DISCUSSION PAPERS

AUSTRALIAN MACROECONOMIC POLICY EXPERIENCE

W. M. Corden

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"I summon up remembrance of things past".

This paper looks at Australian macroeconomic experience from approximately 1972 to 1985. The whole period is divided into five episodes. The idea in preparing this paper was to try to answer three questions namely: how did Australian experience differ from that of other OECD countries, what lessons could be learnt, and finally, what light could be shed on the relevance of various macroeconomic theories, notably rational expectations. In fact, the questions have by no means been adequately answered though the paper goes furthest in dealing with the first question. I hope it will encourage further discussion and research.

Anticipating some of the conclusions, the historical review suggests that Australian experiences have been fairly similar to those of other

1/ This is a revised version of an invited paper presented at the 1988 Australian Economics Congress. The paper was written while I was on leave from the ANU as Senior Advisor in the Research Department of the International Monetary Fund, but the views expressed are strictly my own and do not necessarily represent those of the Fund. In preparing this paper I am greatly indebted to George Tavlas of the Fund.

2/ All figures come from OECD sources—either the annual surveys of the Australian economy or the OECD Economic Outlook— from the World Economic Outlook of the International Monetary Fund, and from the standard Australian sources, notably the Treasury’s regular Round-up and its annual Budget Statements. Thorough accounts of the events and the policy issues of the five periods can be found in the annual OECD surveys of the Australian economy and various places elsewhere, such as the Treasury’s Statement No. 2 of the Annual Budget Statements and the surveys in the Australian Economic Review. The most recent longer-term review of fiscal policy is by Johnston et al. (1987) and two other references that survey many of the issues are Dornbusch and Fischer (1984) and Hewson and Nevile (1985).
OECD countries, notably European countries. But the timing has sometimes differed, the Australian wages explosions have been (more or less) exceptional, and recently Australia has been special in having an incomes policy. It also appears that the theory of rational expectations does not get much support from Australian wages behaviour, that policy from 1976 to 1981 was not really monetarist, and that fiscal expansions since 1982 have been made possible by the availability of the inter-national capital market.

1. Five Episodes: An Overview

1. Imported Inflation 1972-73: How it all began

The Australian inflation story of 1972 and 1973 is remarkably similar to that of other OECD countries. Australian inflation was imported from abroad. In 1972 and 1973 the balance of payments went into large surplus because of capital inflow and the commodity boom, and this led to big monetary expansion. This was a worldwide phenomenon outside the United States, originating in U.S. expansionary policies and speculation against the U.S. dollar, the monetary consequences of which were transmitted to other countries through the fixed exchange rate system.1/ The easy balance of payments situations induced many governments to relax their fiscal policies, and most European countries to raise the shares of government expenditure in GDP. After a while wage inflation accelerated almost everywhere.

In 1970-71 and 1971-72 there was large apparent capital inflow but still, as was normal for Australia, a current account deficit. In 1972-73 the current account actually went into surplus because of the commodity boom, and this has been the only year since 1950 when this was so. The

1/ The fixed rate system for the major currencies actually came to an end in March 1973, but by that time the world-wide inflationary process was already well under way. The Australian dollar continued to be pegged to the US dollar until September 1974, but was appreciated relative to it in December 1972 and September 1973.
result was that the money supply (M3) rose by 10.5 percent in 1971-72 and by 25 percent in 1972-73. Inflation accelerated from 2 percent per annum a few years earlier to nearly 13 percent in 1973-74.

The Labor Party came into power at the end of 1972, not well prepared to deal with unexpected shocks, given that it had been out of office since 1949. It did appreciate the exchange rate, but, as in Germany, it was rather late---having been resisted by the previous government because of the pressure of rural interests---and with hindsight one can see that the September 1973 appreciation was inopportune: by the time its effects came through the current account was deteriorating and Australia was moving into recession.

2. **Boom, wages explosion and crisis 1974-75**

1974 was a historic year all over the world. The oil price rise put many European countries (though not Germany) and Japan into large current account deficits, inflation was accelerating everywhere and budgets were going into deficit. Wages kept on increasing, other than in the United States. Hence in most countries, notably Japan, the monetary brakes were sharply applied. Almost all countries went into recession in 1974 or 1975. World-wide deflation led to a commodity slump.

Australia did not suffer in any significant direct way from the oil price rise, as she imported only one third of her needs at the time. But the result of the world recession—which was partly explained by a monetary policy reaction to the oil price rise—had a somewhat similar effect on Australia. The commodity slump sharply worsened her terms of trade: nearly 24 percent in 1974-75. A key element of the Australian story—terms of trade deterioration associated with movement into domestic recession—was thus similar to what happened in the rest of the OECD area.

The Australian recession of 1974-75 was actually less than in most other OECD countries, and one result was that the rate of inflation—which
rose to 19 percent at its peak in the second half of 1974—was also slower to fall. (By 1977 the Australian inflation rate was down to 12 percent and the general OECD rate to 9 percent.)

