in the overall scheme of things. But it illustrates a number of important points which I wish to address tonight.

These are the strength of the Australian economy, and the associated economic policy context; the new spur to competition which our policies have provided to the financial sector and the Australian economy at large; and the implications of these for the conduct and measurement of monetary policy.

With all of the other media preoccupations of recent weeks, these are developments which have largely been ignored.

Unlike the strong growth leaders overseas, we are expecting our growth performance to be maintained in 1985-86 - our third year of strong economic expansion.

Through the past two years Australia has been bracketed with the United States as the industrial economy performing most strongly on real growth and employment.

Now the international commentators are expecting us to do better than the United States.

The Australian people can take pride in this achievement and can draw inspiration from it as we tackle issues that must be addressed along the path to permanently improved growth performance.

The March quarter National Accounts suggest that, if anything, growth in 1984-85 has been faster than the 5 per cent or so expected at the time of the Budget. Most pleasingly, the improvement since the Budget results from higher than expected growth in the private sector.

Private consumption, abstracting from the purely statistical impact of the introduction of Medicare, seems likely to have exceeded 3 1/2 per cent, compared to the forecast a year ago of 2 3/4 per cent.

Private business investment also seems likely to have grown more strongly than earlier expected, with a particularly strong performance likely in the June quarter.

This strength has been reflected in the stark turnaround in the labour market since 1983.

Employment has grown by around 384,000 since April 1983, including 133,000 jobs in the last year. Indeed employment growth has been strong enough not only to absorb the new entrants to the labour force, but also to cut the unemployment rate to 8.7 per cent, significantly less than the debilitating 10.4 per cent in September 1983.

Moreover contary to widespread expectations we are on the threshold of a year which again promises economic growth in the order of 5 per cent, and which offers every prospect that our commitment to creating 500,000 jobs in our first three years will be met ahead of time.

As we enter the third successive year of 5 per cent growth, it is worth remembering that there was not a single year of 5 per cent growth in the seven lean years of Coalition government which preceded our election in March 1983.

And with over 380,000 new jobs having been created in the past 26 months, it is worth remembering that already this handsomely exceeds the 340,000 new jobs in the 88 long months of Coalition rule.

This dramatic improvement has not happened by accident. It is the result of responsible policies, consistently applied. Policies which were clearly outlined in the 1983 election campaign, and restated in 1984.

Our policies have produced for Australia a sharp reduction in our inflation rate, a sharp reduction in industrial disharmony, the restoration of business profitability and a return to levels of real unit labour costs last seen in the early seventies.

Our policies are based squarely on the Accord and equitable restraint in income claims; a progressively less stimulatory fiscal policy as private sector recovery intensifies; and a supportive monetary policy.

Alongside these macro-economic policies, our industry policy has emphasised the importance of strengthened competitiveness in an international environment. Our trade policy has focussed on opportunities for expansion of our most productive and potentially productive industries.

It has been a hard slog : the steel industry and motor vehicle plans; the dairy plan now hostage to the political expediency of the Senate; the consultations with unions on industry issues in other highly protected industries, in coal, iron ore and other mining, and throughout the economy; and the steady efforts on trade policy, especially as it affects opportunities in the Western Pacific region.

We are raising productivity and reducing costs through improved performance within a wide range of industries. The further reduction in relative costs brought by the devaluation provides the additional necessary element for us finally to establish in Australia an open, competitive industry structure to take us confidently into the 1990s.

Some of the very recent news underlines the potency of these developments.

The contract won by Australian industry for the supply of light railways to Hong Kong is a major breakthrough.

The low tariff premium on four-year motor vehicle quota announced last week, at 11 per cent, shows that our costs of producing vehicles are now closer to

international levels than seemed possible a year ago. Data presented to the media by BHP this week show that the combination of productivity improvements and depreciation has turned the Australian steel industry dramatically, from mediocre performance vulnerable to lower-costs competition from more dynamic economies three years ago, to highly competitive production today.

And particularly pleasing - but not yet able to be released in detail - data available to the Government today show dramatic reductions in tariff premia for footwear and clothing import quota at this year's tender.

We recognise as well the fundamental importance to the longer-term growth of the economy of education and training : of ensuring that programs improve Australia's skill base and enhance the employment prospects of our young people. This is an issue the Government has been examining closely in recent weeks, and on which I shall be making a major policy statement next month.