The increase in Commonwealth government expenditure under the Whitlam regime was indeed remarkable. In nominal terms it increased 47 percent in 1974-75 over the previous year. As a proportion of GDP it increased from 24 percent to 29 percent. But this did not lead to concomitant increases in the budget deficit. The deficit was 4.1 percent of GDP in 1974/5 and 4.9 percent in 1975-6. The reason that it was not higher in the earlier year was fiscal drag: high inflation combined with a steeply progressive income tax scale raised much of the revenue to pay for the extra expenditures. Possibly there was some connection between the higher effective tax rates and the wages explosion, an issue that is discussed later. But it is perhaps arguable that fiscal policy was not very expansionary in 1974-75 and not expansionary at all in 1975-76, bearing in mind the recession as well as the need for inflation adjustment of the nominal deficit. 1/

The famous wages explosion was a particular feature of the Australian situation, though Australia was not really unique. In all OECD countries other than the United States real wages did rise, but in only a few (Belgium and Ireland) to the extent that they rose in Australia. The European problem was that real wages needed to fall because of the oil

1/ It is my impression that, when account is taken of the low level of activity and the high rate of inflation in 1974-75, a case can be made that the net result of the 1974-75 fiscal policy—i.e., the structural inflation-adjusted deficit—was not strongly expansionary. See Newson and Neville (1985) and Johnston et al. (1987), and references cited there, for detailed discussions of the degree of expansion in these budgets. The actual announced budgets for 1974-75 and 1975-76 should be distinguished from the fiscal outcomes in these two years. For 1974-75 the planned deficit was only 1 percent of GDP, but the outcome was 4.1 percent because there were large discretionary expenditure increases during the year designed to help a weak economy—i.e., having a counter-cyclical purpose. For 1975-76 the budget planned a 4 percent deficit and the outcome was 4.9 percent; in this case revenue was less than expected because of the unexpectedly low level of activity.
price rise, and they failed to do so. Hence the Australian unemployment problem that emerged has been similar to that in Europe—insofar as one regards it as "classical." But various calculations have suggested that the "wages overhang" that emerged for Australia was exceptionally high. 1/


In most of the developed OECD countries other than the United States and Italy the period after the 1975 recession and up to 1980 was one of macroeconomic stabilization and the gradual conversion to more or less monetarist policies or at least a strong anti-inflation commitment. In all countries the unemployment rate had ratcheted upwards. The Australian situation was fairly typical.

The Australian inflation rate (consumer price index) was reduced from its 1975 level of 15 percent to a low point of 8 percent in 1978. This 1978 figure was just equal to the OECD average, which was pulled up by some high inflation countries, notably Italy and France. By 1980 the Australian inflation rate had risen again—to 10 percent—but by then the OECD average was up to 13 percent owing, no doubt, to the second oil shock as well as earlier more expansionary monetary policies in some countries.

Unemployment during this period was remarkably high by the standards of earlier years, rising from 2.6 percent in 1972 (OECD standardized unemployment rate) to 6 percent in 1980. But the change was similar to

1/ OECD (1979), p. 143 contains calculations of the real wage gap (excess of real wages and salaries over adjusted national income, with 1967-72 = 100). By 1977 the Australian gap was higher than that of any of the big seven countries, even Italy, but was slightly less than that of Ireland and Belgium. According to the OECD calculations the Australian gap reached its peak in 1974 when it was actually the highest of the OECD countries. But Australian real wages stopped increasing (more or less) from 1975 until 1980 while those of various European countries, notably Belgium and Ireland, kept on rising.
that in European countries: for European Community countries the standardized unemployment rate was 3.3 percent in 1972 and 6 percent in 1980. Only the United States, with its relative real wage flexibility, managed a more modest deterioration, from 5.5 percent in 1972 to 7 percent 1980.

Some effort was made in this period to get the fiscal situation under control—not just to reduce the deficit but also to cut expenditures. Progress was certainly made on the deficit front but not in reducing expenditures. It is true that Commonwealth outlays fell modestly from 30.4 percent of GDP in 1975-76 to 28.5 percent in 1980-81 but outlays of state governments and their instrumentalities rose sufficiently for total public sector outlays as a percentage of GDP to stay roughly constant (38.3 percent in 1975-76 and 38.6 percent in 1980-81).

One development during this and the next period laid the groundwork for problems later. As part of the "new federalism" it became easier for semi-government authorities, notably the state electricity authorities, to borrow directly on the international capital market. In general there was a shift from borrowing by the Commonwealth to borrowing by the states and their instrumentalities. 1/ This can be summed up by comparing the composition of the public sector borrowing requirement as a percentage of GDP at the beginning and at the end of this "stabilization" period. In 1976-77 the Commonwealth deficit was 3.2 percent and the deficit of the

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1/. In The Australian of 7th September 1988 Mr. Malcolm Fraser commented on a report of the present paper as presented at the Australian Economics Congress. He pointed out that "the decision to allow governments and semi-government authorities to borrow overseas was more related to the future deregulation of the capital markets. It would have been quite unrealistic to keep tight controls over State governments and State instrumentalities if the capital markets were ultimately to be deregulated, as they have been by the present government." He noted that "the New Federalism was more related to States raising their own revenues and thus becoming responsible for their own expenditures in the fullest sense..."
states was 0.7 percent. 1/ By 1981-82 the Commonwealth deficit was 0.4 percent and the state deficit 3.0 percent. The explosion of borrowing by the state semi-government authorities was one factor in the rapid accumulation of domestic and foreign debt later.

It is interesting to observe that around the same time a similar problem developed in many middle-income developing countries—those that became “problem debtors” after 1981. Massive borrowings by “parastatal enterprises” in Brazil and Turkey, for example, were major factors in their debt crises and it was difficult for central governments to rein in expenditures by these bodies. Underlying this development was the ready availability of funds on the international capital market and the vigorous courtship of customers by international banks. Borrowing by countries that were widely perceived to have good prospects—for example, Brazil and Australia—was easy. Australia did not encounter a problem in 1981—as many developing countries did—because the reduction in the Commonwealth deficit in preceding years had offset increased borrowing by the states sector.

If one looks at the general government deficit over the period—i.e., the deficit for general government activities, Commonwealth, state, and local, as distinct from trading enterprises—one must conclude that it was a period of fiscal consolidation. In some years there have been surpluses once nominal deficits are adjusted for inflation. A relevant comparison is that in June 1975 the value of government securities outstanding was 27.6 percent of GDP and by June 1982 it had fallen to 21.7 percent. 2/

1/ In both cases the deficits of the semi-government authorities (i.e., the trading enterprises) are included, and the figure for the states also includes local governments.

2/ It could be argued that there is nothing virtuous in running an inflation-adjusted surplus—i.e., in managing to reduce the real value of public debt—when this is achieved by surprise inflation, long-term bondholders making capital losses through being locked into low interest rates. The fiscal surplus was attained through revenue from an inflation tax. Nevertheless the net result would be deflationary if the public aimed to maintain the real value of its assets and so increased its savings accordingly.
Once borrowing by trading enterprises, both Commonwealth and state, is included in the calculations (i.e., the concern is with the public sector borrowing requirement, which is the sum of the general government deficit and borrowing by the trading enterprises) the extent of fiscal consolidation appears to have been much less: the gross public debt/GDP ratio stayed roughly constant. The ratio to GDP of net debt (which allows for the reduced holding of private sector debt by public agencies) actually rose. 1/ The question is to what extent borrowing by trading enterprises, which is presumably for investment, should be taken into account in assessing the fiscal stance. Clearly, debt that is incurred by public enterprises and that is guaranteed by governments, whether Commonwealth or state, cannot be completely ignored when there is a concern for future debt service obligations by taxpayers, and it is certainly not irrelevant for aggregate demand.

On balance, while this was a period of some fiscal consolidation in the general government sector, one cannot really describe this period as notably contractionary, bearing in mind the increased borrowing by the trading enterprises. To conclude that policy was very contractionary as some did at the time, one would have to calculate structural inflation-adjusted budget deficits on the basis of unrealistically high levels of "potential" output. Most important, no sudden fiscal shocks, whether upward or downward, were imposed upon the economy, so that fiscal policy did contribute to stabilization.

The Treasury was criticized for "deficit fetishism," but subsequent events have surely shown that caution in this case was wise. The fiscal expansions that came later—beginning in 1982-3—and that helped to moderate the recession and to maintain the Accord, would have had to end earlier (or to have been more modest) if public debt accumulation in the seventies had been greater. If there are to be periods of high deficits

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1/ See Economic Planning and Advisory Council (1985).
that cause the public debt/GDP ratio to rise there will have to be other periods of low nominal deficits, and possibly real surpluses, when the ratio falls again.

Looking back on this period and bearing in mind what happened since, some interesting contrasts emerge. During this period the Australian and the U.S. fiscal policies were relatively conservative. By contrast, many European countries, as well as Japan, ran large budget deficits. Some countries, notably Japan, Germany and the Netherlands, had high private savings ratios and relatively low private investment so that budget deficits were associated with current account surpluses. But in all these countries the feeling gradually developed that the fiscal situation was getting out of hand. By the end of the period or in the early 1980s most of them, notably Germany and Japan, were determined on "fiscal consolidation" and by 1985 many of them had achieved it.

The U.S. fiscal situation was transformed in the opposite direction from 1982 onwards. As noted below, the Australian situation was also transformed from 1982-83: just as Europe and Japan were embarking on fiscal consolidation, the United States and Australia thus began to "de-consolidate." But Australia has been far more successful in getting the situation under control again beginning 1985-86. Yet it is interesting to reflect that Australia avoided European problems for several years before 1982, and just when European countries were getting worried about their budget deficits Australia followed in their earlier path.

4. Destabilization, recession and fiscal expansion 1981-83

In the next episode the Australian experience was markedly different from that of most or all other OECD countries. In certain respects it was more like that of some developing oil exporting countries, although, of course, there was a great difference of degree.
As a result of sudden monetary restraint applied because of previously accelerating inflation, and because of fears that the second oil shock would increase inflation even more, the U.S. went into recession in 1980 (with zero growth), recovered in 1981 and then entered her severest postwar recession in 1982 (with the growth rate -2.4 percent). In the 1980-82 period most OECD countries went into some kind of recession induced in the main by tight monetary policies designed to reduce inflation, the declines in rates of growth of output beginning in 1980. Britain had negative growth in 1980 and 1981 and Germany in 1982.

But for Australia 1980-81 was the year of the mini-resources boom, or strictly, investment boom stimulated by expectations of a resources boom. This expectation, in turn, was stimulated by the second oil shock, so that the world recession and the Australian boom had a common cause. The Australian labor market tightened with unemployment falling below 6 percent and the current account went into large deficit.

Then, in 1981-82 came the second Australian wages explosion. The details of this--started off by the Metal Industry Agreement at the end of 1981 and then leading to "flow ons"--are so well known that they need hardly be repeated here.