Our general economic policies have thus laid a firm foundation on which to build the future prosperity of Australia. Prosperity which will bring with it more jobs and higher living standards.

Indeed it is because this government places so high a priority on creating job opportunities and curbing unemployment that we have placed so high a priority on containing inflation; on restoring Australia's international competitiveness; on encouraging expansion in the private sector; and on ensuring an equitable distribution of national income.

It is for this reason that the government is committed to the unprecedented fiscal trilogy - a commitment which will be convincingly honoured in the coming Budget. It is for this reason that we ensured that real progress was made in the May Statement.

It was for this reason that the States joined us in the cause of national economic recovery through the unprecedentedly restrained outcome of this year's Premiers' Conference.

It is for this reason that the government has consistently pursued a responsible monetary policy and, indeed, that we tightened monetary policy earlier this year.

It is for this reason that the Accord with the ACTU was negotiated in 1983 giving the Government a further instrument for the pursuit of macro-economic policy.

And I note that it is not an instrument available to the opposition in this country.

I painted for you earlier a generally optimistic scenario of further growth and more jobs in 1985-86. A scenario of yet another year of 5 per cent growth in Australia. A scenario moreover which is more optimistic than most of the private sector forecasts which have appeared - but with justification.

The indicators point to private sector demand continuing to grow strongly. Consumer demand is buoyant and likely to be sustained as employment expands. Surveys of investment intentions are favourable to further growth. There is scope for an increase in business stock holdings.

But a major factor in the outlook is the substantial improvement of our international competitiveness which has occurred following the depreciation of the $A earlier this year.

The depreciation provides the opportunity for domestic producers across a broad range of industries to capture a larger share of the still rapidly expanding demand for goods and services. It permits exporters to earn higher returns if their prices are set in world markets, or to compete more aggressively for a larger share of world trade. Largely as a consequence, net exports could contribute 1 or 2 percentage points to economic growth in 1985-86, after detracting from growth in 1984-85.

That kind of stimulus to private sector economic activity is worth taking some trouble to preserve. It could generate, on its own, in the order of 100,000 additional jobs in the next few years if Australia can maintain and capitalise upon the improvement in our competitive position. But it will take substantial effort to sustain the benefits in the period beyond 1985-86. Already the improved competitiveness from depreciation is threatened by signs of an acceleration of inflation.

The most recent Consumer Price Index, which increased by 2.4 per cent in the June quarter, provided a sobering reminder of the inflationary implications of depreciation.

Of course some initial price rises in the wake of depreciation were only to be expected. Domestic producers can become more price competitive following depreciation only because the prices of imported subsitutes rise.

Up to 1 percentage point of the June quarter CPI rise seems to have been directly attributable to that process, and there will be further adjustments in coming quarters as higher prices of landed imports are progressively passed through into retail prices.

As a consequence our inflation rate could reach 8 per cent or a little more in the course of the next year.

If the depreciation is to make its full contribution to growth in employment, there must be, temporarily, slower growth in real wages than there might otherwise have been.

What we need is a temporary slowing for those in work, to reap the benefit of the 100,000 potential new jobs which could flow from a sustained real depreciation of the magnitude which Australia has experienced.

At 8 per cent, our prospective inflation rate could be almost twice that of our major trading partners by the end of 1985-86; with much of the disparity attributable to the initial impact of higher prices for imported final goods and components. If that disparity were to be built into the cost structure of domestic producers as higher wages, much of their initial competitive advantage would be lost.

Furthermore, if our underlying cost structute is pumped up to that extent, there is a risk that the re-ignition of inflationary expectations will adversely affect employment prospects, even in 1985-86.

In making this call for restraint to Australian wage earners, I know I am asking for something that appears hard.

Australian workers, their unions, and their representatives in the ACTU have contributed magnificiently to the national economic recovery since the Economic Summit 27 months ago.

I know that it is not easy to understand why further restraint may be necessary, after two years of strong growth, and another in prospect.

The reason is that we entered upon the expansionary policies which have been so successful, spectacularly successful, in delivering growth and jobs, when the economy was heavily laden with structural weaknesses which had accumulated over the previous decade.

Australia, like many other exporters of minerals and rural products, has suffered an extraordinary

deterioration in its terms of trade over the last decade. We might have expected some correction during the recent international upturn, but this has not occurred. The continued corruption of world trade in farm products holds back any hope of substantial improvement from the foreseeable future.