There was a sudden investment slump, and hence a recession, in 1982. Thus by 1982 Australia was in phase with other OECD countries again after a brief moment of euphoria in 1981 when she had the highest growth rate in the OECD area. The principal Australian policy response was to shift the fiscal stance. The June 1981 Commonwealth budget had been quite tight--the last of the tight budgets yielding low nominal deficits and a real surplus. The June 1982 budget (the last Fraser budget) was only slightly expansionary but the actual outcome in 1982-83 was much more so because of expenditure increases during the year. In addition, revenue fell short of expectations because of the recession. For that year the general government deficit was 2.9 percent of GDP (compared with 0.6 percent the
previous year). This did not prevent a decline in output but presumably did moderate it. 1/

It is an interesting question whether such fiscal expansion was justified. No doubt inflation would have gone down more if the budget stance of earlier years had been adhered to. In the short run there was an obvious trade-off between unemployment and inflation (Keynes plus Phillips were still relevant, in my view) and a strong Keynesian case could be made for the overall degree of expansion in this period, leaving aside its convenience for political reasons.

Yet there are three factors to consider on the other side.

Firstly, there is the familiar fine-tuning problem: by the time the effects of the fiscal expansion would be felt it may no longer be appropriate. Lags in recognition of problems, in decision making, and in implementation could cause fiscal (and possibly also monetary) fine-tuning to destabilize an economy. Yet in this case Australia's real growth rate only rose sharply in 1984, and 1983 was still a year of modest growth, so from this point of view the 1982-83 fiscal expansion could not have done harm.

Secondly, however appropriate expansion may be at the time, the problem is always to reverse fiscal expansion later, bearing in mind the political difficulties of cutting expenditure or raising taxes from whatever happens to be the starting base. It is a difficulty the government had to face beginning in 1984-85. In retrospect this "fiscal reversing problem" seems to me extremely important and ought to influence the nature of anti-cyclical expenditure increases or tax reductions. Perhaps temporariness should be built in from the start if there is to be

1/ Borrowing by Commonwealth and state trading enterprises also increased somewhat (from 2.8 percent to 3.0 percent of GDP) so that the public sector borrowing requirement rose from 3.4 percent to 5.97 percent of GDP.
any countercyclical fiscal action at all and, if it cannot be, countercyclical fiscal action at a time of economic downturn should be confined to extreme circumstances.

Thirdly, there are the implications for the accumulation of public debt and, indirectly, foreign debt. This is a large subject of its own. Here it may just be noted that old-fashioned Keynesianism neglected the intertemporal budget constraint. In fact it is in this period that the foundations were laid for Australia's external debt problem. The external debt built up as a result of private investment in resource industries and public investment in the associated infrastructure development. This was reinforced by the shift from private borrowing in the form of equity to borrowing in the form of debt, and, above all, from mid-1982 by the increase in the general government deficit. Finally, depreciation of the Australian dollar (which signalled that the real value of the Australian GDP was perceived to be worth less in terms of foreign currency) raised the ratio of foreign debt to GDP. 1/

It needs to be remembered that even when the government did not borrow directly abroad (most external borrowing having been private) its domestically-financed deficit indirectly increased the private foreign debt. It did so by absorbing Australian private savings so that more of Australian private investment had to be financed by foreign savings. The budget deficits raised interest rates and so drew in foreign capital. Hence it cannot be argued that the private sector was wholly or mainly responsible for the growth in external debt just because external borrowing was mostly private; indirectly the growth in external debt can be attributed at least partly to the budget deficits.

5. Growth, the accord and debt 1984-85

The next and final period to be discussed here is so recent that it also hardly needs to be described. Remarkable wage restraint was combined

1/ A thorough exposition of the issues, including the relationship between public debt and external debt, is in Economic Planning and Advisory Council (1983).
with fiscal expansion, high growth in output and employment, and large current account deficits. The general government deficit was 4.2 percent of GDP in 1983-84 and 3.4 percent in 1984-85. (The net public sector borrowing requirement was 6.7 percent of GDP in 1983-84 and 5.1 percent in 1984-85, compared with 3.4 percent in 1981-2.)

In 1984 Australia had the highest growth rate in the OECD area—6.7 percent compared with the OECD average of 4.9 percent, and compared with the average for OECD other than the United States of 3.6 percent. In fact, the United States and Australia, with their recent fiscal imbalances and high current account deficits, were at the top of the (short-term) growth league. (In 1985 the Australian growth rate, at 5.5 percent, was still above the OECD average of 3.2 percent.) From 1983 to 1985 Australia has stood out in the OECD area in two other ways. Firstly, the inflation rate has stayed above the OECD average, and secondly Australia maintained successfully a consensus-based incomes policy, something many European countries (notably Britain) had tried and finally given up in the seventies.

During this period the deterioration of the Australian terms of trade accelerated and by 1986 a serious external debt problem emerged which led eventually to the current policy of quite drastic fiscal consolidation.

6. Has Australia been different?

The principal result that seems to emerge from this brief review is that the Australian experiences have been fairly similar to other OECD countries, notably European countries. But the timing has sometimes differed: for example, most European governments generated real fiscal deficits after 1976 and later went through a fiscal consolidation period, while for Australia it was the other way around. Australian recessions have also tended to come a little later. Recently, of course, Australia
has been almost unique as a country with an explicit incomes policy, again, something that many European countries had gone through earlier. 1/

Many European countries have also had, and some still have, labor market problems broadly similar to Australia's. But the 1981-82 Australian wages explosion was unique while the earlier one, of 1974-75, was also exceptional, real wage increases having been well above the OECD average, though somewhat similar to those of a few smaller European countries. The two major shocks ending in recessions both originated in developments abroad, so that Australian recessions coincided with, or at least followed with short lags, the world recessions. But in both cases problems were greatly intensified by quite excessive wage increases.

European countries and Australia are affected in opposite directions by movements in non-oil commodity prices. Hence the downward trend in these prices relative to manufactures from 1974 made Australia's medium-term stabilization and fiscal consolidation tasks a little more difficult, and those of most European countries easier. This has been particularly true in recent years. But, as noted earlier, in 1974 and 1975 the experiences of Europe and Australia were similar in this respect: the European terms of trade deteriorated because of the oil price rise and Australia's terms of trade deteriorated because of the recession-induced decline in non-oil commodity prices.

II. Some Issues

1. The labor market issue

During the stabilization period 1976-81 the central problem as it was seen by the Treasury, and by just a few academic economists, including

1/ The situation has been remarkably similar in Belgium. See OECD (1988). Real wages and unemployment greatly increased after the first oil shock, and Belgium did pursue something like an incomes policy (with some success) from about 1981 to 1985.
myself, was to get real wages down, at least of those categories of the workforce, notably youth and the unskilled, where there was heavy unemployment. But "popular Keynesianism" was still widely prevalent among academics and regularly proclaimed by the Melbourne University Institute of Applied Economic and Social Research. The focus on "classical" (as distinct from "Keynesian") unemployment was new for the post-war period and also developed about the same time in Europe. The popular Keynesian position was that a nominal demand expansion brought about by more expansionary fiscal or monetary policies, or both, could make a sustained medium or long-term impact on the unemployment situation. It was not denied that it might increase inflation, but this was regarded as a cost worth bearing for the sake of reducing unemployment. My own view was that any benefits for employment would only be short term: the real wage problem had to be faced. I tried to assess the issues with reference to whatever Australian data was available in Corden (1979).

In retrospect the principal failure of Australian macroeconomic policy interpreted broadly during this stabilization period was that nothing was done to reduce labor market rigidities. I say "interpreted broadly," since given the political and institutional constraints, the strength of the trade union movement, and the state of union and public opinion at the time, possibly no government could have done much.

Probably an inevitable learning experience had to be gone through. A consensus-based reform of the labor market involving significant concessions by the unions was hardly conceivable given the relationship between government and unions at the time. The proposal from the Melbourne Institute for tax cuts in return for wage restraint will be discussed below. As for reforms imposed without consensus, Australia was clearly not ready for Thatcherism, essentially because it had not gone through a British-style "winter of discontent" and similar experiences.
2. Rational expectations and the wages explosion

I have discussed the possible "rationality" of the 1974 wages explosion at some length earlier (Corden, 1979, pp. 13-14). If unions simply wanted wages to keep up with prices, was there any rationality in expecting price rises to that extent? Average weekly earnings increased at an annual rate of 37 percent in the second half of 1974 while the consumer price index rose 19 percent. No doubt the unions wanted some real (as distinct from nominal) wage increases, but how much of a real wage increase did they expect to end up with? How much monetary ratification did they expect, and insofar as they expected to succeed in getting real (and not just nominal) wage increases did they believe there would be any adverse effects on employment? If they were "surprised" by the monetary contraction of 1975, and this brought about an increase in real wages that they had not really intended (through the rate of price inflation unexpectedly slackening when nominal wages were still rising), why did they insist on wages being indexed in 1976?

In seeking an explanation one cannot ignore the fact that the then prevalent popular Keynesianism gave no role to real wages in affecting employment. A common argument was that a redistribution from profits to wages would raise total spending out of given national income and so increase employment. Rational expectations theory usually assumes that "private agents" (in this case the unions) know "the model" (i.e., have a correct understanding of economic principles). But a general learning process about the adverse effects of high real wages on employment, based on supply side effects, had yet to begin. This learning process applied not only to the trade union movement and the general public but also to many academic economists. It will also be recalled that at an early stage the government actually encouraged award wage increases, though this can hardly explain the acceleration of the process later when the government switched position and urged wage restraint.

1/ The Whitlam government (specifically, the Labor Minister, Mr. Cameron) proclaimed the public service as "pace setter" for wage increases.
Comming to the second wages explosion, in 1982, it is generally argued that this wages explosion was explained both by the tightening of the labor market in 1981 and by high expectations of a resources boom. There were also certain institutional changes; the Arbitration Commission appeared to lose control of the wage determination process, but it is not so clear what was cause and what effect.

The puzzle is why wage increases of such an extent were sought, and why they were granted (under threat) by employers. In the first half of 1982 average non-farm earnings rose at an annual rate of nearly 17 percent. The metal workers themselves had obtained a settlement at the end of 1981 which represented an average increase in hourly wages of at least 25 percent. The rate of price inflation had not been increasing—so the 1974 story did not apply. Surely no rational assessment of resource boom prospects could justify the extent of the increase that took place. Presumably, in the labor market, as in the foreign exchange and the stock markets, we can have "bubbles" and overshooting that cannot be readily described as "rational."

In both episodes expectations were obviously forward-looking, not backward-looking and some wage increases were certainly "rational." In 1974 they were meant to prevent a large decline in real wages that might otherwise have taken place because of ongoing price inflation. In 1981 the aim was to raise real wages to some extent because of the investment and the expected resources boom. But wages increases were much greater than could be justified in these terms. Wages wildly overshoot. Surely rational expectations theory does not get strong support from these two episodes.