Over recent years, we have accumulated rapidly growing levels of foreign debt - proportionately most markedly during the so-called "resources boom", but since then as well, including through the $10 billion current account deficit in the year that has just ended.

The maintenance of reasonable balance in the external accounts, while servicing the accumulated debt, and overcoming the effects of a decade's deterioration in the terms of trade, requires markedly improved competitiveness.

But over the decade during which we accumulated these structural problems, our productivity growth and our control of domestic costs did not compare favourably with many of our trading partners.

There were thus good economic reasons why the return to strong growth in Australia two years ago was reflected in a weakening balance of payments, and eventually in the depreciation of the dollar.

It was not our approach to let jobs and activity languish until we had corrected the underlying structural weaknesses of the Australian economy.

It was always our approach to fight inflation and unemployment at the same time.

It is still our approach.

So that although now threatened by the inflationary consequences of the fall in the dollar, we are determined to press on with growth, to press on with the creation of jobs.

And this means that we must ask the Australian people to join us, in exercising restraint until we have absorbed the inflationary impact of depreciation, and until a strengthening balance of payments has restored stability to the dollar.

We have gone a long way to re-establish the competitive basis for strong growth, and we are not about to let it slide away.

The Government has already expressed a clear view on these matters to the ACTU within the framework of the Accord. We have put all options on the table, including deferral of the foreshadowed productivity wage round and discounting. The matter of timing will also have to be addressed.

These matters are all relevant to determining the position the Government will take in the September wage case. The Government's position will, as always, promote first of all the community interest in sustained growth in output and employment.

I have every confidence that the Accord is sufficiently flexible to again deliver for Australia the kind of wages growth and industrial environment necessary to create jobs.

What is needed is that all groups exercise restraint in income claims. Some rise in profitability is a necessary market signal. It will redirect resources to areas which now need them to increase production for export or of goods previously supplied from imports. But this must not involve imposing unnecessary cost burdens on others.

Let there be no doubt that the government will be doing its part to provide firm monetary and fiscal policy, to provide the support necessary for the success of prices and incomes policy.

I have heard it said that inflation to the economist is as sex to the novelist : both are associated with a rising rate of interest. For this and other reasons I can assure you that my Government is determined to keep inflation within reasonable bounds.

Which leads me back to my story at the beginning.

You will remember that this was based on the observation that two banks had temporarily offered discounted personal loans, something of an innovation in Australian financial markets.

This is but one of a number of similar steps taken by banks in recent times. Others include the introduction of new and innovative service packages for customers, the spread of low start mortgages, some narrowing of margins between borrowing and lending rates and the expansion of banks into activities previously denied them by the regulatory framework.

Already two new banks are operational, both the result of a conversion of the operations of a non-bank institution. Negotiations are continuing with a view to authorizing another 16 potential new banks, as previously announced. The majority of these will be operating before the end of the year.

This is part of our overall strategy to eliminate unncessary regulation wherever possible and promote innovation and structural change. The rationale for this policy is precisely the same as that of our more general economic policy: namely to create the conditions which will permit an on-going expansion of job opportunities and improved living standards.

Within this new, freer regulatory environment, the financial sector is undergoing a period of transition. Financial institutions are seeking to rearrange their business strategies and reposition themselves in the market place.

Banks, especially, have become far more competitive with non-bank institutions and, as our opening story illustrates, far more aggressive. That is the outcome which we were seeking when we removed many of the earlier restrictions on their operations.

The growing sophistication of the financial system, both before and after deregulation, has necessitated a continuous review of our approach to monetary management.

Decisions on appropriate monetary policies, when and how policies are implemented, must evolve with the financial system.

For example, over the past decade or so, the main objective of policy has shifted from interest rate stability towards the rates of growth of monetary aggregates - particularly M3. And the method of implementation has shifted from quantitative controls on a particular group of intermediaries to open market operations.

By the mid 1980s, these shifts were virtually complete. These days, monetary management is almost entirely based on open market operations in a range of Commonwealth debt instruments.

A particularly important aspect of monetary policy in the post-float era is the day-to-day management of the liquidity base of the financial system. Fine tuning of liquidity conditions was impossible before the float, because the reserve bank had no control over the quantity of foreign exchange purchased or sold.

Efficient day-to-day liquidity management is now not only possible, but also necessary. This is because the external sector is now no longer available as a net source of liquidity when the system is under pressure.

Last week the reserve bank released statistics which showed 17.5 per cent growth in M3 through 1984/85.