But by 1983 learning had taken place. The Accord managed to achieve reductions in real wages and even more in real unit labor costs. No doubt this was helped by the high level of unemployment. While somewhat similar restraint in real wages could be found in many other OECD countries (apart from Britain), it was not generally associated with such high growth in
employment--other than in the United States, a country with very low unionization. One might also have expected strong pressure for wage increases after the temporary "freeze" imposed under the previous government was lifted. Thus wage restraint has been impressive and suggests (to use the language of rational expectations theory) that "private agents" do eventually "learn the model"--i.e., Australian union leaders and (more important) their activist members do eventually learn from experience about the negative relationship between labor costs and employment. 1/ But the skill of union and political leaders involved must surely be given high credit, though there was a cost in a more relaxed fiscal policy, to which I now turn.

3. Tax-wage bargain and the Australian Laffer curve

In the stabilisation period of the 1970s the principal or only intellectual opposition to the Treasury position of fiscal and monetary restraint, and to those who blamed excessively high real wages for the increase in unemployment, came from the Melbourne Institute's Australian Economic Review. The alternative policy proposal of the Institute was for a tax-wage bargain between the government and the trade union movement: tax cuts should be offered in exchange for wage restraint, the latter designed not to lower real wages as cost but to slow up inflation. The model of the Institute was only implicit and appeared not to contain a neoclassical element, but in Corden and Dixon (1980), Peter Dixon and I put it into a neoclassical framework.

We showed that it is at least theoretically conceivable that the extra tax revenue combined with higher private savings resulting from higher employment and output brought about by reduced pre-tax real wages--in turn induced by tax cuts--might be sufficient to compensate for

1/ We have an example here not of rational but of adaptive expectations. Agents learn from their past errors and revise their expectations accordingly. When the learning process about "the model" is complete--as perhaps it is now--expectations are rational.
the direct losses of tax revenue. In other words, we had here an Australian version of the "Laffer curve" argument, in this case a "savings-augmented" Laffer curve, since the idea was to keep the current account rather than the budget in balance. 1/ I expressed doubts about the proposal in Corden (1979) and elsewhere, including doubts about the willingness of the unions to make a firm commitment to wage restraint and the risks for the fiscal situation that would be run.

In fact, one might characterize the 1983-86 period as (to some extent) an application of the Melbourne Institute proposal. The unions certainly kept to their bargain. There were some tax cuts but, more important, expenditure reductions and tax increases required for fiscal balance—notably imposition of a general consumption tax of some kind—were foregone because of the need to maintain the Accord. In other words, wage restraint was indeed attained at a cost and, as we well know, Australia, like the United States, turned out to be on the wrong side of the Laffer curve. The current account deteriorated severely. Of course a full assessment of this episode has to take into account the terms of trade deterioration of 1985 and 1986, some of which was clearly unexpected, and also that tax reductions were agreed upon but their implementation delayed.

1/ The argument should be spelled out more fully. Reduced tax rates would lower pre-tax real wages (given that post-tax real wages are assumed to be fixed by formal or informal indexation) and this reduction in labor costs to firms would then raise employment and output. Hence the tax base would increase. With lower tax rates and a higher tax base aggregate revenue might rise or fall.

Suppose that, on balance, tax revenue fell somewhat. The outcome would depend, among other things, on the responsiveness of output to the fall in real labor costs. If there were no change in government expenditure, the budget deficit would then increase. If private investment and savings also did not change, the current account would have to deteriorate. But we then allowed for a positive marginal propensity to save out of private after-tax incomes. The resultant rise in private savings might be sufficient to finance the increase in the budget deficit, in which case the net result would be to keep the current account in balance.
It might be added here that the attainment of high employment at the cost of fiscal imbalance was also, broadly, the Swedish policy or situation from 1974 or earlier, leading eventually, from 1982-83, to a policy reversal—devaluation, wage restraint and fiscal consolidation imposed by a social democratic government. The Swedish general government deficit rose to a peak of 6.3 percent of GDP in 1982 and by 1986 was 0.7 percent. 1/

4. How much monetarism was there?

Contrary to images created during the stabilization period, Australian policy was not really monetarist in any true sense of the term. The most that one can say is that some attempt was made to maintain fairly stable and predictable money (M3) growth rates over short periods of a year ahead.

From 1977 to 1981 Australia was a fairly average inflation country in OECD. Presumably, with more monetary tightness Australia’s inflation rate could have been reduced more. Even with full or partial wage indexation this could have been brought about, prices leading wages downward. But no doubt it would have come about at the cost of politically unpopular increases in short-term interest rates and at the cost of increased unemployment, at least in the short run. An implicit judgment was made by the government that this short-term cost for the sake of possible longer-term benefits was not acceptable.

Here it is worth noting that rhetoric was out of tune with reality. The proclaimed Treasury doctrine—proclaimed vigorously at home and abroad—was "inflation first"—at all costs get the inflation rate down or, to put it better, there were no costs but only benefits, from reducing inflation. But the inflation rate never fell below 8 percent. Perhaps the firm proclamations had some favorable effects on expectations, though

1/ See OECD (1988). The tax-wage issue—ie the need to reduce tax rates so as to discourage wage increases—also arose in the Netherlands.
I suspect that the market—i.e., the public and especially the unions—looked more at what was actually happening than what some elements of government said they wished to happen. 1/

Essentially what happened was that the authorities set implicit price inflation targets, then forecast both real output and velocity and set "conditional" M3 projections on that basis. They wanted to give an indication of what was likely—and to that extent followed the prescription of monetarism which is aimed at reducing uncertainty for private decision makers.

In most years there was no suggestion that the authorities were firmly committed to the projections—that is, that the projections imposed a constraint on the government’s policies. The "conditional" commitment was, rather, to reducing the inflation rate, at least a little. After all, M3 targets were hard to achieve and the government did not ever want to look as if it had failed in something it had set out to do. And it would be surprising if governments liked being constrained by any rule.

Nevertheless, it is worth noting that the "conditional projections" of M3 growth were relatively close to actual outcomes—and that velocity showed a steady upward trend, so that M3 was quite a good predictor of nominal income growth. Over this period—unlike later periods—the empirical conditions for monetarism (reasonable stable demand for money function) did apparently exist. In some years the targets were clearly exceeded, not because of misjudgments but because of unwillingness to allow the increases in short-term interest rates that achievement of the targets would have required. Furthermore, the flexible-peg exchange rate system of that time also imposed some constraint on management of the monetary base.

1/ Could it be that what Sir Humphrey wanted and proclaimed was not what Mr. Hacker felt he could agree to?
5. Open capital market and floating exchange rate: What difference have they made?

A major development during the Hawke government was that the Australian capital market was finally completely opened up to the world, and that the exchange rate was floated. This had many implications, especially for monetary policy, but here I discuss the relevance of these two connected regime changes for fiscal policy.

In the period of the short-lived resources boom (mostly 1981-82) the current account deficit could be attributed to the boom in private investment and to borrowing by state trading enterprises designed to support resource development. But after that, when private investment was quite low, it was clearly attributable to the general government deficit. In some years the public sector borrowing requirement was very close to the current account in magnitude, private sector savings being roughly equal to private investment. While the greater part of external borrowing was private, it indirectly financed the fiscal deficit. The government borrowed in Australian currency on the domestic capital market (in the main), and this raised interest rates and so drew in funds from abroad.

The result was that for a limited period after 1982 it was possible for the government and the various authorities to accumulate public debt without any serious problems—indeed without any signals of dangers to come—since foreigners happily supplied the necessary resources.

It is interesting to reflect what would have happened if the world capital market had not been readily available. In that case domestic investment would have been crowded out to provide the resources for the fiscal deficit, given that higher savings out of growing output stimulated by fiscal expansion did not turn out to be sufficient. Higher real interest rates or credit rationing would have been the instruments of bringing about the required crowding-out. The political limits to higher
budget deficits would have been reached very quickly. Interest rates would have been the signal.

But this is very hypothetical indeed. The international capital market, with many eager lenders, was there. In view of the developing country debt crisis there was particular eagerness to lend to a country with Australia's reputation. If the Australian capital market had not been opened to the world market (though in practice it is doubtful that it could have been insulated) the story might have differed very little. The government could have borrowed more abroad directly, instead of borrowing at home and then allowing the market to borrow abroad through capital inflows induced by slightly higher interest rates.

Thus, the crucial new development which made fiscal expansion initially rather painless was not the opening of the Australian capital market to private borrowers but rather the availability of ready funds from abroad—the same effect that has made it so painless so far for the United States to run her deficit and that allowed Latin American governments to run large deficits from 1976 to 1981. 1/

One might also reflect what effect the floating of the exchange rate has had. If it had been attempted to peg the rate, and to finance intervention not just out of reserves but also with government borrowing abroad, the consequences of external debt accumulation might have been staved off for some time, though eventually, as expectations of depreciation intensified, the situation would have become unsustainable: interest rates would have had to rise and eventually a devaluation would have been forced. With a floating exchange rate regime, by contrast, the market sends out its warning signals very quickly both directly through the

1/ It should also be added that the Australian capital market was certainly not insulated from the world market before the liberalization. While capital outflow was controlled to a considerable extent, attempts to control capital inflow intermittently for the sake of avoiding expansion of the domestic monetary base were never entirely successful. The ability to insulate the market even to a partial extent was in any case declining.
exchange rate depreciating and through interest rates rising. It is a messenger that signals the bad news early, and this is surely an advantage. Of course it must be admitted that the messenger seems at times a little erratic and not always "rational."

One other point should be added. These days it is usual to complain about the instabilities resulting from a floating exchange rate system. But it is well to remember that in 1972 and 1973 the fixed rate system was the vehicle for importing monetary instability. Of course it is also true that Australia could not be insulated from a world-wide commodity boom other than through deliberate fiscal stabilization actions and variations in the private sector savings ratio.

6. Where shocks came from, and what governments should do

The Inflation of 1972 and 1973 resulted from excessive monetary growth and came to Australia through the fixed exchange rate system. There was a transmission of monetary expansion from abroad. In addition, and quite distinct, for Australia there was a big terms of trade improvement (28 percent in 1972-73) which raised perceived wealth in Australia and was bound to be demand-expansionary in due course even with a flexible rate system.

In an ideal fine-tuning world with quick responses of governments and clear understanding of new situations there would have been a quick offsetting fiscal contraction and also much more sterilization of monetary inflows. Inability, reluctance or slowness to sterilize the domestic monetary consequences of balance of payments improvements led to monetary expansion everywhere outside the United States. The problem of imported inflation was perceived most vividly in Germany where economists worked hard to persuade the authorities to appreciate the DM mark, something that finally happened, though too late to prevent importing inflation, just as in Australia.
The 1973-74 fiscal deficit was only slight, but this was clearly a cyclical effect: if the economy had not been booming the deficit would have been much larger. In retrospect fiscal policy was thus too expansionary. In an ideal world the private sector with admirable foresight or historic sense would have raised its savings ratio sufficiently to allow for the inevitable reversal of the terms of trade and the 1973 budget would have been much more contractionary.