In other circumstances that would rightly have been regarded as a disturbingly high rate of increase. But a significant element of the apparent acceleration of M3 since the beginning of this year was attributable to the reclassification into M3 of the deposits of two institutions that were not even banks a year ago.

Another element was the strong push by existing banks to raise their share of total financing, which adds to bank lending and thus M3, but not to aggregate activity. As well, bank lending was inflated in May and June by a need to finance purchases by 30 June of investment goods which would qualify for the investment allowances.

It is not yet possible to estimate the contribution of this reintermediation to recent growth of M3, but it has clearly been substantial.

The broadest published financial aggregate - "Broad Money" - is less vulnerable to such distortions. Further, broad money appears in practice to have been more stable during the recent period of financial turbulence than the narrow aggregates.

Broad money rose by 15.8 per cent in the year to May, also a high rate. But that figure was inflated by the double counting of some non-bank deposits.

Excluding that effect broad money has increased at an annual rate of 13 1/2 per cent so far this financial year. But even leaving aside some statistical problems that growth rate has, in turn, been somewhat inflated by a shift from direct transactions between ultimate lenders and borrowers towards intermediation by Financial institutions.

Indeed, it is only to be expected that as the cost of financial intermediation is reduced by additional competition and the removal of regulatory distortions, intermediation will increasingly replace marginal forms of direct financing.

Thus even broad money needs to be interpreted with some care.

With the growing complexity of the financial system, it is clear markets will need to monitor a much wider group of indicators than before. No longer will any single measure suffice.

It is worth considering, however, that not all of these alternative indicators necessarily are as easy to interpret as in the past. Take, for example, interest rates over the past six months.

In the long term, the costs of intermediation should be lower in a more competitive and efficient financial sector.

But interest rates rates have been subjected to a range of forces in recent months. Aggressive competition for funds, especially in the short term money market, has undoubtedly placed transitory upward pressure on some short term interest rates.

In addition the financial system has weathered the seasonal liquidity downturn, in the environment of a floating dollar for only the second time.

There has also been upward pressure on interest rates following a deliberate firming of policy - a firming intended to support an overly weak exchange rate and to dampen inflation and inflation expectations. This has been felt initially in markets for short term funds, and will ultimately show up in the volume of lending.

Yields on ten year bonds rose steadily between late 1984 and May of this year. Since yields on 10 year US treasury bonds declined over the period, the interest differential shifted sharply.

But in recent weeks Australian yields have declined to levels of around a year ago and the differential has narrowed a little.

No doubt changing perceptions of the strength of the Australian dollar have been an important part of this story. Our inflation performance and perceptions of whether or not the improved competitiveness of Australian industry can be sustained have an important bearing on views formed about our exchange rate and interest rates.

Given the international linkages and domestic structural changes in both the financial system and the techniques used for monetary control, it is thus no longer easy to interpret monetary policy.

But my Government is committed to making plain our policy intentions and to providing the information which will enable informed judgements to be made. This statement is intended to be part of that process. We recognise that uncertainty about policy detracts from economic performance.

So how is monetary policy now to be judged? My answer is that there can be no suggestion that liquidity management is anything but firm. No suggestion that interest rates are artificially soft. No suggestion that the government is pursuing anything other than a firm monetary policy in conjunction with a flexible, jobs-oriented prices and incomes policy.

Our coming Budget also is focused sharply on our central economic and social objective - jobs.

The coming budget will promote a long term improvement in job opportunities because the deficit will be significantly lower this year than last. That reduction, in conjunction with the restraint in States borrowing programs agreed at the Loan Council will lead to a further cut of 1 per cent in the PSBR as a proportion of GDP.

It will thus help to avoid a clash with the private sector in credit markets and reduce pressures on real interest rates. It will also moderate further the degree of fiscal stimulus at a time when inflationary pressures are mounting and private activity strong.

On both counts the Budget will contribute to durable growth and jobs.

But it will also promote jobs directly. This Budget has a particular focus on enhancing job skills and training, particularly for our greatest national resource, our young people.

The Budget, monetary policy, industry policy and prices and incomes policy thus all share that central objective to provide satisfying, long-term job opportunities.

That is the unambiguous aim of the Government.

We have come a long way.

We are determined to overcome the remaining obstacles to securing for Australians the jobs, the rising living standards, the capacity for improved provision for those in need, that can come only from a long sustained period of strong growth with moderate inflation.

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