Coming next to the recession which began in late 1974, there was a monetary contraction in the latter part of 1974 in Australia. To some extent it was the result of a deliberate policy to dampen accelerating inflation, especially wage inflation, even at the cost of recession. This was the same motive that primarily explained the world recession. But partly the monetary contraction was the mirror image of the earlier expansion. The monetary base was reduced because of a current account deterioration resulting from worse terms of trade and a flood of imports ordered earlier. In addition, capital inflow ceased. One might thus say that this was imported deflation though the cessation of capital inflow resulted from domestic policies and signals, and, as just noted, some deflation—though not as much as actually took place—was wanted anyway.

Given the build up of inflationary expectations world wide, deliberate deflation in all countries, including Australia, was probably inevitable. The accelerating inflation could not be allowed to go on. In Australia the wages explosion made deflation inevitable. As noted earlier, the wages explosion was encouraged in its early stages by the government. It is usual to attribute the world wide recession of 1974-5 to the direct demand-reducing effects of the oil price rise but it is probably much more attributable to the concern about inflation (including that caused by the oil price rise) among policymakers. The moral, presumably, is not to allow the build up of the inflationary boom and the expectations in the first place. It is this 1972-74 episode that converted so many economists and policymakers all round the world to monetarism.
The next shock was the wages explosion of 1981-82 and, almost immediately, the recession of 1982-83. The recession came very quickly and unexpectedly. Suddenly investment slumped. Unlike 1975, the recession did not come to Australia via adverse terms of trade, which declined very little in 1982, nor through monetary contraction brought about by an external deficit, since there was large capital inflow. This time the proximate cause was an investment slump set off by suddenly transformed expectations about prospects for resource exports, by the profits squeeze induced by the wages push (itself the result presumably of excessive expectations), and possibly also by the high world real interest rates.

It is clear that a major factor in this whole unstable episode of 1981-83 was shifting expectations--in the labor market specifically, by the community generally, and by the authorities that had to manage monetary and fiscal policy. It is a theme of much of the recent macro-economic literature originating in the United States that instabilities are created mainly by governments: stable policies would generate stable expectations, and in turn stable economies. But here the unstable policies--notably monetary policies but also OPEC oil price policies--came primarily from governments in other countries. 1/

This is not to say that Australian governments always reacted in the most stabilizing way from a longer-term point of view. But, as far as Australia was concerned there were real shocks, or expectations of real shocks, to cope with. Of course, the expectations-formation process may not have been rational, particularly because trade union leaders and members used incorrect models (at least until 1983), so that there was

1/ The Whitlam government's increase in Commonwealth government expenditure from 24 percent to 29 percent of GDP in one year, 1974-75--financed partly by real tax increases (through fiscal drag), as well as increasing the deficit--was probably the main example in the whole period discussed here of an Australian-government- imposed shock, as distinct from an externally- originating shock or one imposed by trade unions.
scope for further learning. Incidentally, in view of the latest macro-
economic theory fashion in the United States---"real business cycle
theory"---it is worth noting that the external shocks Australia faced
were certainly not shocks originating in productivity changes, innova-
tions, etc. They were primarily the monetary policy shocks that Friedman
has always emphasized.

The lessons that emerge from this whole period cannot be briefly
summarized. Every reader will draw his or her own conclusions.

But two points seem to me important and many would regard them as
obvious.

Firstly, it is always necessary to bear in mind that the government
has a long-term budget constraint so that short-term fiscal expansions for
essentially Keynesian reasons at a time of actual or potential recession
need to be balanced by restraint later. The difficulty of later cutting
expenditure or raising taxes should be kept in mind whenever programs of
expenditure increases or tax cuts are embarked upon. This is the "fiscal
reversing problem" to which I referred earlier. Keynesianism is patently
a guide only for short-term, and not for medium- or long-term policy.

Secondly, the biggest constraint on good management of the Australian
economy is still the inflexible (or inadequately flexible) labor market,
though some measures to deal with this problem are now under way. This is
a "structural" problem that can be resolved neither with the simple
prescriptions of Keynesian demand management nor by the imposition of
monetarist rules.

A final word on the subject of "rules," since modern theory puts a
heavy weight on the rules-versus discretion issue. (See Barro, 1986.)
Governments can aim to be more predictable by making their policy
intentions clear, at the minimum for a year ahead, but preferably much
longer. They can follow certain general principles---as indeed Australian
governments have in responding to shocks coming from abroad or from the labor market. Most importantly, they can make it very clear that they will not ratify with nominal demand expansion any general wage increases that imply rates of inflation above some well-established range.

But in the final analysis, in a democratic society the only meaningful rules—the only constraints—are imposed by the expectations of the voting public. Governments will not willingly impose constraints on themselves and cannot impose them on their successors. But if the general public is unsympathetic to inflation, and to macroeconomic crises caused by earlier expansion, governments are likely to follow more stable policies. If the general public is unsympathetic to the consequences of general wage increases imposed by trade unions—and understands the consequences ("knows the model")—then it becomes politically possible for governments to deal with the problem. But, of course, Australia cannot impose more stable policies on the world and thus governments, like private agents, will always have to be prepared to deal with external shocks.
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1/ Twelve months ending in June.
2/ In percent of labor force.
3/ Price deflator for exports of goods divided by the price deflator for the imports of goods as reported in IMF.
4/ As of May.
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1/ Does not include Commonwealth sector public trading enterprises.
2/ Excludes Commonwealth and state trading enterprises.
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